Exam for the M.Sc. in Economics
University of Copenhagen

Political Economics, Fall 2010

January 11, 2011
3 hours.

Answers should be given in Danish or English.
No aids allowed except Danish-English / English-Danish dictionaries.

1. **Short questions.** Write briefly and concisely, no more than 2 pages per question.

   (a) Define retrospective voting (in words) and give examples of – and explain in detail – retrospective voting strategies under various informational assumptions.

   (b) The standard Downsian model of electoral politics with two office-motivated parties predict full policy convergence, with the two parties proposing similar economic policies.

      i. Suppose, in an otherwise Downsian framework, that parties are also ideological, that is, are motivated both by office rents *and* policy. Does that change the Downsian result regarding policy convergence? Explain!

      ii. Can you give (other) examples of how changing the basic assumptions of the Downsian set-up leads to a prediction of policy divergence in a two-party setting?

   (c) Suppose you are the president for two periods and you want your favorite policy implemented in each period. There is an election after the first period in which you may be replaced by your political opponent with probability x. Implementation of the policy in each period is handled by an official who has preferences over policy. You do not fully know the preferences of the official. You can at time $t = 0$, the constitutional stage, choose between appointing the official for life, that is for two periods without the possibility of replacement, or you can choose to have the opportunity for appointing a new official after the first period. Explain whether – and if so, how – your choice depends on the probability x that you are voted out of office. Include in your explanation an account of how the official chooses policy in the two different regimes.

2. Consider an economy populated by individuals with preferences

$$w = c + 2\sqrt{g},$$

where c is private consumption and g is economy-wide public good. Individuals have different income levels y_i distributed with mean $\overline{y}$ and median y_{med}. The public good is financed by a common proportional income tax t, so that the government budget constraint is

$$g = t \int y_i di = t\overline{y},$$

and individual consumption is given by after-tax income

$$c_i = (1-t)y_i = \left(1 - \frac{g}{\overline{y}}\right) y_i.$$

   (a) Find the public good level g_i preferred by individual with income y_i. How does it depend on y_i? Provide intuition.

   (b) Assume that the tax rate in this economy is decided by pure majority rule. What level of public good is chosen in equilibrium?

(c) Assume now that there is an inflow of immigrants to the country in question. They all get jobs and receive incomes, so the new mean income in this economy is $\overline{y}_{new}$, and their incomes are taxed at the same common tax rate. However, immigrants are not eligible for voting, as they do not have citizenship.

i. Consider the case when $\overline{y}_{new} > \overline{y}$ (high-skill immigration). What happens to the level of public good provided in this economy?

ii. Now assume that $\overline{y}_{new} < \overline{y}$ (low-skill immigration). What happens to the level of public good provided in this economy?

iii. Assume that the median voter in this economy can choose whether to allow for immigration or not. Will she allow high-skill immigration? low-skill immigration? Motivate your answer both mathematically and intuitively!

(d) Assume now that the median voter in this economy can also decide whether to give the citizenship to immigrants already working in the economy, i.e. whether to grant them the right to participate in voting. Will she ever do it? Explain.

3. In recent years, and even more so following the financial crisis, fiscal transparency has been heralded as an important part of good governance.

(a) Explain, based on the readings of the course, what fiscal transparency is and how it affects, or does not affect, decisions of policy makers both in theory and in practice.

(b) In the fiscal transparency index employed in class, Greece scores 0 on a 0-11 scale. At the same time, Greece is in deep trouble regarding its public finances. Suppose the European Central Bank (or some equivalent supra-national actor) would command that Greece improves its level of fiscal transparency; based on your answer in (a) and the readings in class, how would that, everything else equal, affect the future performance of Greek public finances? Would this fully address the challenge of decentralized decision-making in the eurozone? If yes, how? If no, why not and what can be done about it?

Good luck!