THE POLITICAL ECONOMY OF PUBLIC DEBT: A LABORATORY STUDY

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Abstract
This paper reports the results from a laboratory experiment designed to study political distortions in the accumulation of public debt. A legislature bargains over the levels of a public good and of district specific transfers in two periods. The legislature can issue or purchase risk-free bonds in the first period and the level of public debt creates a dynamic linkage across policymaking periods. In line with the theoretical predictions, we find that public policies are inefficient and efficiency is increasing in the size of the majority requirement, with higher investment in public goods and lower debt associated with larger majority requirements. Debt is lower when the probability of a negative shock to the economy in the second period is higher indicating that even in a political equilibrium debt is used to smooth consumption and to insure against economic uncertainty. Also in line with the theoretical predictions, we find that dynamic distortions are eliminated when the first period proposer can commit to a policy for both periods. The experiment, however, highlights two phenomena that are surprising in terms of standard theory and have not been previously documented. First, balancing the budget in each period is a focal point, leading to lower distortions than predicted. Second, higher majority requirements induce significant delays in reaching an agreement. (JEL: D71, D72, C78, C92, H41, H54)

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