A Pleading for Policy-independent Institutional Organizations

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By

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1 Introduction

The aim of the paper is to formulate a pleading for the establishment of policy-independent institutional organizations (IIO). Here we restrict ourselves to public institutional organizations like central banks, statistical bureaus, tax administrations and the control of the international financial markets. With the term “independent” we mean explicitly “policy-independent”. The first two public institutional organizations are very well analyzed. Here, we will concentrate on the role of the tax administration of a country and the role of the regulation of the international financial markets. In some sense the idea that the tax administration should be independent from political influence is new and maybe for some readers surprising. Of course that should not mean that the tax administrations could do what they want to do or to abolish all political influences. It should mean that the political system has the task to decide about at first on questions like the distribution of income, quantity of the supply of public goods, public infrastructure, and quantity of the supply of demeritoric and meritoric goods, environmental targets, quantity of subsidies and so on. After these decisions are made by the government and parliament the task of the tax administration should be to determine the optimal tax and subsidy policy to reach these policy-formulated objectives. The process of determining the optimal tax policy should be made independent of any political influence. Why should this kind of decision mechanism superior to the existing decision mechanism where policy-makers lay down specific tax laws, subsidy laws, and environmental laws?

The answer we will give is that our proposed mechanism will work much more efficient than the well-known decision mechanism. We will base our proposal on some simple insights from the theory of institutional economics and public economics. We want to avoid lock-in effects, want to avoid the influence of lobbyists, principal-agent problems, to simplify institutional changes, and to avoid inconsistencies in the tax system. We will see that our proposal,

* The authors thank the participants of the Rothenberge seminar 2008 for their helpful comments and suggestions. All remaining errors are ours.
although maybe in some sense politically not very realistic to apply could be a helpful one to increase the efficiency of the public sector.

Regarding the regulation of the international financial markets, it seems to be obvious that the existing system, if we would interpret this as a system, has absolutely failed and we can observe the negative economic consequences at the moment every day. The existing system is in principle only based on multi-lateral agreements, which were decided by the policy-makers of the biggest economies, like the group of eight (G8).

Maybe some readers have some doubts; however we will try to convince the critical readers, where we at first repeat the results regarding the independence of central banks in the second section. In the third section, which is based on Stauvermann (2009) we will show that the same hold for statistical offices. In the fourth section we will investigate into the problems of tax systems, and tax administration. In the fifth section we explain the problems of the international financial markets, in the sixth section we introduce a model and in the last part we conclude our results.

It should be noted, we assume throughout the whole analysis that policy-makers are absolutely only self-interested, they want to be re-elected and/or they want to collect rents as much as possible and/or are interested in bribes. This view of policy-makers is not new and goes back to the classical analysis of Anthony Downs (1957), which is widely used in public choice and political economy.

2 Policy-Independent Central Banks

The European Central Bank (ECB) is a prominent example of a policy-independent institutional organization, because neither national European governments nor the EU parliament are able to influence the decisions of the ECB. The tasks of the ECB are laid down in the Maastricht treaty (07.02.1992) and its main task is to avoid an inflation rate higher than 2% pa within the EURO zone. The ECB is free to decide about the means how to reach this objective.

Some people are criticizing this institutional organization, because the ECB is not under the control of elected policy-makers and consequently the critics call it as a non-democratic institutional organization.

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2In our view such rents also arise if policy-makers or their relatives will receive some advantages for their private businesses.
3Here we mean with bribes also good job opportunities after policy-makers have left the parliament. This is usual in German policy.
These critics are not substantial because we know from Arrow’s impossibility theorem, that in general no “democratic” election procedures exist and as a result no democracy in the sense of Arrow. Consequently, we define in this work the term “democracy” as a governmental system where elections take place and where the voters have at minimum the choice between two different political parties. Of course if we follow this broad definition of democracy countries like Iran, Algeria, Pakistan, Egypt etc. are democracies.

Besides this general statement it must be asked, how to justify the independence of central banks from the influence of policy-makers. Here we argue that all policy-independent public institutional organizations have a well-defined framework in which they are acting. This means that the tasks and duties of these institutional organizations are very well defined and not disputed.

To make this point more obvious, we will go back to the central bank example. The most important task of a central bank is to protect the value of the European currency, because money is at first only a mean to simplify economic transactions and to reduce transaction costs in comparison to barter trade. It is easy to see that the value or purchasing power of one unit of money should be as constant as much as possible. In so far it is not surprising that the main task of the ECB is to guarantee a low inflation rate of the Euro. Some economists, especially Keynesians criticize that monetary policy under these circumstances is impossible. They argue that monetary policy is under specific conditions a good political measure to improve the economic situation of a country. Here we do not reject this view in general, but we argue that policy-makers would use the instruments of monetary policy at first in their own interests⁵, which have leaded in history mostly to very high inflation rates. To convince the reader we will look at some empirical results. It becomes clear, regarding the objective “low inflation rate”, that independent central banks are much more successful than policy-dependent ones. To highlight this statement we look at the following figures, which are taken from Alesina & Summers (1993). At first we look at a table from Bernhard (1998), who has surveyed the literature on central bank independency.

⁴A part of this section is taken from Stauvermann (2009).
⁵E.g. before elections will take place the government could increase the salaries of public service by extending the quantity of money like it was done in Russia by the Jelzin government. Here we do not attack the analysis of Keynes (1936), but we must recognize that policy-makers are only using one half of Keynes policy proposals. Especially, policy-makers are using expansive fiscal policies permanently, although Keynes proposed to make use of restrictive fiscal-policies, if the economy is working well. However, this part of Keynes’ work was always ignored and consequently mostly all European countries have a huge government debt and mostly every year a public deficit.
From table 1 it can be concluded that the results of the different articles are very similar. That means that the term policy-independent is well-defined. At next we take a look

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**Table 1**

<table>
<thead>
<tr>
<th>Country</th>
<th>Grilli, Masciandaro, and Tabellini Total&lt;sup&gt;a&lt;/sup&gt;</th>
<th>Alesina and Summers&lt;sup&gt;b&lt;/sup&gt;</th>
<th>Cukierman&lt;sup&gt;c&lt;/sup&gt;</th>
<th>Mean Independence&lt;sup&gt;d&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>0.87</td>
<td>1.00</td>
<td>0.66</td>
<td>0.84</td>
</tr>
<tr>
<td>Switzerland</td>
<td>0.80</td>
<td>1.00</td>
<td>0.68</td>
<td>0.83</td>
</tr>
<tr>
<td>United States</td>
<td>0.80</td>
<td>0.875</td>
<td>0.51</td>
<td>0.73</td>
</tr>
<tr>
<td>Canada</td>
<td>0.73</td>
<td>0.625</td>
<td>0.46</td>
<td>0.61</td>
</tr>
<tr>
<td>Austria</td>
<td>0.60</td>
<td>0.625</td>
<td>0.58</td>
<td>0.60</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0.67</td>
<td>0.625</td>
<td>0.42</td>
<td>0.57</td>
</tr>
<tr>
<td>Denmark</td>
<td>0.53</td>
<td>0.625</td>
<td>0.47</td>
<td>0.54</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.47</td>
<td>0.625</td>
<td>0.39</td>
<td>0.49</td>
</tr>
<tr>
<td>Australia</td>
<td>0.60</td>
<td>0.50</td>
<td>0.31</td>
<td>0.47</td>
</tr>
<tr>
<td>France&lt;sup&gt;e&lt;/sup&gt;</td>
<td>0.47</td>
<td>0.50</td>
<td>0.28</td>
<td>0.42</td>
</tr>
<tr>
<td>Britain</td>
<td>0.40</td>
<td>0.50</td>
<td>0.31</td>
<td>0.42</td>
</tr>
<tr>
<td>Japan</td>
<td>0.40</td>
<td>0.625</td>
<td>0.16</td>
<td>0.40</td>
</tr>
<tr>
<td>Norway</td>
<td>0.44&lt;sup&gt;f&lt;/sup&gt;</td>
<td>0.50</td>
<td>0.14</td>
<td>0.40</td>
</tr>
<tr>
<td>Sweden</td>
<td>0.44&lt;sup&gt;f&lt;/sup&gt;</td>
<td>0.50</td>
<td>0.27</td>
<td>0.40</td>
</tr>
<tr>
<td>Belgium&lt;sup&gt;g&lt;/sup&gt;</td>
<td>0.47</td>
<td>0.50</td>
<td>0.19</td>
<td>0.39</td>
</tr>
<tr>
<td>Italy</td>
<td>0.33</td>
<td>0.45</td>
<td>0.16</td>
<td>0.33</td>
</tr>
<tr>
<td>Spain&lt;sup&gt;h&lt;/sup&gt;</td>
<td>0.33</td>
<td>0.375</td>
<td>0.21</td>
<td>0.31</td>
</tr>
<tr>
<td>New Zealand&lt;sup&gt;i&lt;/sup&gt;</td>
<td>0.20</td>
<td>0.25</td>
<td>0.27</td>
<td>0.20</td>
</tr>
</tbody>
</table>

Notes: All rankings are normalized from 0 (low independence) to 1 (high independence).

<sup>a</sup>The total independence scale developed by Grilli, Masciandaro, and Tabellini (1991).

<sup>b</sup>The Alesina and Summers (1993) index was computed by averaging the Bade and Parkin (1982)/Alesina index (1988) and their conversion of the Grilli, Masciandaro, and Tabellini scale.

<sup>c</sup>The index of legal independence developed by Cukierman (1992).

<sup>d</sup>Mean independence is computed from Grilli, Masciandaro, and Tabellini (1991), Alesina and Summers (1993), and Cukierman (1992).

<sup>e</sup>Ranking prior to 1994 reform.

<sup>f</sup>Unranked by Grilli, Masciandaro, and Tabellini (1991). The missing values were imputed by regressing their scale on the Cukierman and Alesina and Summers indexes for all countries. Using the coefficients from the equation and the values of the missing countries on the Cukierman and Alesina and Summers indexes, I computed the missing values. The correlation between that scale and the Cukierman index is r = 0.86. The correlation between that scale and the Alesina and Summers index is r = 0.85. The correlation between the Cukierman index and the Alesina and Summers index is r = 0.85. All these correlations are significant at the 0.001 level.

<sup>g</sup>Ranking prior to 1993 reform.

<sup>h</sup>Ranking prior to 1994 reform.

<sup>i</sup>Ranking prior to 1990 Reserve Bank Act.
at the following two figures taken from Alesina & Summers (1993).

Figure 1

![Figure 1](image1)

Figure 2

![Figure 2](image2)

It should be noted the higher the independence index of a central bank the lower is the variance of the inflation rate. Figure 2 makes clear that the inflation rate is decreasing with an increasing independence index. Additionally to that, figure 1 shows a strong relationship
between the variance of the inflation rates and the political dependence of central banks. Maybe, it should be noted that there exists no correlation between the independence of central banks and the macroeconomic performance of a country. However, if central banks are only responsible for the stability of the national currency and nothing else, then it looks like that independent central banks are more efficient than policy-dependent ones.

Let us take a look at the current economic situation. The actual world-wide economic crisis is at least partly a result of monetary policy of the Federal Reserve Bank (Fed). In 1987 Alan Greenspan was appointed as the chairman of the Fed by the US president Ronald Reagan. One reason why Greenspan was appointed was that he had promoted consequently the abolishment of strong regulations of the financial market. As a chairman he deregulated the US American financial markets, additionally he lowered the interest rates, while the US government promoted the idea that every American citizen shall live in his own house. This fiscal and monetary policy resulted in the housing bubble, which exploded in 2008. Especially in the years 1997-2006 the average housing price increased by 124% and in the years 2006-2008 is decreased 20%. The exploding housing bubble in combination with the new financial market innovations or derivatives like Mortgaged Backed Securities (MBS), Collateralized Debt Obligations (CDO), Credit Defaults Swaps (CDS), which were very risky and at the end the mortgage crisis resulted in the break-down of the financial market and the whole economy. However, if the Fed would have been only interested in a low interest rate probably the crisis would not be present.

Given these observations, it must be asked if the example of a central bank is maybe an exception. If a central bank is not an exception, then is must be explained what are the specific characteristics of institutions to require the establishment of policy-independent institutional organizations.

To answer these questions we should note that policy-makers are short-sighted, because mostly all four or five years’ elections take place and policy-makers want to be re-elected and/ or they want to maximize the long-run incomes. In general policy-makers have

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8 Please note the independence indexes are calculated before the Federal Reserve act 1990 was applied.
no long-run political interests. With the help of expansive monetary policy it is possible to cheat the voters in the short-run because they feel more rich than they are, but in the long-run the national currency will become worthless and as a consequence the majority of the members of the economy are harmed.

**Independent Statistical Offices**

However, policy-makers also like it to manipulate the official statistics, because the official statistics shall inform the public about the state of an economy. Following the example of a central bank, we argue, that policy-makers would like to influence the official statistics in their own favor to become re-elected. Of course, if the statistical numbers are manipulated they will become worthless.

In principle, statistical offices and central banks are public institutional organizations, which have specific clear defined objectives. Central banks shall protect the stability of currencies and statistical offices shall produce reliable official statistics. Both institutional organizations must therefore protect their norms or rules, which are important to reach their objectives. These rules or norms are the institutions, which should not be influenced by policy-makers. There exists a body of literature which explains why a statistical bureau should be independent from political influences. Good and convincing reasons are given in Birnstiel (2001), Seltzer (1994), Asbrink (1999), Hohmann-Dennhardt (1999), von der Lippe (1989), Rienstra (1999) and Brümmerhoff & Reich (1998). Here we have selected some examples to show what has happened, if statistical offices were under the control of the government.

**Example 1** (taken from Seltzer (1994)): In the 1980’s the government of the former USSR decided to reduce the alcohol consumption in the USSR. The campaign was successful, and as a result the production of the alcohol industry declined sharply. This leaded to a decrease of the overall index of industry production. Because of the fact that it was not the intention to slow down the industry production, the government compelled the statistical bureau to remove alcohol producing industries from its index.

**Example 2** (taken from Seltzer (1994)): In the 1920’s the developments of national accounting methods were associated with the name Nikolai Iwanowitsch Bukharin. After Stalin had got into power the national accounting methods of Bukharin were suppressed and Bukharin was executed on the 15.03.1938.
Example 3 (taken from Seltzer (1994)): In 1953, the administration of the Eisenhower government (USA), especially Edgar Hoover detected that the Bureau of Labor Statistics was using input-output tables since 1941. The idea of the input-output tables goes back to Wassily Leontief, who was born in Russia, and the tables were first used in the USSR for planning. Consequently, the input-output table project was stopped by the Eisenhower’s government, because the administration feared that this methodology is strongly related to communist planning economies.

Example 4: In 2005 it becomes clear that the Greek government has manipulated the national deficit/GDP ratio so that it was always lower than 3% to avoid a punishment by the European Union. However, “the National Statistical Service of Greece (NSSG) is a General Secretariat of the Ministry of Economy and Finance…”. (see http://www.statistics.gr/Parousiasi1_eng.asp (25.04.2006)). So it should not surprising, that the Greek government influences the data.

Example 5: In 1931 Gaetano Salvemini (1931)\(^{10}\) has written about how the Italian dictator Mussolini has forged the numbers of the Italian wheat production to convince the Italian people that he is a good political leader.

We have taken only five examples into account, but the number of cases of manipulated statistics seems to endless (see e.g. Seltzer (1994), Brümmerhoff & Reich (1998), or Birnstiel (2001)). Whenever a government is allowed to influence the statistical data, policy-makers will do it to enhance the chance to be re-elected or in dictatorships to enhance the image of a good economic performance.

Of course, this behavior is very short-sighted, but mostly policy-makers have a preference to take only the short-run into account. But in principle the consequences of wrong information means nothing else then cheating the people and this has similar consequences as not announcing an increasing money supply initiated by the central similar. If economic agents believe in the information of the government and central bank, then they take this information into account with respect to their own economic decisions. But later on they will experience a disappointment, because they based their expectations on wrong information and the (intertemporal) allocation of their wealth will be distorted. Without going more into

\(^{10}\) See also the reply of Mortara (1931).
details, it should be clear that the statistical information should be as reliable as possible, otherwise the work of the statistical office would be a WOMBAT (waste of money, brains, and time) and hence inefficient, because wrong information is useless information.

Not surprisingly, on the international level it is also preferred to let the national accountants decide on national accounting rules. This decision mechanism is also preferred by the United Nations Statistical Division (UNSD), and other international organisations like the OECD and Eurostat. Especially, the UNSD has laid down ten fundamental principles of statistical rules (code of practice), which were overtaken by the CBS and Eurostat.¹¹

The general problem is, if policy-makers have the opportunity to change either the statistical numbers directly or by introducing another accounting methodology indirectly, they will have an incentive to do so. For example, in of end of the 1990er a huge social reform in Germany has taken place. Without announcing it, the government changed also the definition of ‘unemployed’. The consequence was the unemployment rate decreased dramatically. For example if a workless person will become ill, she will be not longer counted as unemployed. Or with the reform so called one-Euro jobs were introduced. That means the labor administration is able to compel an unemployed to work for one Euro per hour for social services. Of course, the unemployed will receive nevertheless some transfers from the administration, but he will not longer count as unemployed. Additionally, workless people who are older than 60 years are not count as unemployed, because their chance to get a new job is very low, nevertheless they unemployed. Consequently, the official number of unemployment is much to low, because it must be assumed that the real number of unemployed people is much higher. A second example is taken from the Netherlands. In the middle 1990ies the Dutch parliament requested the CBS to develop an approach to account for the environment. The one is proposal was the NAMEA (National Accounting Matrix including Environmental Accounts), which was mainly developed by Steven Keuning and the other one the SNI (Sustainable National Income), which was developed by Roefie Hueting in the early 1970ies. The NAMEA relates physical variables for pollution to economic variables; however it is not necessary to determine the value of environmental goods. Contrary to that, Hueting (1980) proposes to subtract the hypothetical abatement costs from the net national income. Of course, the abatement costs cannot be measured; they must be calculated and

additionally, given that the environment would be absolutely preserved, the Dutch economy would look very different from the existing one. In so far an applied general equilibrium model must be used to calculate the SNI.

In the Netherlands is the CBS since 1899 independent from policy-makers, nevertheless especially green activists and their parliamentarian representatives tried to compel the minister of economic affairs to introduce the SNI as a new methodology in the national accounts.\textsuperscript{12} However, the problem with the SNI is that it has nothing to do with statistics, it is a model. Of course, it would be nice to measure all environmental damages in monetary terms, but we cannot calculate it in a reliable way. Consequently, the CBS rejected the idea to make use of the SNI. Once it was calculated by the IVM and the result was that just around 50\% of the net national income is produced in an unsustainable manner. However, if the parliament would had have so much influence to compel the CBS to introduce the SNI concept, it could be manipulated in all directions and that is a risk for the reliability of the work of the CBS. In so far it can be argued, that the independence of the CBS guarantees reliable statistics.

\textbf{Fiscal policy}

Obviously, is fiscal policy not independent from the influence of politicians. However, our argument here is that the existing tax systems are very inconsistent and inefficient. To show that we look at the German tax system, which is very complicate and inefficient. For example the German value-added tax law knows two different tax rates; 7\% and 19\%. The basic idea was that all basic goods like food should be less taxed to support the poor people of Germany. However, in reality we can observe the VAT rate on donkies is 7\%, but on mules 19\%. Nobody understands in this case the use of different tax rates. Or another example; the VAT rate on animal food is 7\%, but the tax rate on diapers 19\%. Does it make any sense to tax diapers higher than animal food? It is well-known in public economics that a tax on goods should be high if the demand is very price inelastic and the tax rate should be low if the demand is very price elastic. Consequently, the German VAT system is going to maximize the market distortions instead of minimizing it. Let us now take a look at the income tax system, which is progressive (increasing average tax rate), the marginal tax rate lies between 0\%-42\%. In economic theory is clear that the aggregate life income should be taxed and not the yearly income. The reason is simple, if two persons would earn in their life the same amount of income, but one person in one year and the other equally distributed about his life.

\textsuperscript{12} See Stauvermann (2009) for the details of the discussion.
It could be that the former one has to pay no income taxes, while the income of the other would be taxed by 42%. Obviously, the basis of one year contradicts the concept of intertemporal equity. Further on, in the income tax law are a lot of unreasonable exemptions, for example it plays a role how someone earns his income, is he farmer or employee in industry, that would make a difference regarding the income tax. Our idea would be to introduce an independent tax administration, which is responsible to structure the tax system in such a manner that the losses of efficiency would be minimized. It should be not the task of this institutional organization to lay down how much taxes must be paid it only shall structure the tax system. Policy-makers would have only the task to determine how the income distribution should look like and the amount of the aggregate tax revenue to finance public goods, public investments and so on. The advantage of such independent organization would be that probably a lot of efficiency gains could be realized.

The international financial market

World’s economy is in the worst economic crisis since the great depression in the 1930ies and the situation grows dire by the day. Nearly 600,000 Americans lost their jobs in January, for a total of 1.8 million over the last three months, in Europe is happening the same the unemployment rates are strongly increasing, capital funded pension systems are in danger to go bankrupt. What caused this catastrophe?

Here we will argue that the financial industries (security companies, insurance companies, accounting companies and commercial banks) in cooperation with the American governments (from Ronald Reagan to George W. Bush) are the main guilty actors, who are responsible for the disaster. However, because of the fact that the worldwide financial markets are absolutely interconnected, it is not only an American crisis it is worldwide crisis. Of course on the international level, the American firms and policy-makers had some supporters like the British government, the Irish government and some more in the last 10 years. These actors have done everything to avoid the introduction of regulations for the international financial market and to blanket other governments who favored the idea of regulations. Whoever wanted to introduce some regulations in the financial markets had two opponents, a domestic one; the financial sector and foreign ones; the governments of the USA, Great Britain and so on. To highlight the development we must go back to 1983. At that time the Reagan Administration agreed on new accounting rules adopted by the financial industry that allowed banks and other companies to take money-losing assets off their balance sheets in
order to hide them from investors and the public. In the years between 1998 and 2000, the US Congress and Clinton’s administration blocked all efforts to regulate financial derivatives, which are nowadays our main problem. In 1999 the US congress abolish the depression-era laws, which forbid banks to offer investment and insurance services and forbid to invest money from the checking and savings account in financial derivatives, which are only understood by a very few people. As stated above the interest rates were historically low at that time, which leaded to offering mortgages to everybody, independently if the house buyers have securities or sufficient incomes. At the same time the US congress take care that banks and mortgage brokers would not become legally liable for fraud when the mortgage was made. Additionally, two US government-owned banks, Fannie Mae and Freddie Mac, bought a huge amount of subprime mortgages and packages of mortgages, so called “mortgage-backed securities” (MBS) from private banks. In 2004 the SEC allowed investment banks to decide for themselves how much money they will take aside to secure their risky trading. The excessive result was, that some speculating companies lend 40 times more money than they hold as own capital. In 1975 the maximum debt to net capital ratio was 12 to 1. It was very profitable for the investment bankers and the CEOs, because their salary was tied to value of their companies. Because of the deregulation policy of the Bush administration, the number of banks decreased fundamentally, because of mergers. In addition, mostly all economic actors believed in private credit ranking companies like Standard & Poor, Moodys and so on, who judge about the quality and safety of financial companies. However, the credit ranking companies have a huge conflict of interests, because they were paid by the firms for issuing the ratings. As an economist it should be clear that such construction has inherently the problem of moral hazard. Not surprisingly, the firms who paid the most received the best ratings. However, it must be asked why did nobody in politics intervene against such constructions? The answer is easy to find, the financial industry received a lot of political influence by supporting political parties and policy-makers and huge investments in lobbying. Let us take a look at the following table, which shows the aggregate expenditures for policymakers and lobbyists in the period 1998-2008 in the USA of the financial sector;

13 Regarding the historical events we follow mostly Rosenfield (2009). See
In the observed period the financial sector spent more than 3 billion US-$ at avoid any regulation of the US financial market and to avoid any regulation of the international financial market. Because of the huge bargaining power of the USA and Great Britain in international negotiations, they were able to block all proposals to regulate the international financial market. The most domestic banks and insurances in Europe argued, it would be a disadvantage for them in the international competition on the financial market, if their domestic governments would introduce national regulations. Further on, they argued if they are not allowed to act as US American banks, they were not able to realize comparable profits and consequently they would be overtaken in the long run by foreign investors. However, for example in Germany the private financial sector delegates direct employees to the ministry of finance, especially the following associations and firms have send their own experts to formulate laws for the financial sector; Bundesverband Deutscher Banken, Bundesverband Investment und Asset Management (BVI), Deutsche Bank, Deutsche Börse, Deutsche Zentral-Genossenschaftsbank AG (DZ Bank AG), Dresdner Bank, HSH Bank, and Zentraler Kreditausschuss. In so far it can be assumed that the financial sectors all over the world have done what the American financial sector did. Anyway, it was a good deal from the view of the CEOs in the business, for example Richard Fuld, the former CEO of Lehman Brothers, earned

http://wallstreetwatch.org/soldoutreport.htm
14 These expenditures are described as ‘campaign contributions’.
15 The numbers are from the Center for Responsive Politics, see www.opensecrets.org
16 See e.g. www.lobbycontrol.de.
2008 484 million US-$ gross income. Consequently, it is not surprising that Lehmann Brothers were under the top 5 security firms, who spent the most money for political parties and lobbyists. However, in such an environment of deregulation and without any functioning control mechanism, it happened what always happens since the tulip-mania crisis in the Netherlands in the 17th century: the arising of a bubble in the financial market by the introduction of derivatives. Warren Buffet (2003) named them “weapons of mass financial destruction”. He explained derivatives in the following way, “pieces of paper that were backed by other pieces of paper that were backed by packages of mortgages, student loans and credit card debt, the complexity and value of which only a few understood.” Consequently, it must be stated that the emitting of derivatives means to start a Ponzi-game or pyramid game. And this is what the numbers are telling us. In 2007 the nominal value of all derivatives in the world was just around 683000 billion US-$, which was ten times more than the worldwide GDP in 2007. At that time the GDP of the world was only 54347 billion US-$.

In so far it is clear that it was a financial bubble which is blowing up since the middle of 2008 and the consequences for the real economy will become very strong, especially for low developed countries. Countries like Iceland, Lithuania, Latvia, Estonia, Hungary, Romania are now more or less bankrupt and nobody knows who will be the next. Regarding the liability for this crisis nobody feels to be responsible neither the financial sector nor policy-makers and that is the real mess. Instead of punishing them, they are now again advisors for policy-makers how to save the ruined financial sector with the tax-payers money. Instead of introducing now immediately a policy-independent control organization, they give advice not to regulate the financial market neither the national one nor the international one.

The model

Here we will show with a model why we need policy-independent institutional organizations. The model was introduced by Grossman & Helpman (1994) and reformulated by Acemoglu, Johnson, Querubin & Robinson (2008). It is a game with three agents, the citizens or voters, the government or policy-maker and an interest group or lobbyist. Let us first define the main variables;

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18 To your knowledge, the only one who was ever punished for bad financial behavior is Michail Chodorkowski, the former owner of Yukos. Michail Chodorkowski is sentenced to stay 15 years in jail in Chita, Russia, because he has violated Russian tax laws and Russian property laws, he wanted to sell natural resources like gas and oil to American enterprises. And this is strictly forbidden since W.W. Putin is in power as a president and now as a prime minister. It is very probable that he will become the next president in 2012, he is one of the most beloved persons in Russia, who are alive.
\( \Pi \in \Re \); is a single policy variable, we call it distortionary policy \( \Pi \), 
\( p \in [0, p_{\text{max}}] \), with \( p_{\text{max}} > 0 \); represents the marginal costs of a distortionary policy reform 
for the policy-maker or government.

Later on, the precise interpretation will become clear. Now, the utility function of the voters is 
given by,

\[
(1) \quad U(\Pi) = -n\Pi, \text{ where } n > 0.
\]

The utility function is maximized if the value of it is zero, and this is the case, if \( \Pi = 0 \). If \( \Pi > 0 \), than the utility of the voters will be reduced. In so far \( \Pi \) represents a distortionary policy from the view of the voters, like deregulation of financial markets, introducing a misleading statistical indicator in the national accounts, inflationary monetary policy and introducing a distortionary tax. All these distortionary political measures could be in the interest of some interest groups. At next we look at the utility of a policy-maker;

\[
(2) \quad v(\Pi, p, t) = \lambda u(\Pi) + (1 - \lambda) t - p\Pi,
\]

where \( t \in \Re \), represents a transfer, campaign contribution or negatively expressed a bribe.

The variable \( \lambda \in [0,1] \) is a weight, which measures in how far the policy-maker will take into account the welfare of the voters. In some sense it could be interpreted as a general institutional frame. For example if \( \lambda = 1 \) the utility function of the policymaker will become \( v(\Pi, p) = u(\Pi) - p\Pi \) and would be independent from a bribe and the government would never initiate a distortionary policy. If \( \lambda = 0 \), the utility function of the policy-maker would be \( v(\Pi, p, t) = t - p\Pi \), this is the case if the government can not be replaced by the voters and consequently the government take the welfare of the people not into account. An example would be the Mugabe regime in Zimbabwe. The last term in the utility function \( p\Pi \) reflects the fact that the distortionary policy implies some costs for the policy-maker, for example that it becomes more difficult to become re-elected or that a revolution will take place. All other variables held fixed, equation (2) indicates that a distortionary policies are not cost free for the government.

Now, we introduce the utility function of the lobbyist, who benefits from distortionary policies.
(3) \[ w(\Pi, t) = \alpha \Pi - \frac{\beta}{2} \Pi^2 - t, \]

where \( \alpha > 0 \) and \( \beta > 0 \) are constants. The form of the utility function is assumed for convenience. The bliss point is easy to calculate by differentiating the utility function with respect to \( \Pi \).

(4) \[ \frac{\partial w(\Pi, t)}{\partial \Pi} = \alpha - \beta \Pi = 0. \]

Solving (4) leads to \( \Pi^* = \frac{\alpha}{\beta} > 0 \). The lobbyist is able to reach this point by offering the bribe \( t \). Consequently, we subtract these costs from the first part in the utility function. Now we are able to analyze the game. We assume that the parameters \( p \) and \( \lambda \) are given. The lobbyist makes an offer to the policy-maker \( (\Pi, t) \). If the policy-maker accepts this offer, he has to introduce a distortionary policy. This is easy to prove, for example by repeating the game, where the number of repetitions is unknown. If the policy-maker accepts the offer \( (\Pi, t) \) he implements the distortionary policy \( \overline{\Pi} \) and receives the bribe \( \overline{t} \). If he rejects the offer he receives \( t=0 \). Now we are ready to determine the subgame perfect equilibrium with the help of backward induction. Consequently, we start with the policy-maker. He has to make a discrete choice between introducing a distortionary policy and receiving the bribe or to change nothing, which would be optimal for the voters. Either the policy-maker chooses \( \Pi = \Pi \) and receives \( \overline{t} = \overline{t} \) or he chooses \( \Pi = 0 \) and gets no bribe, so \( \overline{t} = 0 \). Decisive for him is the resulting utility for him, which means;

(5) \[ \overline{\Pi} = \begin{cases} 0, & \text{if } \lambda u(\overline{\Pi}) + (1 - \lambda)\overline{t} - p\overline{\Pi} < \lambda u(0) \\ \Pi, & \text{if } \lambda u(\overline{\Pi}) + (1 - \lambda)\overline{t} - p\overline{\Pi} \geq \lambda u(0) \end{cases}. \]

In the next step, the policy-maker maximizes his utility subject to equation (5). However, the utility of the lobbyist must be positive, because otherwise he would not offer something, in so far we have an incentive compatibility constraint, the value \( \overline{\Pi} > 0 \), if

(6) \[ \overline{t} = \frac{\lambda n + p}{1 - \lambda} \overline{\Pi}, \]
where we have calculated it from \( \lambda u(\bar{\Pi}) + (1 - \lambda)\bar{T} - p\bar{\Pi} = \lambda u(0) \), where we substitute 
\( u(\bar{\Pi}) = -n\bar{\Pi} \) and \( u(0) = 0 \). After a few reformulations we get (6). Now we have to substitute (6) in the utility function of the lobbyist, and then to maximize the utility function.

\[
\max_{\bar{\Pi}} w(\bar{\Pi}, \bar{T}) = \max_{\bar{\Pi}} \left[ \alpha \bar{\Pi} - \frac{\beta}{2} \bar{\Pi}^2 - \bar{T} \right] = \max_{\bar{\Pi}} \left[ \alpha \bar{\Pi} - \frac{\beta}{2} \bar{\Pi}^2 - \frac{\lambda n + p}{1 - \lambda} \bar{\Pi} \right].
\]

The first order condition is given by

\[
\alpha - \beta \bar{\Pi} - \frac{\lambda n + p}{1 - \lambda} = 0 \iff \bar{\Pi} = \frac{1}{\beta} \left( \alpha - \frac{\lambda n + p}{1 - \lambda} \right).
\]

Now we can conclude, if \( \lambda \geq \frac{\alpha}{\alpha + n} \) then the lobby will never offer a bribe independently form the value of \( p \). This condition implies a policy of \( \bar{\Pi} = 0 \). The implication of this result is that the power of voters to control the policy-maker is very strong. Now we can write down the solution for the maximization problem of the lobbyist and hence the solution of the subgame perfect equilibrium;

\[
\bar{\Pi} = \max \left[ \frac{1}{\beta} \left( \alpha - \frac{\lambda n + p}{1 - \lambda} \right), 0 \right].
\]

That means if \( \lambda \) is relative small then the influence of the lobbyist is relative strong and the policy-maker is not restricted by the voters. However, if \( \lambda < \frac{\alpha}{\alpha + n} \), then the control of the voters is weak and the loss of welfare will increase. If \( \lambda \in \left[ 0, \frac{\alpha - p_{\text{max}}}{n + \alpha} \right] \), then it follows the greater is \( \lambda \), the greater is the decline following the bad policy change. However, these results are well known from Acemoglu, Johnson, Querubin & Robinson (2008), here we concentrate on the parameter \( p \), which can interpreted as an indicator for the implicit costs of the one who is bribed and has the political power. In principle \( p \) is nothing else than the marginal opportunity costs for accepting a bribe. Here we argue as follows, if \( p = p_{\text{max}} \) it can be interpreted as the introduction of a policy-independent institutional organization, which is able to decide about the precise implementation of policy measures, for example how to organize the tax system. The explanation is that policy-independent organizations like the ECB or CBS not only controlled by the voters, but also by the policy-makers. And mostly such organizations have a
very good reputation in the public, which the organization would like to defend. It seems to be very implausible to assume that it would be possible to bribe Jean-Claude Trichet, so that he will increase the quantity of money to reach a high inflation rate; even that many people had some doubts about him before he was in power. He is not doing what the French president Sarkozy wants, he is doing what his task is; to protect Europe against inflation. However, let us determine the conditions for an optimal $p$, which implies $\alpha - \frac{\lambda n + p}{1 - \lambda} \leq 0$. Then we get;

\[
\alpha (1 - \lambda) - \lambda n \leq p .
\]

We see, in principle it would be enough if the voters has a strong power to control policy-makers (a $\lambda$ near one), however that is in reality very rare because of a lot of different causes. Let us see what will happen if $\lambda$ is zero or one. If $\lambda = 0$, then $\alpha \leq p$, which says the marginal costs of accepting a bribe must equal or exceed the marginal benefits of the lobbyist. If $\lambda = 1$, then condition is always fulfilled, because the voters have enough power to control the policy-makers or government.

So we can conclude if the power of voters to control the government is weak, then we must impose high marginal costs for accepting bribery. This can be done at best by an policy-independent institutional organization, because if someone is failing in such institution he is liable, where a policy-maker is never liable and the organization is easier to control than policy-makers, because the existing policy-independent organizations have a clear defined task and they will not only controlled by the voters, but also by the policy-makers. It is easy to check if the ECB is doing its work or not, even that some economists criticize the targets themselves, but this is here not the problem.

**Conclusions**

In this paper we argued that distortionary policies can be avoided if it is possible to increase either the marginal costs for accepting a bribe or if the voters have a strong power to control policy-makers. Further we are arguing that the marginal costs for accepting bribery could be increased with the help of policy-independent institutional organizations, because the control of them is easier, because they have well defined tasks and targets and they will be not only controlled by the public, but also by policy-makers, who are in some cases the “natural enemy” of such organizations. From an legal view it is much more easier to make an public employee of such an organization liable and to punish him than to make a policy-maker liable
for failures. For example if a policy-maker would increase the inflation rate, he would argue that it would be in the general economic interest to do so. The ECB is not able to give such an explanation, if the inflation rate would be higher than 2% in the long term, the ECB has to follow strict laws and international agreements. Regarding the international financial markets, it seems to useful to introduce some similar organizations, the only problem could be that the USA would try to found it in way that they will be the most influential country in this organization like in the World Bank. However, it would go too far, to analyze this incentive problem here, at best independent economists should work out a plan, how this institutional organization should look like and to formulate clear and simple targets which should be reached by the organization. For example to define the debt-own capital ratio of banks, insurances and so on, then the rating firms should be substituted by this new organization. Further on the organization should have the right to introduce world-wide a Tobin-tax, where the tax revenue could be used to become financially independent from countries and a potential profit could be used to solve global environmental problems and problems of global poverty in low developed countries. This proposal would have a lot of advantages, at first the number of international speculations would become lower, because of an increased transaction price and the international food and natural resources markets would become more stable.19 The institutional organization would be financially independent from national governments and probably other organizations of the United Nations could be financed,. This is nowadays not always the case, if we think about development aid and global environmental problems. It seems to be the right time to think about and to do it now and not if everyone will have forgotten the crisis of our days.

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<table>
<thead>
<tr>
<th>Page</th>
<th>Authors</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>15</td>
<td>T.K. Jayaraman</td>
<td>Do Macroeconomic Fundamentals Influence External Current Account Balances?</td>
</tr>
<tr>
<td>14</td>
<td>T.K. Jayaraman and Chee-Keong Choong</td>
<td>Is Fiji’s Real Exchange Rate Misaligned.</td>
</tr>
<tr>
<td>12</td>
<td>Tauisi Taupo</td>
<td>Estimating the production function for Fiji.</td>
</tr>
<tr>
<td>11</td>
<td>Tauisi Taupo</td>
<td>Estimating demand for money in Philippines.</td>
</tr>
<tr>
<td>10</td>
<td>Filipo Tokalau</td>
<td>The Road that is; for whom and why: Impacts of tourism Infrastructural development on Korotogo Village, Fiji islands.</td>
</tr>
<tr>
<td>9</td>
<td>Mahendra Reddy</td>
<td>Sequential Probit modeling of the determinants of child Labour: Is it a case of luxury, distributional or Substitution Axiom?</td>
</tr>
<tr>
<td>8</td>
<td>Neelesh Gounder, Mahendra Reddy and Biman C. Prasad</td>
<td>Support for Democracy in the Fiji Islands: Does Schooling Matter?</td>
</tr>
<tr>
<td>7</td>
<td>Sunil Kumar</td>
<td>Fiji’s declining formal sector economy: Is the informal sector an answer to the declining economy and social security?</td>
</tr>
<tr>
<td>6</td>
<td>T K Jayaraman and Evan Lau</td>
<td>Does External Debt Lead to Economic Growth in the Pacific Island Countries: An Empirical Study</td>
</tr>
<tr>
<td>5</td>
<td>Gyaneshwar Rao</td>
<td>The Relationship between Crude and Refined Product Market: The Case of Singapore Gasoline Market using MOPS Data</td>
</tr>
<tr>
<td>3</td>
<td>Bill B Rao and Rup Singh</td>
<td>Contribution of Trade Openness to Growth in East Asia: A Panel Data Approach.</td>
</tr>
<tr>
<td>2</td>
<td>Bill B Rao, Rup Singh and Saten Kumar</td>
<td>Do We Need Time Series Econometrics?</td>
</tr>
<tr>
<td>1</td>
<td>Rup Singh and Biman C Prasad</td>
<td>Small States Big Problems Small Solutions from Big Countries.</td>
</tr>
</tbody>
</table>

**2007/WP:***

<table>
<thead>
<tr>
<th>Page</th>
<th>Authors</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>24</td>
<td>Biman C Prasad</td>
<td>Changing Trade Regimes and Fiji’s Sugar Industry: Has the Time Run-out for Reform or is there a Plan and Political Will to Sustain it?</td>
</tr>
<tr>
<td>23</td>
<td>B Bhaskara Rao and Rup Singh</td>
<td>Effects of Trade Openness on the Steady State Growth Rates of Selected Asian Countries with an Extended Exogenous Growth Model.</td>
</tr>
</tbody>
</table>
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<table>
<thead>
<tr>
<th></th>
<th>Authors</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>T.K. Jayaraman</td>
<td>A Single Currency for the South Pacific Island Islands: A Dream or A Distant Possibility?</td>
</tr>
<tr>
<td>2</td>
<td>Jon Fraenkel</td>
<td>The Coming Anarchy in Oceania? A Critique of the 'Africanisation’ of the South Pacific Thesis</td>
</tr>
<tr>
<td>4</td>
<td>TK Jayaraman &amp; Rajesh Sharma</td>
<td>Determinants of Interest Rate Spread in the Pacific Island Countries: Some Evidence From Fiji</td>
</tr>
<tr>
<td>5</td>
<td>Ravinder Batta</td>
<td>Ecotourism and Sustainability.</td>
</tr>
<tr>
<td>6</td>
<td>Ravinder Batta</td>
<td>Measuring Economic Impacts of Nature Tourism.</td>
</tr>
<tr>
<td>7</td>
<td>TK Jayaraman &amp; BD Ward</td>
<td>Efficiency of Investment in Fiji: Results of an Empirical Study.</td>
</tr>
</tbody>
</table>