Economic Policy #02

Limits of Economic Policy

The expansion of the role of the public sector #1

The 20th century saw a gradual but large expansion in the role of the state in the economy because of

- political and ideological factors
- marxist and socialist thinking (governments should play significant role in redistributing income, shift toward a *“mixed” economy*)
- Keynesian thinking (countries with large public sector were believed to be less subject to business cycles)
- technical development in economics (concept of government failures)

The expansion of the role of the public sector #2

It was implicitly (if not explicitly) assumed that:

- the governments had abilities lacking in the private sector (better managerial skills, higher level of expertise, sufficient amounts of capital)
- the actions of the public sector were driven by the objective of promoting social welfare
- the public sector was monolithic and economic decisions were made in rational and transparent way
- policy decisions were reversible
- policymakers have all relevant info and full control over the policy instruments

The end of naive picture

Governments are not as omniscient and omnipotent as was implicitly assumed after WWII till 1970s.

There are four main limits to the “traditional” approach to EP:

1. Governments have imperfect knowledge about the structure of economy and of future risks.

2. Governments may not be able to convince private agents that they will actually do what they have announced.

The end of naive picture

3. Policymakers may not have the information they need to take decisions.

4. Policymakers may not pursue the general interest.

1. Uncertainty and risk

Government is not able to predict the consequences of some action exactly

=> uncertainty about adequate choice of policy tools

Many policy decisions have irreversible consequences

=> '*precautionary principle*' of economic policymaking (e.g. joining eurozone), creating a decision-under-uncertainty framework

CS: Surprises and outturns in 15 EU budgetary plans, 1998-2006

	Nominal GDP growth, %	Nominal government revenue growth, %	Nominal government expenditure growth, %	Nominal government balance as percentage of GDP, %
“Positive” surprises	50	58	76	36
“Negative” surprises	50	42	24	64

In spite of higher-than-expected revenues, frequent expenditures overruns often have resulted in the deficit exceeding target => governments do not manage public finances in a way to take into account risks to revenues and expenditures.

2. The limits of confidence: credibility problems #1

Credibility problems arise from intertemporal inconsistency (often called ***time inconsistency***), i. e. temptation for government to mislead private agents in the name of general interest => *ex post* and *ex ante* optimal policies do not coincide.

The limits of confidence: credibility problems

Example:

Government announces it will scrap taxes on fixed capital to encourage investment. Then reneges on its promise because it is socially optimal *ex post* to finance public goods by taxing capital. What will be the result?

Another application to monetary policy, exchange-rate policy, ..

Unfulfilled promises undermine confidence in EP and hamper its effectiveness.

CS. Responsible and irresponsible credible behaviour #1

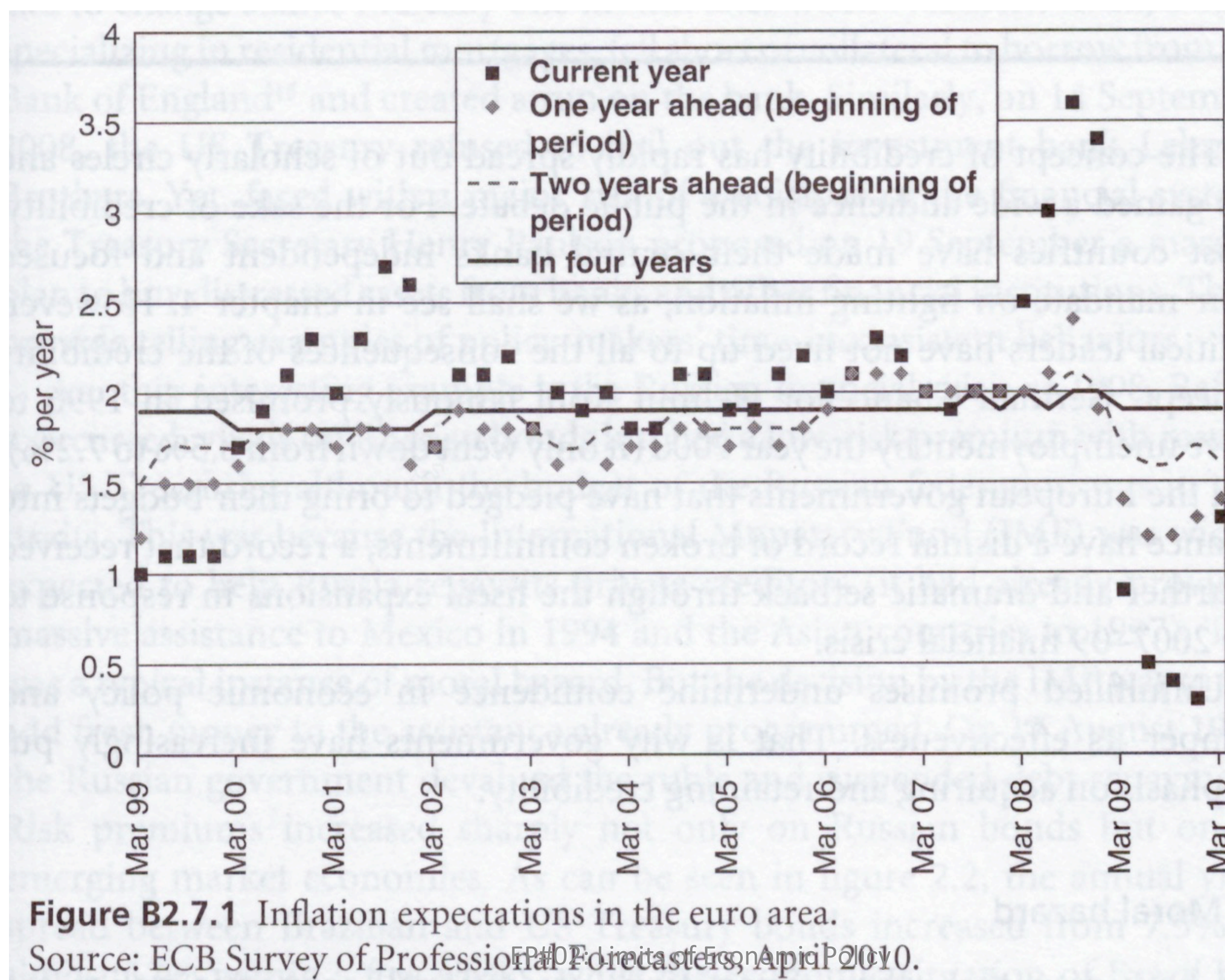

Figure B2.7.1 Inflation expectations in the euro area.
Source: ECB Survey of Professional Forecasters, April 2010.

CS. Responsible and irresponsible credible behaviour #2

- Shorter-term expectations are more volatile, but volatility decreases as the expectation horizon lenghtens > ECB has achieved a high degree of credibility.
- But sometimes it may be important to be *credibly irresponsible* (e.g. deflationary crisis)

The limits of confidence: credibility problems (cont.)

- Solutions:
  - Delegation to independent agencies: central banks, regulatory agencies,…
  - Banish *discretionary policies* and follow fixed *policy rules*: inflation targeting, fiscal rules, currency boards…
  - Transparency

The limits of confidence: moral hazard

Moral hazard problems arise when likelihood of government intervention alters private behaviour and induces more risk taking.

Examples: IMF interventions in emerging countries, role of lender of last resort of the central bank, public insurance schemes…

Solution:

- make public intervention rare and costly (e.g. lender-of-last resort doctrine)

3. The limits of information #1

- Policymakers do not have full access to information and it is used strategically by those with access to it
- Risk of *regulatory capture*
- Major issue for
  - regulation and supervision in technical areas (telecom, energy, finance…)
  - contracts (e. g. for provision of government-financed services such as health care)
  - internal organization of government

The limits of information #2

- Theory:
  - ***principal-agent model:*** the principal, who delegates a task to the agent, does not have full info about agent's capabilities and performance => suboptimal results

- Solution:
  - incentive contracts, possibly within the government (such as performance-related compensation and promotion, e.g. *Walsh contract* for central bankers)

4. Conflict of interests #1

Why politicians may deviate from general interest?

- shortsightedness (electoral cycles)
- pressures from interest groups ("pork-barrel politics")
- reelection motivation (political business cycles)
- partisan behaviour
- divided electorate

Conflict of interests #2

Models:

- attrition wars, vote theory

Solutions:

- Incentive contracts for politicians, procurement rules, antibribery, delegation to independent agencies

Evidence of politically-motivated decisions

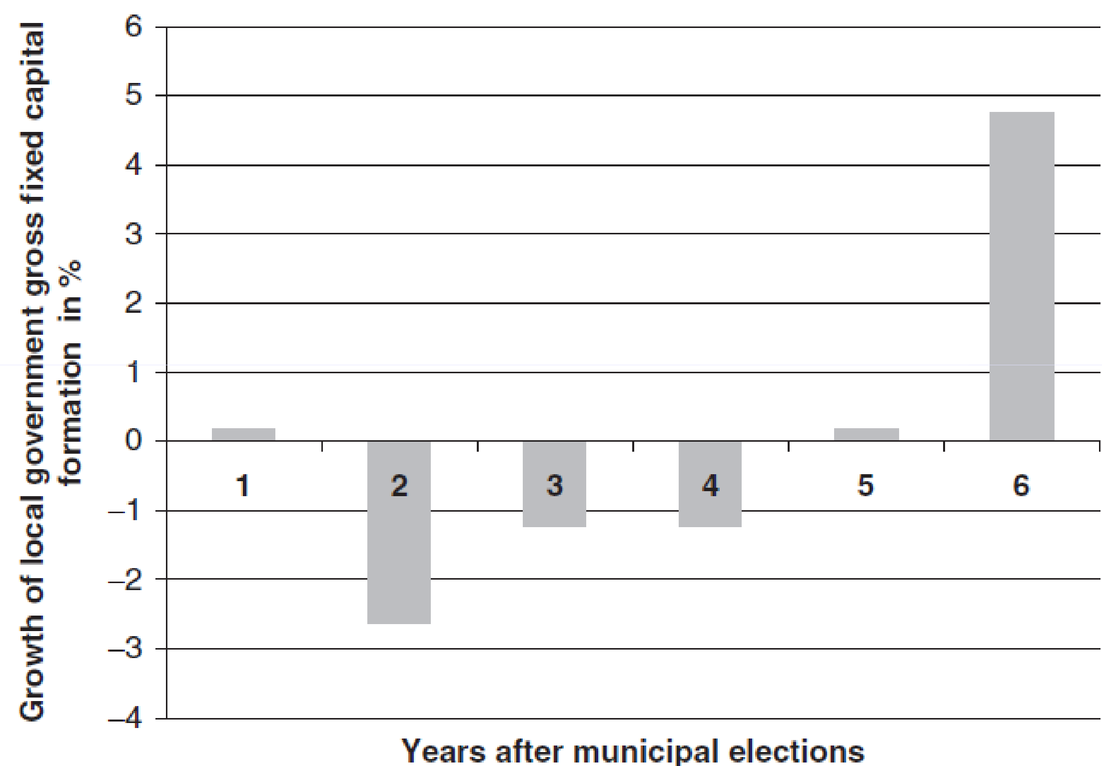

Figure 2.3 Electoral cycle and local investment in France.
Source: Besson (2002).
Note: Contribution of the municipal electoral cycle to grass fixed capital formation, averaged over 1965–2000.

The median voter

Voter chooses the party whose preferences are close to his or her own: voters V_1 to V_4 will for example vote for candidate C_1 and voters V_5 to V_9 to candidate C_2.

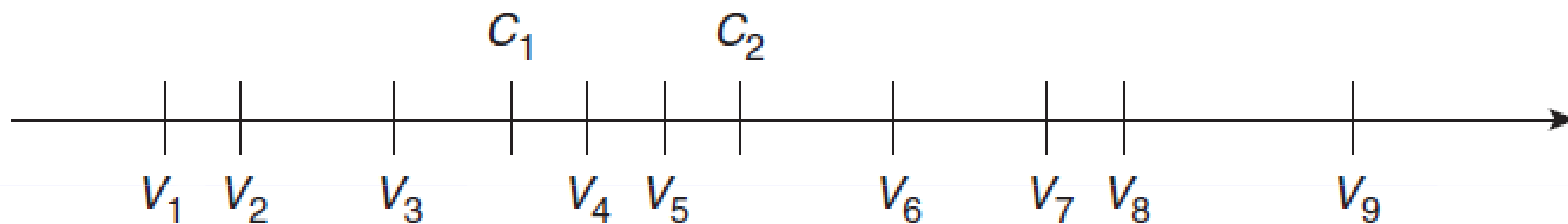

Figure B2.10.1 Preferences, votes, and the median voter.

If there are only two parties (left-wing and right-wing), they will converge on the preference of the median voter V_5 => ***limited program differentiation***

Should policymaking be delegated?

- Technocrats are better in presence of:
  - technical complexity (e.g. financial/safety regulation)
  - judicial nature of decisions (merger control)
  - undesirable trade-offs (public health and safety)
  - intertemporal concerns (distributions across generations)
  - significant international independence
  - benefits to groups likely to engage into political lobbying

Should policymaking be delegated?

- But decision needs to remain political when:
  - social preferences are unstable
  - policy involves unavoidable trade-offs
  - policy involves significant redistributions within generations

=> Today's hot topics: balanced budget rules, fiscal councils

Reference textbook

Bénassy-Quéré, A. et al. *Economic Policy : Theory and practise*. Oxford University Press, 2010. ***Chap. 2.1***