

THE POLITICAL ECONOMIST

NEWSLETTER OF THE SECTION ON POLITICAL ECONOMY, AMERICAN POLITICAL SCIENCE ASSOCIATION

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FEATURE *Essays*

The Politics of Monetary Policy are About to Come Roaring Back From the Dead

Susanne Lohmann, University of California, Los Angeles*

Macroeconomics and politics, or macro political economy, is the subfield of political economy that is concerned specifically with monetary policy and monetary institutions. In recent decades, economists and political scientists have theoretically mapped out a range of issues: the political vulnerability of monetary policy; proposed institutional solutions; and demonstrated empirically that monetary institutions make a difference over time and across countries for monetary policy and economic performance. In response to these findings, countries all over the world have adopted independent central banks, or granted their pre-existing central banks a higher

degree of independence.¹

One indicator that the world has become a safer place, “monetarily speaking,” is the fact that money and central banking have dropped off the domestic political agenda. In the United States, Gallup regularly polls people on the question “What do you think is the most important problem facing this country today?” Inflation was at the top of the agenda in the two presidential campaigns that occurred in the immediate aftermath of the two oil price shocks, Ford vs. Carter in 1976 and Carter vs. Reagan in 1980 (and it is not a coincidence that in both cases the incumbent lost the election: inflation

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Political Institutions and Fiscal Policy*

Carles Boix, University of Chicago **

Since its inception almost thirty years ago, the literature on political business cycles and on political macroeconomics in general has advanced through two main waves of research. In the 1970s and 1980s most of scholarly work focused on the impact that elections and parties may have on the economy, mostly to conclude, in line with the rational expectations revolution in macroeconomics, that their effects are both moderate in size and short-lived in time.¹ Accordingly, political economists moved on to stress the role of institutions on economic policy-making and to model their constraining effects on the ways in which governments purportedly operated. This new generation of research developed in three directions. Drawing on an extensive literature on wage bargaining, corporatist scholars linked unemployment rates and inflation

to the national organization of the labor market, both alone and in interaction with the party in government.² A second strand of inquiry measured the impact of independent central banks on both inflation and real economic variables.³ Finally, in the 1990s, political economists started to assess the consequences that different constitutional structures – namely, electoral rules, the degree to which the executive and the legislative operated as separated powers, and federalism – may have on monetary and fiscal policies and outcomes.

Although still incipient, the latter literature on the economic effects of constitutions has begun to make considerable strides in political economics and political science. Proportional electoral rules have been found to exacerbate fiscal

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A LETTER FROM THE *Editors*

Dear Readers:

We are saddened by the passing of Michael Wallerstein, one of the world's leading political economists, who died on January 7th at his home in New Haven. He was 54. Michael's generosity and kindness touched everyone who knew him. To honor him and his intellectual legacy, his friends and collaborators have established an annual award in his name for the best article in political economy published in the previous year. This issue includes information about the Michael Wallerstein Award, which will be administered by the Political Economy Section. We encourage you to help endow this new award: see page 10 for details on how to contribute. The Spring/Summer issue will contain a memorial to Michael Wallerstein.

Our feature articles examine the politics of macroeconomic policy. Susanne

Lohmann, Professor of Political Science at UCLA, argues that the lull in political activity surrounding monetary policy is likely to be short-lived. Demographic trends and unresolved problems in international finance may soon reignite distributional conflict over monetary policy. Carles Boix, Associate Professor of Political Science at the University of Chicago, examines the politics of fiscal policymaking. Through the lens of recent work by Persson and Tabellini, Boix argues for more realistic models of the policy process to inform our explanations of budgetary choices. Both articles point to new directions for research into the political foundations of macroeconomic policy.

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Co-editors of *The Political Economist*

A LETTER FROM THE *Chair*

Dear Members of the Political Economy Section:

Greetings. This fall has certainly seen storms galore – on both the weather and political fronts. We send messages of hope and encouragement to all of our colleagues who have faced unexpected turmoil in the professional and personal lives.

On looking forward – we will have a very exciting set of panels at the 2006 APSA thanks to the hard work of Liz Gerber and Rick Wilson. Do plan to come and attend as many of our panels as you

can since this is so essential to the continuation of panel assignments for 2007 and thereafter. And, we have a very good new program to support graduate students who might not otherwise be able to attend the meetings – the announcement is contained in this Newsletter at page 11.

See you in San Francisco!

Elinor Ostrom

Chair of the Political Economy Section

UPCOMING ELECTION OF SECTION COUNCIL & CHAIRPERSON

The Political Economy section has a rotating council of six members who have been representing the Section very effectively. In March of 2006 we will need to hold an election for three members of the Council who will rotate off and for the Chairperson for our Section. Be thinking about potential candidates for a new Chairperson to take over responsibility at the forthcoming APSA meetings and three members of the Council. A nominating committee will be appointed in early March and a general request will be sent out at the time. Just an early reminder to be thinking ahead.

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is *not* a vote-getter). Today, in 2005, inflation barely registers at all (only about 1% of the respondents classify it as the most important problem). People do worry about some economic issues — unemployment and jobs (8%), the state of the economy (10%), and the federal budget deficit and federal debt (3%) —, but they do not generally hold monetary policy responsible; they blame globalization, or poor economic stewardship.

Meanwhile, people are preoccupied with non-economic issues such as war (25%), social security (12%), terrorism (9%), health care (9%), and education (6%).² Indeed, Thomas Frank, in *What's the Matter with Kansas?* (2004), argues that Bush vs. Kerry in 2004 was decided by people's moral values rather than their economic interests. Voters who are concerned about the morality of stem cell research and the teaching of evolution, rather than intelligent design, in schools will hardly obsess over money and central banking (though if they start obsessing, it looks like the gold standard could enjoy a comeback).

Americans have good reason not to be concerned about money and central banking—for now. (The future is another matter, as I shall contend.) Inflation is low, and has been for two decades; and output variability is down, arguably because the conduct of monetary policy has improved. Certainly, ill-conceived monetary theories and poorly devised monetary institutions no longer wreck the real economy the way they used to in the 19th century, when the value of the dollar was tied to a flaky bi-metallic (gold and silver) standard, or in the Great Depression, when the real bills doctrine required the central bank to slam on the brakes even as the economy was collapsing.

If the domestic arena is at peace, “money-wise,” the international arena is a different ball game altogether. After the two oil price shocks of the 1970s and the Mexican crisis of 1984-85, the 1990s brought a streak of international financial crises—the European Exchange Rate Mechanism crisis of 1992; the Mexican

crisis of 1994-95; and the Southeast Asian crisis of 1997-98, which in turn triggered the Russian crisis of 1998 and the Brazilian crisis of 1999. Barry Eichengreen estimates that the typical international financial crisis claims 9% of the gross domestic product (GDP) of the afflicted countries, and the worst crises wipe out as much as 20% of GDP.³ With globalization it is becoming ever harder to contain financial turbulence neatly within a single country, or continent.

It is all the more astonishing, then, that money and central banking have become non-issues in the international arena. The big themes are global climate change; global public health, including the AIDS/HIV crisis; and war, including ethnic conflicts that spill across national boundaries. When Björn Lomborg, author of *The Skeptical Environmentalist* (2001), convened a panel of leading economists to set priorities among a range of ideas for improving the lives of people living in developing countries, the resulting Copenhagen Consensus, incredibly, was *not* to include international financial turbulence in the list of top priority concerns. Upon closer inspection, it turns out that the panel chose not to assign any priority to the idea of combating international financial turbulence not because they deemed international financial crises an unimportant problem, but because they felt that the research base was lacking for the panel to make an informed judgment.⁴

This pronouncement is as good an indicator as any that macro political economy is dead. It is dead in part because it was a success story; precisely because macro political economy made a difference in the world, political economists have moved on to the Next Big Thing, which is comparative political economy, or the political economy of development—its non-monetary aspects, that is. Macro political economy is dead in other part because it is intellectually stagnant; political economists should be developing the research base that would allow the world to combat in-

ternational financial turbulence, and they aren't. Macro political economy, with its focus on game theory, is stuck with an impoverished understanding of distributional conflict and political institutions.

This essay calls for macro political economy to rise from the dead—to break out of its rut and develop a richer understanding that attends to history and culture. There is an urgent need for us to create a research base on monetary institutions that will allow us to address two looming challenges (there are surely more than two, but I have only so much space).

One challenge consists of the demographic time bomb in the developed countries. As the number of retirees balloons relative to the number of workers, monetary policy will get sucked into an intergenerational distributional conflict. In a given year, the working population produces a GDP pie, which gets split up between the working and retired populations. The share of older people depends on their entitlements (social security, state employee pensions, and the like). Monetary policy can, among other things, affect the real value of these entitlements, or the share of the GDP pie that goes to older people: to the extent that the entitlements are denominated in nominal currency and not indexed to inflation, they can be “inflated away.”

Another challenge consists of the high likelihood that an extreme unforeseeable event will occur (the specific event is unforeseeable, but it is foreseeable that some such event will occur). For example, if a highly lethal disease spreads quickly and globally, much will depend on the intelligence of the monetary policy response—of an internationally coordinated response, that is—to avert global economic meltdown.

To deal with these challenges, domestic monetary institutions, which for the most part are in good working order, must be strengthened and international monetary institutions, which are in terrible shape, must be reconceived from

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maladjustments and therefore public debt (Grilli, Masciandaro and Tabellini 1991), to boost public spending and reduce corruption (Persson and Tabellini 2003) and to hurt consumers to the advantage of producers (Rogowski and Kayser 2002). Presidential systems purportedly dampen public spending, exhibit clear fiscal electoral cycles and damage overall economic performance (Persson and Tabellini 2003). Finally, a new empirical literature on federalism has shown how different federal arrangements may induce or not budget imbalances and fiscal irresponsibility at the subnational level (Rodden 2005a).

Besides generating important empirical and theoretical insights on the relationship between politics and the economy, the literature on constitutions and the macroeconomics fits squarely with a much broader theoretical paradigm (which has become central if not dominant in both political economy and political science) claiming that institutions and institutional constraints are the key lever to understand the roots of political life, from economic stagnation to voter behavior.⁴ Yet, an examination of the existing institutionalist models of economic policy-making reveals that they still have a long way to go to show that political institutions in general and constitutional structures in particular shape economic policies and outcomes. Although the questions and problems of this research agenda are many, I here focus on three shortcomings of the current literature. First, most of the models remain highly contrived: perhaps built to alleviate otherwise formidable mathematical problems, their assumptions and the rules that govern the behavior of their agents have little to do with the constitutional structures that exist in the real world. Second, they tend to ignore the role that (heterogeneous) preferences may play in the choice of policies. Finally, these models frequently pay no heed to the role of organizations or parties and their coordinating effects across institutional mechanisms.

Presidentialism and Fiscal Policy: Results and Underlying Model

To probe the strengths and limitations of the current models on constitutional rules and the economy, I choose here to discuss Torsten Persson and Guido Tabellini's work on the impact of constitutions in general and on presidential regimes in particular. Theirs is undoubtedly the theoretically and empirically most robust research on this question. It is also, and deservedly so, the most influential analysis done so far.

In *The Economic Effects of Constitutions*, published in 2003, Persson and Tabellini find that presidentialism reduces the overall size of government by about 5 percent of GDP – or the equivalent of 1/9 of the average OECD public spending and 1/6 of the mean level of public spending across the world. In turn, majoritarian elections systematically reduce government spending by almost 5 percent of GDP, welfare spending by about 2-3 percent of GDP and budget deficits by 2 percent of GDP.

The *Economic Effects of Constitutions* is an eminently empirical piece of work. Its theoretical underpinnings, which are very briefly discussed in the book, rely on more detailed work published separately – mostly in a article by Persson, Roland and Tabellini (2000).⁵ According to this article (referred to as PRT from now on), fiscal and in general policy decisions can be modeled as a game in which three representative voters (each one representing one group voting in a single district) elect three legislators respectively. In voting for their representatives, voters maximize their income. Rather crucially, voters from the same constituency coordinate their strategies within the district (as denoted by the use of a single representative voter in each district) but not across constituencies. The legislators, disciplined through a rule of retrospective voting, decide on the level of taxes, the level of public goods and

the extent of redistributive transfers across districts. Policy-makers also decide on the extent of rents they will appropriate for themselves.

The level of taxes, the type of expenditure and the volume of rents vary with the institutional setting legislators employ to decide over policy. In a first institutional set-up, which operates as the baseline for two other constitutional settings, nature selects one of the three legislators as the agenda setter that will propose the level of taxes, public goods and redistributive transfers to the whole assembly. In a second institutional setting, there are two agenda setters instead. The first one sets the tax rate. The second one sets the level of public goods within the tax level already approved by the first agenda setter. In the third institutional setting, nature picks two legislators as members of a majority coalition at the outset of the legislative period – these two legislators constitute a government that drafts a policy proposal that is then passed in parliament. According to its authors, the second setting models the principle of separation of powers in a presidential system. By contrast, the third model approximates a parliamentary system in which the government can only operate as a result of a sustained confidence vote in the assembly.

In the first institutional setting, in which there is a single agenda setter, *A*, *A* buys off the support of one of the other two legislators and sets policy to maximize her own voters' utility as follows. After setting taxes at their maximum, she underprovides public goods (which by definition go to all districts) and compensates that undersupply (to her constituents) with direct redistribution – so that the sum of public goods provision and redistribution is the maximum her voters could obtain. As a result, the other two districts do not get any redistribution at all – they simply do not because they compete with each other to be included

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scratch.

Total special interest gridlock

What message did two decades' worth of macro political economy research send to policymakers? Money cannot systematically raise employment and output. Political attempts to stimulate employment and output are futile and damaging—all they do is create inflation. For this reason, everybody is better off when policymakers delegate monetary policy to an independent central bank—everybody, that is, including the policymakers themselves. It follows that the removal of monetary policy from the political sphere must be uncontroversial, and hence politically straightforward to implement. Macro political economy thus made a successful case for the *depoliticization* of monetary policy.

But if macro political economy successfully depoliticized monetary policy, the question is how monetary institutions that emerged in an era of depoliticization will cope when distributional conflict returns to monetary policy, and with a vengeance.

What distributional conflict has the potential to devastate societies in the coming decades? In the developed countries, the proportion of older people, including the retired population, is ever increasing relative to the proportion of younger people, including the working population. Older people are formally entitled—"entitled on paper," that is—to an ever greater share of GDP. The redistribution from the young working population, which produces the GDP pie, to the older retired population must be implemented through taxation. For example, the government might ask workers to pay social security contributions, which are then used to fund the social security payments to retirees; or state governments might tax workers, and the tax revenue is then used to pay for state employee pensions. But if there are too few workers producing the GDP pie and too many retirees holding paper entitlements, the levels of taxation that are nec-

essary to effect the redistribution can end up confiscatory and economically infeasible. Workers will not simply continue working if, say, 95% of their earnings are taxed away—they will work fewer hours, or participate in a worker riot, or emigrate to another country.

Something will have to give, and the question is what role the inflation tax will play in all of this. Monetary policy can, among other things, affect the real value of entitlements that are denominated in nominal currency and not indexed to inflation. The precise distributional effects of monetary policy depend in detail on which kinds of assets older people hold, which of those assets are indexed, and so on. Moreover, there may well be distributional effects within the group of older people, for example, because the rich and the poor among them hold different kinds of assets, or are protected from inflation to different degrees. My purpose here is not to spell out the redistributional effects of monetary policy in detail. It is simply to say that because monetary policy is such a powerful tool of redistribution, monetary policy is likely to get dragged into the distributional conflict over the split of the GDP pie between the working population and the retired population.

If one part of the problem concerns the distribution of the GDP pie between the young and the old, the other part has to do with government spending on social security, health care for older people, and state employee pensions. If biotechnology increases life spans to 120 years, then it will not help to increase the retirement age by a couple of years at the front end when at the other end people will be spending more time in retirement than they ever spent in the labor force. There will be pressures for government spending that benefits older people even as there are limits on the government's ability to tax and borrow, which will translate into pressures to print money. Once again, it appears inevitable that monetary policy will get dragged into this distributional conflict.

The deeper reason why an ageing population is such a serious problem for advanced democracies is because of a disconnect between the economic and the political side of the equation. On the economic side, there is no alternative to renegeing on the promises made to older people, at least to some degree. Renegeing can take various forms—increasing the retirement age, inflating away nominal entitlements, outright default, and so on. Different forms of renegeing have different political and social costs, and the question is, what is the "least disastrous policy mix" taking into account the welfare of young and old alike. Meanwhile, on the political side, older people will constitute a powerful voting bloc—there will be ever more of them; their participation rates in election are way above average; they have relatively homogeneous interests compared to the young working population; they are relatively well-informed, especially about the issues they care about (social security, health care); and in the United States they are exceedingly well-represented by the American Association of Retired Persons (AARP), which is one of the most powerful lobbies in Washington, D.C.

And make no mistake—older people are attached to their entitlements, and they will not let go of them without a (political) fight. It is no good to say that older people have no needs because their mortgages are paid off—as we speak, the needs are being created. People disproportionately make use of the health care system when they are old. Technological progress translates into expensive high-technology medicine—and once the medicine is available, there will be a demand for it. Health care for older people also has built into it a costly labor-intensive component. And once older people live longer, they will want to "get a life," which includes cosmetic surgery and second homes in warm places.

With such a powerfully united special interest group in place, it seems quite unlikely that the political system will be

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in the majority and therefore outbid each other in the minimum they accept to vote for A 's proposals.

In the second institutional setting, instead, voters employ the separation of agenda-setting powers to discipline legislators as follows. Since in this case the agenda-setter A sets taxes and is then followed by the agenda-setter A , who decides how to allocate revenues, the latter (A) has an incentive to trade off public goods against redistribution – very much in the same way the single agenda-setter A of the first institutional setting does. In that case, again, one should expect a suboptimal provision of public goods with all the redistributive spending going to the constituents of A . However, A 's incentives are constrained by A 's response. Since A represents one of the districts that would be left with no redistribution (were A to decide on everything), A prefers to keep taxes at the minimum needed to finance the optimal level of public goods. With taxes depressed as a result of A 's decision, A has now less revenue at her disposal. As a result, there should be less waste in the form of rents. In short, with separation of powers, voters can exploit the conflict of interest of legislators to reduce biased redistribution and corruption. Naturally this comes along with overall lower public spending.

Finally, in the third institutional setting, where two legislators are ex ante bundled in a single majority by nature, the benefits of public goods are internalized by a broader majority (two out of three districts) than in “presidential” settings and so their level should be higher. With a larger (stable) majority in place, taxes are also higher in “parliamentarian” set-ups – the two legislators can raise taxes to squeeze resources from the minority and they do so to cater to their two districts. Redistributive flows go to these two constituencies.

Limits of the Model

To what extent does this stylized

model represent, in strict theoretical terms, the workings of presidential and parliamentary regimes? The answer is that it only does so in part for the following reasons:

1. A poor fit between theory and practice. The PRT (2000) model does not capture well the institutional structure of current presidential and parliamentary regimes for at least two reasons:

(a) Whereas the legislators of the PRT model come from different districts, in the real world presidents and assemblies are elected through ‘overlapping’ constituencies: the president (purportedly one of the agenda setters) is elected by the three districts together rather than just by one of them. Thus, the electoral incentives of the president do not match PRT's second set-up. Presidents need to organize a broader electoral majority in the real world – the equivalent of gaining two districts out of three in the PRT system. This must have consequences for the policy-making incentives of the president. Intuitively, presidents need to be more careful about the provision of public goods than what is predicted in PRT (2000).

(b) PRT's distribution of functions or agenda-setting powers between A and A – with the former setting taxes and the latter choosing spending – does not correspond to any presidential regime we know of (Tsebelis and Alemán 2004). Instead, in the real world both the executive and the legislative make decisions over tax-and-spend bundles. Moreover, presidential regimes are based, with variations, on the idea of substantial amendment rights given to members of Congress over presidential policy proposals (and vice versa).⁶

2. PRT (2000) as a model of divided government. For the sake of the argument, let us grant the dubious claim that the PRT model captures the traits of presidentialism in a sufficiently convincing manner. Recall then that the policy outcomes (less spending and fewer

rents under presidentialism) predicted in PRT (2000) crucially depend on the assumption that A and A are elected by different districts. Representing two wholly distinct constituencies, the former constrains the latter's spending decisions. The problem with this assumption, which is exogenous to the model, is that it has little empirical support. The proportion of cases in which the majority party in the legislature is not that of the president is very small. According to Cheibub et al. (2004), divided governments represent 10.6 percent of all the cases of presidential regimes from 1946 to 1999.⁷

To put it differently, the PRT model (and its predictions of low public spending) does not describe all presidential regimes as opposed to parliamentary regimes (and hence cannot serve as the theoretical foundations for *The Economic Effects of Constitutions*). At most, it only characterizes a particular subclass of presidential systems – those that have policy-makers of different “types” (or parties) in control of different levers of government. Yet the problem with this revised and more accurate reading of PRT (2000) is that it is at odds with what we know from other studies on regimes with separation of powers. Alt and Lowry (1994) show that divided state governments spend less than unified Democratic state governments but more than unified Republican state governments. Alt and Lowry (1994) also show that divided governments have a harder time adjusting to unexpected shocks – something that, somewhat paradoxically in the face of the Persson-Tabellini book, Grilli, Masciandaro and Tabellini (1991) showed for divided governments in general across the OECD.

3. The absence of preferences. As should be already apparent by now, the limitations of the PRT model are related to what constitutes its core weakness: the absence of any treatment of voters (and politicians) as having heterogeneous

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capable of renegeing in the least disastrous way on promises made to older people. More likely, ageing democracies will respond to the impossible tension between the economic and political sides of the equation by postponing hard decisions and remaining mired in total special interest gridlock.

What are the implications for money and central banking? On the one hand, monetary policy must help society avoid the non-solution of special interest gridlock, and it must contribute its share to the least disastrous policy mix: we can deplore inflation, but the question is: how destructive are alternatives such as outright default? On the other hand, monetary policy must remain aloof from counterproductive political pressures, including those that might emanate from older voters. What monetary institutions can square the circle of being “productively” politically responsive even as they withstand “counterproductive” political pressures?—We do not know, and this is precisely why we need to develop a research base.

Intergenerational distributional conflict is first of all a domestic problem, but it also has international dimensions; first, because older people can be disproportionately found in the developed countries, younger people, in the developing countries; second, because chronic American trade deficits imply that foreigners are accumulating formal entitlements to slices of future American GDP pies. Here, monetary policy can affect the real terms-of-trade and the real value of the entitlements held by foreigners by influencing real exchange rates, capital movements, bond prices, and the like. Second, there is an obvious political incentive to bring relief to the domestic redistribution problem by “taxing” foreigners. On this count, too, monetary policy will inevitably get sucked into the distributional conflict.

The poverty of international institutions

Let me move on to another international threat that arguably requires cross-

country collaboration and international institution-building. Many institutions in place today, such as the European Central Bank and the International Monetary Fund (IMF), emerged in an era of (relative) peace and quiet. Are they equipped to deal with extreme unforeseen contingencies on the scale of, say, the Great Depression?

To fix ideas, imagine you could enter a time machine and return to the year 1900 to what was then the center of the world—Western Europe. Looking back from the vantage point of 1900, you encounter a couple of proud nations that have just experienced a century’s worth of immense technological progress and an increase in material standards of living for which there exists no historical precedent. Now imagine you could tell the policymakers of that era what to watch out for in monetary policy and central banking. What will you tell them?

Let us take a look what lies ahead. There is, first of all, the Great War (later renamed World War I after it was followed by an even greater war). It was funded, in part, by war bonds whose value was subsequently eroded by inflation. In the aftermath of World War I, the Weimar Republic responded to reparation demands by printing money. The resulting hyperinflation impoverished and embittered the German middle class, which largely supported Hitler. Meanwhile, Britain returned to the gold standard at the pre-war parity—a stupid move that created economic hardship and for no obvious gain. Ill-conceived monetary theory and policy contributed to the Great Depression in the United States, which spread across the world and sank the system of international trade. The resulting worldwide depression contributed to the rise of Nazi Germany. Out of all of this flowed World War II and the Holocaust.

Meanwhile, in Eastern Europe, we find the Russian Revolution and the Gulag. Today, as we celebrate the supposed end of history, capitalism and liberal democracy having won out, it is easy to forget that the big ideological debate

of the first half of the 20th was about capitalism versus socialism versus fascism. People from all walks of life—not just the Communists in the Soviet Union—believed that capitalism was inherently unstable and required central planning to make it work; that the extreme inequities created by capitalism were immoral and required for their correction massive government intervention; and that capitalism contributed to the rise of fascism. John Maynard Keynes epitomized the top-down state control school of thought.

At the end of World War II, F. A. Hayek’s ideas, as expressed in *The Road to Serfdom* (1994 [1944]), were seen as practically criminal, and they spelled professional death among economists. Hayek proposed that central planning was unworkable because central planners, as opposed to markets, cannot hope to pick up all of the distributed information they need to make good decisions; that government intervention, especially the surgical type, as opposed to the type that stands for the rule of the law, tends to make things worse; and that National Socialism is a form of socialism, and not a consequence of capitalism. It would take close to half a century before the Berlin Wall fell, and Hayek’s ideas about the power of decentralization triumphed over Keynes’s ideas.

In the second half of the 20th century, Western Europe was, blissfully, at peace. The process of European integration included repeated pushes for monetary integration: after the gold standard broke down, there emerged the European Snake, the European Monetary System, European Monetary Union, and the European Central Bank. Economists, by and large, opposed fixed exchange rate regimes and monetary union. Voters in many countries, especially Germany, were negatively disposed towards a common currency and central bank. But policymakers like Helmut Kohl pushed ahead against both expert and voter opinion. By any reasonable measure, Kohl’s actions were non-opportunistic and non-

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preferences over political outcomes. All districts are modeled as having the same objective function.

This assumption is hard to sustain. Some districts are poorer than others. Districts differ among themselves in their sectoral composition. Some constituencies are more conservative than others. And with preferences varying across districts, predictions ought to change accordingly. For example, if the two agenda setters come from the same type of left-wing (right-wing) districts, we should expect higher (lower) levels of spending. If they come from districts with different types of voters, they would have to settle for intermediate levels of spending.

4. The role of political (as opposed to constitutional) mechanisms of coordination. Finally, PRT (2000) do away with the possibility of collusive behavior among policy-makers (that is, the possibility of parties) across branches in a presidential system. Conversely, they impose a party structure (or a closed coalition) by fiat in parliamentary regimes. Both assumptions are unrealistic. Although generally looser in internal discipline than parliamentary-regime parties, political parties do exist in presidential regimes (and that they matter seems to be validated by, among others, Alt and Lowry's results). If they do exist, the results of PRT (2000) again become circumscribed to the instances of divided government. In turn, coalition governments are often brittle in parliamentary regimes – parties can always abandon the cabinet and seek new elections. But, if that is the case, we are, then, back to the first type of setting (with an agenda setter A and the other parties competing for support) in which parties outbid each other to get policy spoils instead of an institutional setting in which two legislators are inextricably linked (as purported in the third PRT scenario).

It is worth making this latter point more precise. The claim is not that parliamentary regimes are similar (or very

close) to a first-setting scenario but rather that we need to know how tight coalitions are to determine, in turn, the impact of coalitions on spending and rent-seeking decisions. How firm coalitions are is a function of how many outside options do parties have to the one of forming government with party A.

To some extent, this discussion suggests that the PRT model may be interpreted empirically in a very different manner. Whereas PRT (2000) claim that the second and third settings approximate presidentialism and parliamentarism, one can conceivably think of them as characterizing multiparty versus single-party governments. Multiparty cabinets, particularly where actors have reasonable outside options, operate as places with more than one agenda-setter. According to the model, we should expect them to reduce spending. Single-party cabinets instead are closer to the third scenario – with a very tight (electorally-induced) majority. As a result, they should spend more. Again, the empirical problem is that, at least according to *The Economic Effects of Constitutions*, majoritarian electoral rules, which correlate well with single-party governments, depress spending.

What Next?

The study of political macroeconomics has benefited quite substantially from the neoinstitutionalist research program. But, as it currently stands, it also suffers from serious limitations. The purpose of this concluding section is to suggest, in the light of my previous comments on one (probably the most influential) model of economic policy-making, the to-do-list awaiting researchers interested in moving on and making real progress in this subfield.

First, we need to pay attention to the way in which real-world institutions look like. Models must be developed following how constitutions actually define jurisdictional capacities, distribute agenda-setting powers and establish the

rules to adjudicate between different political agents and institutions. To date the literature on veto powers (Tsebelis 2002) comes closest in its ability to model actual constitutional procedures. It is therefore surprising that most political macroeconomists have not exploited it more fully.

Second, any future research must model the preferences and institutions of policy-makers and voters jointly. Simply deriving economic outcomes from a set of institutional rules and constraints (without any attention to the ideal points of the agents occupying the institutions) will not do it. Naturally, looking at both institutions and preferences complicates research from a purely methodological point of view. For example, we still do not have good, consistent indicators of voters' attitudes and parties' programs across countries. But what may be lost in logical precision will be certainly gained in empirical validity. Hansen (1998) has explored how the distribution of preferences among voters and their representatives (conditional on how they have been elected) affects fiscal choices in the United States. There are already several articles on the impact of preferences under divided government for fiscal policy in American states (Alt and Lowry 1994) and for privatization policy in OECD countries (Boix 1997). More recently, Gabel and Hix (2005) correct Persson and Tabellini's results substantially after modeling the effect of voters' preferences in interaction with different electoral rules and executive-legislative regimes. They show, for example, that a left of center electorate will spend *more* under a majoritarian electoral system than under a proportional representation system.

Finally, institutionalist models of political economics must be attentive to the broader institutional and political structures in which the aggregation rules they study are typically embedded. This general consideration can be broken down into three implications. First, so far

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partisan. They were motivated by the idea that the peoples of Europe, who over the centuries have gone to war with each other to the tune of 100 million lost lives (give or take a couple of tens of millions), will find peace if they are tied together by a common set of institutions, including a common currency and central bank.

Kohl may well be right, and the issue here is not just war. The issue is that any extreme event that will require a coordinated response on the part of the European countries will now meet upon an elaborate set of institutions that can deliver such a response. This is not to say that the institutions of the European Community and European Monetary Union are a pretty sight—they are cumbersome and costly, and impossibly bureaucratic. It is simply to say that they will probably help avert large-scale disaster in Europe.

Today, the center of the world is the United States. We can look back at a century's worth of immense technological progress and an increase in material standards of living for which there is no precedent in history. But just like in 1900, if you look carefully, you can see portents of trouble. Religious conflict looms large within the United States and between the United States and Islam. Globalization is running strong—and so are extreme inequalities within and between countries, and not to forget identity politics and ethnic conflict. The World Wide Web is creating unprecedented amounts of public information, but all of this shared information is not exactly creating “one world,” nor is it making people more tolerant. On the contrary, as people emigrate into chat rooms and virtual worlds, they self-select into like-minded groups that serve as echo chambers for their opinions. Religious and ideological conflict has not come to an end, and there is no guarantee that history is ever upward lifting.

We cannot tell for sure what the 21st century will bring us, obviously, but we can say with a high degree of certainty that something extreme will happen. The occurrence of further international finan-

cial crises are almost a given, but there is so much more that can happen, and much of it will require a coordinated monetary policy response. What if the global spread of a contagious disease triggers a global economic meltdown? What if global climate change leads to a sudden immersion under water of whole countries, or parts of countries, which in turn leads to large-scale population movements? What if a war breaks out driven by religious and ideological conflict over the distributional implications of globalization? And what will happen to people's *ideas* about capitalism and liberal democracy when they experience the global economic and political system as grossly dysfunctional—and what will happen when policymakers *act* on the people's ideas? Are our international institutions equipped to respond adequately to extreme events, including ideological clashes over the way the world works?

In the early 1990s the IMF promoted reforms to liberalize capital and financial markets in East Asia that probably aggravated, and possibly caused, the 1997 crisis. Once the crisis was up and running, harsh policy measures prescribed by the IMF arguably contributed to the spread and severity of the crisis. Ill-conceived macroeconomic theory met upon a poorly devised international institution, and the result is a repeat performance, now at the international level, of what we observed in the domestic sphere in the early 19th and 20th century.

What kinds of international institutions do we need today? Three characteristics are essential. First, institutions must support an internal diversity of ideas; links to intellectual communities so they can pick up on competing theories about the way the world works; and elaborate internal collective decision-making processes that are capable of synthesizing conflicting ideas and moving a “representative” synthesis to the final decision-makers. (For example, lower-level staff might make a recommendation but attach to it a couple of minority opinions that serve as red flags.)

Second, institutions must have local listening posts that encourage them to figure out what is happening “on the ground” and pick up on failures of conventional wisdom. This information, too, must be synthesized and moved to decision-makers.

Third, institutions must develop external connections such that they reflect the preferences of the peoples whose economic fortunes lie in their hands, and they must follow people's preferences when those preferences change. Institutions must be political accountable responsive. And yet at the same time, the precise way in which they are political accountable and responsive must allow them to identify and resist counterproductive political pressures.⁵

In well-functioning democracies, such institutions can evolve, and have evolved, in interplay with the pressures emanating from various political and economic actors and institutions. As a result, domestic monetary institutions have the three characteristics listed above, at least in approximation.

International institutions look nothing like this. They lack intellectual diversity; they lack local listening posts; they lack bottom-up collective decision-making processes; they lack political accountability vis-à-vis the people whose economic fortunes they shape, and at the same time they are excessively beholden to the United States. The IMF in particular looks suspiciously like the monetary institutions of the 19th and early 20th centuries, which regularly caused economic havoc.

How can we replicate at the international level what we have largely achieved in the domestic sphere: institutions that, first of all, do no harm—that stabilize economies instead of wrecking them, and more: institutions that can negotiate model uncertainty, aggregate distributed information, and accommodate the preferences of the people up to a “productive” point? Today, more than ever, there is an urgent need for us to develop a re-

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GENERAL ANNOUNCEMENTS

THE MICHAEL WALLERSTEIN AWARD FOR BEST ARTICLE IN POLITICAL ECONOMY CALL FOR DONATIONS

The Political Economy Section of the American Political Science Association has established an award in honor of Michael Wallerstein (1951-2006), whose scholarship, teaching, university service, and professional leadership made vital contributions to the development of political economy. The award will be granted to the best published article in the field of political economy, broadly defined. The award will carry a cash prize, and will be presented at the annual meetings of the American Political Science Association, for work published in the previous calendar year.

The Section is thus soliciting donations from individuals and institutions to fund the endowment for the Michael Wallerstein Award. We hope for a prompt and generous response, which will allow us to establish the Award quickly and to make the first presentation at the 2006 annual meetings of the APSA. Please help us make this a fitting and lasting tribute to an outstanding scholar.

Checks should be made out to "APSA" and on the memo line of the check donors should write "Wallerstein Prize." All contributions, which are tax deductible, should be sent to: Robin Smith-Wallerstein Prize, APSA, 1527 New Hampshire Avenue, NW, Washington, DC 20036.

Requests for further information may be addressed to Rob Franzese, Secretary-Treasurer of the Political Economy Section, at franzese@umich.edu.

MEMORIAL SERVICE FOR MICHAEL WALLERSTEIN

A memorial service in honor of Michael Wallerstein will be held on Sunday, April 30th, from 10:30 AM to 2:30 PM, at the Norris Student Center, 2nd floor, on the Evanston Campus of Northwestern University. For further information about the event, see: <http://www.polisci.northwestern.edu/news/index.html>.

APSA POLITICAL ECONOMY SECTION TRAVEL SUBVENTION PROGRAM

The Political Economy section announces travel grants to the annual APSA conference in set amounts of \$125 or \$250 to be awarded to "graduate students and unfunded faculty or non-faculty members" on a funds-available basis. Paper or poster acceptance announcements will direct all those who are eligible for consideration to apply. Applicants will complete either a webpage or electronic document application, including providing the abstract and a brief characterization of their financial situation (i.e.: "graduate student, no institutional funding source"; "graduate student, limited departmental funds"; "faculty, no funding source"; "non-faculty, no institutional funding source"). The conference section chair will coordinate the selection process. Eligible applicants will be evaluated on the quality of the applicant's proposed contribution; its potential dissemination among section members, as determined by the candidate's involvement on a panel (high priority) or a poster (lower priority); and the applicant's need for financial assistance.

A volunteer committee of Joelle Schmitz, Charles Shipan, and Rob Franzese developed the program in response to a call from the section to increase participation in political economy section events at the APSA meetings.

UPCOMING AWARDS

The **William Riker Best Book Award** is for the best book in political economy published during the past year. The Riker Award Committee will be chaired by Stan Winer (stan_winer@carleton.ca). The other members of the committee include Laura Langbein (langbei@american.edu) and Carles Boix (cboix@midway.uchicago.edu).

The **Mancur Olson Award** is for the best dissertation in political economy published during the past year. The Olson Award Committee will be chaired by John Freeman (freeman@umn.edu). The other members of the committee are Christopher Adolph (cadolph@u.washington.edu) and Catherine Hafer (catherine.hafer@nyu.edu).

The **Best Paper Award** is for the best paper in political economy given at the 2005 APSA meetings. The Committee will be chaired by David Leblang (leblang@colorado.edu). The other members of the committee are Amy Potete (amypoteete@gmail.com) and Bernhard Mueller (86mueller@cua.edu).

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GENERAL ANNOUNCEMENTS

INTERNATIONAL POLITICAL SCIENCE SOCIETY (IPES)

Dear Colleagues,

We write to announce the inaugural meeting of the **International Political Economy Society (IPES)**, and to invite you to submit a proposal for a paper to be presented at the first annual conference to be held at Princeton University, November 17-18, 2006.

Rationale: The purpose of this Society and conference is two-fold. First, we hope to highlight the best new work in international political economy and to promote this exciting field of research. Second, the larger association meetings (e.g., APSA, ISA) have grown somewhat diffuse. Following the example of several smaller societies that have developed in related fields, such as the Public Choice Society, Peace Sciences Society (International) and the International Society for New Institutional Economics, the conference will focus on a smaller number of carefully selected papers. With participants who share a common background and field expertise, we expect the quality of the presentations and discussions to be very high.

Format: We anticipate that 30-40 papers will be presented over the two days. The format of the sessions will range from simultaneous 30 minute presentations in adjacent rooms (15 minutes presentation, 12 minute Q&A), to panels of closely related papers with discussants, to a handful of “keynote” sessions for papers likely to elicit broad interest. The precise mix of these different formats will depend on the proposals submitted and accepted for the conference.

Expenses: The IPES does not have any permanent institutional support. The Center for Globalization and Governance at Princeton University, directed by Helen Milner, has generously offered to underwrite some costs for the first conference.

All participants will be expected to pay their own travel and hotel expenses. We understand that travel funds are limited for everyone, and our inability to cover costs of participants may prove to be a deterrent to some. We hope that the high quality of the meeting and discussions will make this a worthwhile expense.

In addition to organizing and hosting the conference, the Center for Globalization and Governance has contributed limited monies to help defray hotel expenses for those attendees who do not have travel funds of their own. Priority in distributing these funds will be given to graduate students and junior faculty presenting papers at the meeting. If you wish to be considered for these travel funds, please indicate this at the end of your paper proposal (see below).

Information about registering for the conference and logistics (i.e., hotel reservations) will be forthcoming in May 2006 with the preliminary program and posted at our website (under construction at <http://polisci.ucsd.edu/ipes/>).

Proposals: For purposes of the conference, appropriate papers will include some international component (i.e., either the independent or dependent variable must be “international” in some meaningful sense), and should either focus on some area of economic policy or use economic methods to analyze political phenomena. Although we expect the conference to be centered on political scientists working on IPE, we would also welcome submissions from economists and other scholars from cognate fields. One important goal of IPES is to provide an outlet for up-and-coming IPE scholars to increase their visibility. For that reason we will give some priority to presentations by advanced graduate and recent Ph.D.’s. Nonetheless, proposals from scholars at all stages of their careers are encouraged.

The deadline for submitting proposals was February 1, 2006. All proposals will be vetted by the program committee. Participants will be notified by May 2006 and a preliminary program will be released at that time. If you have received this invitation via email, please feel free to pass it on to colleagues, students, and anyone else you believe might be interested.

We are excited by this endeavor and will work to ensure that it is a success. We hope that you are equally interested, will choose to submit a proposal, and will attend the meeting whether or not you are accepted for the program. If you have any questions or concerns, please contact any of the committee members or write to us at ipes@ucsd.edu.

Thank you,

David Lake (Chair) (dlake@ucsd.edu)
Helen Milner (Local organizer) (hmilner@princeton.edu)
Jeff Frieden (jfrieden@harvard.edu)
Judy Goldstein (judy@standford.edu)

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(2006 Program Committee)

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most models have only studied the consequences of certain institutions, namely presidentialism and electoral rules, and within them, mostly its procedural dimensions. Yet it turns out that one of the most important (and most forgotten) facets of institutional design is the extent to which existing institutions bias the representation of voters. Federal systems tend to give more weight to small states. Almost all legislatures are elected through malapportioned districts that often give considerable advantage to rural voters (Samuels and Snyder 2001). In short, neoinstitutionalism has emphasized the checks-and-balances effects of constitutions at the expense of the impact of institutions on preference representation and aggregation. Rodden's (2005b) analysis of the impact of malapportionment on public spending stands up as a notable exception. Second, neoinstitutionalists have generally disregarded the endogenous components of institutions. If Cheibub and Przeworski (2003) are right and presidentialism is proxying for regime instability and the political intervention of the army or if electoral rules are the result of strategic choices given a certain distribution of parties (Boix 1999), then the observed effects of institutions may not be related at all to their hypothesized consequences.⁸ Third, the impact of institutions is mediated by the level of participation of voters (which, as a matter of fact, may be affected by the institutions in place). But, unfortunately, this has been hardly taken into account by a literature that, once again, remains inattentive to the problem of political preferences.⁹

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* Paper prepared for *The Political Economist*. A previous, longer version was presented at the "Workshop on economic consequences of political institutions" at Duke University, April 1-2, 2005. I thank the research assistance of Joan Serra.

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¹ For good summaries of that literature, see Drazen (2001), Franzese (2002) and Alt and Rose (2005).

² Among a very extensive literature, see Calmfors and Driffill (1988), Soskice (1990), Alvarez, Garrett and Lange (1991).

³ See Alesina and Summers (1993) and, in attempt to look at the interaction of central banks and labor markets, Hall and Franzese (1998). For analysis of these institutional structures in an open economy setting, see Boix (2000) and Clark (2003).

⁴ For the relationship between institutions and development, see North (1990) and, very recently, Przeworski (2004). For institutions and political behavior, see Posner (2005).

⁵ See also Persson, Roland and Tabellini (1998).

⁶ As PRT (2000: 1143-44) themselves acknowledge, their results weaken substantially in the presence of these procedures.

⁷ Almost 70 percent of all divided cases in the world have happened in the United States.

⁸ Although Persson and Tabellini (2003) develop instruments to overcome the potential endogeneity problem of their estimations, their choice of instruments is atheoretical and therefore mostly flawed.

⁹ Once we add regime instability and level of turnout to the estimations of Persson and Tabellini, the impact of presidentialism on spending is mostly insignificant from a statistical point of view. See Boix (2005).

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search base on politics and macroeconomics that down the line will translate into a strengthening of domestic institutions and a radical rethinking of international institutions. High time for macro political economy to come out of its funk.

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*Essay adapted from Lohmann (forthcoming).

¹ The two definitive textbooks for macro political economy are *Political Economics* (2000), by Torsten Persson and Guido Tabellini, and *Political Economy in Macroeconomics* (2000), due to Allan Drazen.

² *USA Today* (2005). The poll responses date March 7-15, 2005.

³ Eichengreen (2004).

⁴ *The Economist* (2004).

⁵ Lohmann (2003).

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