Entitlements, by Bouton, Lizzeri & Persico

Discussant: Marina Azzimonti

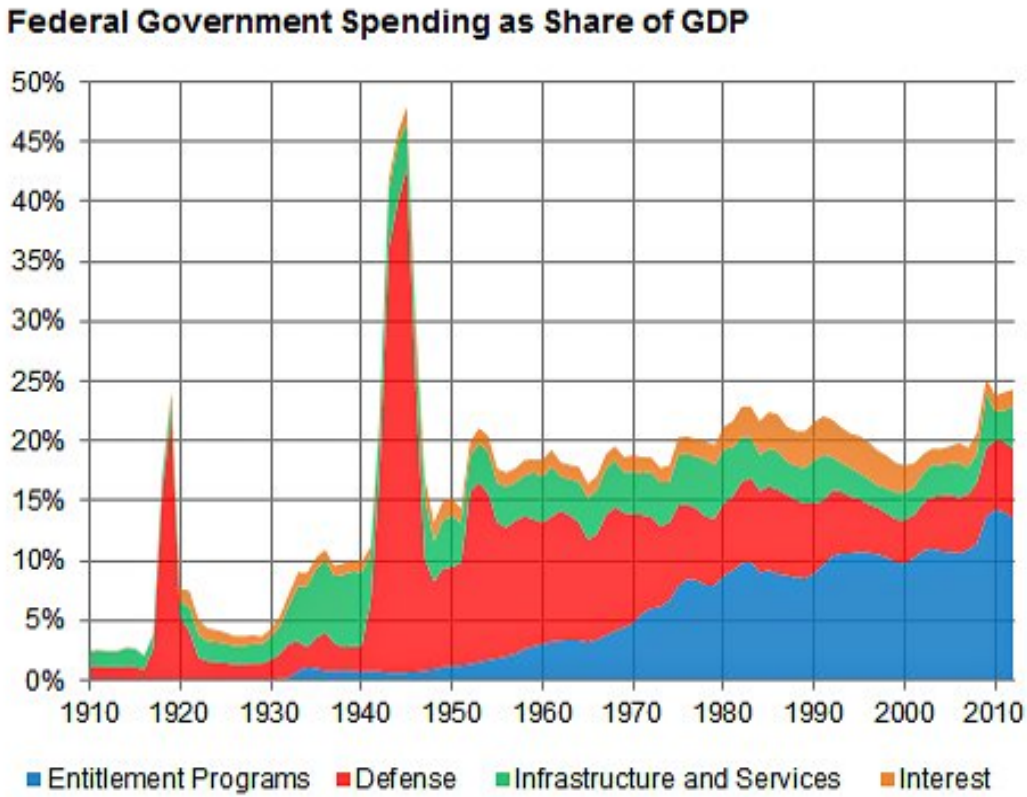
Stonybrook University and NBER

What are Entitlements?

- Government expenditures on
  - Health care programs
  - Pensions and retirement (Social Security)
  - Welfare or social insurance programs (food stamps and unemployment compensation)
- Two important characteristics
  1. Redistributive
  2. Mandatory

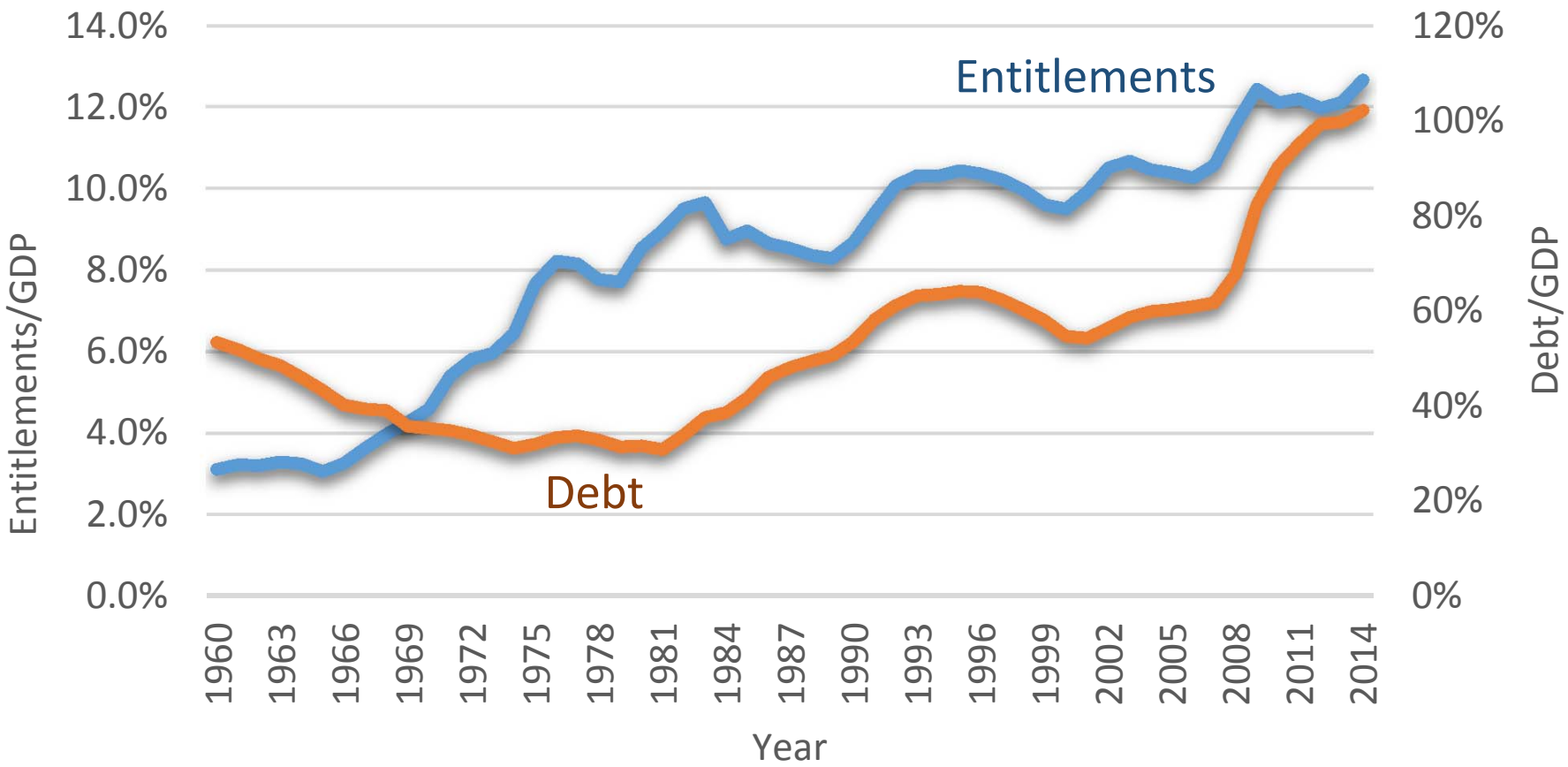
What should we care?

- Entitlements have been growing continuously since the 70s.
- Crowding out infrustructure, defense, etc.



- Main driver of govt spending growth.

Debt and entitlements



Growing together since the 70s

This paper

- Political economy model with entitlements and debt.
- Builds on Alesina and Tabellini
  - Split the pie:

$$\text{Resource Constraint}: \; g_t + x_t^A + x_t^B = 1$$

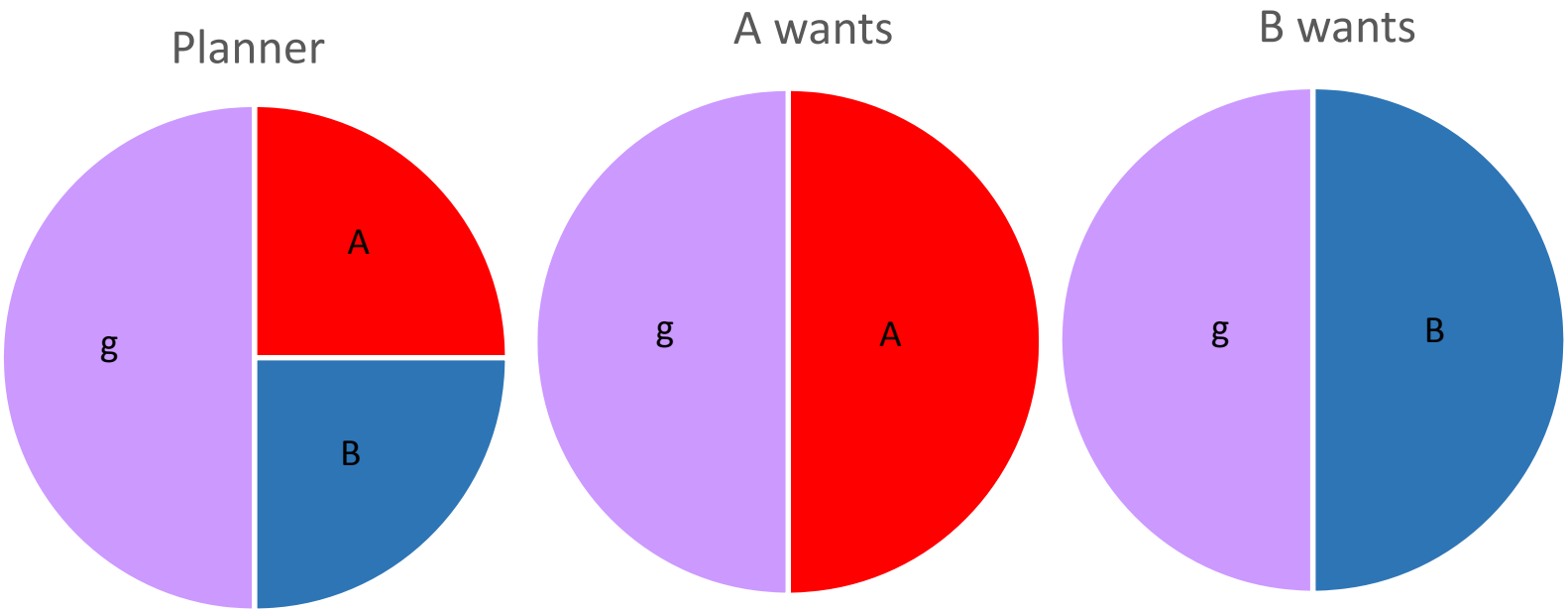
  - Two groups A and B alternate in power

$$u^i = \lambda \ln x^i + (1 - \lambda) \ln g$$

  - Disagreement over the composition of spending.

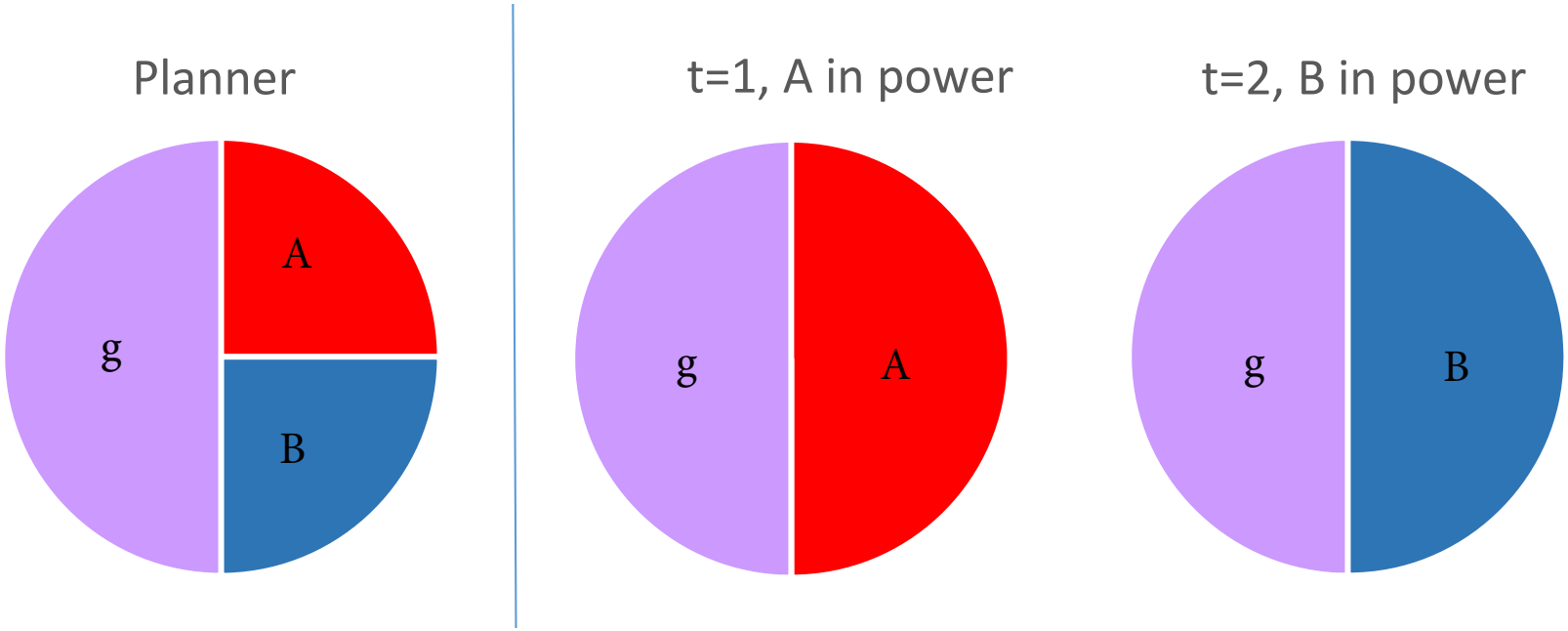
Allocations

Let $\lambda = 0.5$.



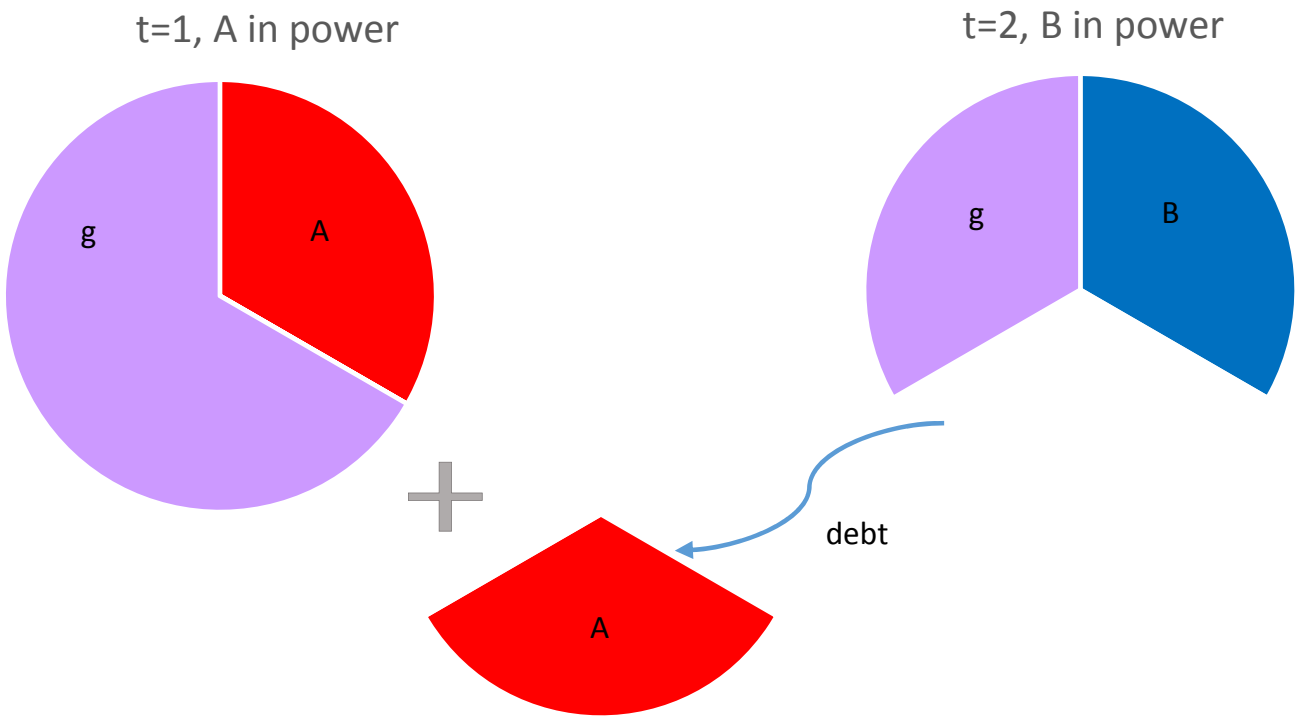
Preferred Allocations

Power alternation (A in 1st period, B in 2nd period)



Allow debt

$$g_1 + x_1^A + x_1^B = 1+b \qquad g_2 + x_2^A + x_2^B = 1-b$$

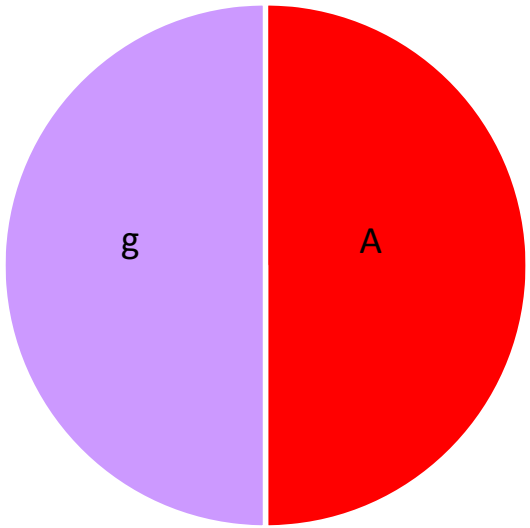


- A Persson-Tabellini result: A cannot force B to choose $x_2^A > 0$. By borrowing, it *starves the beast*.

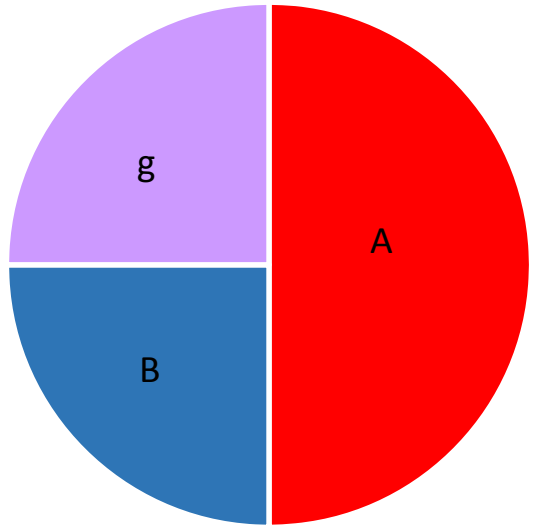
Allow entitlements (+debt)

$$g_1 + x_1^A + x_1^B = 1 + b \qquad g_2 + x_2^A + x_2^B = 1 - b$$

t=1, A in power



t=2, B in power



- Kills Persson-Tabellini result: A can force B to choose $x_2^A > 0$. No need to *starve the beast*.

Allow entitlements (+debt)

- Tension:
  - Optimal for A to set positive entitlements $x_2^A > 0$
  - But also, $b = 0$
- In this model, entitlements are a better instrument than debt.

$\Rightarrow$ Debt is irrelevant!!

- What if entitlements were costly?

$$\lambda \ln(x_1^A - cx_2^A) + (1 - \lambda) \ln g_1$$

$=>$ $x_2^A > 0$ and $b > 0$.

[actually, $b = cx_2^A$]

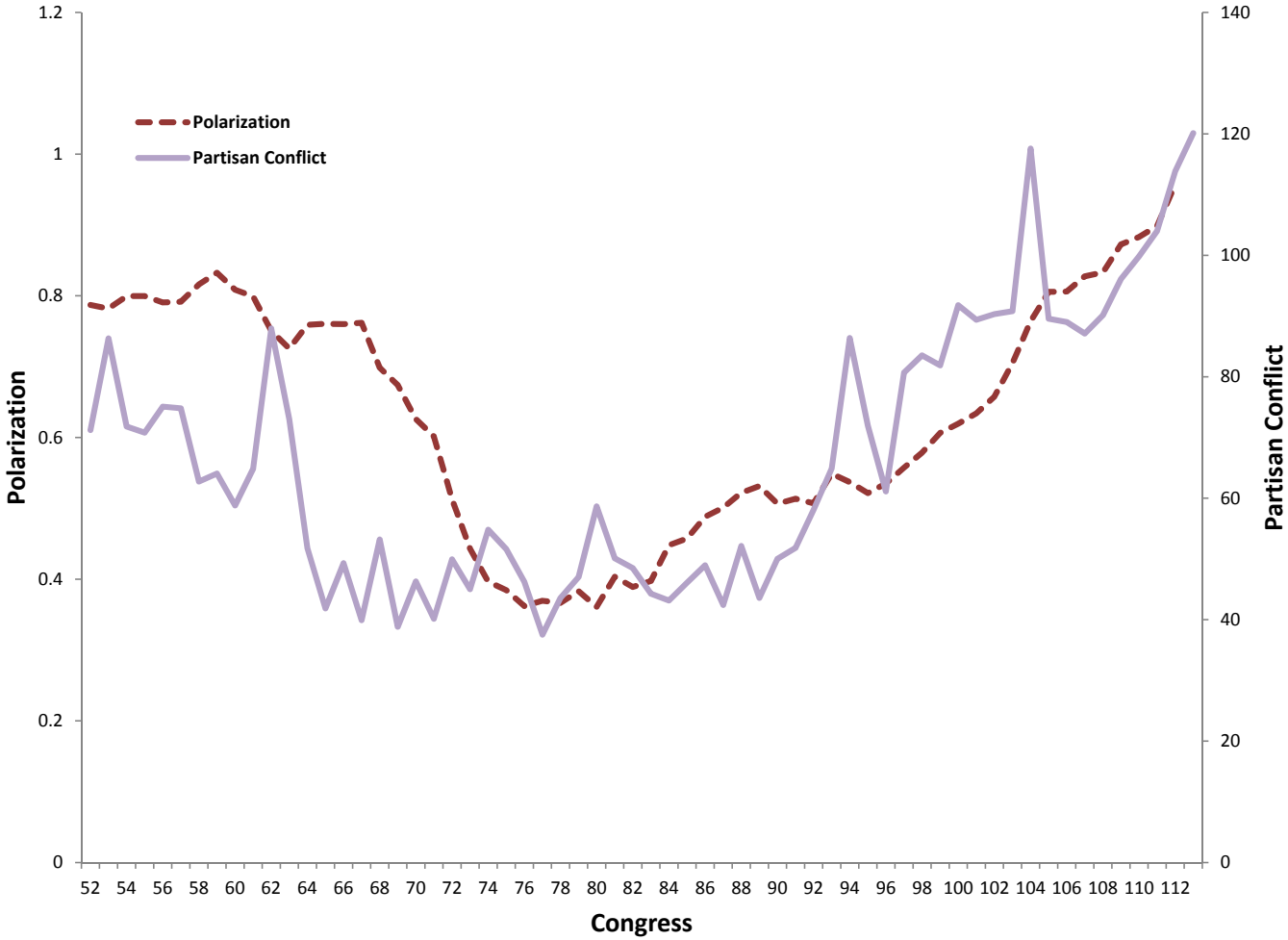
The puzzle

- Can the model generate co-movement between entitlements and debt? No
  1. If c increases, $\uparrow b$ and $\downarrow x_2^A$
  2. Introduce political instability (uncertainty about who will be in power in $t = 2$)

  $=>$ b and x_2^A move in opposite directions as instability increases.
- Extend to CRRA preferences, they might co-move as risk-aversion declines.
  - However, I an guessing result is due to effects of the inter-temporal elasticity of substitution. Interpretation of 'better insurance mechanisms' is un-appealing.

A suggestion

Political disagreement has been growing over the same period



A suggestion

- Political disagreement=λ:

$$u_t^i = \lambda_t \ln x_t^i + (1 - \lambda_t) \ln g_t,$$

the higher the weight placed on x_t^i, the more parties will disagree about the composition of government spending.

- Using the same specification (entitlements + debt + costs), we obtain

$$b = \lambda_2 \frac{c}{1+c} > 0$$

$$x_2^A = \lambda_2 \frac{1}{1+c} > 0$$

- They are both increasing in partisan conflict!
- Moreover, since $g_2 = (1 - \lambda_2)^2$, entitlements also crowd out public goods!

Comments

1. Mandatory spending needs bi-partisan effort (even supermajority due to filibusters)...remember Obamacare?
   - Group B has some veto power on entitlements in real life.
   - Bargaining model (a la Eraslan-Bowen) more appropriate. Reality vs Tractability trade-off.
2. What does $c(x_2^A)$ represent?
   - Utility cost = reduced form for bargaining? Setting up the mandatory program?
3. You borrow $b = cx_2^A$. Quantitatively relevant?

Comments, contd

4. How to think of entitlements in $T > 2$?
   - One-period commitment? Otherwise dynamics uninteresting.
5. If there is a trend in λ, how to get an interior solution for b and x?
   - Interest rates depend on b or
   - Convex $c(x_2^A)$
6. Using logs is ugly ($x^B = 0$ if A in power), specially for the welfare section. Perhaps $\ln(x + \epsilon)$?
7. Welfare and institutions section: I got totally lost here.

My take

- Super interesting and relevant question.
- Over-turns typical intuition form pol-eco models of debt (Alesina-Tabellini, Persson-Tabellini, Battaglini-Coate):
  - It is **not** myopic behavior of politicians (due to political turnover) what generates debt, but the fact that we excluded an important instrument: entitlements!
  - Higher political instability not necessarily associated with more debt.
- Definitely novel: no other model trying to understand entitlements and debt (that I know of).
- Really looking forward to seeing the polished version!