Jointly organized workshop by CESifo, the Center of Public Economics at TU Dresden and the Ifo Institute for Economic Research Dresden.

Conference venue:

**Ifo Dresden**
Einsteinstrasse 3
01069 Dresden
Germany

Summary program:

Friday, 19 November 2010
12.45 - 13.00  Welcome Address
13.00 - 14.00  Keynote Lecture  
**FRIEDRICH SCHNEIDER** (Johannes-Kepler-University Linz, CESifo)
14.15 - 19.15  Working Group Sessions
20.00   Conference Dinner

Saturday, 20 November 2010
09.00 - 11.30  Working Group Sessions
11.45 - 12.45  Keynote Lecture  
**BENJAMIN LOCKWOOD** (University of Warwick, CEPR, CESifo)
13.30 - 15.00  Working Group Sessions
15.00   End of conference
### Welcome Address

**12.45 - 13.00**  
CHRISTIAN LESSMANN (TU Dresden)

### Keynote Lecture

**13.00 - 14.00**  
**On the Political Economy of Environmental Policy: Why do we Observe so Little Sustainability in Representative Democracies**  
(room 1.5)  
FRIEDRICH SCHNEIDER (Johannes-Kepler-University Linz, CESifo)  
*Chair: Christian Lessmann (TU Dresden)*

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**White Costs of Moving to Black Opportunity: Residential Integration, Fertility and Human Capital**

LEONID V. AZARNERT (Bar Ilan University, CESifo)

Discussant: Alexander Kemnitz (TU Dresden, CESifo)

**A Different Look at Lenin’s Legacy: Trust, Risk, Fairness and Cooperativeness in the Two Germanies**

BERND SÜSSMUTH (University of Leipzig, CESifo)

Discussant: Friedrich Heinemann (ZEW Mannheim)

### Saturday, 20 November 2010

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Coffee Break
Friday, 19 November 2010, 13.00 – 14.00, Room 1.5

On the Political Economy of Environmental Policy: Why do we Observe so Little Sustainability in Representative Democracies

FRIEDRICH SCHNEIDER
Johannes-Kepler-University Linz, CESifo

Saturday, 20 November 2010, 11.45 – 12.45, Room 1.5


BENJAMIN LOCKWOOD
University of Warwick, CEPR, CESifo
The Tradeoff between Redistribution and Effort: Evidence from the World Value Survey
CLAUDIA BUCH / CHRISTOPH ENGEL
University of Tübingen, CESifo / MPI Bonn

Increasing economic welfare by providing conditions for economic growth while, at the same time, ensuring a level of income equality which is accepted by society are two main goals of governments. In trying to reach these goals, governments face a trade off. If government taxes income more heavily, it has more scope for restoring fairness of income ex post. However, the higher the tax rate, the lower the incentives of those with particularly high ability to work hard and to increase output. The smaller output, the less future generations may re-distribute. Building on a theoretical model which shows that effort choices and preferences for redistribution are simultaneously determined, we empirically investigate the development of preferences for redistribution, using cross-country panel data and experimental evidence. Our analysis has two main findings. First, it is important to model preferences for redistribution and effort choices simultaneously. Second, while respondents with stronger preferences for redistribution tend to have smaller incentives to engage in effort, the reverse does not hold true. Hence, encouraging higher effort need not have negative implications for redistribution.

Keywords:
JEL classification:

Explaining Preferences for Redistribution – a Unified Framework to Account for Institutional and Instrumental Approaches for the Case of Monetary Transfers for Families and Children
GUIDO MEHLKOP / ROBERT NEUMANN
Dresden University of Technology / Dresden University of Technology

Explanations for different patterns of preferences for redistribution either highlight the role of the institutional framework in a country or highlight the importance of self-interest and rational expectations. The study introduces a unified approach to explain differences in preferences for redistributive measures for the case of inter-generational monetary transfers for families and children. Both explanatory approaches are integrated into the action based theory of Frame Selection that incorporates normative motives and instrumental incentives into the process of decision making. Using a large sample (n=4096) that deals with questions on the approval of public policies for families and accounts for the normative importance of children and family life, we provide evidence that both approaches are valid to explain preferences for government transfers. But, the unit-specific evaluations of the results yield the conclusion that both approaches must not be generalized.

Keywords: welfare state, redistribution, family, decision-theory
JEL classification:
Are Government’s Fiscal Forecasts Different from those of Independent Agencies? Empirical Evidence and Political Economy Considerations

MARTA BOTELLA / ROSSANA MEROLA / JAVIER J. PÉREZ
University of Chicago / OECD / Bank of Spain

The fact that the literature tends to find biases in national fiscal projections has led to a growing claim in the academic and policy arenas for the need to introduce independent forecasts in the fiscal domain, prepared by independent agencies, like the European Commission (EC) in the case of Europe. Within this debate the aim of this paper is to test: (i) is the forecast performance record of governments indeed worse than that of international organizations?; (ii) are fiscal projections prepared by international organizations free from political economy distortions?; on related grounds, (iii) is it the case that government projections are less independent than EC (and OECD) fiscal forecasts? We build up a large real-time dataset for 15 European countries and focus on the period with a common fiscal policy regime, 1999-2007. The results point to the rejection of the three hypothesis; nevertheless, when the sample is split into “good” and “bad” times, the conclusions are toned down. Independent institutions were truly independent only in “bad” times. We rationalize the empirical analysis in the framework of a model in which an independent agency tries to minimize the distance to an unbiased government forecast. We exploit the idea that the government’s information set includes private information not available to outside forecasters. We show how such a framework can rationalize the observed empirical evidence and give some rationale to the strengthening of sanctions to misbehaving governments along the lines of the recent proposals suggested in European fora.

Keywords: forecast errors; fiscal policies; fiscal forecasting; political economy
JEL classification: H6; E62; C53

Fiscal Adjustment and the Costs of Public Debt Service: Evidence from OECD Countries

CHRISTOPH A. SCHALTEGGER / MARTIN WEDER
University of Lucerne, University of St. Gallen, CREMA, economiesuisse / University of Lucerne, economiesuisse

We use a panel of 21 OECD countries from 1970 to 2009 to investigate the effects of different fiscal adjustment strategies on long-term interest rates – a key fiscal indicator reflecting the costs of government debt service. A government confronted with high deficits and rising debt will sooner or later need to enact fiscal adjustments in order to avoid solvency problems. Over the last four decades, such measures taken by governments in OECD countries have varied in duration, size, composition and in their success to re-establish fiscal sustainability. Controlling for various economic, fiscal and political factors, we find that the size and the composition of a fiscal adjustment significantly affect interest rates as well as yield spreads. Adjustments that are relatively large and those that primarily depend on expenditure cuts lead to substantially lower long-term interest rates. However, periods of fiscal adjustments do not generally have an influence on interest rates, even if they were successful and led to lower deficits and debt levels. Instead, financial markets only seem to value strict and decisive measures – a clear sign that the government’s pledge to cut the deficit is credible.

Keywords: fiscal adjustment, consolidation policy, government deficit, long-term interest rates
JEL Classification: E61, E63, H61
According to NEG literature (Baldwin et al. (2004)), spatial concentration of industrial activities increases growth at the regional and aggregate level without generating regional growth differentials. This view is not supported by the data. We extend the canonical model with an additional sector producing non-tradable goods which benefits from localized knowledge spillovers coming from the R&D performing industrial sector. This view, motivated by the evidence, generates both an anti-growth and a pro-growth effect of agglomeration for both the deindustrializing and the industrializing regions and leads to two novel results: 1) when agglomeration takes place, growth is lower in the periphery; 2) agglomeration may have a negative effect on the growth rate of real income, both at the regional and at the aggregate level. In particular, the economy as a whole might suffer a dynamic loss from agglomeration when: 1) the spatial range of the technological spillovers within the R&D sector; 2) the external benefit of local and foreign knowledge capital on non-tradable sector productivity; 3) the expenditure share on non-tradable goods are all large enough. These results are consistent with the empirical evidence reporting regional real income divergence and according to which the trade-off between aggregate growth and interregional equity loses relevance in more advanced stages of development. Our conclusions have relevant policy implications: contrary to the standard view, current EU and US regional policies favouring industrial dispersion might be welfare-improving both at the regional and the aggregate level and may reduce regional income disparities.

Keywords: aggregate real growth, regional real growth, interregional equity, non-tradables, localized knowledge spillovers

JEL classification: R10, O33, O41

Autocratic Transitions and Growth

TOMMASO NANNICINI / ROBERTO RICCIUTI
Bocconi University, IGIER, IZA / University of Florence, CESifo

In this paper we use a transparent statistical methodology – synthetic control methods – to implement data-driven comparative studies about the impact of autocratic transition on real per capita GDP. The applied methodology compares the growth of countries that experienced a transition to autocracy with the growth of a convex combination of similar countries that remained democratic, and it accommodates for the time-varying impact of unobservable heterogeneity. We implement this statistical framework on a panel of 160 countries, and focus on 14 episodes of transition from democracy to autocracy. We find that the effects of autocratic transitions come in all shapes and sizes, since our data are split in almost equal parts between insignificant, negative, and positive effects. We also find that negative effects tend to get worse over time, and that African countries are badly affected by the autocratic transition possibly because of a resource curse.

Keywords: autocracy, democracy, growth, synthetic control methods

JEL classification: C21, C23, O43, O57
An Offer you can’t Refuse: Murdering Journalists as an Enforcement Mechanism of Corrupt Deals
CHRISTIAN BJØRNSKOV/ ANDREAS FREYTAG
Aarhus University/ Friedrich Schiller Universität Jena

Anecdotal evidence suggests that journalists and bureaucrats in some countries are killed when they try to blow the whistle on corruption. We demonstrate in a simple game-theoretical model how murders can serve as an enforcement mechanism of corrupt deals under certain regime assumptions. Testing the main implications in an unbalanced panel of 179 countries observed through three periods, we find that corruption is strongly related to the incidence of murders on journalists in countries with almost full press freedom. While our results provide evidence that journalists are killed for corrupt reasons, they also suggest that some countries may have to go through violent periods when seeking to secure full freedom for the press.

Keywords: corruption, rent-seeking, murder
JEL classification:

Ties That Do Not Bind (Directly): The Education Terrorism Nexus Revisited
SARAH BROCKHO / TIM KRIEGER / DANIEL MEIERRIEKS
Bielefeld University, University of Freiburg / University of Mainz, University of Paderborn / University of Paderborn

This contribution offers a comprehensive empirical analysis of the effects of education on terrorism for 118 countries for the period 1984 to 2007. We find that education and terrorism are not directly linked, so that education neither fosters nor retards terrorism on its own. Rather, our results suggest that education may fuel terrorist activity in the presence of poor political and socio-economic conditions, whereas better education in combination with favorable conditions decreases terrorism. Thus, the precise effect of education on terrorism depends on country-specific conditions. A successful anti-terrorism strategy should therefore focus on a country’s political and socio-economic development, in addition to educational attainment.

Keywords: education, terrorism, counter-terrorism, development strategies, conditional effects
JEL classification: H56, D74, O15, H52, I2, N40
A model of party formation and competition
DAN LADLEY / JAMES ROCKEY
University of Leicester / University of Leicester

This paper investigates the behaviour of a Citizen-Candidate Model in a simple framework with many large constituencies, many policy dimensions, and endogenous coalition formation. A model is simulated in which districts elect representatives who themselves interact to form parties. Competition between parties of different sizes and with different platforms is an emergent property of the model which leads to stable equilibria. The paper shows that the widespread usage of the Citizen-Candidate model may be empirically justified. Our results demonstrate how the number of policy dimensions and representatives elected per electoral district influence the number, size, and relative locations of parties and consequently the possible stable equilibria. Comparison with election data shows strong correspondence between the model’s results and observed outcomes, including variation consistent with Duverger’s law.

Keywords:
JEL classification:

Tying Your Enemy’s Hands in Close Races: The Politics of Federal Transfers in Brazil!
FERNANDA BROLLO / TOMMASO NANNICINI
Universidad de Alicante / Bocconi University, IGIER, IZA

We apply a regression discontinuity design in close electoral races to identify the effect of political alignment on federal transfers to municipal governments in Brazil. We find that municipalities where the mayor is affiliated with the coalition of the President – in the last two years of the mayoral term – receive larger (discretionary) infrastructure transfers by about one-third. This effect is mainly driven by the fact that the federal government penalizes municipalities run by mayors from the opposition coalition who won by a narrow margin, thereby tying their hands for the next election. Politically motivated transfers are larger for first-term mayors, who have higher reelection incentives; for mayors unaligned with the state governor, who may have a hard time obtaining state transfers; and in small towns without a radio station, where the influence of mayors on local politics is stronger.

Keywords: intergovernmental grants, political alignment, regression discontinuity
JEL classification: C21, D72, H77
White Costs of Moving to Black Opportunity: Residential Integration, Fertility and Human Capital
LEONID V. AZARNERT
Bar Ilan University, CESifo

This article analyzes the disadvantageous consequences of involuntary residential integration for the local population of the desegregated neighborhoods. The analysis suggests that desegregation can negatively affect the level of consumption, lead to a reduction in per-capita investment in children’s human capital and decrease fertility. The present model shows that for more educated (wealthy) individuals, out-migration from a desegregated neighborhood is optimal, while the less educated (poor) cannot afford to resort to the White Flight. The analysis also demonstrates that the poor, who cannot afford to avoid the forcible integration, suffer from a higher negative effect than the rich, who can resort to the White Flight and lower their losses.

Keywords: integration policy, moving to opportunity, white flight, fertility, human capital
JEL classification: I2, J1

A Different Look at Lenin’s Legacy: Trust, Risk, Fairness and Cooperativeness in the Two Germanies
GUIDO HEINECK / BERND SÜSSMUTH
IAB, IZA Bonn / University of Leipzig, CESifo

What are the long-term effects of Communism on economically relevant notions such as social trust? To answer this question, we use the reunification of Germany as a natural experiment and study the post-reunification trajectory of convergence with regard to individuals’ trust and risk, as well as perceived fairness and cooperativeness. Our hypotheses are derived from a model of German reunification that incorporates individual responses both to incentives and to values inherited from earlier generations as recently suggested in the literature. Using data from the German Socio-Economic Panel, we find that despite twenty years of reunification East Germans are still characterized by a persistent level of social distrust. In comparison to West Germans, they are also less inclined to see others as fair or helpful. Implied trajectories can be interpreted as evidence for the passing of cultural traits across generations and for cooperation being sustained by values rather than by reputation. Moreover, East Germans are found to be more risk loving than West Germans. We ascribe this finding to path dependence as the evolution of a general notion of risk aversion at the societal level requires a democratic experience, where public deliberation plays a crucial role in evaluating risk. In contrast to trust and fairness, full convergence in risk attitude is reached in recent years.

Keywords: social trust, risk attitudes, political regimes, German reunification
JEL classification: P51, Z31
Saturday, 20 November 2010, 09.00 – 09.45, Room 1.5

Intrinsic Work Motivation and Pension Reform Acceptance
FRIEDRICH HEINEMANN / TANJA HENNIGHAUSEN / MARC-DANIEL MOESSINGER
ZEW Mannheim / ZEW Mannheim / ZEW Mannheim

Although demographic change leaves pay-as-you-go pension systems unsustainable, reforms such as a higher pension age are highly unpopular. This contribution looks into the role of intrinsic motivation as a driver for pension reform acceptance. Theoretical reasoning suggests that this driver should be relevant: The choice among different pension reform options (increasing pension age, increasing contributions, cutting pensions) can be modelled as an optimization problem for the individual voter. In this optimization, intrinsic job satisfaction matters as it decreases the subjective costs of a higher pension age. We test this key hypothesis on the basis of the German General Social Survey (ALLBUS). The results are unambiguous: In addition to factors such as age or education the inclusion of intrinsic work motivation helps to improve our prediction of an individual’s reform orientation. Our results are of importance for reform acceptance beyond the specific topic of pension reform. They point to the fact that the support for welfare state reform is also decided at the workplace.

Keywords: pension system, reforms, pension age, ALLBUS
JEL classification: D78, H55, H31

Saturday, 20 November 2010, 09.00 – 09.45, Room 1.7

Paying a Visit: The ‘Dalai Lama Effect’ on International Trade
ANDREAS FUCHS / NILS-HENDRIK KLANN
Georg-August University Goettingen / Georg-August University Goettingen

China is generally regarded neither as a democracy, nor as a free market economy. Therefore, the state of its bilateral political relations has more room to affect trade than in a market system where – at least in theory – prices and further product characteristics alone determine import decisions. This paper investigates the extent to which the state of bilateral relations has an impact on trade with China. China frequently threatens, in a more-or-less open manner, that meetings between its trading partners’ officials and the Dalai Lama will be met with animosity and lead to subsequent deterioration in the state of their trade relationships. We use data on foreign dignitaries met by the Tibetan leader to test whether countries officially receiving the Dalai Lama are economically punished by the Chinese through trade reductions.

We run a gravity model of exports to China from 159 partner countries between 1991 and 2008 to test for political influences on China’s trading decisions. Our variable of interest is a binary dummy variable, which takes a value of 1 if the Dalai Lama was received by an official in a partner country in the current or previous year. In order to account for the potential endogeneity of meetings with the Dalai Lama, both the number of Tibet Support Groups and the travel pattern of the Buddhist leader are used as instruments in a 2SLS regression framework. Our results indicate that China punishes countries that receive the Dalai Lama at the highest political level. However, this ‘Dalai Lama Effect’ is only observed for the Hu Jintao era and not for earlier periods.

Keywords: international trade, international political economy, diplomatic relations, China
JEL Classification: F13, F51, F59
Saturday, 20 November 2010, 10.00 – 11.30, Room 1.5

Electoral Control under Decentralization: Decentralization as unbundling of public goods provision.
ANTONIO FARFAN-VALLESPIN
Albert Ludwig University of Freiburg

This paper addresses the question of whether a decentralized government is subject to a stronger level of electoral control than a centralized government. Electoral control is exerted by the voter through the threat of not re-electing the incumbent if his performance is below a certain level. We model an economy with two public goods: a lower tier public good (public goods of sub-national or local scope) and an upper tier public good (public goods of national scope), both subject to stochastic shocks. We define centralization as the joint provision of both public goods, upper tier and lower tier, by one single provider, subject to re-election constraint. Decentralization is defined as the separate provision of each public good by a different provider, each of them subject to re-election constraint. Under this novel framework we find two new effects in the trade-off between decentralization and centralization: under centralization there are potential advantages derived from bundling the provision of both types of public goods, whereas under decentralization there are potential advantages derived from a clear delimitation of the responsibilities of the provider of each type of public good. We show that the trade-off depends on the probability distribution of the shocks and on the size of these shocks.

Keywords: Decentralization; electoral control; provision of public goods, bundling of issues
JEL Classification:

Free-riding or Internalizing? An Opportunistic View on Decentralization versus Centralization
FABIO FIORILLO / AGNESE SACCHI
University of Ancona / University of Urbino

The aim of the paper is to analyze a model of local public good provision with positive interjurisdictional spillovers comparing decentralized and centralized system. As in the recent Second Generation Theory (SGT) of fiscal federalism (Seabright 1996; Lockwood 2002; Besley and Coate 2003; Oates 2005; Weingast 2009), we also adopt a political economy approach, assuming different behaviours of political leaders (Leviathan and non-Leviathan). The main contribution of the paper is to consider two relevant aspects neglected by the political economy models: the size of local jurisdictions and the explicit definition of the rent-seeking behaviour. Moreover, modelling interregional externalities as a mechanism contributing to lowering the production cost of the public good in each region, a quite different trade-off - from the traditional and new theory of fiscal federalism - is proposed in order to compare decentralized versus centralized solution: the gains from internalizing externalities and the losses of free-riding advantages, which may differ with regional size and preferences for the public good. Given this general framework, the convenience of decentralization versus centralization mainly depends on the interaction among these factors: i) the free-riding gains exploiting positive externalities; ii) the gains of internalizing externalities; iii) the degree of preferences heterogeneity; iv) the implicit transfers (“cross subsidization”) across different regions. To summarize, from a positive viewpoint, decentralization should not be necessarily pursued only in the absence of externalities, but also with high spillovers. The key insight of this result is represented by different size of regions, which may determine an asymmetry among citizens’ responses concerning the best institutional setting.

Keywords: decentralization; spillovers; free-riding; rent-seeking behaviour; local public goods
JEL Classification: H73, H77, H41, D72
There is an interesting pattern in politics showing that campaigns which used to be dominated by socio-economic issues are now focusing also on other issues such as religion, moral values or the environment. The purpose of this model is to explain the presence of certain issues in electoral campaigns. In my setup issues differ in their divisiveness, to be defined as the extent to which members within a coalition disagree. Political candidates face a trade-off; they can either choose unifying issues which strengthen their own (but eventually also their opponent) constituency or divisive issues which weaken the opponent (but eventually also their own) supporters. Using a model of probabilistic voting, I derive equilibrium campaign strategies of the candidates and interestingly, predictions on equilibrium turnout. In particular, we describe how candidates make use of priming, to be interpreted as a special form of persuasion. The main results are that: 1) divisive issues are mostly used by a candidate to target the "disagreement" group within the more heterogeneous (and/or less partisan) constituency, 2) ceteris paribus, an increase in informational barriers (due to new media) among voters, raises the scope for priming both cohesive and divisive issues to different groups and, 3) turnout decreases (increases) among the voters most targeted with divisive (cohesive) issues. We also present empirical evidence on 2004 US Presidential campaign consistent with the theory. Overall the analysis shows how diversity in voters preferences and features of the media sector affect electoral turnout rates through the strategic use of disagreement within coalitions by candidates. Moreover, taking into account the effects of different campaign activities, my results on turnout suggest that previous evidence of the minimal effect of campaigns might come from averaging out the effects for different portions of the electorate.

Keywords: political campaigns, persuasion, priming, media
JEL classification: D72, D83, L82

The existing literature on lobbying is large, but only a few papers allow for the interaction of post-election lobbying and the voting decision of forward-looking voters. Besley and Coate (2001) use their well-known citizen candidate framework and find that if citizen candidates with sufficiently extreme preferences are available, lobbying has no influence on equilibrium policy. I show that this result does not apply in a more realistic model with ideological parties instead of citizen candidates because the parties cannot adjust their policy positions. In a two-party system, even if forward-looking voters are aware that lobbying will take place, their choice between policies is different when lobbies do and do not exist. However, often the average and/or the median voter are better off with lobbying.

Keywords:
JEL Classification:
Social versus Tribal Conflict and the Determination of Political Regimes and their Boundaries
CHRISTOPHER ELLIS / SILKE FRIEDRICH
University of Oregon, Eugen / ifo Institute for Economic Research Munich

In this paper, we develop a theoretical model of the dissolution of countries. We model a society with two different groups of citizens (we call them tribes), who have different preferences over public goods. We use this framework to analyze how conflicts - and the threat of such conflicts - can determine the political regime of a country and its boundaries. Differentiating between revolutions and civil wars allows us to look at the effects of both forms of political violence separately. We find that while the threat of a revolution can induce oligarchies to increase the franchise, the threat of a civil war can induce a country to dissolve peacefully. Our model predicts that peaceful dissolution is more likely in democracies, whereas oligarchies are more likely to risk civil war to stay united. In democracy, the threat of a civil war, which is the possibility that the elites gain political power as a result of the civil war, induces dissolution. In an oligarchy, the threat of a revolution is least pronounced if the country stays together, which makes it more likely that an oligarchy stays united.

Keywords:
JEL classification:

Beyond Divide and Rule: Sparking Civil War to Hold on Power
GIACOMO DE LUCA / PETROS SEKERIS
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We propose a model where an autocrat rules over an ethnically divided society. The dictator carefully selects the tax rate over the subjects’ production and the nation’s natural resources to maximize his rents under the threat of a revolution. We show that it may be in the interest of a weak ruler to foster civil strife to increase fiscal pressure. By exacerbating existing group antagonisms the leader weakens potential opposition. Large stocks of natural resource and an unequal distribution across ethnic groups makes this strategy more profitable for the ruler.

Keywords:
JEL classification:
Do Countries with Poor Human Rights Records Receive Less Disaster Relief?
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While humanitarian considerations play a role in the decision to grant relief to countries affected by natural disasters, donors may be less likely to provide assistance to countries they perceive as human rights violators. This paper tests the relationship between human rights records and U.S. disaster relief. The results suggest that countries with poorer human rights record are less likely to receive assistance from the U.S. government following a natural disaster, and that those that do obtain aid receive a smaller amount.

Keywords: Disaster Relief; Foreign Aid; Natural disasters; Human Rights
JEL Classification: D7, H5, F35

Does Conditionality Work? A Test for an Innovative US Aid Scheme
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Georg-August University Goettingen / Kiel Institute for the World Economy / Georg-August University Goettingen, KOF, IZA, CESifo

Performance-based aid has been proposed as an alternative to the failed traditional approach whereby donors make aid conditional on the reform promises of recipient countries. However, hardly any empirical evidence exists on whether ex post rewards are effective in inducing reforms. We attempt to fill this gap by investigating whether the Millennium Challenge Corporation (MCC) was successful in promoting better control of corruption. We employ a difference-in-difference-in-differences (DDD) approach, considering different ways of defining the treatment group as well as different time periods during which incentive effects could have materialized. We find evidence of strong anticipation effects immediately after the announcement of the MCC, while increasing uncertainty about the timing and amount of MCC aid appear to weaken the incentive to fight corruption over time. We conclude that – if designed properly – conditionality can work.

Keywords: foreign aid, corruption, Millennium Challenge Corporation, MCC effect
JEL classification: F35, O17
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