Government decisions on income redistribution and public production
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Part II

Investment, infrastructure and institutions

The issues referred to in the previous chapters, could be fairly well analyzed while neglecting dynamic aspects. Attention was concentrated on decisionmaking with respect to redistribution and (public) consumption. In line with Alesina (1988b), it was noticed with respect to redistribution and public consumption that the redistributive conflict between the individuals currently alive seems far more important than the struggle between current and future generations. With respect to intertemporal consumer decisions it was observed that econometric studies found an intertemporal elasticity of substitution close to zero [cf. Hall (1988)]. Moreover, experimental research suggests that the way individuals make intertemporal choices is not in accordance with the rational assumptions that dynamic models presuppose [cf. Loewenstein and Thaler (1989) and Ng (1992)].

In this part the government offers not only a public consumption good, as in Part I, but also a public production good, which may be regarded as infrastructure. Infrastructure affects the productivity in the private sector. The presence of a public good that is needed for production in the private sector has an influence on capital formation. Capital formation depends on investment which is by nature a dynamic process. Therefore, a dynamic model is developed, focusing on the production decisions of both the private and the public sector. It will be assumed that investments are subject to adjustment costs and that the private sector's investment decisions follow from the maximization of the value of the firm [cf. Summers (1981a), Hayashi (1982) and Goulder and Summers (1989)]. For public production decisions this theory is adjusted. Public investments also lead to adjustment costs, but decisions follow from the maximization of the value of the political interest function, which has now a dynamic character.

Apart from the dynamic production decisions, the model in this part differs in some other respects from the model in the first part of this monograph. First, the introduction of imports and exports implies that the model describes an open economy. The economy is assumed to be small, which allows for a fixed interest rate. Second, the model distinguishes two private production sectors, as well as two public production sectors. Third, more flexible forms are used for the utility
functions of consumers. Substitution elasticities may, therefore, differ from one. More details of the model are presented in Chapter 4. Because of its complexity, the model cannot be solved analytically. The numerical solution method used, is also discussed in that chapter. Furthermore, it goes into the relation between the asset price and infrastructure, and finishes with a discussion of the importance of expectation formation.

Chapter 5 re-examines the results with respect to redistribution and public consumption that were discussed in Chapter 2. It is investigated whether the introduction of dynamics on the production side, and the use of a more flexible utility function, influences the conclusions that were reached before. Chapter 6 discusses the relevance of infrastructure for the productivity in the private sector. It is analyzed how the level of infrastructure is affected by changes in the political influence structure. Furthermore, it is investigated in this chapter whether there is a Baumol effect with respect to infrastructure. Does production in a sector fall behind if it becomes more dependent on infrastructure? This chapter ends with an exploration of the role of adjustment costs. Chapter 7 pays attention to institutional aspects. Attention is first focused on the time preference of the government. It is analyzed how changes in the time preference of the government influences its decisions with respect to public production, and how these production changes influence the private sector outcomes. The importance of the time preference of private firms is also investigated. Second, the outcomes for different tax systems are compared. The tax system that only captures an income tax, and neglects the presence of special provisions, is studied in more detail. For this tax system it is analyzed how changes in the political influence structure affect the results.