

Efficiency of Flexible Budgetary Institutions

By Bowen, Chen, Eraslan, and Zapal

Discussion by Marina Azzimonti

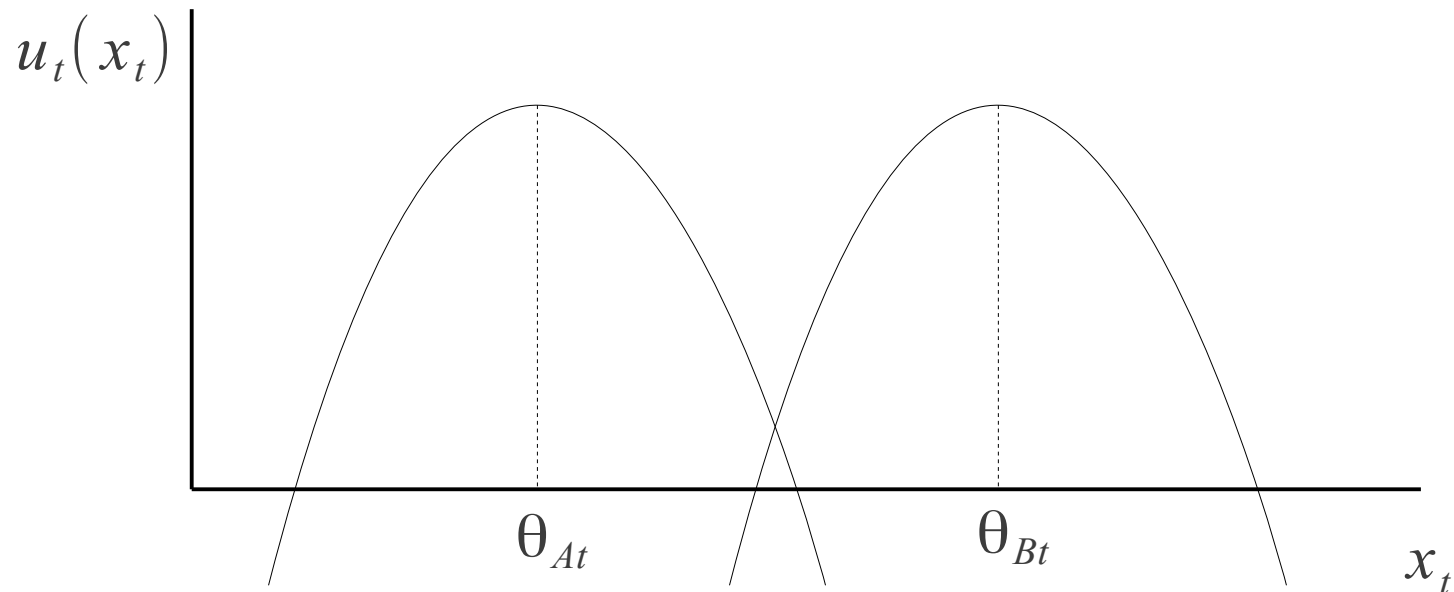
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Objective

- ▶ Can budgetary institutions overcome legislative inefficiencies arising from partisan conflict?
- ▶ Partisan conflict
 - ▶ Polarization (different ideal points)
 - ▶ Political risk (alternation in agenda-setting power)
- ▶ **Inefficiency**: public good provision fluctuates too much

Environment

- ▶ 2 periods, 2 parties
- ▶ One public good: x
- ▶ Parties disagree on the *size* of government



Legislature

- ▶ Bargain over policy
 - Random proposer
 - Take-it-or-leave-it offer
 - Unanimity rule

- ▶ Two key departures relative to traditional bargaining models
 1. Flexible budgetary institutions
 2. Time-varying ideal points

Budgetary Institutions

► Spending rules

Discretionary

Mandatory

status-quo

0

g_{t-1}

“resets”

A & B must *agree* to
change it

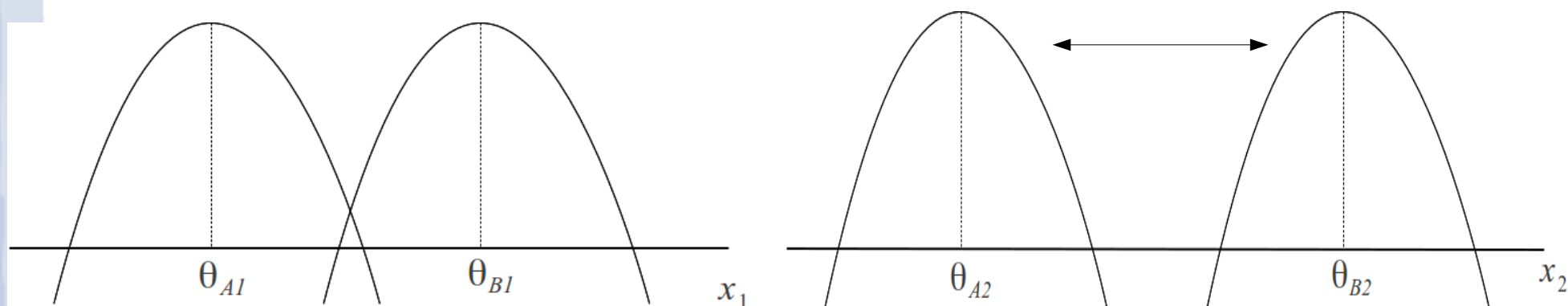


Well understood in lit.

Introduces a dynamic
link: proposer can
improve future bargaining
power!

- ▶ Bowen, Chen and Eraslan (BCE) analyzed it in detail
 - ▶ Mandatory programs are better: *payoff smoothing*
 - ▶ Insurance against political risk reducing fluctuations
- ▶ BCE assumed constant preferences/technology.
 - ▶ Here: would this hold when preferences change?

TFP, War, Polarization



▶ The trade-off

- ▶ Mandatory programs provide some **commitment**

- ▶ But there could be too little **flexibility**

 - ▶ May get stuck with a bad status-quo: *Gridlock!*

▶ Main Findings

- ▶ Discretionary-only and Mandatory-only programs are inefficient.

- ▶ An endogenous mix can achieve efficiency.

- ▶ With stochastic preferences (T-period), state-dependent mandatory programs are efficient.

► Example:

$$u_{it}(x_t) = -(x_t - \theta_{it})^2 + c$$

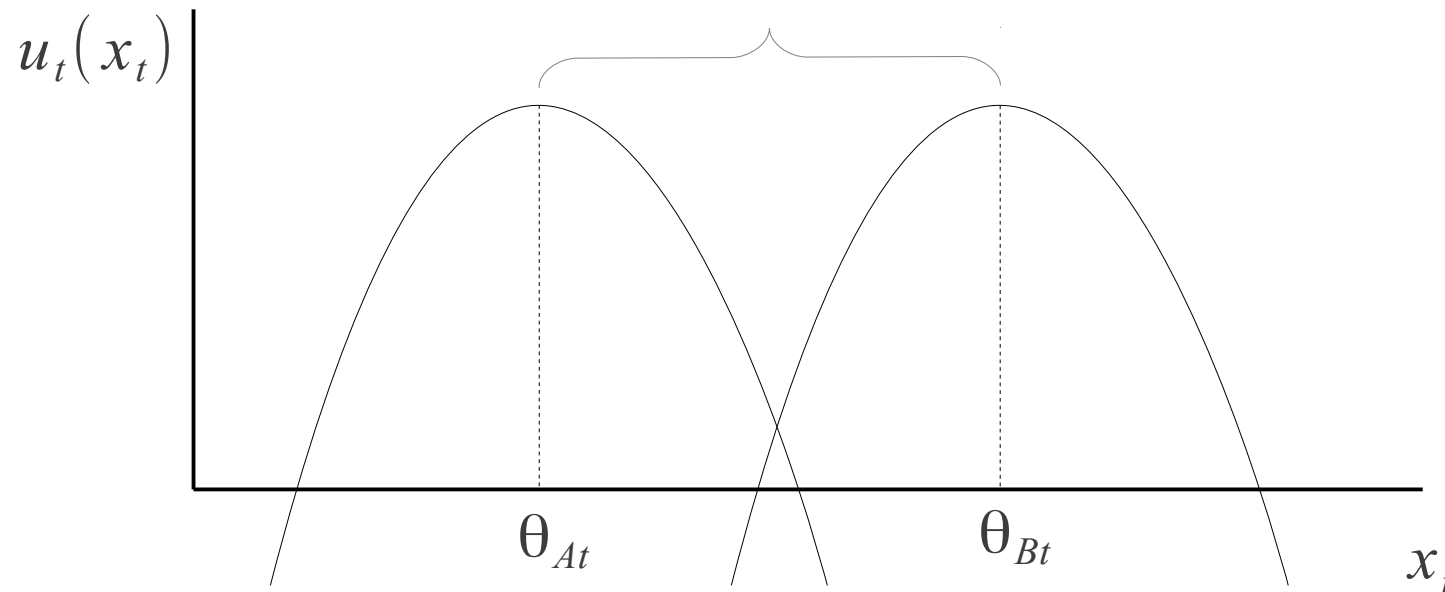
$$\theta_{At} < \theta_{Bt}$$

$$\theta_{i1} \neq \theta_{i2}$$

► Pareto Optimal Allocations (dynamic)

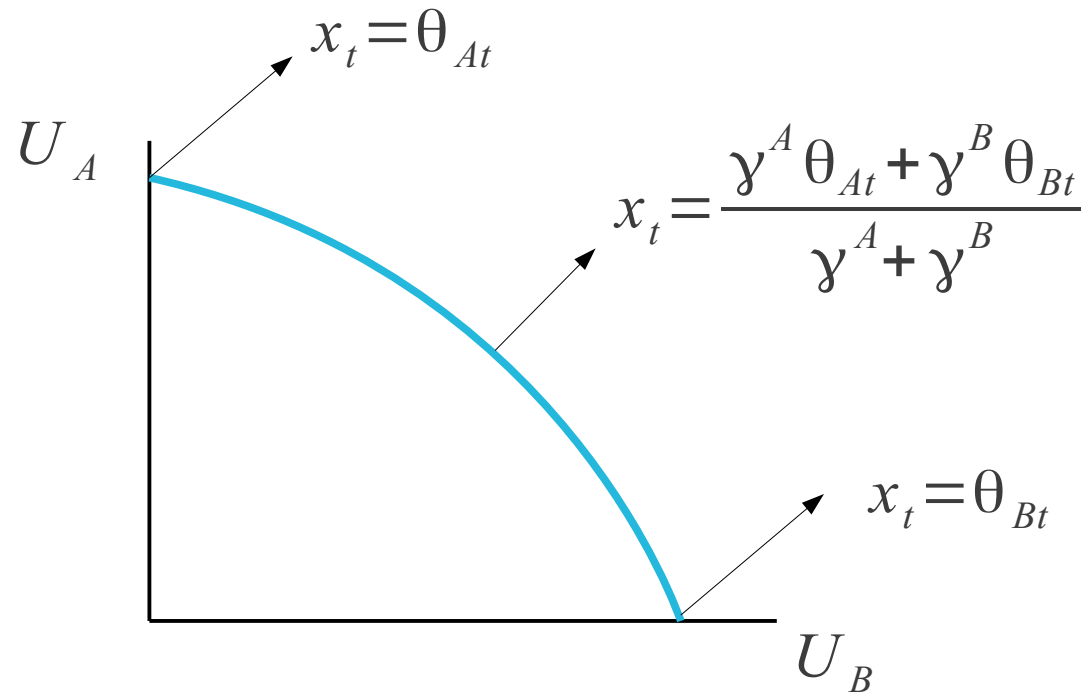
$$\max_{x_1, x_2} -\gamma^A(x_1 - \theta_{A1})^2 - \gamma^B(x_1 - \theta_{B1})^2 + \delta \left\{ -\gamma^A(x_2 - \theta_{A2})^2 - \gamma^B(x_2 - \theta_{B2})^2 \right\}$$

$$x_t = \frac{\gamma^A \theta_{At} + \gamma^B \theta_{Bt}}{\gamma^A + \gamma^B}$$



► Two characteristics:

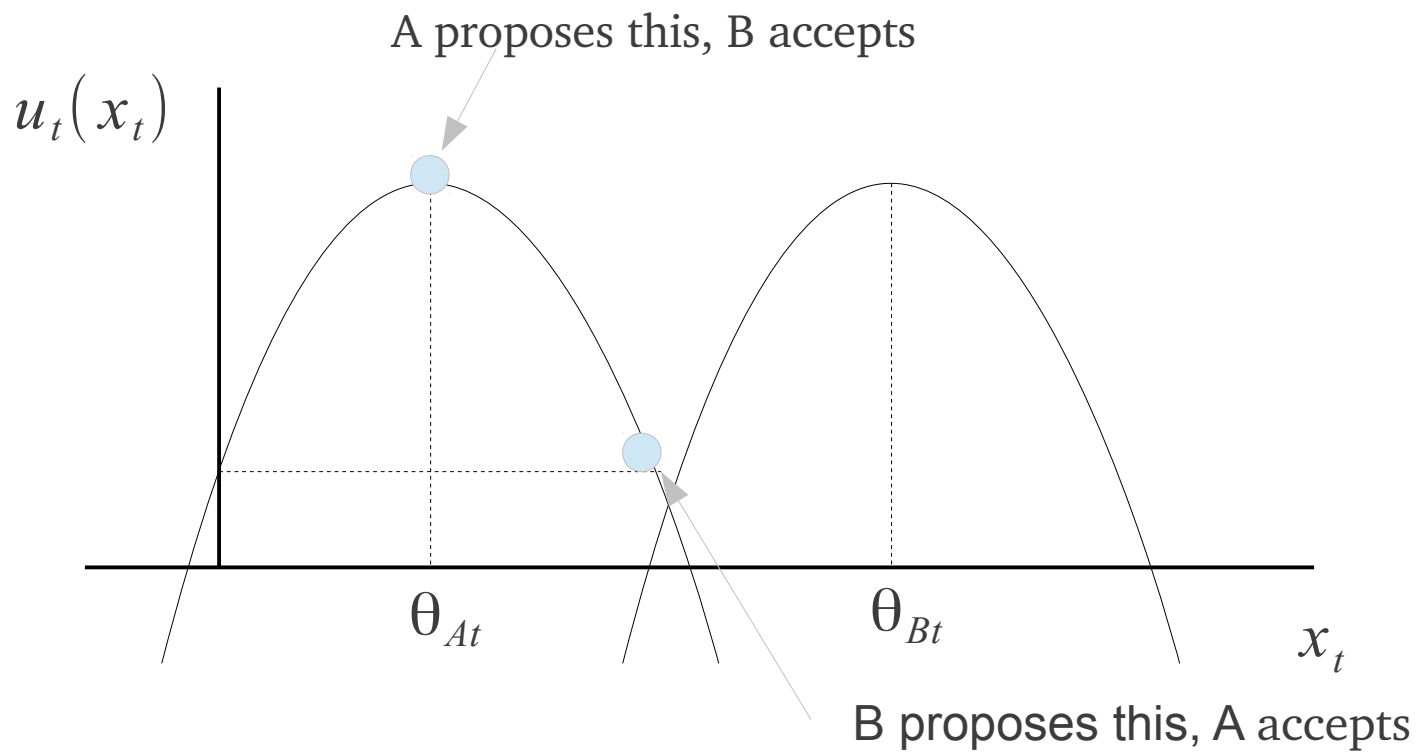
1. Static PE $x_t \in [\theta_{At}, \theta_{Bt}]$



2. Independent of type $x_{At} = x_{Bt} = x_t$ or coincides with ideal at all t $x_t = \theta_{it}$

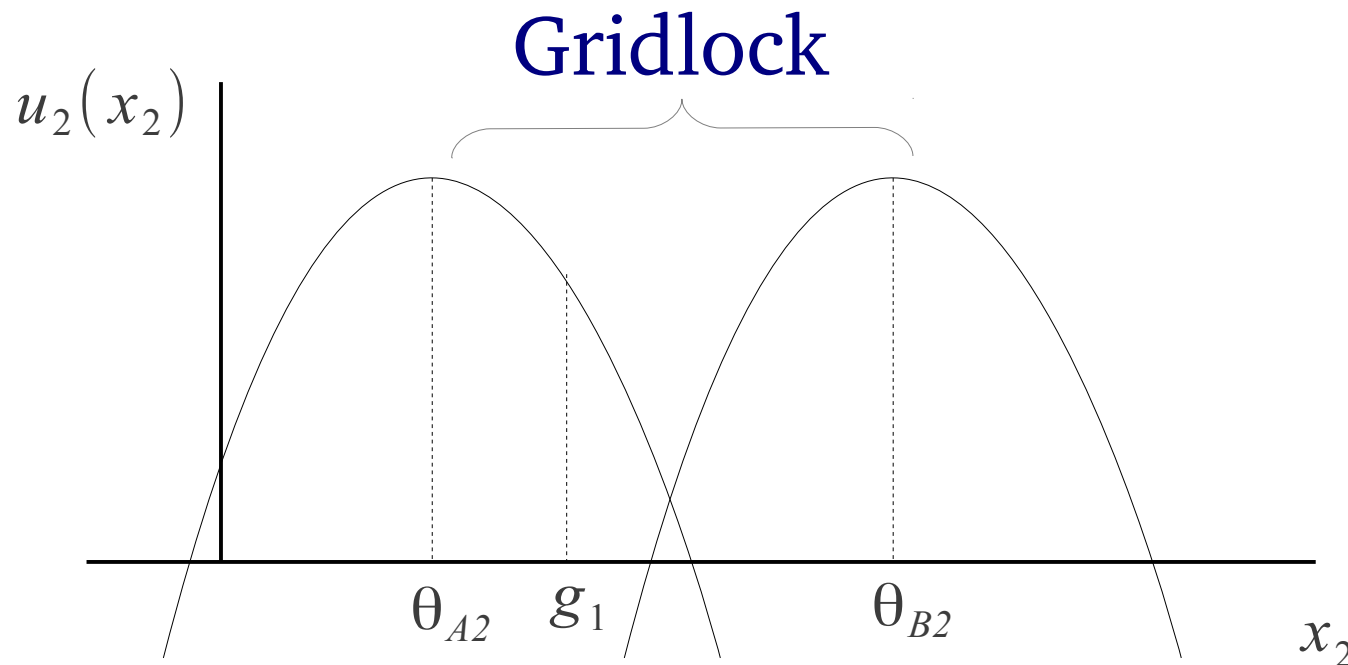
Case 1: Discretionary only

- ▶ Inefficient: policy may depend on the proposer's identity
→ fluctuations



Case 2: Mandatory only

- ▶ If $g_1 < \theta_{A2}$ or $g_1 > \theta_{B2}$ same inefficiency as under discretionary policy: too much volatility.
- ▶ If $g_1 \in [\theta_{A2}, \theta_{B2}] \rightarrow x_2 = g_1$ lack of flexibility bites



Case 2: Mandatory only

- ▶ Recall that preferences are changing $\theta_{i1} \neq \theta_{i2}$
 - ▶ it is optimal to change x
- ▶ Legislators enter a gridlock state where they do not implement reforms that should be implemented!
- ▶ Examples:
 - ▶ extended unemployment insurance benefits for too long
 - ▶ keeping subsidies too low to keep up with inflation

Case 3: Mandatory and Discretionary

- ▶ Problem with mandatory: too inflexible, spending cannot vary over time.
- ▶ Fix: allow for discretionary spending as well

$$x_t = g_{t-1} + d_t$$

▶ Set $g_1 = \frac{\gamma^A \theta_{A2} + \gamma^B \theta_{B2}}{\gamma^A + \gamma^B}$ and $d_1 = \frac{\gamma^A \theta_{A1} + \gamma^B \theta_{B1}}{\gamma^A + \gamma^B} - g_1$



$$x_1 = x_1^{PO}$$

$$x_2 = x_2^{PO}$$

Second period spending independent of identity of proposer

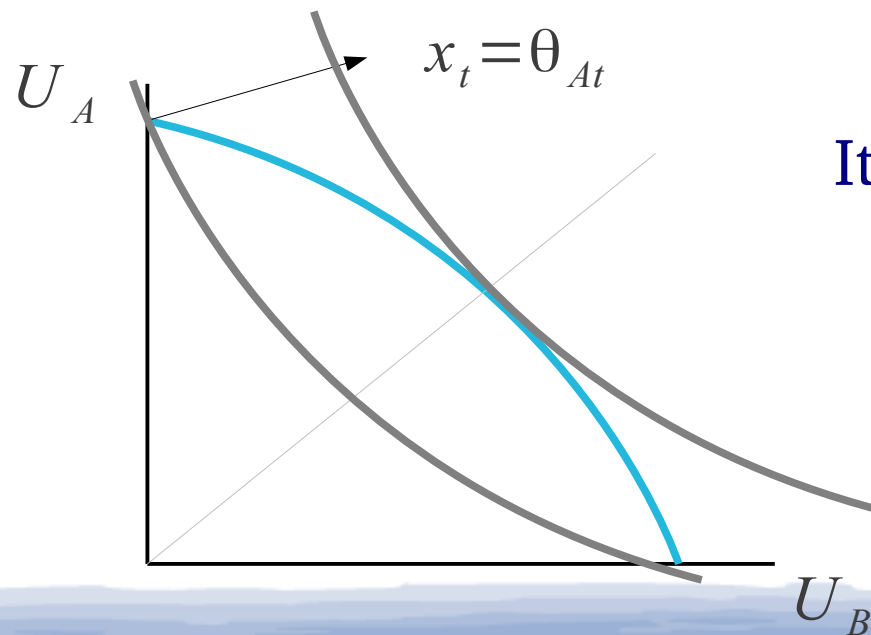
Some Comments

The Literature

- ▶ Relate this to the commitment vs flexibility literature
 - ▶ Werning, Amador, Angeletos: hyperbolic prefs/savings
 - ▶ Yared, Halac: hyperbolic, optimal fiscal rule/debt
 - ▶ Azzimonti, Battaglini, Coate: bargaining, BB rule
 - ▶ Piguillem, Riboni: most related paper! Value added? deterministic (varying) preferences
- ▶ It may help motivate the exercise better

Equity and Efficiency

- ▶ With the flexible program, A could undo “checks and balances”
 - ▶ Mandatory to induce a stalemate at its preferred point: zero political risk
 - ▶ Discretionary to target preferred consumption in first period



It is PO, but is it desirable in terms of equity?

Institutional Design

- ▶ Suppose that you are considering introducing a flexible program in an environment with a discretionary only regime
- ▶ Would both parties be on board?
 - ▶ My guess: it depends on who is proposing it
- ▶ Would it be sustainable? That is, would parties want to maintain it if allowed to eliminate it?
 - ▶ Time consistency of institutions

Micro Foundations

- ▶ Ideal points are exogenous
 - ▶ Changes in preferences may have different efficiency implications than changes in technology
- ▶ Especially if the financing side is taken into account
 - ▶ Variations in endowment would call for a non balanced budget.
- ▶ Could relate to the Economic Policy Uncertainty literature
 - ▶ Institutions that reduce political risk also reduce EPU, may improve efficiency in private sector

Time horizon

- ▶ Flexible institutions deliver efficiency because $T=2$ and preferences evolve deterministically
- ▶ Discretionary spending would not be enough if $T>2$
 - ▶ Example: $\{\theta_A, \theta_B\}$ in odd periods and $\{\theta_A + \epsilon, \theta_B + \epsilon\}$ in even periods
- ▶ A state contingent rule, $\{g^e, g^o\}$ where the state is the position in the cycle
 - ▶ Tax/spending-expirations! After expiration, the status-quo is 0 spending
 - ▶ Would this improve on allocations under stochastic preferences?

Smaller Comments

- ▶ Static Pareto efficiency does not seem like a meaningful concept.
 - ▶ Too many pages devoted to characterizing when it is static PO, too little providing intuition
- ▶ Section 6.2 is a bit uninteresting
- ▶ Cheap comment: best institution is to get rid of the random proposer! A dictator would do much better.
- ▶ Do you get closer to the frontier as p increases?

Conclusions

- ▶ Very interesting paper on really important topic!
- ▶ My comments and suggestions:
 - ▶ Commitment vs flexibility
 - ▶ Equity considerations
 - ▶ Institutional Design
 - ▶ Micro-foundations
 - ▶ Tax/spending limits for $T > 2$