

***UNIVERSITY OF OSLO***  
***DEPARTMENT OF ECONOMICS***

Exam: **ECON4640 – Political Economics, spring 2012**

Date of exam: Friday, June 1, 2012

**Grades are given: June 13, 2012**

Time for exam: 09:00 a.m. – 12:00 noon

The problem set covers 3 pages (incl. cover sheet)

Resources allowed:

- No resources allowed

The grades given: A-F, with A as the best and E as the weakest passing grade. F is fail.

This exam consists of two parts. You need to answer both questions in Part 1 *and* all the questions in Part 2. You can write in English or Norwegian.

## Part 1: Short questions (weight 1/3)

Answer *briefly* (about one page each) the following two questions:

- (a) Why do countries issue debt in the models by Tabellini and Alesina (1990, AER) and Persson and Svensson (1989, QJE)? Discuss briefly whether these theories have any relevance for the crisis currently unfolding in Southern Europe.
- (b) Table 3 in Fisman (2001, AER) is reproduced below. How can Fisman, on the basis of the findings in this table, conclude that a substantial fraction of the market value of the politically connected firms is due to their connections? Recall that  $NR(JCI)$  is the return on the Jakarta Stock Exchange Composite Index net of broader Southeast Asian effects, and that  $POL$  is an index of the firm's political connections. Discuss briefly potential weaknesses in Fisman's identification strategy.

TABLE 3—EFFECT OF POLITICAL CONNECTIONS ON CHANGES IN SHARE PRICE

	(1)	(2)
$POL$	-0.60** (0.11)	-0.19 (0.15)
$NR(JCI)$	0.25 (0.14)	-0.32 (0.28)
$NR(JCI) \cdot POL$		0.28* (0.11)
Constant	0.88 (0.27)	0.06 (0.35)
$R^2$	0.066	0.078
Number of observations	455	455

Note: Robust standard errors are in parentheses.

\* Significantly different from 0 at the 5-percent level.

\*\* Significantly different from 0 at the 1-percent level.

## Part 2: Essay question (weight 2/3)

Answer *all* of the following questions. Each question (a)-(e) has the same weight.

- (a) Consider a society with an continuum (an infinite number) of individuals with mass normalized to one. The individuals have incomes  $y$  with some distribution. The density of the distribution is given by the function  $f(y)$ . The mean income is  $\bar{y} = 1/2$ , whereas the median income is  $y^m = 1/3$ . This income can be spent on private consumption  $c$  and a public good  $g$ , where the public good is financed by a linear tax  $\tau$ , with  $0 \leq \tau \leq 1$ . Hence  $c = (1 - \tau)y$  and  $g = \frac{1}{2}\tau$ . The individual's utility function is given by

$$U = c + \frac{1}{4} \ln g \quad (1)$$

Find the preferred tax rate of an individual with income  $y$ , and derive his preferred level of consumption of private and public goods.

- (b) Assume that there are two parties A and B competing for office with no preferences over policies. Both parties simultaneously propose platforms (here they consist of tax rates  $\tau^A$  and  $\tau^B$ ) to maximize their probability of winning. Voters then vote for the party with the best platform. Describe the platforms chosen by the parties and explain why this is an equilibrium.
- (c) Assume now that voters value parties according to the utility function (1), but in addition have a common taste shock  $\delta$  and an individual taste shock  $\sigma^i$  with the same distribution for everyone. The distributions of  $\delta$  and  $\sigma^i$  are both symmetric with mean 0. Interpret these shocks, and derive conditions for the equilibrium platforms for the two parties in this setting.
- (d) What is the effect on the proposed platforms of a mean preserving spread of incomes in the cases studied in (b) and (c)?
- (e) Assume now that the parties care about both winning elections and the implemented policy. Party A has preferences identical to a person with income  $y = 1/4$ , whereas party B has preferences identical to a person with income  $y = 1$ . In addition, they get ego rents  $R > 0$  if they are in office.
- What are the ideal policies of the two parties, disregarding electoral concerns?
  - If party A wins with probability  $p^A$ , what is the expected utility of the two parties?
  - In the model studied in (b), what are the proposed platforms?
  - In the model studied in (c), derive conditions for the optimal platforms for the two parties in this setting