

INTEREST GROUPS AND AN (IN)ELEGANT MODEL OF INFLATION

Partha Gangopadhyay

School of Economics and Finance, University of Western Sydney
NSW 1797, Australia. Email: p.gangopadhyay@uws.edu.au
Tel: 61 2 46 203403, Fax: 61 2 46 26 6683

Abstract: The analytical foundation to existing theories of inflation ignores a very important aspect of the political reality in democracies: public policies can create special interest groups who compete against each other to influence public policies. Inflation being a *public good* and having large and concentrated effects, the formation of special interests groups is very likely. Since rent-seeking activities of these special interest groups impinge on incentives and temper constraints of a government, the analysis of inflation theory of existing models - without any footing in interest group politics - is at best incomplete, if not misconstrued. A critical problem of this literature is serious difficulties in modelling interest group formation. To circumvent this weakness we model group formation by offering an endogenous determination of *coalition* of voters, which acts as a political constituency for an incumbent government. In order to do that we develop a rent-seeking game in which special interest groups spend real resources to temper inflation in their favour. By so doing we also provide, for the first time in the literature, an endogenous determination of inflation targets of different interest groups. This is important since the endogenization of inflation targets allows us to model a *circular interdependence* that has been consistently neglected in the literature on inflation theory: inflationary experience affects real economy and, thereby, voters' evaluation of the government whilst this evaluation constrains government's behaviour that, in turn, affects inflation which further influences voters' evaluation. From this circular interdependence we model the formation of coalitions of voters that lend political support to the incumbent. In the perfect Nash equilibrium of the proposed game, the incumbent announces and adopts the equilibrium inflation rate that shapes voters' evaluations and triggers an equilibrium coalition of voters. The equilibrium inflation induces an equilibrium coalition of voters from diverse interest groups that, in turn, maximises the probability of re-election of this incumbent. We find that the equilibrium inflation is not unique, thus there is indeterminacy in the choice of an optimal inflation policy. We find that the proposed game has two equilibria: a zero-inflation equilibrium and a non-zero-inflation equilibrium. Given a history (or expectations) of low, or zero inflation rates, the zero-inflation equilibrium gets chosen. The zero-inflation equilibrium is shown to be unaffected by business cycles and political characteristics of an economy. On the other hand, if the non-zero-inflation equilibrium gets chosen due to a history, or expectations, of high rates of inflation; this equilibrium depends critically on the political landscape of a democratic society. We find that the non-zero-inflation equilibrium is counter-cyclical. We also find that conservative governments - quite contrary to Alesina's important findings - can have a larger inflationary bias vis-à-vis a socialist government, if the non-zero-inflation equilibrium gets chosen. One may thus argue that if there is a history of low inflation (or, low inflationary expectations), the equilibrium inflationary policy of a conservative government is identical to the equilibrium inflationary policy of a socialist government (convergence of inflationary policies). The divergence arises only when actual inflation, or inflationary expectation, is high. Contrary to the received doctrine, in such a scenario, the conservatives have an incentive to inflate more than the socialists.