

ps343: Lecture Notes on

Capitalism, Not Globalism:
Capital Mobility,
Central Bank Independence, and
the Political Control of the Economy

William Roberts Clark

I. Approach (from Acknowledgments):

A. Falsificationism

Science is important not because it leads to the correct answer, but because it provides us with the best chance of discarding wrong answers.

B. Utility of Comparing

The discipline of political science seems to be divided between scholars with an intuition that events are the unique product of circumstances that will never be replicated, and those who view the social world as inherently systematic and therefore amenable to comparison and generalization. [Both incorrect in this stark form; if forced choose, Clark places self in latter camp.]

C. Modeling Political Economy

1. Start by positing/establishing goals for actors;
2. Assume reasoned decision-making;
3. Work backward from there to likely actions given those goals, (perceptions of) possible actions, and relations actions to goals.

D. \Rightarrow Context-dependent Political (Elect & Part) Cycles

II. Introduction (Ch. 1)

A. (Recent) Policymaker Behavior in Democracy:

1. As “lefts” became democratic competitors, behavior dictated by that electoral comp. for seats & governmental comp. for control

a) Przeworski (1985): “As soon as they decided to compete for votes, [in late 19th C], socialist parties sought to gain the electoral support of people other than workers...As socialists become parties like other parties, workers turn into voters like other voters.”

b) [One could offer parallel statement for aristocratic parties.]

2. Recent “Left” Govts acting like “Ctr-Rts”:

a) Tony Blair (5/2/97 – 6/27/07):

(1) His “Christian Socialism” & the Party’s “New Labour”

(2) On **May 6**, transferred day-to-day control monetary policy from Whitehall to “Grand Old Lady of Fleet Street” (Bank of England)

b) Gerhard Schroeder (9/7/98 – 11/22/05):

(1) 6 Months later replaced leftist Finance Minister

(2) Soon began series of reforms (retrenchments) welfare state & labor & employ. reg’s

3. Each replaced very long-stand right govts (16yrs Kohl; 19 Thatcher+), only to act as likely to hardwire policy outcomes similar to conserv. prefs.

B. Such Action by Lefts \Rightarrow Evidence of Convergence?

1. Clark's Account:

- a) Popular press (& some academics): growing convergence around *market-friendly* policies b/c *globalization*: esp. rapid, strong integration int'l financial markets
- b) Empirical studies: mixed at best; not strong signs macro-policy convergence...
- c) ...but this odd b/c, as becomes easier, quicker, & cheaper move financial assets to most-favorable environs, economic costs deviating from most-favored practices (e.g., lowest cap tax) rises \Rightarrow growing constraint domestic autonomy.

2. *Aside*: Globalization / Int'l Cap Integr. & Convergence Arg's & Evid.

a) Standard Argument:

(1) Summary:

- (a) Trade & Cap-Mob sharpen capital's threat v. domestic gov'ts to flee "*excessive & inefficient*" taxation & public policies,
- (b) Forcing welfare/tax-state retrenchment, and...
- (c) ...tax-burden shifts more-mobile cap (esp. financial) to less-mobile lab (esp. skilled-manual)

(2)(Slight) Elaboration:

- (a) ↑inter-jurisdictional competition undermines tax-policy autonomy individ. tax authorities (e.g., US states), inducing tax-rate convergence, esp. taxes levied on more-mobile assets.
- (b) Such inter-jurisdictional competition intensifies as cap increasingly liquid & mobile across borders ⇒ virtually unmitigated race to some (ill-defined: below) bottom (e.g., Zodrow & Mieszkowski '86, Wilson '86, Wildasin '89; Oates '01, Wilson '99 review).
- (c) Striking post-70s ↑int'l CapMob & steady postwar ↑trade forcing welfare/tax-state retrench & shift tax burden from rel. mobile (cap, esp. financial) to rel. immob (labor, esp. less-flex-spec)

b) Several (at least 8) Counters:

(1) Empirically challenged:

- (a) *Find support*: Hines '99, Rodrik '97, Dehejia & Genschel '99, Genschel '01...
- (b) *Find no support*: Quinn '97, Swank '98, '02, Swank & Steinmo '02, Garrett & Mitchell '01...

(2) General Gist of Most Counters: *Maneuvering Room* b/c

- (a) Other national differences (e.g., commercial, regulatory, & other policy; lab-mrkt instits; availability intermed-supply; final-mrkt proximity; etc.: Hines '99) also affect invest-locate.
- (b) Plus, other factors than capital mobility affect governments' tax policies.

(3) Garrett: Certain Left-Lab combo's efficient, so not fled.

I.e., certain combos left govt w/ soc-welf, ALMP, coord-barg, & related as or more effic. than neolib minimalism & cons. govt; so cap not flee such combos.

(4) Boix: Left-PubInv & Right-MinIntervention econ'ly close & suff'ly pol. effective

Pub human- & physical-cap investment=alternative to neolib minimalism that sufficiently efficient macroec'ly to attract/retain capital & politically to support left electorally.

(5) VoC: Institutions & Public Policies \Rightarrow comparative advantage \Rightarrow divergence (not convergence)

(a) Hall&Soskice '01: complex national networks of PE inst's confer comparative advant's

(b) Mosher&Franzese '02: VoC \Rightarrow

(i) Fixed-cap mob. & trade integ. spurs specialization (of PubPol & PE-inst'l struct. also);

(ii) Only liquid-cap mobility spurs int'l tax-competition, & it has other implications than commonly thought \Rightarrow Strategic Interdep. & Race to a "Bottom" that is not necessarily ≥ 0 .

(6) Swank: Domestic political & institutional constraints

Institutional structure of the polity & of welfare system itself shape domestic policy-responses to integration. Argument not fundamentally challenge exclusive or superior macroecon efficiency of neoliberal minimalism; Rather, stresses primacy domestic political conditions in determine nature & mag of welf/tax-policy reactions to int'l econ integ.

(7) Hays: Domestic political-economic structure (in partic.: cap-lab endowment & majority/consensus democracy) condition response to increased capital mobility.

(8) Basinger & Hallerberg (and Franzese & Hays):

(a) *Strategic Interdependence*: insofar as any these (3, 5, 6, 7 esp.) constrain 1 state, they ease capital-competition for others.

(b) Extent & effect of capital-tax competition depends on what competitors doing.

(9) Rodrik & others: also could expect \uparrow globalization to \uparrow demand public protection from vicissitudes global economy; so demand \uparrow while ability to supply \downarrow

(a) [Will see 7 & 9 up close in Hays' book @ end semester.]

Aside: Comparative Advantage and International Trade

I. Simple (Ricardian) Comparative Advantage:

A. Standard Baseline 2x2x1 Model:

1. 2 countries (**A** & **B**)
2. 2 goods (**X** & **Y**)
3. 1 factor of production (Labor, **L**)

B. Ctry **A** absolute advantage over **B** in production **X** if can produce **X** more efficiently (w/ less **L**).

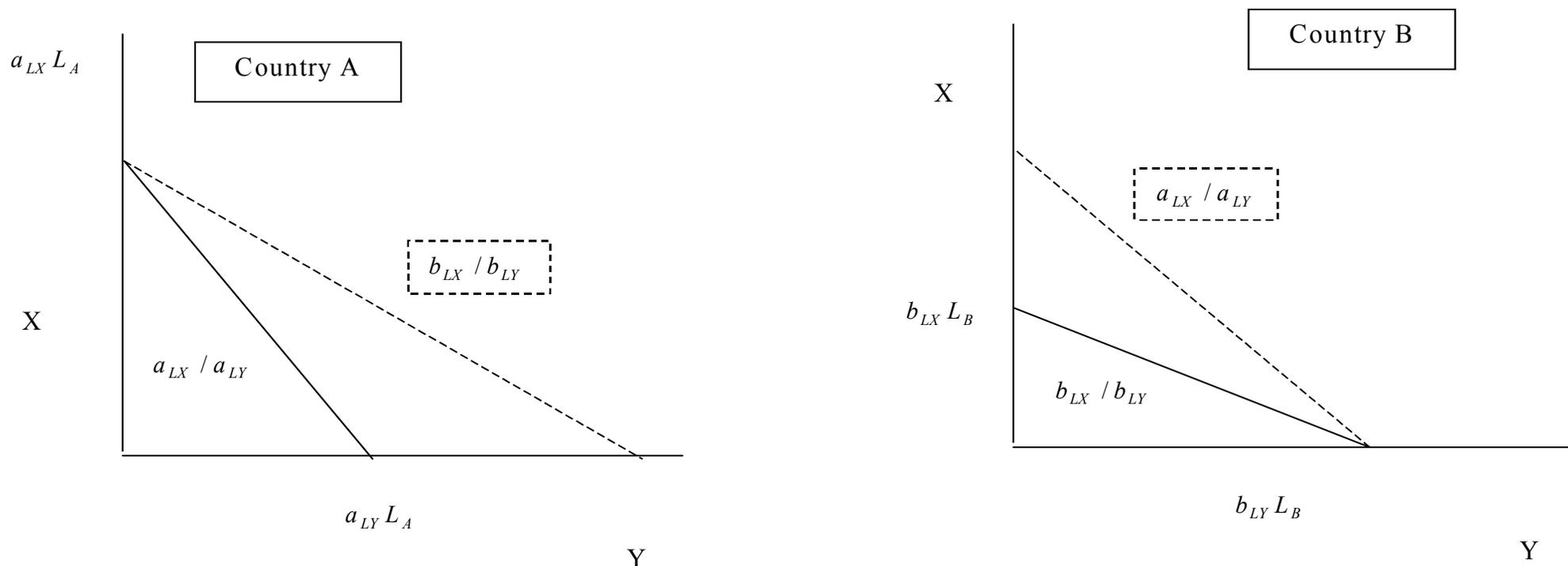
1. Production function: equation that maps input, **L**, into output, **X** or **Y**.
2. Examples: $X = a_X L$ and $X = b_X L$
3. **A** has absolute advantage in production of **X**, if $a_{LX} > b_{LX}$
4. Gains from Absolute Advantage in Trade: If $a_{LX} > b_{LX}$ & $a_{LY} < b_{LY}$, i.e., if **A** has absolute advantage in **X** and **B** has absolute advantage in **Y**, then rather intuitive that each would benefit from specializing in production of good it produces more efficiently and trading for the other.

C. **A** comparative advantage in production **X**, relative to **B**, if **A**'s opportunity cost of producing **X** in terms of good **Y** is less than **B**'s, or in terms of production functions, if $(a_{LX} / a_{LY}) > (b_{LX} / b_{LY})$.

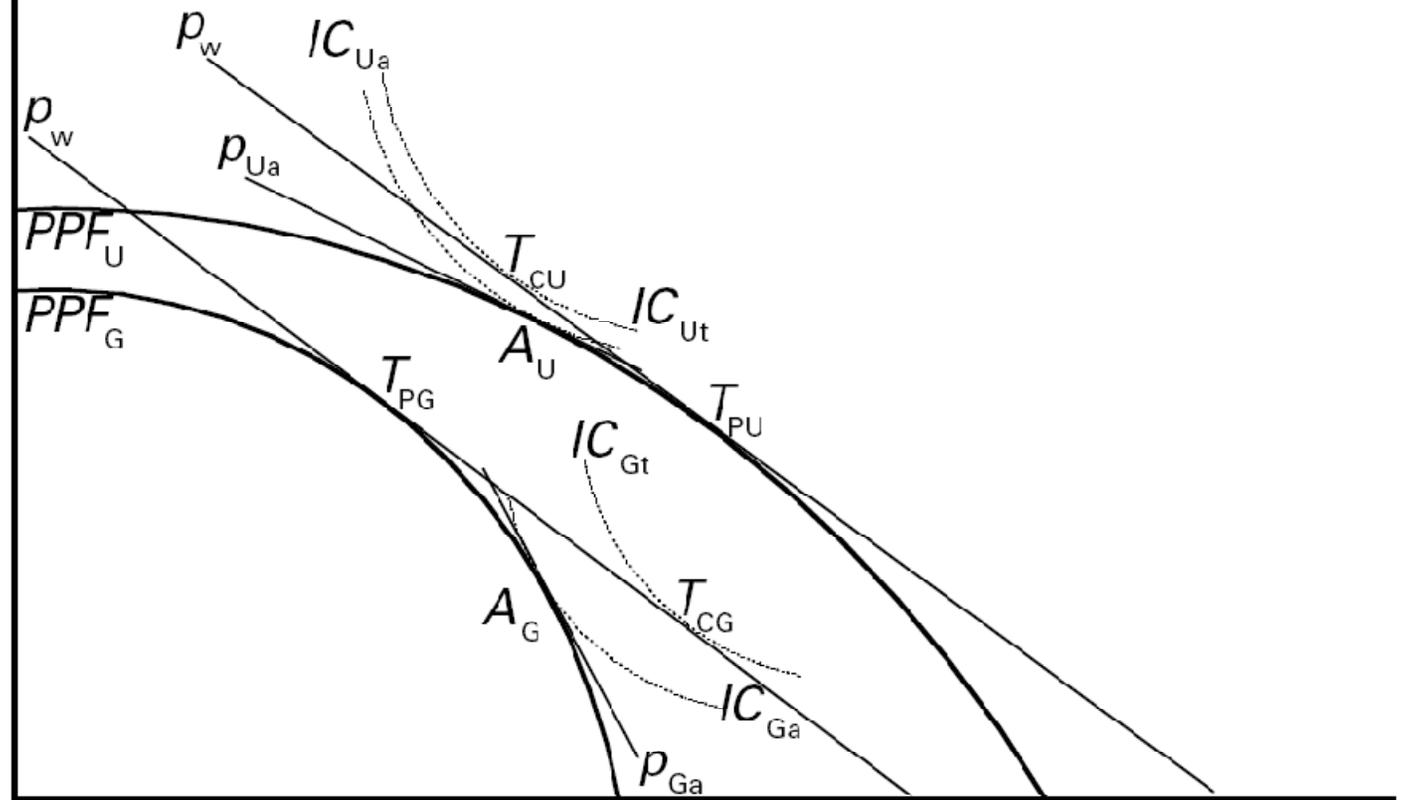
1. Each ctry specializes in & exports its comp.adv., not it's abs.adv.'s &, doing so, both ctrys better off, regardless of abs.adv.
2. B/c comparative advantage is relative, every ctry has comp.adv. in something: here, **A** comp.adv. in **X** \Leftrightarrow **B** comp.adv. in **Y**

D. Production Possibility Frontiers (PPF's): maximum **X** ctry can produce for each level of **Y** produced & v.v. I.e., the limits of output capacity given tech (coefficients) and resources (**L**).

1. Production functions & $L=L_x+L_y \Rightarrow X = a_{LX}L_A - (a_{LX} / a_{LY})Y$ and $X = b_{LX}L_B - (b_{LX} / b_{LY})Y$
2. Graphically (dark lines are PPF's):
3. Country **A** has *comparative advantage* in **X** \Rightarrow steeper PPF than **B**.
4. **A** specializes in **X**, trades **X** for **Y**, (at p somewhere b/w 2 autarky p (i.e., b/w a_{LX} / a_{LY} & b_{LX} / b_{LY} , i.e., b/w the slopes of the 2 PPFs).
5. Dotted line: **A**'s consumption possibility frontier with trade, now seen higher than have consume & produce same
6. A pol-econ example germane to globalization & divergence from Franzese & Mosher (2002) next slide.



Output/consumption
of machine tools



Output/consumption of
banking services

7. PPF_G & PPF_U are hypothetical PPFs for Germany & US under their respective pol-econ institutions.
8. A_G and A_U are their respective productions & consumptions under autarky.
9. T_{PG} & T_{PU} are their productions under trade; T_{CG} & T_{CU} are their consumptions. Trade allows these differ.
10. IC's are (aggregate) consumers' *indifference curves*. Subscripts *a* and *t* refer to *under autarky* and *under free-trade*.
11. The *p* lines are relative prices: Ga, Ua, W subscripts indicating German or US autarkic, & World trade.

3. Clark's Counter: Never was any [macro] partisan diverge to converge.

- a) No evidence rising partisan converge [*macro-policy*] b/ c partisan convergence = “hallmark of [macro] economic policymaking in democratic capitalist societies &, consequently, predated the recent rise in capital mobility” (p. 2).
 - b) “domestic political consequences of *globalization*—partisan convergence, constraints...to anticipate the response of *footloose* capital...are not the recent effects of changes in the international economy.
 - c) Instead, ...enduring features of the process of economic policy choice in polities dominated by private investment and electoral politics” (p. 2).
 - d) N.b., *Privileged Position of Capital + Downsian Electoral Competition* ⇒ partisan convergence on the preferred policies of capital. [Elaboration to follow.]
4. Clark will explore these converge args in broader context:
- a) Nordhaus-Tufte *Electoralist* v. Hibbs-Alesina *Partisan* [macro] Cycles
 - b) Recognizing *Context Dependence* esp. dependence of cycles on *Capital Mobility (& Exchange-Rate Regime) & Central Bank Independence*

C. ASIDE: Downsian Electoral Competition: Partisan Converge & Diverge

1. Black's Median-Voter Theorem (MVT) & Hotelling-Downs' Partisan Convergence [ELABORATED AT BLACKBOARD]

a) MVT:

- (1) 1-dimensional competition,
- (2) binary vote-choice,
- (3) sincere simple-proximity voting,
- (4) "single-peaked" preferences
- (5) \Rightarrow Median-Voter *Rules*

b) Hotelling-Downs: MVT \Rightarrow strong convergence from electoral competition

c) Slight Elaboration:

(1) One Dimension:

- (a) Black (58) Median Voter Theorem (MVT): If voters single-peaked pref's defined on single dim (e.g., left-right), then median-voter's ideal point is only pt majority-preferred to all others
- (b) Hotelling(28)-Downs(57) Party Competition Centripetal Tendency: Applied to **2-party** elects, MVT \Rightarrow strong incentives converge toward MV

(2) Multiple Dimension Extensions:

(a) McKelvey's & Schofield's "*Chaos Theorems*":

- (i) w/ $>1D$, if choices not structured in restrictive ways: virtually certain that policy proposals will cycle around policy space, w/ no proposal majority-defeating all others
- (ii) \Rightarrow either perpetual flux or arbitrary (Arrow's Impossibility Theorem).

(b) Strongly suggests inst'l restrictions on proposal- & decision-making process essential to non-arbitrary democratic decision-making:

- (i) Kadane (1972) showed that if eqbm exists in unstructured multi-D space (may not), then must be multi-dimension median, a.k.a. *Dimension-by-Dimension Median* (DDM).
- (ii) Shepsle's *Structurally Induced Equilibrium* [elaborate...]

2. Theoretically, partisan divergence can emerge as equilibria of several reasonable representations of electoral competition:

a) Already mentioned ***multiple dimensions***; no clear prediction arises there.

b) ***Electoral uncertainty*** (*esp. re: median-voter's 'location'*) / ***abstention*** / ***Extra-Electoral Influences*** (*Lobby or Interest Grp*):

(1) *Uncertainty*: allows policy-interested parties to drift from expected medians at finite (rather than infinite) expected-vote cost, yielding divergence

(a) Issue is uncertainty about effective 'location' median voter's ideal point.

(b) Could be uncertain who is median, where is median's pref, or median re: where parties.

(2) More polarization as uncertainty \uparrow (Wittman 77,83; Calvert 85; Roemer 92).

(3)*Abstention*: several models; *alienation* is one, e.g., that produces divergence.

(4)*Extra-Electoral Influences*:

(a) if resources other than votes can sway elect, by *buying*, *informing*, or *persuading* votes

(b) & if these come not from median (which logical), this can also produce divergence.

c) **Credibility**: Divergence can also arise if pre-electoral promises must be credible, i.e., post-electoral optimal for winners to implement.

(1)w/ 2 parties, no entry, & 1-stage games (e.g., no reelects allowed) winners no incentive to implement median preferences if their own preferences differ, so voters only believe victors will enact victors' own preferences \Rightarrow full divergence.

(2)In repeated elections, parties can build reputations \Rightarrow some ability promise something other than party's ideal point (as known by vote) \Rightarrow some (not full) converge.

(3) \Rightarrow Any degree of divergence is sustainable.

d) **Entry/Multiple Parties**:

(1)Free entry \Rightarrow no equilibria; entry free, so *any number of parties enter anywhere*

(2)Suggests systems w/ low-cost entry [?] could sustain mult prtys w/ any degree diverge.

(3)w/ some entry-cost, multiple *citizen-candidate equilibria* (Besley-Coate 97):

(a) One, that only the median enters, \Rightarrow Hotelling-Downs-Black, but

(b) Others \Rightarrow 2 candidates equidistant from median enter, w/ the degree of divergence sustainable widening as entry costs grow.

(4)Even w/ just 2 parties, potential of entry \Rightarrow **entry-deterrence** reason to diverge.

3. Degree of Divergence, therefore, is an empirical matter

- a) Tufte, Hibbs, Alesina, Me, & Huges Theoretical & Empirical Lit: (1) Clear, Obvious, Manifest, & Important Partisan Differences in (2) Preferences, Policies, & Outcomes, w/ degree of (1) generally ↓ in (2), i.e., as go pref's → pol's → out's.
- b) Clark: Not so much, esp. in **macro**economic policy & outcomes.

D. Explore Implications CBI & CapMob Domestic [*macro*] Policy:

1. Starting Points:

- a) Need appropriate pol-econ model: contested. *Electoralist* or *Partisan*?
- b) Use ways CBI & CapMob (+exchange-rate regime) interact to shape policy control/efficacy to evaluate alternative *electoralist* & *partisan* [**macro**] models

2. Alternative Models:

- a) *Partisan* [**Macro**] Model = Hibbsian Model = “political parties w/ diff ideology orientations enact systematically diff pols & produce sys’ly diff macroec outs”.
- b) *Electoralist* [**Macro**] Model (≈Downsian) = Nordhaus Model (≈Tufte) : “electoral constraints force [all] politicians...to behave in much same way...pols & outs to please med voter (Downs); ...adds...assumpt about way voters form expectations... yields predictions that tie...[policy]...to electoral calendar...[for]...growth & employ in period leading to elections, even if such...leads to future inflation (Nordhaus)”.

3. *Partisan & Electoralist [Macro] Models' Shared Assumption*: pol-mkrs control policies that can affect/control inflation, employment, output (macroec).

4. *CBI & CapMob challenge, or @ least modify, that Central Claim/Assumpt* \Rightarrow

a) Theory: nuanced propositions when, where, & what sort of macro cycles.

b) (Clark's) Empirical Findings:

(1) Little evidence of partisan macro policy or outcome cycles under any conditions.

(2) Electoral macro cycles not ubiquitous either, but growth & UE (& deficit & M^s) cycles *when CBI & CapMob conditions leave policymaker some control over these.*

(3) International Capital Mobility & *Globalization*:

(a) Little macro partisan convergence from *globalization* b/c little divergence to begin.

(b) Altered circumstances under which macroeconomic electioneering occurs.

(c) Altered what macroeconomic policies used for this electioneering.

c) Normative Considerations:

(1) CapMob & CBI generally discourage (macro) *electioneering*, so universally and unambiguously *good*? Well...

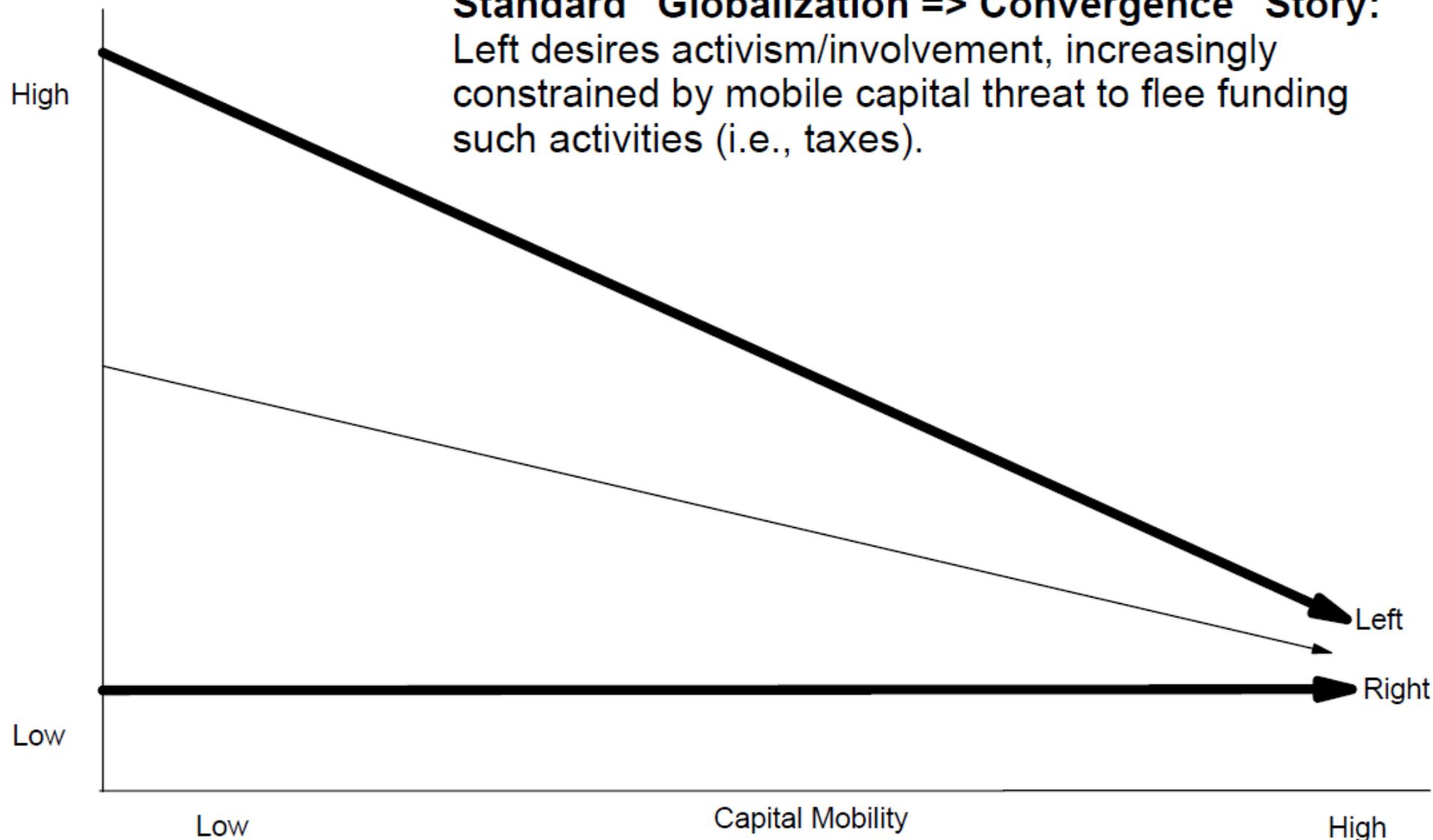
(2) Also induced rightward shift in mean policy & outcomes;

(3) If dem institutions working, then policy use desired, so not clear good to debar it.

(4) [**tradeoff**: rightward mean-shift & foregone democratically responsive policymaking against less cynical (electoral or partisan) manipulation.]

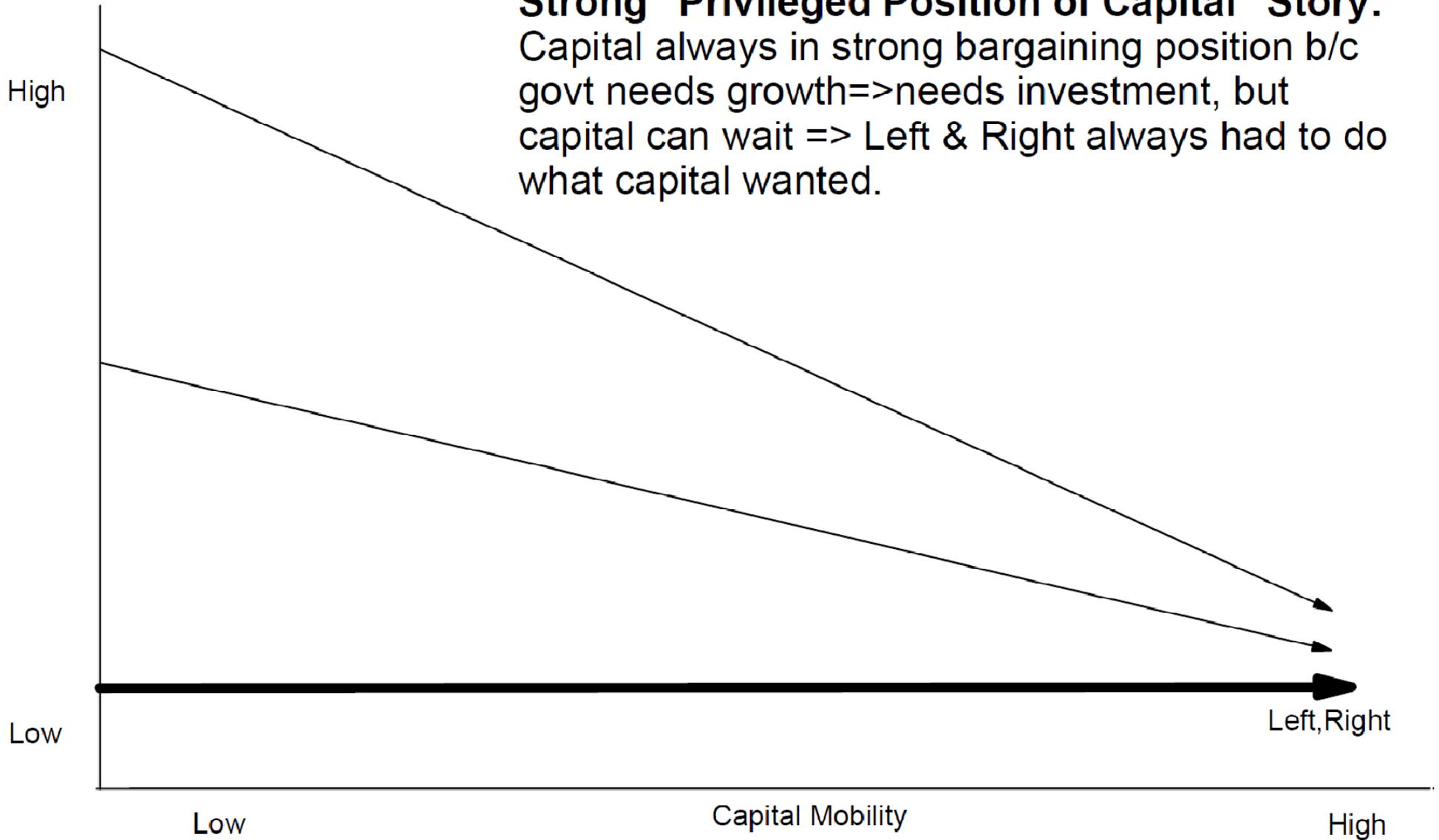
E. Pictures of the Alternative Theories of 'Convergence'

Degree of Policy Activism /
Govt Involvement in Economy



(Top line is left party/constituency preference; bottom is right party/constit. Middle line is median-voter's pref. **Bold** is policy under that partisan govt.)

Degree of Policy Activism /
Govt Involvement in Economy

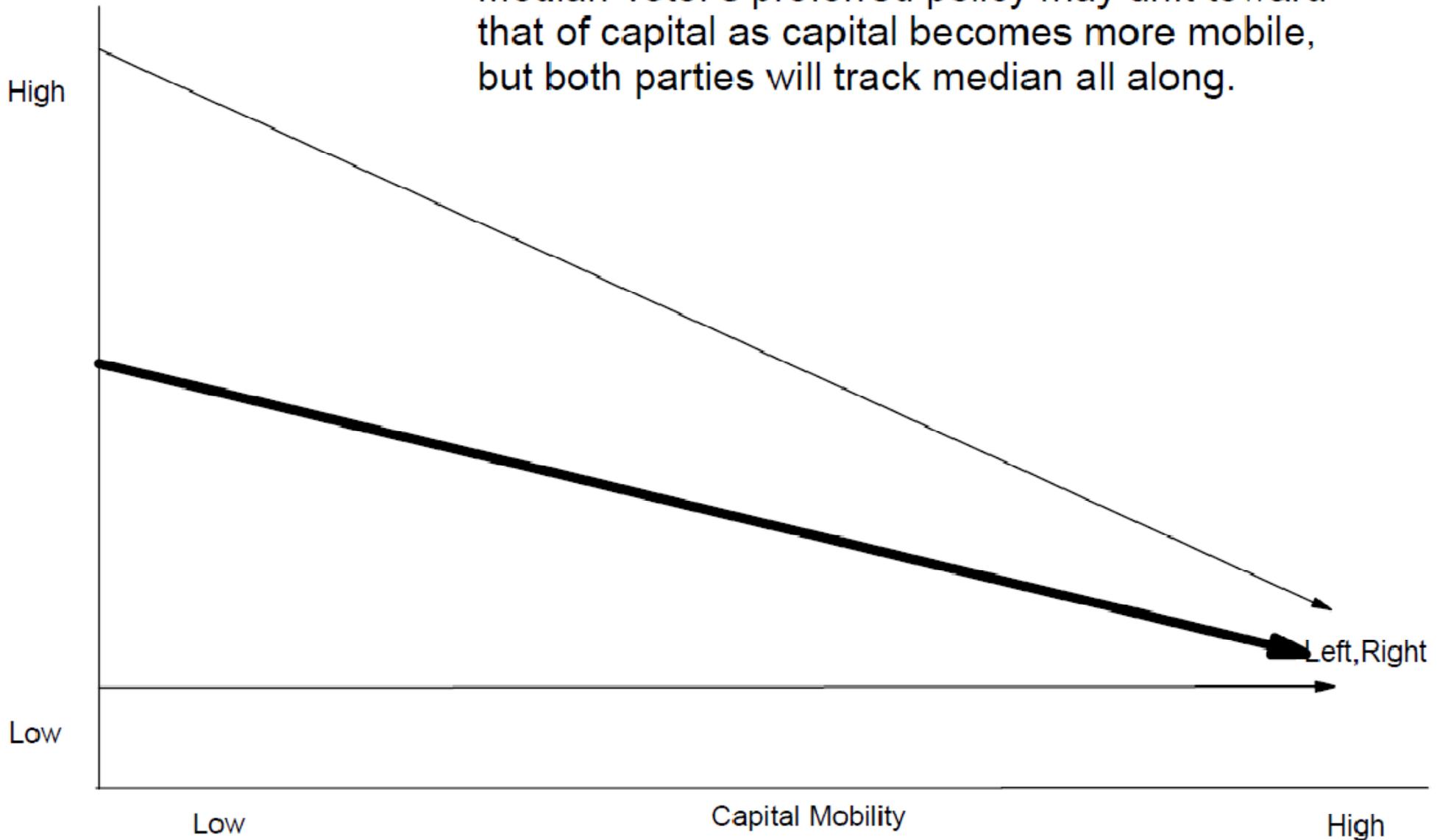


Strong "Privileged Position of Capital" Story:
Capital always in strong bargaining position b/c
govt needs growth=>needs investment, but
capital can wait => Left & Right always had to do
what capital wanted.

Downsian Convergence Story: Electoral competition (b/w 2 parties, on 1 dimension, w/ no uncertainty & full credibility) => convergence on median-voter's preferred policy.

Median-voter's preferred policy may drift toward that of capital as capital becomes more mobile, but both parties will track median all along.

Degree of Policy Activism /
Govt Involvement in Economy



F. *Workhorse Macro Political-Economic Models: Adaptive & Rational Expectations; Electoralist & Partisan Motivations; Endogenous Elections; Context-Conditional Models* [Table 1]

1. Adaptive-Expectations Electoral Cycles [Tufte]

- a) *Pol-mkrs*: care only about reelect; control pols that affect macro to aid reelect.
- b) *Voters*: [naively] retrospective [nec.] & pocket-book [not nec.].
- c) *Predictions*: real macro elect cycles (good pre-, poor post-); less precise re: infl.
- d) *Theory & Evidence*: Challenged.

2. Rational-Expectations Electoral Cycles [Rogoff, Sibert]

- a) *Econ*: Electoral manip not surprise [\Rightarrow , in new-K/-class, 0 real macro effect];
- b) *Voters* not [naively] retrospectively ignore future effects of current policies;
- c) [also, since pro- not retro-spective, not reward past but for expected future]
- d) *Predicts*: lesser real effects; [smaller, less regular macro elect cycles].
- e) Stronger *evidence* policy than outcome cycles [tons reasons for this].

3. Adaptive-Expectations Partisan Cycles [Hibbs]

- a) *Pol-mkrs*: partisan-differentiated weights on nominal vs. real economy;
- b) *Voters*: [naively] recognize these partisan diff's & their relevance to themselves;
- c) *Predictions*: real & nominal macro partisan cycles.
- d) *Theory & Evidence*: Challenged.

4. Rational-Expectations Partisan Cycles [Alesina]

- a) As above, except that only unpredicted policy-change affects real economy;
- b) *The Electoral Surprise* [EXPLAIN] \Rightarrow
- c) *permanent* partisan inflation [& policy] diff's, *temporary* partisan real-econ diffs.

5. Endogenous Election-Timing & Political Surfing

- a) *Adaptive*: straightforward political surfing [or w/ complications];
- b) *Rational*: more difficult to surf to beneficial effect b/c voters can infer signal that incumbent expects worse (or at least less-good) is to come
- c) Some evidence of simple surfing (in India, Japan, maybe UK);
- d) Clark, like most, will essentially ignore endogenous election-timing [which is to assume either no surfing or exogenous surfing or, if endog., *orthogonal* surfing].

6. Context-Conditional Electoral [& Partisan] Cycles:

- a) Relative Inattention in all 1-4 (& 5) to Institutional [& other] Contexts
- b) Helps explain previous empirical weakness;
- c) Attention will uncover further, interesting & important political economy.
- d) Here: relax assumpt constant policy control & efficacy, specifically consider two (prior) institutional commitments that moderate control &/or efficacy:
 - (1)CBI: may be others than elected officials in the monetary-policy driver seat [i.e., Two Hands on the Wheel: see also Franzese *AJP* '99]
 - (2)Capital Mobility (& Exchange-Rate Regime): steering column may be locked [i.e., Multiple Hands on the Wheel: see also Franzese *PA* '03].

TABLE 1. Alternative Models of the Domestic Political Economy

	Traditional Electoralist Model ^a	Rational Electoralist Model ^b	Partisan Model and Rational Variant ^c	Context-Dependent Partisan Model
Assumptions				
Structure of macroeconomy	Output and employment are driven by changes in inflation	Output and employment are driven by changes in unanticipated inflation	Output and employment are driven by changes in unanticipated inflation	Output and employment are driven by changes in inflation
Inflation controlled by	Elected politicians	Elected politicians	Elected politicians	Elected politicians only under certain institutional arrangements
Politicians are	Electoralist	Electoralist	Partisan: Left-wing incumbents attribute higher cost to unemployment relative to inflation than right-wing parties	Partisan
Voters are	Homogenous, retrospective, and "pocketbook"	Homogenous, forward-looking, and "pocketbook"	Heterogenous, forward-looking, and "pocketbook"	Heterogenous, retrospective, and "pocketbook"
Implications				
	Increase in growth and employment prior to elections. Increase in inflation either before or after elections	Monetary and fiscal variables may exhibit short-lived and irregular cycles, but growth and unemployment are all but unrelated to elections	Output growth and inflation should be permanently (temporarily, for rational variant) higher and unemployment lower under left governments	Output growth and inflation should be permanently high and unemployment lower under left governments, unless (a) central bank is highly independent; or (b) country pursues a fixed exchange rate amid highly mobile capital

^aFor example, see Nordhaus 1975.

^bFor example, see Rogoff and Sibert 1988; and Persson and Tabellini 1990.

^cFor example, see Hibbs 1977; Alesina 1987; and Alesina and Rosenthal 1995.

III. Structural Context of Macroeconomic Policy Choice (Ch. 2)

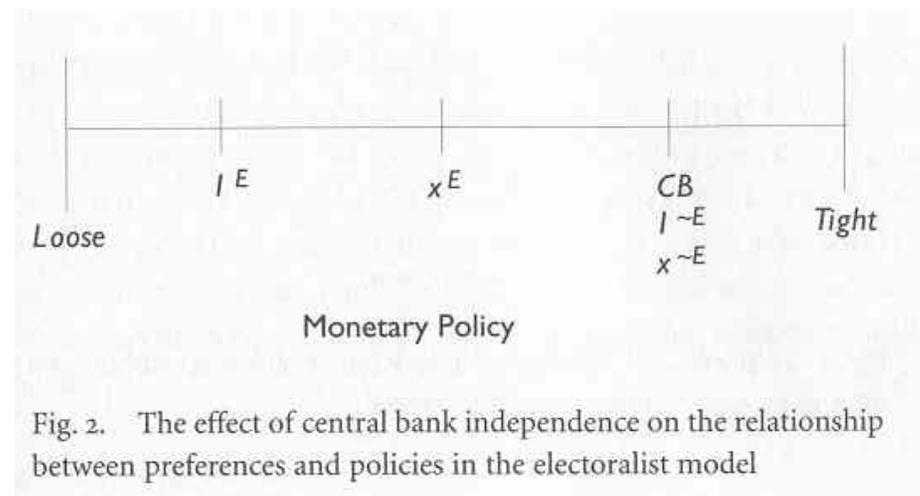
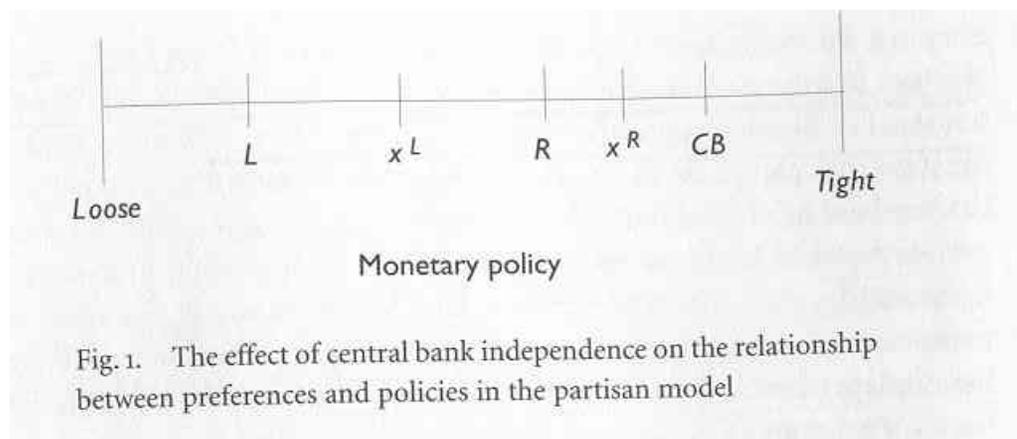
A. Basic Argument/Consideration:

- 1. Common Assumption Electoralist & Partisan Models: Pol-makers [Sufficient, Macro] Policy Control & Efficacy [to Influence Macro] Outcomes*
- 2. Policymakers not actually full control & efficacy, partly b/c world not deterministic, but also limited info & strategic interaction w/ other actors.*
- 3. Consider 2 Such Limiting Factors in Particular: CBI & Int'l CapMob, with effect CapMob on autonomy/efficacy depending on Exchange Regime*
- 4. Consider 1st simple decision-theoretic then strategic game-theoretic model:*

B. Decision-Theoretic Model:

1. CBI & Control:

- If/as CBI \uparrow , likely friction b/w incumbent's incentives & policy \uparrow
- Plausible that \uparrow CBI \Rightarrow \downarrow partisan & electoral cycles
- Figures 1 & 2 illustrate:



d) If CBI=1, then $m = m_b^*$; otherwise [as is always the case], $CBI \in (0..1)$

(1) $\Rightarrow m = \text{some compromise } m_b^* \text{ and } m^*$

(2) $\Rightarrow \downarrow (m_l^* | CBI - m_r^* | CBI)$ and $\downarrow (m_e^* | CBI - m_{\sim e}^* | CBI)$

e) Refer also to Franzese *AJP* '99 for broader implications of this proposition...

2. *Aside: Elaboration of PE Theory CBI*

a) PolSci & Econ gen'y agree CBI ↓ infl; both also similarly def CBI as degree of autonomy of (conservative) CB from political authority in making monetary pol.

(1) From PolSci view:

- (a) CB=bureaucratic institution, populated by financial experts generally hawkish on inflation, whether socialized to that view or coming from a population w/ those interests.
- (b) Govt instead, & especially in democracy, more responsive to various societal pressures that may emerge for inflation.
- (c) Only most conservative Govts as anti-inflationary as CB, so delegation of monetary-policy authority to CB, i.e., CBI, ↓ inflation.

(2) From the (neoclassical) economist's view:

- (a) Monetary policy involves a *time-inconsistency problem* ⇒ inflationary bias if policy controlled by a discretionary, i.e., responsive, authority.
- (b) Credible delegation of monetary authority to an independent & conservative (i.e., a non-responsive) CB offers commitment device to evade time-incons. & so infl. bias ⇒ CBI ↓ infl

b) *Aside: Elaboration of neoclassical model monetary policy by rule vs. discretion:*

(1) Start with a “rational expectations” model of a perfect-competition economy:

(a) Equation (1), the economy: $Y = Y_n + \alpha(\pi - \pi^e)$.

(i) I.e., output (Y) generally equal to natural output (Y_n), but short-run prices may be sticky so, if monetary authority created INF > expected INF (i.e., if $\pi - \pi^e > 0$), then Y temporarily exceeds natural rate. I.e. short-run (or expectations-augmented) Phillips curve (with slope α).

(2) Now suppose the policymaker has value function given by:

(a) Equation (2), policymaker's objective: $V = -(1/2)A(Y - Y^T)^2 - (1/2)\pi^2$

(i) I.e., policymaker does not like deviations of output from some (presumably high) target rate Y^T , & also dislikes inflation (deviations from target, set to 0 for simplicity).

(3) So, policymakers w/ preferences described by (2) facing economy described by (1) & controlling INF rate directly (*a simplification*), will act as if solving following maximization:

(a) $\text{Max}_{\pi} -(1/2)A(Y_n + \alpha(\pi - \pi^e) - Y^T)^2 - (1/2)\pi^2$ where, notice, (1) has been substituted into (2)

(b) $\Rightarrow -A\alpha(Y_n + \alpha(\pi - \pi^e) - Y^T) - \pi = 0$...maximize by taking derivative of expression to be maximized w/ respect to control variable (π) & setting result equal to zero...

(c) $\Rightarrow \pi = -A\alpha^2\pi - A\alpha(Y_n - \alpha\pi^e - Y^T)$...rearranging...

(d) $\Rightarrow \pi(1 + A\alpha^2) = -A\alpha(Y_n - \alpha\pi^e - Y^T)$...rearranging again...

(e) $\Rightarrow \pi(1 + A\alpha^2) = A\alpha^2\pi^e - A\alpha(Y_n - Y^T)$...and again...

(4) So, policymakers w/ preferences (2), facing economy (1), choose INF given by (3e),

(a) but here's the *rational expectations* part: Price setters know policymakers behave this way, so their π^e expectations also given by (3e). I.e, in eqbm, something Abe-Lincoln-like: "you can't fool all the people all the time". On average, π^e will equal π . So, rewriting (3) with $\pi^e = \pi$ gives you:

c) **Rational-Expectations Equilibrium: $\pi = A\alpha(Y_n - Y^T)$** ; and, substituting $\pi^e = \pi$ back into economy, (1), we also get that in eqbm: $Y = Y_n + \alpha(\pi - \pi^e) = Y_n$. I.e., monetary policy has no real effects in eqbm. (Note: if so, then to avoid real costs of monetary contraction: simply announce contraction soon enough & be believed so $\pi^e = \pi$ reflected in wage & price contracts will include expected contraction...]

- d) CB Autonomy from political authority in monetary policy-making, matter of °
- (1) Never complete b/c CB authority invariably derives from legal statute, i.e., law, or constitutional provision.
 - (2) Either subject to change by political authorities if CB policies ever sufficiently distasteful to them to justify expending political capital necessary to change CB status.
 - (3) Furthermore, CB authorities' appointed & perhaps replaced by govt...
- e) Nor can Govt costlessly ensure CB conducts policy precisely as current will:
- (1) CB expertise &/or an information advantage over govt in monetary policy,
 - (2) Plus, time & other resources for govt even to monitor CB, much less conduct monetary policy itself.
- f) CBI must, therefore, measure how far CB could stray from current govt's will before govt would bear political-economic costs to alter CB law or seize mon pol itself. Therefore, mon pol (& so infl) always partly CB & partly govt control ⇒
- (1) Actual monetary policy (inflation) = wtd average what would be if conservative CB credibly, fully, & autonomously controlled monetary policy & what would be if instead curr govt made mon pol w/o any CB influence, w/° CBI measuring wt on former:
- $$m = CBI \times m_b^* (\mathbf{X}_b) + (1 - CBI) \times m_g^* (\mathbf{X}_g)$$
- (2) ⇒ anti-infl effect of CBI not constant; it varies depending on political-economic environment in which CB operates. (Also implies all converses: **[show derivatives]**.)
 - (3) E.g., anti-inf effect CBI greater when left govt than when right & *v.v.*, less the more open the econ & *v.v.*, vary depending other labor- & goods-market institutions & *v.v.*, etc.

3. *International Capital Mobility & Exchange-Rate Regimes:*

a) CB affects control, not efficacy [actually, can affect both, but ignore that]; CapMob can affect efficacy (depending on exchange regime).

b) Mundell-Fleming (Open-Economy Macroeconomics):

(1) *CapMob & Fixed E.R. \Rightarrow monetary pol ineffective [unavailable, act'ly]; fiscal hypereffective.*

(a) $\uparrow m \Rightarrow \downarrow i \Rightarrow (\uparrow I, \text{ but also})$ depreciation, which must fight by $\downarrow m$ so $\uparrow i$ back ($\Rightarrow \downarrow I$); alternative quick explanation: if Fix E.R. & CapMob, then must use m to fix i at rate nec. maintain peg.

(b) $\uparrow def \Rightarrow \uparrow AD \& \uparrow i \Rightarrow$ appreciation, which must fight by $\downarrow m$ to $\downarrow i$ (i.e., fiscal expansion forces reinforcing monetary move also, so doubly effective)

(2) *CapMob & Flexible E.R. \Rightarrow fiscal [relatively] ineffective; mon hypereffective.*

(a) $\uparrow m \Rightarrow \downarrow i \Rightarrow \uparrow I$, & also depreciation, which allowed/accommodated so $\Rightarrow \uparrow (X-M)$ also.

(b) $\uparrow def \Rightarrow \uparrow AD$, but also $\uparrow i \Rightarrow$ appreciation, which $\Rightarrow \downarrow (X-M)$ (i.e., two sources of “crowding out”, crowding investment because $\uparrow i$ & $\downarrow (X-M)$ b/c apprec., so fiscal [relatively] ineffective).

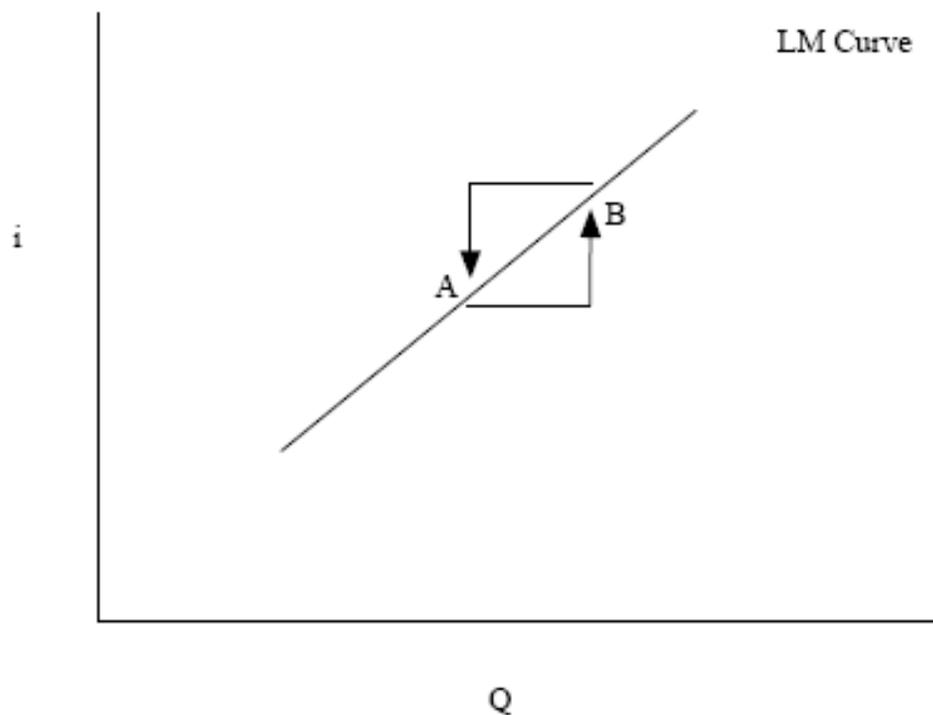
c) Aside: Elaboration of Mundell-Fleming Framework

IV. Open-Economy Macroeconomics (IS-LM-BoP Model)

A. Simultaneous eqbm in money (liquidity) mrkt (LM), goods (investment & saving) mrkt (IS), and balance of payments (BoP); i.e., eqbm is/are interest rates (i) & national income (Q) that clear money & goods markets (IS & LM), & that balance external accounts (BoP).

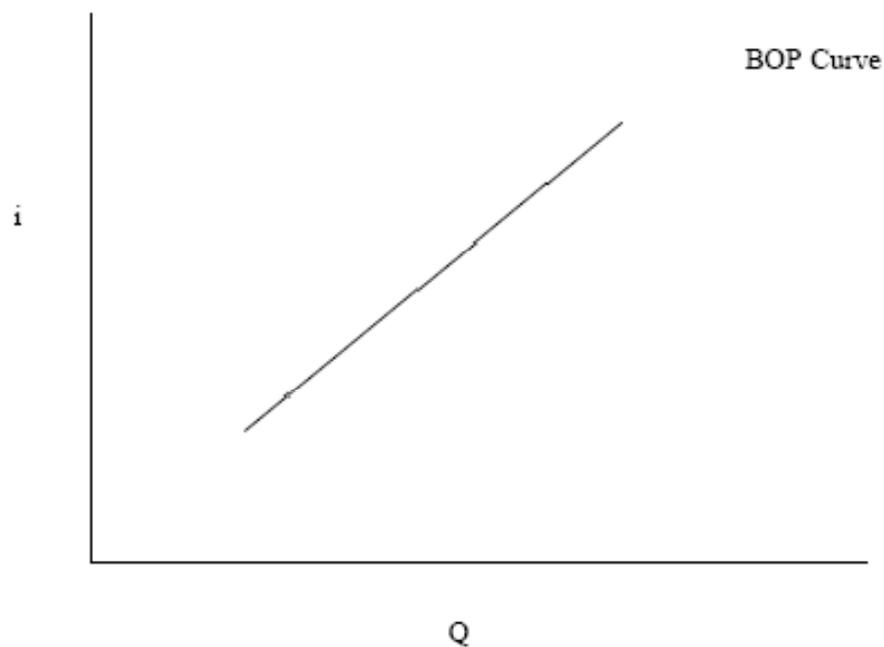
B. The LM (liquidity mrkt) Curve (eqbm in money market)

1. For any given money supply (M^s), some interest rate, i , needed for folks to demand exactly that quantity of money given their income, Q .
2. Slopes upward: if more income, Q , demand more goods & services, \Rightarrow want more money, but for a given M^s , that additional demand for money \Rightarrow price of money (i) must rise:
3. From point A in figure, $\uparrow Q \Rightarrow \uparrow$ demand money, stock money fixed, so i rises, to pt B, say. From B, $\downarrow Q \Rightarrow \downarrow$ demand money, stock fixed, so i falls, to pt A, say.
4. **MONETARY POLICY: $\uparrow M^s \Rightarrow \downarrow i @$ any given Q , $\uparrow Q$ for any given i to keep LM balance; the reverse for $\downarrow M^s$, so expand/contract monetary policy = outward/inward shift of LM curve.**



C. Balance-of-Payments (BoP) Curve (eqbm in external accts)

1. **Balance-of-Payments (BoP)**: Current Account (Trade Balance: $X - M$) + Capital Account (Net Outflow: Cap Outfl. - Cap Inflow) = 0. I.e., $X + M + \text{NetCapFlow} = 0$. [another accounting identity]
2. Thus, trade surplus matched by capital outflow (revenue from surplus is equal to investment abroad); trade deficit matched by capital inflow (excess consumption funded by investment inflow).
3. For any i , some Q balances Trade (export & import demand: $M = f(Q)$, X not) & Capital Accounts (desired invest out-/in-flow) & v.v.
4. Slope? If $\uparrow Q$, imports rise, exports not \Rightarrow trade deficit \Rightarrow need cap inflow, only get if higher i ; and v.v. for $\downarrow Q \Rightarrow$ surplus needs outflow, get by $\downarrow i$.
5. Importantly, **BoP line flatter (elastic, i.e., interest sensitive) the more mobile is cap.** Cap flows greater in response to $i \uparrow \downarrow$, the more mobile capital. Perfect cap mob \Rightarrow horizontal.

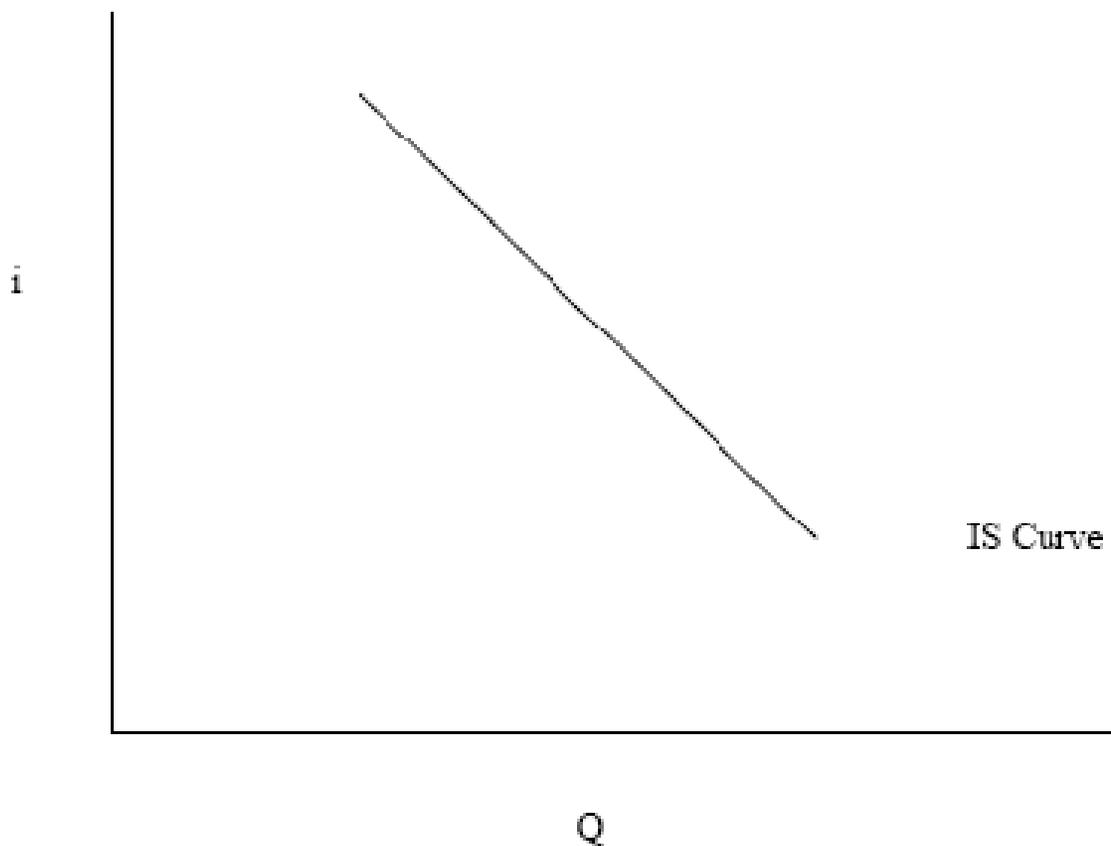


D. IS (investment-savings) Curve (equilibrium in goods markets)

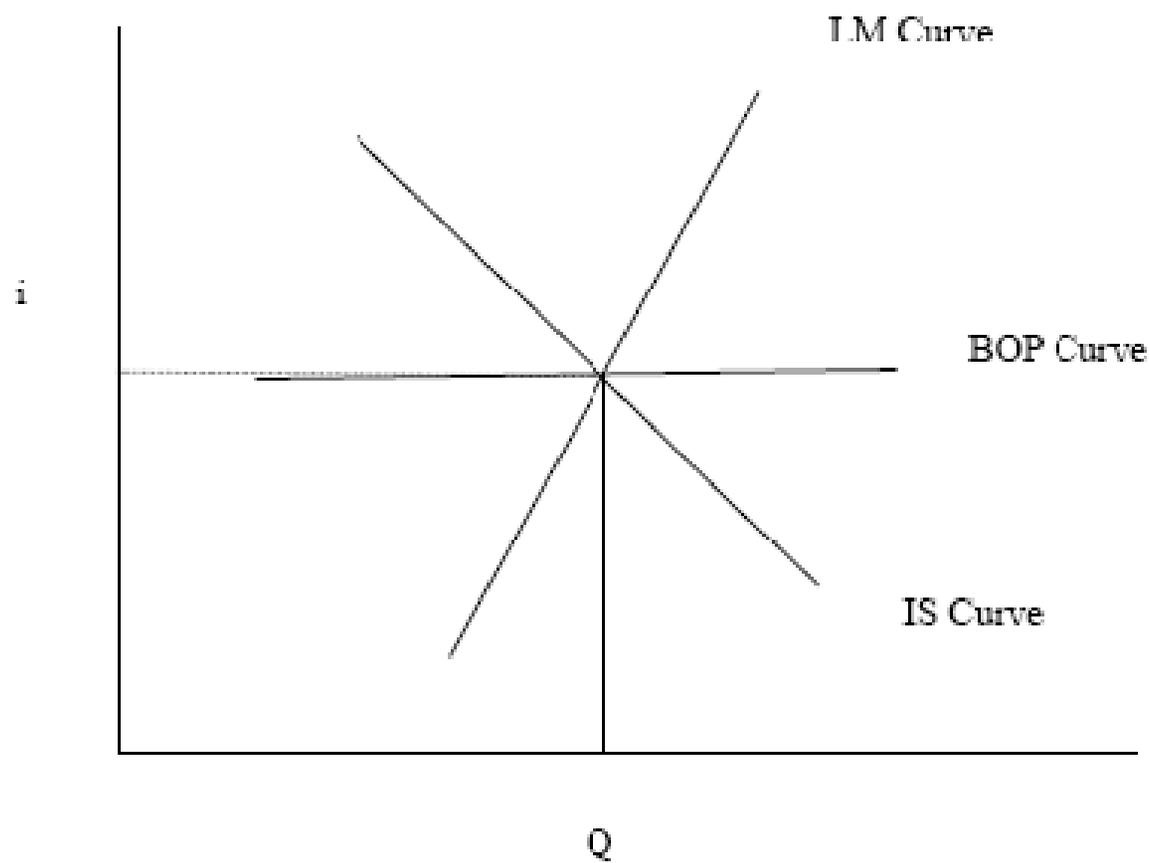
1. National Income \equiv National Expenditures: $Y=Q=C+I+(G-T)+(X-M)$

2. IS-curve slopes downward: For given C , $(G-T)$, & $(X-M)$, any $\downarrow i \Rightarrow \uparrow I \Rightarrow \uparrow Q$.

3. FISCAL POLICY: $\uparrow(G-T) \Rightarrow \uparrow Q$ at any given i ; i.e., outward shift of IS curve.



E. Gen Eqbm in IS-LM-BoP Model: All 3 Curves Intersect



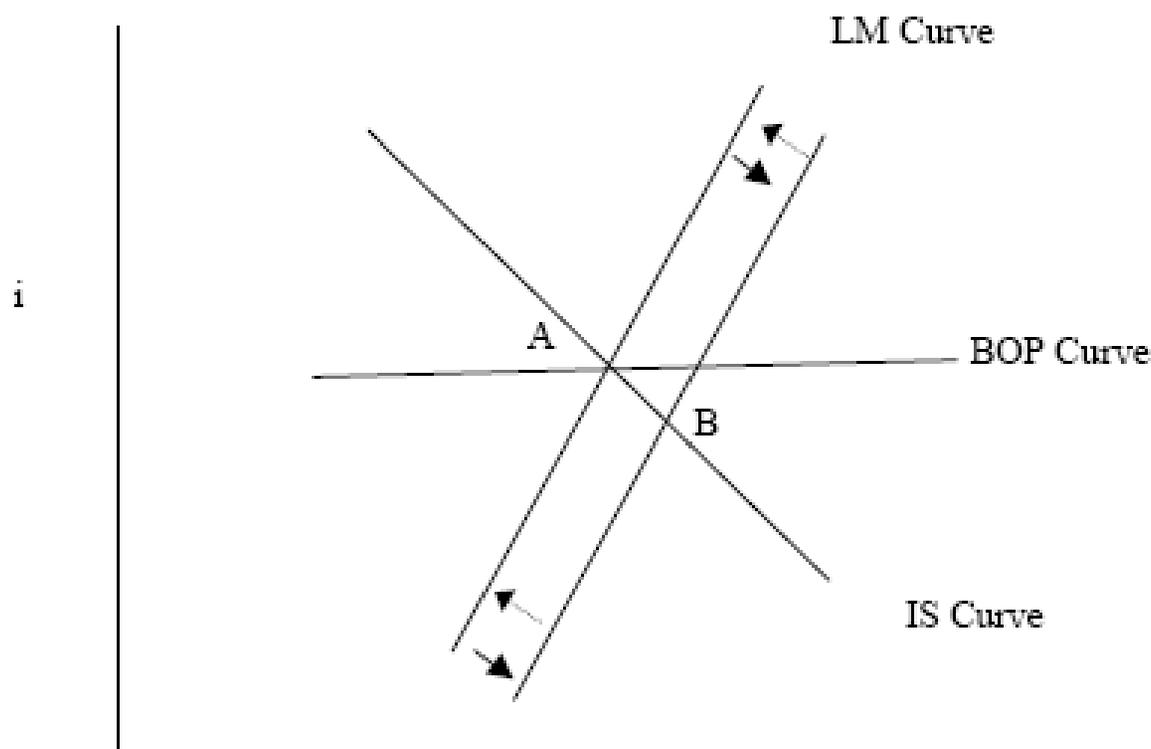
F. Using the IS-LM-BoP Model for Policy Analysis

1. Capital Mobile:

a) **Monetary Policy under a Fixed Exchange-Rate Regime with highly Mobile Capital**

(1) $\uparrow M^s \Rightarrow$ LM shifts out, but this $\Rightarrow \downarrow i$ along IS curve, but this \Rightarrow capital outflow \Rightarrow depreciation, which violates Fixity. $\downarrow M^s \Rightarrow \dots$ [same chain, opposite direction] $\dots \Rightarrow$ appreciation, which violates Fixity.

(2) \Rightarrow **Monetary Policy forsaken (wholly unavailable) under Cap Mob & Exchange Rate Peg**

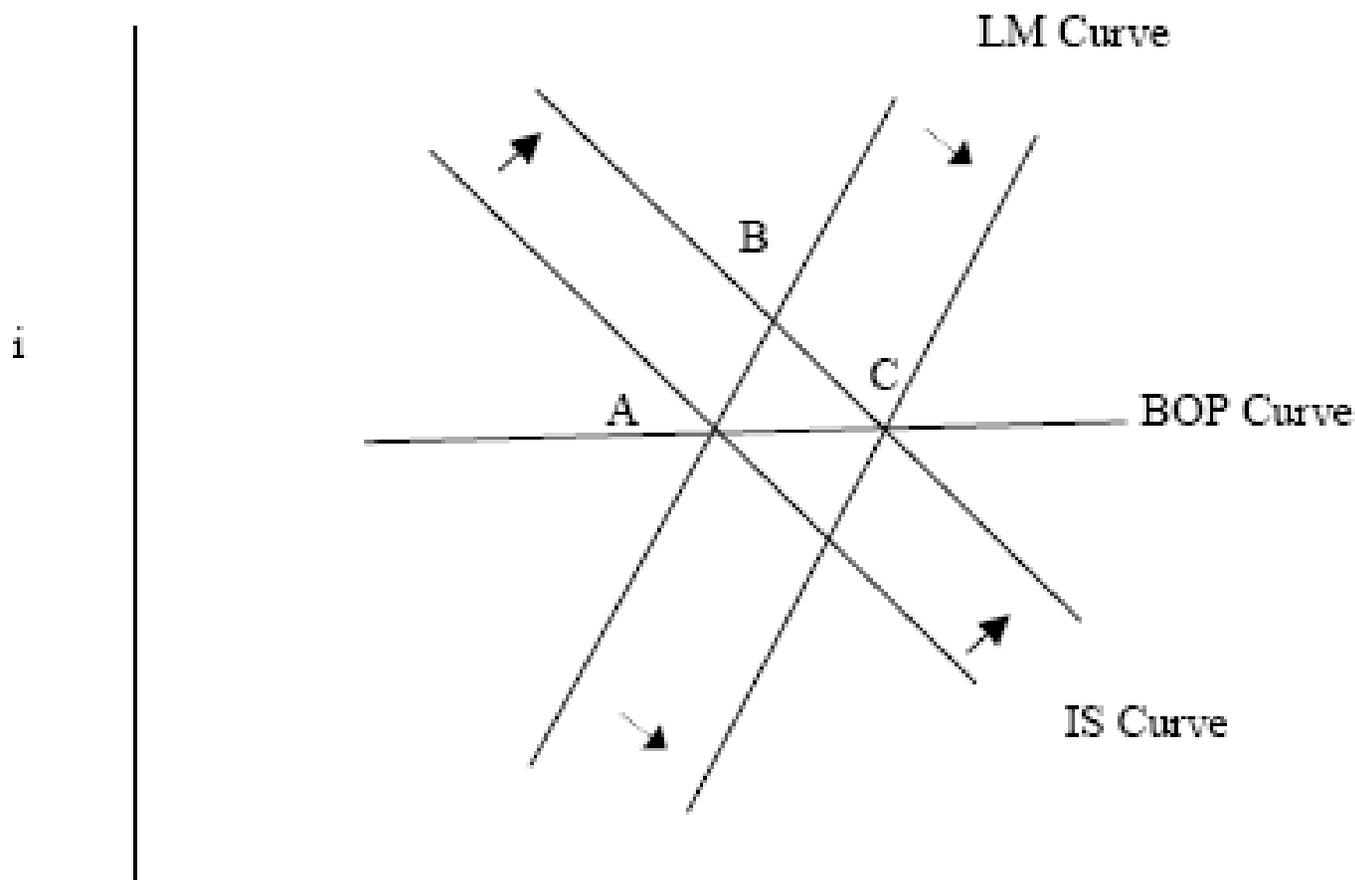


b) Fiscal Policy under a Fixed Exchange-Rate Regime

(1) $\uparrow(G-T) \Rightarrow$ IS shifts out, but this $\Rightarrow \uparrow i$ along LM curve, but this \Rightarrow capital inflow \Rightarrow appreciation, which violates Fixity, so monetary policy must accommodate, i.e., M^s must expand to $\downarrow i$ back, which amplifies stimulus.

(2) $\downarrow(G-T) \Rightarrow$...[same chain, opp. dir.]... $\Rightarrow M^s$ must shrink to $\uparrow i$ back, amplifies stimulus...

(3) UPSHOT: **Fiscal Policy doubly effective under Cap Mob & Peg** (because it forces monetary policy to come along with it in order to maintain peg).

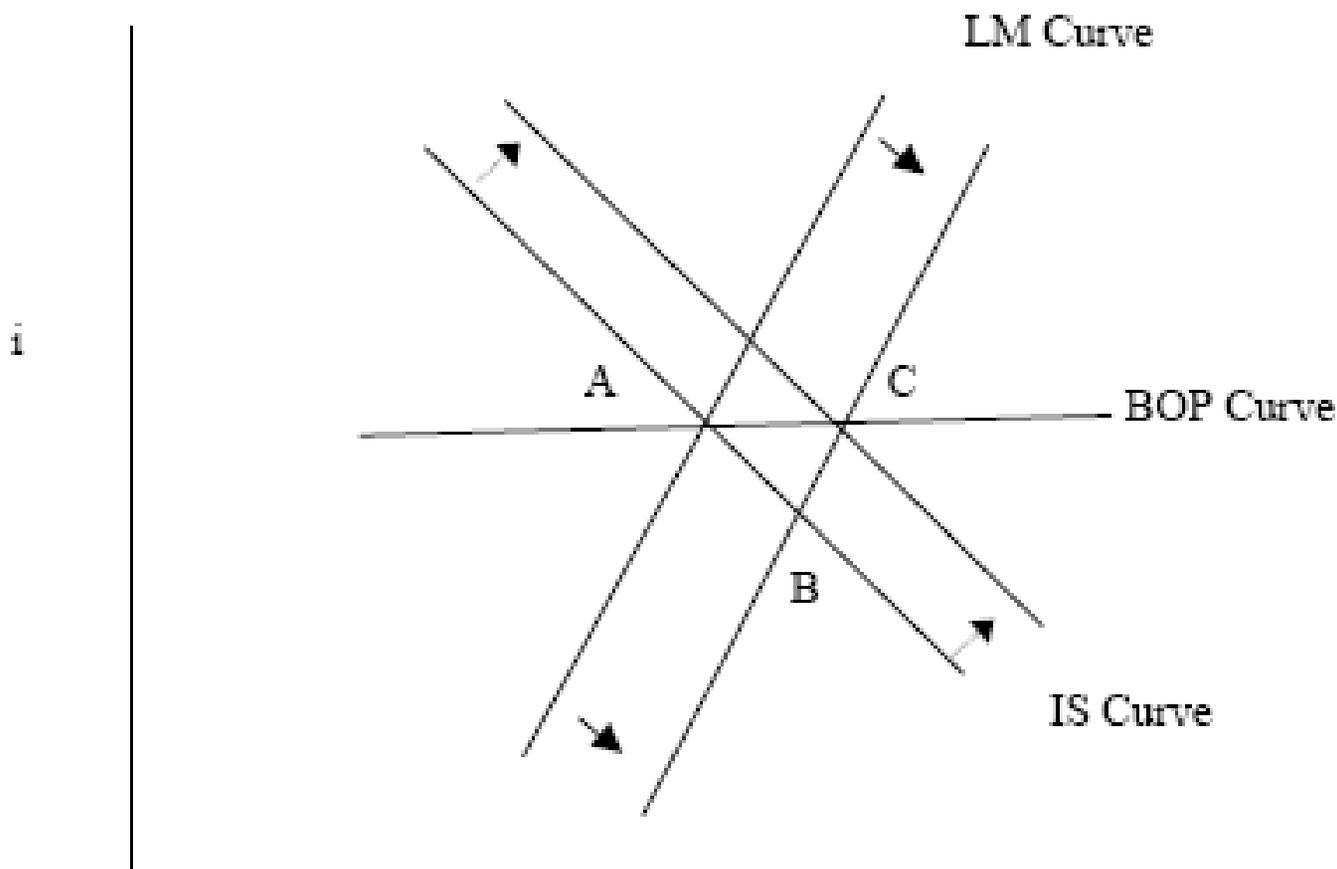


c) Monetary Policy under a Floating Exchange-Rate Regime

(1) $\uparrow M^s \Rightarrow$ LM shifts out, but this $\Rightarrow \downarrow i$ along IS curve, but this \Rightarrow capital outflow \Rightarrow depreciation, which allowed under float, so $\uparrow(X-M) \Rightarrow$ IS shifts out further.

(2) $\downarrow M^s \Rightarrow$...[opposite]... \Rightarrow appreciation, which... $\downarrow(X-M) \Rightarrow$ IS shifts in further.

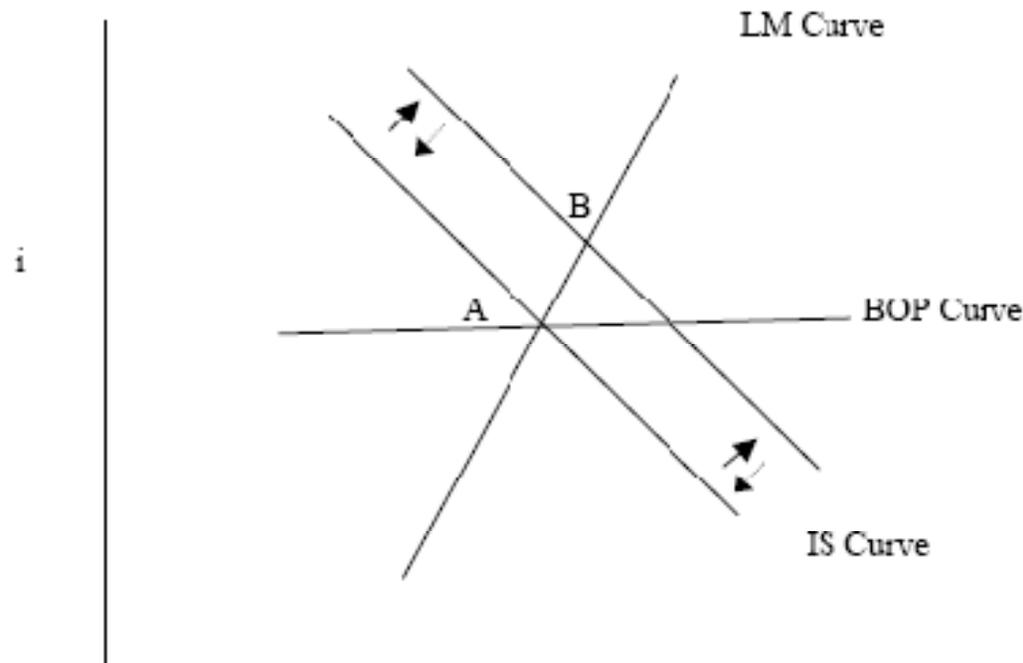
(3) **UPSHOT: Monetary Policy doubly effective under Cap Mob & Float Exchange-Rate.**



d) Fiscal Policy under a Floating Exchange-Rate Regime

(1) $\uparrow(G-T) \Rightarrow$ IS shifts out $\Rightarrow \uparrow i$ along LM curve \Rightarrow cap inflow \Rightarrow appreciation, which $\Rightarrow \downarrow(X-M)$, which \Rightarrow some shift back of IS, might be more or less or same as original shift...

(2) **UPSHOT: Fiscal Policy relatively ineffective if Cap Mob & Float**



2. Capital Immobile: Model reduces to IS-LM (without BoP) \Rightarrow

- Can Peg or Float w/o forsaking monetary autonomy or amplifying monetary efficacy.
- Can Peg or Float w/o amplifying or dampening fiscal efficacy.

II. Purchasing-Power Parity & Interest Parity

C. Alternative way to see how *Cap Mob* may constrain monetary autonomy

D. PPP: $P=EP^*$ or, in logs (ln), $p=e+p^*$

1. Given free trade, price of basket in one currency must equal price of same basket in another currency multiplied by the exchange rate.

2. Logic of *no-arbitrage*: could make ∞ \$ if this not true & trade is free (& costless).

3. Empirical: holds very well on avg over long periods (at least, up to a constant); not very well in short run.

E. IP: $i = i^* + E(\hat{e})$ (... \hat{e} =% change e.r. & $E(\cdot)$ is “expected”)

1. Logic similar, relies on *no-arbitrage condition* in diff mrkts (money mrkts) though

2. If not, all investors would want the better-return currency only, so \hat{e} , i.e., expected depreciation must equalize the returns.

3. Empirical: holds very well up to extremely short-run, although one might note that prediction is VERY flexible given difficulty estimating second term on the right...

4. So: any diff in nominal int-rates (mon policy) will be met fully by nom. exchange-rate depreciation (flexible e.r.) or real exch.-rate deprec. (fixed e.r.). If cap *perfectly* mobile, these capital flows *infinite*, which perfectly unsustainable, so perfect mobility means mon. authorities tiny country must match domestic to foreign policy

5. Clark's CBI & CapMob+E.R.R. Predictions [Franzese's elaboration]:

a) *Upshots from IS-LM-BoP, plus CBI:*

- (1) If Cap Immob, then both Mon & Fisc available & effective
- (2) If Cap Mob & E.R. Flex, monetary doubly effective but fiscal relative ineffective
- (3) If Cap Mob & E.R. Fix, monetary unavailable but fiscal doubly effective
- (4) If CB Independent, monetary policy unavailable (to domestic political actors).

b) *Political-economic implications for policymakers:*

- (1) If *CapImmob* OR *E.R. Flex*, pol-mkrs can use mon pol for electoralist or partisan purposes \Rightarrow macro cycles by monetary mechanism; these monetary-driven cycles would be dampened by *CapMob* & *Fix E.R.*
- (2) If *CapImmob* OR *E.R. Fix*, pol-mkrs can use fisc pol for electoralist or partisan purposes \Rightarrow macro cycles by fiscal mechanism; these fiscal-driven cycles dampened by *CapMob* & *Flex E.R.*
- (3) However, furthermore: If *CBI*, macro cycles by mon mech constrained/damp'd; fiscal-driven cycles still possible, although CB might work against.
- (4) \Rightarrow Cycles achievable under any combo except *CBI+CapMob+Flex*, but one would expect CBI & CapMob perhaps to dampen cycles, esp. for pol-mkrs facing some competing strategic actors under these conditions.

C. Game-Theoretic (Strategic) Model:

1. *Basic Structure*: Govt Controls Fisc Pol; CB Controls Mon Pol, but (conservative) CB Prefs Differ from Govt's Only If [insofar as] Indep.

2. *Model*:

a) *Goals of Policymakers*: $L_i = (y - y_i^*)^2 + \alpha^i (\pi - \pi_i^*)^2$ [DEFINE TERMS]

(1) Real Target: $y_g^* = k_g y^n$: for *electoralist* model: $k > 1$ if election year; for *partisan* model: $k > 1$ if left government; $k = 1$ if non-elect, right, or if $CBI = 1$.

(2) Simplify: $\alpha_i = \pi_i^* = 0 \Rightarrow$ policymakers differ in real target only

b) *Economy*: $y = y^n + \mu(\pi - \pi^e) + \phi g$ [Define terms; note: ϕ =fisc & μ =mon efficacy]

(1) Expectations-augmented Phillips Curve + simple Keynesian fiscal efficacy; *n.b.*, all else equal fiscal-policy preferred to monetary (b/c g not in Loss function, L , but π is).

(2) *CapImmob* $\Rightarrow 0 < \phi, \mu < 1$;

(3) *CapMob, Fix* $\Rightarrow \phi = 1, \mu = 0$;

(4) *CapMob, Flex* $\Rightarrow \phi = 0, \mu = 1$.

c) *Order of Play*:

(1) All learn game structure (E or \sim E; R or L; CBI or $\sim CBI$, all parameters of model); *n.b.*, actually no role for π here; game as modeled entirely b/w CB & govt, no citizens.

(2) Govt chooses g ; then bank chooses π . Note:

(a) Actually, bank chooses π given expects g from govt optimize \Rightarrow some $\pi(g)$; symmetrically, govt chooses g knowing this is how bank will act.

(b) [game somewhat odd for $CBI = 0$ case; because then govt would optimize over g & π]

3. *Implications*: As before but CB not only not act *electorally* or *partisan-ly* but leans monetarily against govt if indep & retains mon. auton.

4. *Predictions*:

a) *If CapImmob*, fiscal manipulation regardless of *E.R.* or *CBI*, but *CBI likely dampens*. [note: fiscal policy Pareto-preferred *ceteris paribus* in this model.]

b) *If CapMob*, fiscal manipulation under *Fixed E.R.* but not under *Flex E.R.*, regardless of *CBI*. [note: fiscal 100% ineffectual under *Flex* in this model.]

c) *If CapImmob*, monetary manipulation in contractionary direction [more generally, monetary counters fiscal policy] if *CBI*.

d) *If CapMob*, monetary manipulation in expansion dir only if \sim *CBI* & *Flex E.R.*

5. *Main Difference from Non-strategic (Decision-Theoretic) Model*: CapMob, Fix, & CBI \Rightarrow fiscal effective & CB constrained from countering \Rightarrow fiscal cycles, if anything, greater outcome cycles w/ CapMob than w/o .

6. [TABLE 3: *n.b.*, absolute (none, all) statements mostly due to dichotomized conditions & extreme resolution of assignment problem (all fiscal policy); viewed as relative statements should hold though.]

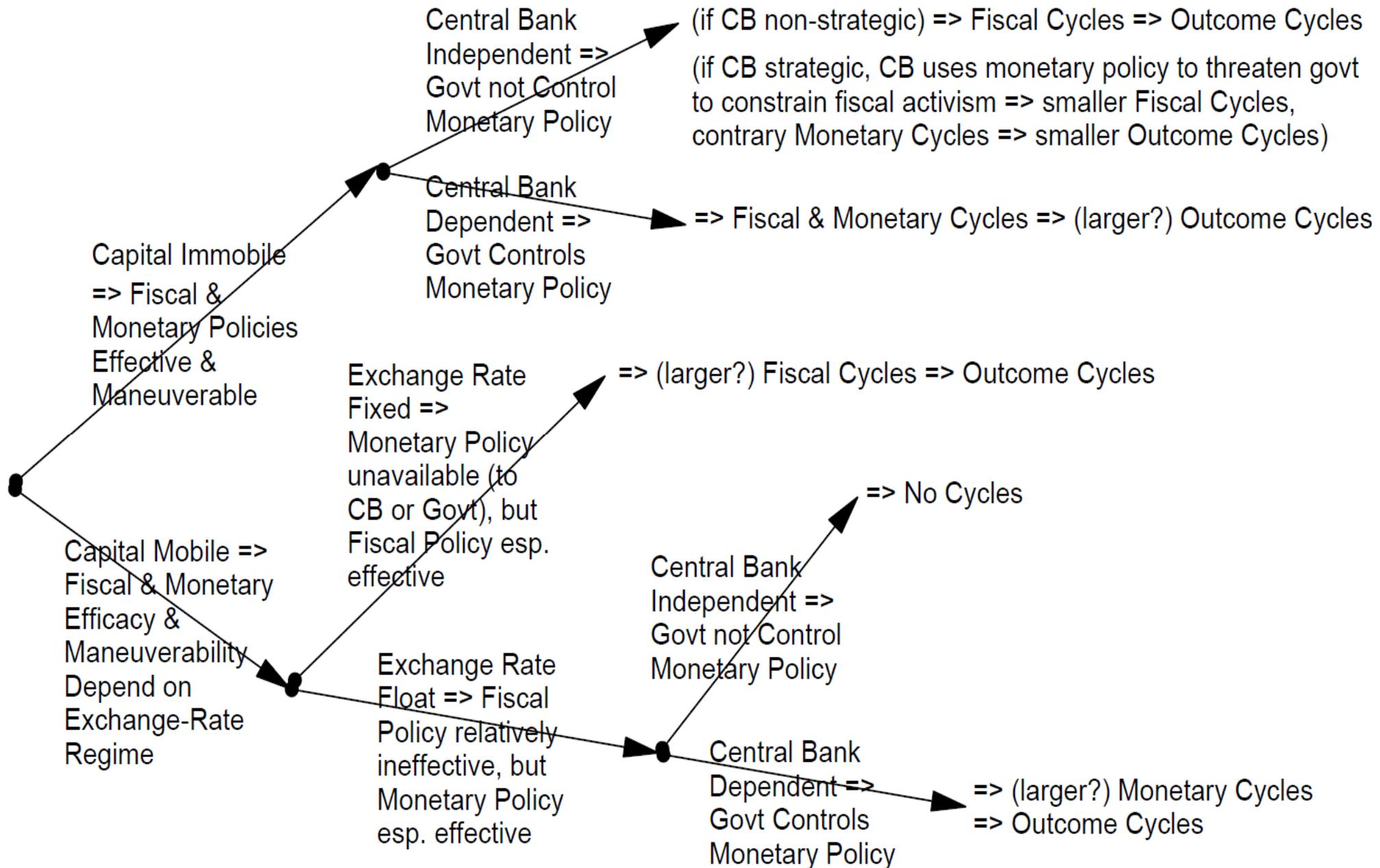
TABLE 3. The Expected Effect of an Increase in Left Governance or the Onset of an Election under Various Conditions

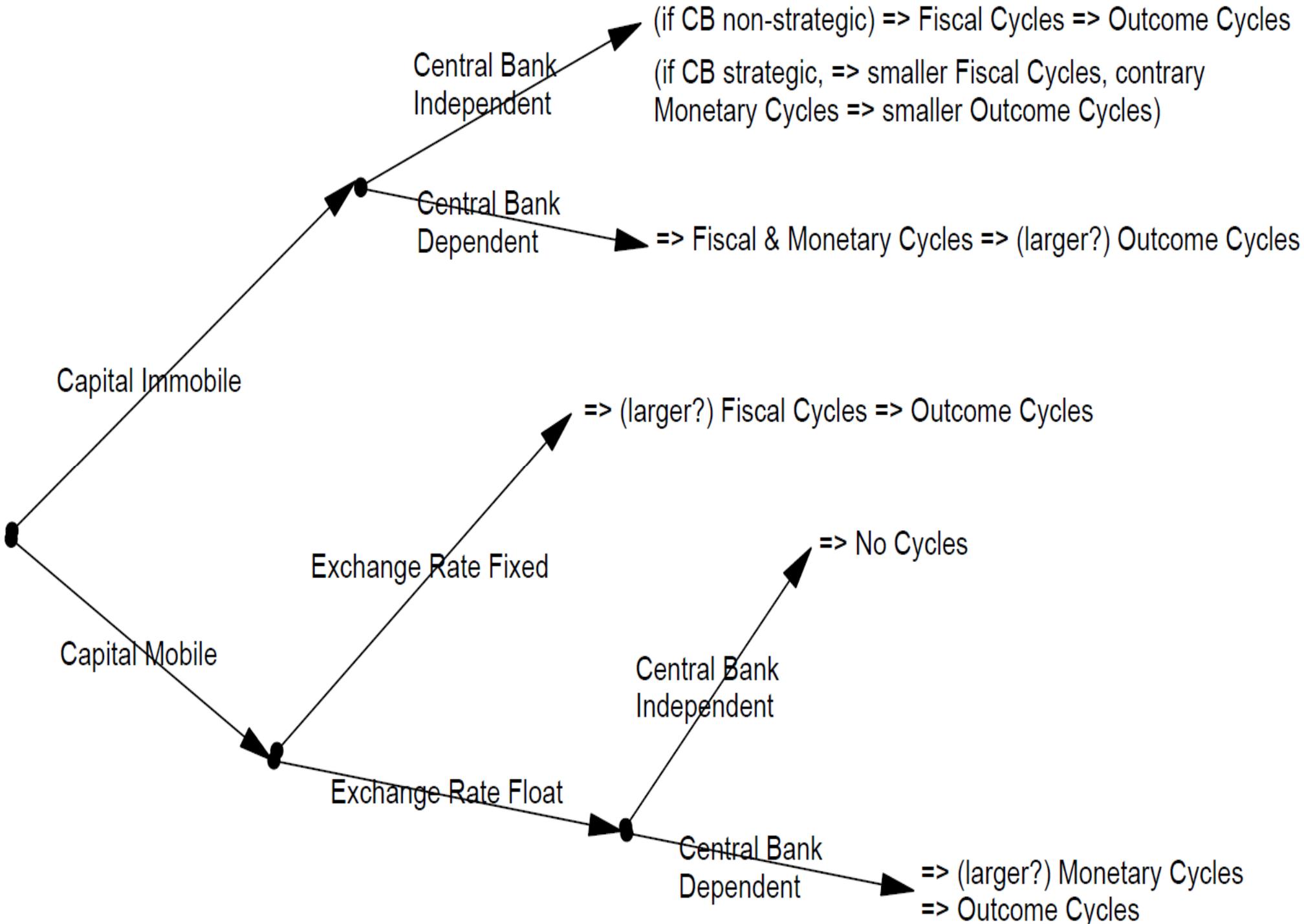
	No Central Bank Independence	Central Bank Independence
No capital mobility	<i>Fiscal policy: expansion</i> <i>Monetary policy: indeterminate</i> <i>National income: expansion</i>	<i>Fiscal policy: (smaller) expansion</i> <i>Monetary policy: contraction</i> <i>National income: (smaller) expansion</i>
Capital mobility and fixed exchange rates	<i>Fiscal policy: (larger) expansion</i> <i>Monetary policy: none</i> <i>National income: expansion</i>	<i>Fiscal policy: (larger) expansion</i> <i>Monetary policy: none</i> <i>National income: expansion</i>
Capital mobility and flexible exchange rates	<i>Fiscal policy: none</i> <i>Monetary policy: expansion</i> <i>National income: (smaller) expansion</i>	<i>Fiscal policy: none</i> <i>Monetary policy: none</i> <i>National income: none</i>

7.NOTE: *CBI*, *CapMob*, *E.R.* all viewed as exogenous.

8. Policymaking Highly Context-Dependent; misleading at best to explore [theoretically or] empirically w/o consider context

D. Diagrams summarizing Clark's Central-Bank-Independence, Capital-Mobility, & Exchange-Rate-Regime Conditional Electoral and Partisan Cycles Theory (1st w/ steps elab'd; 2nd just upshots):





E. Determinants Domestic Policy Autonomy: **DEF's & MEAS's**

1. **Capital Mobility:**

a) *What:*

(1) System or Country Characteristic? Legal or Behavioral?

(2) *Sources:*

(a) [Science & Tech] Information/communication (& other) technological advances;

(b) [Econ] Financial-instrument/market advances (e.g., Eurodollar, futures, etc.);

(c) [Pub Pol] Removal capital controls;

(d) [All of above] Increased trade.

(3) Only Capital Controls seems directly (discretionary) policy & seemed to respond more than cause mobility \Rightarrow use this as more exogenous, behavioral, system characteristic

b) *When:* b/w '60s-'80s; '70s transition period; by '78 seems prominent; key bellweather=1972 \$-gold-window closure & Bretton Woods collapse.

c) *Measures:*

(1) Correlation of Domestic Savings & Investment. [WHY?] [PROBS: S&I both pro-cyclical, so corr. anyway; large-ctry S&I affect world; path may seem oddly volatile]

(2) Counts of Capital Controls

d) *Data:* FIGURE 4.

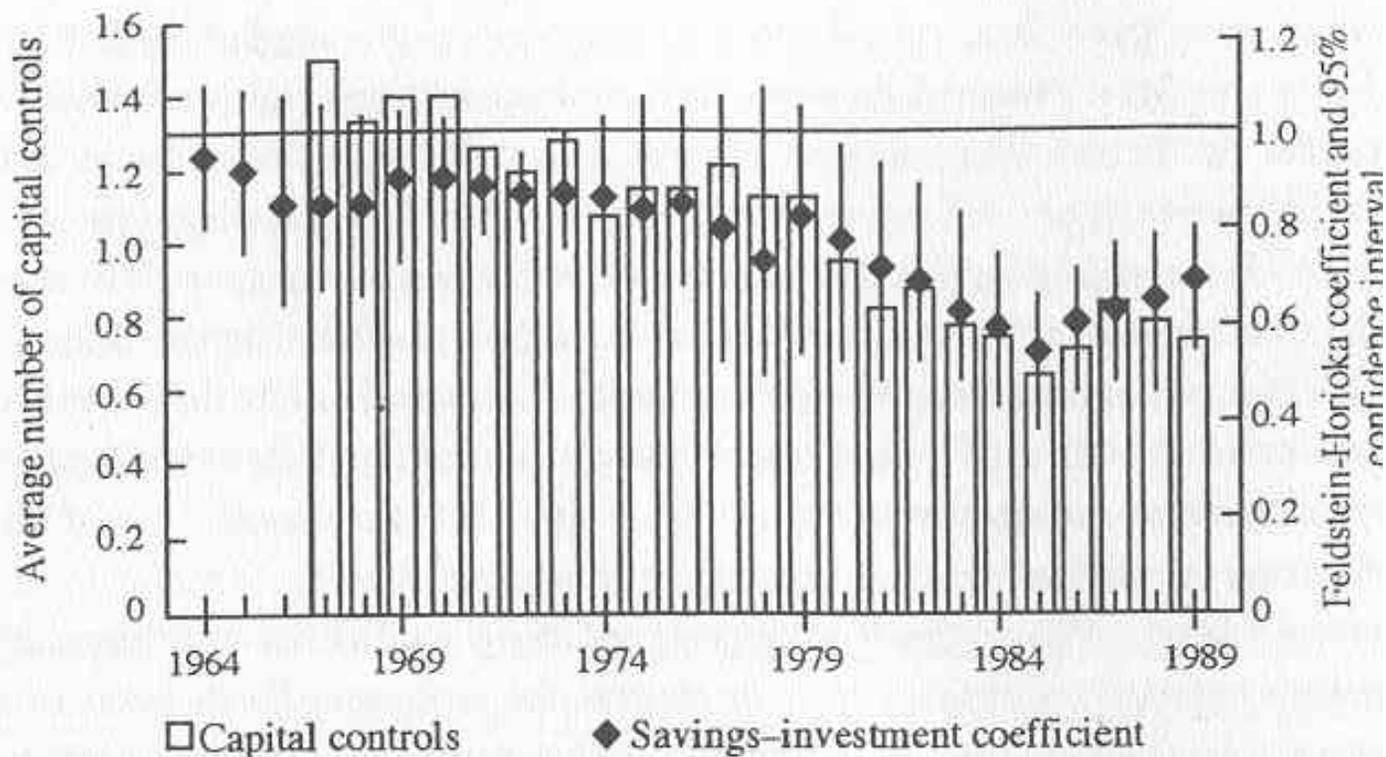


Fig. 4. Alternative measures of capital mobility for 18 OECD countries. (From Clark and Nair Reichert 1998.)

$(R^2 = .91)$

2. Exchange-Rate Regimes:

a) *What & When & Where:*

- (1) WWII-'71 = Bretton Woods: all [most] to \$ [to IMF SDR's ≈ \$] which tied to gold.
- (2) Heterogeneous since: simple pegs; crawling pegs; unilateral baskets; group baskets; managed float; flexible; etc. Great mix; considerable variation across & some w/in ctrys.
- (3) Snake—Tunnel—ERM/EMS—EMU—Euro; a few other patterns.

b) *Measure*: n.b., assumes official policy \Rightarrow effective policy

c) *Data*: TABLE 4.

TABLE 4. Participation in Fixed Exchange Rate Regimes after 1972 and before 1990

	Snake	EMS	Pegged
Australia	—	—	—
Austria	—	—	1973–89
Belgium	1973–78	1979–89	—
Canada	—	—	—
Denmark	1973–78	1979–89	—
Finland	—	—	1977–89
France	Intermittent	1979–89	—
Great Britain	—	—	—
Greece	—	—	—
Ireland	—	1979–89	1973–78
Italy	—	1979–89	—
Japan	—	—	—
Netherlands	1973–78	1977–89	—
New Zealand	—	—	1973–79
Norway	1973–78	—	1979–89
Spain	—	—	—
Sweden	1973–77	—	1977–89
United States	—	—	—
West Germany	1973–78	1979–89	—

Source: Coffey 1984; IMF, *International Financial Statistics*, various years; OECD 1985.

3. Central Bank Independence: [DEF]

a) *What:*

(1) Legal (*de jure*) or Behavioral (*de facto*) [in developing, only latter seems matter].

(2) Legal CBI:

(a) Appointment, dismissal, tenure-length of CB decision-makers;

(b) Procedures of dispute resolution;

(c) Objectives of policy as defined in bank law;

(d) Whether bank may or must buy govt bonds & under what terms;

b) *Where & When:* until recently (ECB/Euro project & convent wisdom), very rarely changed; almost constitutional feature

c) *Measures:* 5 common indices (n.b., a different 5 available)

d) *Data:* TABLE 5.

TABLE 5. Alternative Measures of Central Bank Independence

	<i>AS</i> ^a	<i>BP</i> ^b	<i>GMT</i> ^c	<i>CWN</i> ^d
West Germany	4	4	14	0.69
Austria	—	—	9	0.63
Greece	—	—	4	0.53 ^e
Denmark	2.5	2	8	0.50
United States	3.5	3	13	0.49
Canada	2.5	2	11	0.45
Ireland	—	—	7	0.44
Netherlands	2.5	2	10	0.42
Australia	2	1	9 ^e	0.36 ^e
United Kingdom	2	2	6	0.34
Sweden	2	2	—	0.29
France	2	2	7	0.29
Finland	—	—	—	0.28
Italy	1.75	1.5	5	0.25
New Zealand	1	1	3	0.24
Japan	2.5 ^e	3 ^e	6	0.18
Spain	1.5	1	5	0.17
Norway	2	2	—	0.16
Belgium	2	2	7	0.16
Median	2.0	2.0	7.0	0.30
Mean	2.23	2.03	7.6	0.36

Note: All indexes are constructed so that higher numbers indicate greater central bank independence.

^aIndex created by Alesina and Summers (1993) by rescaling and combining the Bade and Parkin (BP) and Grilli, Masciandaro, and Tabellini (GMT) indexes.

^bIndex proposed by Bade and Parkin (1982) and extended by Alesina (1988b).

^cSum of economic and political indexes provided by Grilli, Masciandaro, and Tabellini (1991).

^dIndex created by averaging Cukierman, Webb, and Neyapti's (1992) aggregate legal measure for the period 1960–89.

^eIndicates an above-median score for a country that is below the median on at least one other index.

V. *Partisanship and Fiscal & Monetary Policy (Ch. 3)*

A. “There’s not a dime’s worth of difference between the Republicans and the Democrats” (G. Wallace, ’68 *Indep Cand*)

1. Remember Blair & Schroeder; but was that new?
2. Mitterand’s U-turn in early ‘80s; opening bell or was that not new?
3. Wilson’s (’64-70; ‘74-76) austerity program in Sterling crisis? Need...
4. *Systematic analysis*: whether & when Left distinctly more interventionist
 - a) Sev’l previous studies: \uparrow integ not clearly erode partisan diff’s, maybe even \uparrow .
 - b) Clark’s reanalysis: suggests little difference to begin, & integration not Δ this;
 - c) & also indirect support for electoralist model over partisan model, perhaps.

B. Hibbsian Partisan Model & Prior Evidence

1. Fiscal & Monetary Policy Differences: Expected Left tendencies...
 - a) Tax Capital & More-Progressive Tax System;
 - b) Pro- Social-Welfare & Redistribution;
 - c) More Counter-cyclical & Expansionary Fiscal Policy;
 - d) Greater taxes, larger govt overall; less debt- & inflation-averse.

2. Partisan v. Downsian Perspectives:

- a) *Partisan*: either intrinsic pol pref's or survival depends on diff constituencies
- b) *Downsian*: must appeal median, regardless of partisan preferences:
- c) *Alesina & Rosenthal*: D=choose policies to win; P=try win to choose policies
- d) Clark: pithy, but D&P need not differ whether part goals diff, but rather whether electoral competition induces policy-actions converge**

3. Prev Empirical Work: Tax, Spend (esp. welfare), & overall fisc (deficit):

a) Tax Size (Revenue share of GDP):

- (1) Generally supportive cross-sectional or long-run partisan differences (Cameron '78; Hibbs '77; Wildavsky '74; Huber, Ragin, & Stephens '93; Hicks & Swank '01)
- (2) TSCS analyses more mixed—support or ambiguous—but stat problems or challenges
- (3) Clark: Cross-sect or LR part diff's not the issue here; Question is whether left-right change in govt, controlling for median, \Rightarrow policy Δ**
- (4) \Rightarrow **examine effect w/in-ctry partisan Δ better test, esp. if control median.**
- (5) **[ELAB: not much challenge view when/where voters want R/L, elect R/L, & then get R/L, but Q is whether govt control by R/L causes pol Δ]**

b) Tax Composition:

- (1) *Capital Tax*: No, evidence actually contrary: L less; R more
- (2) *Income Tax (& not Consumption)*: generally supportive to mixed/ambiguous

c) Spending:

- (1) Castles ('82): $L = \uparrow$ Gov Cons, PubEd, PubHealth; $R = \downarrow$ total spend, welfare, social transfers & subsidies, PubEd, PubHealth;
- (2) Gen'ly Supportive Cross-Sections/LR evidence since; TSCS mixed & often flawed
- (3) Some evidence that C-Dems different Secular Conserv, w/ C-Dems less anti-welfare.
- (4) Some evidence, beginning '80s, L *more* aggressive T-cut
 - (a) "Nixon to China"; Downsian "position jumping"; [or just more to cut where been L gov]
- (5) Iversen '97: not size spend, but R spend via direct transfers, L by G-Cons [*why?*]

d) Overall Fiscal Stance: i.e., Deficits & Debt:

- (1) Alesina & Perotti: not simple & straightforward: Deficits & Debt: $Ctr > L > R$; Probability(VeryTightPol): $L > C, R$; Prob("Successful Adjust"): $L, R > C$
- (2) Boix: $L \Rightarrow \uparrow D$ only in '73-'82 period [*Why?* Clark: CapMob & flex $\Rightarrow \downarrow$ fiscal effect, so need more; [problem w/ other parts arg.; other explanations?] [see also Franzese '02]
- (3) If control *fiscal institutions* (Clark & Hallerberg; Hahm et al.; Halerberg & von Hagen), hard to find any simple relation partisanship & deficits/debt.
- (4)[Cusack '99,'01: L/R not \uparrow/\downarrow debt, but L/R \uparrow/\downarrow activist, i.e., \uparrow/\downarrow Keynesian counter-cyclical (meaning respond more/less to macroecon conditions)]

4. [*Franzese's Summary* of previous results:

- a) *Tax*: fairly supportive overall T; 1/2 pro-, 1/2 anti- re: tax mix.
- b) *Spend*: mostly supportive both size & mix of spend, esp. mix, but some evidence L may be effective cutter in some circumstances.
- c) *Def&Debt*: very mixed, little support of anything simple re: L/R \Rightarrow D&D]

5. Social-Democratic/Corporatist Model:

- a) Left & Labor often closely tied & some versions partisan arguments emphasize their combination &/or interaction explicitly in shaping policies &/or outcomes

(1) E.g., Lab power via strike threat/activity; Left pub pol includes *soc wage*; LftLab \Rightarrow high Social-Wage/low Strike equilibrium;

(2) E.g., Lange & Garret '85 ff(et al.): **[DEF; EXPL:]** *Encompassing, Coordinated, Tri-Partite Bargaining interacts w/govt partisanship \Rightarrow macro policy & efficiency:*

(a) *Coord Barg* \Rightarrow Lab restraint, if credible reason believe some of benefit directed back to Lab; Left Govt provides such credible commitment: Lft+Lab \Rightarrow \uparrow MacroPolActive & \uparrow Efficiency

(b) *Highly Decentralized Bargain* \Rightarrow Lab restraint if expect non-expansionary policy: Right + weak Lab \Rightarrow \downarrow MacroPolActive & \uparrow Efficiency

(c) *Left government+Decentralized labor* \Rightarrow lack of restraint \Rightarrow \uparrow MacroPolActive, but \downarrow Efficiency

(d) *Right government+Centralized labor* \Rightarrow lack of restraint \Rightarrow \downarrow MacroPolActive, and \downarrow Efficiency

b) Evidence:

(1) That Union density or coordination [distinguish] \Rightarrow \uparrow SocWelfare, etc.: gen'y good

(2) That Left+Labor \Rightarrow fiscal or monetary as argued: more mixed at best.

6. Open-Economy Considerations:

a) *Embedded Liberalism*: \uparrow Trade exposure \Rightarrow \uparrow risk in small, concentrated economies \Rightarrow \uparrow (a pro-trade) Left & Labor & associated policies & outcomes

b) n.b., high Cap controls/CapImmob; as \uparrow *CapMob*, convergence arg's have 2 big negative implications for this *Postwar Settlement (Class Compromise) on KWS*:

(1) \uparrow competition for capital \Rightarrow Welfare State now less affordable

(2) \uparrow competition for capital \Rightarrow Keynesian activism now less effective

c) Evidence:

(1) Rodrik'97; Cusack'97; Hallerberg&Basinger'98: not much evidence convergence;

(2) H&S ('98,'01) some evidence *CapMob* & *FinLib* undermine Left-Labor eqbm

(3) Garrett: as *CapMob* \uparrow , gen'y *more* beneficial LftLab effect.

(4) *Clark*: Reconsider Cusack quickly, then Garrett thoroughly.

C. Reconsider Cusack ('97): Party v. Voter Position Effect on G-Spend

1. Estimate Model Like: $G = \gamma_0 + \gamma_1 P + \gamma_2 (P - V) + \varepsilon$

- a) P : measure of the left-to-right position of the current government
- b) V : some measure left-to-right position voters (vote-wtd avg of *parties* prev elect)

c) *Interpretation:*

(1) γ_1 = response of policy to govt partisanship (preferred policy), controlling for how far govt's preference is from electorates' preferences

(2) γ_2 = response of policy to distance govt's partisan prefs from voters' prefs

(a) $\gamma_1 < 0 \Rightarrow$ right parties prefer smaller G than left parties do

(b) $\gamma_2 > 0$ (assuming $\gamma_1 < 0$) \Rightarrow both parties moderate toward voter prefs

(c) if $\gamma_2 = -\gamma_1$, then parties fully moderate to voters' position

(3) *Easier Interpretation:*

(a) $dG/dP = \gamma_1 + \gamma_2$ = effect rt wrd gov Δ , controlling for, holding constant, net of voters' location

(b) $dG/dV = -\gamma_2$ = effect rt wrd voter Δ , controlling for, holding constant, net of govt location

2. Findings [Table 6]:

- a) $dG/dP \approx 0$: seems little effect govt partisanship, once net voter position [in fact, most estimates slightly > 0 —probably insignificant, but can't tell; might suggest some small *Nixon-to-China* effect: right must moderate (slightly) more than left to maintain its credibility w/ voters]

- b) $dG/dV < 0$: policy responds intuitively to left-right preferences voters
- c) $\gamma_1 < 0$: parties pref's clearly diverge, just not much effect net of voters' position
- d) *Summary*: seems primarily that Voter Preferences \Rightarrow Govt Partisanship \Rightarrow Partisan Policies; not much L/R *govt* effect controlling for voters' location.
- e) [*n.b.*: Voter pref measure entirely based on party location; smoother measure than P of that location, but lagged 1 yr; not clear how strongly should lean this distinction; likely hi corr'd]

TABLE 6. Relationship between Government Spending and Government Center of Gravity (γ_1) and the Difference between Government and the Electorate's Center of Gravity (γ_2)

	Full Sample		Subsample	
	γ_1	γ_2	γ_1	γ_2
Entire period	-.65 (.14)	.70 (.17)	-.62 (.16)	.60 (.17)
1955/1961-73	-.79 (.15)	.89 (.19)	-.72 (.16)	.78 (.19)
1974-79	-.67 (.15)	.71 (.19)	-.60 (.16)	.62 (.19)
1980-89	-.69 (.15)	.74 (.19)	-.64 (.16)	.56 (.19)

Source: Cusack 1997.

Note: Full sample includes Australia, but excludes all observations prior to 1961. Numbers in parentheses are standard errors, deduced from the *t*-scores reported by Cusack (1997). All parameters are significantly different from zero at the .01 level or better.

D. Reconsider Garrett ('98): Partisan Politics in the Global Economy

1. G's Arg:

- a) Left+Lab \Rightarrow pro- growth, employment, & redistribution [& less anti-inflation], by public-spending, deficit, tax, monetary, & redistributive policy.
- b) Globalization \Rightarrow \uparrow cap competition \Rightarrow \uparrow cost intervention; OR it \Rightarrow \uparrow economic dislocation \Rightarrow \uparrow demand intervention; OR both \Rightarrow empirical Q which dominant

2. G's Model & Measures: *[important implications of $\mathbf{a}_i + \mathbf{a}_t$]*

$$\text{a) } POL_{it} = \mathbf{a}_i + \mathbf{a}_t + \text{CONTROLS}_{it} + rPOL_{i,t-1} + b_1 LLP_{it} + b_2 Trade_{it} + b_3 CapMob_{it} + b_4 LLP_{it} * Trade_{it} + b_5 LLP_{it} * CapMob_{it} + e_{it}$$

$$\text{b) } \Rightarrow dPOL/dLLP = b_1 + b_4 Trade + b_5 CapMob$$

c) Measures:

- (1) LLP: Left Party Cab Share + stdzd lab-market organization encompassingness score
- (2) CapMob: # cross-border cap-mrkt restricts [n.b., 93% smpl ≤ 2]; Trade = $(X+M)/GDP$ [n.b., almost all smpl ≥ 30 , ≤ 120].
- (3) POL: 5 spend, 5 tax, 2 overall AD stance (fisc: deficits; mon: int rates)
 - (a) Spend: Total, Transfers, G-Consumpt, Industry Subs, Cap Spend
 - (b) Tax: Tot Rev, IncTax Rev, Consumpt Tax, Corp Tax, Employer SS Tax

3. Predictions of [Simple] Partisan Model (Tab 7); Results (Tab 8):

TABLE 7. Predictions of the Partisan Model

Indicator	Predicted Relationship with <i>Left-labor power</i>
Total spending	+
<i>Spending on</i>	
Income transfers	+
Civilian government consumption	+
Subsidies to industry	+
Capital expenditures	+
Total revenues	+
<i>Revenues from</i>	
Personal income tax	+
Consumption taxes	-
Corporate income taxes	+
Employer contributions to social security	+
Macroeconomic policy	
Budget deficits	+
Interest rates	-

TABLE 8. The Estimated Effect of *Left-labor power* on Government Spending Conditioned upon the Degree of Trade and Capital-Market Openness

	Total Spending (1)		Income Transfers (2)		Civilian Government Consumption (3)		Subsidies to Industry (4)		Capital Spending (5)	
	<i>Cm</i> = <i>Cmg</i>	<i>Cm</i> = <i>Cml</i>	<i>Cm</i> = <i>Cmg</i>	<i>Cm</i> = <i>Cml</i>	<i>Cm</i> = <i>Cmg</i>	<i>Cm</i> = <i>Cml</i>	<i>Cm</i> = <i>Cmg</i>	<i>Cm</i> = <i>Cml</i>	<i>Cm</i> = <i>Cmg</i>	<i>Cm</i> = <i>Cml</i>
	(a)	(b)	(a)	(b)	(a)	(b)	(a)	(b)	(a)	(b)
<i>Left-labor power (Llp)</i>	0.082 (0.192)	-0.829*** (0.252)	0.068 (0.089)	-0.197** (0.106)	0.134* (0.097)	-0.168* (0.120)	-0.096** (0.051)	-0.156** (0.070)	0.081 (0.129)	0.038 (0.155)
<i>Trade</i>	-0.043* (0.024)	-0.043* (0.024)	-0.008 (0.011)	-0.008 (0.011)	-0.016* (0.009)	-0.016* (0.009)	-0.008 (0.007)	-0.008 (0.007)	-0.016 (0.012)	-0.016 (0.012)
<i>Capital mobility (Cm)</i>	-0.885*** (0.298)	-0.885*** (0.298)	-0.193 (0.151)	-0.193 (0.151)	-0.382** (0.155)	-0.382** (0.155)	-0.067 (0.083)	-0.067 (0.083)	-0.044 (0.181)	-0.044 (0.181)
<i>Trade · Llp</i>	0.008** (0.004)	0.008** (0.004)	0.001 (0.002)	0.001 (0.002)	0.001 (0.001)	0.001 (0.001)	0.003*** (0.001)	0.003*** (0.001)	0.000 (0.002)	0.000 (0.002)
<i>Cm · Llp</i>	0.228*** (0.058)	0.228*** (0.058)	0.066*** (0.028)	0.066*** (0.028)	0.075*** (0.028)	0.075*** (0.028)	0.015 (0.016)	0.015 (0.016)	0.011 (0.036)	0.011 (0.036)
Lagged dependent variable	0.806*** (0.025)	0.806*** (0.025)	0.859*** (0.030)	0.859*** (0.030)	0.860*** (0.026)	0.860*** (0.026)	0.785*** (0.040)	0.785*** (0.040)	0.709*** (0.052)	0.709*** (0.052)
<i>GDP growth</i>	-0.399*** (0.029)	-0.399*** (0.029)	-0.168*** (0.016)	-0.168*** (0.016)	-0.138*** (0.012)	-0.138*** (0.012)	-0.014* (0.007)	-0.014* (0.007)	-0.052*** (0.016)	-0.052*** (0.016)
<i>Unemployment</i>	0.086* (0.045)	0.086* (0.045)	0.068*** (0.019)	0.068*** (0.019)	0.008 (0.019)	0.008 (0.019)	-0.022* (0.012)	-0.022* (0.012)	-0.038* (0.022)	-0.038* (0.022)
<i>Old-age population</i>	0.241** (0.106)	0.241** (0.106)	0.134** (0.055)	0.134** (0.055)	0.006 (0.056)	0.006 (0.056)	-0.017 (0.025)	-0.017 (0.025)	-0.064 (0.055)	-0.064 (0.055)
Constant	5.291*** (1.651)	8.833** (1.744)	-0.141 (0.858)	0.630 (0.907)	1.972*** (0.751)	3.502*** (0.773)	0.642* (0.376)	0.909** (0.378)	1.873** (0.885)	2.047** (0.861)
F_{DW}	0.60	0.60	1.31	1.31	0.65	0.65	0.65	0.65	7.49	7.49
Prob. > F	0.661	0.661	0.267	0.267	0.629	0.629	0.629	0.629	0.112	0.112
Observations	350	350	350	350	350	350	350	350	350	350
Number of countries	14	14	14	14	14	14	14	14	14	14

Note: Columns 1a–5a use Garrett’s coding for the capital-mobility measure; columns 1b–5b use transformed capital-mobility measure.

Panel-corrected standard errors are in parentheses.

The term F_{DW} is the test statistic for Durbin-Watson’s m .

* $p < .10$, ** $p < .05$, *** $p < .01$, one-tailed test for variables involving *Llp*, two-tailed otherwise.

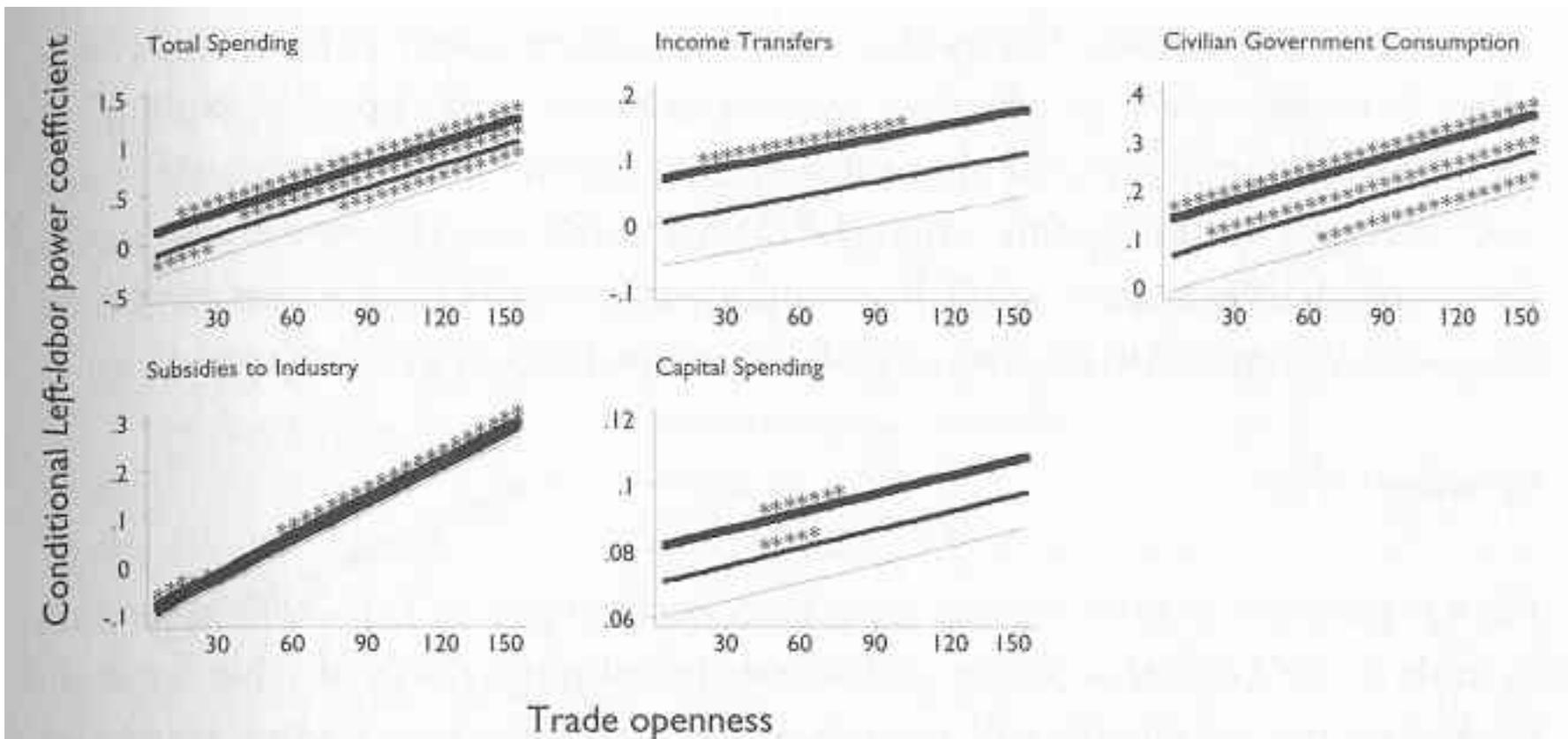


Fig. 5. The estimated effect of *Left-labor power* on government spending at various levels of trade and capital-market openness. Darker lines denote increased capital-market liberalization. (Note: * indicates coefficient is significant at $p < .10$, one-tailed.)

a) Spend:

(1) Esp. recalling that $Trade > 30$, this remarkably GOOD for G's arg.

(2) Least strong Transfers & Capital Spending, but results basically Partisan as expect (mostly signifly so as **) & \uparrow in both $CapMob$ & $Trade$ (mostly signifly so), as expect.

b) Tax:

(1) Considerably more mixed, less significant, & less good for G's arg.

(2) Perhaps some partisanship in *Total Tax* as expected, but differences ↓ in *Trade* (convergence) while ↑ *CapMob* as G argues.

(3) Income Tax ↑ in LLP, but significant only in mostly non-sample value-ranges, & convergence in *Trade* (significant) and *CapMob* (insignificant) here.

(4) Consumption Tax & Corporate Tax: find opposite naive partisan story, find divergence & convergence respectively, but insignificantly so in both cases

(5) Employer Social-Security contributions mostly partisan as expected but not significant & these converge (significantly).

(6) ⇒ Simple partisan tax-level & tax-instrument stories not well supported except for *Total Tax*, but some evidence of convergence.

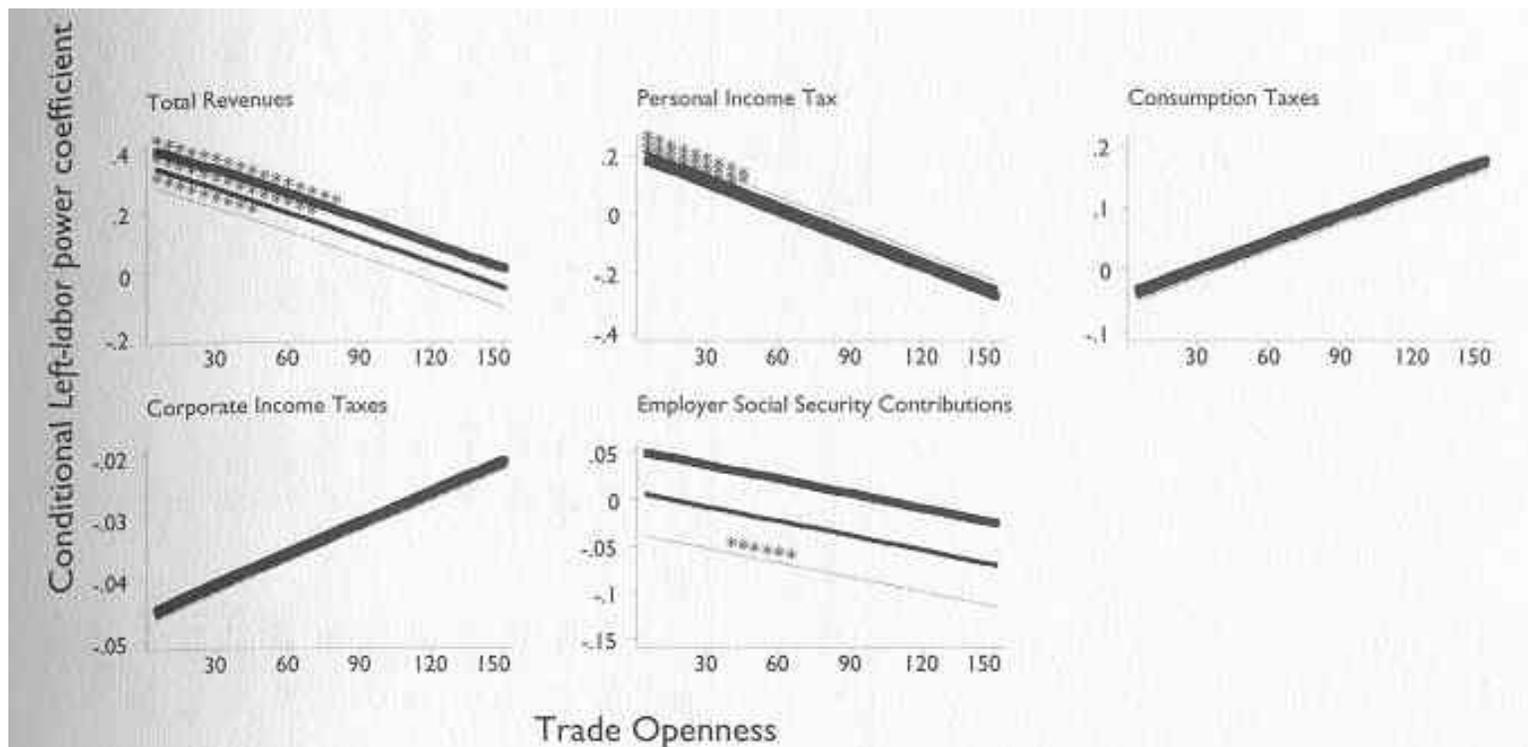


Fig. 6. The estimated effect of *Left-labor power* on government revenues at various levels of trade and capital-market openness. Darker lines denote increased capital-market liberalization. (Note: * indicates coefficient is significant at $p < .10$, one-tailed.)

c) *Overall AD Policy Stance: Def & IntRates (real 1-yr G-Bonds)*

(1)G's IntRate model problematic: controls inflation (badly endog.), & US IntRate (\Rightarrow spatial dynamics & further endog.), ***CBI (supposed to dampen partisan policies, not just an additive control)***

(2)Policy instrument is ***nominal*** interest rates; hard to back out of equation.

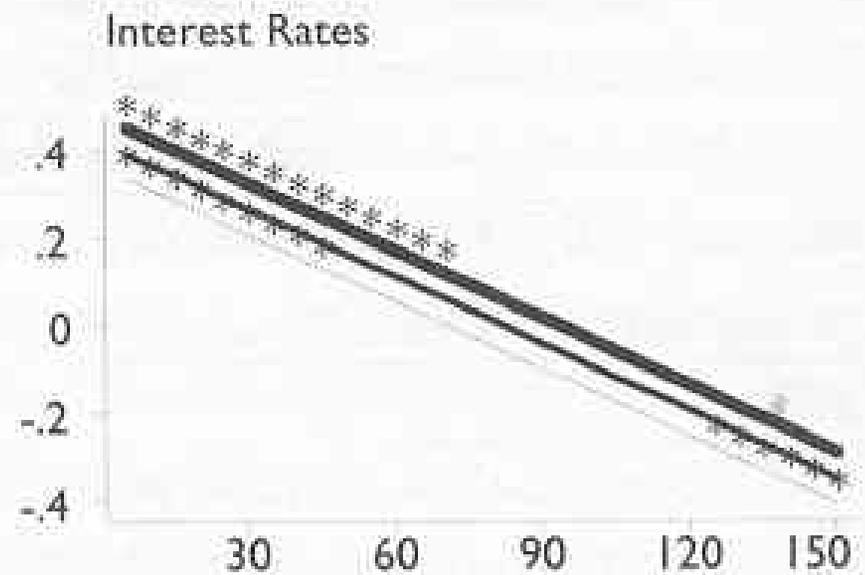
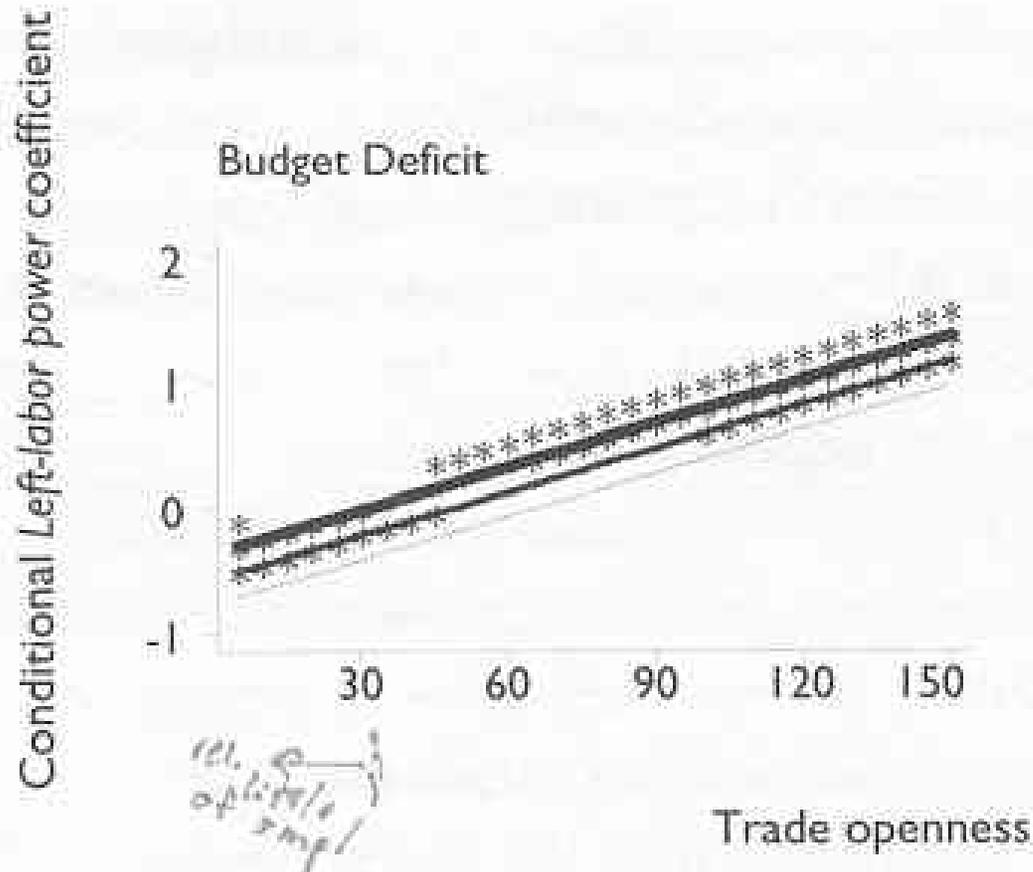


Fig. 7. The estimated effect of *Left-labor power* on macroeconomic policy at various levels of trade and capital-market openness. Darker lines denote increased capital-market liberalization. (Note: * indicates coefficient is significant at $p < .10$, one-tailed.)

d) Conclusions: pretty good for partisan policy & for Garrett on fiscal policy; perhaps some signs convergence on monetary policy, but convergence responding trade-open, not cap-mob [which odd].

e) CLARK: *Reconsider Spend, Tax, & AD Pol, conditional also upon Exchange-rate regime:*

$$(1) \text{ Model: } POL_{it} = \mathbf{a}_i + \mathbf{a}_t + C_{it} + rPOL_{i,t-1} + b_1 LLP_{it} + b_2 CapMob_{it} + b_3 Flex_{it} + b_4 LLP_{it} * CM_{it} + b_5 LLP_{it} * Flex_{it} + b_6 CM_{it} * Flex_{it} + b_7 CM_{it} * Flex_{it} * LLP_{it} + e_{it}$$

$$(2) \Rightarrow dPOL/dLLP = b_1 + b_4 CM + b_5 Flex + b_7 CM_{it} * Flex_{it}$$

E. ELABORATION: All of Clark's empirical models some version of this:

$$\begin{aligned} E(Policy) = & \beta_0 + CONTROLS + \beta_1 CapMob + \beta_2 Fix + \beta_3 CBI + \beta_4 EP \\ & + \beta_5 CapMob \times EP + \beta_6 Fix \times EP + \beta_7 CBI \times EP \\ & + \beta_8 CapMob \times Fix + \beta_9 CapMob \times CBI + \beta_{10} Fix \times CBI \\ & + \beta_{11} CapMob \times Fix \times EP + \beta_{12} CapMob \times CBI \times EP + \beta_{13} Fix \times CBI \times EP \\ & + \beta_{14} CapMob \times Fix \times CBI + \beta_{15} CapMob \times Fix \times CBI \times EP \end{aligned}$$

Where EP is either an electoral indicator or a govt-partisanship indicator, and Policy is a fiscal or a monetary policy.

F. Models: Interpretation

1. In these models, the effects of Partisanship (i.e., size of partisan cycles), or the effects of an Election year (i.e., the size of partisan cycles) are given by the combination of CapMob, Exchange-Regime, and CBI conditions according to:

$$\begin{aligned} \frac{\partial E(Policy)}{\partial EP} = & +\beta_4 + \beta_5 CapMob + \beta_6 Fix + \beta_7 CBI \\ & + \beta_{11} CapMob \times Fix + \beta_{12} CapMob \times CBI + \beta_{13} Fix \times CBI \\ & + \beta_{15} CapMob \times Fix \times CBI \end{aligned}$$

2. So, for example, monetary cycles (electoral or partisan) are supposed to be impossible under capital mobility and fixed exchange-rates, so we expect the effects of EP to be zero when CapMob and Fix are both 1. CBI is irrelevant under these conditions. That is:

$$\left. \frac{\partial E(MonPol)}{\partial EP} \right|_{CapMob=Fix=1} = +\beta_4 + \beta_5 + \beta_6 + \beta_{11} + (\beta_7 + \beta_{12} + \beta_{13} + \beta_{15})CBI = 0$$

$$\Rightarrow +\beta_4 + \beta_5 + \beta_6 + \beta_{11} = \beta_7 + \beta_{12} + \beta_{13} + \beta_{15} = 0$$

3. Another example: monetary cycles (electoral or partisan) are supposed to occur (i.e., be non-zero, namely positive) under capital mobility and flexible exchange-rates, i.e., when CapMob=1 and Fix=0, but only if CBI=0 and not if CBI=1. So:

$$\left. \frac{\partial E(MonPol)}{\partial EP} \right|_{CapMob=1;Fix=0;CBI=1} = +\beta_4 + \beta_5 + \beta_7 + \beta_{12} = 0$$

$$\left. \frac{\partial E(MonPol)}{\partial EP} \right|_{CapMob=1;Fix=0;CBI=0} = +\beta_4 + \beta_5 > 0$$

$$\Rightarrow +\beta_4 + \beta_5 = -(\beta_7 + \beta_{12})$$

And so on...

a) *OK, back to Clark's Reconsider Spend, Tax, & AD Pol, conditional upon CBI, CapMob, and Exchange-Regime:*

$$(1) \text{ Model: } POL_{it} = a_i + a_t + C_{it} + rPOL_{i,t-1} + b_1 LLP_{it} + b_2 CapMob_{it} + b_3 Flex_{it} + b_4 LLP_{it} * CM_{it} + b_5 LLP_{it} * Flex_{it} + b_6 CM_{it} * Flex_{it} + b_7 CM_{it} * Flex_{it} * LLP_{it} + e_{it}$$

$$(2) \Rightarrow dPOL/dLLP = b_1 + b_4 CM + b_5 Flex + b_7 CM_{it} * Flex_{it}$$

(3) *Simple Convergence Story* $\Rightarrow b_4$ & $b_4 + b_7$ opposite sign as b_1

(4) Clark/Mundell-Fleming:

(a) **fiscal convergence under flex, not fix $\Rightarrow b_4 + b_7$ opp. sign b_1 , but not b_4**

(b) **[mon convergence under fix, not flex $\Rightarrow b_4$ opp sign b_1 , but not $b_4 + b_7$]**

(c) **[n.b., M-F logic may not apply solely to G or to T, but jointly to AD]**

(d) **[n.b., ignoring CBI complication for now]**

(e) **[n.b., recall the sample range mostly $CM \leq 2$]**

(5) Conclusions [see results 2 slides down]: Largely similar to before...

(a) **Cleanest results on Spending side, where looks Garrett-like, little difference by Exchange-Rate Regime, although *Individual Subsidies* insignificant & *Capital Spending* odd (& insignificant)**

(b) **Tax results mixed to counter the naïve partisan story; only *TotRev* remotely supports simple partisan story & only at high mobility; simple partisan story on *CapTax* and *EmpSS* looks increasingly wrong, only last shows any difference by exchange-rate regime.**

(c) ***Budget Deficit & Interest Rate* give some support partisan+M-F story**

4. Conclusion [Franzese's]:

a) Points where agree w/Clark:

- (1) Evidence of large partisan diff's macroec policy not overwhelming.**
- (2) Simple partisan tax story finds very little support in evidence.**
- (3) Simple partisan converge or diverge stories also at best mixed support.**
- (4) Fisc. & mon. (AD) policies seem conditional on combo *CapMob&E.R.***
- (5) Electoral cycle evidence [to come] more cleanly supports Clark/M-F.**

b) Points Clark may overstate:

- (1) Partisan differences in spending & responses to globalization seem largely as G argued, & largely unconditional on exchange-rate regime.**
- (2) Partisan differences Capital/Employ Tax may actually be significantly opposite simple partisan story, Garrett, & Clark—not just a null result: needs explanation.**
- (3) Signs of Clark/M-F partisan cycles in Deficits & Interest Rates better than the text credits; but *CapMob* constrains MonPol *even in Flex*, just more so w/ *Fix*.**

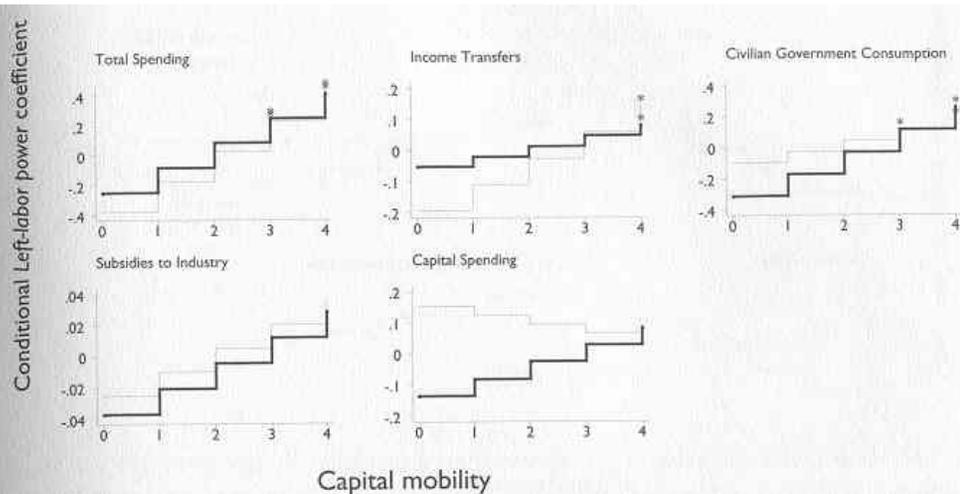


Fig. 8. The estimated effect of *Left-labor power* on government spending under various degrees of capital-market openness and alternative exchange rate regimes. Darker lines denote flexible exchange rate. (Note: * indicates coefficient is significant at $p < .10$, one-tailed.)

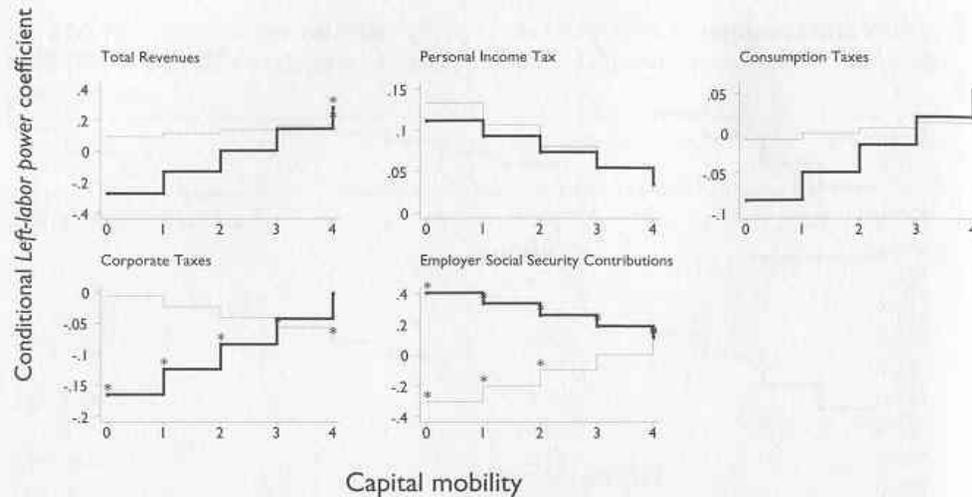


Fig. 9. The estimated effect of *Left-labor power* on government revenues under various degrees of capital-market openness and alternative exchange rate regimes. Darker lines denote flexible exchange rate. (Note: * indicates coefficient is significant at $p < .10$, one-tailed.)

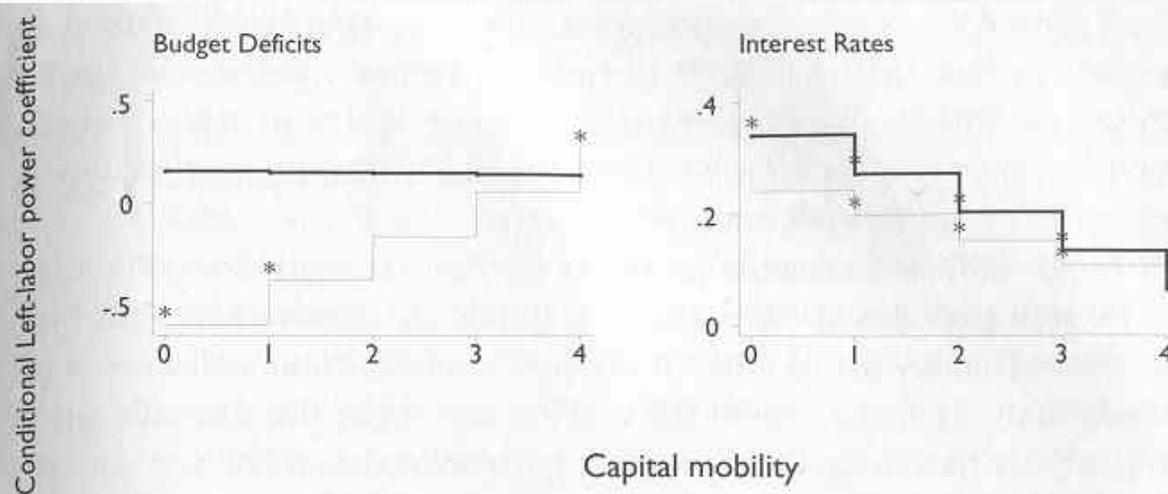


Fig. 10. The estimated effect of *Left-labor power* on macroeconomic policy under various degrees of capital-market openness and alternative exchange rate regimes. Darker lines denote flexible exchange rate. (Note: * indicates coefficient is significant at $p < .10$,

VI. *Elections and Fiscal & Monetary Policy (Ch. 4)*

A. Intro/Motivation:

1. If not [so much] partisan, then electoral?
2. Again, prev. lit ambig., can considering CapMob, ER, CBI \Rightarrow sense?
3. Clark et al.'s previous work:
 - a) CBI constrains electoral cycles; CapMob & Fix also constrains
 - b) Leaves questions:
 - (1) Fiscal policy not necessarily constrained by these conditions;
 - (2) CBI constrain monetary cycles when *CapImmob*, or *CapMob&Flex*, but should not be able to do so when *CapMob&Fix* (beyond effect of that mobility & peg).
4. \Rightarrow Reconsider w/ this fuller story: [n.b., some Δ s from partisan chpt:]
 - a) [Database: 1973-89 quarterly for monetary, 1981-92 annually for fiscal]
 - b) [CBI not considered in partisan case; considered here.]
 - c) [Evaluation only *CapMob*, post-BW, post-OPEC, & largely assume constant]
 - d) [Monetary instrument more appropriately $d(M1)$]
 - e) [No time-period dummies in monetary-policy models]
 - f) [*Partisan* tests combined Left+Lab; *Electoral* tests unadulterated Left.]

B. Electoral Policy-Cycle Hypotheses

TABLE 14. Electorally Induced Cycles in Macroeconomic Policy Instruments under Various Structural Conditions

	No Central Bank Independence	Central Bank Independence
Capital mobility and fixed exchange rates	Fiscal cycles; no monetary cycles	Fiscal cycles; no monetary cycles
Capital mobility and flexible exchange rates	Monetary cycles; no fiscal cycles	No fiscal or monetary cycles

C. Electoral Cycles in Monetary Policy:

$$1. \quad \text{Model: } m_{it} = \mathbf{b}_1 + \sum \mathbf{b}_j m_{it-j} + e_{it} \\ + b_1 E + b_2 \text{CBI} + b_3 \text{Fix} + b_4 E * \text{CBI} + b_5 E * \text{Fix} + b_6 \text{CBI} * \text{Fix} + b_7 E * \text{CBI} * \text{Fix}$$

$$2. \Rightarrow dm/dE = b_1 + b_4 \text{CBI} + b_5 \text{Fix} + b_7 \text{CBI} * \text{Fix} \quad [\text{for dum-var model, } \Rightarrow]$$

$$a) \quad dm/dE \Big|_{\text{CBI}=\text{Fix}=0} = b_1$$

$$b) \quad dm/dE \Big|_{\text{CBI}=\text{Fix}=1} = b_1 + b_4 + b_5 + b_7$$

$$c) \quad dm/dE \Big|_{\text{CBI}=1; \text{Fix}=0} = b_1 + b_4$$

$$d) \quad dm/dE \Big|_{\text{CBI}=0; \text{Fix}=1} = b_1 + b_5$$

e) Only 1st should be distinguishable from 0 [$\Rightarrow b_4, b_5 \approx -b_1; b_7 \approx b_1$]

3. Results (Table 16):

- a) Gen'y as expect: CBI & *Fix* each gen'y constrain, but some possibility *Fix* | CBI actually allows.
- b) [n.b., stat'y insig'y diff from 0 & =0 very diff. things] Fig 11: continuous CBI \Rightarrow sim., slightly less clean

TABLE 16. Conditional Effects of Elections on Monetary Policy

Central Bank Independence	Exchange Rates	
	Flexible	Fixed
	Calculated from column 1 in table 15	
High	-0.118 (.429)	0.866 (.655)
Low	1.071** (0.499)	0.859** (0.413)
	Calculated from column 3 in table 15	
High	-0.202 (0.540)	0.159 (0.922)
Low	1.56** (0.725)	0.533 (0.553)

Note: The coefficients are conditional coefficients with conditional standard errors in parentheses.

* $p < .10$, ** $p < .05$, one-tailed test.

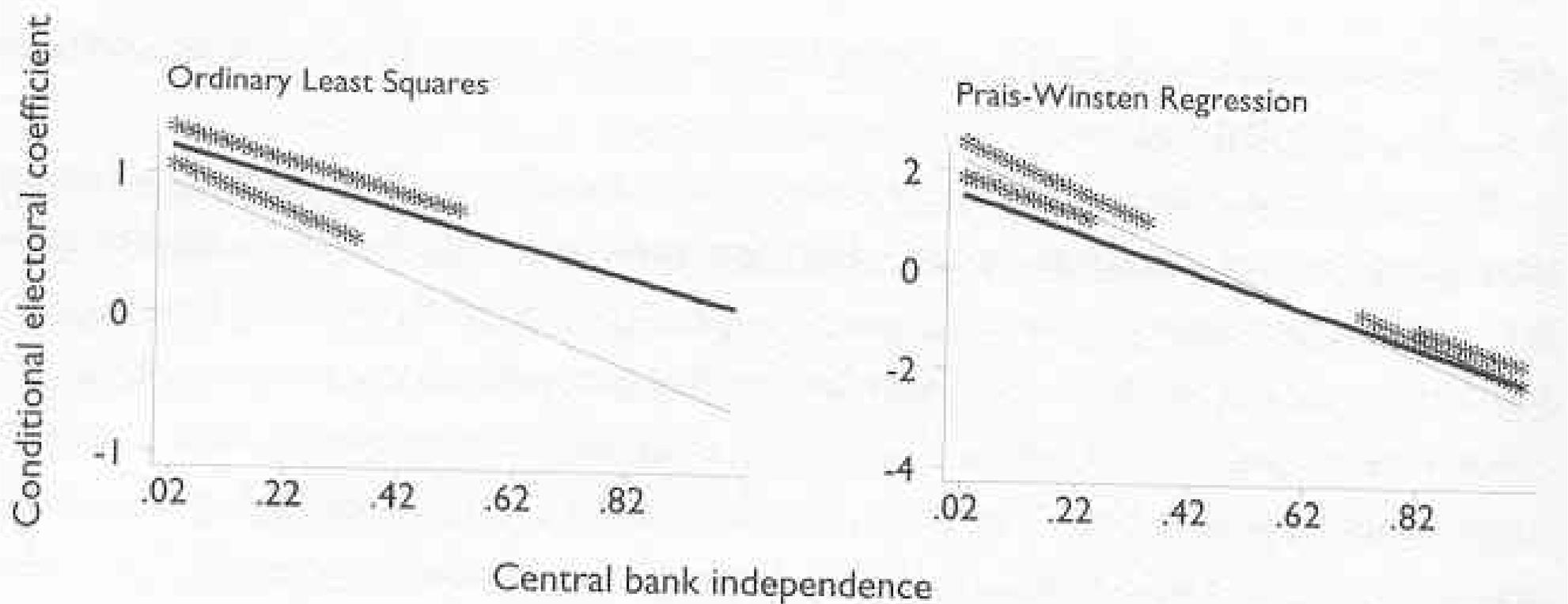


Fig. 11. The estimated effect of an election on the money supply under fixed and flexible exchange rates and various degrees of central bank independence. Darker lines denote fixed exchange rate. (Note: * indicates coefficient is significant at $p < .10$, one-tailed.)

D. Electoral Cycles in Fiscal Policy

1. *Model A*: $dD = \mathbf{a}_1 + b_4 dD_{t-1} + b_5 dU + b_6 D_{t-1} (r - y) + b_7 \text{GovType} + b_1 E + b_2 \text{Flex} + b_3 E * \text{Flex} + e$

2. *Model B*:

$$dD = \mathbf{a}_1 + b_8 dD_{t-1} + b_9 dU + b_{10} D_{t-1} (r - y) + b_{11} \text{GovType} + b_1 E + b_2 \text{CM} + b_3 \text{Flex} + b_4 E * \text{CM} + b_5 E * \text{Flex} + b_6 \text{CM} * \text{Flex} + b_7 E * \text{CM} * \text{Flex} + e$$

3. *Model A* $\Rightarrow d(dD) / dE = b_1 + b_3 \text{Flex}$; hyp: $b_1 > 0, b_3 \approx -b_1$

4. *Model B* $\Rightarrow d(dD) / dE = b_1 + b_4 \text{CM} + b_5 \text{Flex} + b_7 \text{CM} * \text{Flex}$; [Hyp: $b_1 > 0, b_7 < 0, b_4 \geq 0, b_5 \approx 0$; Clark not explicitly state]

5. **Results (T17, F12)**: Esp. if use reasonably accurate measure E, quite nicely supportive of Clark/M-F electoral budget cycles.

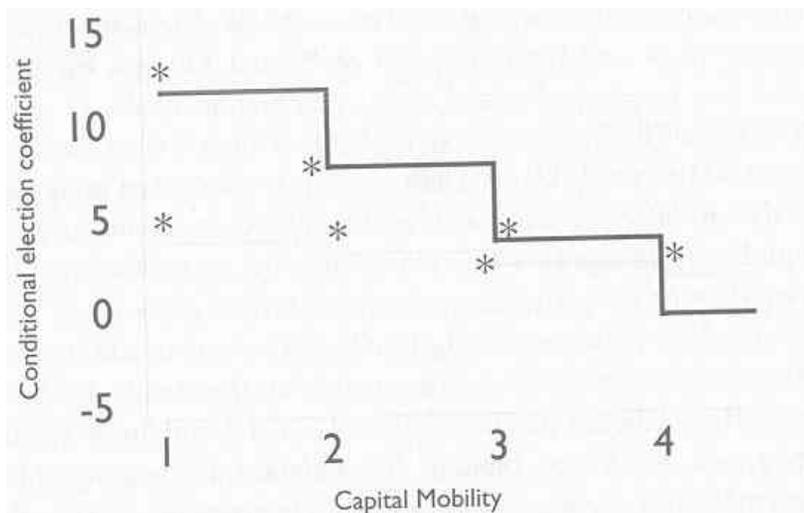


Fig. 12. The estimated effect of an election on government debt under fixed and flexible exchange rates and various degrees of capital-market openness. Darker line denotes flexible exchange rate. (Note: * indicates coefficient is significant at $p < .10$, one-tailed.)

TABLE 17. The Conditional Effects of Elections on Changes in Gross Debt in the Period 1982–92

	Coding of Elections		
	Standard (1)	Franzese (2)	Franzese (3)
<i>Election</i>	0.49 (0.60)	1.52** (0.75)	4.239 (3.341)
<i>Capital mobility</i>			0.549* (0.292)
<i>Flexible</i>	-0.20 (0.60)	0.14 (0.64)	-0.420 (3.839)
<i>Election · Flexible</i>	-0.26 (1.18)	-1.42 (1.25)	-0.742 (0.855)
<i>Election · Capital mobility</i>			11.320 (8.681)*
<i>Capital mobility · Flexible</i>			0.000 (0.972)
<i>Election · Capital mobility · Flexible</i>			-3.342* (2.253)
<i>d Debt_{t-1}</i>	0.47*** (0.10)	0.48*** (0.10)	0.442** (0.109)
<i>d Unemployment</i>	1.27*** (0.22)	1.27*** (0.22)	1.212** (0.216)
<i>d GDP</i>			
<i>d Debt costs</i>	0.38** (0.15)	0.39*** (0.14)	0.389** (0.142)
<i>Government type</i>	-0.17 (0.24)	-0.16 (0.25)	-0.257 (0.256)
Intercept	0.67 (0.59)	0.35 (0.63)	-1.098 (1.302)
Conditional coefficients			
<i>Election Flexible = 0</i>	0.49 (0.60)	1.52* (0.75)	
<i>Election Flexible = 1</i>	0.22 (0.85)	0.10 (0.98)	
<i>F_{DW}</i>	0.57	0.57	0.06
Prob. > <i>F</i>	0.66	0.69	0.99
Observations	206	206	206
Number of countries	19	19	19

Note: The dependent variable is the change in the gross-debt-to-GDP ratio. Following de Haan and Sturm, I do not include country dummy variables, although their inclusion does not affect the qualitative results. Note that the political variables (election, the three variables for the type of government, strong finance ministers, and negotiated targets) are evaluated according to a one-tailed test.

The term F_{DW} is the test statistic for Durbin-Watson's m .

* $p < .10$, ** $p < .05$, *** $p < .01$.

E. Implications:

1. European Economic & Monetary Union

a) Concerns about fiscal excess:

(1) *Fixed E.R.* (1 currency now) & *CapMob* \Rightarrow fiscal-policy dominant (although ECB in Frankfurt may not monetary reinforce fiscal or to same degree as had domestic CB).

(2) *Moral Hazard / Common Pool:*

(a) if govts believe EU bailout, then \uparrow incentive to borrow (deficit).

(b) each individual country only a portion of the solvency of Euro \Rightarrow common pool \Rightarrow “over-fishing” that common resource, in this case, borrowing.

b) EU Moves to Limit these Problems:

(1) *Maastricht Treaty* explicitly banned EU bailout member states;

(2) *Stability & Growth Pact* procedures monitor & punish excess deficits.

c) Whether work [enforce so far difficult], clearly not affect Electoral bdtg-cycles: timing of EU censure & action allows plenty room for domestic Electoral cycles.

(1) *Alternatives:* negotiated bdtg trgt or delegate to strong finance min (H&vonH).

(2) *Federal systems:* signs financial mrkts, *via* debt-interest premia, can induce states to self-regulate by anti-deficit &/or other tight rules in bdtg legislation (Poterba *et al*)

2. *Policy-Tool Choice*: Given *CapMob* [& *CBI*], *E.R.* choice to opt macro pols

3. *Mon-Insts Choice*: Given *CapMob* [& *ER*], *CBI* choice [should be joint]

a) If *Flex*, $\uparrow CBI \Rightarrow \downarrow$ policy efficacy & autonomy [b/c only fiscal left & it ineffect]

b) If *Fix*, $\uparrow CBI \Rightarrow$ no loss autonomy or efficacy [b/c only fiscal effective & mon dedicated to *Fix* either way]

c) [If *CBI*, $\uparrow Fix \Rightarrow$ no loss autonomy [b/c CB had monetary anyway], maybe **gain** efficacy [b/c only fiscal effective & now CB can't move to counter]

d) [If *CBI*, $\uparrow Flex \Rightarrow$ **lose** fiscal efficacy, & **no gain** monetary autonomy b/c CB has that either way.]

F. A couple of final thoughts:

1. Why, if fiscal cycles under *Fix+CBI* (& *CapMob*), & fiscal policy should be effective find no outcome cycles under these conditions?

a) Monetary blunt, macro instrument; Fiscal better suited to targeting; so these not macro demand-management cycles, but cycles targeted policy.

b) [This doesn't really work w/in the M-F macro logic, though]

2. [Fiscal is better target though; n.b., partisan evidence too on fisc.]