Essays on Dynamic Political Economy

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Abstract

This thesis consists of three papers in dynamic political economy:

Ideology and the Determination of Public Policy Over Time investigates how public policy responds to persistent ideological shocks in dynamic politico-economic equilibrium. We develop a tractable model to analyse the dynamic interactions among ideology, public policy and individuals' intertemporal choice. Analytical solutions are obtained to characterize the Markov perfect equilibrium. Our main finding is that the relationship between ideology and the size of government turns out to be non-monotonic. In particular, a right-leaning ideological wave may lead to higher taxation, which makes the size of government much less distinctive under different political regimes. Incorporating ideological uncertainty per se has its theoretical relevance. Sufficient ideological uncertainty helps pin down a unique equilibrium. This is in contrast with recent works on dynamic political economy which feature multiple equilibria and have no sharp empirical predictions.

Dynamic Inequality and Social Security analyses the dynamic politico-economic equilibrium of a model where the repeated voting on social security and the evolution of household characteristics are mutually affected over time. Political decision-making is represented by probabilistic voting a la Lindbeck and Weibull (1987). We analytically characterize the unique Markov perfect equilibrium. The equilibrium social security tax rate are shown to be increasing in wealth inequality. The dynamic interaction between inequality and social security leads to growing social security programmes. The predictions of our model are broadly consistent with empirical evidence. We also perform some normative analysis, showing that the politico-economic mechanism tends to induce too large social security transfers in the long run.

A Markovian Social Contract of Social Security analyses the sustainability and evolution of the pay-as-you-go social security system in a majority voting framework with intra-cohort heterogeneity. We find that there exists a Markovian social contract through which the self-interested middle-aged median voter has incentives to support the system. This is in contrast with the approaches in the existing literature, which either resorts to the imperfect temporal separation of contributions and benefits, or builds the expectation of future social security benefits on variables that are payoff-irrelevant for future policymakers. Correspondingly, our model has a number of distinctive empirical implications. First, the social security tax rate converges along an increasing path to the steady state. Second, the growth of social security is negatively correlated with income inequality. Third, the impact of income inequality on the equilibrium social contract induces a non-monotonic relationship between income inequality and social security. These predictions are broadly consistent with the data from the OECD countries.