

CESifo Bulletin

Volume 21 No. 4
October 2011

Munich Lectures in Economics 2011

We all try our best to make our children better off than ourselves. But our commitment usually does not stretch to subsequent generations. And yet, things like accumulating debt, depleting resources and warming up the planet are also part of the bequest we leave to our descendants. **Sir Partha Dasgupta**, this year's Distinguished CES Fellow, will address the ethical issues involved in a series of lectures, "Time and the Generations", that are associated with the award. *(page 2)*

The Formula for Green

The economic logic behind the so-called Green Paradox, which neatly explains why carbon dioxide emissions increase when green policies are adopted, is flawless. What is more difficult is to formalise it. **Ngo Van Long** has taken up the challenge. *(page 8)*

Who Benefits from Regional Trade Agreements?

Regional trade agreements are all the rage. But they are also controversial: witness the grumbles against the effects of NAFTA or the ages it took for the US Congress to approve free-trade agreements with Colombia and South Korea. How to find out who benefits from them? Well, ask the financial markets, suggests **Christoph Moser**. *(page 3)*

From Great Depression to Great Recession

What can we learn from the Great Depression of the 1930s that can help with coping with the Great Recession now raging across the western world? **Solomos Solomou** is doing his bit to provide the answers. *(page 6)*

Corruption, Human Rights and Disaster Aid

The connection between (lack of) respect for human rights, (abundance of) corruption and the provision of aid in case of disaster is not obvious. **Samia Costa** has done great strides in unraveling the links. *(page 7)*

Optimal Environmental Regulation in an Open Economy

In an increasingly interdependent world, what you do here is affected by what is done (or not done) elsewhere. This makes it difficult to devise optimal environmental regulations, as **Charles Kolstad** explains. *(page 8)*

Germany's Creditworthiness Threatened

The yield on Germany's government bonds is the benchmark against which a country's financial health is measured nowadays. Now, thanks to the ballooning liabilities Germany is assuming in the battle to rescue the floundering southern flank of the Eurozone, its own creditworthiness is taking a hit. **Hans-Werner Sinn** explains why. *(page 4)*

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Munich Lecture in Economics 2011 Time and Generations

Is it fair to bequeath public debt to future generations? From reducing the risk of depleting natural resources through ensuring proper funding for future pensions to keeping climate change in check, concerns about the correct ethical approach to processes stretching across generations are the subject of much thought and debate.

These issues have long been part of the research focus of **Sir Partha Dasgupta**, this year's Distinguished CES Fellow.

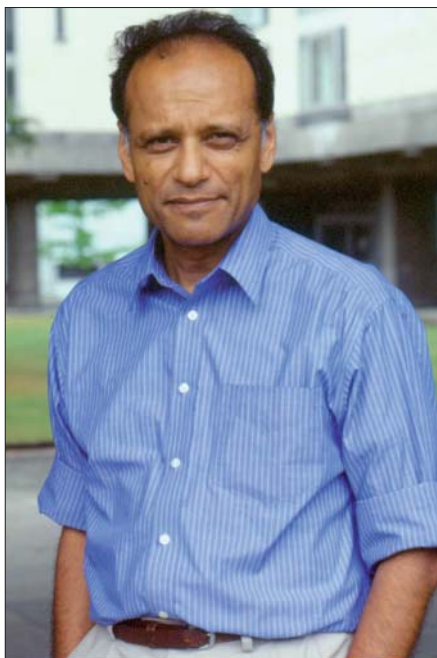
As an example of his approach to such issues, one of his papers on intergenerational equity calls attention to the fact that social discount rates have universally been taken to be positive, on grounds that the rate of return on investment is positive. *"But if consumption and production activities give rise to environmental pollution as a by-product, the social rate of return on investment could be zero even when the private rate is positive; at the very least, the social rate would be lower than the private rate."*

Thus, he continues, the current practice among most global energy modellers of relying exclusively on (risk-free) market rates of return for estimating optimal carbon taxes is *"conceptually faulty"*.

This is a glimpse of the territory through which Sir Partha will take the audience during in his three-part Munich Lectures in Economics, entitled *"Time and the Generations"*, to be held as part of the award ceremony for the 2011 Distinguished CES Fellow prize.

It promises to be a scholarly voyage into the philosophical aspects of economic thinking, in which Sir Partha will most assuredly apply the same ardour and rigour as he does with the intricacies of his mathematical modelling.

With his oeuvre speaking of compassion, and with his sharp observation and above all analytical brilliance, Mr Dasgupta is an ideal thinker for some of the most important problems of our age. The book resulting from his Munich Lecture will in time undoubtedly become compulsory reference for students and researchers in economics.



Sir Partha Dasgupta

On Sir Partha Dasgupta

Partha Dasgupta is the Frank Ramsey Emeritus Professor of Economics at the University of Cambridge and Fellow of St John's College, Cambridge. He has been Professor of Environmental and Development Economics at the Sustainable Consumption Institute since 2008, where he is also a Professorial Fellow.

Born in 1942 in Dhaka (at that time part of India), he first obtained degrees in Physics (University of Delhi, 1962) and Mathematics (Trinity College Cambridge, 1965). He went on to complete a PhD in Economics at the University of Cambridge (1968) in an amazingly short 18 months.

He is the son of renowned economist Amiya Dasgupta, who encouraged him to focus on applied theory. Being a theorist by temperament and training, a recurrent theme in his work is the attempt to introduce Nature (natural capital) into economics.

When he talks about his research agenda he emphasises that economists need to engage with anthropologists and ecologists in order to understand, for example, poverty in the Third World, because

these disciplines have gained insights from years of experience.

With this non-standard way of framing social problems and re-constructing economics, he is now one of the most-cited scientists in the fields of welfare and development economics, as well as in environmental and resource economics.

For his outstanding contributions to economics, he was named Knight Bachelor by Queen Elizabeth II in her 2002 Birthday Honours List. In addition, he has been awarded the 2002 Volvo Environment Prize, the 2004 Kenneth E. Boulding Memorial Award of the International Society for Ecological Economics, and the 2007 John Kenneth Galbraith Award of the American Agricultural Economics Association.

Mr Dasgupta is a former President of the Royal Economic Society (1998-2001), the European Economic Association (1999), Section F (Economics) of the British Science Association's BA Festival of Science (2006), and currently President of the European Association of Environmental and Resource Economists (2010-11). He has authored 22 books and sits on the editorial board of many prestigious journals. His *"Inquiry into Well-being and Destitution"* (1993), in which he interconnects different disciplines, is considered his most important work.

The Distinguished CES Fellow Award

Every year the Center for Economic Studies (CES) awards a prize to an economist who has made great contributions to the understanding of economic policy issues.

Sir Partha Dasgupta follows in the footsteps of previous prominent awardees such as Peter Diamond (Nobel Laureate 2010), Paul Krugman (Nobel Laureate 2008) and Richard Blundell, and will give the Munich Lectures in Economics 2011 as part of the ceremony. The prize is endowed with 10,000 euros.

The event, financially supported by Munich Re, will start on Tuesday, 15 November 2011 at 6 p.m. in the Great Hall of the Ludwig Maximilian University of Munich. The entire lecture series will also be published by MIT Press.

Asking the Financial Markets

Moser

Who benefits from Regional Trade Agreements (RTAs)? Empirical studies have a hard time answering this seemingly innocent question decisively. Estimating the impact of a RTA on trade is not easy and only a few papers try to go beyond pure trade effects.



Christoph Moser offers an alternative approach in a joint paper with Andrew Rose (University of

California, Berkeley): he consults the stock market for its opinion on RTAs.

What are the most critical pieces of RTA news for a stock market? Two candidates stand out: i) When governments officially announce the onset of negotiations; and ii) when they reach a general agreement.

He gathers dates for these announcements for over one hundred RTAs and 80 countries over 20 years. Then, he computes the domestic stock market returns around these events (adjusted for international stock market movements).

What characteristics of both the countries involved and the RTAs explain these excess stock market returns? Two main findings emerge. First, countries that already trade a lot with each other show positive stock market returns. This is consistent with the idea that trading partners

should be “natural”. Second, poor countries profit from RTAs. Since prominent economists such as Joseph Stiglitz fear that poorer countries face “take-it-or-leave-it” offers during bilateral trade negotiations, this comes as somewhat of a surprise.

During his stay at CES, Christoph Moser will continue working on an ongoing project with Alexander Keck

(WTO). Once more, daily financial market data lie at the heart of the identification strategy. Based on a very rich data set, he seeks to test for the credibility of the WTO Dispute Settlement Mechanism (DSM). If the DSM is perceived as credible, stock market returns of affected firms should react systematically around decisions of the “international trade court”. This allows determining the economic importance of this institution.

Christoph Moser is a post-doctoral researcher at KOF Swiss Economic Institute, ETH Zurich. He received his doctorate in Economics from the University of Mainz in March 2008. He has published in international journals such as the *Journal of International Economics* and the *Journal of Money, Credit and Banking*. His research focuses on international trade and labor market outcomes, international finance, and sovereign risk.

Tax the Rich?

Scheuer

Next to bankers, highly paid individuals have become everyone's favourite hate figures after the financial crisis. Calls for taxing them more steeply have become louder and ubiquitous, not least from the “occupy” crowds populating newspaper covers lately. Tea-partiers, in contrast, foam at the mouth at the slightest mention of tax increases. So what does economic thinking say?



Ask **Florian Scheuer**. He has provided, together with Casey Rothschild, a theoretical foundation for studying the merits of arguments in favour of a more steeply progressive tax code, or the introduction of very high taxes for instance on bonus payments in the financial sector. This is part of a current research project that considers the implications of rent-seeking behaviour for optimal income tax design.

Mr Scheuer is also working on the regulation of markets for financial derivatives in view of counter-party risk, another policy issue that has received considerable attention recently.

An Assistant Professor of Economics at Stanford University, Mr Scheuer will be visiting CES in December 2011. He joined the Economics Department at Stanford in 2010, after receiving a PhD in Economics from MIT in the same year. His undergraduate studies were at LSE and the University of Konstanz, from where he holds a MSc in Economics. His fields of interest include public finance, macroeconomics and economic theory, with a focus on tax policy and government interventions in credit and insurance markets. He has published in the *Journal of Political Economy* and the *Journal of Public Economics*, among others.

Mr Scheuer was awarded the Robert Solow prize for excellence in teaching and research at MIT and selected as a participant to the Review of Economic Studies tour, both in 2010.

Interaction Between Trade and Labour Market Outcomes

Prat

The selection effect of trade liberalisation is likely to lower unemployment and raise real wages, as research by **Julien Prat** and Gabriel Felbermayr shows. They study economies where workers can direct their search effort. The introduction of directed search, apart from being a realistic extension, allows them to characterise the impact of trade on both unemployment and residual wage inequality. Their research aims at separating the predictions that are

robust across environments from the ones that are specific to the search technology.

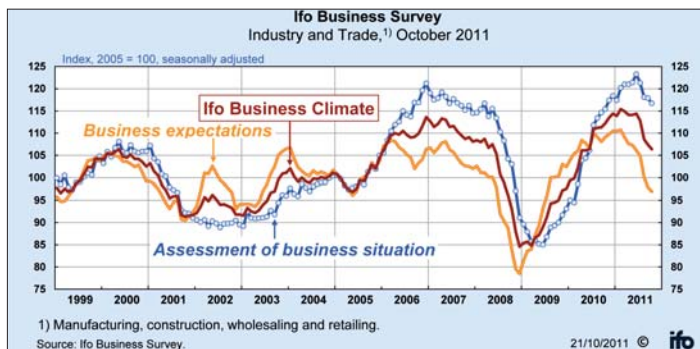
Currently working at the Institute for Economic Analysis in Barcelona, Mr Prat obtained his PhD from the European University Institute in Florence. Previously, he was an Assistant Professor of Economics at the University of Vienna.



ifo News

Ifo Business Climate Index Losing Momentum

The Ifo Business Climate for industry and trade in Germany cooled further in October. The business situation is not rated quite as positively as in the past few months. Regarding business in the coming half year, companies are more sceptical than before. But given the international turmoil, the German economy is still performing well.



In manufacturing the business climate index declined slightly. The business situation weakened somewhat but is still assessed as favourable. Regarding future business development, companies remain sceptical but somewhat less so than in the previous month. Firms' export expectations have even improved somewhat. Although capacity utilisation is significantly lower than in summer, the expansive trend in personnel hiring continues.

In retailing the business climate index fell slightly. The current business situation for retailers is somewhat less favourable than last month. With regard to business expectations for the coming half year, firms remain cautious. The business climate in wholesaling cooled significantly. Although the survey participants assessed their business situation predominantly as favourable, they do not regard it quite as positively as in September. Their business expectations are noticeably more pessimistic than previously.

In construction the business climate has again deteriorated, but assessments of the

current business situation remain very good. Overall, however, the business expectations point to a clear cooling.

Euro-zone: Growth Outlook Deteriorates

After a sharp slowdown in Q2, real GDP growth in the euro area is expected to remain subdued until Q1 2012. The loss in GDP momentum owes to a stronger than expected weakening in global demand and self-reinforcing negative impulses from the

following: the deepening of the sovereign debt crisis, financial markets turbulence and a worsening of business and consumer confidence.

This deterioration of the economic climate is weighing on domestic and external demand. Investment is projected to grow slowly in the next quarters as a result of weak economic fundamentals and financial market tensions. Private consumption growth will also remain fragile over the forecast horizon, in a context of precautionary savings and lacklustre real disposable income. Under the assumption that oil price stabilizes at USD 110 per barrel (in Q4 and Q1 2012) and that the euro/dollar exchange rate fluctuates around 1.37, inflation is expected to decelerate sharply over the forecast horizon.

The Euro-zone Economic Outlook is jointly produced by the German Ifo Institute, the French INSEE institute and the Italian Istat.

Germany's Creditworthiness Undermined

With its participation in the rescue operations of the Eurozone Germany is undermining its creditworthiness, said **Hans-**

Werner Sinn, President of the Ifo Institute. Germany's insurance premium for ten-year government bonds rose to 124 basis points in September. In the course of the rescue operations the premium has risen much faster than the British premium and had overtaken it for the first time as early as August. The German premium was 17 times what it had been in the first half of 2008. An insurance premium of 124 basis points implies, according to Mr Sinn, that over a period of ten years the markets expect the bankruptcy of Germany with a probability of almost 12%.

Mr Sinn further pointed out that the Target loans, which the German Bundesbank has made available to the ECB in order to permit the countries of the southern periphery to print more money to finance their current account deficits, had reached 390 billion euros in August. In August alone, the credit volume rose by 47 billion euros.

According to Mr Sinn, the rising insurance premium shows that the markets are reacting to the exorbitant rescue programmes that had already been passed and are to be further expanded, as decided by the Bundestag. The markets assumed that Germany may overextend itself. Together with the first rescue package for Greece, the Target credits of the ECB to the countries of the periphery, the bond purchases by the ECB, and the assistance of the IMF and the EFSF, the decisions of the parliament would bring the total assistance of the community of states to 1,679 billion euros.

In case of default by Greece, Ireland, Portugal and Spain, Germany would have to assume a liability of 468 billion euros. Should Italy also default, the German liability would rise to 520 billion euros. The probability was high that this liability would in large parts be called, said Mr Sinn.

In Mr Sinn's view, it is especially problematic – if the simulation games of the EU become reality – after ratification of the agreements to give the EFSF a leverage

effect by creating AAA-rated structured securities that allow lending a multiple of the 440 billion euros that are mentioned in the law. Thus, the funds of the EFSF would tend to get the character of lost insurance premiums to insure the sovereign debt of the crisis countries.

The Ifo President interpreted the financial crisis as a poker game between western world asset owners and the Federal Republic of Germany about who should get the dodging government bonds of the southern countries. Germany was taking on asset risks that are hardly controllable, warned Mr Sinn. The rise in the insurance premium shows that it is well on the way to gambling away its creditworthiness.

Ifo Automotive Industry Forecast: Cooling Motors

The production volume of the German automotive industry is expected to grow by an average pace of 11 to 12 percent in 2011, according to a forecast by the Ifo Institute. According to the Ifo calculations, passenger car production volume will increase by about 5.5 percent to 5.85 million vehicles.

In addition, commercial vehicles as well as the increasing quality of vehicles will lead to a significant increase in production volume in monetary terms for the industry as a whole. Passenger car exports are likely to increase by 5%, on an average annual basis. However, for the remainder of the year, new domestic and foreign orders for the auto industry will no longer be expansive but are more likely to hover at present levels.

A precise forecast for 2012 is difficult due to the euro debt crisis and the restructuring efforts of many public budgets, which particularly affect cyclically sensitive industries such as the automotive sector. The potential for a further surge in demand next year does exist, however, according to the Ifo experts: taking business-cycle aspects into consideration, there is still room for improvement in the major industrialised regions (Western Europe, North America), while in the major emerging economies such as the BRIC countries, the demand driven by the structural catching-up process remains large. *“The extent to which this growth potential can be realised will only be able*

to be assessed quantitatively once the nervousness on global financial markets subsides”, comments Ifo expert **Reinhard Hild**.

Ifo Name Changes

On June 29, 2011 the General Meeting of



the Ifo Institute decided to change the official name of the Ifo Institute to *Ifo Institute – Leibniz Institute for Economic Research at the University of Munich*.

The Ifo Institute is a part of the Leibniz Association. In 2002 the Bavarian State Government awarded the Ifo Institute the status of an institute at the University of Munich. Both additions were not previously named in the by-laws of the Ifo Institute. This has now been remedied. The name change is purely declaratory and has no legal relevance.

Because of the high visibility and uniqueness of the Ifo Institute, the supplemental name components can be dispensed with in everyday use, where it will continue to use its nationally and internationally established name “Ifo Institute”.

Euro Crisis Due to Structural Imbalances

The roots and mechanisms of the euro crisis were explained by Ifo President Hans-Werner Sinn at the annual congress of the International Institute of Public Finance (IIPF), held last August at Ann Arbor, Michigan. The IIPF is the world organization of Public Finance economists.

As Mr Sinn explained, the euro area suffers from a severe balance of payment crisis that is due to structural imbalances and not, as claimed by politicians, merely to speculative attacks. The euro brought about a convergence in interest rates, lowering all euro members' borrowing costs down to German levels. This triggered massive capital flows to the euro zone's periphery, in particular to Greece, Ireland, Portugal and Spain (GIPS), fueling a decade-long boom in those countries.

But it proved to be a mixed blessing. The competitiveness of these countries was severely eroded in the process, since their wages and prices rose excessively over

the period. To come out of the crisis, the GIPS now need to depreciate in real terms, i.e. reduce wages and prices relative to their trading partners, a painful process that requires harsh austerity programs, straining the social fabric and causing significant political strife.

Interest spreads, i.e. rates that differ according to the creditworthiness of each borrowing country, are necessary as a disciplinary device, as they make it more expensive to borrow beyond the real capacity to repay the debts. Italy recently reacted to the interest spreads with an austerity program, whereas for years it had failed to react to political constraints. Thus the debt repurchasing policies of the European Central Bank (ECB) and, in particular, the new ESM as planned by the EU countries in July, which aim at reducing the interest spreads, are counterproductive. Furthermore, the sums necessary to repurchase the existing debts would be gigantic, probably over 3 trillion US dollars.

As private capital flows to the GIPS dried up when the crisis hit, the ECB stepped in to prop up the resulting balance of payment deficits. It tolerated the creation of base money by the GIPS national central banks that ultimately did not circulate in those countries, but was used to pay for a net flow of goods and assets bought from other euro countries, crowding out the money created by refinancing operations in the euro core countries. Basically, the ECB allowed the GIPS to take over the role of reserve countries in the euro area in a manner similar to that of the USA under the Bretton Woods system. This, said Mr. Sinn, amounted to a forced capital export from the core to the periphery, amounting to about a third of its total capital export under the euro, which itself was 1,071 billion euros.

Given that the shifting of base money creation from the core to the periphery is quickly depleting the stock of refinancing loans that the core countries' national central banks could make available to their respective economies, the ECB cannot extend this policy beyond 2013 without fundamentally changing its set of policy tools. Mr. Sinn called for the establishment of a long-term plan for redeeming the existing Target debt, and for a system to be instituted whereby Target liabilities are settled once-yearly with marketable assets, as is the case in the USA.

From Great Depression to Great Recession

Solomou



The Great Recession of 2008/09 has resulted in renewed interest in the policy lessons from the Great Depression of the 1930s. A rich historical literature already exists providing evidence on the links between devaluation and economic recovery in the 1930s.

The comparative approach developed by Choudri and Kochin, and Eichengreen and Sachs, suggest that devaluation had a positive effect on economic recovery in the 1930s. These results have been shown to be applicable to a wider set of countries. More recently, panel econometric methods have been used to isolate the effects of fiscal and monetary policies; Almunia et al. find that monetary policy made a difference to economic recovery in the 1930s and fiscal policy was a missed opportunity in that fiscal multipliers were large, but, in general, countries hesitated to use fiscal expansion.

Solomos Solomou's research, working together with Moritz Schularick, will contribute to the existing literature in three significant ways: first, by extending the set of control variables for a wide selection of countries. Secondly, the analysis of the effectiveness, or otherwise, of particular policies during the 1930s has to recognise that a number of policies changed within the same period.

As such it seems surprising that tariffs have been neglected by the studies that focus on devaluation-monetary policy and vice versa for studies that focus on the role of tariffs in the recovery of the 1930s. The proposed study will consider devaluation, monetary policy, tariffs and fiscal policy variables within a unified empirical framework.

Finally, to date researchers have started from the unlikely assumption that countries entered the Great Depression in similar shape so that variation of economic outcomes can be mainly explained as a function of differences in policies. This stands in contrast to the emerging literature about the Great Recession of

2008/09, which shows that the extent of the preceding credit boom and the build-up of economic imbalances had identifiable effects on the recession.

On another strand, Mr Solomou examines what has been described as "Start-Stop Growth" in the post-war period, entailing large swings of growth

within twenty-year intervals. His work aims to contribute to this area by adding an historical perspective to the topic, motivated by such question as: Are the segmented episodes of economic growth nation-specific or is there a common patterns across countries? Are the variations of economic growth purely episodic or are they partly cyclical or quasi-cyclical? Do events and specific policies affect episodic economic growth? Are long swings merely swings in financial fragility?

Why does economic growth display segmentations over time in frequencies that are longer than the business cycle as conventionally understood? Kehoe and Prescott use the real business cycle framework to explain episodic "great depressions", averaging approximately a decade, as the result of institutional failings and policy mistakes.

In contrast to the idea of one-off "great depressions", the long-swing perspective has observed fluctuations of high and low economic growth of approximately 20 years in duration. Mr Solomou's aim is to use comparative historical evidence to develop an understanding of such growth episodes, making it possible to evaluate the long-swing hypothesis that there is a cyclical or quasi-cyclical component to episodic growth, against the alternative hypothesis that these observed phases are purely random. Such swings are likely to be time-varying and the aim is to identify these time-varying features.

Solomos Solomou is a Reader in Economics at the University of Cambridge, where he obtained in PhD in 1983. He was awarded a Pilkington teaching prize from his alma mater in 1991.

Exporting vs. Non-Exporting

Impullitti



Many plant-level studies find that average wages in exporting firms are higher than in non-exporting firms from the same industry and region. An additional related finding is that trade liberalisation increases the wage gap between exporters and non-exporters, thus contributing to widening wage inequality.

Giammario Impullitti will work on this with Julien Prat (see p. 3) and Gabriel Felbermayr, introducing search and matching frictions into a static framework of trade and heterogeneous firms with endogenous market structure that Mr Impullitti developed with O. Licandro. Their model introduces firm heterogeneity into an innovation-driven growth model. The key distinguishing feature of their model is that it focuses on the interactions between trade, firm heterogeneity and innovation in a dynamic oligopolistic environment.

In their model, export markets are more competitive and yield lower equilibrium markups. If workers and firms bargain wages individually, they find that lower markups lead to higher wages, therefore generating the wage difference between exporting and non-exporting firms found in the data. Moreover, trade liberalisation produces a reduction in markups and an increase in the wage gap. Interestingly, under centralised (union) bargaining the wage gap is lower, and trade liberalisation produces wage compression. They are currently calibrating the model to two different benchmark economies: the US calibration, in which they use US data and wages are set with individual bargaining, and the Europe calibration, in which unions bargain with firms. The goal is to study whether the different labour market institutions can account for the difference in the export wage premium between US and Europe.

Mr Impullitti is an Assistant Professor at Cambridge University. He obtained his doctorate from the University of Rome "La Sapienza" and a PhD from New School University, New York, in 2006.

Corruption, Human Rights, and Disaster Aid

Costa

Do human rights violators report fewer disaster-related casualties? A case that springs to mind is Myanmar during the 2004 earthquake and tsunami that devastated South Asia. Despite its proximity to the epicenter, it reported merely 61 casualties. Witness reports, according to some sources, mention over 600. If the government indeed underreported the human cost, what could have motivated it?

This will be part of **Samia Costa's** research focus while at CES, in line with her interest in examining the determinants and consequences of natural disaster aid. The reasons why pariah states would report fewer disaster-related casualties, according to her, may be due to the fact that they do not expect to receive assistance, in which case they may invest more in disaster prevention. On the other hand, these countries may simply underreport the number of casualties.

Another strand of her research will be studying the impact of freedom of information laws at the country level, which chimes in with her studies on the effects of transparency on corruption.

One of her papers, forthcoming in the *Journal of Law, Economics, and Organization*, examines the effect of freedom of information laws on corruption across countries. Freedom of information laws



may decrease corruption due to greater accountability. However, these laws also allow for increased scrutiny, which could increase the perception of corruption. She finds that corruption perceptions rise and the quality of governance falls following the adoption of freedom of information laws, and in particular in the initial years after the reform.

Her results also suggest that there is no significant decrease in the long term, and that countries with a free press are the ones that experience the increase in corruption perceptions, suggesting that the observed increase is indeed due to increased scrutiny.

In current working papers, she has explored the effects of US disaster relief on human rights, and the effects of corruption and human rights on aid provided.

Samia Costa obtained her PhD from the University of Florida in 2002 and is currently Assistant Professor of Political Economy of Development at the University of St. Gallen. She is a member of the Department Economics and of the Profile Area "Global Democratic Governance", which is an interdisciplinary unit focusing on assessing the causes, consequences, and democratic legitimacy of new forms of governance that have resulted from globalisation.

Vertical Imbalances

Dahlby

Why do vertical fiscal imbalances emerge in federations, in the sense that the marginal rates of substitution between state-provided public services and federally-provided public services do not equal their relative marginal costs of production?

This is one of the questions that **Bev Dahlby** will attempt to solve while at CESifo. To this end, he will develop a political economy model of the vertical fiscal gaps and vertical fiscal imbalances in a federation. This model will attempt to explain the factors that determine the extent to which central governments provide grants to subnational government in a democracy where residents vote in both state and national elections.

A second research topic during his stay concerns the development of a model of the optimal intergovernmental transfers to achieve vertical and horizontal fiscal balance in a federation, and to correct vertical and horizontal expenditure externalities.

Bev Dahlby, Professor of Economics at the University of Alberta, attended the University of Saskatchewan, Queen's University, and the London School of Economics. He has published extensively on tax policy and fiscal federalism. His book, *The Marginal Cost of Public Funds: Theory and Applications*, was published by MIT Press in 2008. Two years later, he was awarded the Doug Purvis Memorial Prize by the Canadian Economics Association for a work of excellence relating to Canadian economic policy.

He has served as a policy advisor to the federal and provincial governments in Canada on the reform of business taxation, the fiscal equalisation program, tax credits for television and film industry, taxation of inbound foreign direct investment, saving non-renewable resource revenues, and programs in support of research and development and innovation.



Labour Market Flows

Mike Elsby, of the University of Edinburgh, was a recent visitor at CESifo. He worked on projects related to the role of adjustment costs in the propagation of business cycles through the labour market, new estimates of worker flows between employment, unemployment and nonparticipation, and the role of non-work benefits in accounting for the secular rise in male joblessness in the United States.

Mr Elsby obtained his PhD from the London School of Economics in 2005.

His research focuses on the interface between macroeconomics and labour economics, in particular unemployment and wage determination. In recent work, he has examined the role of trend wage growth on long-term increases in joblessness, and the theory and measurement of labour market flows in developed economies before and during the Great Recession, amongst other issues.



Formalising the Green Paradox

Ngo Van Long

It sounds unbeatably sensible. If you want to reduce the carbon dioxide emissions resulting from energy generated by burning fossil fuels, look for carbon-neutral alternatives and make it more onerous to stick to the fossil variety. So you subsidise biofuels and solar and wind power. The upshot? Surprise: carbon dioxide emissions increase.



Ngo Van Long started thinking along the lines of the effects that the anticipation of tax changes can have on natural resource extraction more than a quarter of a century ago. He wrote a paper with Hans-Werner Sinn on the issue (*"Surprise Price Shifts, Tax Changes and the Supply Behaviour of Resource*

This is the so-called *Green Paradox*, a term coined by Hans-Werner Sinn (the English-language version of his namesake seminal book will be published by MIT Press before year-end). It appears that the promise of ever tighter carbon-reducing regulations to come prompt resource owners to bring fossil fuel extraction forward, thereby increasing CO₂ emissions.

The economic reasoning behind the Green Paradox is impeccable. What is somewhat more difficult is formalising it. **Ngo Van Long** decided to tackle the challenge. During a one-year stay at CESifo, he will attempt to refine the formal theory underpinning the paradox. *"It is tough. Not least because the risk of expropriation is a hard thing to formalise and measure."*

He acknowledges that the Green Paradox may or may not happen: *"It all depends."* For instance, on such things as technological developments, substitutability, and the behaviour of the suppliers, amongst other factors.

But there are some indications that such is indeed the case. In Canada, oil is being extracted from its abundant tar sands fairly quickly, amidst concerns that legislation allowing its extraction may be made more restrictive in the future.

Extracting Firms") that was published in *Australian Economic Papers* in 1985. Now he wants to refine the theoretical considerations by considering the effects of a non-constant rate of interest.

Mr Long was born in Vietnam. In the midst of the Vietnam War, he got a scholarship from the Australian government for studies at a university down under. He received his PhD from the Australian National University in Canberra in 1975, became a professor there and stayed for 15 years in the country.

Twenty years ago he went to Canada for a one-year stay as a visiting professor. He liked Montreal so much, in particular his two children did, that he ended up staying there for good. He is now the James McGill Professor of Economics at McGill University in Montreal.

In addition to Resource and Environmental Economics, Mr Long's research interests also include the Theory of International Trade, the Theory of Dynamic Optimization and Dynamic Games in Economics, and Applied Microeconomic Theory. He received the 2010 Award for Distinction in Research at McGill University.

He will be a guest researcher at CESifo until the end of August 2012.

Environmental Regulations

Kolstad

Designing an optimal environmental regulation in an open economy is no walk in the park. As an example, how should an EU carbon trading scheme be differentiated from the ideal, taking into account that regulated EU firms may lose market share to imports from firms outside the EU that are not subject to carbon regulation? This "leakage" limits the power of domestic regulation. Border tariffs can solve this problem, though they are often precluded on political grounds. California faces a similar problem.



Charles Kolstad will work on such issues during his stay at CES in December and deliver a number of lectures on international environmental agreements.

A former president of the Association of Environmental and Resource Economists, Mr Kolstad is an environmental economist specialising in uncertainty and learning in environmental regulation, particularly as applied to climate change. He is a coordinating lead author for the Intergovernmental Panel on Climate Change and editor of the journal *Review of Environmental Economics and Policy*. He is also the author of numerous scholarly articles and books. His text book, *Environmental Economics*, recently appeared in a second edition and has been translated into Spanish, Japanese and Chinese.

Mr Kolstad obtained his PhD in economics from Stanford University in 1982, and is now Chair of the Economics Department and a professor of environmental economics at UC Santa Barbara. Since 2009 he has been a Co-Director of the University of California Center for Energy and Environmental Economics, and Editor of the *Review of Environmental Economics and Policy*.