Abstracts

A Political Economy Theory of Fiscal Policy and Unemployment
Marco Battaglini, Cornell University and Stephen Coate, Cornell University

This paper presents a political economy theory of fiscal policy and unemployment. The underlying economy is one in which unemployment can arise but can be mitigated by tax cuts and increases in public production. Such policies are fiscally costly, but can be financed by issuing government debt. Policy decisions are made by a legislature consisting of representatives from different political districts. With the available policies, it is possible for the government to completely eliminate unemployment in the long run. However, with political decision making, the economy always has unemployment. Unemployment is higher when the private sector experiences negative shocks. When these shocks occur, the government employs debt-financed fiscal stimulus plans which involve both tax cuts and public production increases. When the private sector is healthy, the government contracts debt until it reaches a floor level. Unemployment levels are weakly increasing in the economy’s debt level, strictly so when the private sector experiences negative shocks. Conditional on the level of workers employed, the mix of public and private output is distorted. (JEL: E24, E62, H62)

The Limits of Career Concerns in Federalism: Evidence from China
Petra Persson, Stanford University and Ekaterina Zhuravskaya, Paris School of Economics (EHESS)

Performance-based promotion schemes in administrative hierarchies have limitations. Chinese provincial leaders, despite facing strong career concerns, make different policy decisions depending on their career backgrounds. Provincial party secretaries who rose from low to high positions within the province they govern (“locals”) spend a higher share of budgetary resources on education and health care and invest less in construction infrastructure than party secretaries who made their most significant career advancements in other provinces (“outsiders”). Identification comes from variation in central leadership and term limits. As the promotion mechanism rewards infrastructure investments, locals are less likely to be promoted at the end of the term. We explore various mechanisms and provide evidence that the difference between locals and outsiders is not driven by knowledge or experience. Several pieces of evidence suggest that locals cater to low-level provincial elites, who helped them rise to power. Thus, local career trajectories limit the power of career concerns by fostering competing allegiances. (JEL: H11, H70, P26)

Evidence for Relational Contracts in Sovereign Bank Lending
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This paper presents direct evidence for relational contracts in sovereign bank lending. Unlike the existing empirical literature, its instrumental variables method allows for distinguishing a direct influence of past repayment problems on current spreads (a "punishment" effect in prices) from an indirect effect through higher expected future default probabilities ("loss of reputation"). Such a punishment provides positive surplus to lenders after a default and decreases the borrower's present discounted value of the net benefits of future borrowing, which create dynamic incentives. Using data on bank loans to developing countries between 1973-1981 and constructing continuous variables for credit history, we find evidence that most of the influence of past repayment problems is through the direct, punishment channel. (JEL: C73, D86, F34, G1)
Quantifying the Premium Externality of the Uninsured
Stephen (Teng) Sun, Stanford University and Constantine Yannelis, Stanford University

In insurance markets, the uninsured can generate a negative externality on the insured, leading insurance companies to charge higher premia. Using a novel panel data set and a staggered policy change that introduces exogenous variation in the rate of uninsured drivers at the county level in California, we find that uninsured drivers lead to higher insurance premia: a 1 percentage point increase in the rate of uninsured drivers raises premia by roughly 1%. We calculate the monetary fine on the uninsured that would fully internalize the externality and conclude that actual fines in most US states are inefficiently low. (JEL: G22, H23)

Payroll Taxes, Social Insurance and Business Cycles
Michael C. Burda, Humboldt-Universität zu Berlin and Mark Weder, The University of Adelaide

Payroll taxes represent a major distortionary influence of governments on labor markets. This paper examines the role of time-varying payroll taxes and the social safety net for cyclical fluctuations in a nonmonetary economy with labor market frictions and unemployment insurance, when the latter is only imperfectly related to search effort. A balanced social insurance budget induces countercyclical payroll taxation, renders gross wages more rigid over the cycle and strengthens the model's endogenous propagation mechanism. For conventional calibrations, the model generates a negatively-sloped Beveridge curve and countercyclical unemployment as well as substantial volatility and persistence of vacancies and unemployment. (JEL: E24, J64, E32)

Expectations-Based Reference-Dependent Preferences and Asset Pricing
Michaela Pagel, Columbia Graduate School of Business

This paper explores the quantitative asset-pricing implications of expectations-based reference-dependent preferences, as introduced by Koszegi and Rabin (2009), in an otherwise traditional Lucas-tree model. I find that the model easily succeeds in matching the historical equity premium and its variability when the preference parameters are calibrated in line with micro evidence. The equity premium is high because expectations-based loss aversion makes uncertain fluctuations in consumption more painful. Additionally, loss aversion introduces variation in returns because unexpected cuts in consumption are particularly painful, and the agent wants to postpone such cuts to let his reference point decrease. This variation generates strong predictability. However, it also causes counterfactually high volatility in the risk-free rate, which I address by allowing for variation in expected consumption growth, heteroskedasticity in consumption growth, time-variant disaster risk, and sluggish belief updating. (JEL: G02, D03, G12)

A Model of Non-Belief in the Law of Large Numbers
Daniel J. Benjamin, Cornell University and University of Southern California, Collin Raymond, University of Oxford and Matthew Rabin, Harvard University

People believe that, even in very large samples, proportions of binary signals might depart significantly from the population mean. We model this "non-belief in the Law of Large Numbers" by assuming that a person believes that proportions in any given sample might be determined by a rate different than the true rate. In prediction, a non-believer expects the distribution of signals will have fat tails. In inference, a non-believer remains uncertain and influenced by priors even after observing an arbitrarily large sample. We explore implications for beliefs and behavior in a variety of economic settings. (JEL: B49, D03, D14, D83, G11)