

Table of Contents

| | |
|--|-----------|
| EUROPEAN UNION..... | 2 |
| 01. One Market, One Money..... | 2 |
| 02. Other..... | 4 |
| GOVERNING BRITAIN SINCE 1945 | 5 |
| 03. Post-War Consensus..... | 5 |
| 04. Thatcherite Consensus..... | 7 |
| 05. Economic Crises..... | 9 |
| POLITICAL AND SOCIAL INSTITUTIONS | 12 |
| 07. Mix 'n' Match | 12 |
| 08. Media..... | 15 |

define, geometry, rich technical exposition

EUROPEAN UNION

01. One Market, One Money

The Problem

- In theory benefit from transaction cost savings, increased price transparency, eliminating ER uncertainty, and inflation fighting credibility. In practice also serious disadvantages...
- If fixed ER an asymmetric shock requires imperfect trade-off (see Fig 01.01). Maintaining E harms A; devaluing to E' harms B; floating (i.e. in between) is sub-optimal for both.
- Germany has highest trade surplus in the world. Overvalued currency incentivises other MS to increase G to remedy $Y < Y_{FE}$, leading to Eurozone debt crisis (see Fig 01.02).
- Impossible Trinity means no sovereignty over MP. Instead set by ECB, which either aggravates German insurance companies or jeopardise Mediterranean recovery
- Theory of Optimum Currency Area (OCA) has four criteria needed to overcome this...

Fiscal Transfers

Why it is necessary

- Aligns above AD curve via ΔG (fiscal) or Δr (monetary)
- During the Great Recession, Florida, received \$40bn, largely from 'automatic stabilisers' such as federal welfare, hence recovered quicker.

Why it is not working

- Typically require central body control 40% of tax revenues. EU budget is small, a mere 1% of GDP, and ineffective: CAP (half of budget) allocates 80% of funds to 20% wealthiest farmers.
- ECB's restrictive mandate means not guaranteed lender of last resort for Eurozone (quasi-fiscal). Explains why 2012 UK gilt yields as low as Germany's despite deficit similar to Italy

Why it can never work

- 2012 Outright Monetary Transactions 'corrects' interest rates of lagging economies; after €110bn Troika Greece bailout European Stability Mechanism created. But... only for crisis.
- No-bail out clause in Stability and Growth Pact. Each MS wants to more than they're paying. Germany only tolerates a little: dismissed Eurobonds and EU deposit insurance scheme.

Economic Convergence

Why it is necessary

- Homogeneity should make asymmetric shocks rarer. Note this is a weak substitute.
- Has been the main focus of EMU since the start as it is the least controversial. Part of Delor's Plan, which set foundation for euro and demanded "macro discipline"

Why it has not worked

- EU is political project so enlargements not scrutinised properly (e.g. Greece lied). Also focused on nominal not real indicators (Maastricht criteria vs. Brown's five economic tests)
- Created asymmetric shocks by giving periphery countries access to low IR: Irish property prices grew 10%p.a. until 2008 FC; Greek sovereign debt 170% of GDP; doom loops

Why it can never work

- Six-pack Law limited deficits to 3% of GDP and government debt to 60% with automatic sanctions. Banking Union enables ECB to monitor and unilaterally intervene in commercial.
- But... no enforcement (9 MS have already breached Six-pack; Italy €17bn bail-out with no ECB involvement) and requirement of unanimity (no treaty after 2007 Lisbon "housekeeping")

Flexible Prices

Why it is necessary

- Recall $\varepsilon = E \frac{P}{P^*}$. If E is fixed, ε can still be controlled by changes in P
- Many bailouts are conditional on structural adjustment programmes or "internal devaluations" to achieve just this

Why it has not worked

- Friedman's "day-light saving time" argument says this is much harder to do compared to flexible exchange rate (change one vs. a million).
- Frictions in the economy include sticky prices (menu costs) and sticky wages (minimum wage laws and welfare)

Why it can never work

- European Social Model envisions tightly regulated labour markets, generous welfare state, and a limited role of the market. Most spend ~30% of GDP compared to 20% Anglo-Saxon
- No political appetite for thorough reforms: Greek Bailout Referendum saw 61% vote against due to "excessive austerity", including a majority in every single region.

Labour Mobility

Why it is necessary

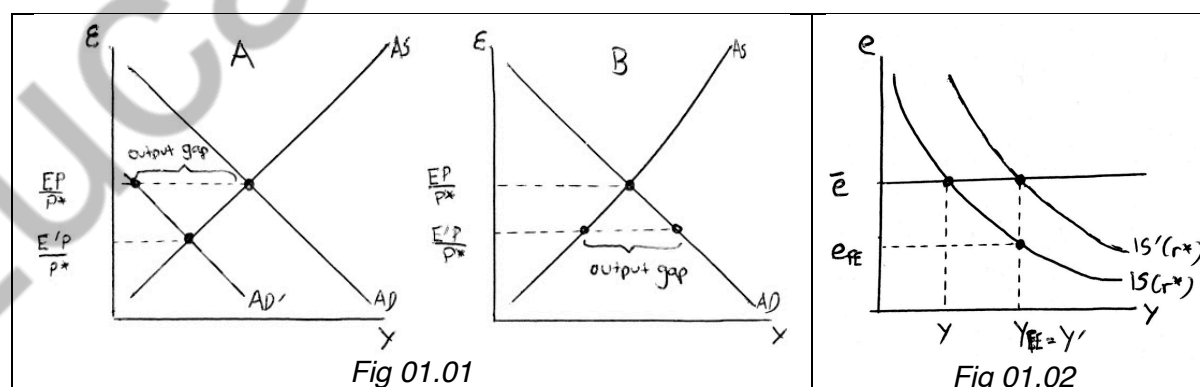
- With perfect labour mobility, unemployed migrate from affected country to where more jobs are available. This eases the impact of shock and makes countries more homogenous.
- Should be enshrined in EU's principle of "freedom of movement" and Schengen Area

Why it has not worked

- Adverse Selection: Most productive (i.e. rich) can reallocate, whilst most vulnerable (i.e. poor) are left behind. "Brain Drain" can also prevent convergence (0.4m Hungarians have left)
- Could explain why five years after 2008 Financial Crisis, the Spanish unemployment rate remains three times higher than before

Why it can never work

- Not just physical barriers to migration but also cultural (language) and institutional (3 months search period then "habitual residence test" for benefits).
- Could explain why US has higher migration rates and why the EMU's has a more amplified cyclical unemployment rate



02. Other

Basics

Structure: (Exec.) European Commission | (Leg.) European Parliament | (Jud.) CJEU | (National) Council of Europe | (Indep.) ECB

Power

- Exclusive: trade, competition in ESM, EZ monetary policy
- Shared: competition in internal market, agriculture, justice
- Supporting: culture, education, civil protection

Governance

- Community Method: centralised and Brussels drive e.g. CAP
- Regulatory Mode: rule-making state e.g. Single European Act
- Distributional Mode: multi-level governance, closest to those affected e.g. structural funds
- Open Method of Coordination: voluntary cooperation of MS e.g. Lisbon Strategy
- Intensive trans-gov.: MS agreement with little involvement of Brussels e.g. Schengen

Progression to the Single Market

- FTA: "Castle with three walls" as outsiders import to lowest-tariff member. Hence...
- Customs Union: Outputs can move freely, why not inputs? Hence...
- Common Market: Can't work if companies don't play by the same rules. Hence...
- Single Market: Only difference left are macro-economic policies. Hence...
- Monetary Union: Doesn't work without fiscal transfers. Hence... ???

Why did MS comply?

- FTA was initially seen as a measure against more and a condition for US support. Customs Union and Common Market followed shortly thereafter, with Federal European ideal.
- Single Market was "Thatcher Revolution" abroad after 1970s Eurosclerosis. Continent tolerated this as it believed boom of liberalisation would make political union bearable. Former occurred (Cecchini: 7% GDP boost, -4.5% inflation), latter did not.
- Monetary Union was the French way of getting DM without the Bundesbank. Germany believed it could still exert control and benefit greatly from devalued currency.

A history of the Euro

- 60s: EEC was a subsystem of Bretton Woods System which collapsed in 1971
- 70s: Flexible ER were too volatile. Hence snake-in-the-tunnel but $\pm 2.25\%$ too restrictive.
- 80s: European Monetary System added wide band of $\pm 6\%$, with DM becoming anchor
- 90s: Speculative attacks on GB in '92 (ir=15%; Black Friday) and threatened others (esp. Italy)
- 00s: Euro introduced so there was nothing to sell against

Why did MS comply?

- Benefits seemed large, esp. importing German deflation after stagflation crisis. National inflation was correlated with support for EMU everywhere except Britain
- Drawbacks seemed small, as monetarists discredited CB as stabiliser ["long and variable lags"] and the Phillips Curve as a whole [adaptive inflation expectations]

Welfare

| | Low Efficiency | High Efficiency |
|--------------------------|--------------------------|-----------------|
| High Equity (30% of GDP) | Continental (SocDem) | Nordic |
| Low Equity (20% of GDP) | Mediterranean (Catholic) | Anglo-Saxon |

GOVERNING BRITAIN SINCE 1945

03. Post-War Consensus

Basic

- Historians talk of “five planks of consensus”: a mixed economy, the primary goal of full employment, support for Trade Unions, universal welfare, and decolonisation
- Really an informal agreement between party elites, who often had more in common with each other than their members and voters.
- This has long existed, hence caused by systematic factors. Post-war was exceptionally strong because circumstances strengthened it. Few big changes were quickly accepted.
- To be coherent these policies must also be sustainable. But Keynesianism and Illusion of Grandeur were not.

Nature of Consensus: Policy Continuity (i.e. Government)

Economic/Domestic Policy

Industry

- Selective nationalisation (20% of industry) accepted by Tories in their 1947 Industrial Charter: only iron & steel and freight haulage were ‘re-privatised’. NHS was accepted (sacred cow).
- Macmillan (Tory) encouraged defence contractors to merge (British Aircraft Corporation); Wilson (Labour) encouraged automobile companies to merge (British Leyland Company)

Macro

- Keynesian Paradigm saw both parties manage the economy in the same way: the term ‘Butskellism’ was coined as both government’s Treasuries were nearly indistinguishable
- Believed in flat LM and steep IS, and hence relied on fiscal policy (see Fig 03.01). Both used stop-go policies for political purposes.

Education

- Wilson introduced comprehensives schools to replace tripartite system. Heath (Tory) expanded this via education secretary Margaret Thatcher.

Foreign Policy

- Reluctant de-colonialization: Attlee let India go in 1947 but held onto Singapore and HK. Tories accepted after “loG” dispelled by 1956 Suez Crisis (Macmillan “Wind of Change Speech”)
- Believed in Eu project but didn’t want to join a political union themselves (prevent hegemonic continental threat). Break came in 60s when Macmillan (’61) and Wilson (’67) applied to EEC.
- Attlee initiated nuclear deterrent; Tories expanded this. Churchill began ‘special relationship’ with US; Labour continued this.

Nature of Consensus: No Ideological Convergence (i.e. Party)

Economic/Domestic Policy

- Left: Keynesianism was sceptically accepted as ‘appeasement socialism’ but maintained commitment to Clause IV.
- Right: Supported BMA resisting Bevan’s NHS (contractors vs employees). Many local councils refused to abolish Grammar schools after Wilson abolished 11-plus and tripartite system.

Foreign Policy

- Left: was split over “the Bomb” (3/4 of 60s CND members were Labour) and European integration (Labour Party took no official position in 1975 referendum)
- Right: was split over decolonisation. Monday Club had, in 1971, 35 MPs and 35 peers, including 6 ministers.

Nature of Consensus: Origin

Wartime coalition

- Wartime coalition lay foundation for post-war consensus: Beveridge Report (1942), Employment Policy White Paper (1944), Butler's Education Act (1944).
- Churchill and Attlee dominated their parties and shared a close bond. Churchill did not have domestic vision so accepted SocDem, even wanting to continue coalition during peace time.

Historic phenomenon

- Broad consensus has always existed to some extent since the Glorious Revolution. Never succumbed to Fascism or Communism. Post-war consensus was a cumulative achievement
- Welfare State largely brought existing benefits under a single system, notably those by Lloyd George and Churchill himself (trade boards, National Insurance, widow's pensions).

Reasons for Consensus: Political Structure (i.e. why consensus always existed)

Non-party actors

- Largely from the same elite: 42/56 PMs went to Oxbridge; 'champagne socialists'
- Permanent civil service ensured policy continuity, esp. before SPAds. Supported by Public Choice Theory. Treasury's rejected monetarism, despite IEA support since 50s
- System of 'corporatism' was created involving the gov., CBI, and TUC. Trade Unions are a great for conservatism, limiting labour reforms, and CBI restricts major regulations.

Elections

- FPTP inherently creates two 'big-tent' parties with significant overlap. Winning a majority can only be achieved by gravitating to the median voter
- Leftwards paradigm shift in politics explained by median voter fearing return of mass U (see Fig 03.02) and fully-flexible wage price adjustment discredited by GD
- Easy for Tories to adapt as conservatism has no foundational ideology but is office-seeking. 1945 GE was biggest defeat since 1906 so rediscovered Disraeli's 'One Nation Con.'

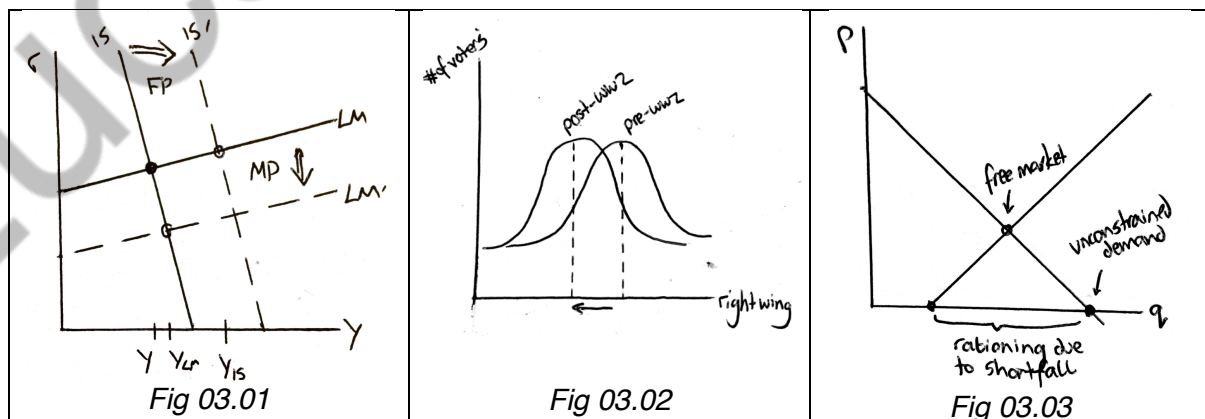
Reasons for Consensus: Context (i.e. what made post-war different)

Doing well enough to avoid conflict but not well enough to afford radical policies

- Booming 50s and 60s: Full employment meant voters didn't care whether jobs should be prioritised over inflation; did not need to cut benefits and limit universal welfare.
- Crisis 70s: 1976 IMF bailout and compensation costs ended Callaghan's socialism; Tories couldn't afford Empire and had to nationalise bankrupt firms (e.g. aeronautical Rolls Royce)

US hegemony limited foreign policy

- Eden's embarrassment during the Suez Crisis dispelled "illusions of grandeur". Now relied on US "special relationship" (being biggest recipient of Marshall Aid) which came with conditions
- US free trade prevented continuation of Chamberlain's "imperial preference"; NATO commitment was extension of Truman doctrine; Macmillan was obliged to buy US Polaris



Was it Effective?

- Social Policy: Yes but at great cost (NHS)
- Macro: Yes in SR but self-destructive in LR (Stop-Go Keynesianism)
- Industry: Yes in SR but self-destructive in LR (Structural decline)
- Foreign Policy: Failure and required rethink (Illusion of Grandeur)

Economics of the NHS

Supply and Demand

- "Free at the point of use" means price is fixed at 0 so demand is unconstrained, equilibrating where the demand curve intercepts X-axis.
- Where to place the supply curve is a political choice but ultimately has to end in rationing. See Fig 03.02
- Note intersection doesn't even have to occur (i.e. demand curve can be asymptote) if coverage includes trivial treatments (e.g. cosmetic surgery)

Efficiency

- Healthcare doesn't have a clear production function. From what we know inputs tend to be complementary (rectilinear isoquants) so cannot substitute expensive L for cheap K
- Also difficult to measure improvement in the quality of a patient's life

04. Thatcherite Consensus

Basic

- Neoliberalism: ideological belief that that emphasizes the value of free market competition
- Though Blair and Brown accepted Thatcher's monumental feat of privatisation and destroying TUs, they never shared the same blind trust in deregulated markets.
- Line that "we are all Thatcherites now" came out of political realism not conviction and only applied to some socio-economic policies

Nature of Consensus: Structure of the Economy

Privatization

- Thatcher's, to reverse "managed decline", privatised virtually everything but the post office (profitable firms, natural monopolies, and "basket cases"). Should reduce AC (see Fig 04.01)
- Sold shares to ordinary people below the market price and in small quantities, giving them stake in capitalist system (share-owning democracy).
- Blair accepted this, not renationalising any industry. Brown only belatedly did so due to Financial Crash. Rewrote Clause IV, ending party's historic commitment to public ownership.

TU relations

- Thatcher saw them as root cause of unemployment (high rw graph). Prepared to challenge them by building up coal stocks and power stations, "buying off" security forces.
- Kept an iron-will through the eleven month long miners' strike, and was able to pass 1984 TU Act, which outlawed secondary picketing and made secret ballots compulsory.
- Blair accepted this and shifted Labour away from "worker movement" by moving from 'trade union block vote' to 'one-member one-vote' and leaving them out of Policy

Nature of Consensus: Role of the State

New Public Management

- Thatcher used it to shrink the state: Next Steps justified cutting budgets and eliminating 57 quangos; internal markets substituted for privatisation (e.g. NHS Trusts)
- Blair's "Third Way" did not shrink the size of government but instead created an "activist, innovative state". NPM was a goal within itself and legitimised intervention...

- The NHS's 50% budget increase was tied to "money following the patient" and performance tables; Major's PFI used to expand public services by offloading its costs to the private sector.

Regulation

- Thatcher saw regulation as obstructing Pareto efficiency. Removed all currency-exchange restrictions in her first year.
- Blair never had blind trust in deregulated markets, introducing minimum wage, The Competition Act (1998), and pro-employee labour laws

Nature of Consensus: Macroeconomic Policy

- Thatcher MP: "public expenditure is at the heart of our current difficulties" as QToM states $\pi = g_M - g_Y$. Hence raised MLR by 5%-points in 1979 to reduce M and π^e (see Fig 04.02)
- Thatcher FP: Contra Keynesianism, believed IS curve is flatter than LM (see Fig 04.03). Hence rarely used it. Also abided by Laffer Curve (cut top income tax rate from 83% to 40%).
- Blair believed in old "tax and spend". Didn't want to save money but ensure it was spent so the electorate felt it e.g. used 2000 budgetary surplus to create 500,000 public sector jobs.
- Self-imposed 'Golden Rules', these meant little in practice: Extended internal definition of 'economic cycle' from 7 to 9 years to still hit target. Gov. as % of GDP doubled under NL.

Nature of Consensus: Institutional

- Despite calling for a "night-watchman state", Thatcher drastically increased the authority of the central government making the UK the most unitary state in Europe
- Reduced power of (Labour) local authorities (rate-cap and attempted Poll Tax on over-spending councils; Local Management of Schools and national curriculum)
- Blair, by contrast, devolved "earned autonomy", increasing legitimacy of HoL, created Supreme Court, handing monetary policy to BoE, and signing ECHR.
- Whilst Thatcher disagreed with 'wets' they were consulted. Blair ruled by 'sofa government' and ended "primus inter pares", bypassing Cabinet over Millennium Dome

Nature of Consensus: Foreign Policy

- Thatcher continued existing foreign policy. It was mainly characterised by 'special relationship', which despite her personal connection to Reagan, saw GB as inferior partner
- Obligated to purchase Trident D5; US only reluctantly supported GB in Falklands War; US invaded Grenada, a commonwealth country, without consultation
- Blair wanted an ethical foreign policy (stricter control of arms trade and end poverty in Africa). Hence had 'constructive approach' towards EU for leverage, coordinating in defence
- But mainly remembered for being dragged into Gulf War in Iraq and Afghanistan due to special relationship. First time GB was involved in regime change since post-colonial period.

Reasons for Consensus: Political Structure

Elections

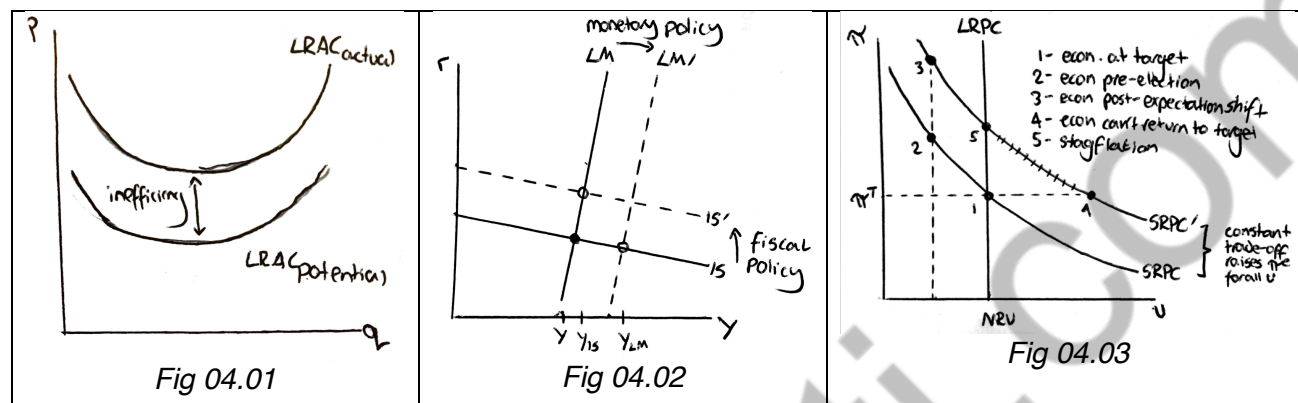
- FPTP inherently creates two 'big-tent' parties with significant overlap. Winning a majority can only be achieved by gravitating to the median voter
- Rightwards shift in politics explained by median voter seeing Keynesianism discredited by stagflation, socialism by the end of the Cold War, and embourgeoisement (adapt Fig 03.02).
- Especially relevant as Blair was "office seeking politician". Shown by rebranding of 'New' Labour, symbolic privatisation of air traffic control, and reliance on spin doctors.

Non-Party Actors

- Thatcher made GB heavily reliant on FDI so the short-term cost of renationalisation would be too expensive. Deregulation of finance meant BoE had less control over money supply.
- Thatcher's reduction in TU power and Blair's widespread use of SPADs and think tanks removed traditional check on power. CS had 30y of consensus history but under attack.

Reasons for Consensus: Context

- Paradigm shift from Keynesian (full employment) to Monetarism (stable prices) was permanent. Keynesianism did not just fail to explain stagflation but caused stagflation itself!
- Shown by adaptive expectations model of Phillips Curve (see Fig 04.04). In early 1980s unemployment peaked at 3m, by mid 1980s returned to 1.5m.



Note: Was Thatcher a conservative? Yes if conservatism means pragmatism, no if conservatism means gradualism. Thatcher was less popular than Callaghan but fit 70s/80s context better.

05. Economic Crises

Cause

70s Stag- & 80s Deflation: Internal \downarrow LRAS (prod) and \uparrow SRAS (cost-push). See Fig 05.01.

- Stop-Go I: expansion $\Rightarrow \uparrow$ prices and \downarrow unemployment [A] (so called Political business cycle)
- Doesn't solve prod. deficit (Sickman of Eu) \Rightarrow Firms pass on inefficiencies via prices \Rightarrow pp. falls \Rightarrow TU demand higher wages. Wage-price spiral until $\uparrow \pi^e$ and return to NRU [B]
- Stop-Go II: downward pressure on \pounds in BW ($\varepsilon = \bar{e} \frac{P}{P^*}$) \Rightarrow contraction $\Rightarrow \downarrow$ prices and \uparrow unemployment [C]. All amplified by OPEC quadrupling oil prices in 1973. See Fig 05.02
- Thatcher contractionary policy (raised MLR 5%-points in 1979) to shift π^e back down.

1990/1 Recession: AD Internal \downarrow AD (overreaction in MP had to be reversed). Draw Graph

- 1987 stock market crash \Rightarrow fear global recession \Rightarrow excessive monetary expansion "Lawson boom" \Rightarrow Requires correction \Rightarrow Join ERM (commitment device)
- Had to raise IR to 15% to fend off Soros speculative attack as you can't violate the impossible trinity. Ultimately failed and resulted in Black Wednesday.

Great Recession: External \downarrow AD (global panic) and \uparrow SRAS (banks didn't lend). Draw Graph

- Basel I&II were too lax: world's largest fifty banks having avg. capital-to-asset ratio of 4% (expect 30-40%); subprime mortgage share in US $<10\%$ in 2004 but 20% in 2006.
- Banks were 'too big to fail', hence acted with moral hazard, and created a "originate to distribute model". Resulted in too many/lenient loans to 'NINAs'
- Statistical 'Disaster myopia' with firms ignoring the tail risks of the investments due to their heavy reliance on VaR as a measurement and the complexity of MBS, CDOs, and CDS.
- "Minsky moment" created panic. Northern Rock was too scary (not too big) to fail

Effect

| Crisis | Real GDP | Inflation | Unemployment | Recovery |
|--------|----------|-----------|--------------|----------|
|--------|----------|-----------|--------------|----------|

| | | | | |
|--------------|-------|--------------|---|-----|
| 1970s | -3.3% | +; 5% => 25% | 6% (historic break from FE) | 13q |
| 1980s | -4.6% | -; 18% => 5% | 12% (regionally concentrated) | 13q |
| 1990s | -2.5% | -; 10% => 2% | 10% | 14q |
| 2000s | -6.0% | -; 5% => 1% | 8% (low due to wage flexibility; see Fig 05.01) | 25q |

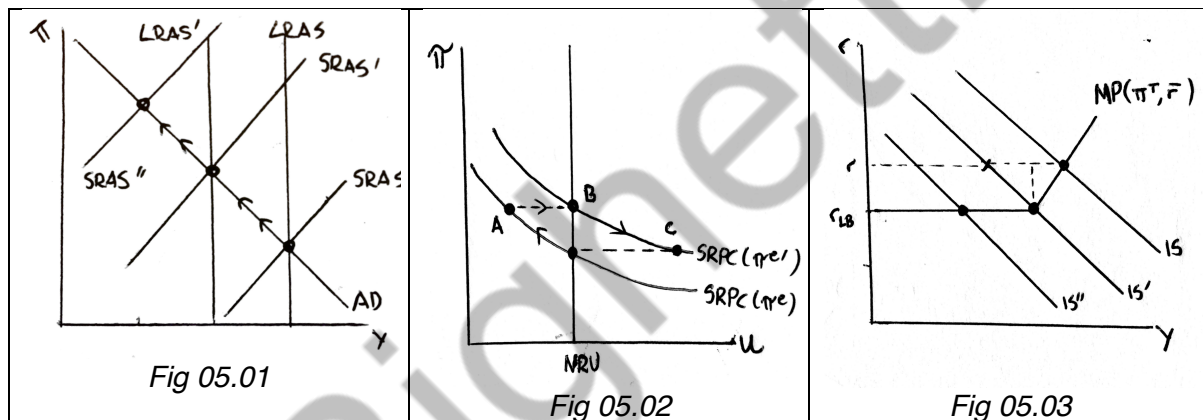
Response

1970s Stagflation and 1980s Deflation: Paradigm shift from Keynesianism to Monetarism (QToM). Perception of IS and LM gradients changed.

1990/1 Recession: Left ERM, accepting a floating ER, and distanced from EU project.

Great Recession:

- Short Run: BoE provided liquidity, with ZLB requiring QE (see Fig 05.03); Treasury bought shares to keep banks solvent via 'pragmatic nationalisation'; some limited counter-cyclical FP
- Medium Run: Austerity (see below) was big ideology but short-lived. Set up Financial Policy Committee to regulate banks at the cost of some growth but... likely to be reversed



06. Austerity (Cameron administration)

Theory

- \uparrow Budget Deficit \Rightarrow investors lose trust $\Rightarrow \uparrow$ Bond Yields \Rightarrow *Repeats*. At some point this escalates into a “death spiral” e.g. Greece “doom loops”. Remedy is to restrain government expenditure
- Government spending is inefficient and crowds out private sector (see Fig 06.01). Hence cuts shouldn't be painful. ‘Bad debts’ are also the root of many crises

Justification

- Financial crash caused Real GDP to fall 6% and automatic stabilisers to increase government spending. UK annual deficit tripled in absolute terms in just two years.

| | 2007 | 2009 | 2014 |
|---------|------|------|------|
| Deficit | 3% | 11% | 6% |
| Debt | 44% | 66% | 89% |

Action

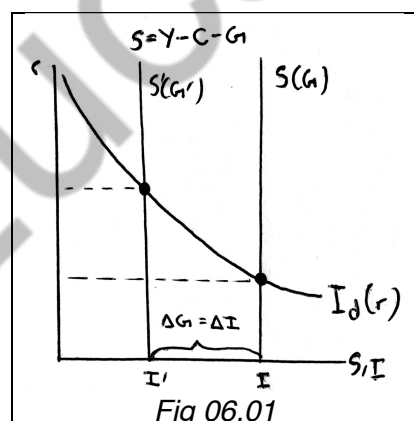
- 5y programme but... restricted by manifesto commitments to ring fence NHS, education and foreign aid. Government also committed itself to NATO 2% defence spending target.
- Cut Justice by 34% [closed 91 courts and tribunals and merged 31] and Work & Pensions 36% [largest part of gov; 1% limit on most benefit rises] and Local Government 51% [Lab controlled]

Effect

- Deficit was reduced but not to pre-crisis levels and debt continued to grow. See tables.
- Cutting government spending also has negative social consequences.
- ✓ In 2009-2010 gov. borrowed £1 in every £4 it spent. In 2015-2016 it was £1 in every £10. First monthly surplus achieved in April 2018.
- ✗ Government expenditure was 10% higher in 2016-17 than in 2010-11.
- Still spend 5% of government spending on debt interests (exc. BoE). 5th largest chunk.

Criticisms

- Keynes: recession $\Rightarrow \downarrow$ confidence $\Rightarrow \uparrow$ private savings $\Rightarrow \downarrow$ bond yields \Rightarrow signal to increase spending. Britain enjoyed German bond yields whilst still having a Greek deficit.
- Austerity only worsens Debt:GDP. BoE can always print money (unlike ECB) as virtually all debt is in £, and this may actually help deflationary environment!
- “If you owe the bank \$100 dollars, that's your problem; if you owe the bank \$100 million, that's the bank's problem.” But... banks may be reluctant to lend in the future.



POLITICAL AND SOCIAL INSTITUTIONS

07. Mix 'n' Match

Institutions

- Culture is value system of society and institutions set the rules. Collectively create incentive structure of economy, promoting policies and resolving collection action problems
- Formal: constitutions, laws: endogenise TFP instead of “manna from heaven” (DDR/BDR); contracts allow specialisation; property rights solve Tragedy of the Commons (see Fig 07.01)
- Informal: sanctions, taboo, customs: Solow says higher savings rate is necessary for long run wellbeing (see Fig 07.02); Bateman says EMP allowed GB to defy Malthus (see Fig 07.03)
- Especially relevant as today as we become more specialised and coordination more pertinent. But reverse causality and limitation of econometrics means still a black box.

Political

Effect: Case Study: Democracy

- Neoliberal: ensures rule of law and well-functioning free markets (i.e. enforces contracts), which in turn allows FWT to hold. Small government and high human capital helps as well.
- Progressive: Leaders are accountable to the public via elections, hence increased provision of public goods and better social policies. No tail risk of autocratic abuse.
- But... enhanced role of interest groups, short-term attitude ('political business cycle') and public choice theory suggests democratic government is not benevolent.
- Barro regression analysis finds democracy is weakly negative correlated with growth (inverted U-shape: helpful until moderate freedom is attained, then harmful/not-sig.)

Effect: Case Study: Colonialism

- Acemoglu, Johnson and Robinson: Use settler mortality (100y ago) as proxy for institutions were. Extractive colonial regimes focused on hoarding resources for the benefit of the few.
- Explains 50% of variation in GDP/today. Robust for climate, religion, natural resources, ethnolinguistic fragmentation etc. Explains African “development gap” with other LEDCs.
- But... Glaeser: correlation \neq causation. Institutions proxy for human-K. Data from 89 countries 1960-2000 show edu. levels can predict institutional outcomes but not vice versa.

Reverse Causality: Case Study: Glorious Revolution

- Political institutions determine *de jure* distribution of political power. Economic resources determines the *de facto*. Glorious Revolution was result of cumulative economic trend
- \uparrow Merchant's profits (due to trade) $\Rightarrow \uparrow$ de facto political power (monarch relied on their taxes) \Rightarrow got more concessions \Rightarrow powerful enough to create constitutional monarchy
- Lipset hypothesis: Countries accumulate human and physical capital under autocratic regimes, and then, once they are richer, improve their institutions e.g. post-war Asian Tigers.

Legal

Effect: Case Study: Common >> Civil Law

- Built-in judicial independence: jury, not a judge, makes ultimate decision so harder to capture (esp. government's 'power of the purse')
 - Generally have mandatory deadlines for judges, contingency fees for attorneys, and "loser pays" rules. All help suing government and big corporations.

- Based on precedence not comprehensive codes: places greater emphasis resolving private disputes and contracts rather than legislation and regulation
 - Better financial development as associated with higher shareholder protection, more efficient debt enforcement and less government ownership of banks.
- Less Formalism: Djankov et al.: explains 40% of variation in formalism (index of seven indicators) among 109 countries. Robust for latitude, religion, education, ethnolinguistic etc.
 - Better contract enforcement, hence enables market mechanism to function properly, hence Pareto-inefficient via FWT [Note reliance on neoliberalism throughout]
- La Porta 1960-2000: civil law countries grew 0.6% p.a. slower with similar differences in productivity and capital per worker
 - Robust for politics: Some claim proxy for elite who determined legal origins and what laws to enforce. But... political variables themselves explain little and results remain sig. (Differences in legal rules are accounted for to a significant extent by legal origins)
 - Not robust for human capital: Effect becomes weak. Glaeser and Shleifer: Each country developed most efficient legal system given context (Strong initial law-&-order allowed common law. Weak needed civil law.)

Social Capital

- Includes both 'bonding' (i.e. us vs. them; easy) and 'bridging' (e.g. globalisation; hard)
- Reciprocity enables cooperative solutions. Knack and Keefer: sd increase in country-level trust increases economic growth by more than $\frac{1}{2}$ sd. But could be proxy for human capital.
- Criticisms with many studies: Can we generalize from experimental games (Transfer more money to Western than Eastern Jews)? How reliable is macro data (migrants are self-selected) and surveys (don't always tell truth)?

Channel: Information Asymmetry

- Reduce opportunism: MVB GB dominated finance because overcame Akerloff lemons' market via old boys network
- Grameen Bank: loans to poor without collateral overcome with "solidarity lending" (group commitment)

Channel: Public Good

- Forest management's free rider problem in Gujarat India was solved by communal solution after government officials created too much conflict.
- Putnam: Meridionale Question (North vs South Italy) can be explained by density of voluntary associations. But... possibility of reverse causality.

Cause: Culture/Religion

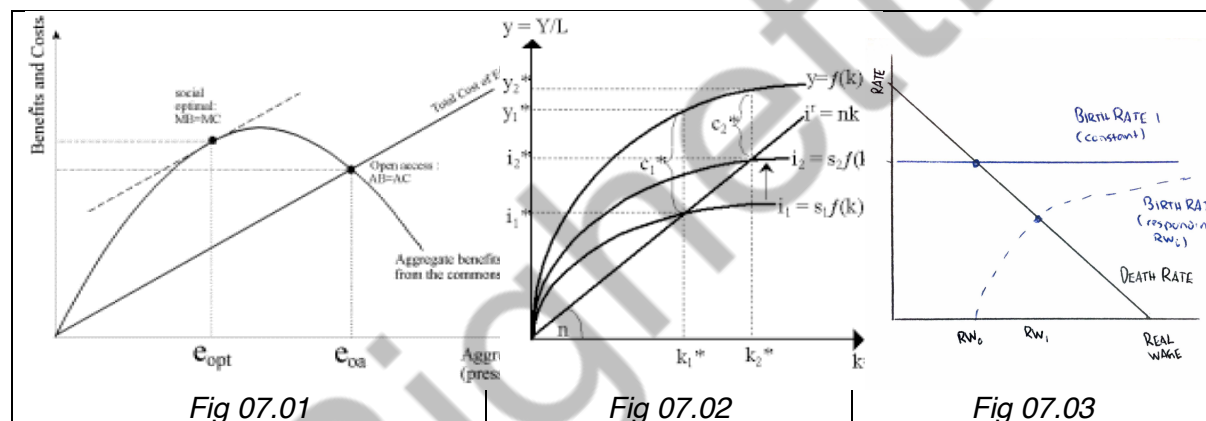
- Weber's Protestant Work Ethic North-West European success to "spirit of capitalism". Barro and McCleary back this via 59 country panel with six surveys: religion associated with SK.
- But... Norris and Inglehart: rich associated with secularisation. [u(religion or secular consumption); Higher wage increases opportunity cost of religion]
- Campante: increase in Ramadan fasting period associated with less growth in ME (robust and significant). Evidently, institutional context matters Hard to screen out other factors.

Cause: Government

- Can facilitate via reducing access costs (e.g. internet, public transportation) or creating opportunities/climate for people to meet (e.g. state schools, health & safety)
- Can replace private solutions (contracts replaced promises, increasing trust)
- But... Fukuyama: should not to overbear (Guilds became discriminatory' "Volksgemeinschaft")

Requirements

- Accountable: Beath et al.: Afghan elected councils generally decreased food aid embezzlement unless task was no clearly assigned. Tested 500 random villages.
- Small: Olson Paradox: smaller groups provide more public goods as defection cost is higher.
- Homogenous: Alesina et al.: spending on public goods in US localities 70s-90s is inversely related to ethnic fragmentation. Robust for socioeconomic and demographic factors.
 - Why? Different ethnic groups have different preferences and/or ethnic groups satisfaction is diminished by others. Hence don't pressure authorities as hard.
 - But can be overcome: Miguel: Tanzania built stronger national identity than similar Kenya. Kenya's hetero regions have 25% less primary school funding per pupil; Tanzania near 0%



08. Media

Affecting Growth

Moral Hazard

- Coyne and Leeson: The media increases political accountability by removing information asymmetries (politicians tend to be better informed than the electorate).
- Incentivises officials to not extract rents in line. Can overcome Reformer's Dilemma by turning game of conflict (politician. vs. electorate) into one of cooperation. See Fig 08.01
- In line with Game Theory's "Folk Theorem": Multi-person games end in cooperative solution given long time horizon as defection, though SR gain, is followed by LR punishment.
- Note this relies on populace holding 'good' beliefs (else 'good' laws are ineffective) and is willing to punish politicians that deviate (else 'bad' payoff is not negative for officials)
- Besley and Burgess: a 1% increase in local newspaper circulation in India was associated with a 2.4% increase in public food distribution and a 5.5% increase in calamity relief expenditure
 - Correlation \neq Causation? No! Stronger than any economic factors; robust for political variables; local association is much stronger than national (as they report on local floods)

Determine Policy

- Shape electoral outcomes by keeping voters informed (e.g. discussing manifesto pledges which no one would read) and scrutinising candidates (adverse selection).
- Down: Else voters would be "rationally ignorant" about politics as they have significant costs of being informed but only negligible benefits.
- Directly influence officials. Trump gets 'daily briefing' from 'Fox & Friends'. Segments are repeatedly mirrored by tweets and policy decisions (e.g. threat to cancel FISA Act)
 - Media is aware of this. Analysis of 17 months of their daily programs shows sentences that instruct and advise increased 15% after the election
- Indirectly choose talking points and vocalise public concerns. In China 500 students fell ill because school was built near former chemical plants but couldn't be reported on until after.
- But 'feedback loop' between polls and media attention. Media clearly has some clout given how much attention politicians give it ("It's The Sun wot won it", Blair and Murdoch Press)

Determine Behaviour

- Can inform or skew public on true costs and benefits of things. E.g. tobacco companies can run advertisements that show smoking as a harmless or organisations can run anti-smoking campaigns. Media is a tool like a knife, can be used for good or bad.

But... **Reverse Causality**: Effective institutions promote free/effective media.

[Optional] But... **Hurts Social Capital**

- Olken investigates the impact in Indonesia by collecting data from 600+ villages in Java on variation in signal reception (due to mountainous terrain AND varied roll out of private TV)
- Each additional strong-signal channel is associated with villagers watching 7 minutes more of TV every day. This is associated with less participation in social organisations and trust

- Effects felt more strongly among wealthier households, possibly because these are more likely to own TVs/radios. Suggests we aren't conflating correlation and causation.
- But... does not affect village governance, measured by amount of discussion in meetings and corruption road project

Public Choice Theory vs. Public Interest Theory

Revenue (PIT)

- Hayek: social good comes from individual actions (max profits max welfare). Journalists are incentivised to uncover "scoops" and keep readers informed (paid and promote careers).
- Reliance on sales means news is entertaining not informative and targeted to customer audience not objective (coverage and choice of stories)
- Reliance on advertising means issue because it may directly hinder a firm from reporting on certain stories due to threat of pulling sponsorships
- Government funding insulates from these pressures (e.g. BBC, PBS, ARD) and media can be regulated explicitly to show both sides (e.g. equal political ad airtime)

Monopoly (Both)

- PIT: Media industry is quasi-natural monopoly due to high fixed costs (see Fig 08.02). 1996 Telecom. Act deregulated radio stations and saw Clear Channel gain 25% market share.
 - Sinclair own 193 local TV stations and restricts diversity of opinion via 'must runs' (e.g. Daily "Terrorism Alert Desk", anti-Hillary package, unison "False News" script)
- PIC: In 1990s Seoul, the removal of licensing laws increased the number of different newspapers from 6 to 17
- PIT: Digitisation decreasing the marginal cost of distributing articles to essentially zero, media is becoming closer to a "winner-takes-all" market.
- PIC: Internet reduces barriers to entry and many web-based news companies (such as Vox and BuzzFeed news) have already disrupted the market.

State Capture (PCT)

- In "second best" world state uses media to assist politicians to extract rents in exchange for a share of the benefits, smearing opposition members or doing cover ups
 - Indirect control: Thatcher fired Board of Governor and replaced with Duke Hussey, someone with same vision. MP expenses whistle blower went to Telegraph not BBC.
- Beslet-Prat model: Private plurality prevents media capture: capturing one outlet yields small benefits; independent ownership increases transaction costs
 - Leeson: state ownership correlates to apathy (60 country test). 1989 Poland enshrined free speech and praised as key for quickest EE turnaround. But Lipset Hypothesis.
- Djankov et al examined media ownership in 97 countries in the late 1990s. Selection was broad, covering Americas, Asia, Africa, Middle East and Europe.
 - Find gov. ownership of media is higher in countries that are poorer, more autocratic regimes, and have lower levels of school enrolments
 - But... admit cannot be interpreted as causal without screening out other variables. Some notable counter example e.g. Singapore's top 5 newspapers are owned by PM's family.

Conclusion

- Plurality creates echo chambers, need unifying and reliable truth. But there is no single truth, so variety of opinions is best thing we have. State should set broad modus operandi.
- Ultimately, depends on institutional context of the country but tail risk of serious abuse is lower when media is free.
- Coyne and Leeson: privatise all aspects of the media industry; open borders to foreign investment and media; consumer demand is critical

