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Rent-Seeking

Rent-Seeking and Public Policy

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Introduction

Firms and industries across the world regularly engage with political and government players in order to obtain economic rents through a variety of elaborate strategic tools. Scholars in political economy and economics refer to this behavior as rent-seeking, while scholars in business and management often call it non-market strategy or corporate political strategy. The usual goal of these rent-seeking efforts is to secure benefits from the government that would ultimately allow the rent-seekers to improve or maintain their economic position. Examples are plentiful in a variety of institutional settings across the world and include classic cases (e.g., agricultural protection). As Mueller (2003) points out, rent-seeking usually imposes welfare losses on society, which can be substantial depending on the type of rent-seeking behavior that takes place, as well as the political system it occurs in. However, despite the prevalence of rent-seeking and the increasingly salient participation of firms in the political process, rent-seeking behavior and its costs to society often do not receive as much public scrutiny when new policies are developed as they should. This can be quite problematic for a country's political process and economic development, particularly because rent-seeking by its very definition distorts the efficient use of resources.

Why rent-seeking matters

One of the main characteristics of rent-seeking is that it can be defined as the re-allocation of resources to rent-seekers. For example, if a government decides to award subsidies to farmers to grow a certain crop, those funds will not be available for other uses that might be more efficient given the overall composition of the economy. Similarly, if a government institutes trade protection as a response to pressure from a certain industry (e.g., through tariffs), prices for consumers are likely to be higher than without the tariffs in place. Within this view, the rent-seeking process can be described as a game where multiple interest groups compete with each other to influence government players to their benefit. As a result, the outcomes of those processes often reflect which group is more skilled at the rent-seeking game rather than an optimal allocation of resources. Not surprisingly, these outcomes can alter the competitive landscape and consumer behavior in fundamental ways and often persist for a long time as they become entrenched. Recently, we have seen how rent-seeking behavior by interest groups can impede important structural reforms in countries that need to modernize their economies and make them more competitive. In several Euro countries, for instance, governments have struggled to implement reforms against the opposition of groups that are receiving rents through the status quo (e.g., through preferential tax treatment, regulations that eliminate competition, etc.). Another case of rent-seeking that becomes salient regularly during negotiations for free trade agreements is when countries are reluctant to eliminate protective measures for their agricultural sectors, partially as a result of successful rent-seeking by those sectors. As these cases illustrate and my own research shows, one of the key characteristics of rent-seeking is that it can be found in many different political systems.[2] Moreover, it occurs in a broad variety of different policy arenas (e.g., environmental policy, food safety regulations, etc.), making it an important issue for policy makers regardless of the political structure they operate in.

Rent-seeking and public policy

Since rent-seeking efforts by firms and industries are likely to emerge whenever there are economic benefits to be reaped from governmental and political players, it is imperative for well-functioning democracies to protect their institutions and policy makers from too much pres-

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sure from rent-seekers. If rent-seeking behavior is not kept in check within the confines of a balanced political system, not only will welfare losses for society increase, but the system will inherently become less democratic as the rent-seekers' influence rises. Not surprisingly, in countries with a low quality of institutions, rent-seeking often devolves into its illegal and most destructive form: corruption. In very corrupt countries, the rent-seekers through a variety of illegal means (e.g., bribery, coercion, etc.) are able to capture disproportionately large rents. This often keeps those countries in a low-level equilibrium as the limited economic resources available are mostly channeled to the rent-seekers rather than utilized more efficiently.

However, even when considering modern democratic countries, the costs imposed by rent-seeking – both indirectly through welfare losses and directly through the costs rent-seekers have to expend to secure their rents (Mueller 2003)[3] – rarely receive the public attention they warrant. For example, for years, the US and several EU countries have provided government support that was found to be against WTO rules to airplane manufacturers Boeing and Airbus, respectively (Rooney 2012). The question that arises is why public funds are used to support those companies instead of other sectors/firms? What makes the aerospace industry special compared to other industries or compared to putting those funds to different uses? Were the subsidies awarded because the often cited benefits of supporting those firms (e.g., the provision of jobs, potential national interests, etc.) outweigh the costs of the government subsidies? Or were they awarded because those two companies have been more successful in influencing political decision makers in their respective home jurisdictions? The public often receives little justification for the decisions to distribute those rents to private entities, which to some degree is a testament to the success of the strategies rent-seekers are employing (such non-market strategies are subject to a growing stream of research in applied economics and strategic management).

Another example can be found in the area of environmental policy. We are currently seeing strong rent-seeking efforts by fossil fuel companies to impede the regulation of greenhouse gases within the broader context of tackling climate change. Unfortunately, many of those efforts have been quite successful in derailing or weakening proposed legislation to curb the emissions of greenhouse gases, particularly in the United States.

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[3] Such expenditure includes, for example, spending on formal lobbyists, PR campaigns, political campaigns, etc..

This not only steers public policy away from policies that would benefit society at large, but undermines credibility in the respective political system as it becomes captured by more powerful interest groups.

Limiting the negative effects of rent-seeking

While the previous sections listed a lot of negative examples of rent-seeking, this should by no means imply that all interactions among firms, industry groups and government actors are detrimental to society. There is a legitimate role for information exchanges between firms and political actors, as many of the policy makers do not have all the necessary expertise to make decisions that affect a wide variety of stakeholders. However, it is imperative for democratic systems that those interactions are transparent and that they lead to policy outcomes geared towards maximizing overall economic welfare rather than only benefitting the groups that engage in rent-seeking. I believe that steps can be taken to reduce those rent-seeking efforts that are damaging to societal welfare, while at the same time allowing for productive and useful interactions between firms and political actors.

First, it would be essential for policy makers to take the costs of rent-seeking more explicitly into consideration when designing policies. Different policy alternatives should therefore also be evaluated based on (1) their potential vulnerability to rent-seeking, (2) the direct costs incurred by groups seeking to influence those policies and (3) the expected welfare losses if some of the rent-seeking were to be successful. (1) implies that a new policy could be implemented and designed in a way that restricts the ability of rent-seekers to influence the policy to their benefit. (2) implies that when policy makers compare different policy tools on the basis of their costs and benefits, the expected expenditures incurred by potential rent-seekers to influence the policy should factor into these calculations. Finally, (3) implies that if policy makers do make the conscious decision to award rents to certain interest groups (e.g., for political reasons, reasons of national interest, etc.), the expected welfare losses incurred should be included in the cost-benefit analysis. This would result in a more comprehensive evaluation of the actual costs of certain policies.

Second, it would be imperative to introduce much greater transparency into any interactions between firms and political/government actors. While there are some rules (e.g., laws requiring the disclosure of official lobbying

activities in the US) that allow the public to trace some of these interactions, many of the existing regulations leave room for rent-seeking efforts that are hidden from the public's view. By expanding existing disclosure laws and tightening the rules on how firms can engage with government actors, rent-seeking efforts could be limited as policy makers would be more sensitive to public concerns when responding to rent-seekers.

Conclusion

This article – which is by no means all-encompassing – provides a brief overview of important considerations with regard to rent-seeking and public policy. The topic of rent-seeking is very interesting both from the view of academics and practitioners. Many topics within the area of rent-seeking have yet to be explored further and the potential richness of studying rent-seeking in different contexts around the world promises interesting and rewarding results.

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Rent-Seeking on the Supply Side of Politics[1]

Mark A. Zupan[2]

In studying how rent-seeking diminishes a nation's well-being, the focus typically is on the demand side of the policymaking process: crony capitalists, economic elites, labor unions, industrial cartels, consumer activists, and/or environmentalists seeking favorable policies to promote their own economic rents at the expense of the general public. Precious little attention, however, is devoted to a potentially far more dangerous and pervasive form of political capture by government insiders who operate on the supply side of the policymaking process – rulers, elected officials, policymakers, and public employees. Government insiders have the motive, means, and opportunity to co-opt the machinery of the state to promote their monetary and ideological interests at the expense of the general citizenry. This malignancy operates akin to how cancer hijacks the body's own reproductive machinery to grow at its expense.

Politics can be defined as "Who Gets What, How, Why, When, and Where." It is helpful to keep this definition in mind when thinking about government self-capture: who and what it involves; how it grows both in autocracies as well as in democracies; why it is so difficult to counteract and thus was a core concern of the Founders when constructing the constitutional foundations of the American Republic; and the numerous settings when and where it has accounted for national decline and failure.

The list of storied civilizations succumbing on account of government self-capture is lengthy. It includes Egypt's New Kingdom; China's Han Dynasty; the Roman Empire; the Republic of Venice; the Mamluk sultanate; France's Ancien Regime; and the Ottoman Empire.

The lessons to be learned from these historical failures are manifold. While difficult to counteract, government self-capture is not inevitable and there are some important curbs with which it can be combated. Moreover, the current importance of understanding the affliction of government self-capture and its debilitating consequences cannot be overstated.

In today's developed nations, total government outlays average more than 50 percent of GDP, while public sector employment averages over 28 percent. Public sector employment exceeds 50 percent in some developing countries such as China (OECD 2015). In the United States, the unfunded pension and health care liabilities of state and local government workers and K-12 public education provide two compelling examples of the negative effect of government self-capture. If not addressed, the magnitude of these negative effects will continue to grow and threaten the viability of the American Republic.

Government self-capture: who and why?

Government self-capture involves self-enrichment by government insiders at the expense of the overall body politic. Rulers, political leaders, and public employees can benefit from their positions on the supply side of the policymaking process. The perks or economic rents that they derive on account of imperfect accountability on the supply side of the policymaking process may be material (kleptocratic) or ideological.

In building an effective state, one must overcome an important conundrum. Specifically, while political order provides important benefits for a society and its citizens, such monopolization of power also contains the seeds of political decay. This resembles the natural monopoly problem: economies of scale militate toward a sole supplier of the entire market, but the resulting monopoly position affords, if unchecked, the sole supplier the means and opportunity to extract rents at the broader public's expense. The rents derived by government in-

siders on account of their roles on the imperfectly accountable supply side of the policymaking process impose an efficiency cost on society and thereby diminish national well-being.

How does government self-capture work?

Government insiders capture rents when the supply side of the policymaking process is imperfectly accountable. Financial rents can be secured openly or in secret and can accrue from the diversion of public funds or from payments received from other sources (legal as well as illegal) on account of politicians' visibility, status, and/or ability to influence policy outcomes. The various potential channels for material remuneration include campaign contributions, honoraria, in-kind gifts, revolving-door positions in industry, and payments to family members and family businesses. The rents may be derived from relevant interest groups in return for promoting particular policies. They also may accrue on account of politicians' threatening to undertake activities that will make an interest group worse off.

Recent examples of kleptocratic leaders and the estimated amounts, in today's dollars, that they amassed include: Indonesian President Suharto, USD 15–35 billion; Philippine President and First Lady Marcos, USD five to ten billion; Congolese dictator Mobuto, USD five billion; Egyptian President Mubarak, USD 70 billion; Generalissimo Franco of Spain, USD 2.2–3.5 billion; and Libyan dictator Gaddafi, USD 200 billion. Russian President Putin's private wealth has been estimated to be as high as USD 40 billion. Putin heads a ruling clan, moreover, whose assets total over USD 200 billion (Dawisha 2014).

In China, 203 of the 1,271 richest people in the country, or more than one in seven, are delegates to the nation's Parliament or its advisory body according to the Shanghai-based Hurun Report. The delegates' combined net worth is nearly USD 500 billion. 18 of them have assets exceeding the combined wealth of all 535 members of the US Congress, President Obama's cabinet, and all nine members of the Supreme Court (Forsythe 2015).

Historical cases of kleptocracy also abound and include names such as Croesus, King Solomon, Henshen, Tsar Nicholas II, Mir Osman, Ali Khan, Mansa Musa of Mali, Mausolus, Trujillo, and the Perons. At the end of Trujillo's regime in the Dominican Republic his family's fortune equaled 100 percent of the country's GDP

and 60 percent of the country's labor force owed their living, either directly or indirectly, to him (Acemoglu, Robinson and Verdier 2004).

It has been estimated that fully 87 percent of humanity presently lives under a corrupt government (McCloskey 2015). Although kleptocracy is more common in developing countries with less democratic political institutions, democracies are not immune to the phenomenon. Winners of Indian state elections realize annual growth in assets three to five percent higher than for runners-up. Asset appreciation, furthermore, is greater for electoral winners in more corrupt states, those holding ministerial positions, and those with greater incumbency (Fisman, Schulz and Vig 2014). In the United States, the common stock investments made by members of the US Senate and House between 1985 and 2001 generated significant above-market returns: 12.3 percent per year in excess of the market for members of the Senate and six percent for members of the House (Schweizer 2011; Ziobrowski, Boyd, Cheng and Ziobrowski 2004, 2011).

While the pecuniary returns pale relative to those generated by a Marcos or Mubarak in a developing-country setting, some notable First World democratic leaders have profited from political power. Lyndon Johnson amassed a personal fortune of USD 100 million. Bill and Hillary Clinton have surpassed such a total net worth recently through a variety of means such as consulting, giving speeches, and writing books. From modest roots, Newt Gingrich has used similar means to secure as much as USD 31 million in private wealth. Former British Prime Minister Tony Blair is estimated to be worth over USD 150 million on account of the extensive consulting that he has done on behalf of ruling elites in Azerbaijan, Kazakhstan, Kuwait, Qatar, Saudi Arabia, and the UAE, as well as to companies such as British Petroleum and JPMorgan Chase (Caro 2012; Ellison 2015; Schweizer 2015).

Public employees are lower in the pecking order than elected or non-elected political leaders and thus have less apparent capacity to earn rents. That said, public sector positions tend to be insulated from competitive market forces. This is because the government is often the sole supplier or has some effective monopoly power with respect to the provision of a good or a service. In addition, public employees effectively get "two bites at the apple" versus the one available to their private sector counterparts. Not only can they organize themselves to collectively bargain with their managers, as can private sector employees, they also have the ability to elect

and/or otherwise manage the people who are supposed to be managing them (for the sake of ordinary citizens). Governor Scott Walker of Wisconsin recently learned how challenging it can be to stand up to the collective political power of state employees.

Historical examples of government employees benefiting financially from their insider status include: the barons, nobles, and knights in service of feudal European kingdoms; ancient China's Shi warrior-scholar-bureaucratic class; and Janissaries, the elite infantry force created by the Ottoman Sultan Murad I in 1383. Janissary recruits came from lands conquered by the Ottomans and consisted primarily of young Christian boys. Known for their cohesion and discipline, the Janissary ranks swelled from 20,000 in 1575 to 135,000 in 1823. Generously rewarded with salaries, pensions, education-based advancement opportunities, and benefits for their children, Janissaries became an ever more significant political force in the Ottoman Empire.

While initially integral to the Empire's advancement, Janissaries became an important impediment to reform over time, especially after they successfully lobbied in the late 16th century to have their positions become hereditary as opposed to merit-based. They countered efforts to limit their power and perquisites and murdered two reform-minded Sultans (Osman II in 1622 and Selim III in 1807). In such a way, they mimicked the effects of the Praetorians, the vaunted bodyguards relied upon by ancient Roman emperors, who often represented the greatest threat to those same emperors, and the Streltsy, elite troops of Russia's Tsar Peter who strenuously resisted any diminishment of their influence and perks. Not until the Janissary corps was abolished in 1826 by Sultan Mahmud II and over 6,000 of them were executed in a single night was their chokehold on the Empire curtailed.

Government insiders also have the leeway to promote particular ideologies or policy ideas. Consider the world views that individuals such as Ataturk, Gandhi, Gorbachev, Hitler, Lenin, Mao, Mandela, Napoleon, Tsar Peter the Great, Roosevelt, and Thatcher were able to advance through their positions of power, often in the face of well-established traditions and the associated resistance from fellow citizens.

Although it is easier to conceive of autocrats having the means to advance their ideological interests, democratically-elected representatives also have considerable leeway to pursue their world views at the expense of con-

stituent interests. Such leeway is the result of imperfect competition on the supply side of policymaking and the resulting imperfect policing of politician-agents by their constituent-principals (Diermeier, Keane and Merlo 2005; Kalt and Zupan 1984, 1990; Kau and Rubin 1979; Levitt 1996).

Because government, moreover, affords relatively unusual opportunities to impose ideologies on the population at large, politics attracts individuals with relatively intense demands for promoting their particular world views. After all, it is much harder to promote one's ideology through private firms than through the unique coercive powers available through government.

Whether the perks of political power are ideological or material, an added consideration involves the extent to which government insiders dissipate resources to acquire or preserve them. Any resources devoted to such rent-seeking activities, albeit on the supply side of the policymaking process, must be added to the total cost imposed on a society by government self-capture. In early 2015, for example, Freedom Partners, the political organization funded by brothers Charles and David Koch, announced that it is budgeting USD 889 million toward the 2016 US presidential contest (versus USD 240 million in 2012). Ross Perot spent over USD 100 million (in today's dollars) of his own money when pursuing the US presidency in 1992 (Encyclopedia Britannica 2015). While these amounts are still small relative to the impact that the exercise of presidential power can have on US wealth and its distribution, they indicate that rent-seeking costs on the supply side of policymaking are non-zero.

What increases the likelihood of government self-capture?

Seven factors work to increase government size and thereby the means and opportunity for government insiders to co-opt the apparatus of the state for their own benefit. These factors, present in both autocracies and democracies are the perks of power; patronage and other political advantages associated with public provision; bureaucratic growth incentives; the transaction costs associated with government programs; special-interest groups; the common-pool problem; and the political clout of public goods.

For example, consider public goods that are most regularly cited by economists as justifying state intervention.

Once state intervention is justified, account must also be taken of public choice considerations and the logic of collective action to understand why public goods are likely to be over-provided. Whereas public goods provide non-rival benefits to many individuals, these individuals, as a group, are likely to be more concentrated and have more political clout than general taxpayers. Furthermore, public good suppliers, whether public or private, also will be more concentrated than taxpayers. Witness the enduring potency of the military-industrial complex noted by President Eisenhower in the United States and the difficulty of terminating existing weapons systems and military bases. Due to greater political clout on both the demand and supply side of politics, we thus can expect public goods to be overprovided and the potential for government self-capture to grow accordingly.

While some of the factors behind government growth originate from the demand side of the policymaking process (e.g., domestic producers seeking government protection from foreign competitors), all are relevant to the supply side populated by government insiders. By driving growth of the supply side of the political market, all of the identified factors increase the potential for government self-capture and national decline.

The symbiotic relationship between supply- and demand-side interests when it comes to appropriating the rents associated with policymaking helps explain the tyranny of the political status quo. When government insiders have "skin in the game", important added resistance to policy change is introduced, especially since the restraints on government self-capture are imperfect. In contrast to demand-side interests, supply-side interests have the power to write and enforce the rules. This power (the means and opportunity), when linked with the rents government insiders can appropriate (the motive), helps ossify political outcomes. As Milton and Rose Friedman once observed: "Nothing is so permanent as a temporary government program" (Friedman and Friedman 1984).

The symbiotic coupling of supply- and demand-side capture can be likened to what happens to an individual's DNA when cancerous gene mutation leads to cell over-replication. In the case of DNA and its four component nucleobases, guanine (G) always pairs with cytosine (C) while adenine (A) always couples with thymine (T). Thus, when cancer leads to an improper sequence on one of the two strands of DNA's double helix it also is associated with an incorrect nucleobase on the other strand. Analogously, we can expect any demand-side capture of the body politic to be intertwined with supply-side capture thereby further locking in a political outcome while amplifying the overall damage done to the body politic by demand-side special interests.

What factors constrain government self-capture, albeit imperfectly?

Although not without drawbacks, there are six potential curbs on government growth and self-capture. These include the negative impact of government growth on a nation's productivity; the ability of constituents to vote with their feet; constitutional, legal, institutional, and/or cultural restraints; electoral competition; a market for political control; and benchmarking across polities. That these curbs only imperfectly limit government growth and the risk of government self-capture is suggested by a series of studies suggesting that the overall productivity of developed nations would be maximized if government spending was limited to 15 to 22 percent of GDP (Niskanen 2008).

Due to the perks of power, government insiders have an incentive to hang on to power. Because of the political power that government insiders possess, moreover, they have some unique means and opportunities to hang on to the perks.

Unlike in the corporate world, buy-out packages in politics are rare. The difficulties to be surmounted by those attempting to buy-out government insiders include the collective action problem and risks inherent in organizing an opposing faction (jail or death are possible outcomes). In addition, politicians contemplating relinquishing power confront risks and negative consequences. It is difficult to fully specify beforehand all the parameters of an arrangement for public officials and their associates once they are out of office. Political positions also provide unique opportunities to promote one's world views. Furthermore, the attractiveness of any promised arrangement must be discounted due to the fact that one's successor has both an interest in and the means to break the promise. Can government insiders put credence in the value of any promised arrangements in return for ceding power when in doing so they surrender the right to enforce the promises? Rulers such as Charles I of England, Czar Nicholas II, and Louis XVI and Marie Antoinette all ended up paying with their

lives after ceding power, even though they had assurances of safety beforehand.

While the examples cited above point to the untoward consequences that can befall rulers who lose power, they also highlight how a market for political control may still operate, albeit not exactly in the manner of the market for corporate control. Specifically, part of the reason why monarchies have become less common likely is due to the fact that their associated economic cost, at least relative to democracy, increases as a society becomes more productive through factors such as specialization, education, and trade. A higher opportunity cost creates greater incentive for change in governance form. Any change in governance form, however, is likely to require a resort to violence given rulers' vested interest in retaining power and their inability to rely on the non-violent buyout options available to corporate raiders.

In short, the operation of a Coase theorem in the political arena and a (non-violence-based) market for political control is impeded by monitoring costs and the associated slack in the relationship between constituent-principals and their political-agents on the supply side of politics; the instability of property rights owing to the ability of those in political power to redefine those property rights coupled with the associated tendency of those in power to hang on to it; and collective action considerations (Coase 1960). On account of such factors, we cannot expect competition between interest groups on the demand side of politics for economic rents to result in policies that maximize national economic well-being.

A systematic statistical examination of tenure across national leaders provides evidence of the incentive that political leaders have to hang on to power when they have the means to secure perks through their positions (Zupan 2016). Such congealing of political power exacerbates the negative impact government self-capture has on the wealth of nations.

It is worth noting that this congealing of power is the exact opposite of what we expect in market settings where competition promotes consumer welfare: firms and their managers have longer tenures the *better* they serve consumer interests. In the political arena, by contrast, leader tenure is longer in countries with extractive political-economic institutions that benefit government insiders at the expense of national well-being.

Where and when has government self-capture led to national decline?

When government insiders profit from power either in autocracies or democracies, the adverse consequences include declines in prosperity, restrictions of citizens' liberties, erosion of trust in government, violence within and between nations, and the dissipative use of resources to acquire or maintain power. Argentina, Cuba, Syria, Iraq, Greece, Venezuela, Japan, and North Korea, offer telling case studies of the consequences of government self-capture. Argentina, for example, has gone from being one of the world's most prosperous countries as of the 1920s to an economic laggard due to the sustained dominance of the political party created by the Perons interspersed with several, largely military, dictatorships.

South Koreans now earn more than 15 times per capita and live an average ten years longer than their North Korean counterparts (Ridley 2010). No such differences existed prior to the communists coming to power in the North in 1947 and three generations of autocratic rule by the Kim family.

Historical examples of the adverse consequence associated with government growth and self-capture include: the Ming and Qing Dynasties of China; Castilian and Hapsburg Spain; Tsarist Russia; the Philippines under Marcos; the Dominican Republic under Trujillo; and the Congo under Mobuto.

Why worry? The European Union and unfunded state and local government liabilities in the United States

Government self-capture is not just a clear and present danger associated with autocracies. It can affect the viability of well-established democracies. Witness some of the effects of the Treaty of Maastricht of 1992 that established the European Union (EU) and led to a common currency, the euro. As documented by economist Hans-Werner Sinn, the steps taken by EU policymakers induced huge capital flows from the euro-zone core to the periphery, triggering an inflationary bubble in the latter. The bubble, fueled by certain banking provisions and expectations promoted by policymakers, led to excessive private debt in countries such as Ireland and Spain while relaxing the constraint on interest payments on outstanding government debt in most EU periphery countries. The latter, in turn, freed up funds for expand-

ing government payrolls, an expansion that negatively impacted the long-run competitive positions of these nations. Between 2000 and 2008, for example, public employee salaries increased by 80 percent in Greece and 30 percent in Portugal versus ten percent in Germany and relative to a cumulative inflation rate of 15 percent. In addition, public employment increased by 16 percent in Greece and six percent in Portugal versus a decline of seven percent in Germany over the same time period (Sinn 2014).

Across the Pond, one in six workers in the United States is currently employed by state or local government and the unfunded pension and health care liabilities associated with such public workers have been estimated to be USD 5 trillion. Unfunded state and local pension liabilities are the country's second largest fiscal problem – larger than Social Security, but not as significant as Medicare/Medicaid/Obamacare. In contrast to Paul Krugman's argument that the bankruptcy of Detroit is an anomaly that should not give cause for concern, the Motor City instead epitomizes the fiscal challenge of government self-capture that is increasingly constraining the quality of services provided by state and municipal governments (DiSalvo 2015; Novy-Marx and Rauh 2014).

Why worry? K-12 public education in the United States

K-12 education, so critical to the development of human capital and thus to any nation's future, also suffers from government self-capture in the United States. Notwithstanding the significant increases in real per-student spending over the past half century that have been documented by economist Caroline Minter Hoxby (1996) of Stanford, high school graduation rates continue to decline, as does the preparedness of high school graduates for college studies and professional responsibilities. Until government self-capture in this vital sphere of American society is addressed, there will be important limits on the country's ability to promote broad-based educational opportunity; foster equality; revitalize its cities; and spur entrepreneurial activity and macro-economic growth. Indeed, Stanford political scientist Terry Moe (2011) argues that public sector unionization has been the principal impediment to educational innovation and betterment over the last half century in the United States.

How can we form a more perfect union?

James Madison in *The Federalist Papers* noted that "the great difficulty is this: you must first enable the government to control the governed; and in the next place oblige it to control itself" (Library of Congress 2015). As the role of the state in developed countries has grown over the past century and thereby the risk of government self-capture, what factors can we keep in mind to limit the undesirable consequences of such co-opting of political power at the expense of the general public?

The first factor is restraints on the power of public unions to organize and lobby. The provision of government goods and services is characterized by imperfect competition. Public employees, furthermore, have the ability to manage their managers through their influence on the electoral process. Consequently, policy changes such as those enacted in the US over the last few decades allowing public employees to engage in collective bargaining do not serve the public interest. Much as antitrust laws are enacted to limit the monopoly power that private sector firms exercise to the detriment of consumers, so too can legislative limits be placed on the monopoly power that public employees exert, at the expense of the public interest, through collective bargaining and lobbying.

President Grover Cleveland observed that "a public office is a public trust." While "trust" referred to the fiduciary responsibility of government insiders, the growth of public union power has diametrically altered the manner in which Cleveland's statement can be interpreted. If anything, we now have to fear the heightened power of public trusts, or combinations in restraints of trade, analogous to the worries that their private-sector counterparts generated over a century ago. The ability of such public trusts to organize and sustain themselves, either directly or through facilitating practices such as requiring all public employees to pay "agency fees" for collective bargaining whether they belong to the union or not, merit close questioning if not outright restrictions.

Second, the public interest can be advanced by incorporating political-economy considerations when determining how much competition to promote in the supply of government goods and services. Much as we are averse to a single firm providing all of our military goods, so too should we be wary of the state being the sole or predominant supplier of K-12 education, medical services for veterans, and postal delivery. Options such as vouchers, charter schools, and competitive outsourc-

ing and franchise bidding all diminish reliance on a sole public provider; and thereby the likelihood of capture by government insiders.

Rethinking the conventional wisdom of ever-larger school districts and municipal service territories is also the order of the day. The trend toward monopolization, often pursued for well-intentioned moral and economic reasons (for example, desegregation and achieving economies of scale and scope), has resulted in some unfortunate consequences by diminishing competition on the supply side of politics. We cannot be driven solely by narrow economies of scale and scope factors when evaluating policies. Public choice considerations – the interests of government insiders as well as those groups on the demand side of politics – must also be incorporated into the policymaking calculus.

Third, America's Founders realized that competition for office is a primary means of controlling government. Over time, Americans and citizens of many other countries have also come to appreciate term limits as a means of curbing political power ossification. In too many nations, however, the possibility of being president (or holding another government position) for life persists due to a lack of sufficient legitimacy or competitiveness when it comes to the ballot box.

The adverse consequences of inadequate competition for public positions are significant. Robert Mugabe's iron-fisted rule over Zimbabwe since 1980 provides a compelling example. While his country's social well-being indicators have regressed to their 1960 levels, Mugabe's cronies organized a 91st birthday bash in 2015 for the president for life. Held at the Elephant Hills golf course at Victoria Falls, the guest list included 20,000 of Mugabe's closest friends and the menu featured two elephants, two buffaloes, two sable antelopes, five impalas, and a lion donated by a local farmer. In addition to the USD one million raised by his cronies for the feast, every teacher in the country was forced to contribute up to USD 10.

While term limits can curb political power ossification, they are not without weaknesses. For example, term limits applied to legislators may impede their ability to acquire experience and govern effectively, including exercising oversight over the executive branch. Government insiders are also creative at finding ways to evade the intent of term limits – as shown in Russia by Putin and in Turkey by Erdogan, two nations with term limits on their political chief executive.

A smaller, but significant example of how inadequate competition for government positions subverts the public interest, notably in democracies, involves provisions that strengthen the grip of public employees on their jobs. Some of these provisions were instituted for well-intentioned reasons, such as the desire to discourage patronage and party machines through civil service reforms including competitive exams, qualifications, and regular schedules for advancement and pay raises.

An unintended and adverse consequence has been greater job security for public employees. Most K-12 public school teachers in the US are granted tenure after only two or three years on the job. They are automatically paid for earning a master's degree and must have a state teaching license. Yet research indicates that none of these features increase teacher effectiveness in the classroom. Furthermore, by diminishing the emphasis placed on teaching quality, the ossifying tenure and dismissal systems employed by K-12 public systems disproportionately disadvantage the prospects of minority and low-income students.

The fourth mechanism of restraint builds on the research of Persson and Tabellini (2003) examining the extent to which government constitutions provide sufficient checks and balances on the supply side of politics. In the case of democracies, for example, proportional electoral rules enhance the hold-out or monopoly power of minority interest groups. This greater power, which operates both through the demand and supply sides of politics, increases government spending, welfare spending, and public budget deficits relative to democracies with majoritarian voting. Furthermore, presidential systems reduce the size of government by at least as much as majoritarian elections. Relative to parliamentary countries with fewer checks and balances between the executive and legislative branches, presidential systems promote greater overall accountability of the supply side of politics, at least as far as accountability is reflected by fiscal performance.

Fifth, improvements in communication, transportation, information, and productivity enhance constituent mobility and knowledge of the impact of government actions, while making it costlier for government insiders to hijack the state for their benefit. Anything that can be done to promote such factors and their salutary impacts is to be championed. A free press plays a key role along these lines. Technological innovations that increase "reporting" by a broader public while better disseminating information to that public, moreover, are bound to foster

government transparency while boosting the effectiveness with which the public can police its public servants.

Finally, when it comes to collective action, general taxpayers are the most widely diffused interest group. Future taxpayers are even more poorly represented politically. These factors enhance the ability of government insiders, as well as interest groups from the demand side of politics, to co-opt political power for their benefit.

Deficit spending makes the present-day cost of government actions less transparent. Moreover, compared to future taxpayers, government insiders are more focused on the near term and the payoffs that they can secure from their power. In light of such considerations, constitutionally-mandated speed bumps that curtail the ability of politicians to over-spend or otherwise slough off obligations to future generations merit consideration. Examples of such speed bumps include balanced-budget rules requiring two-thirds legislative approval to circumvent; and a "debt brake" rule such as that approved in 2001 by 85 percent of Swiss voters.

The Swiss debt break rule caps any increases in central government spending to average tax revenue increases over a multi-year period. Reliance on debt has to be approved by both chambers of parliament. Furthermore, any increased spending through increased taxes requires a double-majority referendum, meaning a majority of voters in a majority of cantons have to approve. This is unlikely based on the extent to which Swiss voters historically have favored tax cuts over tax increases.

Prior to the implementation of the debt brake rule in 2003, Swiss federal spending was increasing by 4.3 percent per year. Since then, spending has increased by 2.6 percent annually. In addition, while the average debt-to-GDP ratio for euro-zone nations has risen from 70 percent in 2005 to 92 percent in 2014, Switzerland's ratio has declined from 53 percent to 35 percent.

In short, the foregoing factors offer some hope for optimism regarding the potential to mitigate the extent to which government insiders subvert the public interest. Like Dorothy and her red slippers in the movie The Wizard of Oz, we, the people, have (to an ever increasing extent) the ability to form a more perfect union. While the historical, global trend toward democracy, and thereby more government by the people, is to be applauded, we must remain mindful that government must also operate for the people.

A broader perspective on institutional self-capture

As long as the supply side of an institution lacks perfect accountability, there is the potential for damaging self-capture by insiders. The insights cited above regarding government self-capture thus have some broader applicability to other non-profit settings ranging from churches to universities, as well as to for-profit firms. While there are additional restraints on corrupt insider behavior in such settings versus the political arena, the curbs are not always perfect. The damage done at various points in time by insiders to organizations such as FIFA, Kodak, Volkswagen, Enron, Satyam, Bernie L. Madoff Investment Securities, and the Catholic Church attests to the consequences of imperfect accountability.

In non-political settings, self-capture is most commonly termed the "principal-agent problem". Due to monitoring costs, imperfectly policed agents-managers will not act in complete consonance with the interests of the organization's principals-owners.

The bottom line

In most legal systems, motive, means, and opportunity are the three key aspects that must be established to determine guilt in a criminal proceeding. Contrary to the existing literature that largely has sought to convict demand-side rent-seekers (capitalists, labor unions, one-percenters, the bourgeoisie, special interests, and so on) for the capture of the state and the untoward demise of nations, government insiders on the supply side of politics merit closer scrutiny regarding culpability. Government insiders have all three key aspects that prosecutors seek to establish in criminal proceedings. They have the motive – political power provides significant pecuniary and non-pecuniary benefits. They have the means – those who operate the apparatus of the state are uniquely and favorably positioned to use it to secure economic rents. Finally, they have the opportunity, which widens as the state's role in a society increases.

The existing literature often assumes that government insiders strive to serve the public interest or act, in a dis-interested manner, to weigh the demands of competing interest groups when it comes to supplying policy-making services and thereby determining the associated wealth transfers. Non-self-interest is inconsistent with the assumption made by economists, as well as most other social scientists, about what motivates human behavior. The assumption that the preferences of gov-

ernment insiders do not have to be taken into account, furthermore, flies in the face of evidence regarding imperfect competition on the supply side of politics – in autocracies as well as democracies. Such imperfect accountability provides latitude to those within government to promote their own interests.

Prying open the black box on the supply side of politics allows us to better understand why the decline of nations may be, more than anything else, internally determined instead of imposed by external factors. Much as a leading cause of human death is cancer, so too may one of the most prevalent explanations for the demise of the body politic be ultimately linked to the co-opting of the apparatus of the state by government insiders.

Over the centuries, there have been occasional suspicions that those within the black box on the supply side of politics might play influential roles. For example, the Great Man theory fashionable in the 19th and early 20th centuries, posited that history is shaped by heroes possessing superior attributes. While falling out of favor after World War II, the converse side of the theory, that individual leaders can lead nations to ruin, received less attention, even though we can readily identify people who have done so (Bloody Mary, Idi Amin, Nero, and Pol Pot, to name but a few). Even less attention has been paid to the damage that can be done by those inside government below the top leader level, although these ranks are populated by individuals from the same genus and species as their bosses. Cases can also be readily identified of the apparent negative impact that the so-called cogs in the state machine have had on their countries (Himmler, Mladic, Rasputin, and Torquemada).

Suffice it to say, there appears to be a lot in what we have heretofore largely treated as a black box on the supply side of the politics. Prying open the lid to that box is worthwhile if we seek to deepen our understanding of the well-being of nations.

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Modern Lobbying:
A Relationship Market

Thomas Groll[1] and
Maggie McKinley[2]

Introduction

To date, theoretical models of lobbying have assumed a simple transaction between policymakers and lobbyists and have not yet explained why lobbying is largely conducted through repeated interactions between policymakers and lobbyists, why the lobbying industry is so focused on building relationships, and what value is added by lobbying intermediaries. Recent empirical research has begun to highlight the importance of relationships to the lobbying industry and how the daily practice of lobbying is focused on perfecting and implementing the art of relationship building. Belying the reality that relationships are central to lobbying, little work has been done to explain and model the lobbying industry's fixation on relationships and reputation, or to address the simple fact that political access is a key scarce resource. Given the exponential growth in lobbying firms, which rely heavily on relationships, understanding the particularities of the relationship market has become increasingly important.

Before introducing and modeling the theory of the "relationship market," we briefly describe traditional notions from the literature that characterize lobbying as a single transaction of exchange, information, or subsidy. We then describe recent empirical work documenting the rise of lobbying intermediaries and the increasing emphasis on relationships within the lobbying industry. Finally, we introduce the "relationship market," a theory that incorporates the incentives of policymakers, lobbyists, and citizens as repeat players. We then explore the implications of the "relationship market" for our understanding of the influence industry, including the observation that policymakers have an incentive to provide greater access to citizen-donors and lobbyists with whom they have a relationship.

Market for political influence and access

The literature on political influence activities spans separate fields of economics, law, and political science and has largely focused on lobbying activities as a form of market exchange between special interests and policymakers.

There are three broad theories that describe these markets for political influence and access.[3] The first – rather cynical – theory posits that special interest groups offer resources (such as campaign contributions, political endorsements, vote campaigns, campaign support, or future career opportunities) to policymakers in exchange for policy favors. Many of these contributions model the interactions between special interest groups with contest functions[4] or auction games[5] and study how special interests provide resources to policymakers to achieve their desired policy outcomes.

However, the literature is not conclusive as to whether special interests have been able to capture the political process by using campaign contributions as bribes. Belying this cynical view is the fact that most donations come from individual donors and specific demographics rather than organized special interest groups (Ansolabehere, de Figueiredo and Snyder 2003). Furthermore, most contributions do not capture the expected rents (Tullock 1972; Ansolabehere et al. 2003); put simply, special interests are not providing very large campaign contributions, given the windfall the special interests can expect from favorable policy. Moreover, the dollars invested in electoral campaigns might appear tremendous in isolation, but these figures pale in comparison to the amount spent on lobbying every year.

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1   Columbia University.
2   Harvard Law School.

3   For general reviews on special interest group and lobbying activities, see Olson (1965), Grossman and Helpman (2001), Hall and Deardorff (2006) and Congleton, Hillman and Konrad (2008).
4   See, for example, Tullock (1980) for an introduction and Nitzan (1994) for a review.
5   See, for example, Bernheim and Whinston (1986) and Grossman and Helpman (1994).

Figure 1

Early models

Policymakers
Politicians, staffers, bureaucrats – Congress, agencies

| Money for favours | Information for policies | Costly access, information | Legislative subsidies |

Special interests
Trade associations, unions, corporations, non-profits, government, individuals

Source: The authors.

Figure 2

Growth in lobbying expenditure and share of lobbyists

Commercial lobbyists — Share in %
Commercial lobbyists — Internal lobbyists — Revenues in millions US dollars (in prices of 2006)

Source: The authors, based on Bertrand, Bombardini and Trebbi (2014).

Two alternative theories focus on the informational characteristics of lobbying. Special interest groups approach policymakers with a mix of private information and financial resources, where the latter does not buy policy, per se, but instead signals the credibility of their information or secures access to policymakers for presenting information. In these models special interests may either provide unverifiable or verifiable information. If the information is unverifiable for a policymaker, then she has to form an expectation about the accuracy of the interest group's provided information. A policymaker may either face a situation of "cheap talk," where the interest group's claims are unverifiable and not necessarily credible, with only a limited ability to learn about the political consequences of an interest group's

objective or claim,[6] or the policymaker receives "costly signals" – that is, signals and access that are costly to the interest group and enhance the credibility of the information provided.[7]

A fourth theory, mostly present in the political science literature, is one of legislative subsidies by Hall and Deardorff (2006). This tradition posits that special interests with similar objectives support resource-and time-constrained policymakers with whom they share policy objectives and provide those policymakers with additional resources to consider more policy issues. Contributions free up a policymaker's time from fundraising obligations and express joint objectives and efforts in the policymaking process.

However, none of these four theories, illustrated in Figure 1, takes into account the growing market in Washington for relationships, largely facilitated by the growth of lobbying firms and their employees.

Growing market for intermediation and relationships

Economics and political science research have neglected the growing market for intermediation services. Rather than assuming only a single type of lobbyist, as earlier models did, we now observe two groups of professional lobbyists who are active in the hallways of both houses and government agencies. In addition to representatives of classical special interest groups, such as trade and occupational associations or larger corporations, lobbyists employed by commercial lobbying firms have joined the market for lobbying services. By contrast to special interest groups and their employed representatives, commercial lobbying firms and their employees, bound by a service contract alone,

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6 See, for example, Crawford and Sobel (1982).
7 See, for example, Grossman and Helpman (1994) or costly access models that enhance credibility such as Austen-Smith (1995) or Lohmann (1995).

may not be directly affected by a policy they lobby on or have ideological preferences over policy outcomes.

Figure 2 illustrates data from Bertrand, Bombardini and Trebbi (2014) and shows how the growth in lobbying expenditure can be attributed to commercial lobbying firms, and that the majority of registered lobbyists are commercial lobbyists, working as "hired guns," rather than in-house lobbyists of special interests.

These commercial lobbying firms act as intermediaries between citizens, corporations or special interest groups and policymakers; they seek to make profits by selling their intermediation services to their clients and rely heavily on their existing relationships with policymakers. Their intermediation services include direct advocacy in all three branches of government, legal and political consulting, legislative strategy advice, formation of coalitions and grassroot organizations, legislative drafting for policymakers, legislative witness-hearing preparations, and public relations for both clients and policymakers. Despite the growing ubiquity of firm lobbyists, little theorizing has been done on the particulars of the firm lobbyist market and the implications of these distinctions on access and influence. Our work seeks to address this shortfall with the introduction of the theory of a "relationship market" and the implications for that market on who gets heard in the policymaking process.

The relationship market

Contrary to public misconception, the daily life of firm lobbyists is not filled with glamorous parties and smoke-filled backroom politicking where lobbyists engage in *quid pro quo* transactions of money for policy. Rather, these firm lobbyists focus their professional attention on honing the fine art of building relationships, primarily with members of Congress and their staffs, but also with potential clients, coalitions, and other individuals and organizations related to their clients and issue areas. This focus on relationships is reflected in the practices that fill their daily lives as they build, preserve, and then commodify these relationships.

Figure 3

Source: The authors.
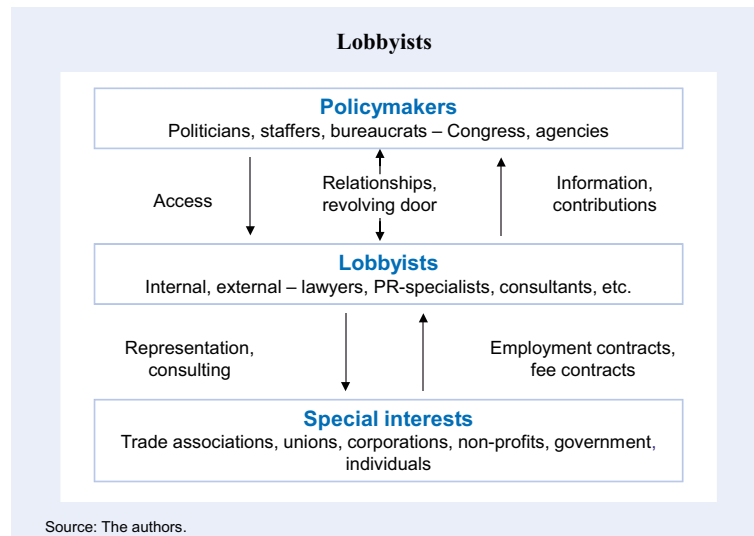
The following previews work from McKinley and Richland (2015), introducing the theory of a "relationship market," illustrated in Figure 3, drawn from an eleven-month field study of federal lobbyists.

Cultivation

According to McKinley and Richland's observational data firm lobbyist participants reported spending a portion of each workday engaged in relationship cultivation practices. These practices included interacting repeatedly with policymakers or their staff or providing support, typically in the form of electoral, legislative, or personal support.

Repeat interactions

All participants reported cultivating relationships through repeated interactions with a member and her staff. The overwhelming majority of participant lobbyists reported being the primary initiator of most interactions with policymaker offices. In building a relationship with a policymaker and her staff, lobbyists reported that they often found it challenging to strike the delicate balance between contacting an office often enough to maintain a relationship and contacting an office too frequently. Respecting the time of a policymaker and her staff, the lobbyist participants reported, was paramount to relationship building. Accordingly, lobbyist participants reported engaging in a range of interaction-initiation practices – from least to most intrusive – that they varied based on context.

Lobbyist participants reported contacting policymaker offices most often with the least intrusive and most helpful practice: emailing information and news of genuine interest to the policymaker. Forwarded news content was less likely to (but could) contain information pertinent to the participant lobbyist's client, but was generally directed entirely toward the policymaker's informational concerns and, as an email, could be disregarded easily by the receiver. The forwarded content served more as a signal to the office that the lobbyist participant still held a relationship to the office and still understood the needs of the office, while taking little, if any, of the policymaker's time.

Another less intrusive relationship-building practice is informal interaction – e.g., catching staff at hearings or other formal legislative events and inviting staff for personal coffees or group lunches. Lobbyists rarely mention client concerns during these interactions, but both the emails and informal interactions afford time and attention to the lobbyist and serve as a reminder to the policymaker and her staff that the lobbyist is a supporter.

The most intrusive relationship-building practice is setting and attending formal meetings with policymakers and staff. In fact, were it not for the time spent together during the meetings, lobbyist participants might hardly consider the meetings relationship-building practices at all. Rather, formal meetings are seen as a prized commodity on the Hill and lobbyist participants reported that they would never schedule a formal meeting unless they had an "ask," i.e., a specific legislative request that the office might reasonably fulfill.

Support

In addition to initiating interactions with policymaker offices to signal and remind of ongoing relationships, lobbyist participants also built relationships by providing support. Generally, support took one of three forms: electoral, legislative, or personal.

Distinguishable from the stereotypical *quid pro quo* arrangement of goods for policy outcomes, lobbyists would provide support to policymakers and their staff as "gifts" – i.e., aimed at building solidarity and without any clear valuation or expectation of reciprocation. Rather, lobbyist participants engaged in extensive formality to frame support as gifts between political and legislative allies and friends. The general sense is that providing support in small amounts, at the "right" mo-

ments, served to build trusted relationships over time and to offset any inconvenience caused by taking the policymaker's time. A transaction or *quid pro quo* exchange, like borrowing money from a family member, would undermine the relationship and, thus, was to be avoided at all costs.

Drawing primarily from the work of French anthropologist Marcel Mauss (1954), scholars have equated the practices of providing support to policymakers and their offices by lobbyists to "a gift economy," i.e., a market where gifts are given to increase solidarity without any clear legal or contractual obligation on the receiver to reciprocate, but where solidarity (or the relationship) then provides the motivation to reciprocate (Lessig 2011). Fostering a gift economy, lobbyist participants would carefully provide each form of support – electoral, legislative, and personal – in order to maximize the likelihood that the support was received as a gift and minimize the appearance of a *quid pro quo* transaction.

Electoral support

The most well-known, as well as the most vilified, form of electoral support is the campaign contribution. But lobbyist participants also provided other forms of electoral support by rallying constituent clients for votes and other volunteer campaign support. These forms of support were limited in their utility to build relationships, however, because lobbyists could only offer certain forms of electoral support proximal to an election.

Unlike most other forms of electoral support, the practice of providing campaign contributions is available all year-round. Despite its year-round availability, however, criminal laws[8] make the practice of providing campaign contributions a bit more complicated. Under threat of a USD 5,000 sanction and up to three years in prison, a policymaker cannot receive a campaign contribution in her office, so the policymaker must hold the meeting where she receives the contribution off Capitol grounds. To accommodate the need for an off-site meeting location, each political party has set up a "club" just off of the Hill where policymakers, staffers, lobbyists, and individuals can build deeper relationships over coffee or a meal, and where the policymaker can receive contributions.

In addition to offering electoral support directly, lobbyist participants would often remind policymaker offices

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[8]   18 U.S.C. § 607. This regulation is one, among many, that seeks to prevent *quid pro quo* arrangements of money for policy.

of other forms of electoral support provided by clients when discussing a client issue or setting up a meeting. Formal and informal meetings, especially with policymakers, often included some mention of past electoral support, usually in an expression of gratitude by the policymaker herself. Policymakers and staffers expressed a strong preference for meetings with constituents, often explicitly requiring the presence of at least one constituent in order to meet with the lobbyist, and expressed a similar preference for supporters.[9]

Legislative support

In addition to electoral support, lobbyist participants also provided legislative support to policymakers and their staffs, in the form of policy reports, draft statutory language, private information and data regarding constituent clients, insider political and legislative information, and lobbying support to gather cosponsors or rally defeats. This form of lobbying has been well-documented by the literature as providing a "legislative subsidy" to supportive policymakers' offices in order to incentivize scarce attention to your client's issues over others (Hall and Deardorff 2006). But these gifts also serve a similar function to electoral support in building relationships and provide another opportunity for a lobbyist to demonstrate trustworthiness and dependability.

Personal support

Finally, observational data showed (and participant lobbyists reported) the importance of providing personal support to offices, and to staffers in particular, in building relationships. Personal support, probably due to the danger of *quid pro quo* arrangements, most often took the form of advice or information provided to staffers regarding career or personal advice. Advice to staffers included a range of personal and professional advice; for example, information regarding which other policymaker offices were hiring or which non-Hill organizations (including lobbying firms) had openings at a time when a staffer's policymaker was either retiring or had lost an election, or sage advice from a participant lobbyist on how to navigate difficult office politics.

In addition to building new relationships, some lobbyists brought established relationships to private practice from earlier government employment. As noted, the profession of federal lobbyists in D.C. includes a number of former staffers who have left the Hill in search of

a sustainable salary and more stable employment prospects (Rosiak 2012). Many offices have formal and informal norms to deter new lobbyists from engaging with former colleagues on staff, but for many new lobbyists, former relationships on the Hill become paramount. For the first few months on the job, a participant lobbyist reported relying heavily on former Hill and agency contacts both for assistance on substantive issues, as well as access for meetings and other connections, as the new lobbyist learned the substantive area of law and policy of his new position.

Established relationships with policymakers, especially for senior staff, also prove important to a lobbyist throughout her career (Blanes I Vidal, Draca and Rosen 2012). Participant lobbyists described policymakers for whom they worked as mentors and friends to whom they would turn for professional advice and support. Participants also described relationships with former policymaker employees as fraught with concerns over balancing the relationship with the policymaker against the demands of the lobbying business. On the one hand, the relationship with a policymaker could prove the most important to a client in gaining access. On the other hand, a lobbyist risked diminishing the relationship with the policymaker, as well as losing future mentorship and support, with every potential meeting and every potential "ask."

Preservation

In addition to building and accessing established relationships, lobbyist participants also engaged in a range of practices to preserve established relationships. Most notably, lobbyist participants reported experiencing a heightened concern over preserving their own professional reputation, especially with respect to honesty. Not only did participants feel that it was important to actually be honest within the profession, but they also felt that a lobbyist must aim to always be *seen* as honest, and they would invest incredible energy into preserving a reputation for honesty. Participant lobbyists reported verifying information extensively before providing it to a policymaker's office and also reported wariness of representing clients whom the lobbyist worried would provide unreliable information.

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[9] Moreover, a constituent could always provide future electoral support, even if she has not done so already.

Commodification

Relationships, once established, were readily commodified. During each stage of the lobbying business process – from new client pitches to contracting with clients to strategy planning with colleagues and coalitions – relationships were treated as highly valuable goods that the lobbyist could convert into time with the policymaker or staffer with whom the lobbyist has a relationship.

In the context of new client pitches, lobbyist participants reported that they would present a substantive policy proposal and legislative strategy to potential clients. But, in order to convey the feasibility of the legislative strategy, they would also stress the fact that they or their firm had the relationships necessary to put the strategy into action. Clients and lobbyists would then codify those relationships into contracts, which would include promises to secure meetings with particular offices or to enact a legislative strategy necessarily dependent on those relationships.

Strategy meetings between firm lobbyist colleagues would focus similarly on relationships: many lobbyist participants described that strategy sessions centered around a spreadsheet that listed the names of necessary contacts for legislative action—paradigmatically, a list of possible co-sponsors to establish a House or Senate majority. Once the list of names was compiled, the strategy meeting would then turn to identifying those lobbyists, if any, who held a pre-existing relationship with policymakers listed on the spreadsheet.

Modeling the relationship market

Current work by Groll and Ellis (2015) seeks to answer the question of how policymakers allocate access to "citizen-donors" – individuals, citizens, or, broadly, special interest groups – and intermediaries, to whom they refer as "commercial lobbyists."[10] From their analysis, they conclude that policymakers are more likely to allocate access to citizen-donors and commercial lobbyists with whom they have developed a "relationship," or engaged in a series of exchanges over time. These relationships allow the policymaker to solve the problems she faces with information (which she needs, but cannot verify) and with contributions (which she needs, but for which she cannot contract). Over time, the policymaker can provide access to those citizen-donors and lobbyists

whom she knows – based on earlier interactions – will provide reliable information and promised campaign contributions. Like a gift economy, these relationships form an implied contract, incentivizing future exchanges between policymakers and special interests and lobbyists. Their framework articulates why commercial lobbying firms coexist with traditional special interest groups such as associations, unions, firms and governments, and offers explanations for the recent substantial growth in the size of this industry and the current predominance of commercial lobbyists.

Groll and Ellis's (2015) general equilibrium model focuses on three types of agents: citizens, commercial lobbyists and policymakers. Citizens are endowed with policy proposals, which, if enacted by a policymaker, yield them a private benefit and generate a social spillover which can be either positive or negative. Commercial lobbyists possess some form of expertise that allows them to gain more information about a proposal's implications and operate for profit. Policymakers have a time endowment that allows them to enact a limited number of policy proposals. The enacted policy proposals can be presented by citizens directly or by commercial lobbyists on their behalf, and both types can offer financial contributions. This implies a two-sided market structure with a market for political intermediation for which citizens pay a market clearing fee to commercial lobbyists and a market for political access in which policymakers design access rules that allocate their time between citizen-donors and lobbyists.[11] Technically, individuals choose between the roles of citizen and lobbyist, but the analysis shows that policymakers create barriers to entry as an incentive device for allocating scarce political access and receiving informational and financial resources. The scarcity of political access and the policymakers' need to incentivize lobbyists for their unobservable effort create barriers to entry for citizens into the lobbying industry. Similarly, citizen-donors' financial contributions cannot be formally contracted, and therefore citizen-donors are awarded with future access as long as they honor their current promises. These access rules take the form of repeated agency contracts and are closer to relationships than *quid pro quo* interactions, though policy values are traded.

Groll and Ellis's model exhibits an equilibrium with both citizen-donors and commercial lobbying firms receiving political access. Special interests' advantag-

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[10] Earlier work by Groll and Ellis (2014) focused on commercial lobbyists only.

[11] In this sense commercial lobbyists share features of "biased experts" and "advocates" (Krishna and Morgan 2001), but they are not directly affected by policy outcomes like biased experts or incentivized by their clients like advocates.

es are in contributing more per proposal as they fully internalize the private benefits of their policy proposals; commercial lobbyists' advantages are in the economies of scale in providing both credible information and bundling contributions. Citizen-donors' advantages are clear, as they can bid more per proposal, but they offer only one proposal to the policymaker from which she can draw an inference about the citizen's information, whereas commercial lobbyists represent many clients and policymakers observe more signals about the quality of exchanges. The better monitoring of commercial lobbyists enhances their credibility and allows policymakers to rely on their expertise. However, commercial lobbyists can also bundle contributions from many clients that reduce policymakers' cost of monitoring and collecting many contributions.

The growth in commercial lobbying can be explained with a change in politics, as the difficulty of accessing policymakers is rising. As political access becomes scarcer, the model predicts a growth in the number of commercial lobbyists and their revenues. It has been widely recognized that politicians are time-constrained and well-documented that Congress members face greater resource-demands for their electoral motives. Lessig (2011) reports that Congress members spend 30 to 70 percent of their work time in a given week on fund raising. The model explains how commercial lobbyists benefit from increasingly busy policymakers by providing them with much-needed resources and how policymakers rely more on those repeated lobbying partnerships to perform their own political tasks.

The alternative framework provides an understanding for the observed repeated agency, designed by policymakers in a world of asymmetric information. These interactions incentivize lobbyists to supply a desired mix of financial contributions and policy relevant information. In other words, these repeated implicit contracts are solving the policymaker's information and contracting problems. The need to solve these information and contracting problems provides an explicit explanation for the observed repeated interactions between policymakers, special interests and lobbyists. The analysis also shows that these repeated agency contracts, which may appear to involve cronyism, can in fact be socially desirable as they enable policymakers to gain socially beneficial information. However, there are the distortions introduced by the existence of commercial lobbying and their welfare implications, as policymakers do not internalize all social benefits and costs of policy proposals and lobbying and control access according to

the weight they place on their information and contracting problem.

Conclusion

Our work demonstrates how in a "relationship market" policymakers have an incentive to provide greater access to citizen-donors and lobbyists with whom they have a relationship. Recognition of the relationship market has the potential to modernize the traditional models of lobbying that envisioned lobbying as a simple *quid pro quo* transaction or subsidy, by incorporating the dynamics of the growth of the contract lobbyist market in Washington and incorporating the incentives of policymakers, citizen-donors, and lobbyists as repeat players. Understanding the lobbying industry as a market for relationships could also shed light on recent lobbying research, which finds a consolidation of access and perspectives in Congress; if access to policymakers now requires a long-standing relationship, the policymaking process would probably begin to focus on those who are able to maintain those relationships in the long term.

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The Role of Political Parties in Rent-Seeking Societies[1]

Panu Poutvaara[2]

Total government expenditure accounted for 32.2 (Latvia) to 52.4 (France) percent of GDP in EU countries in 2014, versus 33.2 percent in the United States and 39.3 percent in Japan (DICE Database 2015). An important part of this expenditure consists of income transfers, but governments also spend considerable resources on education, healthcare, senior care, and many other welfare services. More traditional public expenditure includes the military, police, and spending on infrastructure. An increasingly large share of these tasks is being outsourced. Politicians and civil servants are therefore often in a position to distribute lucrative contracts. Anti-corruption laws forbid selling these contracts, but there are legal ways of influencing decision-makers. Rent-seeking refers to activities in which a rent-seeker aims to obtain an economic rent by manipulating political or other decisions, rather than seeking profits from a socially productive activity. A classic example of rent-seeking would be road tolls, if these are collected without providing any real service, like road maintenance, in return. Similarly, lobbying for protective tariffs would be a form of rent-seeking.

Although politicians and civil servants are forbidden from selling contracts, they often distribute them among close acquaintances. Interested rent-seekers can thus gain an advantage from building favourable connections with decision-makers. Such connections, however, come with a cost in terms of time and effort on both sides. It follows that the decision-maker must be compensated for his or her time. The compensation can take various forms, from lunches and entertainment to participation in campaigns and fund-raising events, which will be promptly brought back to memory at the moment when rents are distributed. The rent-seeker may maximise

his or her chances of success by getting involved with multiple decision-makers. Miettinen and Poutvaara (2014) show that this results in rent dissipation due to time-consuming network formation. Therefore the impossibility of selling projects generating rents can cause excessive network formation.

Political parties can economise on the time costs of rent-seeking by restricting wasteful network formation. Considering that each politician can only belong to one party at a time and that the same party membership is often divided into subgroups, i.e. local party associations, party associations for students, pensioners, women, etc., it is crucial to analyse the extent to which parties play the role of gatekeepers, requiring that politicians only nominate members belonging to their subgroup. By doing so party members outside of this subgroup, or members of other parties altogether, have no incentive to lobby such a politician, as they will not be able to be nominated. Miettinen and Poutvaara (2015) analyse rent-seeking with political parties acting as gatekeepers. In their model, party leaders direct their politicians to nominate members from their own subgroups. As a result, rent-seeking can be reduced. The most straightforward example of such implementation would be that of one-member districts, wherein party politicians would be directed to nominate rent-seekers who belong to the same district.

Parties as gatekeepers

Political parties are powerful gatekeepers in representative democracies. In most countries, it is very difficult to be elected to an office without running as a party member. In the current United States Senate, there are only two independent members, and in the House of Representatives there are none. In the current German Bundestag, French Parliament and Italian Parliament all MPs belong to a political party. The British House of Commons currently has one independent MP. While it is somewhat more common to have independent politicians in municipal politics, party membership is still an important route to success. For a rent-seeker, the attractiveness of party membership depends on the value of the rents being distributed. The link between public sector

jobs and party membership is particularly pronounced in Austria. In Austria, the political parties are well represented in the public administration, with many firms and organisations having traditionally double heads - one for the Social Democrats and one for the Conservatives. The strong politisation of the nominations has been associated with an exceptionally high level of party membership (Encyclopedia of Austria 2005).

How political parties save on membership costs

Miettinen and Poutvaara (2014) present a model in which agents cannot sell contracts that they are delegated to decide upon, due to anti-corruption laws. Even if rent-seekers are not allowed to pay for the spoils that decision-makers distribute, they can pay for access, in the hope of being remembered if a decision-maker has a chance to make a nomination. The higher the value of contracts and the higher the probability that a decision-maker is able to distribute spoils, the more a contract is worth. As decision-makers (from now on, decision-makers are referred to as politicians and rent-seekers as citizens, although the model is more general and also applies to a situation in which the decision-maker is not a politician) cannot commit to not spending time with other people, it is typically the case that each politician spends time with several citizens, and each citizen with several politicians. Figure 1 illustrates an equilibrium with four politicians and eight citizens, provided that rents are sufficiently valuable that each citizen finds it worth it to buy links to three politicians. It is assumed that the marginal costs of time spent in networking are increasing, which implies that if politicians are identical, they all have the same number of links (or one of two consecutive numbers of links between which they are indifferent). The same applies to rent-seekers. We highlight the links of one rent-seeker by red, to ease the comparison with the case with political parties below. An increase in the value of rents would result in more links being formed, thereby dissipating part of the rents. Similarly, the lower cost of networking would result in more links being built.

In Figure 1, there are in total 24 links. This is clearly inefficient, given the assumption that all citizens are equally good at carrying out the task under delegation. Miettinen and Poutvaara (2015) extend the model to allow for the role of political parties. In their set-up, party bosses first recruit politicians as party members. After that, they sell party membership to citizens who want to network with politicians. This means that party boss-

es act as gatekeepers between politicians and citizens. For simplicity's sake, Miettinen and Poutvaara (2015) assume that each party boss receives the right to design the network between politicians and citizens connected to the party, provided that the party bears the networking costs. Party bosses pay politicians to join the party, and charge citizens for their membership. Payments to politicians may take the form of parties paying for advertising, or perks benefiting politicians privately. Party bosses then find it optimal not to link to citizens directly, but only through politicians. Furthermore, political parties are also unable to commit to not taking new members. However, they can still economise on the networking costs by connecting each citizen to one politician. Figure 2 illustrates the resulting network structure. The link from one citizen to one politician is again denoted with red. The link between the politician to which this rent-seeker is connected and the party boss is denoted by a dashed red line, as this link serves two rent-seekers connected to the politician in question.

A crucial difference between rent-seeking with and without political parties is that political parties in Miettinen and Poutvaara (2015) are associated with a fixed network structure: each party member is linked to one politician, and each politician to one party leader. Further increases in the value of rents do not result in more links being acquired. As a result, the presence of

Figure 1

Rent-seeking networks without political parties

Politicians   Citizens

Source: The author.
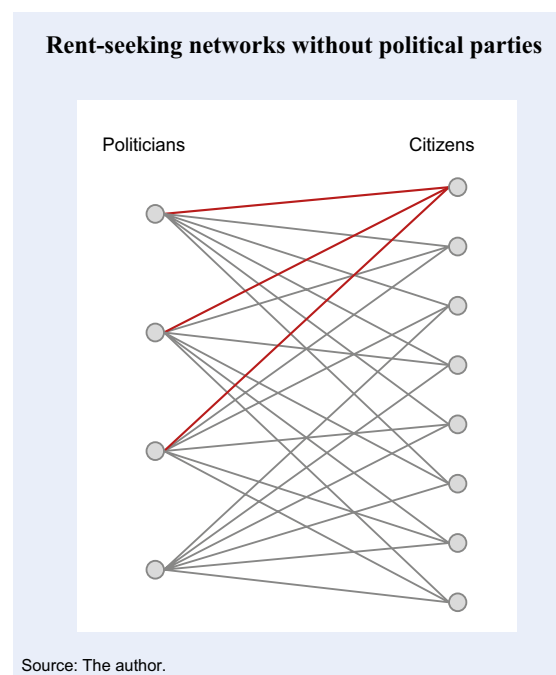
political parties will probably lead to efficiency gains in circumstances in which the value of rents distributed is high (resulting in large dissipation by excessive network formation in the absence of parties), or when the linking costs are low. If the value of rents is low, then the level of networking would also tend to be low in the absence of political parties, and introducing parties need not improve efficiency. After all, parties also need to cover the linking costs between party leaders and politicians.

Miettinen and Poutvaara (2015) take as their starting point that there are anti-corruption laws that prevent political nominations from being sold. In their setting, there are still inefficiently many links, compared with a situation in which a politician would sell a project to one rent-seeker. Of course, there are important arguments in favour of forbidding the sale of nominations and rents, which are not captured in the model. For example, Miettinen and Poutvaara (2015) assume that there are no productivity differences between rent-seekers, and that the value of the spoil from the rent-seeker's perspective is exogenous. If there are productivity differences between rent-seekers, some amount of network formation may be efficient. There would then be a reason for politicians to connect with citizens, as a connection would be necessary in searching for the citizen most suited to the task. However, the main insight is unchanged, as politicians would still want to sell more connections

than would be optimally efficient. Therefore, efficiency can still be improved by political parties if they limit connections when rents are sufficiently high.

Another important simplification is that Miettinen and Poutvaara (2014, 2015) do not include the role played by ideological considerations. Because parties have a certain ideology, some politicians and citizens may join for purely ideological reasons. In order to account for ideology, a model would have to include ideologically heterogeneous citizens, and political parties would value different citizens to different extents. Parties may then need to choose between citizens who are more ideologically aligned and those who are willing to pay more for access. Additionally, there are differences in the ideological importance of the positions that political parties fill. Taking trade-offs and differences into account may help to explain why some positions, such as those of leading civil servants, are more often filled by party members with strong ideology, whereas others are not. Those without as much ideological importance can be used as rewards for contributors. For example, in the United States presidents have nominated important campaign fund-raisers as ambassadors, although they tend to select a small and calm destination country, in which the ambassador can be expected not to make a big difference. Supreme Court Justices, by contrast, are chosen based on both ideology and proven competence, with campaign contributions being of no interest, apart from potentially signaling the candidate's ideology.
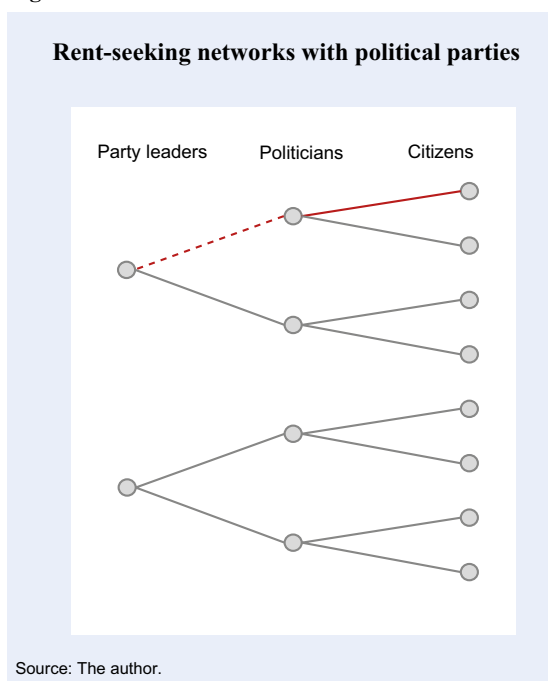
Of course, there is also a lot of rent-seeking that violates anti-corruption laws and in which political parties take part. Politicians can sell nominations or other favours, and rent-seekers can give outright bribes, instead of resorting only to legal methods of buying influence. Such direct bribes are well captured in classical rent-seeking literature, building on the classical contribution by Tullock (1967). It is also important to note that legal norms on what constitutes legal lobbying and what constitutes illegal bribing have changed over time and differ across countries. One person's lobbying is another's blatant bribing.

Figure 2

Rent-seeking networks with political parties

Source: The author.

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CRONY CAPITALISM

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VLAD TARKO[2]

Introduction

Over the past few decades Western economies have become increasingly more regulated. Looking across 16 sectors in 49 developed nations, Jordana, Levi-Faur and Fernández i Marín (2011) have found that the rate by which new regulatory agencies (RAs) have been created has grown from about three new RAs per year in the 1970s, to seven per year in the 1980s, to about 30 per year in the 1990s. The United States provides a fairly typical example of such trends. The increase in the staffing of Federal Regulatory Agencies grew from about 50,000 in the early 1960s, to a peak of 150,000 in the early 1980s, followed by a slight decline to about 100,000 during the Reagan era, but returning to a high level of about 170,000 throughout the 1990s, and then sharply increasing to over 250,000 in the 2000s (de Rugy and Warren 2009). Similarly, the growth of federal government spending on regulation grew from about three billion USD in the 1960s (in 2000 USD adjusted for inflation), to about 15 billion in the early 1990s, to over 40 billion in the present (de Rugy and Warren 2009). The number of occupations requiring licensing in the United States grew from about five percent in the 1950s to almost one in three today (Krueger and Kleiner 2010).

Although some regulations may have a public interest rationale, most of them are probably better explained by rent-seeking and regulatory capture (Dal Bó 2006), with incumbent firms obtaining more or less transparent privileges from government agencies (Mitchell 2012; Henderson 2012). Such privileges need not take the form of direct subsidies or tax breaks, but, more subtly, they involve setting up a regulatory environment that creates greater costs to their competitors. For example, large firms have an easier time getting through various bureaucratic and regulatory hurdles. This leads to less competition and less entrepreneurial "creative destruction", and, hence, protects the profit margins of the incumbent firms. Such artificially increased profit margins are known as "rents". Rent-*seeking* refers to the resources that firms are willing to spend in order to obtain such privileges (Buchanan 1980; Tullock 2005; Congleton & Hillman 2015). Such resources are taken away from productive activities, which is why rent-seeking leads to large-scale economic inefficiencies.

In democracies, when political actors create such rents for firms, they take a risk. Even if they do not go into illegal territory (e.g. by taking bribes), voters might still penalize them if they acquire the image of corrupt politicians. For this reason, policies that create privileges are usually dressed up under the pretense that they serve the general interest (Yandle 1983). For example, environmental regulations are advocated on general welfare grounds, but the *details* of the regulations are often set up to benefit specific firms. Voters support the regulation in the abstract and do not pay attention to the details. For instance, rather than simply regulating the level of emissions, and leave the "how" question open ended, the regulations may mandate the use of a particular type of filter, which happens to be produced by few firms. Because the voting public is "rationally ignorant", i.e. people have better things to do than become informed about such details, the cover given to privileges often works.

The rent-seeking firms also have a problem. If *anyone* can lobby for such benefits, their own privileges may get eroded. This is known as the "transitional gains trap" (Tullock 1975). Because firms do not actually own the politicians, they face the risk at any time that the politicians will switch against them. In other words, rent-seeking works on a subscription model. Hence the trap: to maintain their privileges, the rent-seekers need to continue to pay, which actually erodes their rents. The higher profit margins that they obtain because of privileges do not go into their own pockets, but go into paying for the continuation of the rent-creating policies. They are thus trapped and the true beneficiaries are the

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political actors with the power to grant or lift privileges. A typical example of this is the taxi medallion system. Many cities limit the number of taxis, which artificially increases their price, and hence leads to larger profits for taxi companies. But these profits are eroded by the need to pay for the medallions, and by the need to pressure city governments to maintain their privileges (e.g. by trying to ban firms like Uber).

These two risks, the risk faced by the politicians who create privileges and the risk faced by rent-seeking firms caught in the transitional gains trap, find a common solution. The concept of "crony capitalism" aims to describe the system that embodies this solution. The full-fledged crony capitalist system has the following characteristics. On the one hand, in order to secure their rents, firms need a mechanism for limiting access to rent-seeking by other firms. As the name "crony" suggests, this is achieved by making sure that only those who have personal (or even family) relations with politicians can obtain privileges. In other words, access to rent-seeking is restricted based on crony relations, while everyone else is refused access to politics. But what incentives do politicians have to restrict rent-seeking? In practice, such restrictions occur when they themselves (or family and friends) are on both sides – as business owners and as regulators. On the other hand, how can such a system that institutionalizes corruption be legitimized and accepted by voters? The answer is known as "populism". Populism is a "thin ideology" (Stanley 2008) that lacks any strong policy commitments, and which projects itself by the claim to reflect the "voice of the people". This claim can be easily adapted by skilled politicians to support a variety of ad hoc policies targeting various economic sectors in order to implement strong regulations, which create rents to favored firms. Moreover, in highly corrupt countries, firms with access to crony political relations are allowed to operate outside the strictures of the law, unlike their competitors. Hence, the law is created on populist grounds, but then it is applied in a discretionary manner based on crony relations. This combination of rent-seeking, populism and personal relationships is called "crony capitalism" (Aligica and Tarko 2014).

Typical full-fledged crony capitalist countries are South American countries (Haber 2002) like Argentina and Brazil, and South-East Asian countries like Philippines and Indonesia (Kang 2002). Eastern European countries, such as Romania and Bulgaria, also have strong crony capitalist features. Advanced liberal democracies like United States and Western European countries are

better understood as "regulatory capitalist" (Jordana and Levi-Faur 2004; Braithwaite 2008; Aligica and Tarko 2015). The main question about those is if their system is stable or, if it is gradually drifting towards crony capitalism instead. Prominent economists like Zingales (2012) have recently argued that a drift towards crony capitalism seems to be occurring.

The next section briefly describes full-fledged crony capitalist countries. The article then moves on to describe the regulatory capitalist reality of advanced liberal democracies and discuss Zingales's "road to cronyism" hypothesis in light of Buchanan and Hayek's analysis of the concept of rule of law.

Crony capitalism as a second-best solution to weak institutions

The first thing to bear in mind about full-fledged crony capitalist countries is that their economies operate under a very weak institutional framework (Table 1): protections of private property and the enforcement of contracts are very weak, the judiciary is subjected to political control and courts lack impartiality. As we can see from Table 1, both in South America and in South-East Asia, notable exceptions from the full-fledged crony capitalist system exist: Chile and, to some extent, Uruguay, Singapore, Malaysia, and Brunei. This suggests that the main source of their problems is institutional, and that a way out exists.

How does an economy work when property and contract protections are so weak? In full-fledged crony capitalist countries, cronyism plays an important role by providing a second-best solution to a problem facing all governments (Haber 2002, vii-viii):

"Any government strong enough to protect and arbitrate property rights is also strong enough to abrogate them. Unless the government can find a way to tie its hands, asset holders will not invest. And if there is no economic growth, the government will be unable to finance its needs because there will be insufficient tax revenue."

The Western, "first-best solution" to this commitment problem is limited government and rule of law. However, most countries lack limited governments. As seen in Table 1, many governments are doing anything but protecting property and contracts. Moreover, contrary to the belief that in crony capitalist countries businesses operate in an unregulated manner, they are

actually *more* regulated than Western democracies. Yet, in order to achieve growth, the commitment problem has to be somehow solved. Crony capitalism allows the government "to guarantee a *subset* of asset holders that their property rights will be protected" and "[a]s long as their assets are protected, these asset holders will continue to invest as if there were universal protection of property rights. Thus, economic growth can occur, even though the government is not limited" (Haber 2002, xiv, emphasis added). What provides the guarantee is that

the "members of the government itself, or at least members of their families … share in the rents generated by the asset holders" such that any unexpected change of policies would "have a negative effect on the wealth and happiness of crucial members of the political elite" (Haber 2002, xv). Thus, the system of property rights remains stable as long as the political elites do not change and the commitment problem is solved if they are sufficiently integrated with the economic sector. Moreover, as pointed out by Dreher and Schneider (2010), in socie-

Table 1

Institutional weaknesses in South-East Asia and South America, compared to some advanced liberal democracies, for 2012

	Property rights protection	Legal enforcement of contracts	Judicial independence	Impartial courts	Business freedom
Brunei	6	4.2	6.7	5.2	7.1
Cambodia	4.4	1.8	2.9	4.2	5.3
Indonesia	5.1	1.7	4.4	4.9	6.2
Myanmar	2.5	1.9	3.1	2.4	4.6
Philippines	5.6	3.4	3.6	4.2	6.5
Thailand	5.1	6.2	4.7	4.5	6.2
Timor	3	0	4	3.9	5.8
Vietnam	4.2	5.7	3.9	3.9	5.2
Malaysia	7	5.6	5.9	6.5	7.1
Singapore	8.9	7.8	7.8	7.5	7.9
Average (without Malaysia and Singapore)	4.5	3.1	4.2	4.2	5.9
Argentina	2.5	4.8	2.3	2.1	4.9
Bolivia	3.7	4	3.5	4	4.5
Brazil	6	4	4.8	4	3.6
Colombia	4.7	2.1	3.4	3.8	6.4
Ecuador	4.6	4.4	3.6	3.7	5.6
Guyana	4.8	4.6	4.2	4.4	6.2
Paraguay	3.4	4.2	1.2	3	6.1
Peru	4.5	5.1	2.6	3.5	6
Suriname	4.3	2.7	5	3.5	5.7
Uruguay	6.5	3.8	7.4	4.9	6.3
Venezuela	1	3.2	0.2	1.1	3.6
Chile	6.8	5.1	7.1	5.9	6.9
Average (without Chile)	4.2	3.9	3.5	3.5	5.4
United States	7	6.6	6.7	5.9	6.7
United Kingdom	8.6	4.7	8.7	7.3	7
Switzerland	8.7	6.1	8.5	7.5	7
Sweden	8.1	6.2	8.6	7.6	7
France	7.8	6.4	6.8	5.3	6.2
Germany	8.1	6.6	8.4	6.8	6.6
Average	8.1	6.1	8.0	6.7	6.8

Source: Fraser Institute's Economic Freedom of the World Index (2014).

ties with weak institutions, the privileged firms operate outside the law on the books (e.g. they are allowed to engage in massive tax evasion), while their competitors lacking crony relations are subjected to very heavy regulations.

Such an institutional arrangement based on personal relationships is very different from that in advanced, "open access", capitalist countries (North, Wallis and Weingast 2009). And, yet, as Zingales (2012) argues, while some crony capitalist countries may be moving in the direction of rule of law "open access societies", Western democracies are also in danger of moving in the opposite direction.

Regulatory capitalism and the road to cronyism

As Buchanan (1999) has pointed out, the fall of socialism in 1989 may have led to a "loss of faith in politics", but has not been "accompanied by any demonstrable renewal or reconversion to a faith in markets" (Buchanan 1999, 186): "We are left, therefore, with what is essentially an attitude of nihilism toward economic organisation". This "attitude of nihilism" is ripe for the growth of populism, which rationalizes state interventions, but not from a coherent ideological perspective. Under the regime of such a "thin ideology", one may offer justifications and legitimacy to any types of government interventions on the market. A rent-seeking oligarchy or any rent-seeking group finds in populism a wonderfully malleable and effective instrument. This is visible on a grand scale in countries like Venezuela and Bolivia, but it is also a non-negligible reality in Western democracies.

Zingales describes a vicious cycle created by the combination of rent-seeking and populism (2012, xxii):

"[P]opulism really becomes a threat to the survival of the free-enterprise system when markets lose legitimacy as a way of allocating rewards – in other words, when the system looks unfair to growing numbers of people. … [W]hen voters lose the confidence in the economic system because they perceive it as corrupt, then the sanctity of private property becomes threatened as well. … In response to the uncertainty stemming from today's populist backlash, companies have begun to demand special privileges and investment guarantees. … Such privileges and guarantees stoke the public anger that generated the populist backlash in the first place by confirming the sense that government and large-market

players are cooperating at the expense of taxpayers and the small investors. … No longer certain they can count on contracts and the rule of law, legitimate investors then grow scarce. This, in turn, leaves troubled businesses little recourse but to seek government assistance, thereby reinforcing crony capitalism."

He also cites examples that showcase the fact that this vicious cycle is not inevitable. To date, however, we only have anecdotic evidence about the way in which the problem has been avoided. Thus, gaining a better understanding of this process becomes an important task for political economy.

The most striking and disturbing aspect of the cycle described by Zingales (2012) for the United States is how similar it sounds to Haber's theory of full-fledged crony capitalism described above. Zingales basically describes a process whereby the United States may be gradually turning into a crony capitalist country of the South American kind. As individual firms seek guarantees against outbreaks of populism, they effectively seek to obtain individual favors which begin to look suspiciously similar to business-politics crony relations. Similar fears about the drift towards more and more rent-seeking have been raised before by authors like Hayek (1960), Buchanan (1980), and Olson (1982). What is the alternative? As Buchanan (1980, 11) pointed out,

"[R]ent seeking emerges under normally predicted circumstances because political interference with markets creates *differentially advantageous positions* for some persons who secure access to the valuable 'rights'. From this fact, we may derive a 'principle'. *If political allocation is to be undertaken without the emergence of wasteful rent seeking, the differential advantages granted to some persons as a result of the allocation must be eliminated.*" *(emphasis added)*

In other words, rule of law must be carefully guarded to prevent the slide towards cronyism. Rule of law, or the "generality norm" (Buchanan and Congleton 1998), is the idea that all laws must be non-discriminatory to avoid creating differential costs and benefits for some groups and not others. Such differential costs and benefits generate conflicts between those groups and spur rent-seeking – i.e. some groups using their resources in a bid to gain the benefits and protect themselves against the costs. This idea of rule of law is fundamentally at odds with the empirical reality described in the introduction – the extraordinary growth of regulatory bodies and increasingly arcane regulations.

The question thus arises: is the Hayek-Buchanan solution the *only* possible solution? To put it differently, their argument describes a *sufficient* condition for preventing the slide to cronyism – if we were to comply with the generality norm, we would be safe from this danger. But is this also a *necessary* condition? Can this slide be avoided by some other means, without the generality norm?

The literature on regulatory capitalism and on entrepreneurial capitalism (Vogel 1996; Aligica and Tarko 2015) offers some (perhaps meager) grounds for hope. We can observe the evolution of *outcomes* using Fraser´s sub-indices (Aligica and Tarko 2015, Ch. 3). The size of government can be measured as an average of Fraser's Area 1 sub-indices for government consumption spending, transfers, and government enterprises. Regulation can be measured by Fraser's Area 5 aggregate sub-index, "Regulation of Credit, Labour, and Business".

While on average, between 1970 to the present the size of government in OECD countries fluctuated back and forth, as far as regulation is concerned we observe a much clearer trend towards deregulation (despite the institutional increase of regulatory agencies). This trend in terms of regulatory outcomes (the increasing ease of doing business), creates the puzzle of "more rules, freer markets" (Vogel 1996). What are the regulatory agencies doing if their growth corresponds to deregulation in terms of outcomes? Two main ideas have been proposed as a solution to this puzzle.

First of all, the Hayek-Buchanan argument relies on the hidden assumption that regulatory bodies have monopoly power, and hence the ability to abuse their positions. But do they? As noted by Vogel (1996), economic freedom can increase in an environment of numerous regulators if market players can engage in "regulatory arbitrage". Economic actors can often choose their favorite regulator, e.g. pick the most favorable state in a federal system. Moreover, if one regulator provides an unfavorable decision, economic players can often contest the decision to another authority, while a favorable decision is definitive. This creates a business-friendly dynamic. Some waste is indeed present in this system, especially as far as the legal expenditure involved in the process of challenging the undesired rules is concerned. However, it is not clear to what extent or whether this type of order creates the transition toward fully-fledged crony capitalism.

Secondly, it is often the case that entrepreneurial innovations undermine the existing regulatory order. As Meltzer (2012, 9) put it: "Lawyers and bureaucrats regulate. Markets circumvent regulation. … Regulations are static. Markets are dynamic. If circumvention does not occur at first, it will occur later." The growth of regulatory bodies may partly reflect the failed attempt to keep up with entrepreneurial developments.

Such processes highlight that the relationship between regulatory capitalism and crony capitalism is more subtle than many people assume. While we believe that the Hayek-Buchanan emphasis on the generality norm is still significant, at least as a normative benchmark, and that Zingales's warning requires more attention than it has received to date, we also need to recognize the polycentric nature of modern regulatory systems (Ostrom, Tiebout and Warren 1961; Ostrom 1999; 2014), rather than operate under the monopolistic assumption as Hayek and Buchanan did. We are still far from fully understanding the structural, long-term dangers posed by regulatory capitalism, and the best institutional means of avoiding them.

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Natural-Resource Rents and Political Stability in the Middle East and North Africa

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Resource rents and political institutions in MENA

The Middle East and North Africa (MENA) has the highest level of dependency on the resource rents in the world. Figure 1 shows the position of the MENA region compared to other world regions. While the share of total resource rents in GDP in an average country in the world is about five percent, this ratio for the MENA and Arab countries is around 31 percent and 34 percent, respectively.

Based on the World Bank (2015) information, the Arab/MENA region has the lowest share of manufacturing added value in GDP. The average ratio for 2010–14 in the Arab world is 10.88 percent, versus a global average of around 16 percent. The total youth unemployment rate in the Arab/MENA region is the highest in the world (around 28 percent), while the average world rate is around 14 percent. These numbers for female youths in the Arab/MENA region are even higher (around 47 percent) compared to the world average of 15 percent. Dependence on resource rents with institutional deficits such as high corruption and rent-seeking, fragile rule of law and property rights and weakness of democratic institutions marginalize the private independent business innovators and entrepreneurs. The Arab world has the lowest new business density (new registrations per 1,000 people ages 15–64) in the world (0.87) while the average world is 3.69 and in East Asia and Pacific (with very low rents dependency) at 5.34 (the highest in the world).

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Resource rents and political stability: A brief literature review

Resource rents can have a destabilizing effect on the political system by marginalizing the population from politics. In resource rent-dependent countries, taxation becomes an insignificant instrument in funding the government administration and national projects. As a result, the state becomes financially independent from the electorates. At the same time, the people, by not contributing significantly to the provision of public goods, may not exercise the pressure on the state for more accountability. This financial independence of the state from electorates in the long run leads to marginalization of civil society. By neglecting the importance of a well-functioning tax system, resource-rich countries are at higher stability risks compared with resource-poor ones (Mahdavy 1970; Bornhorst, Gupta and Thornton 2009). It is shown that resource-rich countries with ethnical fractionalized societies are at higher risk of economic and political instability. Ethnical-based discrimination in allocation of opportunities can marginalize specific groups, which in the long run can lead to political tension within countries (Montalvo and Reynal-Querol 2005; Hodler 2006).

Resource rents also affect the structure of the economy, which, in turn, may have negative effects on political stability. The most well-known argument is the Dutch Disease. Positive shocks in resource rents increase spending on both tradable (e.g., manufacturing and agriculture) and non-tradable (e.g., real-estate and services) goods. Resources thus have to be moved from the tradable to the non-tradable sector, and this process of de-industrialization harms long-term growth. As a result, unemployment rates may increase, which could trigger political protests and eventually destabilize the political system (see van Wijenbergen 1984 for the theoretical basis of this channel and Farzanegan and Markwardt 2009 for the case study of Iran).

The quality of institutions has been found to be an important determinant of whether resource rents are a blessing or a curse (Torvik 2002 Robinson, Torvik and Verdier 2006; Mehlum, Moene and Torvik 2006). Resource-rich countries with a low quality of govern-

ance (e.g., high corruption, weak rule of law and property rights and lack of democratic institutions and press freedom) suffer more from their natural resource wealth. In a game theoretical model and panel data analysis, Bhattacharyya and Hodler (2010) show that the effect of resource rents on corruption depends on democratic institutions. Extensive corruption and the existence of "grabber friendly" institutions reward rent-seeking behavior and punish entrepreneurship. Farzanegan (2014) conducts an empirical analysis of 65 countries from 2004 to 2011 and shows a negative and statistically significant association between oil rents dependency and entrepreneurship indicators.

Figure 1

Total resource rents
(average 2010–2013)

Source: World Bank (2015).

The type of government (democracy vs. autocracy) can also determine the effect of resource rents on political stability. Democratic institutions can secure the inclusion of different ethnical groups in policy formulation and distribution of resource rents. Democracies are also allocating a larger part of their resource rents to public goods provision (education and health). By contrast, autocratic regimes represent narrow groups of elites (e.g., military) and thus have a greater tendency to allocate more rents to military and security projects (Dizaji, Farzanegan and Naghavi 2015). Caring more about the population as a whole in democratic systems can increase the feeling of belonging to a system among citizens, establishing a sustainable peace. The index of democratization (Vanhanen and Lundell 2014) shows that the MENA region has the lowest level of political competition and participation. The democracy index for the MENA region over the period of 2002-12 was 7.78 which is lower than average of the index for Eastern Europe and post Soviet Union (20.43), Latin America (18.11), Sub-Saharan Africa (8.60), Western Europe and North America (33.91), East Asia (16.90), South-East Asia (9.75) and South Asia (13.01).

Higher levels of dependency on natural resource rents can not only destabilize the economy as a whole, but can also constrain family formation (Gholipour and Farzanegan 2015) and promote family break-ups (Farzanegan and Gholipour 2015), leading to social crisis. This indirect effect of rents on family structure
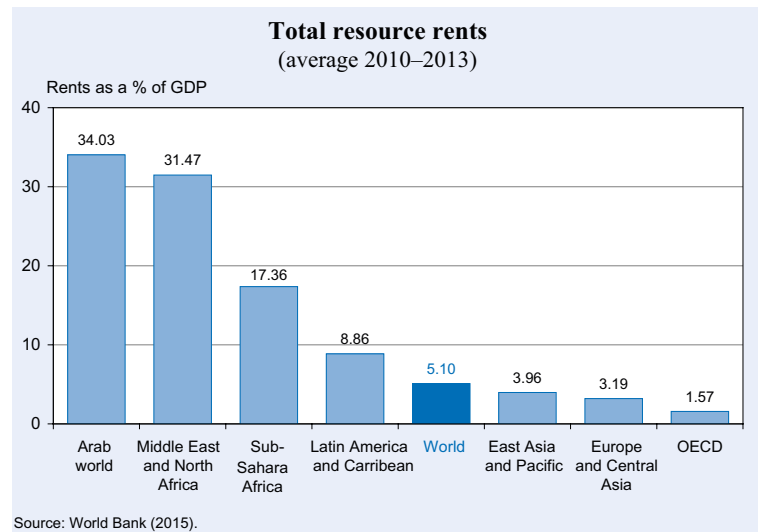
is shown to work through the rising price of real-estate and housing costs in rent-based economies. Finally, Bjorvatn and Farzanegan (2013) find that the resource rents negatively impact economic growth in cases where countries are in the process of a demographic transition.

An analysis of resource rents, power balance and political stability in the MENA

In a new study, Bjorvatn and Farzanegan (forthcoming), hereafter BF, highlight the importance of the distribution of political power as a mediating factor between political stability and resource rents. The political stability in their analysis is the assessment of political violence in the country and its actual or potential impact on governance (ICRG 2011). There are three sub-components in the stability index that they use: civil war/coup threat, terrorism/political violence and civil disorder. This index measures the perception of political risk of internal conflict. The higher scores of stability in their analysis mean a lesser perception of internal conflict (i.e., more internal stability) and vice versa. The ICRG index has been used extensively in the literature on this topic (for instance, Farzanegan, Lessmann and Markwardt 2013; Bjorvatn and Farzanegan 2013).

The data on distribution of power in BF is taken from the database of Political Institutions (Keefer 2010). The lack of power dominance index (*LACK_POWER*) ranges from 0 to 1 and is defined as *"the probability that two randomly picked members of parliament from governing parties belong to different parties"* (Beck et al.

2001). In other words, it shows the degree of government fractionalization: the higher this index, the larger the number of small parties and thus the lack of a dominant strong party (see Bjorvatn, Farzanegan and Schneider 2012, 2013 for growth effects of balance of power).

In a theoretical model, BF show that resource rents can buy internal stability when the incumbent is powerful, and destabilize the system in the presence of a less powerful incumbent. They test their theoretical hypothesis by using panel data for over 120 countries from 1984–2009 and show that when the political power is sufficiently concentrated, resource rents can buy stability while resource rents lead to instability when there is a balance of political power. This finding remains robust after controlling for income, quality of institutions (law and order, democratic accountability and corruption), lag of political stability, country and time fixed effects, and the possible endogeneity of rents and power balance to political stability. Earlier studies such as Andersen and Aslaksen (2013) emphasize the moderating role of "type of government" in the stability effects of rents. BF show that not (only) the type of government, but also the *strength* of government is a key moderating factor in the stability and rents nexus.

Here, we focus on the MENA sample and update the data relative to BF.[3] We test the following hypothesis:

Hypothesis: The ultimate stability effect of resource rents depends on the balance of power. If the incumbent is powerful, then rents are more likely to have a stabilizing effect. When we have a less dominant incumbent, rents can lead to political instability.

To test this hypothesis, we use panel data for 20 countries in the MENA region from 2002 to 2012. To investigate whether the relationship between stability and rents depends on the balance of power, we use the following specification:

$$STAB_{it} = \beta_1 \cdot RENT_{it} + \beta_2 \cdot LACK\_POWER_{it} + \beta_3 \cdot (RENT_{it} \times LACK\_POWER_{it}) + \beta_4 \cdot Z_{it} + \mu_i + \delta_t + \varepsilon_{it}$$
(1)

where i refers to the country and t to the time period. The political stability index *STAB* in our analysis is Political Stability and Absence of Violence/Terrorism from World Governance Indicators. It captures perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means,

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[3] We use the political stability index from World Governance Indicators as dependent variable and the Vanhanen Index of democracy (as one of the control variables).

Table 1

Rents, power and political stability in the MENA region					
	(1)	(2)	(3)	(4)	(5)
			STAB		
Rent (-1)	0.012	0.011	0.013*	0.014**	0.014**
	(1.43)	(1.56)	(1.78)	(2.12)	(2.12)
Lack_Power(-1)	0.508*	0.597**	0.482	0.472	0.417
	(1.77)	(2.14)	(1.65)	(1.57)	(1.38)
Rent(-1)*Lack_Power(-1)	-0.017**	-0.025**	-0.021**	-0.022**	-0.021**
	(-2.18)	(-2.56)	(-2.45)	(-2.69)	(-2.59)
Log_GDPPC(-1)		1.129	1.104	1.036	1.081
		(1.50)	(1.43)	(1.44)	(1.69)
Van_Democracy(-1)			0.011	0.009	0.004
			(0.75)	(0.58)	(0.25)
Youth_Unemployment(-1)				-0.016**	-0.016**
				(-2.25)	(-2.32)
Inflation(-1)					-0.009***
					(-3.18)
Observations	175	175	157	157	149
R-sq	0.25	0.30	0.28	0.31	0.30

Note: The method of estimation is panel OLS (country and time fixed effects). The constant term is included (not reported). t-statistics shown in parenthesis are based on robust standard errors, * p < 0.1, ** p< 0.05, *** p< 0.01.

Source: The authors.

including politically-motivated violence and terrorism and it varies from about -2.5 to 2.5 (higher values mean more stability). The political power index *LACK_POWER* is as in BF, and described above. Z includes a vector of control variables such as a logarithm of real GDP per capita, the Vanhanen index of democracy, the youth unemployment rate and the inflation rate. We also control for country specific characteristics such a geographical location, ethnical, language, and religious characteristics and historical background. Year fixed effects also control for time-specific shocks such as financial crises, and political shocks (e.g., the Arab Spring). The effects of rents and balance of power and other right-hand side variables may take time to manifest themselves in the internal stability of countries. To take this issue into account, we use a one year lag of all independent variables. In addition, this may reduce the reverse feedback effect from internal stability on the right-hand side variables. The source of data for all variables is the QOG Standard Dataset 2015 (Teorell et al. 2015).

Table 1 shows the results. In Model 1 we start with our main variables of interest (*RENTS, LACK_POWER* and their interaction), adding other control variables until Model 5, in which we have our general specification. It is interesting to see that higher resource rents in countries that have strong states (*LACK_POWER* close to zero) have positive stability effects. In line with the theoretical predications of BF, we find empirical evidence that within the MENA region, the balance of power also matters for the final stability effects of rents. Rents can buy stability when the state is strong (homogenous). This result is not driven by omitting democracy (which may affect both the balance of power and stability) and income per capita. Youth unemployment rate and inflation are destabilizing factors.

Conclusion

Can rents buy stability? Following the theoretical predictions of Bjorvatn and Farzanegan (forthcoming), we test the relevance of regime strength (balance of power) in the final stability effects of rents in the Middle East and North African countries (MENA).

Our panel data analysis for 20 MENA countries from 2002 to 2012 shows that rents can buy stability in the MENA region only when the incumbent is sufficiently strong ex ante. In other words, rents are stabilizers when the regime strength is high and factional politics is low,

and works as a destabilizing force in regimes that are weak from the outset.

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Rent-Seeking in a Time of Austerity: Greece[1]

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Introduction

A widely held view regarding the influence of Greece's membership in EEC/EU (and later in EMU) was that it has exercised a benign influence on the functioning of Greek economy and society by acting as an external constraint enabling Greek governments to invoke the EU as a scapegoat for unpopular, but efficiency-enhancing policies. The onset of the Greek Great Depression[4] put the tombstone on this view, as it revealed that the semblance of "Europeanization" of the institutional and policy infrastructure masked the existence of deeply embedded, clientelistic networks that supported the country's "democratization" of rent-seeking (Moutos and Pechlivanos 2015).

The masking of the underlying reality was stronger during the period 1995–2009, which started with the European Monetary Union (EMU) accession effort. This effort appeared, initially, to tame the ability of the political machine to cater for its constituents, as economic policy focused on EMU accession, and the rhetoric in support of overt populist policies was retracted. Yet somehow this successful bid sowed the seeds of restoration of the previous agenda. Eurozone membership gave the Greek economy low-cost access to international financial markets for the first time. This was a game changer, as this was understood to be a tap on unlimited funding, whose cost would be deferred to future generations. Both government and banks were locked in a growth- on- (foreign) credit- steroids regime, which, as long as foreign credit to both parties was available,

allowed Greek governments to continue their clientelistic politics and the private sector (mainly the banks) to postpone the consequences of their increasing foreign indebtedness. As a result, the Greek economy found itself heavily indebted to the rest of the world in the wake of the global financial crisis.

In 2010, Greece lost access to international financial markets, and sought out official assistance. The bailout terms offered to the Greek government by the Troika of lenders (EU, IMF, and ECB) included a heavy dose of (necessary) fiscal consolidation, and a host of other measures – which we may summarily call structural reforms – aimed at assisting the transformation of the Greek economy.

In the rest of this article we examine to what extent the timing and the design of fiscal consolidation and structural reforms, initiated as part of the two Economic Adjustment Programmes (EAPs) for Greece since 2010, have allowed vested interests to largely maintain their privileges by shifting the burden of adjustment to the general population.

Seeing the crisis as an opportunity

"Reform"-minded policy pundits and business leaders understood from the onset of the economic crisis in 2008 that this was an opportunity to push their agenda for structural reforms.[5] Their main argument was that the economic crisis had uncovered and highlighted the economic inefficiencies of the clientilistic politics that have shaped economic policy throughout a great part of the post-dictatorship period in Greece.

The argument went as follows: the sovereign debt crisis severed the country's access to the international financial markets. This meant that the previously overused channel of transferring the costs of inefficient policies to future generations via public indebtedness was shut down. As a result, citizens could start to see the link between the adoption of inefficient "handout" policies

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targeted at particular interest groups and the costs they entailed to be borne by society.

Historically, Greek society has adopted a very relaxed view with respect to the influence exerted by interest groups on public policies. Almost every demand for some sort of "special treatment" to a special group was accommodated. The political economy equilibrium resembled a Ponzi-like scheme, in which new demands were accepted by the already established coalition, as the element of inclusiveness enhanced the political stability of the pact. The economic inefficiency involved, that called into question the long term sustainability of the pact, was suppressed in the public discourse. To understand this, one has to take into account the ideological background against which public discourse on economic policy developed in Greece. Fuelled by ancestral feelings of economic inequality and social stratification (i.e., deep-rooted perceptions against the illegitimacy of the existing social and economic order), requests for "special treatment" were understood as a fair payback for previous grievances. Arguments against the adoption of "handout" policies to particular groups due to the imposition of costs to society were ostracized from the public discourse with the smear that were turning parts of society against each other, and hence were tearing away at the social fabric.[6]

Hence, the main question was whether fiscal consolidation and structural reforms are complementary instruments or not. Would citizens see themselves as part of the general populace that stands to benefit from the enhanced efficiency of the reformed economy, or would they instead relate separately to their group's endangered sweet-deal? Which is then the optimal time structure of the reforms to minimize resistance to reform by creating supporting coalitions for the policies needed?

Obviously, if a reform program is to be implemented one has to decide on its pace. Should it be frontloaded to take advantage of the initial window of opportunity given to the reforms by the general populace? If a more gradual approach is to be adopted, it has to be decided which reforms should be given precedence so that an appropriate sequencing of reforms creates coalitions for further reforms (Dewatripont and Roland 1992; 1995).

It is interesting to note that, nominally at least, the Greek population seemed to be in favor of "reform" when the crisis erupted. This attitude was shaped in no small measure from the media, which started exposing gross cases of tax evasion and public sector corruption, as well as cases of under-worked and over-paid public sector employees. As a result, many Greeks started feeling that an externally imposed, and thus more likely to be fair, austerity and reform package could set the country on a virtuous path and punish (at least some) of those responsible for the crisis (EEAG 2011).[7] Needless to say, this support retreated soon after the first "pain" from the measures was felt.

The uneven pace of reforms

By design or fiat, a dual approach was employed throughout the lifespan of the two Economic Adjustment Programmes (EAPs) for Greece since 2010. Mainly by necessity, fiscal consolidation was frontloaded. Structural reforms, by contrast, were designed to be implemented at a gradual pace. Their actual implementation, if at all, was much slower.

The first major pillar of EAPs was fiscal consolidation. Figures 1a and 1b portray the discretionary fiscal effort (DFE) undertaken by the Greek governments regarding current expenditure and revenue since 2010. The DFE – as calculated by the European Commission – provides an alternative measure of the discretionary policy actions to the traditional measure of the change in the cyclically adjusted budget balance, which suffers from well-known robustness and endogeneity problems (European Commission 2013). The two figures indicate that during the first two years (2010 and 2011) budget consolidation relied more on revenue increases (57 percent of the total DFE) than on expenditure decreases, whereas during the latter three years the modality of fiscal consolidation was reversed, with expenditure decreases accounting for 66 percent of total DFE. Clearly, the DFE was frontloaded, with 58.7 percent of it taking place in the first two years. The average DFE per year was 5.8 percent of GDP.

The heavy dose of austerity, in tandem with the credit squeeze and the sharp rise in real interest rates, took their toll on macroeconomic outcomes. GDP in 2014 was 25.7 percent lower relative to its peak in 2007, whereas final consumption expenditure dropped by 23.6 percent

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[6] This argument was codified in the public discourse as a defense against "social automation". Hence, for example, a private sector employee should not be complaining about the perks enjoyed by certain public sector employees (at taxpayers' expense), but should fight for an equivalent deal instead.

[7] See EEAG (2011) for more details.

Figure 1

Discretionary fiscal measures

a) Annual measures

b) Cumulative measures

Source: AMECO; authors' calculations.

market liberalization and privatizations. Priority was given to those reforms with a clear positive fiscal effect, such as the streamlining of the compensation scheme of public sector employees, and of the pensions and social benefits structure. Reforms affecting the general population were also prioritized over those targeting specific groups. This approach was underpinned by the idea that these reforms could produce a more pronounced outcome, or even set the pace for the rest. On the other hand, such an approach helped special interest (and better organized) groups to retrench themselves to avert the reforms or minimize their negative impact.

Fiscal structural reforms

The urgent need to eliminate the primary budget deficit was the driving force behind the swift implementation of reforms related to public sector employees' compensation and government spending on pensions. For instance, the general compensation scheme for public employees was the first to be reformed and serious efforts were made to abolish its fractured nature.[9] The reform of compensation schemes for special categories of civil servants, by contrast, was delayed at least a year, and maintained its opaqueness regarding various allowances intact, which later on down the road of the reform path were used to partially reverse the intended reform goals, as court orders pronounced some of these allowances tax-free.[10]

The same urgency was not observed with other reforms such as the broadening of the tax base. Delays were observed in transferring experienced staff from other public bodies into tax administration and completing new recruitments. For example, the large taxpayers' unit has many fewer staff than intended, and their work has been diverted to transfer pricing cases, rather than generally targeting large taxpayers. Tax authorities were not insulated from political interference, as was demonstrated in 2014 by the decision of Greece's Secretary General for Public Revenue to resign from his job due to intense political pressure not to go after the well-connected, just 17 months into what should have been a five-year term.

between its peak in 2008 and 2014. The drop in investment was enormous, as its level in 2014 was only one-third of its peak level in 2007 (a drop of 64.7 percent). In tandem with these developments the unemployment rate peaked at 27.5 percent in 2013 from a low of 7.8 percent in 2008 and declined to 26.5 percent in 2014. It is worth noting that the youth unemployment rate (of under 25 year-olds) soared from 21.9 percent in 2008, to 58.3 percent in 2013, and to 52.4 percent in 2014.

Ultimately, however, the austerity policies did the trick and addressed the fiscal and external imbalances facing the country.[8] The consequence of the austerity medicine was nevertheless a general populace backlash against the first EAP, which led to political turmoil in 2011-12 and uncertainty about Greece's place in the euro area, both of which emboldened vested interests opposed to reforms (IMF 2014).

The second basic pillar of the EAPs for Greece was structural reforms, which mainly comprised fiscal structural reforms (including social security), labor and product

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[8]   Indeed, both the current account and the primary budget deficits were over ten percent of GDP when the adjustment started, and by 2014 both registered a small (less than one percent) surplus.

[9]   A major step in this direction was the establishment of the Single Payment Authority for all public-sector employees. Unfortunately, even to this date, some government organizations (e.g. the Greek Parliament) have been allowed to remain outside its purview and control.

[10]   It remains a mystery why the government did not try to generate conflicting interests between the general and special classes of civil servants by setting a certain "rebate" for the general public servants, tied to the savings brought by the reform on the special compensation schemes, applicable whenever the reforms for the special classes of civil servants get implemented.

Labor and product market liberalization

Labor market regulation has also been a contentious field in which significant reforms were adopted earlier in the program in the wage bargaining system with the abolition of the automatic expansion of sectoral agreements and the adoption of firm-level agreements. Nonetheless, according to the IMF (2014) excessive restrictions remain that raise the cost of doing business and inhibit the establishment or expansion of larger-sized firms. For example, disputed collective dismissals are de facto not allowed. They used to require the approval of the Minister of Labour (and now the Ministry's Secretary General), but no such approval has been granted since 1982, forcing companies to offer very high voluntary severance packages or resort to bankruptcy. Lockouts are still prohibited, even as a defensive tool for employers during negotiations.

However, even although employment protection legislation (EPL) in Greece did not proceed as far as the Troika would like, it became significantly lighter than before. Indeed, OECD's EPRC_V3 indicator (i.e. the weighted sum of sub-indicators concerning the regulations for individual dismissals (weight of 5/7) and additional provisions for collective dismissals (weight of 2/7)) declined from 2.85 in 2008 to 2.41 in 2013 – the corresponding numbers for the EU15 average were 2.64 in 2008 and 2.52 in 2013 (OECD 2014). Thus, whereas Greece had above-EU15 average EPL in 2008 according to this indicator (five countries had EPRC_V3 higher than Greece), by 2013 its EPRC_V3 indicator was below the EU15 average (nine countries had EPRC_V3 higher than Greece). We note that among the Southern European countries, members of the EU15 (Greece, Italy, Portugal, Spain, or SE4), Greece's EPRC_V3 indicator was lower than that of both Italy and Portugal in both 2008 and 2013.

Many of the enacted policy changes were in accordance with the stated objectives of the main employer organizations since the 1990s, i.e. Federation of Greek Industries (SEV), the General Confederation of Professionals, Craftsmen and Merchants (GSEVEE) and the National Confederation of Greek Trade (ESEE). However, it should be stated that there were significant differences among these organizations – due to differences in size and dependence on foreign markets – with SEV showing the biggest interest in dismantling pieces of EPL.

In summary, with the exception of SEV's support for EPL reform, no major political party or social partner (either before or after the crisis) had publicly expressed an interest in weakening EPL. The standard political-economy explanation for this state of affairs is that EPL benefits a well-organized (through the device of trade unions) part of the population, thus making the implementation of any reform difficult. An alternative explanation is that although the main beneficiaries of EPL are trade union members in industries facing little international competition, there is a "lighthouse effect" on employment and pay conditions in the rest of the economy, since EPL increases the bargaining power of labor vis-à-vis oligopolistic firms, thus providing a wider base for political support. (The case that some (large) incumbent firms may perceive strict EPL as a way to stifle potential competition from start-ups should not be discounted either.)

In a similar vein, Greek governments have shown reluctance to follow OECD recommendations, which could foster product market competition, increase competition and lower prices. Some measures that were implemented early on in the liberalization of road freight transportation and taxi services met with significant resistance and possibly derailed further measures.[11] Some of the recommendations that the OECD estimated would yield significant benefits to consumers are being implemented only partially, such as the elimination of advertising charges, the removal of excessive restrictions on milk, the liberalization of prices and distribution channels for over-the-counter drugs and food *supplements*, and the liberalization of Sunday trading. Other actions that have been fiercely restricted by the authorities include opening up the mediation profession (which will help reduce the high inflow of new cases in courts), eliminating remaining excessive restrictions relating to lawyers, eliminating excessive reserved activities for engineers, and adopting secondary legislation on a number of important professions and activities (including electricians, actuaries, chartered valuers, and pharmacists – see below). As a result, and despite the pressure exercised by the Troika, Greece's overall index of product market regulation, as measured by the OECD (2015), stood at 1.74 in 2013, which was higher (i.e. stricter) than any other euro area country.

The reform in the pharmacy profession is a particular good example of the muddle- through process, with stalls and reversals present in many sectoral reforms, where resistance from vested interests was ferocious.

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[11] The interesting element in the above mentioned reforms was that they were taking place concurrently with changes in the tax code that allowed regulatory takings to be compensated via temporary grandfathering clauses in the tax code. That was an opportunity that could not be exploited subsequently in other reforms.

The intended goal of the reform was to abolish regulations in the pharmacy profession such as covering limits on the number of pharmacies, opening-hours restrictions and minimum profit margins. Although most of the measures were enacted by law, subsequent ministerial decrees relegated final decisions to local authorities, more easily susceptible to vested interests pressure. At the end of the day changes were side-tracked. For example, stricter opening-hours restrictions were re-imposed on a local scale, while those pharmacists operating within the "nationally" allowed time schedule were persecuted.

Why were fiscal targets (mostly) met, but structural reforms lagged?

Wide-ranging reform initiatives like those needed in the Greek case, face two types of political constraints. The first type is ex-ante political constraints that can block decision-making and prevent reforms from being accepted. The second type is ex-post political constraints that are related to backlash and policy reversal in case of undesirable outcomes following their implementation (Roland 1994).

The political economy argument in favor of gradualism is that an appropriate sequencing of reforms can provide demonstrated successes to build upon, thus creating constituencies for further reforms (Dewatripont and Roland 1995). A gradualist approach was indeed adopted in Greece as of 2010, but the sequencing of reforms was exactly opposite to that which would gradually increase support for further reforms.

Since Greek governments knew that it would be easy for the Troika to assess whether the quantitative fiscal targets were met, fiscal consolidation proceeded at a fast pace, and the fiscal targets regarding the budget deficit were (mostly) achieved. However, the initial heavy reliance on tax increases rather than expenditure cuts hurt all tax-paying citizens, but maintained the privileges of the traditional non-tax-paying groups and special groups of public-sector employees whose wages suffered smaller declines.

On the other hand, structural reforms were designed to be implemented at a gradual pace. Their actual implementation, if at all, was much slower. Unlike fiscal targets, many structural reforms were legislated, but few were implemented as important follow-up ministerial "clarifications" regarding their implementation were

either not issued or significantly weakened their force to break the power of privileged stakeholders. The large drops in real incomes and the steep rise in unemployment rates suffered in the early years of heavy fiscal adjustment – before the beneficial effects of the limited set of actually implemented structural reforms could be observed –created huge constituencies against further implementation.

A key issue in this respect was the existence of complementarities between labor and product market liberalization. As argued by Blanchard and Giavazzi (2003), deregulation in product markets, by reducing rents, increases acceptance of more competitive wage setting in the labor market. Clearly, by setting different time schedules for labor and product market reforms, the EAPs missed this opportunity.

The common cry of the suffering unemployed and of those that managed to maintain their privileges was that the EAPs had failed and that the reforms prescribed in them should be revoked. The popular backlash made Greek authorities unwilling to proceed with further reforms (or implement those already legislated). It is thus not surprising that less than half of the planned IMF reviews were completed, and that only one has been completed since mid-2013, due to the failure to implement the agreed reforms.

Concluding remarks

With the benefit of hindsight it is clear that if one wanted to derail the effort to eradicate the web of interlocking interests that brought Greece to the brink of the crisis that became visible six years ago (and is still gathering strength), it could do no better than follow the structure and sequence of policy decisions taken since 2010.

One way to understand what happened is to note that the crisis brought to the fore what has been a perennial characteristic of Greek society, namely the lack of social trust. Political scientists and economists have noted that Greek society is characterized by what Banfield (1958) called *amoral familism,*[12] i.e. the fact that individuals rarely extend their trust beyond the family nucleus and a restricted number of friends and acquaintances (see Siotis 2011 for an interesting analysis applied to the Greek context). The existence of a fragmented and clientelistic "social welfare system" has helped to cement this

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[12] Banfield used this expression to describe southern Italy.

attitude. This also explains why the young – especially the educated ones – have not exercised any political pressure to stop the excessive budget subsidies received by many pensioners, i.e. because it is their parents or grandparents that receive these subsidies, part of which, in turn, are transferred to them. From the perspective of economic efficiency (and social justice as well), it would have been better if the excessive budget subsidies paid to many pensioners had been used to allow for a reduction in the labor tax wedge and a rise in employment, thus increasing support for further reforms.

Instead of sequencing the reforms to build coalitions supporting further reforms, the opposite was achieved. Reforms horizontally affecting the general populace were given priority, leaving targeted reforms affecting special groups for later on. Nonetheless, the greater than predicted recession, with the social pain it inflicted, brought about reform fatigue among the general population. Special interest groups rode along this popular backlash and stalled the implementation, or even revoked already legislated measures. It is a pity that the suffering unemployed or bankrupt businessmen inadvertently became the shield that allowed powerful interest groups to maintain their privileges.

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Overcoming the Rent-Seeking Defect in Regional Policy: Time to Re-think the Institutional Design

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Regional support policy: Germany and the European Union

Divergence between economically leading and economically lagging regions has been a permanent problem of national states, as well as of the European Union. On the national as well as on the EU level, governments have used transfers of public funds in favour of the backward regions to stop economic divergence and promote economic convergence. Since the first results of regional policy were not convincing, spending has been increased over the past 25 years. In Germany, spending on regional policy became a top priority following German reunification in 1990. Under the programme "*Gemeinschaftsaufgabe Verbesserung der regionalen Wirtschaftsstruktur*" (GRW), national and subnational matching grants-in-aid for backward regions were substantially increased. From 2014 to 2020 about 25 billion EUR will be spent per year for matching grants (Federal Ministry of Economics 2015). The underlying intention was to promote economic convergence in the regions, so that the backward, industrially under-developed German East would catch up with the progressive West.

At the European level, an EU cohesion policy was created in the Single European Act of 1986 when Spain, Portugal and Greece became members of the European Union and has been extended continuously since then. For the period of 2014 to 2020 the European Commission has budgeted 325 billion EUR or about

46 billion EUR per year for regional support policies (ERDF), (Federal Ministry of Economics 2015).

The idea is that federal funds in Germany or the European Union should be spent in backward regions on investments in private businesses and public infrastructure. The supporters of regional policy assume that capital's productivity is highest where there is the highest necessity. The economic planner is placed in the position of selecting those regions that best comply with these criteria. It is, however, surprising to see that (in the case of Germany) one federal and 16 *Länder* ministers with their administrative entourage struggle to solve such an allegedly simple selection problem. A closer look at this issue, however, reveals that the application process for potential support candidates and the selection procedure is not at all simple and costless, but a Sisyphean task. Applicants need resources to present themselves as eligible and ministers have to make calculations to sustain their selections. The basic goal of the authors of this paper is to show that the costs of application and selection are not trivial. All of the rational applicants together spend as much as the anticipated benefit of all subsidies distributed, so that the net benefit dissipates. Tullock's "Law of the dissipation of rents" (Tullock 1980) becomes reality in regional policy.

The key to understanding regional policy is to understand its underlying process of rent-seeking. Rational candidates invest in order to obtain the prize up to an amount that equals the benefits of the prize. The net effect is zero. In fact, a large empirical study by Philippe Montfort (2008) from the Université Catholique de Louvain (UCL) in Belgium finds that the net contribution of the EU cohesion policy to regional convergence is not actually visible.

The theory of rent-seeking, which will be further developed in this article and applied to the case of regional policy, can explain in greater detail why regional policy fails. In the next part of this article, different models of rent-seeking will be presented. The explanation provided here can be applied to different concepts of regional policy in federal or quasi-federal systems. After that, the German (GRW) and European Union (ERDF) regional policy will be analysed with the tools previ-

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ously developed. Conclusions from this analysis will be drawn in the last part of this article.

Different models of rent-seeking

Rent-seeking theories: an overview

All human pursuit is a kind of rent-seeking game. All individials try to collect resources, particularly when they believe that they can extract more value from these resources than their competitors. Crowding out is a prime character trait of the homo economicus. The result might be profit-seeking in competition or rent-seeking in monopoly (Buchanan 1980). The profit-seeker pays the incumbent a price so that the incumbent leaves the market and the profit-seeker can improve on the current market situation. The process is open to subsequent competitors who can create an additional surplus. Profit-seeking results in an improvement of resource allocation in a competitive market. The consumer pays the competitive equilibrium price PC.

Rent-seekers, however, do not strive for an efficient deployment of resources in a competitive market, but aim to exploit their monopoly position (Tullock 1980). Fig. 1 shows the contrast between rent- and profit-seeking. The profit-seeker enters the market with a price lower than the current monopoly price P_M. The rent-seeker does not strive for an optimal use of resources, i.e., a competitive price PC, but invests L into building market entry barriers for competitors, so that the rent-seeker can defend the price tag P_M and collect the monopoly rent M. In the case of artificial market barriers by regulation, politicians, regulators, i.e., those players who can build or tear down market barriers, sell the monopoly rent M to the profit-seeker for a price L.

The consumers are worse off in a rent-seeking model. Moreover, the monopolist does not clear the market, i.e, does not exploit the gains from trade options in X_C - X_M.

A textbook example of rent-seeking is the distribution of cab licenses in New York City. The city administration distributes a restricted amount of licences to long-established cab companies. These licences contain a monopo-

ly value. Ronald Coase (1959) described how radio frequencies are allocated by the Federal Communications Commission, creating monopoly positions for the incumbent. As far as natural monopolies exist, i.e., where the costs for the creation of an additional or extended access to the market would outweigh the benefits, an efficient allocation can be ensured by auction. Television, radio, or telecommunication licences have been auctioned in Germany as a result. The bidder who expects to exploit the most value from the limited access to the market will submit the highest bid and will be awarded a (temporary) property right to the previously public good.

In the case of rent-seeking, the scarcity is not naturally necessary. Scarcity is artificial and, in most cases, caused by regulation – as the example of the cab licences in NYC shows. Supplier and regulator agree upon a regulation that grants the supplier a monopoly position, which the supplier can exploit. The allocation of artificially restricted access to the market is not distributed in a market-like auction. Typically, market access is not auctioned to the bidder who makes the highest offer, but to the candidate who fits best into the scheme that regulators and suppliers have previously defined. From a market perspective, this process is greatly inferior to the auction model. Suppliers get access not by actually maximising value, but by lobbying for 'tailor-made' clusters in advance, so that they have a head start when the pie is finally distributed. Organised cab drivers, for example, may have an incentive to lobby for criteria like driving experience, so as to outpace newcomers in the business. Candidates have to invest a portion of M in lobbying so as to finally collect the prize in terms of market access. The economic loss of rent-seeking can eventually increase from L + D to L + M + D. Such

Figure 1

Basic rent-seeking

Source: The authors.
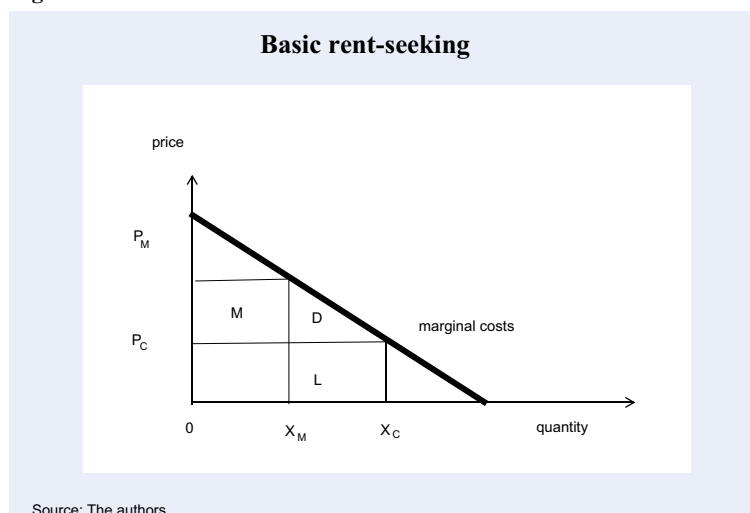
rent-seeking costs can be avoided by drawing the lot of cluster-distribution instead. However, this process does not ensure that the most productive candidate enters the market. Profit-seeking, i.e., the dominance of the most capable candidate, can be achieved by an auction that grants the highest bidder the right to exploit the market. Such an auction is only necessary and recommendable where natural monopolies exist. Where monopolies are artificially created – like in the cab license example – competition in the markets will ensure the 'survival of the fittest' without regulatory influence.

Rent-seeking in legislation

Rent-seeking via networking is rife in politics and legislation. Interest groups compete for favourable legislation. The benefits that politicians may receive for legislating in favour of organised lobby groups might consist of campaign donations, in mobilising voters of a certain group, in information provided by the lobby groups, et cetera. The more interest groups try to influence legislation to their benefit, the more expensive the lobbying effort becomes, and the more likely a dissipation of rents is. Browning (1974) suggests that lobbying is less a problem in legislation than in the case of established monopolies. A monopoly that a rent-seeker tries to defend is the concrete and exclusive source of a monopoly rent. If, however, an individual invests in lobbying, other members of the group of potential beneficiaries participate in the public good created by legislation. The availability of rules as a public good limits the willingness of individuals to invest in lobbying. Olson (1965) already pointed out that the public good, or free rider problem makes it more complicated for individual rent-seekers to

achieve their goals, especially with growing numbers of potential rent-collectors.

Later on, Olson (1982), however, stated in "The Rise and Decline of Nations" that the free-rider problem diminishes in societies with stable institutions between potential beneficiaries. The higher the degree of organisation (fortified by informal rules and reputation mechanisms) within a certain society, e.g., in trade unions, employer, and/or industry lobbying groups, the more likely rent-seeking investments are. Accordingly, Olson sees rent-seeking as a problem of complex and stable societies, rather than of those societies that are in a transformation or re-organisation process, e.g., after a war, a revolution, or system change.

All-pay auctions

In planned economies, rent-seeking by queuing is a well-known issue. A limited amount of goods, for instance, an unknown number g of indivisible bunches B of bananas, is distributed at a given instant of time to each of the g persons first in the line. Everyone who queues pays an equal individual waiting price P_W per unit of time waited, although s/he might not collect a bunch of bananas. The first g persons in the line take all bunches B, while everyone behind them leaves with empty pockets. Everyone joins the queue until they expect that the benefits to collect a bunch of bananas B times its respective probability p_B minus the waiting cost P_W times the units waited tn equals zero, i.e., everyone queues as long as $B*p_B - P_W*tn \geq 0$. Eventually, the g bunches of bananas are distributed according to individuals' position in the queue, i.e., the individual's waiting time. The first player who joins the queue receives a bunch B after a high waiting time. The highest payoff is eventually collected by the player with the shortest waiting time who is the last in the queue to receive a bunch B. The highest loss is suffered by the player just behind the last successful player. With equal waiting costs per unit of time per person, the overall benefits are netted out by the overall costs, see figure 2. If transferred to the case of regional policy, the units of waiting cost equal the units of upfront investment in time, effort, and consultants' fees for lobbying and application, i.e. the sum of investment to collect C (all subsidies in a given

Figure 2

All-pay auctions

Source: The authors.
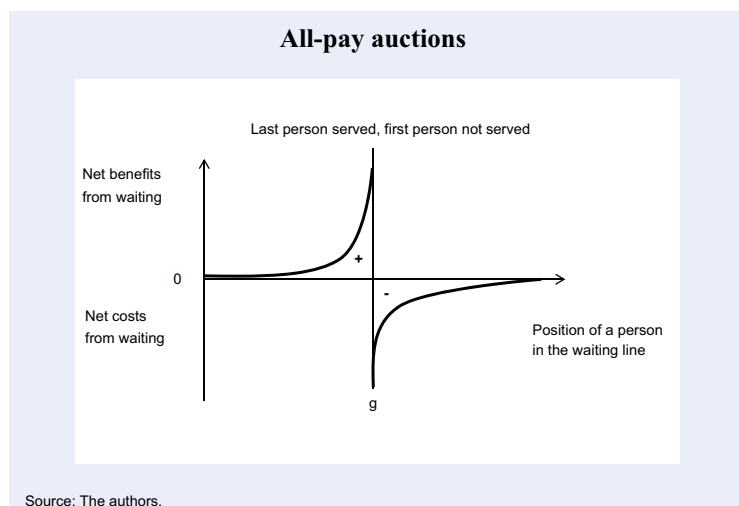
application period) by all support candidates = sum of the distinct probabilities to collect the expected share of C by all potential support candidates.

Rent-seeking in regional policy: Germany and the European Union

The present model: GRW and ERDF

The ERDF regional economic subsidies for the period of 2014–2020 are calculated at 325 billion EUR, i.e., approximately 48 billion per year. Political agents are convinced that a structural economic change cannot only be achieved by supportive structural adjustment policy, but requires concrete measures to be taken that influence economic development. The distinct goals are set in the GRW-coordination committee for GRW subsidies, or negotiated between the European Commission and the member states for ERDF subsidies. The supply of regional subsidies is fixed. Politicians decide how much they are willing to spend on regional support programmes. The demand for subsidies is open. Potential support candidates are encouraged to apply for subsidies in a tender process. This step shall avert suspicion of nepotism, corruption, and arbitrariness. Everyone shall have the same chance to enjoy a portion of the pie. Information is asymmetrical in this process. Politicians know the exact figures of all subsidies, while the actual costs of the tender process are opaque. Support candidates are forced to make ex ante investments in order to increase their chances of eventually collecting the prize. Such ex ante investments push up the economic costs of the tender process, so that the net benefits of the entire process for society ultimately approach zero.

While all economically sensible investments should be made according to the principle that subsidies of C should yield a utility of U, where $U \geq C$, it is highly doubtful as to whether the current regional policy can achieve this goal. Firstly, citizens have to be taxed with C so that C is available to be distributed in regional policy subsidies. Problematically, a sum of money C extracted from the economy most commonly leads to an excess burden, i.e., a welfare loss higher than C. In Brennan and Buchanan (1980), it is assumed that the total economic cost (EC) of taxation regularly exceeds the taxed sum (C), by 3/2 C. Secondly, the economic benefit (EB) that can be achieved by injecting C into a certain project is most likely to lie considerably below C. Only if C (as a right, rather than a cash subsidy) is auctioned to the candidate that makes the highest bid, i.e., to the candidate that is able to contribute the most to GDP, EB may reach C. Let us recall the example of auctioning television, telecommunication, or radio licences in Germany. Such a procedure, however, is not foreseen in the GRW and ERDF-policies. The GRW coordination committee for GRW subsidies and the European Commission in negotiation with the member states for ERDF subsidies define the criteria for support, i.e., they create clusters such as 'creative media', 'medical technology', and 'biotechnology'. The process whereby such 'innovative' clusters are established involves extensive negotiations and frequently also entails high fees for consulting firms that do a lot of persuading in cluster design. In Germany, for instance, smaller businesses like hairdressers, butchers, and bakeries that really tend to struggle in less developed regions, not least because of the minimum wage limit, have no realistic chance to argue for a cluster in their favour (Eisenring 2015).

Extra costs arise ex ante in negotiations over cluster design and ex post in applying for subsidies within the specified cluster. The distinct probabilities P_i of receiving a share of all subsidies C_i times the respective share, i.e. $P_i * C_i$ sum up to C for all potential support candidates with C being the total amount of subsidies to be distributed in a given application period. Every support candidate has the incentive to invest his or her expected share $P_i * C_i$. Since the ex ante investment in cluster design creates a public good for all support candidates who fit within the same cluster, the ex ante incentive to invest in cluster design is lower than the ex post incentive to invest in the application process. However, as previously pointed out, the higher the degree of coordination and organisation within a specific candidate group is, the higher the chance to avoid the free riding problem, and to bundle efforts so as to secure an as large as possible pool for 'their' cluster. After the cluster is defined, the grab race starts. Every candidate has to estimate his/her distinct probability of acquiring the prize, the value of the prize, and the competitors' investment. The theory of rent-seeking applied to GRW and to EDRF regional policy shows: if all candidates have perfect information about their chances of success and the value of their subsidy, the net benefit of subsidies will tend towards zero. Imperfect information, however, might lead to a negative or positive outcome in the end. The net benefit for society is largely diminished by the ex ante and ex post transaction cost of acquiring the prize. Empirical research that shows either a positive or negative net effect of specific subsidies supports our assumption of a zero net effect on balance. Econometric studies cannot replace a theoretical profound analysis of regional policy.

An alternative regional policy: distribution of rights instead of top-down distribution of revenues

In order to create a sustainable model for regional policy for the future, one first has to recognise the failure and flaws of current regional policy, and secondly, one has to recall the goal of regional policy, namely the strengthening of regional units and in particular of regional business activities. The institution of the GRW and ERDF funds suggests that sub-central regions lack finance, while the federal republic or the European Union have spare funds that can be distributed top-down to regions in need. As shown in this article, the distribution of revenues from tax rights is highly inefficient, as it leads to a dissipation of rents.

An alternative solution, which we would like to propose without the claim of eventually developing and proving this model, but merely as a contribution to the discussion of re-modelling regional policy, is to focus on the distribution of rights, instead of the top-down distribution of revenues from the use of rights. If regions are seen to lack the necessary funds to develop a successful business infrastructure while the central institutions have excess finance on balance that they can distribute, one should give the local units the rights to tax, or the chance to raise sufficient revenues themselves, and to create a supportive environment for their local businesses. Politicians who control the GRW and ERDF funds, however, may have an interest in the current inefficient constellation: an excess of funds and the chance to distribute revenues top-down means political power. But that is a problem of political opportunism.

An important step towards an efficient deployment of resources would be a distribution of rights that would allow the local units to meet their duties with the revenues that they can create from 'own rights'. An allocation of rights to tax and burden towards the local units would, moreover, give them the chance to set incentives for companies and citizens with lower taxes to locate in their region if the region is less attractive in other respects; and, vice versa, to charge companies and citizens for the use of a highly developed infrastructure in other regions. If, finally, some regions struggle because of 'extraordinary' issues (natural catastrophes etc.), temporary support measures certainly can be taken. Endless competition for rents does not, however, strengthen the regions; the desired benefits just fade away.

Conclusion

Regional policy is unrewarding in almost all countries. In Italy, the central government has tried to bring the relatively poor South closer to the economically prosperous North for over 65 years. Since 1980, the European Union has devoted significant funds to resolving the mezzogiorno-problem. An end, or even a visible improvement of this situation, is not within sight. This article offers an explanation for the failure of regional policy. It may be a first step towards a brighter future for regional development.

The agents of central institutions are generally quite clear about what they want to achieve with their regional support programmes in detail. Projects, the amount of funding available for distribution, and the conditions attached to its awarding are defined. It is, however, unknown who will win the prize, meaning that every candidate has an incentive to invest in transaction costs up to an amount that equals the expected subsidy for their project multiplied by the probability of collecting the prize. The sum of all candidates' transaction costs destroys the benefits of the prize competition for society.

The underlying problem is an inefficient allocation of revenues that arises from the deployment of rights. Negotiations between central and decentral institutions over an efficient re-allocation of rights to tax and to raise revenues in the regions should lead to a socially favourable solution.

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The Positive Relationship between Institutions and the Economic Development – Evidence from a Panel Data Set of OECD Countries

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Introduction

Institutions are one of the biggest impact factors on a country's economic development[2] (Matthews 1986, 903). Neoclassic theory suggests that the differences in economic power between countries can be explained by differences in capital endowment, for example. But as reality shows, some differences remain after controlling for these factors (Hall and Jones 1999, 83). One of these remaining factors are institutions. The positive impact of well-designed institutions on economic development – recognizable in a positive correlation – is nowadays mostly considered to be common sense in economics (Harms 2010, 109). But the term "institutions" can be interpreted very broadly, which means there is no commonly accepted definition of it (Erlei, Leschke and Sauerland 2007, 22). In view of this fact, the studies conducted to date that try to assess the correlation between institutions and economic development vary in many ways. According to North (1990), informal types of institutions play a key role in this regard. Moreover, the transformation process in Eastern Europe has shown that the adaption of well-designed formal institutions in one country can only take place in another if there is a fit with existing informal institutions (Mummert 1995; Grusevaja 2005). Effective interaction between formal and informal institutions is therefore a necessary precondition for strong economic development. In existing empirical studies on this topic the focus is mainly on formal institutions due to problems with measuring informal institutions (Knowles and Weatherston 2006, 1; Bratton 2007, 97). This paper's goal is twofold: a dataset is compiled that can measure the interaction of formal and informal institutions and it is used to assess the relationship between this interaction and economic development. This dataset is a panel data set, meaning that the correlation between institutions and economic development that is normally evaluated with cross-sectional-data can be viewed over a longer period of time. The next chapter summarizes correlation studies to date, while the following chapter examines the data that are used and the subsequent chapter presents the empirical model. The results are presented and discussed in the last chapter.

Literature review

One of the first studies to assess the correlation between institutions and economic development is Scully (1988). He establishes a relationship between the growth rates of 115 market economies and measurements of political, civil and economic aspects of freedom over the period from 1960 to 1980. The data measuring economic growth are taken from Summers and Heston (1984) and those for measuring institutions are from Gastil (1982). As a result, he finds that those countries with greater democratic freedom have growth rates that are three times higher than those of countries with less freedom (Scully 1988, 661). Kormendi and Meguire (1985) conducted an explorative study that postulates a relationship between several theoretically derived impact factors and economic development. One of these factors is once again the civil form of freedom. They also use data from Gastil (1979) and come to the conclusion that civil freedom has a negative and slightly statistically significant impact on economic development (Kormendi and Meguire 1985, 156). Barro (1991), by contrast, uses political instability as a variable for measuring the institutional environment. He uses data from Banks (1979) that contain the numbers of revolutions and coups per year and the number of politically-motivated assassinations per million of inhabitants. He finds a negative relationship between political instability and economic development (Barro 1991, 437).

Another one of the early studies – before the differentiation between formal and informal institutions by North (1990) is generally taken into account – was made by Levine and Renelt (1992). They conducted their study because they had the impression that the results up to that point regarding the impact factors on economic development had not been robust (Levine and Renelt 1992, 942). In their view, this was due to the fact that most of the authors had only considered very few impact factors in their respective studies. The study by Levine and Renelt addresses this problem by conducting sensitivity analyses with a large set of potentially relevant impact factors. Among others, they use data going back to Banks (1979). In the end, they find very few robust impact factors on economic development (Levine and Renelt 1992, 959). All of the last three studies mentioned here use objective measures of institutions. From this point onwards, the studies tend to use increasingly subjectively measured variables of institutions. Two famous examples in this respect are Mauro (1995) and Knack and Keefer (1995), which are widely considered to be the most important studies evaluating the correlation between institutions and economic development (Grogan and Moers 2001, 326). Mauro (1995) uses the amount of corruption in a country as an approximation for institutions. His data are obtained from a Business International survey (Mauro 1995, 683) featuring subjective assessments of experts from the Business International network. With the help of regression analyses, he finds statistically significant negative relationships between corruption and investments and between corruption and economic growth (Mauro 1995, 683). Knack and Keefer (1995) deal with the role of property rights in economic growth. They propose that the objective data used by Kormendi and Meguire (1985) and by Barro (1991) are not able to appropriately depict the protection of property rights (Knack and Keefer 1995, 223). Instead, they use subjective data from International Country Risk Guide and Business Environment Risk Intelligence, as such data are available on a disaggregated level and can therefore be used more specifically in the context of property rights. Compared to previous studies, they find that institutions have a greater impact on investments and economic growth (Knack and Keefer 1995, 207). Some years later, Aron (2000)

provides an overview and a summary of the studies in this area. Additionally, she conducts her own calculations of the correlation, but uses data from Easterly and Levine (1997) and Mauro (1995). Accordingly, her result falls into line with previous findings, as she finds a positive and statistically significant correlation between well-designed institutions and economic development (Aron 2000, 118). As most studies resulted in a positive correlation, subsequent work mainly focused on special aspects like the importance of institutions to economic development in the transformation process, e.g. Brunetti, Kisunko and Weder (1997a;b), Grogan and Moers (2001) and Havrylyshyn and Van Rooden (2003). But the main focus of the empirical studies after that point was assessing the causality of the relationship, which is a question that still needs to be addressed (Albouy 2012).

Data

When setting up a panel data set, the selection of both the time frame and the individuals under consideration have to be explained and described.

Selection of the time frame

Williamson and Kerekes (2011) stated that prior to their study, analyses based on cross-sectional data prevailed due to data availability problems. However, Dawson (1998, 604) considered the emerging of international surveys as a new tool for assessing the relationship between institutions and countries' economic development. Figure 1 illustrates both statements: it shows

Figure 1

Availability of studies per year
till 2012

Source: Several, especially Kaufmann et al. (2009).
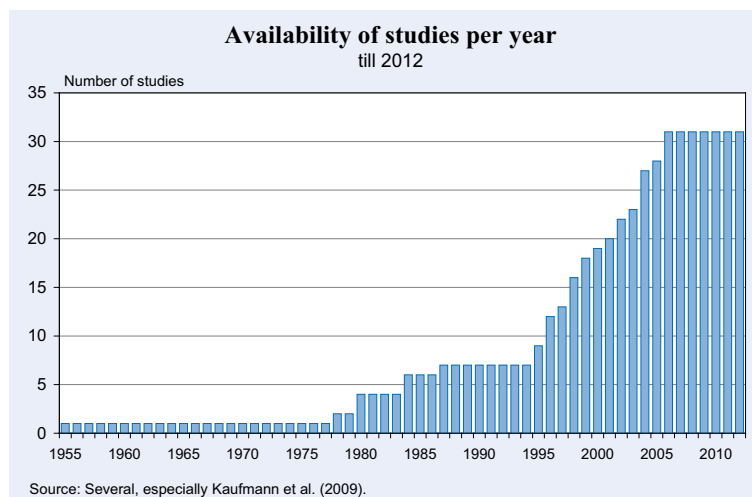
the accumulated studies available in every year and includes the surveys featured in this paper.[3]

The Figure reveals that ten and more surveys have only been available on an annual basis since 1996. However, since this Figure is currently rising, it may now be possible to conduct a panel data study based on reasonable data. Accordingly, the panel data set of this paper starts in 1996.

Selection of countries

The selection of individuals i.e. the countries in this paper follows a two-step approach. First, a global set of countries was created to depict the shapes of institutions worldwide. For a detailed description of this step, see Wicher (2014). Second, for the purposes of this paper, the set of countries was reduced to the 28 OECD countries that were available in the global data set.[4] This was done because the content of the statistical analysis in this paper is, of course, limited due to data availability. The variables used here are described below, but the set of variables is obviously not sufficient to describe all of the institution designs that exist worldwide. By reducing the set to OECD countries, a harmonization of the set takes place and at least some of the shapes of institutions that are not depicted in the variables tend to be similar in these countries and do not vary between them, limiting the influence of these differences in the analysis. The harmonization of the institutions in OECD countries is, for example, mentioned by Sachs and Warner (1995, 1).

Variables in the data set

This paragraph describes the variables for the following empirical analysis. As mentioned above, the term "institution" is multifaceted, so it is impossible to summarize the shapes of institutions in one variable. But for the purposes of maintaining clarity, it is possible to build categories of institutions, as we do in this paper. A common approach also adopted in this paper is the division of institutions into political, judicial, economic and societal institutions (Jütting 2003, 14; Acemoglu and Johnson 2005, 950; North 1991, 97). Figure 2 depicts the categories and variables used here.

The main selection criterion of the data set in this paper is, of course, availability in the surveys that this paper is based upon. The usage of the variables in the existing literature also plays a key role: first, there can be a "posi-

Figure 2

Categories and variables

Cat. 1:	Political institutions
Var. 1-1:	Political corruption and transparency
Var. 1-2:	Political stability
Var. 1-3:	Satisfaction with the political system
Cat. 2:	Judicial institutions
Var. 2-1:	Crime
Var. 2-2:	Judicial corruption
Var. 2-3:	Independence of justice
Var. 2-4:	Trust in judicial system
Cat. 3:	Economic institutions
Var. 3-1:	Economic corruption
Var. 3-2:	Opinion on tax system
Var. 3-3:	Competitive environment
Cat. 4:	Societal institutions
Var. 4-1:	Polticial participation
Var. 4-2:	Human Rights
Var. 4-3:	Civil society

Source: The authors (2015).

tive" justification for the selection of a variable. One can explain why a variable is able to depict a certain aspect of the interaction between formal and informal institutions and postulate that this interaction has probably already been tracked in the past by other authors. Second, there can be a "negative" justification for certain variables that are not considered appropriate for the purposes of this paper, although the data are available and the variable has previously been used to describe certain aspects of institutions and their interactions. This leads to a clearer description of the data set. As it is impossible to describe all of the underlying variables in detail here, the composition of the "political stability" variable – the second variable in the "political institutions" category in Figure 2 – is given as an example below. Please note that the allocation is not always selective, which means that certain aspects could also be assigned to different variables. This holds true for all four categories.

Example: political stability

The use of political stability as a variable to describe aspects of institutions has already been mentioned before. Barro (1991) used the numbers of revolutions and political coups as an approximation. More recently, Dauner, Park and Voigt (2012, 12) stated that variables measuring civil turmoil may be used to capture certain aspects of informal institutions. Survey questions regarding the political stability of a country are used here to assess the interaction of formal and informal institutions. A high amount of political stability is an indicator of good interaction, as the written rules (formal institutions) and those considered to be good (informal institutions) seem to be aligned. On the other hand, a high degree of political instability may be a sign of a mismatch between

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[3]   See Appendix 1 for the complete list.
[4]   See Appendix 2 for the list of these countries.

Table 1

	Political stability		
Nr.	Content / Question	Scale	Source
1	Frequency of politically motivated assassinations	0 – 2	Cingranelli Richards Human Rights Database
2	Frequency of (politically motivated) kidnapping	0 – 2	Cingranelli Richards Human Rights Database
3	Frequency of torture	0 – 2	Cingranelli Richards Human Rights Database
4	Amount of political terror	1 – 5	Cingranelli Richards Political Terror Scale
5	Assessment of Security Risk	1 – 5	iJET Country Security Risk Rating
6	Violent underground activities	1 – 4	Institutional Profiles Database
7	Violent social conflicts	1 – 4	Institutional Profiles Database
8	High risk of political instability	0 –10	Institute for Management Development World Competitiveness Yearbook

Source: The authors (2015).

formal and informal institutions. Table 1 shows the respective questions, scales and sources.

As mentioned above, there are some questions in the underlying surveys that are comparable with regards to content, but cannot be considered as appropriate for the purposes of this paper. They include, for example, questions investigating the amount of political terrorism. Such questions can, of course, be interpreted as a measurement of satisfaction with formal rules, but may lead to a strong bias. Political terrorism may possibly emanate from a small group of people and their dissatisfaction cannot be equated with the dissatisfaction of the other, larger group of the country's inhabitants. Additionally, there is no clear definition of the term terrorism, building another potential bias. Political instability might also be based on the influence of another country. There are several surveys with questions leading in this direction. They are not appropriate for the purposes of this paper, as the instability is not generated by the inhabitants of the country in question.

Data preparation

After the exemplified presentation of the variables in the data set, the data preparation for the following empirical analysis is described. This is necessary because not all survey results are based on the same scale, as Table 1 indicates. This problem holds true for all the other categories and variables of Figure 2. Moreover, not all surveys cover all of the countries that will be looked at in this paper. Please note that the following adjustments of the data are made to the global data set described above. Applying the adjustments only to the set of the OECD countries would result in overemphasis on the variation

within these countries, which is exaggerated if you look at institutions from a global perspective. Due to the differences in the underlying scales, a standardization on a relative scale is conducted. This step allows a later aggregation and average calculation over several questions. The countries with the most extreme results within a question get assigned the values 0 and 100, while the remaining countries receive values relative in distance to these extreme values (Enste and Hardege 2006, 54). If a high scale value implies good interactions between formal and informal institutions, the standardization equation can be written as follows:

$$R_i = \frac{V_i - \min(V_i)}{\max(V_i) - \min(V_i)} * 100$$

V_i denotes the absolute value of the question in the respective country and R_i is the assigned relative value. On the other hand, if a low value on a scale implies good interaction and informal institutions, the standardization equation is as follows:

$$R_i = \frac{\max(V_i) - V_i}{\max(V_i) - \min(V_i)} * 100$$

Subsequently, it is possible to calculate the average overall questions for a specific country relating to a certain variable. This average calculation minimizes the problems created by missing values. It is also possible to calculate single values for each country over all variables in a certain category, but as the analysis in this paper takes place on a disaggregated level, this is not necessary. Categories are only defined to provide a clearer overview here.

Test: separation of variables

It was mentioned above that the distinction between the different variables of institutions is not always definite due to overlapping contents. However, this could lower the accuracy of the empirical analysis conducted later in this paper. The distinctiveness of the data set is therefore tested in this paragraph. The procedure relies on Grogan and Moers (2001). They constructed four variables measuring institutions from four different sources and assessed their distinctiveness by calculating the correlation coefficient. The result is 0.73, so they conclude that it is difficult to differentiate between the variables (Grogan and Moers 2001, 331). Additionally, Woodruff (2006, 10) finds a correlation of 0.77 for different indices measuring corruption. Table 2 shows the results for the correlation calculations of the variables on a disaggregated level in this paper. The data cover the year 2012.

The Table shows that there are several cases where the correlation coefficients are lower than those of Grogan and Moers (2001) and Woodruff (2006), illustrating the advantage of looking at the variables, and not the categories in this paper. Taking into account that there are also some high coefficients, the distinctiveness of the variables in this paper can be described as sufficient.

Methodology

The model used in this paper is the one-way error component regression model. It is applicable to all panel data sets and in certain specifications, it has the advantage of controlling for individual unobserved heterogeneity like the fixed effects model (Baltagi 2008, 6). One can easily think of factors that are unobservable in the context of this paper such as cultural aspects, for example. When the basic specification of the model is applied to the relationship investigated here, the following equation results:

$$(GDP\ per\ capita)_{i,t} = \alpha + I'_{i,t}\beta + C_{i,t}\gamma + \mu_i + v_{i,t}$$

Here, $I'_{i,t}$ denotes the vector of independent variables, i.e. the variables measuring the interaction of formal and informal institutions. $C_{i,t}$ is the vector of control variables, μ_i controls for the individual unobserved heterogeneity mentioned above and $v_{i,t}$ contains the disturbances with $v_{i,t} \sim N(0, \sigma_v^2)$.

Table 2

Correlation coefficients

	Pol. Cor.	Pol. Stab.	Satisf.	Crime	Jud. Cor.	Ind. Jus.	Trust	Eco. Cor.	Tax	Com. Env.	Pol. Par.	Hum. Rig.	Civ. Soc.
Pol. Cor.	1	0.80	0.55	0.79	0.54	0.77	0.83	0.79	0.74	0.73	0.64	0.62	0.66
Pol. Stab.	.	1	0.44	0.75	0.37	0.66	0.66	0.63	0.62	0.53	0.55	0.57	0.58
Satisf.	.	.	1	0.46	0.54	0.65	0.41	0.71	0.33	0.54	0.73	0.75	0.79
Crime	.	.	.	1	0.45	0.64	0.79	0.65	0.63	0.58	0.46	0.47	0.52
Jud. Cor.	.	.	.	.	1	0.59	0.51	0.68	0.35	0.53	0.57	0.55	0.60
Ind. Jus.	.	.	.	.	.	1	0.67	0.78	0.58	0.58	0.72	0.77	0.79
Trust	.	.	.	.	.	.	1	0.67	0.67	0.59	0.38	0.42	0.46
Eco. Cor.	.	.	.	.	.	.	.	1	0.56	0.77	0.75	0.76	0.79
Tax	.	.	.	.	.	.	.	.	1	0.66	0.32	0.39	0.40
Com. Env.	.	.	.	.	.	.	.	.	.	1	0.53	0.51	0.59
Pol. Par.	.	.	.	.	.	.	.	.	.	.	1	0.91	0.90
Hum. Rig.	.	.	.	.	.	.	.	.	.	.	.	1	0.96
Civ. Soc.	.	.	.	.	.	.	.	.	.	.	.	.	1

Source: The authors (2015).

Control variables

The selection of appropriate control variables is an important factor in terms of the quality of the estimated model. When trying to estimate the importance of variables for the economic development of a country, there are many potential impact factors and control variables besides institutions (Ciccone and Jarocinski 2010, 222). Most empirical studies tend to only use a handful of variables (Ciccone and Jarocinski 2010, 222). This leads to criticism regarding the method and – as stated above – non-robust results (Levine and Renelt 1992, 959). But in order to be consistent with the old studies, only four control variables are used here. The first control variable in this paper is – in line with Fischer (1993) – the inflation rate. He concludes from the existing literature that a stable macroeconomic environment is a precondition for good economic development and, as he considers inflation to be a sign of instability and general flaws in economic policy, he suspects a negative relationship between the inflation rate and economic development (Fischer 1993, 487). Data published by the OECD are used in this paper (OECD 2013a). The second control variable in this paper is government expenditure. Barro (1991) cites public spending as a potential impact factor on economic development. He argues that it does not have a direct impact on private productivity, but it does have an indirect negative impact on savings via a tax channel (Barro 1991, 430). The analysis in this paper draws on data released by the OECD and the Fraser Institute (OECD 2013b; Fraser Institute 2013). When comparing the results to those of Barro (1991), one has to take into account that the variables in this paper feature expenditure on education and defense. The third control variable is also taken from Barro (1991) and controls for the education of a country's inhabitants. Unlike with the control variables above, Barro (1991, 409) suspects a positive relationship to economic development as higher education leads to higher productivity. This paper draws on the data from the OECD study entitled: "Education at a Glance" (OECD 2013c). The information is split into two variables that control for the attendance rates of primary schools and secondary schools respectively. The fourth and last control variable is the unemployment rate, which can already be found in a study by Frank (1968). A larger number of unemployed inhabitants not only leads to an increase in expenditure on social welfare, but also to lower levels of tax income than potentially possible. He therefore suspects the relationship to be negative (Frank 1968, 250). The data used in this paper are also given by the OECD (2013a).

Test: fixed effects vs. random effects

The decision between the choice of a fixed effects and a random effects model is based on a Hausman (1978) test. To this end, the null hypothesis is tested of whether the relationship can be modeled with a random effects model or not. If this hypothesis is rejected, a fixed effects model results in a better model fit. However, the test result is inconclusive (χ^2_{13} = 14.3729, p-Value = 0.3481) and the null hypothesis cannot be rejected. No preference for either the random effects model or the fixed effects model can be found as a result. As the fixed effects model has weaker assumptions and can be described as more appropriate for inter-country analyses (Baltagi 2008, 14), it is adopted in this instance.

Tests for heteroscedasticity and serial correlation

One of the assumptions of the standard one-way error component regression model is that the regression disturbances are homoscedastic with the same variance across time and individuals (Baltagi 2008, 87). According to Baltagi (2008), this may be a restrictive assumption for panels, where the cross-sectional units may be of varying size and may exhibit different variation as a result. Additionally, Barro (1991, 414) suggests that heteroscedasticity can be a problem for inter-country analyses. To check for heteroscedasticity in this paper, a Breusch and Pagan (1979) test is conducted. The null hypothesis is tested that homoscedasticity prevails (Breusch and Pagan 1979, 1288). Here, the null hypothesis has to be rejected (χ^2_{13} = 161.66, p-Value = 2.2e^-16), so the regression disturbances tend to be heteroscedastic. A data set faces serial correlation if the characteristics of an individual are correlated with past characteristics of the same individual (Auer 2007, 391). Ignorance of serial correlation when it is present will result in still consistent, but not efficient estimation results and biased standard errors, just like the ignorance of heteroscedasticity when it is present (Baltagi 2008, 92). To check for serial correlation a test designed by Wooldridge (2010) is conducted, as it does not require the regression disturbances to be homoscedastic. The null hypothesis that there is no serial correlation present has to be rejected in this case (Test statistic of a z-distribution = 4.2453, p-Value = 2.183e^-5), so that both heteroscedasticity and serial correlation are present. To take this into account, a robust covariance-matrix of the form

$$\widehat{Cov}\left(\hat{\beta}\right) = (X'X)^{-1}\left(\sum_{i=1}^{N} X_i'\widehat{u_i}\,\widehat{u_i}'X_i\right)(X'X)^{-1}$$

Table 3

Category	Variable	Coefficient	Std. Error	t-Value	Pr (> t)
Political institutions	Political corruption	-0.32	1.05	-0.31	0.76
	Political stability	0.28	1.13	0.25	0.80
	Satisfaction with the political system	-4.57	4.99	-0.92	0.36
Judicial institutions	Crime	0.26**	0.13	1.97	0.05
	Judicial corruption	0.32**	0.15	2.09	0.04
	Independence of justice	-0.34	1.12	-0.30	0.76
	Trust in judicial system	-1.95	2.05	-0.95	0.34
Economic institutions	Economic corruption	0.27***	0.10	2.64	0.01
	Opinion on tax system	0.68	1.08	0.62	0.53
	Competitive environment	-2.61***	0.82	-3.20	0.00
Societal institutions	Political participation	-0.20	0.73	-0.28	0.78
	Human Rights	-0.57	1.60	-0.36	0.72
	Civil society	-2.75	1.91	-1.44	0.15
Control variables	Inflation	2.06	2.64	0.78	0.44
	Government expenditures	9.87	14.15	0.70	0.49
	Unemployment	0.03	6.36	0.00	1.00
	Primary school enrollment	0.40	2.78	0.14	0.89
	Secondary school enrollment	0.25	0.76	0.32	0.75
Adj. R²	0.16	Countries	28		
F-Statistic	3.75	Years	13		
p-Value	8.3064e^-7				

Estimation result

Source: The authors (2015).

must be used to make the estimation results efficient (Arellano 1987, 432; Croissant and Millo 2008, 31).

Results and discussion

The estimation results of the specified model given above are depicted in Table 3.

Overall, four of the variables are estimated as statistically significant, including two variables that measure corruption. These are the judicial and economic types of corruption. Due to the operationalization of the variable, the estimated relationship is positive in both cases. They do not measure the amount of corruption, but the assessment of the amount. Generally, a country with a low amount of corruption will get a better assessment. On the other hand, the variable measuring the political type of corruption was not estimated as statistically significant. This might also be due to the operationalization, as this variable captures all those aspects that could not be assigned to one of the three defined types. Therefore, the content of this variable is not as distinctive as that of the other two. The estimated result for this relationship

between corruption and the economic development is in line with Mauro (1995). A possible explanation for the positive relationship might be that a higher standard of living reduces the necessity of personal gain through corruption. On the other hand, when there is a low amount of corruption within a society, political and economic procedures will be more efficient and will therefore increase productivity, leading to a better economic development. As the causality is not addressed here, the direction of the relationship will remain open. The second type of variable that was estimated as statistically significant is the one measuring crime. Here, the relationship is also estimated to be positive. The same comment regarding the operationalization of the corruption variables holds true for this variable, as it is the assessment of crime that is measured here. The direction of the relationship can be considered as two-fold. If there is better protection of private property within a society, people do not have to spend that much money on their own and can spend their earnings in more productive ways, which, in turn, boosts economic development. On the other hand, a higher standard of living might again reduce the necessity to conduct criminal activities, just as mentioned above for the corruption variables. Again,

the causality of the relationship cannot be addressed here. The only statistically significant variable that is surprising in Table 3 is the competitive environment that has been estimated as negatively related to economic development. A better economic situation would therefore go hand in hand with a more negative assessment of the competitive environment. There are two possible explanations for this. First, the economic success could be achieved by companies that get too powerful in the following and the competitive environment could be assessed as negative. Second, it could be possible that the people participating in the underlying surveys of this paper do not all have an explicit economic educational background. Therefore, the term "competition" could be connoted in a more negative way for them than for economists. Once again the causality of the relationship cannot be answered here. It is also quite surprising that none of the control variables has been estimated as statistically significant. As mentioned above, several studies have come to other conclusions, although the results have always been non-robust. Nevertheless, the results of this paper should be treated and considered as preliminary since there is a great demand for further research.

Demand for further research

Although the paper at hand has shown that there is now a sufficient amount of data available to conduct a panel data analysis, more and better data are needed. This is true for both the length of the time frame and the depth for each of the years. As mentioned above, there are a lot of aspects with regard to institutions that have not been addressed in surveys and cannot therefore be taken into account in this paper. Only such data will make it possible to conduct studies that do not focus on OECD countries, but on other regions in the world that might be more interesting in terms of finding factors improving the economic development.

Additionally, the topics regarding control variables should be addressed. Here again, the problem of data availability prevails. At this point it is not possible to obtain quality data over a certain time frame for many countries other than the OECD without coming up with too many missing values. Further studies, perhaps relying on different or more control variables, should be conducted.

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Appendix 1

List of studies	
Study	Organization
Country Policy and Institutional Assessments	African Development Bank
Afrobarometer	(3 organizations)
Country Policy and Institutional Assessments	Asian Development Bank
Business Environment and Enterprise Performance Survey	World Bank, European Bank for Reconstruction and Development
Bertelsmann Transformation Index	Bertelsmann Stiftung
Global Risk Service	Global Insight
Transition Report	European Bank for Reconstruction and Development
Economist Intelligence Unit	Economist
Freedom in the World	Freedom House
Freedom of the Press	Freedom House
Nations in Transit	Freedom House
Global Corruption Barometer	Transparency International
Global Competitiveness Survey	World Economic Forum
Global Integrity Index	Global Integrity
Gallup World Poll	The Gallup Organization
Cingranelli Richards Human Rights Database	University of Binghamton
Political Terror Scale	University of North Carolina
Rural Sector Performance Assessments	International Fund for Agricultural Development (IFAD)
Country Security Risk Ratings	iJET
Institutional Profiles Database	French Ministry of the Economy
Latinobarometro	Latinobarometro
Media Sustainability Index	International Research and Exchanges Board
Open Budget Index	International Budget Project
Country Policy and Institutional Assessments	World Bank
Corruption in Asia Survey	Political and Economic Risk Consultancy
International Country Risk Guide	Political Risk Services
Press Freedom Index	Reporters without borders
Trafficking in People Report	U.S. Department of State
Americas Barometer	Vanderbilt University
World Competitiveness Yearbook	Institute for Management Development
Business Risk and Conditions	Global Insight

Appendix 2

List of countries			
Australia	Austria	Belgium	Canada
Czech Republic	Denmark	Finland	France
Germany	Greece	Hungary	Ireland
Italy	Japan	Luxembourg	Netherlands
New Zealand	Norway	Poland	Portugal
Slovakia	Slovenia	Spain	Sweden
Switzerland	Turkey	United Kingdom	United States

Integrating Older Employees into the Labour Market – Evidence from a German Labour Market Programme

Bernhard Boockmann[1] and

Tobias Brändle[2]

Introduction

Across countries with different demographic developments and different labour market institutions, age is a considerable risk factor for entry into long-term unemployment. The share of the long-term unemployed among all unemployed over the age of 50 is about one third in Germany, amounting to 590,000 people in July 2015 (Bundesagentur für Arbeit 2015). In 2011, the share of the long-term unemployed among all unemployed was highest for individuals aged 50 and above (42 percent), especially for those aged between 55 and 60 (48 percent). For this age group, 13.5 percent of all unemployed have very long unemployment spells of four years or longer (Bundesagentur für Arbeit 2014). Older individuals can therefore be considered a group among the unemployed with special needs.

This article addresses the question of whether and how active labour market policies (ALMP) can help to shorten older workers' unemployment spells and integrate them into regular employment in the first labour market. After setting out the issues in the remainder of this section, we present recent evaluation results for a large-scale ALMP programme in Germany, which provided intensive coaching and counselling to older long-term unemployed workers. Drawing on results presented in Boockmann and Brändle (2015), we summarise the main policy lessons learned from this programme. We then put these results in the context of international ev-

idence of the effects of ALMP programmes for older workers.

Does ALMP help older workers?

Active Labour Market Policy (ALMP) programmes are designed to provide investments in human capital. Whether or not these investments pay off depends, among other things, on the age of the individual. Ceteris paribus, older workers benefit less than younger workers because the period of amortisation is shorter. In addition, the latest findings of empirical literature on the evaluation of ALMP programmes suggest that the largest effects are attained not in the short-run, but in the intermediate and long-run (Card, Kluve and Weber 2010; Lechner, Miquel and Wunsch 2011). Yet there is no long-run with respect to the effects of ALMP for older workers. This could result in older workers leaving the labour force just at the moment when the greatest programme effects should unfold. Hence, it could be more efficient to target the younger rather than the older unemployed.

Another issue is that ALMPs for older workers may be ineffective because employers might not hire older workers, whether trained in ALMPs or not. Ilmakunnas and Ilmakunnas (2015) obtain this as a result of a simulation model and an empirical analysis of a recent Finnish labour market reform. Heyma et al. (2014) use a conjoint analysis with a hypothetical hiring process and derive that hiring probabilities decline with age, particularly after the age of 58. They identify multiple channels: uncertainty about productivity, increasing labour costs, less training effectivity. Older workers also have a less dynamic labour force participation: they change jobs less frequently, but once they become unemployed, their reemployment rate is usually lower than for similar younger unemployed (Heyma et al. 2014).

On the other hand, targeting older unemployed workers may be reasonable if they possess sufficient skills and labour market experience, but have lost the habit of applying for jobs and writing CVs. Job search assistance may be more effective for older than for younger workers in this case.

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The fact that ALMP programmes have rarely been applied to older workers until recently, however, has little to do with a lack of effectiveness or efficiency. In times of high unemployment, it was felt that older workers should leave the labour force early to make their jobs available for younger workers. This rests not only on a logical fallacy, but has failed spectacularly: countries with the lowest youth unemployment often have the highest employment ratios among older workers (Eichhorst et al. 2013).

Many countries have subsidised early retirement or continue to do so. Since ALMP and early retirement programmes target the same group of older workers, problems may arise that these policies are not consistent. For instance, in an evaluation of a wage subsidy scheme, Huttunen, Pirttilä and Uusitalo (2013) find that the programme made part-time early retirement arrangements more costly to employers relative to subsidized full-time employment. Thus, the subsidy was effective in counteracting those early retirement incentives that had been created by other programmes.

Who should be targeted?

Older unemployed workers differ in similar ways from one another as unemployed workers in other age groups. This raises the question of which (sub) groups in particular should be targeted by ALMPs. In their study of wage subsidies for older workers, Boockmann et al. (2012), for instance, differentiate their analysis according to four population groups: men and women in East and West Germany. Women in East Germany are the only group for whom significant employment effects are found. They explain this by the fact that East German women are a group particularly affected by unemployment. Therefore, the elasticity of labour supply is particularly high in this group and upward pressure on wages as a response to the subsidy is unlikely. At the same time, owing to the policy of encouraging female labour force participation in the former GDR, East German women are often well-trained and have substantial labour market experience so that demand is also elastic. These demand and supply factors lead to relatively large quantity effects.

Apart from skill, gender and local labour market conditions, specific target groups among older workers may be defined by age, health status, migration background and placement obstacles such as psycho-social problems or disabilities. The issue of targeting has been identified as crucial for the integration of the older unemployed;

however, there is too little systematic evidence that provides guidance to employment agencies or caseworkers.

Specific needs of older workers

Existing studies suggest that training can have a positive impact on the retention of older workers (Picchio and van Ours 2013). This does not mean, however, that any kind of training for older workers will be worthwhile. Rather, the training content must be designed so that the special needs of older workers are taken into account.

Findings from the human resources management literature are relevant here (Zwick 2011). Firstly, it should be noted that older workers have a substantially different motivation for training than younger workers. For older workers, staying in employment is of central importance, while the quality of work and relationships with colleagues also often matter a great deal to them. For younger workers, especially the career motive and income growth are central. Younger workers achieve promotion and a career change more frequently than older workers as a result of training.

As far as age-specific skills are concerned, younger workers are stronger with respect to rapid and flexible handling of new information (fluid intelligence). Mature workers, by contrast, have advantages in terms of experience and factual knowledge (crystalline intelligence). Thus older workers prefer more informal training with a clear reference to practical and current problems in the workplace and not formal courses with theoretical content (Zwick 2011).

Types of programmes

Assuming ALMP programmes work, are correctly targeted, and designed according to the special needs of older employees, there remains the challenge of choosing between different types of programmes. In the ALMP literature, several types of programmes can be distinguished. Each type of programme has its own advantages and disadvantages, especially with regard to the age of the individuals that participate. The effects of each programme type are discussed in more detail in recent overview articles such as Brown and Koettl (2015), Spermann (2015), or Card et al. (2010).

Job search assistance programmes provide coaching and counselling, activation measures and sometimes incentives like sanctions. These programmes involve intensive counselling, the provision of short-term training

and other services. They are given in addition to regular counselling by placement officers and are often characterised by a higher staff-unemployed ratio compared to regular services.

Short-term training programmes with a duration of up to several weeks are designed to refresh a job applicant's qualifications. They often lead to training certificates. Long-term training programmes like vocational training or occupational retraining may take up to several years. This makes it difficult to offer retraining programmes to older employees. While older workers often lack contemporary, off-the-job skills and, therefore, would benefit from intensive training, these measures are unlikely to pay off due to large costs and lock-in effects.

Wage or hiring subsidies aim to integrate individuals directly into firms. They may be an appropriate tool for integrating older workers with sufficient labour market qualifications and provide an opportunity to update job-specific skills. However, the high fiscal costs of wage subsidies require the employment relationship to be lasting in order for the programme to be efficient.

In many countries, a significant share of ALMP consists of public employment schemes. These are publicly-funded jobs, mostly in the second labour market, aiming at increasing the employability of participants. These measures are relatively expensive and often have severe lock-in-effects and small positive effects on employment in the short- to long-run. It is also unclear whether they pay off, i.e. the potential increase in employability is large enough to catch up with the reduced search effort during the programme. This trade-off is, of course, affected by the potential remaining time in the labour force. It is therefore harder to break even for older employees.

These drawbacks leave policymakers with a reduced toolbox of potential active labour market programmes to offer to older employees. Job search assistance and short-term training programmes are particularly worthwhile, while assigning older workers to long-term training and subsidised employment is often unlikely to be efficient.

Evidence from a German labour market programme

This section presents evidence from the evaluation of the German active labour market programme "Perspektive 50plus" (Boockmann and Brändle 2015).

The programme targets the unemployed recipients of means-tested welfare benefits aged 50 and older, was launched in 2005, expanded in 2008, and prolonged until 2015. The programme is organised in regional employment pacts. The funds are supplied by the German Federal Ministry of Labour and Social Affairs (BMAS) based on the fulfilment of integration targets in previous periods.

Employment pacts are set free in their choices of measures and organisation of the programme (bottom-up approach). Regarding the set of measures pursued, "Perspektive 50plus" can be characterised as a job search assistance programme. It typically provides coaching and counselling, as well as short-term training and advice in case of problems such as debt, health, and addiction. Other types of measures such as employment subsidies can be provided, but affect only a small share of participants. Hence, the programme is clearly oriented towards integration into regular, unsubsidised jobs.

The causal effects of the programme were estimated using the difference-in-differences method (DiD), propensity score matching, and a combination of both. The DiD approach uses the fact that local job centres have joined the programme in successive steps (see Figure 1, which represents the extension of the programme). A substantial number of job centres joined in July 2009 or January 2010. Hence the DiD estimator is based on the difference in the evolution of integration numbers from 2007 to 2010. On the basis of survey results among job centres, one can argue that accession to the programme was driven by exogenous reasons like existing contacts to job centres that had joined earlier.

Using DiD, we estimate an intent-to-treat effect: the effect of the programme on the potential participants, i.e. unemployed in participating job centres. The control group consists of unemployed in non-participating job centres. The propensity score matching estimations are based on differences in outcomes between actual participants and similar non-participants in non-participating job centres. The data contain a large set of control variables, including detailed information on individuals' employment histories. The DiD matching estimates are based on a DiD estimation on matched samples of participants and non-participants. For details, see Boockmann and Brändle (2015).

Figure 2 shows the estimated effects of participating in the programme on integration into the first labour mar-

Figure 1

Geographical coverage of "Perspektive 50plus"

01 January 2008   01 July 2009   01 January 2010

Source: Boockmann and Brändle 2015.
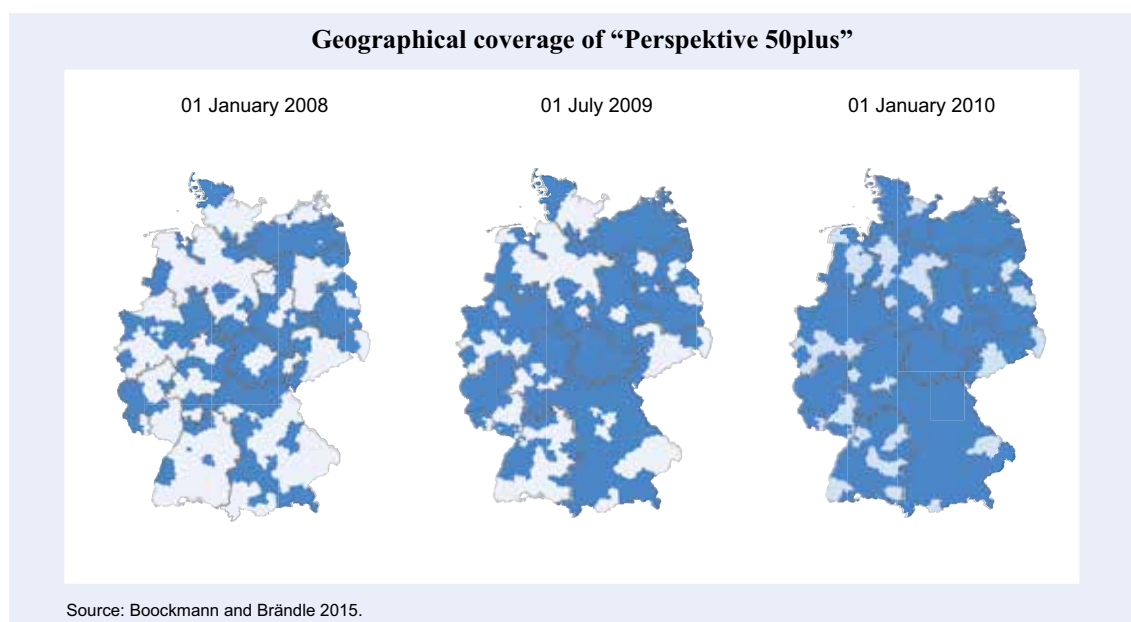
ket (unsubsidised employment subject to social insurance contributions) from the DiD matching procedure.

The estimated treatment effect is 4.8 percentage points 90 days after entry into the programme and increases to a maximum of 12.1 percentage points after 16 months in the programme, after which it starts to decline. The matching estimator also yields positive treatment effects; they tend to be even larger than those obtained from DiD matching. The intent-to-treat-effects from the DiD estimator are significantly positive, but smaller than those using individual participation. The implied magnitude for the effect on actual participants (obtained by weighting with the inverse probability of programme participation) is a maximum of five percentage points.

The differences between the effects obtained from matching and DiD can be interpreted as evidence for displacement or substitution effects because the treatment group contains non-participants from participating job centres who may suffer from negative spill-over effects.

In addition to integration into unsubsidised employment, Boockmann and Brändle (2015) looked at the probability of leaving welfare benefit receipt. The effects on this outcome measure are generally smaller and tend to be negative, particularly in the first months of programme participation. Negative effects may be due to reduced exits of participants in other branches of the public welfare system for reasons such as early retirement and invalidity benefits.

Summarising the findings, the evaluation yields large positive effects for older unemployed workers, a disadvantaged and hard-to-place group of the unemployed. Additional results show that both men and women benefit from the programme, although the treatment effects are larger for men. From these results, it appears that assigning older workers to job search assistance may be effective.

Empirical evidence in existing literature

Given the vast amount of studies that evaluate ALMP programmes, the literature regarding programmes specifically targeting older individuals is not large. We therefore also compare the results from our evaluation with evidence from ALMP programmes for all groups of workers if subgroup effects for older workers are separately estimated.

ALMPs for the older unemployed

Lammers, Bloemen and Hochguertel (2013) use a recent policy change in the Netherlands to study how changes in search requirements for older unemployed individuals affect their transition rates. They find a significant increase in the entry rate into employment for treated individuals of 6 (11) percentage points for men (women). Arni (2010) uses a social experiment for the evaluation of counselling and training policy, especially designed for older workers in Switzerland. He finds that the poli-

Figure 2

Estimated treatment effects for integration into the first labour market

Source: Boockmann and Brändle (2015).

Result for older and younger workers

Most ALMPs do not specifically target groups like older or younger workers, but are available to all groups. For a discussion of targeting, see Eichhorst et al. (2013).

Centeno, Centeno and Novo (2009) analyse the short-term heterogeneous impact of two active labour market programmes composed of intensive job-search assistance and small basic skills training implemented in Portugal, where one subpopulation of unemployed individuals are older employees. Exploiting an area-based pilot experiment, they identify average treatment effects on unemployment duration and show that the programme shortens the unemployment duration of older workers, but only to a limited extent. As far as transitions to employment are concerned, the effects on older employees are insignificant. The estimated effects on individuals aged 30 to 40 and among the better educated were slightly better.

Cavaco, Fougère and Pouget (2005) estimate the short-term effects of a French retraining programme for displaced workers. They find mixed evidence regarding the relevance and effects of the programme, mainly because of selection based on observables, i.e. cream-skimming. They find, however, that older participants are less likely to obtain a permanent job and more likely to stay unemployed after the end of the programme.

Heinrich et al. (2013) estimate the impact on earnings and the employment of the two primary adult workforce support and training programmes under the US and find that participants realise improved employment levels and increased average quarterly earnings of several hundred dollars. Older Workforce Investment Act participants (those aged 50 and over) displayed patterns that largely matched the full population.

cy increases the job finding rate in the treatment group and attributes this change to an increase in job search efficiency of 12 percentage points and a reduction of reservation wages of 40 Swiss Francs. Bollens (2011) analyses the treatment effect of an active labour market programme consisting of job search assistance, counselling and training, for older unemployed in Belgium. He finds significantly higher transitions to employment of about 3.5 to 4 percentage points due to the programme. Thus the positive effects found by Boockmann and Brändle (2015) are no exception.

Romeu-Gordo and Wolff (2011) analyse short-term training measures (from two days to eight weeks) for older workers as part of the German Hartz reforms and find an estimated positive impact of classroom training on employment outcomes for West German men. In-firm training affected the outcomes of all participants positively and the effects are far higher than for classroom training participants.

Hiring subsidies for older workers have been studied for Germany, among others, by Boockmann et al. (2012). They only find positive employment effects for a specific group of unemployed (females in East Germany), while deadweight effects cause the programme to be ineffective for all other groups. This finding, obtained by DiD estimation, substantially deviates from previous matching estimates for all workers amounting to treatment effects of up to 40 percent after 20 months (Bernhard, Gartner and Stephan 2008).

Conclusions

What lessons can be drawn from the evaluation results for "Perspektive 50plus" and other ALMPs? In general, results show that providing job search assistance to the

older unemployed may be effective for integrating them into jobs. The effectiveness of these programmes is not necessarily weaker than for other age groups. Other policies, such as training and wage subsidies, seem to be less effective for older workers.

The results for "Perspektive 50plus" are even more strongly positive than the results obtained for job search assistance to older workers in other countries. The reason may be that "Perspektive 50plus" is very comprehensive. It includes age-specific measures addressing health problems, a lack of mobility, care obligations and other obstacles for placement. In addition, the programme conveys the message that older unemployed should not withdraw from the labour market, but should continue to seek regular employment. In this respect, it appears that not only older workers, but also employers should be targeted. Existing research results suggest that this approach is successful not only with respect to older workers, but may be extended to all of the unemployed with specific placement needs.

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Measuring Migrant Integration Policies

The benefits from immigration increase with better integration of immigrants – both from an economic as well as from a social point of view. The active participation of immigrants in the labour market and in public life is as important for the immigrants as for the social cohesion and the economy in the host country. This is why the integration of immigrants is a topic high up on the policy agendas of EU countries.

There is a wide range of different approaches to facilitate integration. National and regional integration policies target cultural, social, educational and economic aspects of life. Besides this, effective integration programmes have to take into account the reasons why people migrate. The policies that are in place today differ considerably between countries. Hence, it is difficult to compare the policies and to measure the effectiveness of different integration programmes. Existing indicators that intend to measure migrant integration can focus on comparing and assessing the integration policies and/or on measuring the outcomes of these policies.

An indicator with a strong focus on migrant integration policies is the Migrant Integration Policy Index, or MIPEX (2015).[1] It measures and compares immigrant integration policies of all EU Member States, Australia, Canada, Iceland, Japan, South Korea, New Zealand, Norway, Switzerland, Turkey and the US. The overall index is formed by 167 indicators, which are grouped into eight policy areas. The index ranges from 0 (failed integration) to 100 (successful integration). The eight policy areas of MIPEX are labour market mobility, education, political participation, access to nationality, family reunion, health, permanent residence and anti-discrimination. The first MIPEX was published in 2004 and the 2015 version is the fourth round of the index.

Figure 1 summarises the MIPEX score for different country groups: It shows that immigrants face more obstacles in emerging destination countries with fewer immigrants and higher levels of anti-immigrant sentiment (the Baltics, Japan, Central and Southeast Europe; EU13 average is 41/100). Wealthier, older and larger countries tend to grant more equal rights and opportunities (EU15 average is 60/100), which holds even more for tradi-

tional countries of immigration (67/100 on average for Australia, Canada, New Zealand and the US). But political will certainly matters just as much as tradition, since more inclusive integration policies may both encourage more immigrants to settle permanently and the public to trust immigrants more. Within Europe, national policies are stronger and more similar in the areas that are covered by EU law.

Figure 2 shows the overall MIPEX score with data from 2010 and 2014. Denmark passed considerable reforms to assimilate its policies to the ones in the other Nordic countries. Germany improved the targeted support for migrant integration and reformed its dual nationality policies. Many countries have made smaller improvements, either by reinforcing current programmes (Portugal and the US) or by improving procedures (France, Ireland, Japan, Switzerland and Turkey), or by implementing EU law (Czech Republic, Poland, Hungary, Italy, Lithuania and Romania). The Netherlands and the UK show the largest drop in the MIPEX score from 2010 to 2014. This is due to cuts in targeted support and the residence restrictions implemented in both countries.

Bertelsmann (2015) publishes another index for migrant integration[2] (see Table 1). The Sustainable Governance Indicators (SGI) aim at comparing and analysing policy performance and governance capacities in the OECD and EU. There are three rubrics: Policy performance, democracy and governance. The integration report is part of the rubric policy performance and analyses how effectively policies support the integration of migrants into society.

A major difference of the integration index in the SGI and the MIPEX is that the SGI combines policies with policy outcomes. The table shows the SGI-integration indicator 2015. It is a combination of an index of integration policy and two education and two labour market indicators.

While MIPEX focuses on integration policies, the integration index of Bertelsmann (2015) combines policies and outcomes. A third way of dealing with the difference of policies and outcomes is used by the OECD/European Union (2015): They focus on policy outcomes. The *Indicators of Immigrant Integration 2015* present a comparison across all EU and OECD countries of the outcomes for immigrants and their children. Their 27 indicators are organised in five policy areas: Employment,

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[1]   This project is led by the Barcelona Centre for International Affairs (CIDOB), and the Migration Policy Group (MPG).

[2]   The index has also been published for the years 2009, 2011, and 2014.

Figure 1

Summary of the overall MIPEX score 2014

index score

[Bar chart showing index scores: EU 13 ≈ 41, all 38 countries ≈ 52, EU 15 ≈ 60, Traditional destination ≈ 67]

EU 13: Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovak Republic, and Slovenia.
EU 15: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom.
Traditional destination: Australia, Canada, New Zealand, US.

Source: Migrant Integration Policy Index – MIPEX (2015).

Figure 2

Overall MIPEX score 2010 and 2014

[Horizontal bar chart comparing 2010 and 2014 MIPEX scores for: Portugal, Sweden, Finland, Belgium, Canada, New Zealand, Norway, Australia, Germany, US, Netherlands, Spain, Luxembourg, Denmark, Italy, United Kingdom, South Korea, France, Ireland, Estonia, Austria, Slovenia, Greece, Hungary, Iceland, Switzerland, Czech Rep., Romania, Bulgaria, Croatia, Japan, Poland, Malta, Lithuania, Slovak Rep., Cyprus, Latvia, Turkey]

■2010 □2014

Source: Migrant Integration Policy Index – MIPEX (2015).

education, social inclusion, civic engagement and social cohesion.

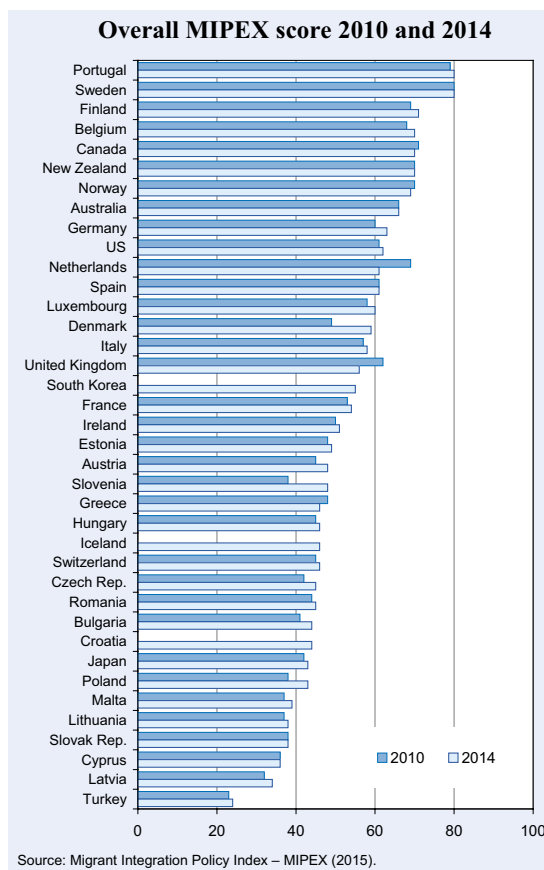The comparison of migrant integration policies and indexes that summarise countries' policies are important to see where a country stands in terms of its integration effort. Analysing the integration outcomes, such as education and labour market statistics, and monitoring them over time, helps to measure the effectiveness of integration policies. But a key indicator that characterises the different needs of different migrants is the reason why these people migrate. The "International Migration Law and Policy Analysis" – IMPALA database project, which is compiling a new database on immigration regulations, can fill this gap. This new database will distinguish between policies that target economic migration, family reunification, asylum and humanitarian migration, student migration, and acquisition of citizenship.[3]

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[3] See Beine et al. (2014) for preliminary evidence from IMPALA.

Table 1

Sustainable governance indicators 2015: Integration

Rank	Country	Score	Integration Policy [1]	Upper Secondary Attainment [2]	Tertiary Attainment [3]	Unemployment [4]	Employment [5]
1	Canada	8.8	CAN	CYP	SWE	AUS	EST
2	New Zealand	8.4	NZL	ISL	AUT	CYP	IRL
3	Estonia	8.1	AUS	POL	DNK	HUN	ISL
4	Australia	8.0	FIN	CHL	CHE	LVA	MLT
5	Lithuania	7.9	DEU	LUX	CYP	ROU	POL
6	Ireland	7.8	LUX	KOR	NOR	USA	ROU
7	UK	7.8	NLD	EST	HRV	CAN	KOR
8	Finland	7.6	NOR	LVA	ISL	NZL	CAN
9	Norway	7.6	AUT	LTU	LTU	ISR	CZE
10	US	7.6	DNK	ESP	USA	POL	GRC
11	Germany	7.5	EST	GBR	EST	CZE	NZL
12	Iceland	7.5	IRL	HUN	FRA	GBR	USA
13	Denmark	7.3	LTU	NOR	JPN	JPN	AUS
14	Netherlands	7.2	PRT	DNK	LVA	LTU	BGR
15	Luxembourg	7.1	SWE	ITA	BEL	TUR	PRT
16	Latvia	7.0	CHE	CAN	DEU	CHL	ITA
17	Spain	7.0	GBR	NLD	SVK	IRL	LVA
18	Austria	6.9	USA	SVK	CHL	SVK	SVN
19	South Korea	6.9	BEL	HRV	KOR	EST	GBR
20	Switzerland	6.9	FRA	CZE	ESP	BGR	TUR
21	Greece	6.8	GRC	IRL	FIN	PRT	CHE
22	Czech Rep.	6.7	ISL	ISR	ITA	HRV	FIN
23	Cyprus	6.6	ISR	JPN	NLD	MEX	DEU
24	Israel	6.6	ROU	AUS	CAN	ITA	LTU
25	Italy	6.6	ESP	FIN	GBR	GRC	NOR
26	Portugal	6.6	CZE	NZL	IRL	KOR	CYP
27	Poland	6.5	HUN	GRC	CZE	ESP	ESP
28	Slovak Republic	6.5	ITA	SVN	HUN	SVN	AUT
29	Sweden	6.4	LVA	AUT	GRC	ISL	HRV
30	France	6.3	POL	BGR	PRT	DEU	MEX
31	Hungary	6.3	SVK	BEL	AUS	MLT	SVK
32	Japan	6.0	KOR	SWE	NZL	FRA	FRA
33	Romania	6.0	CHL	CHE	SVN	LUX	ISR
34	Belgium	5.8	CYP	USA	ISR	FIN	JPN
35	Chile	5.8	JPN	FRA	LUX	DNK	DNK
36	Croatia	5.6	SVN	DEU	MLT	NLD	BEL
37	Slovenia	5.5	TUR	ROU	POL	AUT	HUN
38	Bulgaria	4.8	BGR	MLT	BGR	CHE	CHL
39	Turkey	4.6	HRV	MEX	TUR	BEL	LUX
40	Malta	4.2	MLT	PRT	MEX	SWE	NLD
41	Mexico	3.6	MEX	TUR	ROU	NOR	SWE

Notes:

[1] This question covers integration-related policies comprising a wide array of cultural, education and social policies insofar as they affect the status of migrants or migrant communities in society. Policies fostering the integration of migrants will ensure migrants' equal access to the labour market and education, opportunities for family reunion and political participation, the right of long-term residence, effective pathways to nationality as well as protection from discrimination and equality policies.

[2] Ratio of foreign born to native born population with at least upper secondary attainment (ISCED 3 and above), age group 25-64 years.

[3] Ratio of foreign born to native born population with tertiary attainment (ISCED 5 and above), age group 25-64 years.

[4] Foreign-born to native-born unemployment rate, age group 15-64 years.

[5] Foreign-born to native-born employment rate, age group 15-64 years.

Source: Bertelsmann (2015).

CENTRAL BANKS: FUNCTIONS, DECISION-MAKING AND ACCOUNTABILITY

Introduction

The main task of central banks is to conduct monetary policy. However, not all central banks have the same monetary policy mandate. In addition to implementing monetary policy, central banks fulfill a number of other functions (e.g. the supervision of banks), which differ from country to country. Central banks also differ with regard to decision-making responsibilities and accountability obligations. This article gives an overview of the functions of central banks and presents their decision-making and governance structures, as well as the accountability and transparency regulations of central banks.

Monetary policy mandate

All central banks are responsible for conducting monetary policy. The monetary policy objective, however, is not the same for all central banks. While the maintenance of price stability is an important objective across the board, some central banks are also supposed to pursue additional goals, which have the same priority as the maintenance of price stability. The monetary policy mandate of the European Central Bank (ECB), for example, consists primarily of maintaining price stability: "Without prejudice to the objective of price stability, the ECB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union…" (European Central Bank 2015b). The Bank of England (Bank of England 2015) and the Bank of Japan (Bank of Japan 2015), for example, have similar monetary policy mandates. The Federal Reserve in the United States, by contrast, is an example of a central bank that shall pursue several goals that are equally weighted. According to the Federal Reserve

Act (Federal Reserve 2015), it shall "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates".

Functions of central banks

In addition to the conduct of monetary policy, some other responsibilities have been assigned to most central banks. Table 1 gives an overview of the functions of central banks.[1] All central banks listed in Table 1 have at least partial responsibility for acting as a lender of last resort, which means that they lend to banks that do not have market access. Many central banks even have full responsibility for this task. Most central banks are also at least partially involved in conducting prudential policy to promote financial stability. As far as responsibility for bank supervision is concerned, there are major differences across countries. While the Central Bank of Brazil and the Reserve Bank of New Zealand are fully responsible for supervising banks, a substantial number of central banks (like the Norges Bank, the Swiss National Bank and the Bank of Canada, for instance) are not involved in this task. The ECB has been partially responsible for banking supervision since November 2014 (European Central Bank 2015a); the Bank of England and the Federal Reserve, for example, also have a shared responsibility for supervising banks.

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[1] For a more detailed version of the Tables included in this article see DICE Database (2015).

Table 1

Functions of central banks

	Monetary policy	Lender of last resort	Prudential policy	Supervision of banks
Euro Area	Full	Shared	Shared	Shared
Sweden	Full	Shared	Shared	No or minor
United Kingdom	Full	Shared	Shared	Shared
Norway	Full	Shared	Shared	No or minor
Switzerland	Full	Shared	No or minor	No or minor
Australia	Full	Full	No or minor	No or minor
Brazil	Full	Full	Full	Full
Canada	Full	Full	Full	No or minor
Japan	Full	Full	Full	Shared
Korea	Full	Full	Full	No or minor
Mexico	Full	Full	Full	Full
New Zealand	Full	Full	Full	Full
United States	Full	Full	Full	Shared

Key:
- No or minor involvement
- Shared or partial responsibility
- Full responsibility

Source: DICE Database (2015).

Table 2

<table>
<tr><td colspan="2"></td><td colspan="2">Composition of decision-making body</td><td rowspan="2">Length of term</td></tr>
<tr><td></td><td>Decision-making responsibility</td><td>No.</td><td>Positions</td></tr>
</table>

Table 2

	Decision-making responsibility	No.	Positions	Length of term
			Monetary policy formal decision-making frameworks	
	Decision-making responsibility	No.	Positions	Length of term
Euro Area	Governing Council	25	President, Vice-President, 4 other Executive Board Members, 19 National Central Bank (NCB) Governors	Executive Board = 8 years NCB Governors = minimum 5 years
Sweden	Executive Board	6	Governor (as Chair), 5 Deputy Governors (fulltime, but non-executive)	5 years (rolling schedule)
United Kingdom	Monetary Policy Committee	9	Governor (as Chair), 2 Deputy Governors, Executive Director for monetary analysis (Chief Economist), Executive Director for markets, 4 non-executive external members	Governor/Deputy = 5 years Chief Economist, Executive Director and external members = 3 years
Norway	Executive Board	7	Governor (as Chair), Deputy Governor, 5 external members	Governor/Deputy = 6 years External members = 4 years
Switzerland	Governing Board	3	Chair, Vice-Chair, 1 other member	6 years
Australia	Board	9	Governor (as Chair), Deputy Governor, Secretary to Treasury, 6 external members	Governor/Deputy Governor: up to 7 years External members: up to 5 years
Brazil	Monetary Policy Committee	8	Board of Directors (Governor and Deputy Governors)	No fixed term
Canada	Governor	1	Governor	7 years
Japan	Policy Board	9	Governor, 2 Deputy Governors, 6 full-time members drawn from outside the Bank of Japan	5 years (staggered terms)
Korea	Monetary Policy Committee	7	Governor (as Chair), Senior Deputy, Governor, 5 external members	Governor = 4 years Senior Deputy Governor = 3 years External members = 4 years
Mexico	Board of Governors	5	Governor, 4 Deputies	Governor = 6 years Other members = 8 years
New Zealand	Governor	1	Governor	5 years
United States	Federal Open Market Committee	12	7 members of the Board of Governors, President of the Federal Reserve Bank of New York, 4 of 11 remaining Federal Reserve Bank Presidents in rotations	Board members = 14 years, or (if replacing previous Board member) unexpired term plus 14 years President of the Federal Reserve Bank of New York = continuous basis Federal Reserve Board Presidents = one year rotations as a voting member

Source: DICE Database (2015).

Decision-making and governance

Table 2 gives an overview of the decision-making bodies for monetary policy. The size of the bodies varies significantly across countries. In Canada and New Zealand, it is the governor of the central bank who is responsible for monetary policy decisions. In other central banks, decisions are taken by a committee that comprises a different number of members. Usually, the committee (in some countries also called council or board) consists of the governor (or president), deputy governors and other members. The number of additional members differs between central banks; the governing board of the Swiss National Bank, for example, has one other member, whereas the board of the Reserve Bank of Australia has six external members. The Federal Open Market Committee in the United States consists of 12 members and includes four of eleven Federal Reserve Bank presidents on a rotating basis. The central bank with the largest decision-making body is the ECB. The governing council has 25 members, among which are the 19 governors of the National Central Banks of the Eurozone. The length of term of members varies between countries. It ranges between three years (in the United Kingdom and in Korea) and 14 years (in the United States). Not all members can be reappointed in all countries, and sometimes this is only

possible once. Members of decision-making bodies are usually appointed by members of the government. (For more detailed information on the appointment of board members see DICE Database (2015).)

For tasks other than monetary policy decisions, a governance body is responsible, which is referred to as a board in the following. In some central banks (e.g. the ECB and the Bank of Japan), the board is the same committee as the decision-making body for monetary policy issues. Other central banks have different bodies for monetary policy decisions and other tasks. The role of the boards also differs between central banks. The Reserve Bank of New Zealand, for example, in which it is only the governor who is responsible for monetary policy, has a board of directors comprising five to seven non-executives in addition to the governor. The board has an oversight function with regard to monetary poli-

cy. Other central bank boards (in Norway and Canada, for instance) have no oversight function regarding monetary policy issues, but are only responsible for the operation and administration of the central bank. (For more information on the boards of central banks see DICE Database (2015) and Aldridge and Wood (2014).)

Accountability and transparency

All central banks are accountable to legislators for the conduct of monetary policy. Usually, decision-makers of central banks present monetary policy reports to a parliamentary committee. The frequency of the presentation of such accounts varies between central banks. The minimum frequency is once a year (in Norway, for example), but most central banks give account two or four times a year. Some central banks (like the Bank of

Table 3

			Publication of monetary policy meeting "minutes" (narrowly defined)	
	Publish	Delay	Identify votes	Comprehensiveness
Euro Area	Yes	4 weeks	No	Overview of financial market, economic and monetary developments and summary of discussion on economic and monetary analyses and on monetary policy stance.
Sweden	Yes	2 weeks	Yes (dissenters' views are explained in the decision section of the minutes)	Short overview of briefings followed by very detailed coverage of proceedings including attributing comments, views, questions and answers to Board members.
United Kingdom	Yes	2 weeks	Yes	Summary of briefings with coverage of discussion points. Outline of decision and reasoning, including areas where there were differences of opinion (without identification).
Norway	No			Minutes are only released after 12 years.
Switzerland	No			Minutes available from archive after 30 years on request.
Australia	Yes	2 weeks	No	Short summary of briefings, discussion and considerations for monetary policy.
Brazil	Yes	Up to 6 working days	Yes	Comprehensive economic overview and summary of briefings.
Canada	No			
Japan	Yes	4 weeks	Yes	Comprehensive summary of briefings on economic developments and the outlook and discussion among members. The attendees of the meeting are identified.
Korea	Yes	2 weeks	No	Summary of briefings and discussion. Outline of decision and reasoning. The attendees of the meeting are identified.
Mexico	Yes	2 weeks	No	Comprehensive summary of briefings. Detailed outline of considerations and summary of decision and unanimity.
New Zealand	No			
United States	Yes	3 weeks	Yes	Detailed summary of proceedings and briefings. Full transcripts available after 5 years.

Source: DICE Database (2015).

England, for example) present reports six times a year. (For more details on the accountability of central banks see DICE Database (2015).)

Table 3 gives an overview of the publication of the minutes of monetary policy decision-making meetings. Over half of the central banks publish minutes; the purpose of this policy is to increase the transparency and strengthen the accountability of central banks. In general, the practice of publishing minutes has become more common over the last decade. The Bank of England, the Bank of Japan and the Federal Reserve, for example, publish monetary policy meeting minutes, whereas the Swiss National Bank and the Reserve Bank of New Zealand, for example, do not publish minutes. The ECB started this practice in January 2015 (European Central Bank 2014). It publishes accounts of monetary policy discussions containing an overview of financial market, economic and monetary developments, which are followed by a summary of the discussion on the economic and monetary analyses and on the monetary policy stance. In general, there has also been a trend towards shortening the time lag between monetary policy meetings and the release of their minutes. With the exception of the Central Bank of Brazil (up to six working days), the minimum delay is two weeks. The ECB and the Bank of Japan have the largest time lags of four weeks. Some central banks (like the Swedish Riksbank, the Bank of Japan and the Federal Reserve) include the votes of the members of the monetary policy decision-making body in the minutes, while other central banks (such as the ECB and the Bank of Korea) do not include any information about the voting behaviour of their members. The minutes vary significantly between central banks with respect to their comprehensiveness. The Bank of Japan and the Federal Reserve, for example, provide more detailed information than the ECB. In Sweden, the minutes even include comments, views and questions to board members.

Conclusion

This article revealed significant differences with regard to the functions, decision-making structures and accountability obligations of central banks across countries. However, none of those remains constant over time. The ECB, for example, has recently implemented changes to both its functions and its transparency.

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R&D: EU's Progress Towards Europe 2020 Strategy

R&D intensity

Research and Development (R&D) is an investment from a corporate or a government in innovation. Instead of yielding immediate profit, R&D focuses on long-term growth through science and technology. The R&D intensity (RI) for a country is defined as the percentage of gross domestic product (GDP) spent on R&D, and it is used as a measurement for how much a country is investing in future developments. A country's gross domestic expenditure on R&D (GERD) is broken down into four sectors of performance, which are expenditure by the business enterprise sector (BERD), the government sector (GOVERD), the higher education sector (HERD) and the private non-profit sector.

RI comparison for EU, US and Japan in 2013

Figure 1 shows the RI of the EU countries, the US and Japan in 2013. For each country, RI is broken down into BERD and the rest. More information about GERD and each sector of performance can be found in DICE Database (2015a). The country differences in RIs are wide and range from Romania (0.39 percent) to Japan (3.47 percent). The EU's RI (2.01 percent) lagged behind that of the US (2.73 percent) and Japan. Among the EU countries, only the nordic countries (Finland, Sweden and Denmark) spent over three percent of their GDP on R&D. Germany, Austria and Slovenia had an RI close to three percent. On the other hand, ten EU countries (Lithuania, Poland, Malta, Slovak Republic, Croatia, Greece, Bulgaria, Latvia, Cyprus and Romania) spent less than one percent on R&D.

The R&D expenditure in BERD as a percentage of GDP (e.g. EU (1.28 percent), US (1.92 percent) and Japan (2.64 percent)) go a long way to explaining the differences in RI between the countries. Moreover, among the countries in the European Union, the relative share of BERD expenditure is the highest in those countries with high RI. Countries with RI bigger than two percent (Finland, Sweden, Denmark, Germany, Austria, Slovenia, Belgium and France) derived around two-thirds or more of their expenditure on R&D from the business enterprise sector. In contrast, five (Greece, Cyprus, Latvia,

Lithuania and Romania) of the ten countries with RI less than one percent had a BERD to GERD ratio of even less than 40 percent. This suggests that business R&D investment is not very attractive, and realising knowledge-based business activities seems more difficult in these countries.

The European Commission also attributes the continued gap in RI between the EU and US, Japan to the low level of investment from the EU's business enterprise sector (European Commission 2010). The Innovation Union Competitiveness report 2011 points out that in the manufacturing sector, from which most of BERD comes, the US' and Japan's high-tech industries are larger and more research-intensive. In particular, the weight of Japan's high-tech sector to its economy is one third larger than that of Europe's (European Commission 2011a).

Europe 2020 Strategy and support from government

In March 2002, the European Council had set the objective of increasing the EU's RI from 1.9 percent to three percent by 2010 (Commission of the European

Figure 1

R&D intensity 2013
Gross domestic expenditure on R&D as % of GDP

Source: DICE Database (2015a).
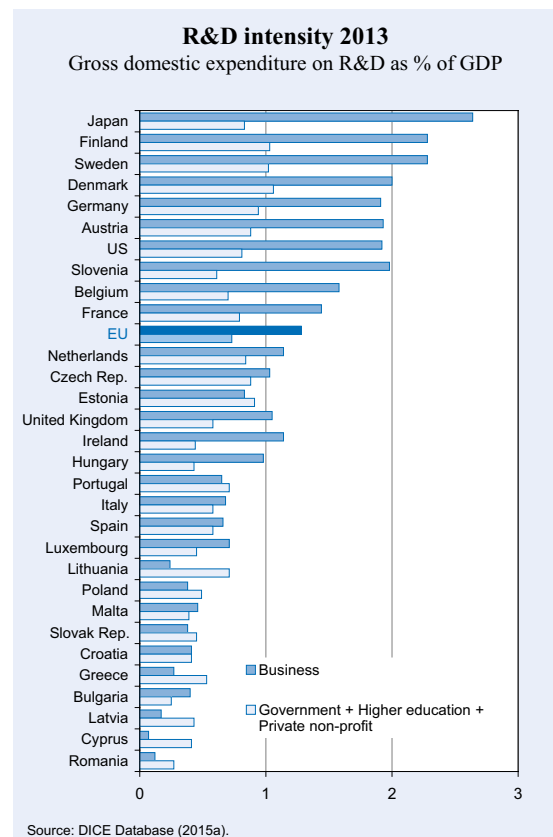
Communities 2003). The negative impact of the recent financial crisis on R&D was not great, as many EU countries maintained and some even increased their expenditure on R&D from 2008 to 2010 (European Commission 2014a). Nevertheless, with the average RI of 1.93 percent in 2010, R&D investments in EU countries were below the target value (Eurostat 2015).

As a continued effort, the European Commission set the expenditure of three percent of the EU's GDP on R&D as one of its five headline targets for the Europe 2020 Strategy (European Commission 2010). Reaching the goal is expected to create up to 3.7 million jobs and increase GDP by EUR 795 billion by 2025 (Zagamé 2010).

The EU Framework Programme (FP) is one of the most significant financial support provided by the European Union. FP7, the seventh Framework Programme that ran from 2007 to 2013, supported research and innovation with EUR 55 billion in funding (European Commission 2011b). The programme notably increased public expenditure on R&D (GOVERD plus HERD) in Slovenia, Estonia, the Czech Republic, Croatia and Malta (European Commission 2013). Horizon 2020, which succeeds FP7, is expected to run with EUR 80 billion in funding (European Commission 2015).

National governments are also implementing various strategies in order to encourage R&D activities. DICE Database (2013) lists some of the strategies adopted by EU members. For example, in Germany, which has the largest economy in the EU, the new High-Tech Strategy 2020 identifies five societal and global challenges and aims to be a key leader in each field in the next 10–15 years. The Czech Republic's International Competitiveness Strategy aims to place the country in the top 20 by 2020, with a focus on infrastructure, institutions and innovation. In Portugal, a new Science and Technology National Council was formed in 2011, and Portugal 2020, the national reform programme, focuses on business R&D and sets entrepreneurship and innovation as the nation's priorities. A lot of policies adopted by these governments are in line with the Europe 2020 Strategy.

Japan and the US are implementing their own policies to improve R&D even further. The Japanese government has identified five goals to achieve by 2030 and aims to increase RI to four percent, at least quarter of which is invested by the government (Tang 2015). The US government is expected to spend USD 145.2 billion on R&D in 2016, an increase of 6.4 percent in nominal

dollars from 2015, with a focus on creating knowledge and technology that will generate businesses and jobs in the future (White House 2015).

Trend towards R&D tax incentive in the EU

As Figure 1 suggests, BERD takes the largest proportion of GERD in most countries. Governments also directly invest in BERD, but recently their indirect support on BERD, which mostly consists of tax incentives, has substantially increased (European Commission 2013). Policies relating to R&D tax incentives are often mixtures of several types and vary among countries, but currently most EU countries have some sort of tax policy aimed at supporting innovation (only Germany and Estonia currently do not have a tax policy aimed directly at stimulating innovation). The most common scheme is R&D tax credits, used in 21 countries, followed by enhanced allowances (16 countries) and accelerated depreciation (13 countries) (see DICE Database 2015b for more details).

From 2007 to 2010, according to the Innovation Union Competitiveness report 2013, tax reliefs aimed at fostering R&D activities have increased significantly in France, Portugal, Ireland, the Netherlands, Austria, Denmark, Italy and the Slovak Republic. 13 EU members have also announced new or updated R&D tax incentives by 2012. The report also argues that tax incentives should be applied to expenditure that brings about strong knowledge spillovers, and one of the best ways to achieve that is to provide wage-related incentives for researchers.

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Pension Taxation in the EU: A Concern for Mobile Pensioners?

In the face of an ageing population and an increasing proportion of pensioners, there has been some recent policy reform to shift the tax burden toward the elderly, as part of the effort to combat potentially unsustainable pension systems. The ongoing transition to the deferred taxation of pensions in Germany, where contributions are not taxed, but pension benefits are taxed in full, is one such example.

For pensioners, the structure of the personal tax system and the amount of social security contributions they are expected to pay play a large role in determining the actual level of old-age income received. Within countries, pensioners tend to receive preferential treatment over workers in terms of taxation and social contributions, often paying lower rates or nothing at all. However, unequal tax treatment of pensions across different countries could motivate increasingly wealthy and mobile pensioners to consider taxation as an important factor in the emigration decision, as well as in the choice of a destination country. This possibility is particularly relevant in the EU, where mobility is relatively high and continues to improve.

This article begins by comparing the current second pillar pension taxation systems in EU countries, Iceland, Norway, and Switzerland. It then focuses on the taxation of pension benefits, and examines whether mobile pensioners might have tax incentives to migrate to or from particular countries.

Pension taxation systems

In addition to the first pillar public pension, most countries in the EU have some form of fully funded second pillar, mandatory pension, usually occupational, or a similar voluntary occupational pension. However, there are exceptions: the Czech Republic did not have a second pillar until 2013, and thereafter it did not prove popular and is to be phased out by 2016 (Pension Funds Online); Malta has never had a second pillar pension (OECD 2008). Many countries have a third pillar as well, usually consisting of a variety of voluntary private pension products, and in some countries, second and third pillar

pensions may receive different tax treatment. However, third pillar pensions are difficult to compare across countries, even in cases where they exist because of highly varied composition.

The size and importance of second and third pillar pensions in each country depends partially on how generous the first pillar public pension is, and whether or not the second pillar pension is mandatory. France, for example, has a large public pension system as well as a mandatory occupational pension, and has a very small third pillar. In contrast, the three pillars in Switzerland are almost the same size. Countries like Austria, Greece, Italy, Luxembourg, Portugal, and Spain (Pension Funds Online, OECD 2008) in which participation in second pillar pensions is voluntary may see low participation.

There are essentially three transactions that make up a pension, and therefore three points at which it can be taxed: when contributions or premiums are paid, when investment income accrues, and when the benefit is received. Usually tax will be levied at one or two of these times.

Most countries tax pension benefits, while leaving contributions and interest tax exempt. This deferred taxation scheme is commonly referred to EET (exempt, exempt, taxed). Additionally, pensioners in Cyprus, Croatia, Estonia, Latvia, Ireland, Slovenia and the United Kingdom receive tax relief or exemption on a portion of their benefits, and those in Austria, France, Italy, and Norway are taxed at a lower rate than workers (Insurance Europe 2014). In Finland, however, wealthy pensioners must pay an additional tax. Denmark, Portugal, Italy, and Sweden are ETT countries that tax the investment yields on pension plans in addition to benefits. Hungary, Luxembourg and Poland have a TEE system where the initial contributions or premiums are taxed, but the investment yields and pension benefits are exempt. However, Hungary grants a tax allowance that effectively makes contributions exempt. Bulgaria and the Slovak Republic also have an EEE system where pensions are not taxed at all (OECD 2008). Table 1 offers a summary of the above information.

Migration incentives for pensioners

For first pillar public pensions, the ability to tax at source largely eliminates any possibility of tax avoidance, but this does not apply to second pillar private pensions. Emigration to avoid taxation could undermine the ef-

fectiveness of deferred taxation and again lead to shifting the tax burden towards youth. Meier and Wagener (2015) show that immediate taxation of savings and tax exemption on interest is never optimal for countries; and in the case of mobile pensioners, the optimal tax policy is partial deferral and lower taxation on interest. For immobile pensioners, the optimal case is full deferral with full taxation of interest, or ETT. With a high enough level of mobility, full taxation of savings combined with a high taxation of interest, or TTE, could become optimal. This finding contradicts the assertion by Whitehouse (2005) that, because taxation of interest is distortive, it is also suboptimal, and that EET or TEE systems should be used. In the context of trying to shift the tax burden away from youth, however, some form of deferred taxation is still preferred; and as long as pensioner mobility in response to taxes remains low, deferred taxation should remain optimal and functional.

Not all EU countries have adopted an EET or ETT system, however, and in TEE and EEE countries, pension benefits are not taxed at all, in contrast with the case of countries implementing deferred taxation. For pensioners and individuals who are nearing retirement, taxation on benefits is the only pension tax that remains relevant, and it makes an immediate difference for net pension income.

The comparison is not quite between tax and no tax. There are great differences across countries in the tax rate itself. Furthermore, personal income tax is not the only concern for net pension income. Countries also vary in whether they expect pensioners to make social or solidarity contributions. Social contributions can be treated as an additional tax, since they are compulsory and the benefits received are not proportional to the payments.

Figure 1 compares the total taxes and contributions that a pensioner who has continuously worked in a given country would expect to pay at the gross replacement rate of an average and high earner. The variation across countries is large, with the tax and contribution rate for an average earner ranging from zero in Bulgaria, Ireland, Lithuania, Malta, the Slovak Republic, and Slovenia to over 30 percent in Denmark and the Netherlands. There is also a clear cross-country variation in progressivity of tax, with wealthy pensioners facing a rate twice as high as their less wealthy counterparts in some countries, while enjoying nearly the same rate in others. Pensioners considering a move to a wealthier (poorer) country must then also determine whether they would

move down (up) tax brackets. These considerations may make some countries more appealing than others from a tax perspective.

Government policies geared towards attracting immigrants may also be relevant for mobile pensioners. Portugal, for example, has a tax regime for non-habitual residents that provides favourable income tax rates to recent arrivals and tax exemption on foreign income for ten years. As most double taxation treaties grant taxation rights to the country of residence, pensioners emigrating from some countries may be able to avoid taxation of their private pension, or achieve a lower rate.

The actual portability of pensions and the content of double taxation agreements vary across origin and destination countries, so that migrating from a country with a high tax rate to one with a low tax rate does not have as straightforward effects as a simple comparison of tax rates might suggest. Considering taxation only as a cost would also be a mistake, as countries with higher taxes and contributions tend to provide better social benefits that pensioners may find important, such as quality healthcare. Furthermore, in countries where private pensions are unpopular, the taxation of such pensions would be irrelevant to many pensioners. It is therefore

Figure 1

Pension income tax and contribution rate

Source: OECD (2015).

not immediately clear what role, if any, differences in taxation play for mobile pensioners in migration decisions.

There is very little research into the migration decisions of the elderly. The difficulties encountered by Williams, King and Warnes (1997), who looked at elderly migration from northern to southern Europe, remain in place. These include a lack of data on the age of migrants or unreliable estimates thereof, difficulty in determining which movements of the elderly should be considered migration, and uncertainty about the level of unrecorded retirement migration.

Determining the response of mobile pensioners to taxation is important, however, as different possibilities could result in very different outcomes. Notably, three of the four countries implementing the ETT system are also in the top six countries with the highest overall taxes and social contributions for pensioners. If tax rates play a negligible role in pensioner migration decisions, then these countries are implementing the optimal taxation system. But if mobile pensioners respond significantly to tax rates, then this taxation system could be undermined.

Angela Xu

Table 1

Second pillar taxation systems				
	EET	ETT	TEE	EEE
Austria	x			
Belgium	x			
Bulgaria				x
Croatia	x			
Cyprus	x			
Czech Republic	x			
Denmark		x		
Estonia	x			
Finland	x			
France	x			
Germany	x		x	
Greece	x			
Hungary			x	x
Iceland	x			
Ireland	x			
Italy		x		
Latvia	x			
Lithuania	x			
Luxembourg			x	
Netherlands	x			
Norway	x			
Poland			x	
Portugal		x		
Romania	x			
Slovak Republic				x
Slovenia	x			
Spain	x			
Sweden		x		
Switzerland	x			
United Kingdom	x			

Source: Pension Funds Online, Insurance Europe, OECD 2008.

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New at DICE Database

Recent entries to the DICE Database

In the third quarter of 2015, the DICE Database received a number of new entries, consisting partly of updates and partly of new topics. Some topics are mentioned below.

- Financial crisis aid: Approved amounts, totals per aid instrument
- Government responses to improve access to finance
- SME access to finance index
- Financial secrecy index
- Macroprudential measures to deal with housing/mortgage market booms
- Supervisory authorities
- Overview of recent changes in bank resolution legislation
- Personal income tax: Entrance and top tax rates
- Property tax
- Taxation of capital gains
- Earnings dispersion, total, men and women
- Monetary policy decision-making and accountability structures

The interactive graphics application Visual Storytelling has been further expanded.

Forthcoming Conferences

CESifo Area Conference on Behavioural Economics

23–24 October 2015, Munich

This will be the fifth conference in the area of Behavioural Economics. The purpose of the conference is to bring together CESifo members to present and discuss their ongoing research, and to stimulate interaction and co-operation between them. All CESifo research network members are invited to submit their papers, which may deal with any topic within the broad domain of behavioural and experimental economics and applications to other fields. The keynote lectures will be delivered by Raymond Fisman (Columbia Business School) and Michael Woodford (Columbia University).

Scientific organisers: Prof. Dr. Klaus Schmidt, Prof. Dr. Ernst Fehr

9th Norwegian-German Seminar on Public Economics

6–7 November 2015, Munich

This conference, jointly organised by CESifo, the Norwegian Center for Taxation at NHH, and Oslo Fiscal Studies at UiO will take place at the CESifo conference centre in Munich. The conference invites the submission of both theoretical and empirical papers from all fields of public finance.

Scientific organisers: Prof. Dr. Marko Köthenbürger, Dr. Dirk Schindler

10th Workshop on Macroeconomics and the Business Cycle

19–20 November 2015, Dresden

The workshop should provide a forum for the latest research findings in the field of macroeconomics and business cycle research, while contributing to better networking of young researchers. Welcome are lecture offers from all areas of macroeconomics. Priority is given to papers from the field of business cycle research, as well as papers with empirical orientation.

Scientific organisers: Prof. Dr Michael Berlemann, Robert Lehmann, Michael Weber

9th Workshop on Political Economy

27–28 November, Dresden

CESifo, the Center of Public Economics at TU Dresden and the Ifo Institute for Economic Research Dresden will jointly organise a workshop on Political Economy. In the tradition of the previous workshops, the conference will take place in Saxony's capital Dresden. The two-day workshop will serve as a forum to present current research results in political economy and will give researchers the opportunity to network. The keynote speakers will be Geoffrey Brennan (UNC-Chapel Hill & Duke University) and Kai Konrad (Max Planck Institute for Tax Law and Public Finance).

Scientific organisers: Prof. Dr. Christian Lessmann, Dr Gunther Markwardt

6th Ifo Conference on "Macroeconomics and Survey Data"

4–5 December 2015, Munich

The Business Cycle Analysis and Survey Department of Ifo in association with Rüdiger Bachmann (University of Notre Dame) and Eric Sims (University of Notre Dame) will organise a conference in Munich on "Macroeconomics and Survey Data". The conference is intended to discuss ongoing research on survey and micro data and its role and usage in macroeconomics. Papers, theoretical, empirical and policy oriented, are actively solicited on issues like (the list below is not exhaustive): methodology of business surveys; uncertainty modelling, survey data and the business cycle, transmission of cyclical fluctuations, forecasting performance of survey data in business-cycle research, usage of micro-data in macroeconomics.

Scientific organisers: Dr Klaus Wohlrabe,
Prof. Dr Ruediger Bachmann, Professor Eric R. Sims

NEW BOOKS ON INSTITUTIONS

Cultural Governance and the European Union
Evangelia Psychogiopoulou
Palgrave Macmillan, 2015

Performance and Progress - Essays on Capitalism, Business, and Society
Edited by Subramanian Rangan
Oxford University Press, 2015