THE POLITICAL ECONOMY OF REDISTRIBUTION AND EFFICIENCY

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≠LACIR



LACIR is an independent scholarly endeavour created with the aim of understanding why, despite major structural economic and social change, inequality in Latin America and the Caribbean persists at exceptionally high levels.

The review will focus on inequality along various dimensions, including income, wealth, education, health, and political power.

THEMES

We study inequality in the region through five broad themes:



VIEW THEME ONE

playing field

VIEW THEME FOUR



Levels and trends of inequality Inequality of opportunity

Establishing the facts about levels and trends of inequality in outcomes

Taxation and redistribution

Considering the limited role that fiscal

redistribution plays in the region to level the

Analyzing the role of the family and communities in shaping inequality in outcomes and intergenerational mobility

VIEW THEME TWO



Examining how inequality shapes political voice, political representation, social unrest and political outcomes

VIEW THEME FIVE



We hope that understanding the nature, causes and consequences of Latin America's stable high-inequality equilibrium may provide a basis for action intended to make the region more equitable.

Inequality and markets

markets for labor, capital and goods

Studying the link between inequality and







A good characterization for some countries



A good characterization for some countries

But not for others

Government size and redistribution in "Latin America"



Source: Izquierdo et al. (2018). Source in the original: Author's calculation based on OECD National Accounts, FMM Spending database, IMF-WEO and (Pessino et al, 2018). Note in the original: Spending data follows the concepts of Government Finance Statistic Manual GFSM. 'Wage Bill' refers to all compensation in cash or in kind in return for work, called Compensation of Employees in GFSM. 'Goods and Sen the Use of Goods and Sevices in the GFSM.'Capital Expenditure' includes Capital Transfers plus Investment. 'Transfers' is defined as Social Benefits plus Subsidies and Grants. 'Other' is defined as Other current expenditure. Belize, Barbado Suriname, The Bahamas and Trinidad and Tobago refers to Central Government spending and Haiti refers to Non-Financial Public Sector. Only data for Total Spending for Haiti, Jamaica and Suriname and they are not included in LAC averag Mexico and Chile not included in OECD average.

Government size and redistribution in "Latin America"



Note: Countries are ranked by total social spending (direct transfers, education, health and other social spending) plus contributory pensions. Calculations are made using the latest available data for each country in the source. Source: Commitment to Equity Institute.



A good characterization for some countries

But not for others

We suggest a more general political economy approach which allows to understand different cases





Populism



Populism

Low growth Low productivity Insufficient savings and investment Low quality of public policies



POLITICAL ECONOMY EQUILIBRIA Different countries in different equilibria

What we do in this paper

- 1. Characterize the *fiscal vector* of Latin American countries
- 2. Review two branches of political economy that attempt to explain different outcomes anchored on different syndromes
- 3. Propose a simplified, yet more general, framework that might explain different configurations of countries as <u>outcomes of different political</u> <u>economy equilibria</u>

Section 1. The fiscal vector

- How large the State is (taxation and/or spending)
- How much they redistribute
- How well do they do it
 - Microeconomic effectiveness
 - [Macroeconomic sustainability]
 - Do interventions change lives of the poor in the long run?







TAX	REDISTRIBUTION	EFFICIENCY	
LOW	LOW	LOW	"Guatemala"
LOW	LOW	HIGH	"Chile"
HIGH	HIGH	LOW	"Argentina"
HIGH	HIGH	HIGH	"Sweden"

SECTION 2: The Political Economy of Redistribution <u>and</u> The Political Economy of Efficiency

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2a. The Political Economy of Redistribution (or lack thereof)

• Size of government / redistribution

□ Meltzer – Richards model

Meltzer, A. H. and S. F. Richard (1981). A rational theory of the size of government. *Journal of Political Economy* 89(5), 914–927.

Tax and Redistribute Income heterogeneity Median voter result More unequal income distribution → higher taxes and more redistribution (democratization)

EMPIRICAL RESULTS: mixed

Deviations from Meltzer-Richards (MV plus):

• Could be grouped sociologically:

(equivalent to raising assumptions of the basic MR model in various dimensions)

✓ <u>The poor</u> do not demand enough redistribution

- Info
- Preferences
 - Other dimensions like race religion that distract
- Lack of cohesion
- Political Institutions Federalism

✓ <u>Middle Class</u> (raise assumption of flat redistribution)

• Could form a coalition with either

□ the poor: high taxation – high redistribution

□ the rich: low taxation - TRUNCATED WELFARE STATES

✓ <u>Rich / Elite / Bus</u>

CONOMIC ORIGINS OF DICTATORSHIP AND DEMOCRACY

Elite capture (Acemoglu Robinson)

- Democratization
- Basic model within democracy (MR) would predict high redistribution
- But... The Rich can invest in *de facto* political power in democracy
- In this MV+ model, the distributive effects of democratization might be quite meager.
- "Latin America" seems to fit the mold



2b. The Political Economy of (IN)EFFICIENCY

- Acemoglu 2003 Why Not a Political Coase Theorem?
- Acemoglu, Egorov, and Sonin 2013 A Political Theory of Populism
- Acemoglu and Robinson 2001 Inefficient Redistribution
- Acemoglu, Robinson, and Torvick 2013 Why Do Voters Dismantle Checks and Balances?
- Alesina 1988 Credibility and Policy Convergence in a Two-Party System with Rational Voters
- Becker and Mulligan 2003 Deadweight Costs and the Size of Government
- Besley and Coate 1998 Sources of Inefficiency in a Representative Democracy: A Dynamic Analysis
- Coate and Morris 1995 On the Form of Transfers to Special Interests
- Caruso, Scartascini, and Tommasi 2015 Are We All Playing the Same Game? The Economic Effects of Constitutions Depend on the Degree of Institutionalization
- Dixit and Londregan 1995 Redistributive Politics and Economic Efficiency
- Dixit 1996 The Making of Economic Policy: A Transaction-Cost Politics Perspective
- Drazen and Limao 2008 A Bargaining Theory of Inefficient Redistribution Policies
- Keefer, Scartascini, and Vlaicu 2022 Trust, Populism, and the Quality of Government
- Robinson and Verdier 2013 The Political Economy of Clientelism
- Rodrik 2018 Is Populism Necessarily Bad Economics
- Scartascini, Stein, and Mariano Tommasi 2013 Political Institutions, Intertemporal Cooperation, and the Quality of Public Policies
- Scartascini and Tommasi 2012 The Making of Policy: Institutionalized or Not?
- Spiller and Tommasi 2007 A Theory of Intertemporal Political Cooperation

UNDERLYING DISTORTION	Paper or book
	Acemoglu 2003
	Acemoglu Robinson 2001
TIME INCONSISTENCY	Dixit Londregan 1995
	Dixit 1996
	Robinson Verdier, 2013
IMPERFECT INFORMATION	Coate and Morris 1995
Non-cooperation in	Alesina 1988
REPEATED GAME	Spiller and Tommasi 2007
Lack of	Scartascini and Tommasi 2012
INSTITUTIONALIZATION	Caruso et al 2015
Inefficiency leads to less	Becker Mulligan 2003
redistribution or changes	Drazen Limao 2008
bargaining position	
	Acemoglu, Egorov, Sonin 2013
POPULISM ⁸	Acemoglu, Robinson, Torvick 2013
	Keefer et al 202x
	Rodrik 2018

- That vast literature in one line: most explanations of inefficient government policies have a intertemporal micro-foundation (time inconsistency or similar).
- Acemoglu (2003): "parties holding political power cannot make commitments to bind their future actions because there is no outside agency with the coercive capacity to enforce such arrangements."
- The possibility of committing to more efficient actions through repeated-game enforcement is not considered.
- If we add such considerations (as in Alesina 1988 and Spiller and Tommasi 2007, for instance) the efficiency or inefficiency of redistributive policies will depend on the degree of intertemporal cooperation in political equilibria.

Towards an integrated view

SECTION 3: The Political Economy of Redistribution and Efficiency

- A possible Political Economy Model to explain those variations
 - 2 social groups:
 - Rich
 - Poor
 - The Rich decide **investment**. This determines growth
 - **Politically dominant group** decides redistribution after investment/growth.

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ONE-PERIOD MODEL

- Politically dominant group appropiates all (feasible) output
- Investment will depend on parameters (productivity, cost)

 In general, it will be low

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REPEATED GAME

- Institutional version: (representative democracy)
 - Political parties
 - Add agency problem {good agent, bad agent}

- the political party in power decides policy (redistribution) and how much it keeps for itself (corruption is like a tax)

	Parties as Agents of Constituency	
Distribution of Power	GOOD	BAD
The Rich are very powerful		
Balance/alternation		
"Left" Party dominant		

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The Rich are very powerful	Non-coop Eq 1 {high investment, low redistribution}	Non-coop Eq 3 {low investment, low redistribution}
Balance/alternation	Cooperative Equilibrium {high investment, reasonable redistribution}	
"Left" Party dominant		Non-coop Eq 2 {low investment, high redistribution}

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	"Left" Party dominant		Non-coop Eq 2 {low investment, high redistribution}
			POP





SECTION 3b:

The Political Economy of Redistribution and Efficiency - Empirics

- Each of these equilibria has different correlations for:
 - Size of government
 - Redistribution
 - Efficiency
 - Investment and growth
 - Institutionalization
 - Corruption
 - Trust / beliefs



Note: In clusters names, lower cases represent that the observations have a value under the mean in the respective dimension, while upper cases represent that the cluster is composed by observations with values over the mean.

Control of corruption is the first principal component of the control of corruption indicator from the World Governance Indicators and two indicators from the Global Competitiveness Report (favoritism in government decisions and transparency in government policymaking) Institutionalization is the first principal component of two indicators from World Governance Indicators (rule of law and regualtory quality), two indicators from V-Dem (legislative party cohesion and core civil society index), and two indicators from the Global Competitiveness Report (judicial independence and property rights)



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Corruption, institutionalization, and trust



Graphs by clusters by redistribution, government efficiency (PCA), and size (revenue)

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