THE POLITICAL ECONOMY OF PRUDENTIAL REGULATION

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ONE PAGE SUMMARY

- **Research question:** How do elections influence the choice of prudential regulations and what are the welfare implications?
- **Approach:** Two key ingredients
  - Pecuniary externality leads to over-borrowing (perfect-foresight model); exacerbates inequality between rich- and poor-borrowers (capital trade channel)
  - Debt limit set through elections between two competing politicians
- **Findings:**
  - Elections with committed politicians improve welfare (constrained efficient outcome → knife-edge case)
  - Greater initial inequality increases the debt limit iff rich borrowers are more responsive to policy shifts

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- Role of politics is even more pronounced when policies are redistributive / impact inequality
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  - **2016 `Brexit' decision (UK) and election of Trump (US):** empirical evidence suggests that inequality and distributional conflicts were key factors (Green et al., 2021; Baccini and Weymouth, 2021)
- Formal analysis of interaction between politics and policy, and their economic implications, is limited, **making this paper a timely contribution** (some related work: Majumdar and Mukund, 2004; Chang, 2010; Pastor and Veronesi, 2021; Anand et al., 2021)

MODEL STRUCTURE

INITIAL DATE

- BORROWERS ENDOWED WITH (DURABLE) CAPITAL AND BORROW FROM LENDERS
- PECUNIARY EXTERNALITY: IMPACT OF BORROWING ON THE PRICE OF CAPITAL IS NOT INTERNALISED

INTERIM DATE

- LOW PRICE OF CAPITAL LEADS TO BORROWING CONSTRAINT, $d_1 \leq \phi p k_2$, TO BIND
- POOR BORROWERS SELL CAPITAL TO RICH BORROWERS TO SMOOTH CONSUMPTION

FINAL DATE

- BORROWERS PRODUCE (NON-TRADABLE) CONSUMPTION GOODS USING CAPITAL
- LENDERS LAY CLAIM TO DEFAULTING BORROWERS' (DURABLE) CAPITAL AND SELL IT (OFF-EQ)

MODEL STRUCTURE INCLUDING ELECTIONS

INITIAL DATE

- GENERAL ELECTIONS: CANDIDATES CHOOSE DEBT LIMITS FOR (SOME) BORROWERS AT THE INITIAL DATE
- LENDERS AND RICH- AND POOR-BORROWERS GROUPED INTO DISTINCT BLOCS AND VOTE

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- This paper: Aggregation of voters' preferences =
  - Borrowers' utilities, which depends on the debt limit (spatial component) +

    Random (non-spatial) characteristics about voting group +

    Random (non-spatial) characteristics about politicians

MY TWO and a half COMMENTS

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  - Is this grouping redundant → borrowers are already divided based on their endowments?
- Inefficient platform choices: politicians choose debt levels based on expected biases
  - Hypothesis: analysis goes through for realised biases → the "median voter" is a weighted rich- and poor-borrower → efficient platform choices

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- Alternative: emphasis the role of consensus style politics wherein the entire ``political class'' credibly pledges to a policy course
  - Typically requires government decision-making bodies to be non-adversarial and civil institutions to protect minority rights (Lijphart, 1984; Anderson and Guillory, 1997)

WRAP UP

- This paper is a timely contribution
  - Model is elegant; perhaps could be simplified along some dimensions
  - A discussion on the specific role of elections in the model would be welcome
  - Lemma 2 (how inequality impacts outcomes) lends itself to an importantly testable implication → speaks to (anecdotally) the reasons behind some recent events (e.g., Chilean constitutional referendum of 2021)