Abstracts

The Equality Multiplier: How Wage Compression and Welfare Empowerment Interact
Erling Barth, Institute for Social Research, Oslo and Karl Ove Moene, University of Oslo

We explore how more wage equality fuels the generosity of the welfare state via political competition in elections, and how a more generous welfare state fuels wage equality via empowerment of weak groups in the labor market. Together the two mechanism may generate a cumulative process that explains how equality multiplies, and why countries with more equal distributions of market outcomes also have stronger welfare states. The complementarity between wage setting and welfare spending can explain why almost equally rich countries differ so much in economic and social equality among their citizens. (JEL: H53, I31, J31)

Public Education and Pensions in Democracy: A Political Economy Theory
Francesco Lancia, University of Vienna and Alessia Russo, University of Oslo

A dynamic political economy theory of fiscal policy is presented to explain the simultaneous existence of public education and pensions in modern democracies. The driving force of the model is the intergenerational conflict over the allocation of the public budget. Successive generations of voters choose fiscal policies through repeated elections. The political power of elderly voters creates the motive for adults to support public investment in the human capital of future generations since it expands future pension possibilities. We characterize the Markov perfect equilibrium of the voting game in a small open economy. The equilibrium reproduces salient features of intergenerational fiscal policies in modern economies. (JEL: D72, E62, H23, H30, H53)

Ethnic Diversity and the Spread of Civil War
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This paper theoretically and empirically investigates the relationship between local-level ethnic composition and the spread of conflict. Cross-country literature on conflict finds that ethnic diversity, and ethnic polarization in particular, are associated with greater incidence of conflict. However, the question remains as to where within ethnically diverse countries conflict begins and where and how it spreads. To study this question, I present a model in which local ethnic groups' decision to attack depends on three key variables: ethnic population shares, ethnic groups' weapons ratio, and the share of co-ethnic successes in the battles that took place in the previous period. The model generates three predictions: conflict starts in ethnically homogenous areas and only later spreads to ethnically heterogeneous areas; neighbor co-ethnics' success increases subsequent probability of winning and may lead to attack; and greater ethnic diversity is associated with costlier conflict. I find strong support for these predictions using detailed municipal-level data on attacks and ethnic polarization during the initial spread of the Bosnian Civil War. Moreover, my conflict model is able to predict the sequence of actual conflict outcomes with reasonably high accuracy. (JEL: D39, D74, J15, R12)

Poverty and the Political Economy of Public Education Spending: Evidence from Brazil
Leonardo Bursztyn, UCLA Anderson

A large literature has emphasized elite capture of democratic institutions as the explanation for the low levels of spending on public education in many low-income democracies. This paper provides an alternative to that longstanding hypothesis. Motivated by new cross-country facts and evidence from Brazilian municipalities, we hypothesize that many democratic developing countries might invest less in public education spending because poor decisive voters prefer the government to allocate resources elsewhere. One possible explanation is that low-income voters could instead favor redistributive programs that increase their incomes in the short run, such as cash transfers. To test for this possibility, we design and implement an experimental survey and an incentivized choice experiment in Brazil. The findings from both interventions support our hypothesis. (JEL: C90, H52, I25, O15, P16)
Risk Aversion Relates to Cognitive Ability: Preferences or Noise?
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Recent experimental studies suggest that risk aversion is negatively related to cognitive ability. In this paper we report evidence that this relation may be spurious. We recruit a large subject pool drawn from the general Danish population for our experiment. By presenting subjects with choice tasks that vary the bias induced by random choices, we are able to generate both negative and positive correlations between risk aversion and cognitive ability. Our results suggest that cognitive ability is related to random decision making rather than to risk preferences. (JEL: C81, C91, D12, D81)

The Right Amount of Trust
Jeffrey V. Butler, EIEF and University of Nevada Las Vegas, Paola Giuliano, UCLA Anderson School of Management and Luigi Guiso, EIEF

We investigate the relationship between individual trust and individual economic performance. We find that individual income is hump-shaped in a measure of intensity of trust beliefs. Our interpretation is that highly trusting individuals tend to assume too much social risk and to be cheated more often, ultimately performing less well than those with a belief close to the mean trustworthiness of the population. On the other hand, individuals with overly pessimistic beliefs avoid being cheated, but give up profitable opportunities, therefore underperforming. The cost of either too much or too little trust is comparable to the income lost by forgoing college. Our findings hold in large-scale international survey data as well as inside a country with high quality institutions and are also supported by experimental findings. (JEL: A1, A12, D1, O15, Z1)

From Maize to Haze: Agricultural Shocks and the Growth of the Mexican Drug Sector
Oeindrila Dube, New York University and BREAD, Omar Garcia-Ponce, New York University and Kevin Thom, New York University

Understanding how economic incentives affect illegal drug production is essential for crafting policies in response to the international drug trade. Policymakers typically face a choice between two strategies: targeting criminal groups via law enforcement, and offering producers incentives to engage in alternate activities. Yet, little is known about how the returns to alternate legal activities affect drug supply. We contribute to this literature by examining how shocks to legal commodity prices affect the drug trade in Mexico. Our analysis exploits exogenous movements in the Mexican maize price stemming from weather conditions in U.S. maize-growing regions, as well as exports of other major maize producers. Using data on over 2200 municipios spanning 1990-2010, we show that lower prices differentially increased the cultivation of both marijuana and opium poppies in municipios more climatically suited to growing maize. We also find impacts on downstream drug-trade outcomes, including drug cartel operations and killings perpetrated by these groups. Our findings demonstrate that maize price changes contributed to the burgeoning drug trade in Mexico, and point to the violent consequences of an expanding drug sector. (JEL: K420, O13, Q17)
I present a model with Discontinuous Asset Market Participation (DAMP), where all agents are non-Ricardian, and where heterogeneity among market participants implies financial-wealth effects on aggregate consumption. The implied welfare criterion shows that financial stability arises as an additional and independent target, besides inflation and output stability. Evaluation of optimal policy under discretion and commitment reveals that price stability may no longer be optimal, even absent inefficient supply shocks: some fluctuations in output and inflation may be optimal as long as they reduce financial instability. Ignoring the heterogeneity among market participants may lead monetary policy to induce substantially higher welfare losses. (JEL: E12, E44, E52)