

Dynamic political economy – Summer 2017

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This course introduces students to modeling policy choices in a dynamic setting. It starts with applications of dynamic programming techniques to incentive problems, both for the design of policies, their credibility. We then characterize equilibrium when policies themselves are endogenous and equilibria are restricted to be Markov. Most examples will be on fiscal policy.

Students are expected to learn the logic behind dynamic programming with incentive problems and their applications to the understanding of contract design. Students will be taught the basic framework of dynamic voting models that use dynamic programming tools for economic and political decision simultaneously. At the end of the course the student is expected to understand, and be proficient in the application of the concepts and methods from the models covered in the course. The student should show competence in analyzing a macroeconomic problem, where the above mentioned concepts and methods are central, that is competence in solving such models and explaining in economic terms the results and implications and how they derive from the assumptions of the model.

The particularly good performance, corresponding to the top mark, is characterized by a complete fulfillment of these learning objectives.

Some lectures will have time dedicated to solving problems sets that will be given in advance

As a prerequisite the student must be familiarized with basic dynamic programming as covered, for example, in chapters 3, 4 and 7 in Ljungqvist L. and T. Sargent “Recursive Macroeconomic Theory” (2004) MIT Press.

Basic textbook: Ljungqvist L. and T. Sargent “Recursive Macroeconomic Theory” (2004) MIT Press (or later editions).

1 Optimal taxation. Self insurance.

*LS chapter 15 and 16

Lucas R. and N. Stokey “Optimal Monetary and Fiscal Policy in an Economy without Capital” (1983), *Journal of Monetary Economics*, 12(1), 55-94

Barro R. “On the Determination of Public Debt” (1979), *Journal of Political Economy*, 87, 940-971

Aiyagari S., A. Marcet, T. Sargent and J. Seppala, “Optimal Taxation without State Contingent Debt” (2002), *Journal of Political Economy*, 110(6), 1220-1254

2 Social insurance with incentive problems. Dynamic contracts.

*LS chapters 19 and 20

Kocherlakota N. (1996) “Implications of Efficient Risk Sharing without Commitment” *Review of Economic Studies*, 63(4)

Kletzer and M. Wright, (2000) “Sovereign Debt as Intertemporal Barter”, *American Economic Review*, Vol 90(3), 621-39

Gonzalez-Eiras M. (2016) “Why Might the Old Want to Honor Sovereign Debt”, working paper

3 Optimal unemployment insurance. Redistribution.

*LS chapter 21

Hopenhayn H. and J. Nicolini (1997) “Optimal Unemployment Insurance” *Journal of Political Economy*, 105(2)

Shimer R. and I. Werning (2007) “Reservation Wages and Unemployment Insurance”, *Quarterly Journal of Economics*, 122(3), 1145-85

*Werning I. “Optimal Fiscal Policy with Redistribution” (2007), *Quarterly Journal of Economics*, Vol 122(3), 925-967

4 Credible government policies. Fiscal and monetary.

*LS chapter 22

Abreu D., D. Pearce and E. Stacchetti (1990) "Toward a Theory of Discounted Repeated Games with Imperfect Monitoring" *Econometrica*, 58 (5)

Phelan C. and E. Stacchetti (2001) "Sequential Equilibria in a Ramsey Tax Model" *Econometrica*, 69(6)

Athey S., A. Atkeson, and P. Kehoe, (2005) "The Optimal Degree of Discretion in Monetary Policy." *Econometrica*, 73(5), 1431-75

5 Dynamic voting. Positive theory of taxation.

*Krusell P., V. Quadrini and J. Rios-Rull "Politico-economic Equilibrium and Economic Growth" (1997) *Journal of Economic Dynamics and Control*, 21

Krusell P. and J. Rios-Rull (1999) "On the Size of the US Government: Political Economy in the Neoclassical Growth Model", *American Economic Review*, 89(5), 1156-81

Farhi E., C. Sleet, I. Werning and S. Yeltekin, (2012) "Non-linear Capital Taxation Without Commitment", *Review of Economic Studies*, 79, 1469–1493

6 Dynamic voting. Social security

Forni L. (2005) "Social security as Markov equilibrium in OLG models", *Review of Economic Dynamics*, 8, 178-194.

Gonzalez-Eiras M. (2011) "Social security as Markov equilibrium in OLG models: a note", *Review of Economic Dynamics*, 14, 549-552.

*Gonzalez-Eiras M. and D. Niepelt (2008) "The future of social security", *Journal of Monetary Economics*, 55 (2), 197-218.

Song Z. (2011) "The dynamics of inequality and social security in general equilibrium", *Review of Economic Dynamics*, 14(4), 613-635.

*Gonzalez-Eiras M. and D. Niepelt (2012) "Ageing, Government Budgets, Retirement, and Growth", *European Economic Review*, *European Economic Review*, Vol. 56(1), 97-115.

7 Dynamic voting. Debt

*Battaglini M. and Coate S., (2008) “A Dynamic Theory of Public Spending, Taxation and Debt”, *American Economic Review*, 98(1)

Song, Z., Storesletten, K. and Zilibotti, F. (2012) “Rotten parents and disciplined children: A politico-economic theory of public expenditure and debt”, *Econometrica* 80(6), 2785-2803.

Gonzalez-Eiras M. and D. Niepelt (2015) “Politico-Economic Equivalence”, *Review of Economic Dynamics*, 18, 843-862

8 Dynamic voting. Sovereign debt

*Arellano C. (2008) “Default Risk and Income Fluctuations in Emerging Economies”, *American Economic Review*, 98(3) 690-712.

Niepelt D. (2014) “Debt maturity without commitment”, *Journal of Monetary Economics*, 68, S37–S54.

Sunder-Plassmann L. (2016) “Writing off sovereign debt: Default and recovery rates over the cycle”, working paper.

9 Dynamic voting. Other

Gonzalez-Eiras M. and D. Niepelt (2016) “Fiscal Federalism, Grants, and the U.S. Fiscal Transformation in the 1930s”, working paper

Pei Y. and Z. Yie (2016) “A Quantitative Theory of Time-Consistent Unemployment Insurance”, working paper

Formal Requirements

The students are required to pass a take home, open book, written final exam. At the beginning of every lecture, except for the first one, students will be given a short quiz based on the selected readings from the bibliography

Examination

The grade will be determined by a written exam. To be able to take the exam, students need to pass at least 50% of quizzes .

Resit examination: Same as ordinary.

Requirements for PhD students

PhD students may take this course and complete a research module. For this on addition of the requirements stated above, they must write a term paper that has to be handed in by October 1, 2017.