Discussion of "Voters, Bailouts, and the Size of the Firm"

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Summary

- A political-economy theory of bailouts.
  - The firm has voters and non-voters (foreigners).
  - A politician maximizes the chance of reelection by setting the bailout scale.
  - Bailout is a transfer from population outside the firm to the firm.
  - Both voters and non-voters are taxed, but only voters are relevant for election.
- Benchmark: social optimality and political optimality disagrees when voting-population share at firm and society differs.
- Main result 1: Not "too-big-to-fail", but "too-many-votes-to-fail".
- Main result 2: under certain utility specifications, larger firms always get more bailouts (absent from externality or systematic risks).

Literature on Bailouts

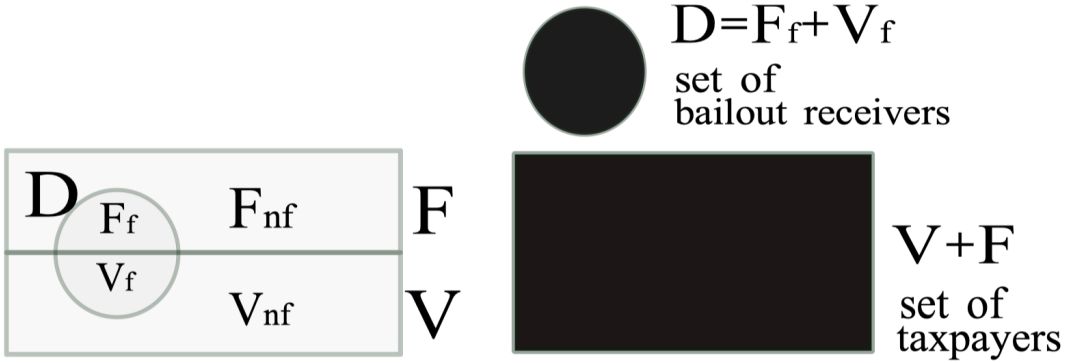
Bailout: government provision of financing to firms to keep them operating.

- Bank bailouts (e.g., TARP in global financial crisis)
  - Diamond and Dybvig (1989): avoid the panic equilibrium.
  - Holmstrom and Tirole (1998): alleviate agency conflicts.
  - Acharya and Yorulmazer (2007): causing incentive to fail together
  - Farhi and Tirole (2016): causing collective moral hazard
  - Davila and Walther (2020): causing large banks levering up and making bailouts more likely
  - Optimal design: Philippon and Schnabl (2013), Philippon and Wang (2023)
- Non-bank bailouts (e.g., PPP during COVID for small firms)
  - Zombie firms: Caballero, Hoshi, and Kashyap, (2008); Acharya, Lenzu, and Wang, (2021)
  - Li and Li (2020): dynamics of firm quality distribution casing a slippery slope.

This paper

- Key difference from the bailout literature: politics in decision-making by the government. Only voter utility enters "planner's objective".

- Model:
  - Failing firm: voters V_f and foreigners F_f. Wealth is $\bar{w} - \epsilon$ due to shock.
  - Economy: voters V and foreigners F. Non-failing-firm agent wealth is $\bar{w}$.
  - Bailout: tax all agents and transfer that fully to stakeholders of the firm.



Model Setup

- Voting based on probabilistic voting model of Lindbeck and Weibull (1987).
- A voter chooses incumbent if the ideology preference for contender (no bailout because too late) is below the utility gain from incumbent bailout:

$$\Delta_i \leq v(w_i + t_i) - v(w_i)$$

where t_i is a transfer.

- Voter of the bailout firm gains utility:

$$v(\bar{w} - \underbrace{\epsilon}_{\text{shock}} + \underbrace{\frac{S}{F_f + V_f}}_{\text{bailout transfer}} - \underbrace{\frac{S}{V + F}}_{\text{tax}}) - v(\bar{w} - \underbrace{\epsilon}_{\text{shock}})$$

- Voters outside the firm gains utility:

$$v(\bar{w} - \underbrace{\frac{S}{V + F}}_{\text{tax}}) - v(\bar{w})$$

Policy Choice

- The size of bailout package S will be determined by maximizing reelection probability

$$\frac{1}{2}\left(\begin{array}{c}\frac{V_f}{V}\left(v(\bar{w}-\epsilon+\underbrace{\frac{S}{F_f+V_f}}_{\text{bailout transfer}}-\underbrace{\frac{S}{V+F}}_{\text{tax}})-v(\bar{w}-\epsilon)\right)\\ +(1-\frac{V_f}{V})\left(v(\bar{w}-\underbrace{\frac{S}{V+F}}_{\text{tax}})-v(\bar{w})\right)\end{array}\right)+\frac{1}{2}$$

- Social planner cares about all agents and utilitizes a different weight $\frac{V_f+F_f}{V+F}$.
- "Too many voters to fail": increase firm's voters V_f primarily boosts voting power and thus S^*.
- "Too-big-to-fail-alike": increasing firm's non-voters F_f boosts S^*.

Comment 1: Social Value of Bailouts

- In the model, the social value of bailout is to insure stakeholders of the failed firm, i.e., an insurance contract.
- The typical argument is that bailouts alleviate the severe consequence of market failure and aggregate externality.
- Modify the framework to account for it:

$$\text{(original obj)} + \underbrace{\kappa(S)}_{\text{aggregate improvement in disaster}}$$

  where the additional term $\kappa(S)$ is increasing and concave.

- My conjecture: most results should go through, except for the limit case of $\epsilon = 0$.

Comment 2: Ex-ante v.s. Ex-post Welfare

- The model is cast as after a bad shock on the firm. Welfare evaluation is conditional on the bad shock. What about ex-ante welfare?
- In particular, expecting bailouts, stakeholders of the firm may choose to overspend in normal times, anticipating larger bailouts in bad states.
- Loop in the stakeholder decision problem (c denotes consumption):

$$\max_c v_0(c) + \beta E[v(\underbrace{w_0 - c}_{\bar{w} \text{ in the model}} + (t^A - \tilde{\epsilon})\mathbf{1}_{\tilde{\epsilon}>0})]$$

  - The bailout transfer t^A only happens for bad realization $\tilde{\epsilon} > 0$.
  - The presence of $t^A > 0$ incentives a larger c, leading to lower $\bar{w} = w_0 - c$, begging more bailouts.
  - Note that this happens even if individual stakeholder is small, i.e., no coordination.

Comment 3: Taxation as the Cost of Bailouts?

- "Wisdom" from ChatGPT: the primary cost of bailout is an expansion of government debt.
- In reality, bailouts are financed by debt. Higher debt does not necessarily require increased taxation in the near term.
  - Both democrats and republicans are no longer fiscally conservative.
- Other costs of bailouts:
  - Inequality between capitalists and workers.
  - Sovereign credit risks (Acharya, Drechsler, and Schnabl, (2014))
  - Excessive risk taking and moral hazard issues (Farhi and Tirole (2016))
  - Lingering effects of Zombies (Caballero, Hoshi, and Kashyap (2008); Acharya et al. (2021))
  - Distort quality dynamics (Li and Li (2020)).

Summary

- A unique angle on an increasingly important question!
  - Expanded government intervention in many aspects of private markets.
- High-level thought: modeling politics in policy making, rather than only "benevolent social planner".
  - Why it is so difficult to end a war despite severe economic consequences?
  - Does financial integration reduces geopolitical tensions?
  - How politicians distort beliefs of private agents by controlling information dissemination?
  - Is there a political-diabolical loop of government intervention in private markets?
  - What forces can stop the U.S. from exhausting its debt capacity?