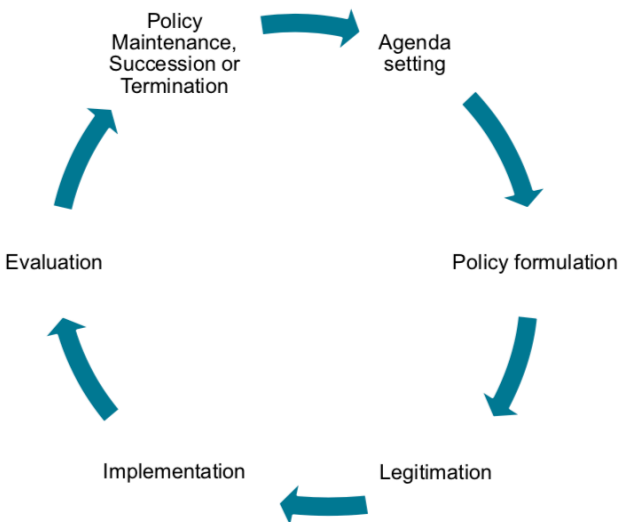
Political Economy

L1 - Institutions and Economic Principles

- **Economics**:
  - studies man's behavior in marketplace
  - cares about markets and efficient allocation
  - Government intervention needed to correct market failures (PG, externalities, monopolies)
- **Political Economy**:
  - analyses government behavior and assesses consequences of having non-benevolent politicians
- Politics affects the economy: immigration, trade, energy taxes, health, monetary policy
- Economy affects politics: lobbying, campaign finance, previous jobs of politicians
- **Institutions**:
  - Role of institutions is to reduce uncertainty by establishing a stable structure to human interaction - D. North
- Economic institutions: property rights, commercial law, contract law…
- Political institutions: constitutions, voting rules, separation of powers…
- **Public goods**:
  - Samuelsonian public good: just non-rival, no mention of excludability
    - Property rights for ex.
  - pure public good: non-rival and non-excludable
    - National defense for ex.
- Policy Cycle
- When do we need institutions?
  - **Coase Theorem**: if trade in an externality possible, and sufficiently low transaction cost, no need for government intervention.
  - **Problem**: initial assignment of property rights, large number of actors



  - Why is there a state?
    - efficiency: public goods and property rights, externalities, market power
    - equity: ensure social fairness
- **Conceptions of the state - Acemoglu 2010**
    - Institutions are outcomes of collective choices
    - The state without agency: no interests or incentives of its own, only there to rectify market failures
    - State as a nexus of cooperation: **Hobbes & Rousseau**, as compared to anarchy
    - State as agent of a social group: capitalists, financial sector, ethnic group, men,…
    - State as grabbing hand: **Downsian model**: Bureaucracy and politicians use state for their own interests
    - State as autonomous bureaucracy: **Weberian theories**
- Homo Oeconomicus: Rationality and Utility maximization
- **Pareto-optimality**:
    - there is no alternative state that would make some people better off without making anyone worse off
- **Kaldor-Hicks improvement**:
    - Some are better off, some are worse off
    - those better off could compensate those that are made worse off and lead to a pareto-improving outcome

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L2 - Experimental Evidence on Cooperation and Preference Aggregation

- **Tragedy of the commons**: situation within a shared-resource system where independent action according to self-interest leads to depletion. Agains the common good of all users.
- Voluntary provision of public goods: Nash equilibrium is not Pareto optimal, need some tacit agreements
- **Public goods**:
    - **Summation Technology**: additive quantity supplied —> Prisoners's Dilemma

    - **Weakest-link Technology**: quantity supplied equal smallest individual amount provided —> Pareto-optimum achievable without coercion or coordination
    - **Best-shot Technology**: quantity supplied equal largest individual amount provided
- **N-person social Dilemma - Ostrom 1998**: N players chose between cooperating or not. The persons cooperating have smaller payoffs than those not cooperating (free riding). Prediction is no contribution to the public good.
- Limits to self-organized regimes: Group size, marginalization behavior within group (fair punishment), monitoring costs and efficiency
- Public Goods Game
    - non-cooperative strategy if game only played once
    - if indefinitely repeated, cooperation might start
- Reasons for contributing / Contribution type
    - **Warm-glow**: positive utility derived from contributing, independent of others
    - **Altruistic preferences**: want to benefit others - independent of others
    - Errors and Learning / Conditional Cooperation / Social Norms
- **Empirical Evidence - Fähr and Gächter 2007**:
    - if partner changes over time, provision of PG lower as if partner constant
    - conditional cooperation: voluntary contributions go down if game repeated
    - homo oeconomicus predicts everyone puts 0. —> Disproved
    - Social optimum is put all your endowment —> not happening
    - Voluntary cooperation is fragile —> **conditional cooperation**
    - path dependency in contributions: first round highly important
- **The cooperative environment - Ostrom 1998**
    - models of complete rationality don’t work in non-competitive environments
    - communication helps to build trust
    - reciprocity, reputation and trust can overcome temptation of short-run self interest
- **Social Dilemmas and Institutions**
    - in absence of formal or tacit agreement Prisoner’s dilemma predicts non pareto optimal outcome
    - Solutions:
        - Efficient institutions - Coase theorem: **The market**

    - State intervention: enforcement of contract, taxes, subsidies. **Benevolent government**.
    - Endogenous cooperation, reputation building: **Conditional Cooperation**
- **Research Example - Lanz, Bruno et al 2017**:
    - Field experiment in London area, compare measures to reduce footprint of consumption: Information label / Pigouvian tax / Neutrally framed price change
    - effectiveness of policy higher if good is substitutable
    - Critique: external validity, non state solution
- Market Failure vs Government Failure
- **Arrow's impossibility Theorem**:
    - the only voting method that is not flawed is dictatorship
    - Social welfare function - preference aggregation rule: ranked voting system which transforms set of preferences into a single societal preference order while assuming some reasonably fair voting method
    - With at least two members and three options, impossible to build social welfare function
    - Requirements are:
        - non-dictatorship
        - Universality (unique and complete ranking)
        - Independence of irrelevant alternatives
        - Pareto efficiency (unanimity)
- Why are institutions different across the world?
    - **efficient institutions view**: societies choose institutions maximizing total surplus (Coase). Institutional differences should not cause economic outcomes.
    - **social conflict view**: institutions are chosen by groups with political power - Rent maximization
    - **ideology / beliefs view**: different views about what is best for society
    - **incidental institutions view**: by products of other social interactions

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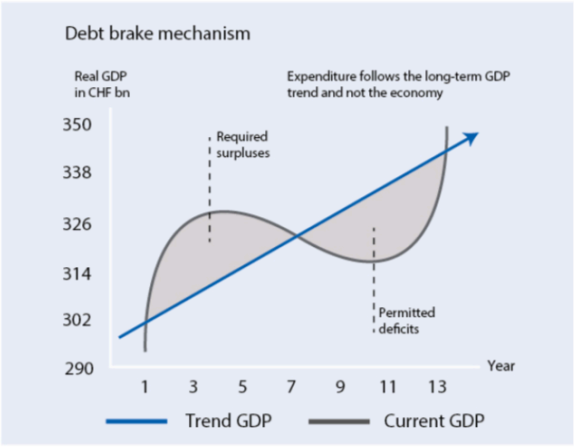
L3 - Bureaucracy Theory, Principal Agent Model

- **Economic Theory of Bureaucracy**
    - Homo oeconomicus optimizes his own utility

  - Bureaucrats pursue self-interest within the given constraint
  - Max Weber - 1922: natural objective of a bureaucrat is **power**
  - Power enters in the utility function. Economic man pursues profit, bureaucratic man pursues power.
- **Types of political power - Russel 1938**:
  - Direct physical power / Rewards and punishments / Influence on opinion
  - uncertainty creates potential to exert power, allowed by information
- Power often stems from asymmetric possession of information under uncertainty.
- Personal advantage enabled by power for Bureaucrat:
  - Non-monetary benefits, job security, job for relatives, reputation
- Environment and incentives - Government & Bureau:
  - Measurement and monitoring issues: public sector offers activities, not the same as output —> What is the output of an agency?
  - Government is monopsonist buyer: everything it wants to do, it has to do it through the bureaucracy
  - Bureau is monopolistic supplier: no competitive pressure for efficiency
- Incentives for efficient bureaucracy? Monetary through salaries, bonus, performance pays etc.
- **Budget-Maximizing Bureaucrat Model - Niskanen 1971**:
  - Assumptions:
    - Personal interests of bureaucrats (power) followed by maximizing the budget
    - Bureau has monopolistic position
    - Cost function of the bureau is not known by the sponsor
    - Bureau can make ultimatum budget proposals: agenda-setting role
  - Bureau's objective is to maximize the budget
  - Constraint is that budget of agency = cost of quantity of output produced
  - **Consequence**: marginal costs higher than normal benefits. Leads to over provision of the quantity of public good. More production than is marginally beneficial. Not optimal. Optimum would be marginal cost = marginal benef.
  - If bureau has to reveal its cost function: under provision of public good, price well above marginal cost.
- How to reduce information advantage of bureaucrats? monitoring / competition…

- **The Slack-Maximizing Bureaucrat**: doesn't reach optimum. Underprovision of Public Good.
- **The Risk-Avoiding Bureaucrat**:
  - risk aversion raises penalty and brings us closer to sponsor's (social) optimum
  - can also lead to avoidance of action
- Argument in favor of bureaucrats: there is considerable competition for promotion in bureaucracies. Less discretionary power than in private sector. Market for public bureaucrats is competitive. Need empirical testing to compare to private sector.
- Empirical evidence, public vs private efficiency - Mueller 2003:
  - 80% of the studies, public less efficient than private
  - These studies use cost comparison, might underestimate social losses
- Why public less efficient?
  - Lack or wrong internal incentives
  - Lack of external control: budget constraints, competition, feedback
  - **Selection bias**: state is generally active where markets work poorly
- **Government as Leviathan - Brennan and Buchanan - 1980:**
  - the government seeks to maximize its power, maximize tax income
  - oppose to traditional public finance: tax reflect what we decide tasks of the government should be
- How to control the public sector?
  - Introduce competition: between administrative units, in a federal system for ex, with private providers
  - Tighten budget constraint: external audit commission
  - Increase political restriction: direct democracy, prohibit direct participation of public servants in parliament
  - Rewards and punishment
- **Debt Brake Mechanism in Switzerland**
  - Expenditures may not exceed receipts over an economic cycle
  - If not reached, deficit have to be eliminated over following years
  - Currently budget underspending mainly shows that taxes are too high
  - Since introduction, debt has fallen



    - Due to systematic underestimation of revenues and regular budget underruns
- Why are budgets not fully spent?
    - Lower costs or lower demand: basically estimation errors
    - Shifts between fiscal years: transfers of budget between years
    - Precautionary motive: over-budgeting used to cover unforeseen events
    - Fiscal Commons: administration is budget-maximizing.

L4 - Redistribution

- Reasons for Redistribution
    - **Redistribution as insurance:**
        - Rawls Veil of ignorance, before birth, don't know what your characteristics are going to be —> avoid adverse selection
        - Market for lemons - Akerlof / asymmetric information / transaction that are beneficial do not take place due to asymmetric information
        - State can make insurance compulsory - can be a Pareto improvement for society
        - Ex: Healthcare, unemployment, retirement
    - **Redistribution as public good:**
        - warm glow as a reason for redistribution
        - Need state intervention to avoid free-riding
    - **Redistribution to satisfy fairness norms:**
        - Dictator game: participant generally give something to the other party, even if they lose from it and are not forced to —> fairness norm
    - **Redistribution as to improve allocative efficiency:**
        - There are differences in productivity, the initial allocation might not be optimal. Achieve Pareto improvement with redistribution.
        - Governable by state or private contracting
    - **Redistribution as taking:** Pure involuntary transfers
- **Political Economy of Redistribution**
    - Politicians might prefer to cut taxes since it wins them votes, even though it might mean less redistribution

    - Politicians might prefer a minimum wage to a wage subsidy, because money for wage subsidy could be spent elsewhere and minimum wage costs nothing to politicians.
- **Income Inequality, Capitalism - Sturm & de Haan 2015**:
    - Gini coefficients as proxy for inequality
    - adjusted economic freedom as proxy for capitalism
    - Measuring redistribution: compare income before and after taxes

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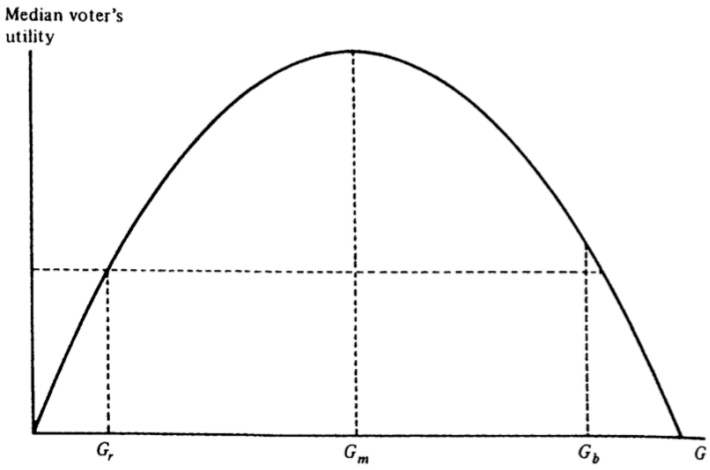
L5 - Democracy and Voting

- Voting rule:
    - is a preference aggregation mechanism
    - affects the outcome
    - maximizing the social welfare function
- **Rational Voter**: calculates expected utility from each candidate's victory and votes for the candidates whose policies promise the highes utility to him
- **Unanimity Voting Rule:**
    - to use for grave and important matters - Rousseau
    - only voting rule certain to lead to Pareto outcome
    - no coercion under unanimity —> Only win-win
    - Problems:
        - Slow, allows strategic behavior, outcome depends on bargaining power
    - Compare cost of decision process (time) vs external cost for individuals who would have been coerced into some decision
- **Majority Voting Rule:**
    - to use when speed is important - Rousseau
    - To chose what majority is required: weight time against utility losses of individuals who would be worse off
    - small majority: favored by people with high opportunity cost of time, disfavored by people with widely different opinions
    - Problems:
        - **Cycling?**, Coalition forming
        - **Logrolling?**: Majority voting ignores variation in intensity of preferences

- **Median Voter Theorem**
  - Assumes singled peaked preferences, one dimension, only informed voters vote
  - Results in the median voter deciding
- Power of the agenda setter

- Utility of median voter peaks at G_M
- Referendum
  - Failure: fall back to G_r
- Bureaucrat can use the situation and propose G_b as alternative
  - Proposal will succeed if median voter prefers $G_r < G_b$
- Example: Oregon school budget
  - Legally set budget maximum that can be increased by annual referendum
  - School boards propose budget
  - Budgets are 16.5-43.6% higher than preferred by median voter

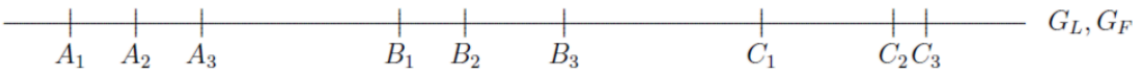


- **The Paradox of Voting**:
  - decision to vote depends on
    - expected benefit of having preferred candidate
    - probability of casting decisive vote
    - cost of voting
  - Given that probability of casting decisive vote extremely low, the costs outweigh the benefits and rational people should not go and vote
  - Redefine rationality:
    - new utility function: taste for voting or civic duty
    - minimal-regret strategy
    - non-cooperative game of voting/abstaining
    - Rational irrationality: instrumentally rational to be epistemically irrational
- **Inequality and Democracy - Bonica et al 2013**
  - Why has democracy not slowed rising inequality?
    - immigration, low turnout of poor
    - political influence of rich
    - ideological shift towards free market and less government
    - limits to national government regulation (tax, salary, competitiveness)

L6 - Federalism

- **The assignment problem**:
  - Functions of the state: solving social dilemma and market failures, provide public goods
  - Benefits are often localized
  - Who should pay?
- **Federalist Country**
  - Separate and overlapping level of government exist
  - Different responsibilities assigned to different levels of government
- How many levels of government needed?
  - for each governmental component, the size of the community should capture the spillover of public goods and correspond to size of group caught in prisonners' dilemma
  - this would lead to many overlapping governments
  - Trade-off: transaction costs vs. fiscal equivalence
  - Result: imperfect fiscal equivalence
- Reasons for formation of federation
  - external threat (military or diplomatic)
  - economies of scale
- **Assignment problem: Example**

  - Two (single-dimensional) public goods
    - G_F: Public good at the federal level (e.g. defence)
    - G_L: Public good at the local level (without spillovers)



  - If decision taken at federal level under majority rule, median voter theorem says that level of public good GL and GF of B2 will be provided.
  - If decision for local public good at federal level
    - incentive for regions B and C to form coalition and force higher taxes on A st higher level of public good in their regions
    - high probability of cycling
- **Indifference curve**: in graph Public Good vs Private Good —> **Optimize U_0?**

- **Intergovernmental grants**:
  - one level of government transfers money to another level
  - efficiency: local PG has positive externalities on other regions
  - Assumption: grant leads to increase in income that leads to increase in consumption of private good
  - **Motivations**:
    - spillovers
    - offset differences in fiscal capacities
    - enforce higher consumption of a certain public good (for ex. education)
  - **Unconditional/general grants**:
    - budget line simply moves outward
    - increase in private and public good
    - no substitution effect
  - **Earmarked/specific grants**: for a particular purpose
    - if grant smaller than original amount intended for this good, like unconditional grand —> shift some already allocated funds to something else
    - if grant larger than amount intended —> **substitution effect?**
  - **Matching grants**: price of G for this region declines
    - thus quantity of G increases (for same budget allocated to G)
    - income and substitution effects lead to increase in G
    - effect on private good unclear
- **Flypaper effect**:
  - a grant sticks where it hits (like fly to a flypaper)
  - Flypaper effect suggest that grant to local government increases level of local public spending more than the local income
  - Explanations:
    - Fiscal illusion: grant revenue not fully perceived by citizens, governments can spend it (increase re-election chances of politicians)
    - Information asymmetries between government and bureaucracy (principal-agent problem)
    - Earmarked grant might implicitly be a matching grant
- **National Finanzausgleich (NFA)**

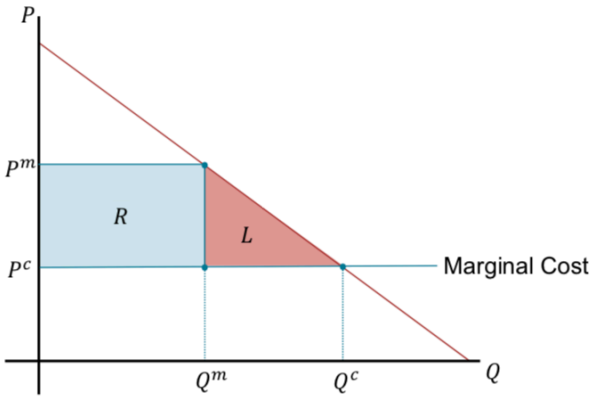
  - Goals: Compensate fiscal capacity (income side)
    - minimal level of tax resources to provide some resources
  - Goals: special burdens (expenditure side)
    - infrastructure for mountain cantons for ex.
  - based on tax potential, not on tax income (otherwise incentive to lower taxes)
  - Assume natural and legal persons are immobile, same elasticity.
  - Reform asked to take into account different mobility.
- Two-level Federalist government:
  - Federal government can provide local public good or grant to local government
  - By providing local public goods, federal government increases re-election chances. —> increases total supply of local public good (too much)
  - This is done at the expense of federal public good (too small)
  - Centralization tendency of federal state
- **Popitz Law**: Federal government takes over all major sources of tax revenue
  - evidence suggests that it leads to net increase in size of government
  - ex: USA, counterexample CH because of direct democracy, constrained tax increase
- **Theory of Fiscal Federalism**:
  - Government maximizes social welfare (corrects mkt failure, stabilizes economy, redistributes)
  - Each government level seeks to maximize social welfare of own constituency
    - decentralization needed to tailor to local demands
  - Tiebout sorting: people sort themselves into homogeneous groups regarding demand for local public goods —> increases potential welfare gains from decentralization
  - public choice perspective: bureaucracy at all levels seek to maximize budgets. Decentralization creates competition, can constrain expansion
- **Soft Budget Constraints and Fiscal Bailouts - Oates 2005**
  - reliance of local gov on centralized revenues increases moral hazard
  - Bailout expectation creates an incentive to raid the commons
  - A central government can’t commit not to bail out a local government (Electoral consequences, repetitional effects, too big to fail, contagion..)
  - Systems to circumvent such soft budget constraints:

- local taxes for local programs, limitations in debt financing, good public bankruptcy laws, centralization, efficient credit markets

L7 - Federalism

- **Monopolies and rent seeking**

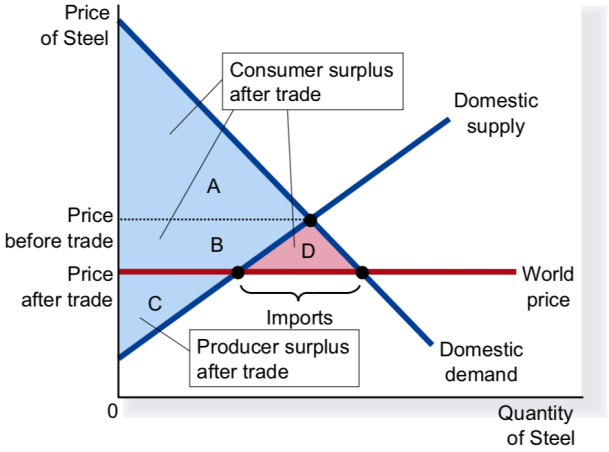
- Monopoly creation and preservation
  - Natural monopolies (e.g., bridge)
  - Artificial monopolies (regulation)
- Traditional monopoly theory
  - Monopoly rent R (redistribution)
  - Welfare loss L (efficiency)
  - Loss of consumer surplus R+L
- Political economy analysis
  - Size of R and L change due to rent-seeking
    - Monopoly rent smaller than R
    - Welfare losses might exceed L
  - Total loss increased (due to incentive changes)



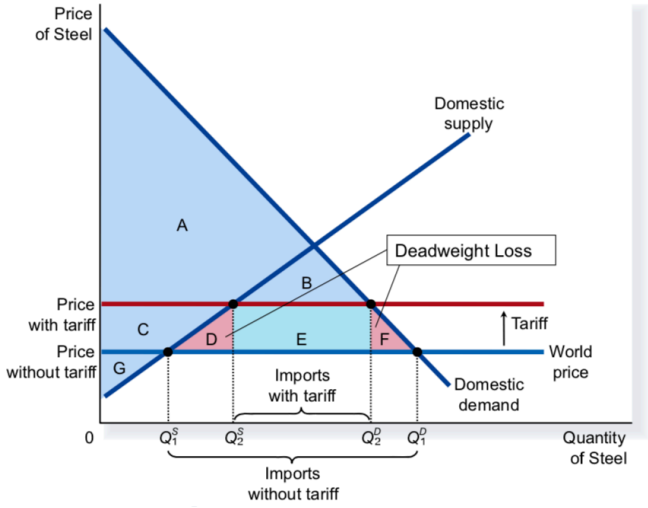
  - Inefficient allocation (like monopoly) leads to welfare loss for society

- **Three types of socially wasteful rent-seeking**:
  - Expenditures of companies to win price: like in the rent-seeking game
  - Costs of politicians to obtain expenditures: efforts to become renowned. Does not benefit society
  - Third party distortions: as a consequence of the rent-seeking activity. Gov creates more tax income due to higher monopoly rent —> creates incentive for interest groups to start lobbying.

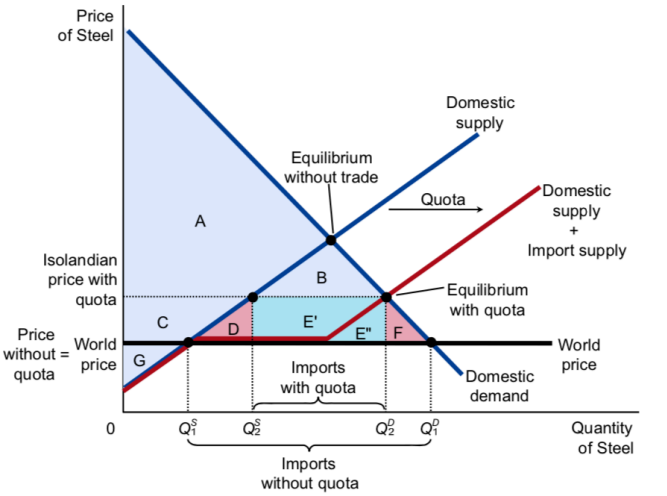
- **How Free Trade affects Welfare in an Importing country:**
  - Consumer + Producer surplus = Welfare
  - domestic producers are worse off after trade (-B)
  - domestic consumers are better off after trade (+B+D)
  - Trade raises economic well-being of nation as a whole because loss of producers smaller than gain of consumers. Total Surplus+=D



- **Effect of a Tariff**:
  - Tariff reduces quantity of imports
  - Domestic producers better off after tariff (+= C)
  - Domestic consumers worse off after tariff (-C - D -E -F)
  - Government gets revenue (+E)
  - Loss of social welfare (-D -F) —> Deadweight Loss



- **Effect of Import Quota**:
  - Domestic producers better off after quota (+= C)
  - Domestic consumers worse off after quota (-C -D -E -F)
  - License Holders are better off after quota (+E)
  - Loss of social welfare (-D -F) —> Deadweight Loss
  - Quota can potentially cause even bigger deadweight loss if mechanisms such as lobbying employed to allocate import licenses (rent-seeking)



- Trade Restrictions and Resulting Inefficiencies:
  - Lobbying efforts in importing countries
  - Wasteful competition on the side of government
  - Excess entry in importing country
- Why is there Rent-Seeking?
  - subsidy vs tariff, psychological effect?
  - Loss aversion effect in lobbying efforts?
- **Determinants of occupational choice - Murphy, Shleifer and Vishny 1991**
  - RQ: what occupation chosen by the most talented people to maximize the returns to their ability?
  - Choice to be an entrepreneur/inventor:
    - private benefit, highest possible income

    - societal outcome: better technology —> productivity —> contribution to welfare
  - Rent-seekers:
    - private benefit, highest possible income
    - societal outcome: redistribution, reduced growth
  - Find that engineers contribute more to growth in GDP than lawyers for example. But evidence is exaggerated, also measurement challenge, how do you determine « most talented » people?
- **Entrepreneurship: Productive, Unproductive and Destructive - Baumol 1990**
  - explain historic slowdown or great leaps in economic growth
  - policymakers can influence the allocation of entrepreneurs
  - Hyp: depending of rules of the game, entrepreneurs decide to spend their efforts on productive or unproductive activities
  - Evidence:
    - Ancient Rome: talents choose politics
    - Medieval China: talents choose bureaucracy
    - Early Middle Age: talents choose military career
    - Later Middle Age: some innovative activities

L8 - Interest Groups and Lobbying

- **Interest groups and free riding**:
  - the achievement of a group's goal is a public good to this group. Incentives to free-ride for the potential beneficiaries of the public good.
  - easier to form groups when benefits are symmetric. Create benefits for joining the group, for ex labour unions.
- Different Benefits for Interest Groups:
  - If benefits of collective action are not the same for all actors within groups, there will be an exploitation of the large actors by the smaller actors. (Small are free-riding)
  - Costs of lobbying for large actors are smaller than benefits from successful lobby times probability to succeed —> start lobbying.
- How to influence politics:
  - campaign contributions

    - market power: strikes, boycott
    - lobbying: information to politicians and public
- **Campaign contributions**: like consumer advertising
    - **informative campaigning**: influence the outcome of elections. Increases votes for candidate with similar positions.
        - assume voters already have opinion and preferences, only inform them about the position of the IG's preferred candidate.
        - result is that the outcome will be closer to the median voter
        - In this model, contributing to campaigns doesn't make sense.
    - **persuasive campaigning**: investing, influence position of candidates.
        - increase vote for candidate, independent of position
        - competition for votes moves candidates toward median but competition for contribution move candidates away from median.
        - In this model, contributing to both candidates might be interesting. Large winning probability of less favored candidate and the contributions will shift the position of the candidate.
            - evidence from PACs
    - **Theoretical Predictions**:
        - positions of candidates in past, ideologies affect amounts of money contributed to them
        - campaign expenditures should increase number of votes received
        - voting behavior of representative should be influenced by magnitude and sources of campaign funds they have received
    - With campaign contributions, the outcome goes away from the median voter. The best organized and financed will decide.
    - Contributions and lobbying as rent-seeking: Could be seen as a prisoner's dilemma. If both candidates spend nothing or if they spend all funds, it's the same.
- **The Value of the Revolving Door - Luechinger and Moser 2016**:
    - Revolving door:
        - former politicians moving to management, consulting positions in private sector - connection for politics, information about political DM & competitors
        - manager moving to political positions, state bureaucracy - favoring former employers in procurement, strategic planning

    - Hurdles: minimal time between two positions, but politicians easily get around
  - Advantage: political influence and sector knowledge
  - Disadvantage: no company insight and conflict of interests
  - **RQ**: is it beneficial for companies if former employee gains political position / if former politician becomes employee?
  - Event study for US Department of Defense
  - Results:
    - Empirical evidence of benefits for companies through revolving door (as measured by cumulative abnormal return)
    - However no cost estimate of this behavior
    - How firms profit exactly is not known

L9 - The Size of Government

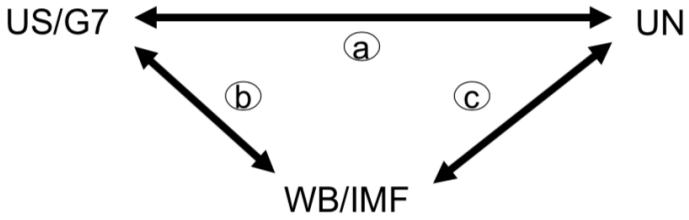
- **Wagner's Law**: Size of Government steadily growing
- Hypotheses 1-3: citizen's preferences reflected in policies
- Hypotheses 4-6: state-rules-citizen approach
- **H1 - Government provides public goods and eliminates externalities**:
  - explain growth with changes in risks. Risks from open economy are higher.
  - change in demand of public goods due to population density
  - most PG provided by government are services, productivity of services don't grow as fast as private sector —> increase in size of government
- **H2 - Government redistributes wealth**:
  - different median voter over time, different push for redistribution
    - rich median voter —> smaller size of government
  - counterargument: people with below median income don't support redistribution to a large extent.
- **H3 - Interest groups increase the size of government**:
  - benefits for interest groups financed through taxes
  - taxes collected from everybody finance benefits for interest groups
  - Counterargument: some interest groups favor less government spending.
- **H4 - Bureaucracy and the growth of government**:
  - bureaucrats seeking larger budgets and larger salaries

    - Counterargument: limited term of politicians and bureaucrats, rents cannot be exploited easily
- **H5 - Fiscal Illusion**:
    - citizens see only their tax bill, legislature can deceive citizens about the size of government
    - Government can increase tax without knowledge of citizens
    - Complex tax system, indirect taxes facilitate the fiscal illusion
- **H6 - Tax Elasticity**:
    - Assumption: Politicians and bureaucrats want to maximize government size and thus try to extract maximum revenue from taxpayers
    - taxing has become easier in past decades: move of women in labor force, computers and data digitization, move from agriculture to industrial production —> easier to keep track of output and thus tax
- **Baumol effect**
    - increase in salaries in sectors where productivity has not risen
    - increase in salaries as response to increased salaries in other jobs that have experienced productivity growth
    - Counterargument:
        - military sector quite capital intensive
        - computer increase productivity in unproductive service jobs
- **What drives health care expenditures - Hartwig 2008**:
    - Explanations: population aging, health as a luxury good, Baumol effect
    - Regress growth in health care sector on nominal wage growth in excess of productivity
- **Robust determinants of health expenditure growth - Hartwig & Sturm 2014**:
    - **no idea what they do?**

L9 - Political Economy of International Organizations

- International Governmental Organizations (IGOs)
    - IMF, World Bank, UN, WTO, EU, OECD
    - Standard-setting technical IGOs less politicized
- Existence and survival of IGOs

  - trade-off: benefit from cooperation and private goods vs loss of control
- **Political science Theories**:
  - **Realism**: IGOs uniquely serve the pursuit of national interests and are used by powerful states to control weak countries
  - **Neo-realism**: IGOs inform, direct and constraint its members through rules, standards and common interests
  - **Liberalism**: IGOs foster cooperation and allow members to pursue their interests
- **International Horse-Trading - Dreher Sturm Vreeland 2009**
  - US influence and often control the UN. Coerce the organization to take another position or reject a position or pressure a country to vote in a certain way.



  - IMF is an instrument of the G7 countries. All positions taken by IMF are tacitly or explicitly supported by the US and the G7 countries - **Realist** school of thought.
  - US indirectly influences voting in the UN through IMF/WB
- **The UN Security Council**:
  - 5 permanent members with veto power: China, France, US, UK, Russia
  - 10 elected members with 2 year limits - nominated by regional caucus, elected by UN general assembly
  - **Competency**: determines existence of threat to international peace or act of aggression. Recommends what actions to take, may impose sanctions or authorize the use of force.
- The World Bank:
  - founded after WW2 to promote reconstruction and development
  - projects: loans + conditions + advise
  - influence in WB: G7 controls over 40% of the votes. Decisions of executive board usually by consensus
- IMF:
  - program: loans + conditions + advise
  - Goal: facilitate expansion and balanced growth of international trade
  - influence in IMF: US 17% of the votes = effective veto power, US Japan, Germany, France and UK control 40% of the votes.

- **Why would the US use WB of IMF**?
  - for political benefits: to do the “dirty work”
  - huge size of loans
  - cost benefits: WB and IMF loans more valuable to the borrower than costly to the shareholder
  - In cases of divided US government (Congress and Presidency to different party) there is evidence that US uses more IMF and WB
- Why influence UNSC votes?
  - voting power - unlikely, voting power of temporary members very small
  - **supermajority**: pursuing unilateral action more costly than buying i**nsurance votes** - possible
  - **legitimacy**: premium for getting near unanimous votes, domestic public support - Possible
- **Importance of UNSC membership - Dreher et al 2009**
  - non-permanent UNSC membership
    - increases number of WB project received
    - increase probability to participate in IMF program
  - major shareholders of WB/IMF pressure WB/IMF to favor UNSC members
- Anecdotal evidence:
  - intervention in Iraq 1991: pressure from US to UNSC to support resolution permitting military intervention
  - Tanzania: first IMF program when running for UNSC election in 1974. Unconditional loan the same year. Voted agains US in 1976, stopped receiving loans.
  - Argentina: no WB projects before joining the UNSC. Drop in WB projects when leaving UNSC.
- **Effect of UNSC membership on new WB project - Kersting Kilby 2016**
  - endogeneity problem third factor influencing UNSC membership and IMF/WB projects - Dreher and al 2014 argue agains this possibility
  - members receive more loans than non members (10%)
  - size of loan not affected by UNSC membership
- **Effect of UNSC membership on IMF program - Dreher Sturm Vreeland 2015**
  - members receive more loans than non members
  - number of policy conditions lower for UNSC members

    - size of the loan not affected by UNSC membership
- **Do Domestic Politics shape US influence in WB? Kersting Kilby 2016**
    - US both uses bilateral aid and international financial institutions to pursue foreign policy objectives
    - Hypothesis: divided US government determines when to use which
    - uncooperative congress can make bilateral aid difficult to use

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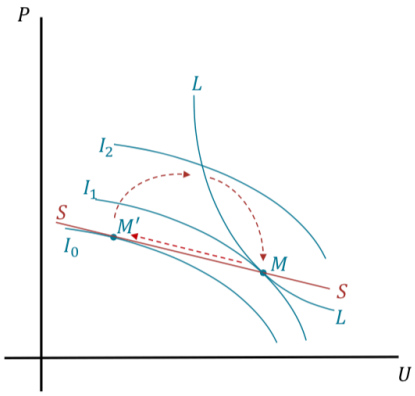
L11 - Political Competition and Macroeconomic Performance

- Voting for the incumbent
    - inversely related to inflation —> more inflation, less votes
    - positively related to income growth
    - not all politicians held responsible to same extent
- **Economic Analysis of Voting in Sweden - Jordahl 2006**
    - do micro or macroeconomic variables have an impact on individual voting behaviour?
    - look at changes in unemployment and inflation and vote for a party in the bloc
    - also subjective variables: perception of change in economy, change in household financial situation, personal experience with unemployment
    - Results:
        - subjective macroeconomic variables have larger impact on voting decisions than macroeconomic variables.
        - Macro and Microeconomic variables have same magnitude of effect
- **Deficits, Grow and Re-election - Brender and Drazen 2008**
    - do increased deficits during election year raise probability of re-election?
    - do loose fiscal policies/growth during the term in office help re-election?
    - Results:
        - loose fiscal policies have negative effect on probability of re-election
        - deficit expansion in election years are punished in developed countries
        - macroeconomic expansion has a positive effect on re-election
    - Paper questions existence of political cycles in fiscal aggregate because election-year political manipulation may take forms not affecting fiscal aggregates.

- changing composition of spending, targeting some voters

- **Opportunistic macroeconomic politics**

  - Macroeconomic variables of interest to voters:
    - Unemployment (U) and inflation (P)
    - Economic trade-off: (long(er)-run) Phillips curve (LL)
  - Indifference curves voters: II
    - Voters' preferences are single-peaked along LL
    - Median voter theorem:
      - M is optimal and therefore strived by all politicians if voters are fully-informed and rational
  - Assume short-run price stickiness (SS) and myopic voters
    - Allows government to move economy to M' to gain votes
    - Full inflationary effect will come in later which myopic voters ignore

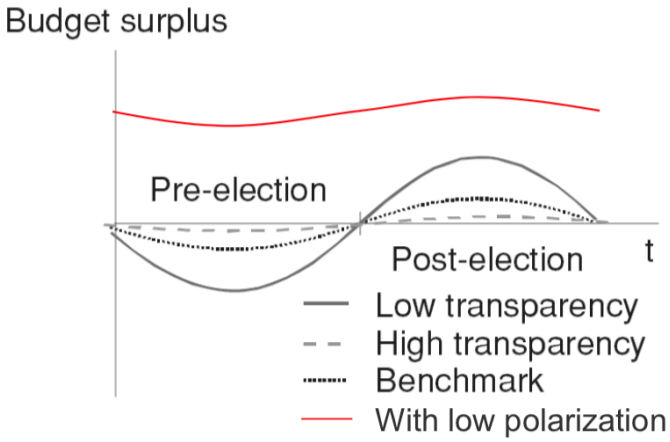


- **Rational voters**:
  - Incumbent stimulates economy to secure re-election by (backward-looking) electorate
  - **Adverse selection models**:
    - parties differ in their abilities to manage the macroeconomy. Without information problems, the party that can bring the economy at the lowest Phillips curve should always win.
    - voters not fully informed about the type of party.
    - the agent (incumbent) has private knowledge not available to principal (voters)
    - information asymmetries (about competence level of incumbent) cause the incumbent to signal his competence level by expansionary fiscal policy
  - **Moral-hazard models**:
    - competence levels unknown ex ante, electorate tries to derive competence level from observed outcomes
    - agent can take action unknown to the principal, can exert a hidden effort
- **Political Budget Cycles and Revisions in Fiscal Data - Jong-a-Pin Sturm De Haan 2012**
  - Standard procedure: use latest-available data
    - assumes fiscal data are generally available with a lag
    - assumes corrections are small or non-existent
  - analyzing policy using today's data set misleading because it gives no sense of the data that policymakers had available when decision were taken

    - For ex: explaining interest rate decisions by monetary policy committees
  - Testing the models by looking at revisions in fiscal data
    - Adverse-selection model:
      - before elections incumbent signals competence by producing statistics showing expansionary fiscal policy
      - over time degree of expansionary fiscal policy shown in fiscal data **decreases**
    - Moral-hazard model:
      - before elections incumbent pursues expansionary fiscal policy but hides these efforts by underreporting its degree
      - over time, degree of expansionary fiscal policy shown in fiscal data **increases**
    - Results: Revisions in officially released statistics about fiscal data are sizable and non-random
      - Government current disbursements: governments spend more than reported before an election —> **moral hazard, hidden efforts**
      - Government current receipts: Government received more than reported before an election —> **adverse-selection, signaling**
      - Overall: government size smaller before than after elections
- **Partisan politics**:
  - if assume voters don't only vote because of the program
  - different social classes have different interests: for blue-collar it is rational to be more concerned about unemployment
  - generally assume, left more concerned about unemployment and right about inflation
- **Hibbs model**: voters evaluate performance on issues important to them (low income focus on unemployment, high income on inflation). Retrospective voters.
- **AR model**: rational forward-looking voters. Uncertainty about election outcome triggers political business cycle.
  - Democratic victory leads to initial fall in U and return to natural rate
  - Republican victory leads to initial increase in U and return to natural rate
  - it explains why President's party loses seats in congress during midterm elections. Voters generally worried that Inflation is too high/low due to the increase/fall in unemployment rate. —> vote for opposing party
- Empirical evidence: political business cycles

- cycles rather found in fiscal variables than in monetary variables. Because central banks are largely independent.
- cycles rather found in presidential system than in parliamentary systems.

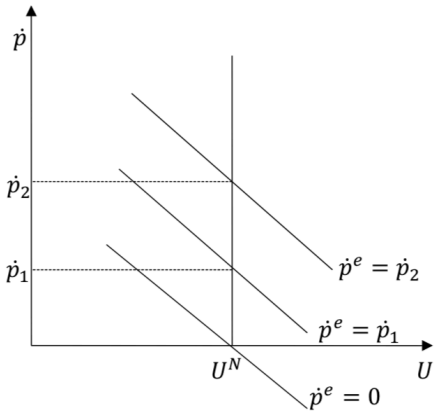
- **Transparency, polarization and PBC in the OECD - Alt and Lassen 2006**
  - How does fiscal transparency by government and political polarization influence PBC?
  - Idea: fiscal transparency makes it less interesting to initiate fiscal cycles. Higher polarization of parties makes it more interesting to initiate fiscal cycles.
  - **Results**:
  - scope for a PBC depends on degree of fiscal transparency
  - PBC induced by political polarization
  - state-controlled media reinforces effect of low transparency



L12 - Political Economy of Monetary Policy

- **Policy rules and discretion**:
  - Policy rules: binding plans in advance, how will policy react to particular inflation or unemployment
  - Policy discretion: no commitment to future actions, but policymakers make what they believe is the optimal policy response given the circumstances
  - discretionary policy is subject to time-inconsistency problem: tendency to deviate from long-run plans with short-run decisions.
  - Solution: stick to a certain rule

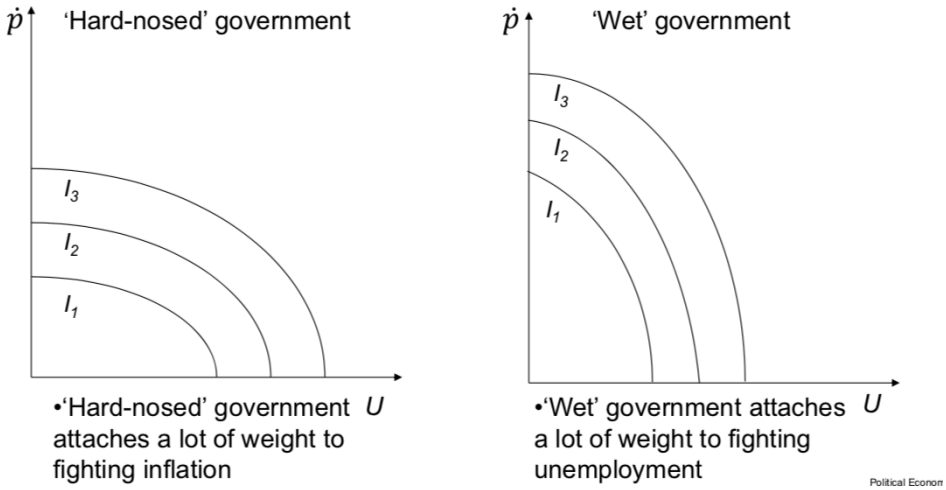
- **Barro-Gordon model**:
  - Short-term trade-off between inflation and unemployment
  - vertical line defines the natural rate of unemployment U^N
  - vertical line is long-term Phillips curve, unemployment does not depend on



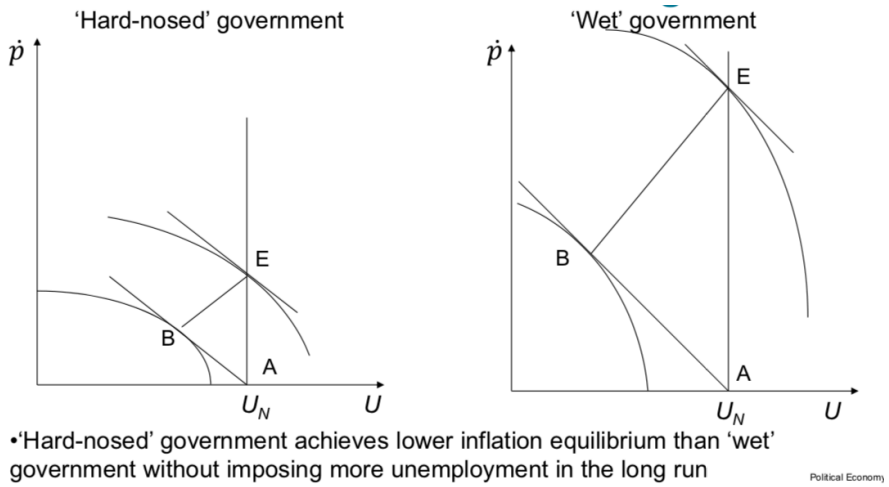
inflation, in the long run.

- The diagonal curves are the short term adjustments.

- **Preferences of the authorities**
  - indifference curves are concave
  - slope is relative importance of fighting inflation vs fighting unemployment

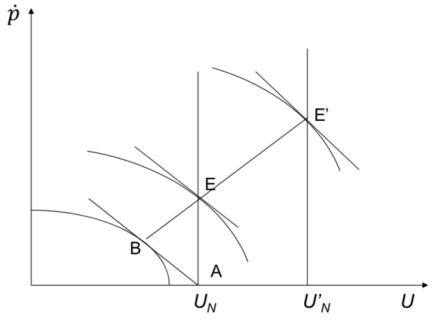


- **Equilibrium inflation rate**:



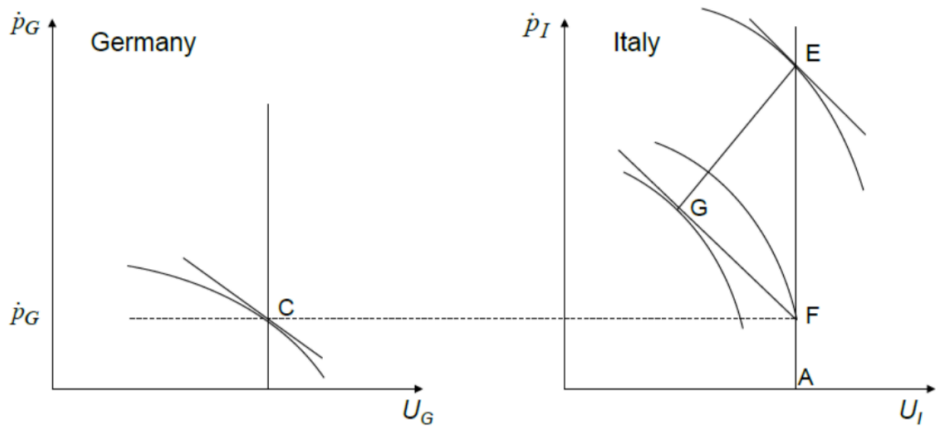
  - announcing zero inflation policy not credible because authorities prefer point B to A
  - rational agents know it and set their expectations about inflation to E, basically keep the resulting unemployment constant and take the inflation normal to B
  - creates an **inflationary bias**, basically due to **discretion policies**

- equilibrium inflation rate also depends on the level of the natural unemployment



- **How to reduce welfare losses under discretion?**
  - because of time inconsistency, we can't install optimal policy by decision
  - Assumption: CB sets inflation rate st marginal cost of inflation = marginal benefit of inflation
  - Idea: increase cost of inflation
    - Internalize cost of a deviation from first-best inflation - reputation
    - Distort perception of CB to assure high inflation rate seen as costly - appoint individuals with conservative preferences for inflation
    - Inflation targeting
- **Inflationary bias**: under perfect foresight in the labor market, discretionary policy leads to higher than optimal level of inflation
- **Role of expectations - "Lucas critique"**: policy evaluation procedures fail to recognize that economic agents adapt their decision rules to changes in policy.
  - economic planning is a game against rational economic agents
- **Impossible Trinity - Trilemma**: impossible to have at the same time
  - free capital flows
  - fixed exchange rate
  - discretionary monetary policy
- **Conservative monetary policy**: conservative interpreted in terms of the weight placed on inflation objective relative to output objective
- **Barro-Gordon model in an open economy**:
  - purchasing power parity condition: links inflation rates of two countries

$$\dot{e} = \dot{p}_I - \dot{p}_G$$



- **How can Italy reach a lower inflation equilibrium?**
  - fixing exchange rate between Lira and Deutsch Mark not credible because Italy then has incentive to create surprise inflation —> devaluation
  - only by abolishing Italian CB and adopting the mark can Italy escape from high inflation equilibrium —> Impossible trinity
  - create a monetary union: But, CBs with higher reputation reluctant to join, newly created CB might not have same reputation
- **Cukiermann, Webb, Neyapti Index**
  - autonomy of Central banks and inflation
  - doubling degree of autonomy of Bank of England in seventies would have reduced inflation rate in UK by 4 percents
- **When is a central bank governor replaced? - JME 2010**
  - estimate the chance that a central bank governor is replaced
  - probability of turnover affected by
    - current time in office
    - high levels of political instability
    - ocurence of elections in democracies
    - high inflation
- **Does high inflation cause central bankers to lose their jobs? - EJPE 2008**
  - inflation differentials across countries often explained by differences in CBI
  - endogeneity problem: turnover rate not a great measure for CBI, reverse causality