The Influence of Political Distortions on Economic Performance

The contributions of Alberto Alesina

An interview with introduction by Brian Snowdon

“A politico-economic approach takes into account the institutional constraints and rigidities in which policymaking occurs by emphasising the role of distributive conflicts, ideological and opportunistic incentives of the politicians, and other factors.”

(Alesina, 1994)

“Most economists have now come to the realization that good economic advice requires an understanding of the political economy of the situation.”

(Rodrik, 1996)

“It is heterogeneity of interests that is the basis of the field of political economy.”

(Drazen, 2000a)

Introduction

The relationship between the economy and the political system has always attracted the interest of economists since it is obvious that politics will influence the choice of economic policies and consequently economic performance. During the last thirty years, research into the various forms of interaction between politics and economic performance has become a major growth area. For example, a field known as ‘the new political macroeconomics’, a research area which has developed at the interface of macroeconomics, social choice theory and game theory, is now well
established.\textsuperscript{1} This burgeoning field makes specific use of the modern technical apparatus of economic analysis to investigate numerous key public policy issues such as business cycles, the conduct and implementation of stabilization policies, the relationship between dictatorship, democracy, inequality and economic growth, the origin of persistent budget deficits, international integration and the size of nations, and the impact of ethnic diversity on economic performance.

Major contributions to this field of research activity, both in terms of theoretical analysis and empirical investigation, have come from Professor Alberto Alesina of Harvard University. Since 1987 over seventy of his influential papers have been published in leading academic journals, and to date he has also co-authored or edited nine books.\textsuperscript{2} As this article reveals, a major feature of Alesina's research is its originality. Both he and his co-researchers have repeatedly made imaginative use of the tools of modern economic analysis to explore a wide range of important and controversial contemporary issues. In the interview that follows, Professor Alesina gives his views on several important contemporary issues, including: politics and the business cycle, budget deficits, currency unions, the European Union, the size of nations, economic growth, inequality, democracy, foreign aid, ethnic fractionalisation, and the welfare state in the US and Europe. First, I will provide a brief review of some major issues in the research agenda of the ‘new political economy’ to set the interview in context.

\textbf{Political distortions to policymaking}

The ‘benevolent dictator’ image of government acting as a platonic guardian of social welfare, has increasingly been criticised by economists. In particular, many economists have called into question the assumption that elected politicians will always pursue policies aimed at maximizing net social benefit. Although Keynes had an extremely low opinion of the intellectual capacity of most politicians, in the context of his era it never really crossed his mind to view the political process as a marketplace for

\textsuperscript{1} See Alesina, Roubini and Cohen, 1997; Drazen, 2000a, 2000b; Gärtner, 2000; Hibbs, 2001.
\textsuperscript{2} Details of Professor Alesina's publications can be found at http://post.economics.harvard.edu/faculty/alesina/alesina.html
votes. In terms of the *ideal* policy making process, Keynes had in mind a variant of what can be described as a linear model. In this framework the role of the economist is to offer advice, predictions and prescriptions, based on sound economic analysis, to role-oriented politicians responsible for policymaking. In such a model it is assumed that politicians will automatically take the necessary actions to maximize social welfare by following the impartial and well-informed advice provided by their economic advisors. This linear idealized view of the policymaking process is illustrated in the upper part of Figure 1.

From a new political economy perspective, policymakers will be heavily influenced by powerful societal and state-centred forces rather than acting impartially on the advice of economists. In reality societies are often fragmented and heterogeneous, especially if there are significant religious, ethnic, linguistic and geographical divides compounded by extreme inequalities of income and wealth. As a result, governments will

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3 In correspondence with Duncan Grant, in 1911, Keynes made the following observation about politicians: “You haven’t, I suppose, ever mixed with politicians at close quarters. They’re aweful. I think some of these must have been dregs anyhow, but I’ve discovered what previously I didn’t believe possible, that politicians behave in private life and say exactly the same things as they do in public. Their stupidity is inhuman”. See Moggridge, 1992, p. 191.

4 See Alesina *et al.*, 2003.
frequently be preoccupied with conflict management, representing particular rather than general interests, responding to a constantly shifting balance of preferences. Therefore, policy advice is mediated through a political system that reflects a balance of conflicting interests that inevitably arise in a country consisting of heterogeneous individuals. In the *society-centred approach* various groups exert pressure on the policymaker to ‘supply’ policies that will benefit them directly or indirectly. While neo-Marxists typically focus on class struggle and the power of the capitalist class, the new political economy literature highlights the influence of various interest groups (e.g. farmers), political parties and voters. 

In the *state-centred approach*, emphasis on the role of technocrats is equivalent to accepting the ‘benevolent dictator’ assumption. In contrast, the new political economy literature focuses on the impact that bureaucrats and state interests exert on the policymaker.

In modelling politico-economic relationships it is important to view the government as standing at the centre of the interaction between political and economic forces. Incumbent politicians are responsible for the choice and implementation of economic policy and their behaviour will clearly be shaped by the various institutional constraints which make up the political system. Accordingly, a politico-economic approach to the analysis of macroeconomic phenomena and policy highlights the incentives which influence politicians and distort their policy choices.

**Politicians and stabilisation policy**

According to Frey (1978) the traditional Keynesian circular flow model needs to be modified to take account of self-interested government behaviour. The politico-economic system resulting from this modification is illustrated in Figure 2.

There is no doubt that following the Keynesian revolution, voters have increasingly held governments responsible for the state of the economy. As is evident from Figure 2, in the politico-economic circular flow model politicians are seen to be driven by a balance of both ideological and reelection considerations. Alesina (1994) has highlighted two general political forces that are always likely to play a crucial distorting role in the conduct of policy. The first factor is the incumbent policymaker’s desire to retain power, which acts as an incentive to ‘opportunistic’ behaviour. Voters
evaluate politicians on the basis of how successful they have been in achieving desirable economic goals such as high employment, low inflation and rapid growth of real disposable incomes. The state of the economy in the immediate pre-election period is crucial and politicians are obviously aware that in order to survive in government it is preferable to have a buoyant economy. If economic conditions are unfavourable, voters may well choose to elect the opposition party and the incumbents lose office. Meanwhile the opposition party makes attractive promises to the electorate. Therefore economic conditions influence election results and the

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5 Recall, for example, George Bush Snr.’s famous 1988 pre-election pledge… “Read my lips, no new taxes”.

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incentive to get elected directly influences the choice and use of macroeconomic policies.

Second, society is polarised and this inevitably gives rise to some degree of social conflict. As a result ideological considerations will manifest themselves in the form of ‘partisan’ behaviour and actions. Hibbs (1977) examined the post-war patterns of economic policies and outcomes in twelve advanced capitalist democracies for the period 1945–69 in order to test the proposition that left- and right-wing governments have different preferences with respect to the trade-off between inflation and unemployment. Hibbs argued that the empirical evidence supported the ideological view of macroeconomic policymaking that the differing interests of various occupational groups will be reflected in the policy preferences of left- and right-wing political parties. Hibbs (1987) also found significant partisan effects on the distribution of income and, more recently, Bartels and Brady (2003) concluded that the “consistent partisan differences in economic performance identified by Hibbs remain alive and well two decades later” and partisan influences have had a “profound influence on the workings of the US economy”.

During the past 30 years economists have produced a rich array of politico-economic models which incorporate many of these considerations. The interdependence between the economy and the polity is now a well-established area of research for economists interested in identifying the underlying causes of aggregate instability. This research has attempted to answer a number of interesting questions, for example:

1. how important are economic factors in influencing voter choice? (Frey and Schneider, 1988);
2. do opportunistic politicians manipulate the economy for political profit? (Nordhaus, 1975);
3. do ideological (partisan) considerations lead to political parties producing a differentiated product? (Hibbs, 1977; Alesina, 1988);
4. can political cycles exist in a world of rational non-myopic voters and economic agents? (Alesina, 1987; Rogoff and Sibert, 1988);
5. does the empirical evidence provide support for politico-economic models? (Alesina, Roubini and Cohen, 1997);
6. what are the policy implications of such models? (Alesina, 1989; Alesina and Gatti, 1995; Drazen, 2000a, 2000b)
Alternative approaches to the ‘political business cycle’

In the theoretical literature on the political business cycle, which has developed since the mid-1970s, we can distinguish five main approaches which have evolved in two separate phases. The main assumptions and predictions of these five different approaches are summarized in Table 1.

During the first phase, in the mid- to late 1970s, Nordhaus (1975) reawakened interest in this area by developing an opportunistic model of the political business cycle. This was followed by Hibbs (1977) who emphasized ideological rather than office-motivated considerations. An alternative hypothesis, suggested by Frey and Schneider (1978a; 1978b) is that political parties behave in an opportunistic way when their chances of re-election are perceived to be low, but when a party is ‘popular’, and confident of winning the next election, it can afford to indulge in ideological policies. Because the temptation to use opportunistic policies is strongest when governments do not feel confident they can win the next election, opportunistic behaviour will be an increasing function of the incumbents’ political insecurity.

However, these models were swept aside somewhat during the so-called rational expectations revolution which dominated macroeconomic discussions during the mid- to late 1970s. After a period of relative neglect a second phase of politico-economic models emerged in the mid-1980s, and research in this area has continued to flourish ever since. Due to the influence of new classical theorists, these new models incorporate the assumption of rational economic agents and voters. While economists such as Rogoff and Sibert (1988) developed rational opportunistic models, Alesina (1987) developed a rational partisan theory.

Rational partisan theory

Hibbs (1977), in his partisan theory of macroeconomic policy choices, argued that parties of the left will systematically select combinations of unemployment (lower) and inflation (higher) which differ from those preferred by right-wing parties. However, following the rational expectations revolution, theorists questioned the ability of policy makers to influence

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6 See Alesina, 1988; Gartner, 2000; Frey and Benz, 2002; Snowdon and Vane, 1999a, 2005.
Table 1: Alternative politico-economic models

<table>
<thead>
<tr>
<th>Politico-economic model</th>
<th>Main assumptions</th>
<th>Predictions</th>
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<tbody>
<tr>
<td>Non-rational opportunistic business cycle theory (Nordhaus, 1975)</td>
<td>Expectations augmented Phillips curve. Politicians only care about re-election. Agents are myopic and have non-rational expectations.</td>
<td>All governments, both Left and Right, behave the same. Output will increase and unemployment will fall before an election. Inflation will accelerate as the election approaches but will peak and be observed by voters after the election. Discretion leads to an inflation bias in democracies.</td>
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<tr>
<td>Strong partisan theory (Hibbs, 1977)</td>
<td>Exploitable Phillips curve trade-off. Policymakers and voters are ideological and non-rational. Left of centre parties have a strong aversion to unemployment relative to inflation. Right of centre parties have a strong aversion to inflation relative to unemployment.</td>
<td>Governments of different ideological persuasions will have different macro economic priorities with respect to inflation and unemployment. Governments of the Right will tend to have persistently higher unemployment and less inflation than parties of the Left.</td>
</tr>
<tr>
<td>Weak partisan theory. Opportunistic-partisan synthesis (Frey and Schneider, 1978a)</td>
<td>Politicians alternate between partisan and opportunistic behaviour. Actual behaviour of politicians depends on their ‘popularity surplus’ in the polls.</td>
<td>If incumbent’s popularity is in deficit (below some critical level) prior to an election, the incumbent switches from partisan to opportunistic behaviour. Incumbents with a popularity surplus behave ideologically.</td>
</tr>
<tr>
<td>Rational opportunistic theory (Rogoff and Sibert, 1988)</td>
<td>Short-run Phillips curve trade-off. Agents have rational expectations but imperfect information. Voters elect the party that they expect to perform best. Politicians care only about re-election.</td>
<td>All governments behave the same. Monetary growth and fiscal expansions before elections.</td>
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<tr>
<td>Rational partisan theory (Alesina, 1987)</td>
<td>Short-run Phillips curve trade-off. Agents have rational expectations but election outcomes are uncertain. Left of centre parties have a strong aversion to unemployment relative to inflation. Right of centre parties have a strong aversion to inflation relative to unemployment.</td>
<td>Left of centre governments produce an inflation bias compared to Right of centre governments. Output is above (below) the natural rate at the beginning of a Left (Right) of centre government. The partisan effect of monetary policy on real variables is temporary.</td>
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Source: Snowdon and Vane, 2005; adapted from Edwards, 1994.
real economic activity using systematic aggregate demand management policies. Alesina, in a series of publications, demonstrated that the partisan theory of political business cycles can survive in models incorporating rational expectations providing that (i) voters are uncertain about election outcomes, and (ii) uncontingent labour contracts are signed for discrete periods and are not subject to renegotiation after the election result is declared (see Alesina, 1987; 1988; 1989). In Alesina’s model, economic agents cannot enter into state-contingent nominal wage contracts that provide insurance against electoral risk. Central to the rational partisan theory is the idea that the political systems of many industrial democracies are polarized.

In the partisan theory, politicians are ideological and adopt different policies when in power. “There is no presumption that in a multi-party system with self-interested politicians one should observe policy convergence” (Alesina, 1989). In the case of the US, empirical work has shown that although the degree of polarization has varied throughout American history, the Republican and Democratic parties have never fully converged (Alesina and Rosenthal, 1995). In Alesina’s model, macroeconomic policies create short-run aggregate disturbances because rational voters are uncertain about election results. When Republicans or Conservatives are elected, economic agents are confronted in the period immediately following the election with a deflationary shock, that is, inflation is lower than expected. When Democratic and Socialist governments are elected, the opposite occurs. There is a larger than expected ‘inflation surprise’. It is the combination of election outcome uncertainty and ideological differences between the two parties that leads to aggregate instability in Alesina’s model. If a common macroeconomic policy could be agreed between the two political parties, aggregate fluctuations would be reduced. We can therefore summarize the predictions of the rational partisan theory of the business cycle:

A1 A change to a Conservative or Republican government will be followed by a recession and rising unemployment. Once inflationary expectations have been reduced, output growth returns to its natural rate. Inflation is low as the next election approaches.
A2 A change to a Labour or Democratic government will be followed by an acceleration of inflation as the economy expands more rapidly.
Alberto Alesina interviewed by Brian Snowdon

Unemployment will initially fall. Once inflationary expectations adjust, output growth returns to its natural rate but inflation remains high. Should a government of the Left attempt to fight inflation in the run up to the next election it will create a recession.

A3 The stronger the ideological convictions of the two parties, the greater will be the disturbance to output and employment following a change of policy regime after an election.7

A4 Unlike the Hibbs model, the rational partisan theory predicts that differences in unemployment and growth resulting from changes in government will only be a temporary phenomenon.

A considerable amount of empirical work has been done to test the rational partisan theory (see Alesina and Sachs, 1988; Alesina, 1989; Alesina and Roubini, 1992; Alesina and Rosenthal, 1995). These studies have found supporting evidence for temporary partisan effects on output and employment and long-run partisan effects on the rate of inflation as predicted.8 For the US, systematic differences have been found to occur in the first half, but not the second half of a large number of administrations. Alesina concludes that the more recent rational versions of politico-economic models of cycles have been much more successful empirically than the earlier models of Nordhaus and Hibbs. In particular, ‘partisan effects’ appear to be “quite strong” while ‘opportunistic effects’ appear to be “small in magnitude” and seem to affect only certain policy instruments, particularly fiscal variables (see Alesina, 1995). It is also well documented that during the Reagan and Thatcher administrations the income distribution consequences of the micro and macro policies were “particularly partisan”. Inequality increased under both administrations (see Alesina, 1989).

Policy implications of politico-economic models: an independent central bank

UK Chancellor Gordon Brown’s decision to grant much greater independence to the Bank of England had its origins in a 1992 Fabian Society paper

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7 Alesina (1989) argues that this is a major characteristic of the period following the elections of both Margaret Thatcher in 1979, and Ronald Reagan in 1980.

8 For a critique and response see Drazen, 2000a, 2000b; Alesina, 2000a.
entitled ‘Euro Monetarism’, written by Ed Balls.9 As a former student of economics at Harvard, Balls was familiar with the empirical work on central bank independence produced by Alesina and Summers (1993). In a visit to the US in March 1997, Shadow Chancellor Brown and his economic advisor met both Alan Greenspan and Lawrence Summers.10 And so was born the strategy to go for immediate greater central bank independence if elected.

There is now an extensive literature related to the issue of central bank independence. The empirical case for central bank independence is linked to cross-country evidence which shows that for advanced industrial countries there is a significant negative relationship between central bank independence and inflation, at least as far as advanced industrial democracies are concerned (Eijffinger, 2002a). On the theoretical side, the political business cycle and time-inconsistency literature has pointed to the various reasons why industrial democracies have tended to develop an inflation bias where governments are allowed discretion in their use of fiscal and monetary policies. As a result, as McCallum (2004) recently argues, “academic economists favour monetary policy based on (activist) rules, rather than discretion”.

In a very influential paper, Alesina and Summers (1993) highlight empirical evidence which, for advanced industrial countries, shows that inflation is negatively correlated with the degree of central bank independence without this having significant adverse effects on real growth and employment in the long run. Central bank independence seems to offer a ‘free lunch’! However, this issue is made more complicated by the causes of output variability. Alesina and Gatti (1995) distinguish between two types of variability which can contribute to aggregate instability. The first is economic variability resulting from different types of exogenous shocks to aggregate demand and/or supply. The second type is political or


10 Lawrence Summers is currently (since July 2001) the 27th President of Harvard. He formerly taught at MIT and Harvard (1979–87) before becoming the Nathaniel Ropes Professor of Political Economy at Harvard (1987–91); Vice President of Development Economics and Chief Economist at the World Bank (1991–93); Undersecretary, Deputy Secretary then Secretary to the Treasury (1993–2000); Distinguished Fellow in Economics, the Brookings Institution (2001). In 1993 he was awarded the John Bates Clark Medal, given biannually to the outstanding US economist under the age of 40.
policy-induced. Alesina and Gatti (1995) argue that an independent central bank will reduce policy-induced output variability. Hence the “overall effect of independence on output induced variability is, thus, ambiguous”. It follows that in cases where policy-induced variability exceeds that resulting from exogenous shocks, a more independent central bank can reduce inflation and the variance of output, a result consistent with the Alesina and Summers (1993) data.

If this line of argument is accepted, then it follows that what is needed is an institutional framework which creates an environment conducive to the more frequent implementation of sustainable economic policies geared to longer-term objectives. The dilemma faced in industrial democracies is how to constrain the over-zealous short-term discretionary actions of politicians through institutional reform without threatening the basic principles of democratic government. To the critics, central bank independence is no panacea and the Alesina–Summers correlations do not prove causation. In addition, the numerous domestic and international policy coordination problems which independence can give rise to could outweigh the potential benefits. In the face of powerful ‘economic’ shocks a conservative and independent central bank may not be superior to a democratically elected government.11 It seems likely that the relationship between economic and electoral cycles will remain a rich and fertile area of research for macroeconomists.

### The political economy of debt and deficits

During the mid-1970s several OECD countries accumulated large public debts. This rise in the debt/GNP ratios during peacetime amongst a group of relatively homogeneous economies is unprecedented and difficult to reconcile with the neoclassical approach to optimal fiscal policy represented by the ‘tax smoothing’ theory. While countries such as Greece, Italy and Ireland had accumulated public debt ratios in excess of 95 per cent in 1990, other countries such as Germany, France and the UK had debt ratios in 1990 of less than 50 per cent (Alesina and Perotti, 1995, 1996a).

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In order to explain the variance of country experience and the timing of the emergence of these rising debt ratios, Alesina and Perotti argue that an understanding of politico-institutional factors is ‘crucial’. In explaining such wide differences, Alesina and Perotti conclude that the two most significant factors are (i) the various rules and regulations which surround the budget process; and (ii) the structure of government—i.e., does the electoral system tend to generate coalitions or single party governments. In the face of large economic shocks, weak coalition governments are prone to delaying necessary fiscal adjustments. While a ‘social planner’ would react quickly to an economic shock, in the real world of partisan and opportunistic politics a ‘war of attrition’ may develop which delays the necessary fiscal adjustment (Alesina and Drazen, 1991).

Research by Alesina and Perotti (1996b; 1997a) also indicates that the ‘composition’ of a fiscal adjustment matters for its success in terms of its sustainability and macroeconomic outcome. Two types of adjustment are identified: Type 1 fiscal adjustments rely on expenditure cuts, and reductions in transfers and public sector wages and employment; Type 2 adjustments depend mainly on broad-based tax increases and cuts in public investment. Alesina and Perotti (1997a) find that Type 1 adjustments “induce more lasting consolidation of the budget and are more expansionary while Type 2 adjustments are soon reversed by further deterioration of the budget and have contractionary consequences for the economy”. Hence any fiscal adjustment that “avoids dealing with the problems of social security, welfare programs and inflated government bureaucracies is doomed to failure” (see Alesina, 2000b). Type 1 adjustments are also likely to have a more beneficial effect on ‘competitiveness’ (unit labour costs) than policies which rely on distortionary increases in taxation (see Alesina and Perotti, 1997b).

**Political and economic instability: are they related?**

A further related area of research in the politico-economic sphere concerns the relationship between political and economic stability. There are good reasons to believe that economic performance will suffer if a country is politically unstable.12 Frequent riots, politically motivated violence and

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12 For an interesting review of a contrary view, see Bates, 2004.
revolution inevitably have a negative impact on a country’s economic performance. As Keynes always highlighted, uncertainty has a depressing effect on investment and productive entrepreneurship.

A further destabilizing influence on policy arising from political instability derives from the inability of fragile coalition governments to carry through the tough but necessary economic policies crucial for long-run stability. Alesina (1989) found a positive correlation between an index of political instability and Okun’s misery index (inflation + unemployment) for the period 1973–86. An exception in his 20-country sample is the UK, which managed to combine relatively poor economic performance during this period despite having a high degree of political stability. In Alesina and Drazen’s (1991) analysis of why necessary stabilization policies are frequently delayed, they consider a situation where two parties with different ideologies engage in a war of attrition as they each attempt to pass on the burden of fiscal reform to the other party’s supporters. The resultant delay and government inaction in the reform process leads to debt accumulation and crisis before one of the parties is forced to accept a larger share of the fiscal burden. As Drazen (2000a) notes, “the failure to adopt socially beneficial economic reforms or their adoption only after long delays is a leading example of the divergence between the simple textbook models of economic policymaking and real world experience”.

The political economy of economic growth

One of the most important potential adverse effects of inequality is its negative impact on economic growth. Various mechanisms have been suggested as possible causes of a negative association between inequality and subsequent growth performance. The credit market channel highlights the limited access to finance that the poor have in order to invest in human capital formation. Since in this environment most people have to rely on their own resources to finance education, a reduction in inequality could therefore increase the rate of human capital formation and economic growth. A second fiscal channel highlights the distortions and disincentive effects of taxation introduced under political pressure to reduce high inequality. Redistribution of income, by raising the tax burden on potential

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13 See Alesina and Perotti, 1994; Alesina and Rodrik, 1994; Alesina and Perotti, 1996c.
investors, reduces investment and consequently economic growth (Alesina and Rodrik, 1994).

A third channel suggests that high inequality leads to a larger number of agents engaging in rent seeking, corruption and criminal activities. These activities threaten property rights and the incentive to invest. Fourth, Alesina and Perotti (1996c) show that inequality promotes social and political unrest and the threat of violence and revolution reduces growth-enhancing activities. These conclusions are empirically “quite solid”.14

The size of nations

Since the late 1990s several economists have been using the tools of modern economic analysis to explore the determinants of the size of nations (see Alesina and Spolare, 1997, 2003, 2004a, 2004b; Alesina, Spolare and Wacziarg, 2000, 2005). Although historians and other social scientists have studied this issue, economists “have remained on the sidelines”. Of particular interest to economists is the observation of Alesina, Spolare and Wacziarg (2005) that there has been a dramatic increase in the number of nations since the end of the Second World War. In 1948 there were 74 countries, 89 in 1950, and 193 in 2001. They also note that the world “now comprises a large number of relatively small countries: in 1995, 87 of the countries of the world had a population of less than 5 million, 58 had a population of less than 2.5 million, and 35 less than 500 thousands”. The proliferation of countries has also led to too many separate currencies (Alesina and Barro 2002; Alesina, Barro and Tenreyro 2002).

During this same period the second age of globalisation has emerged and the share of international trade in world GDP has increased dramatically (Snowdon, 2002, 2003). Can economists help to explain these developments? Alesina, Spolare and Wacziarg (2005) make the following important points:

1. political borders are made by humans and are not exogenous geographical features;
2. economists should think of the equilibrium size of nations (measured by total population) “as emerging from a trade-off between the benefits of size and the costs of preference heterogeneity in the population”;

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14 See also, Alesina et al., 1996.
3. the main benefits of size are as follows: economies of scale with respect to the production of public goods such as defence, maintenance of law and order, public health etc; greater safety from foreign aggression; internalization of cross-regional externalities; better income insurance to regions subject to specific shocks; income transfers across regions to achieve greater equity among the overall population; a larger internal market increases the potential for greater specialization as noted by Adam Smith;

4. in a world of free trade, country size, as measured by population, is no longer a determinant of market size;

5. it therefore follows that “the benefits of country size decline as international economic integration increases;

6. the benefits of international economic integration increase the smaller is a country;

7. economic integration and political disintegration are positively correlated;

8. the costs of size include administrative and congestion costs, but much more important are problems associated with the heterogeneity of preferences of individuals which obviously increase with the size of a nation;

9. using ethnolinguistic fractionalisation as a proxy for heterogeneity of preferences, economists have found that ethnic diversity is inversely correlated with economic performance, the quality of governance, and economic and political freedom (see Alesina et al., 2003; Alesina and La Ferrara, 2005);

10. to conclude, as international economic integration increases, the trade-off between the benefits of size of a nation and the costs in terms of heterogeneity of preferences shifts in favour of small nations.

This work has important implications for the future of the European Union (EU). EU enlargement clearly increases the heterogeneity of preferences, and economic integration lowers the benefits of country size thereby reducing the costs of independence for small countries. As Alesina, Spolare and Wacziarg (2005) note, “many have argued that Europe will (and perhaps should) become a collection of regions loosely connected within a European confederation of independent regions”.
Research by economists on the determinants of the size of nations is in its infancy. However, many interesting relationships remain to be explored, including the interconnection between international integration, democracy, the size of nations and international conflict.

**Conclusion**

Since the late 1980s, there has been a major revival of political economy utilizing the tools of modern economic analysis. A common theme running throughout this ‘new political economy’ literature is the need to integrate political factors into mainstream economics. The policymaking process does not consist of a benevolent dictator taking advice from economists in order to maximise social welfare; rather it consists of a complex game played out by various competing groups whose interests do not always coincide.

Not only have economists enhanced our understanding of aggregate instability by adding a political dimension to their models, they have also explored the deeper determinants of growth miracles and disasters. In doing so they have highlighted the important constraint on economic growth imposed by ‘bad’ institutions and policies. Recent research has explored the interaction of politics and economics, yielding new insights into the political economy of economic growth and development, and the impact of international economic integration on the size of nations. These are certainly areas where much more research is required. Just as economic forces cannot be ignored by political scientists, the main message coming from the research discussed here is that economists interested in positive models of economic policy “cannot and should not ignore the political arena” (Alesina, 1988).

**INTERVIEW**

*In your work you have always emphasised the interaction of political and economic forces in order to provide greater insights into key public policy issues. What or who influenced you to pursue this line of thinking in your research?*

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15 I interviewed Professor Alesina in his office at the Department of Economics, Harvard University, on 28th May, 2004.
There was no particular person who early on influenced me to take this direction. The most important influence was growing up in Italy. Going to University there led to a view that an understanding of political forces was critically important for understanding how an economy functions. At that time, in the late 1970s, students in Italy were eating and breathing politics. There were many intense political debates going on and I was a very interested participant. My undergraduate supervisor was Mario Monti, currently a member of the European Commission responsible for competition, who was very involved in the political-economic debate in Italy. He wrote many newspaper articles and I learned from him how economics was interesting, not as an abstract science, but as a way of influencing economic policy.

You then left Italy and came here to Harvard.

When I first came to Harvard in 1982, for a couple of years I was immersed in studying economic theory, math, econometrics, and the other tools used by economists. But when I started to work on my thesis my interest in the linkages between politics and economic policy resurfaced. This was about the time that Robert Barro was writing his seminal papers relating to the time inconsistency issue in monetary policy, first introduced to the economics literature by Finn Kydland and Edward Prescott.16 That whole literature was very influential to me. One of my supervisors was Jeffery Sachs who at that time was getting heavily involved with providing policy advice to various countries. From his practical experiences he also emphasised to me just how important an understanding of political forces are in influencing economic policy decisions.17

Is this when your interest in political business cycles began?

Yes, and I wrote my PhD thesis on this issue.

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Politics and the business cycle

You have described your work as ‘new political economy’. How does this differ from the ‘old political economy’? Was the rational expectations revolution the dividing line that separates your work from that of ‘political business cycle’ theory contained in the 1975 seminal paper by William Nordhaus?

I would not classify the Nordhaus paper on political business cycles as something fundamentally different to the work in this area in the late 1980s. The connections are much stronger than the differences. The main differences between the older tradition of political economy, that I associate with James Buchanan and the public choice school, and what has been called the new political economy, is not so much the subject matter or the nature of the results, rather it is that the older tradition has always been on the sideline of mainstream economics whereas the new political economy is part of the mainstream. James Buchanan was always reluctant to use the standard tools of economics in his work and on the other side economists were not ready to open their mind to the fact that politics was important. There was a definite schism. What the new political economy has done is to reduce this schism. Mainstream economists now have a much greater appreciation of the importance of taking into account the influence of political factors into their analysis. Those economists researching in the new political economy field now use the same tools and methodology as those working in the mainstream. While the Nordhaus paper created a lot of interest it did not generate a burst of work in political economy. That came in the late 1980s. Since then there has been an explosion of research in this area.

Allan Drazen has recently reviewed a quarter century of the political business cycle literature. His review concluded by arguing that “…monetary surprises are an unconvincing driving force for political cycles, either opportunistic or partisan; research should concentrate on fiscal policy as the driving force, especially for opportunistic cycles. Political monetary cycles are more likely the effect of

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18 See, for example, the recent contributions of Daron Acemoglu reviewed in Snowdon, 2004.
20 Drazen, 2000a. See also Drazen 2000b; Alesina 2000a.
accommodation of fiscal impulses, that is, are passive while fiscal policy is active in trying to affect election outcomes”. What is your view of Drazen’s conclusion?

I think that paper gives the wrong overall impression. It is not necessary to choose between one view or the other on the causes of political business cycles. I don’t think it is particularly interesting whether or not it is fiscal or monetary policy that is being used opportunistically by politicians. It is possible that politicians will use both. In some countries fiscal manipulations may predominate, in other countries monetary manipulations may predominate. There is also evidence that governments that manipulate fiscal policy in election years may alienate voters.21 However, it is true that most recent papers that I have seen on the political business cycle issue have focussed on fiscal policy. So I do not deny the importance of fiscal policy but there is evidence for both fiscal and monetary distortions of policy. Having said that, if I were to review the literature on the political business cycle I would not try to present the research findings in this way.22

How would you approach such a survey?

I see the main issues in the political business cycle literature to be related to whether or not voters behave rationally, the significance of opportunistic behaviour versus partisan behaviour, the link between electoral systems and the business cycle, the impact of central bank independence on the opportunistic and partisan behaviour of politicians, and the extent of political distortions to policymaking in developed versus developing countries. To me these are some of the more important research issues. In his survey paper Drazen offers his AFMP model [Active Fiscal Passive Monetary Policy] in order to address some of the problems associated with earlier models such as the partisan monetary surprise model. However, it seems unlikely that opportunistic models will find strong empirical support from US data because the US has a well-informed media and a large degree of central bank independence.23

22 See Snowdon and Vane, 1999a or 1999b for an extended interview with Professor Alesina on the issue of political business cycles.
Your rational partisan theory suggests that left-of-centre governments are likely to have a problem in establishing their anti-inflation credibility when they get elected.\(^{24}\) Coming from Britain this is of particular interest because as soon as the ‘new’ Labour government was elected in May 1997, the Chancellor, Gordon Brown, hit the ground running by announcing that the Bank of England would be given ‘operational independence’ in the conduct of monetary policy. I understand that Gordon Brown’s former economic advisor, Ed Balls, was a student here at Harvard in the late 1980s. It is tempting to believe that it was your ideas, carried to Downing Street via Ed Balls, that played a significant part in the Chancellor’s decision.\(^{25}\)

Ed Balls was not directly my student but I did know him and he was certainly aware of my work. I think the work that has been done on central bank independence has been very influential and I have contributed to that literature.\(^{26}\) I agree with the inference from your question that the Labour Party did make the Bank of England independent to strengthen their anti-inflation credibility.\(^{27}\) This line of research linking anti-inflation credibility with central bank independence has in general been very influential.\(^{28}\) As I recall, when Chancellor Brown announced that the Bank of England would be given operational independence, he explicitly identified the need for monetary policy to be free from political influences as a major factor influencing the decision.\(^{29}\) Today, few economists disagree with the idea of giving the central bank a certain amount of independence although controversy still remains over the optimal degree of independence.

**The political economy of budget deficits**

*During the mid- to late 1990s you produced a number of important papers on the problem of excessive budget deficits in OECD economies.\(^{30}\) In those co-authored*
papers, with Roberto Perotti and others, you made it clear that reducing budget
deficits would involve making difficult and unpopular decisions because sustain-
able reductions in deficits require cuts in government spending in politically
sensitive areas. Your influential 1991 paper with Allan Drazen, ‘Why are
Stabilisations Delayed?’, also highlights the ‘war of attrition’ problem that
inevitably occurs when different groups in society attempt to escape bearing the bur-
den of adjustment that accompanies a programme of deficit reduction. Looking
back, what are your reflections on that body of research?

Modesty aside, I think it was some of my most successful work. The paper
with Allan is certainly one of my most cited papers. That paper helps to
rationalise why the path of policy during a crisis often appears to be com-
pletely crazy. Everybody knows that sooner or later tough decisions will
have to be made and that the longer the decisions are delayed, the tougher
will be the outcome. And yet we observe countries where governments
continue with non-sustainable policies that lead to the excessive accumu-
lation of public debt and severe inflation. While an efficient social planner
would stabilize immediately, in societies populated by heterogeneous
groups, conflict arises over who should bear the burden of adjustment.
This is what leads to the costly delay of the required stabilisation policies.
Stabilisation is eventually implemented when one group becomes visibly
stronger than the other and the weaker group ends up bearing the
increased tax burden.

The work on fiscal adjustments captured the attention of policymakers
at the IMF and OECD. What we found with that research was that suc-
cessful fiscal adjustment, that is, adjustments that can be sustained, are
those that cut spending rather than raise taxes, and significant cuts in
spending can only be achieved by reducing politically sensitive items that
tend to grow automatically such as public transfers, social security and
public sector wages. This is the bad news. The other result that we found,
which is the good news, is that if you make this kind of effective fiscal
adjustment there is a good chance that the cuts will not produce a reces-
sion as a traditional textbook Keynesian model might predict. Contrary to
popular opinion the macroeconomic environment does not necessarily
deteriorate as the result of a fiscal adjustment. The most famous example
is Ireland where following the late 1980s fiscal adjustment economic
growth took off. In neoclassical models a permanent cut in government
consumption should lead to a rise in private consumption because the reduction in future tax liabilities increases the wealth of the private sector. A successful fiscal consolidation is also likely to lead to a reduction in interest rates due to a reduction in default and inflation risk. So effective fiscal adjustments can be expansionary.

*Some economists have argued that budget surpluses are undesirable because they present a great temptation for governments to expand spending and the size of government. Budget deficits, in contrast, act as a constraint on government spending. Do you agree with this argument?*

That is an interesting question because I am currently writing a paper with Guido Tabellini that addresses this very issue.\(^{31}\) There is certainly some substance to this argument particularly for non-OECD countries where mismanagement and corruption are more of a problem. One observation that is now commonly accepted is that fiscal policy in a lot of non-OECD countries is pro-cyclical so when there is a boom in the economy, and a consequent budget surplus, spending increases. In recessions, spending is cut. This is the exact opposite of what should be happening to stabilise the economy.

*In the Financial Times earlier this week there was a leading article discussing Italy’s current fiscal position.*\(^{32}\) *The article points out that Italy’s fiscal position is probably the most serious in the European Union and that Italy has slow growth, rising unemployment, inflexible labour markets and a loss of competitiveness. Moreover, having joined the single currency Italy has lost independence with respect to its monetary and exchange rate policy. This is a pretty depressing summary of Italy’s current economic situation. As an Italian what are your thoughts on this assessment?*

Although I have not seen this particular article I agree with the general summary that you provide. Italy does have all the problems that you highlight from this article. The Silvio Berlusconi government is a right wing government but has not yet introduced the necessary reforms. One problem is that the ‘social right’ in Italy has many of the same preferences as

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the ‘social left’ and are very reluctant to accept any kind of cuts to spending, or the reform of pensions, and they want to preserve the over protective labour market legislation. They certainly have little interest in market liberalisation. Another problem for Berlusconi is that he has been involved with personal problems involving conflicts of interest for a long time. Italy desperately needs a more pro-market economic policy based on the usual changes involving a serious tax cut, supply side reforms, market liberalisation in both the goods and labour market, and control of government spending. The education system also needs reforming. Having said all that, I am not so sure that Germany is in any better shape than Italy at the moment although Italy does have some problems that other countries do not have such as the disparity of living standards between the north and the south, a significant tax evasion problem, and an administration that is not as efficient as in other EU countries.

Currency unions and the European Union

In your recent publications on currency unions you argue that since 1947 the increasing integration of international markets would imply “that the optimal number of currencies would tend to decrease, rather than more than double as it has”. Why are there too many currencies in 2004?

In 1945 there were 76 countries and 65 separate currencies. Now there over 190 countries in the world and over 160 different currencies. Either there were too few currencies in 1945 or there are too many now unless we think that every country needs to have its own currency. There is no economic rationale for believing that there needs to be a one to one relationship between the number of countries and the number of currencies. So there appear to be too many currencies and that is the starting point of our recent research in this area. An increase in the number of countries increases the volume of international transactions and this should increases the attractiveness of currency unions. So the number of currencies should rise disproportionately with the number of countries. As Robert Mundell showed many years ago in pioneering work on optimal currency areas, political borders and currency boundaries should not

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always coincide.34 That there are so many currencies across the world economy must reflect the importance governments attach to maintaining a symbol of monetary autonomy.

What are the main costs and benefits of a currency union?

The main benefits of currency unions result from lower transaction costs of trading in goods and services, and, as the recent research of Jeffrey Frankel and Andrew Rose shows, common currencies do stimulate bilateral trade and also boost overall trade leading to gains in output and consumption.35 Research has also shown that ‘border effects’ are significant. For example, trade between Canadian provinces is much greater than between a Canadian province and a neighbouring US state across the border.36 These border effects are large even without explicit trade restrictions. Where there are different currencies across borders it appears that this acts as a restriction on trade flows. Currency unions also commit member countries to greater monetary stability. This is especially beneficial to countries that have a history of monetary indiscipline. These benefits need to be compared to the loss of monetary sovereignty and the implications of this for the use of independent monetary policy to target specific domestic shocks within member countries. The European Central Bank does not use monetary policy to deal with specific shocks that may affect any single member country. Rather, its mandate is to target European shocks.

Who gains the most from the formation of currency unions, small countries or large countries?

Our research shows that small open economies gain the most from the formation of a currency union, especially if they trade a lot with one big partner. Countries that have difficulty maintaining a credible low inflation policy also gain from joining a currency union. Such countries gain credibility by eliminating domestic monetary policy. El Salvador, for example, has Dollarised, and gained a lot. Countries that have the largest

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34 See Mundell, 1961.
35 See Frankel and Rose, 2002.
36 See McCallum, 1995.
co-movements of GDP and prices with a potential anchor currency will have much less to lose from a loss of monetary independence.

*The early research on optimal currency areas highlighted the relevant issues that needed to be considered when a particular group of countries are considering the formation of a currency union or fixed exchange rate system. It was Nobel Laureate Robert Mundell who pioneered the analysis of which countries or which groups of countries represent an 'optimal currency area'.*\(^{37}\) In his seminal paper, Mundell asked the question, ‘What is the appropriate domain of a currency area?’ Do you think that the European Union is an optimal currency area?

If you read what economists were writing six months before the Euro came into place, it was all quite negative on economic grounds. The introduction of the Euro seems to have worked reasonably well. It is certainly true that some of Mundell’s conditions are not satisfied. If we believe that labour mobility is a fundamental precondition for a successful currency union then there would be few currency unions. So there are other factors that must compensate for this deficiency. These include the gains from trade, financial integration, and greater competition. It remains to be seen whether or not the Euro will be a long-term success. However, we should not forget that the introduction of the Euro is also seen as an important step towards political integration. That really worries me. The European currency union is fine but I do not want to see EMU used as an excuse to co-ordinate taxes and labour laws, and eventually everything else. That is a very slippery slope to get on.

*One particular problem for UK entry into the EMU is that the UK’s business cycle is currently out of line with the major countries in the Euro area. Some writers have suggested that business cycles will harmonise endogenously as countries respond to a common monetary policy.*\(^{38}\) Is that a plausible argument?

Yes, to a certain extent. With a single monetary policy there is bound to be some harmonisation of the business cycle across the economies of the Euro area. Increased trade should increase the co-movements of output and prices. But research into this issue has not provided a clear answer.

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\(^{38}\) See Frankel and Rose, 1998.
Theoretically the answer depends on the extent of inter-industry trade versus intra-industry trade with the latter more likely to lead to more co-movements as trade increases following the formation of a currency union. In the former case, heightened specialisation is likely to lower co-movements since a specific shock to an industry then becomes a country-specific shock. Since intra-industry trade is more important in rich countries I suspect that ten years from now we will read a lot of papers that show that business cycle harmonisation has taken place. The lack of perfect business cycle synchronisation creates potential costs from the formation of a currency union, and these costs have to be weighed against the benefits of such a union that include reduced transaction costs and the gains from increased trade and greater competition. That said, I think the reluctance of the UK to enter EMU has much more to do with the fear that it will mark an important step towards European political integration, rather than technical monetary policy considerations.

According to Hugh Rockoff it took something like 150 years for the USA to become an optimal currency area.\(^{39}\) Surely this is not good news for Euro enthusiasts?

Although I have not read that particular paper I would be wary of transferring the experiences of the US 200 years ago to Europe today.

In your paper with Robert Barro and Sikana Tenreyro on ‘Optimal Currency Areas’ you argue that although there exist well-defined Euro and Dollar currency areas, there is no well defined Yen currency area. Why is this the case?

In that paper we considered the Dollar, the Euro and the Yen as three potential anchor currencies. We identified which countries were correlated in business cycle terms with each of the US, the EU and Japan. We also looked at the trading links of various countries with the US, the Euro and Japan. We found that there was a fairly well defined group of countries that traded a lot with the US and were reasonably well correlated to the US business cycle. The same is true in the case of Europe. But as far as Japan is concerned we found that there are very few countries that trade mostly with Japan and are also in line with Japan’s business cycle. In fact the

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Japanese business cycle over the last thirty years does not appear to have been correlated much with that of any other country. At the moment there is a lot of discussion about the possibility of an East Asian currency union but it is unlikely that this will involve the adoption of the Yen. Rather it will likely involve the introduction of a new currency, as was the case with the Euro.

The EU changed profoundly on May 1 with the entry of ten new members. In your recent papers on the EU you have argued that the policymaking institutions of the EU have now extended their domain well beyond the original mission of establishing a free market zone with a common external trade policy. Is there a danger that the EU has now become too large and hence a potentially unwieldy international organisation?

The general theme of these papers is to review the evolution of European integration and the allocation of powers between European institutions. There is a well-established literature in economics related to the issue of fiscal federalism that discusses what different levels of government should be doing. That literature generated a set of criteria that can be used to determine what policies are appropriate at different levels of government. In our recent papers we have tried to apply the same principles to the EU. What are the appropriate tasks for the various layers of government within the EU? Empirically, we find that the allocation of tasks in the EU is the outcome of conflict between different bureaucracies fighting with each other in order to maintain their prestige and influence rather than a rational allocation. Currently the EU has a complex web of institutions that have overlapping jurisdictions. This has lead to a distinct lack of clarity in the allocation of powers across the major EU institutions. As a result the European Commission does a lot of things that duplicates activities, or does lots of things that it shouldn’t really be doing at all. Conversely, there are many things that the Commission should be doing that it is not doing. If you think of the EU as a federal state, which I don’t think it should be, then foreign policy is clearly something that should be co-ordinated at the highest level. Yet it seems highly unlikely that such a co-ordinated foreign policy will happen any time soon. In other areas such as regulation, social

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41 For a recent survey, see Oates, 1999.
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protection and agriculture, EU involvement is over expanded and there is far too much involvement. In short, the EU is heavily involved in too many areas where economies of scale are low and the heterogeneity of preferences among citizens is high. The result is a significant difference between the desirable compared to the actual allocation of policy responsibilities among EU institutions. The ongoing debate on what the functions of the EU should be is very important, not least because of the enlargement of the EU. There are certainly inconsistencies between both enlarging and deepening the scope of the EU.42

The size of nations

Much of your recent research has been focussed on the economic determinants of the size of nations, where size is measured by total population.43 How much does size matter for economic success?

If you look at the five largest countries in the world in terms of population, that is, China, India, the US, Indonesia and Brazil, only the US has a high per capita income. We also find that many of the richest countries in the world have populations below the world median which is about 6 million people. These small countries also have some of the fastest growth rates of per capita income. Of course not all small countries are rich, but Singapore, with a population of 3 million, shows just how much a small country can prosper by being integrated into the world economy.

To what extent is the size of a country determined by geography?

Political borders are made by people and are not exogenous geographical features.

To most non-economists the determination of the size of nations has to do with politics. Your research provides a coherent explanation of the determination of the size of nations based on economic analysis. What are the main benefits and costs associated with the size of a nation?

42 See Alesina, Angeloni and Etro, 2005.
It is best to think of the equilibrium size of countries as the outcome of a trade-off between the benefits of size versus the costs of preference heterogeneity which inevitably increase with population size. One of the main benefits of size is national security. There are clear economies of scale linked to military spending. Even if you are a small country you can take advantage of size by belonging to a military alliance with a large country, but it is unlikely that as a junior partner that you will be able to determine policy. So size matters for security. A second benefit relates to economies of scale in the production of certain public goods. For example, a small country may find it difficult to develop a good university system. A third benefit of size is mutual insurance. If you live in a particular region of a large country, and that region suffers a recession, then there are likely to be transfers from other regions that can stabilise the regional economy. Fourth, in a world of trade restrictions there are economies of scale coming as a result of having a large internal market. In contrast, in a world of free trade a country can be small and trade with the whole world. So this last benefit of size becomes less important as the world economy becomes more open and globalised. The importance of market size as a determinant of the limits of specialisation and productivity growth was recognised early on by Adam Smith in the *Wealth of Nations*. As far as the costs of size are concerned, the most significant one that we emphasise is that a large country is likely to be very diverse in terms of culture, preferences, ethnicity and religion. This makes it much more difficult to govern because of the heterogeneity of preferences. Larger countries may also experience increasing administrative and congestion costs.

*Given that the benefits of size fall as international economic integration increases should we therefore expect to see, in a more globalised world, more countries?*

Yes, the optimal size of a country will be smaller in a world economy with freer trade. Increasing trade openness shifts the balance of benefits and costs so that small countries can prosper. This is why political disintegration and economic integration are correlated. Country size is endogenous to several important economic factors.

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44 See Alesian and Perotti, 1998.
There is evidence that a more democratic world would almost certainly be a more peaceful world. Some writers argue that globalisation has a positive effect on the spread of democratic political institutions. Does this imply that international economic integration and globalisation will lead to a more peaceful world?

I think so. Think about two countries that may go to war with each other. If they have significant economic ties then a war will be very costly in economic terms. So economic integration acts as a disincentive to conflict between two countries. The evidence also strongly supports the idea that democracies do not tend to go to war with each other. Whether democracies do not go to war with each other because they are democracies or because democracies are more open to trade remains to be determined. So democratisation, globalisation and peace should go together. So there is great potential for small countries to prosper. Although the world in 2004 does not look very peaceful, I would attribute much of that to the fact that there remain many non-democratic countries that are also not very open.

**Economic growth, inequality, democracy and aid**

Another research area where you have been a participant is the nature of the relationship between economic growth and inequality. The old view that dominated thinking in the early development economics literature was that inequality is good for growth because the rich tend to have a high propensity to save and capital accumulation was viewed as the key driver of economic growth. This thinking came out of the influential Lewis and Harrod-Domar growth models. The modern view, supported by your research, suggests that inequality may be detrimental to growth. Why should inequality be bad for growth?

The modern literature emphasises a variety of channels. For example, credit market imperfections reduce the ability of the poor to invest in human capital, inequality creates socio-political instability, thereby increasing uncertainty and reducing investment. Inequality is also likely to promote redistributive policies that introduce tax distortions and damage

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47 See Alesina and Perotti, 1994, 1996c; Alesina and Rodrik, 1994; Alesina et al., 1996.
work effort and entrepreneurship. It is fair to say that there is also not much empirical evidence to support the proposition that more inequality leads to more growth. The evidence that less inequality leads to more growth is certainly stronger. While the whole issue is complicated because the relationship between inequality and growth may be different at different levels of income, most people now seem to agree that too much inequality may be counterproductive in terms of growth for poor countries but not for rich countries. The main controversy is over the mechanism that links inequality to slower growth. Economists don’t fully understand this link.

What about the relationship between economic growth and democracy. Does democracy promote growth?

The relationship between democracy and growth is very controversial but I do not think that there is any strong positive empirical relationship running from democracy to economic growth. The rich countries of the world are certainly more democratic but that does not prove any causation. We have also seen excellent growth performance from some dictatorships in East Asia and dreadful growth performance from dictatorships in sub-Saharan Africa. Having said this, my view is that if you put yourself behind a veil of ignorance and ask whether you would like to live in a dictatorship or a democracy, most people will choose democracy. Good dictators are rare and if you get a bad dictator you are in really big trouble. So while democracies have various problems they are a much more attractive proposition than having a bad dictator. Having a benevolent dictator might be acceptable but there are not many of those around, and what if they turn ‘bad’?49

In a recent paper, Daron Acemoglu and his co-authors argue that in countries where initial political institutions placed checks on the absolute power of the monarchy, the growth of Atlantic trade in the period after 1500 led to further empowerment of the merchant groups and changes in institutions that favourably affected the protection of their property rights. These changes were crucial to the acceleration of

economic growth in the more democratic European states such as Britain compared to the more absolutist states such as Spain.

I am not so convinced that the link between Atlantic trade, democracy and growth is so strong. There is certainly a link between Atlantic trade and growth but that link does not necessarily run through the democracy channel. Looking at more recent times, the fact is that if you run a regression on data for the last thirty years on democracy and growth performance you find no relationship. I find the Barro-Lipset story that increasing prosperity promotes democracy to be more convincing.\(^5^0\) The case of England in the seventeenth century, highlighted by Douglass North, Daron Acemoglu and others, may be correct, but during the last thirty years the evidence on a positive link between democracy and growth is weak. The correlation between the protection of property rights and economic growth is far from perfect.

Many papers have been written in recent years on the issue of convergence and divergence of living standards across the economies of the world. For example, Robert Lucas is an optimist on convergence while Nick Crafts and Tony Venables are much less sanguine.\(^5^1\) Drawing on the new economic geography and new institutional economic history literature, Crafts fears that “the handicaps of distance and the persistence of sub-optimal institutions will act to dilute this process” of convergence. What do you think are the prospects for convergence in the twenty-first century?

Although I am reluctant to make a prediction on such a big issue my feeling is that Robert Lucas is right. I am especially optimistic for India, China and Eastern Europe. I certainly agree that the case of sub-Saharan Africa is a major problem, but with this exception I am very optimistic that other regions of the world will experience significant catch-up during this century, especially if global economic integration continues to increase.\(^5^2\)

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\(^5^0\) See Barro, 1997, 1999; Lipset, 1959.
\(^5^1\) Lucas, 2000; Crafts and Venables, 2002; Crafts, 2004.
\(^5^2\) See Artadi and Sala-i-Martin, 2003.
Much attention in economic growth research has recently focussed on what Dani Rodrik has called the ‘deeper determinants of growth’. These deeper determinants include the impact of institutions, geography and culture. Jeffrey Sachs has criticised economists for their neglect of geography in their explanations of international differences in the level and growth rate of per capita income. Do you agree with Sachs that economists have for too long neglected the impact of geography on the economic performance of nations?

I think that geography is very important. I know Jeff very well and when he wants to make a point he tends to exaggerate. Sometimes it almost sounds like he is saying that geography is all that matters. It certainly matters, but how much is the interesting question. Jeff is certainly right in criticising economists for underestimating geographical influences for a long time. There are some aspects of geography that are endogenous. Jeff makes a big issue about whether or not a country is landlocked. But, as we discussed earlier, that is a question of politics, not of geography. That is why wars have often been fought, to gain access to the sea and trading routes.

Jeffrey Sachs has also been a vociferous champion of the role of foreign aid in promoting development. Your recent papers on foreign aid, along with those of Bill Easterly, are highly critical of placing such high faith in the role of foreign aid in promoting growth and economic development. Why has aid had such disappointing and often counterproductive results?

Jeff Sachs has taken on the role of advocating an increase in resource transfers from rich to poor countries. In my view he underestimates the waste and corruption generated by aid transfers. For Sachs to be more convincing he should be more up front about how to deal with the corruption problem. Jeff Sachs argues that the sub-Saharan tragedy is mostly about adverse geography rather than bad governance and destructive policies. I think that this is an over simplistic view and ignores too much the extensive failure of governments on that continent. Political instability has been

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55 See Sachs et al., 2004.
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a major constraint on economic progress and I do not believe that providing more foreign aid in that kind of environment is sensible. To take a very small but revealing example, a friend of mine got married and collected money from wedding guests to donate to some charitable foundation in Africa in order to build a school. We heard later that a local warlord had stolen all the money, so my donation is now probably financing the purchase of weapons, drugs or prostitutes! The evidence shows that the way that aid is dispersed has a lot to do with political links between the donor and recipient. The only exception to this is the aid dispersions from the northern European countries such as Norway and Sweden. With a lack of colonial history and few political links they can do a much better job at allocating their aid resources.

Ethnic fractionalization

Another burgeoning research area is investigating the impact of ethnic diversity on the economic performance of nations, regions and cities. You have contributed several important papers to this important issue. What are the costs and benefits of ethnic diversity?

I am currently writing a survey article on ethnic fractionalisation for a forthcoming issue of the Journal of Economic Literature. I find this to be a fascinating subject. The potential benefits arise from variety of production while the costs come from increased problems linked to difficulty in agreeing the provision of public goods and public policies. For example, on the costs side there is mounting empirical evidence that supports the hypothesis that in more ethnically diverse localities in the US, the provision of public goods is less efficient, trust is less and economic success, measured by growth of city size is inferior.

Why does ethnic fractionalisation so often lead to negative rather than positive outcomes?

For a variety of reasons, having to do with individual psychology, culture, language and history, different ethnic groups have difficulty understanding

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58 See Alesina, Baqir and Easterly, 1999.
each other, sometimes to the extent that they hate each other. There is evidence that trust does not travel well across racial groups. So a lot of political conflict around the world has an ethnic dimension to it. Recent well known examples include the conflicts in Bosnia, Kosovo, the Caucasus region of the former Soviet Union, Rwanda and the Sudan. There is a lot of evidence that ethnic fractionalisation causes huge problems in some countries such as many in sub-Saharan Africa. On the other hand the US and Switzerland are countries that have very successful economies even though they have a high degree of ethnic and/or linguistic fractionalisation. Of course there are examples of ethnic conflict in the US in the form of racial problems in the inner city. And yet New York and Los Angeles, both of which have very high ethnic fractionalisation, have very successful economies and lead the way in the Arts. So when ethnic diversity works well it becomes a very creative melting pot. When it works very badly we get, in the extreme, cases like Rwanda and Bosnia. In Africa they seem to be getting the worst consequences from high ethnic diversity whereas in the US, in the main, we see some of the best consequences from ethnic diversity. There is now a large literature on the impact of ethnic fragmentation on government activities, the quality of institutions, and economic outcomes. I suspect that this whole area of research is going to be absolutely critical over the next few years and beyond. Ethnic diversity also has implications for the size of countries. As we discussed earlier, heterogeneous preferences, that increase with country size and the extent of ethnic diversity, make it more difficult to implement common policies. Hence the break up of a country often has an ethnic dimension.

Paul Collier suggests that democracy is much better than dictatorship in resolving conflict for countries that have high ethnic diversity. Do you agree?

Collier’s idea is that minorities feel more represented in democratic systems and therefore less oppressed as they would under dictatorship. The problem with this line of argument is that democracy is highly correlated with the level of income per capita. So it is hard to say for certain that it is democracy that helps a country cope with ethnic diversity, or the fact that

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59 See Alesina and La Ferrara, 2002.
60 See Easterly and Levine, 1997.
61 Collier, 2001. See also, Easterly, 2001b.
rich countries are more capable and have more resources to solve or pre-
vent ethnic conflict.

**The Welfare State in the US and Europe**

*In an interesting paper you ask the following question: ‘Why doesn’t the US have a European style Welfare State?’*\(^6\) The US and Europe clearly have a very different approach to the welfare state. How do you explain this?

This issue is also the subject of my new co-authored book with Edward Glaeser, *Fighting Poverty in the US and Europe*.\(^6\) In that book we conclude that purely economic explanations leave the investigator almost empty handed. We find that the most important reasons for the difference relate to the nature of the political institutions in the US compared to Europe, together with American ethnic heterogeneity. These differences lie deep in their respective histories and culture. The US has a majoritarian rather than proportional system of representation, federalism and numerous checks and balances. These institutions favour the forces of conservatism. More generous welfare states are associated with political systems that allow proportional representation. The US Constitution was drawn up by men of property who were determined to prevent a predatory state from confiscating their property. Therefore the political left in the US have always found it very hard to make any progress and have influence on policy outcomes.

*Why did the US develop this way?*

One reason is linked to ethnic diversity. Income differences are correlated with racial fragmentation with the average income per capita of whites being higher than blacks and Hispanics. The white majority have never supported the development of a welfare state that would redistribute income to racial minorities. Ethnic and racial fractionalisation in the US made it virtually impossible to build up the Marxist idea of class con-
sciousness and that is one major reason why a socialist or communist party

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\(^6\) Alesina, Glaeser and Sacerdote, 2001. See also Alesian and Perotti, 1997b.

Alberto Alesina interviewed by Brian Snowdon

never materialised in the US. If you were an Irish worker in Boston you felt Irish before you felt any working class solidarity with an Italian worker. With the exception of the Civil War, the US has been a very stable country politically. Another part of the story relates to the perception by others of the poor. While seventy per cent of Americans think that the poor are lazy, in contrast, seventy per cent of Europeans think that the poor are unlucky and deserve help. The typical American feels that they live in a very mobile society while Europeans feel much less upwardly mobile. So the key differences relate to political institutions, ethnic diversity, and attitudes to poverty.

*You also have a paper that discusses the relationship between happiness and inequality.* Again it seems that Europeans and Americans are different.

That paper is part of the same story. In that research we found that individuals tend to be less happy when inequality is high. However, Americans are much more tolerant of inequality than Europeans because if a person is poor it is largely perceived to be their own fault and even if you are poor today you could very well be rich tomorrow. Europeans view inequality as much more stable. If you are poor today you are also likely to be poor forever. Thus, in Europe the poor and the political left are much more unhappy about inequality than their counterparts in the US. Perceptions of social mobility do influence preferences for redistribution. Where people perceive that they can move up the income ladder through their own efforts they are more tolerant of inequality. Given these different perceptions it is not surprising that, in general, European citizens are more in favour of redistributive policies than US citizens and the evidence shows that European fiscal systems are more progressive, and the welfare state is more generous than in the US.

**Current research**

*What are your current research priorities?*

I will have a very hard time answering this question because I never really know what I am doing until after I have done it! [laughter] Nevertheless

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64 See Lipset and Marks, 2000.
The Influence of Political Distortions on Economic Performance

here goes. Currently I am working on ‘endogenous Constitutions’. A vast literature takes, for instance, electoral rules as exogenous and examines their effect on the politico-economic environment. But the latter itself determines who will write constitutions and who will benefit from them. Another area that I am pursuing is a better understanding on when and why policymakers delegate functions to relatively independent bureaucrats. Why, when central banks are independent, do politicians keep a firm grip on every aspect of fiscal policy? I am also continuing my work on fiscal policy. In particular, I am interested in explaining why, in so many middle-income countries, fiscal policy is pro-cyclical, that is, it has the opposite properties that it should have. Also, I continue to be interested in the question of why different countries follow such different policies in terms of welfare and distribution.66

References


66 Many of Professor Alesina’s current working papers are available on his webpage at Harvard, http://post.economics.harvard.edu/faculty/alesina/alesina.html
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