Economic Policy #01

The Concept of Economic Policy

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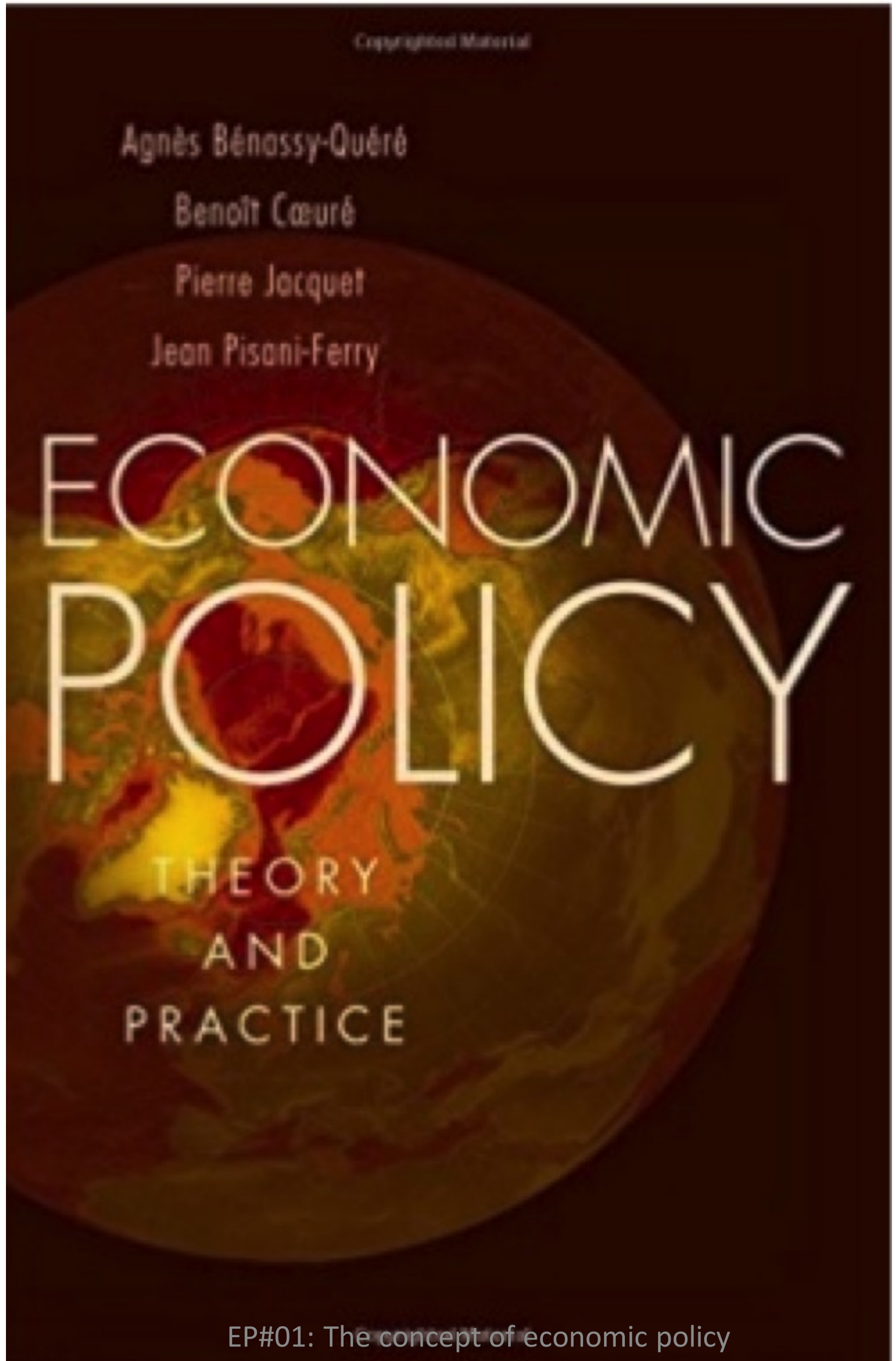
Course contents (subject to change)

- Concepts of Economic Policy (L#01)
- Limits of Economic Policy (L#02)
- Fiscal Policy (L#03,04)
- Monetary Policy (L#05,06)
- Foreign Economic Policy (L#07)
- Growth Policies (L#08)
- Labor Market Policy (L#09)
- Social Policy (L#10)
- Policy seminars (L#11-13)

Assessment methods

- Policy presentation (1/2)
  - during the last 3 classes
  - topic list will be published, students will enroll
  - each presentation should last around 15’ and be based on ppt or equivalent handout
- Final written exam (1/2)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The Concept of Economic Policy

- Approaches to economic policy
- Objectives of economic policy
- The whys and hows of public intervention

Three approaches #1

- *Positive economics*:
  – studying the effects of economy policy (EP) choices on the economy => EP is regarded as *exogenous*
  – determining transmission channels (e.g. impact of an interest rate cut)

- *Normative economics*:
  – making recommendations to the Prince
  – based on positive-economics results on the Prince’s utility function
  – political and social constraints (*second best* problem)
  – information contraints (asymmetric information, communication failures)

Three approaches #2

- *Political economics*
  - Agents ‘ behaviour is *endogenous*
  - Government is a machine directed by rational players with specific objectives and facing specific constraints
  - EP is determined by *policy regime*

The main tasks of policymakers

- set and enforce the rules of the economic game
- tax and spend
- issue and manage the currency
- produce goods and services
- negotiate with other countries

A general framework of EP making

Role of institutions

Douglass North (1993): *"Institutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (rules, laws, constitutions), informal constraints (norms of behavior, conventions, and self imposed codes of conduct), and their enforcement characteristics."*

Institutional framework affects directly market equilibriums and effectiveness of EP instruments.

Objectives of EP (examples)

- Humphrey-Hawkins Act (USA):

  “promote full employment and production, increased real income, balanced growth, a balanced Federal budget, adequate productivity growth, proper attention to national priorities, achievement of an improved trade balance..”

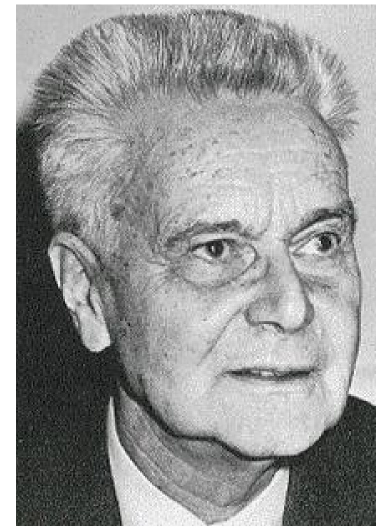
- Article 3 of the treaty on the EU:

  “work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement the quality of the environment.”

=> Objectives of EP are numerous and sometimes contradictory.

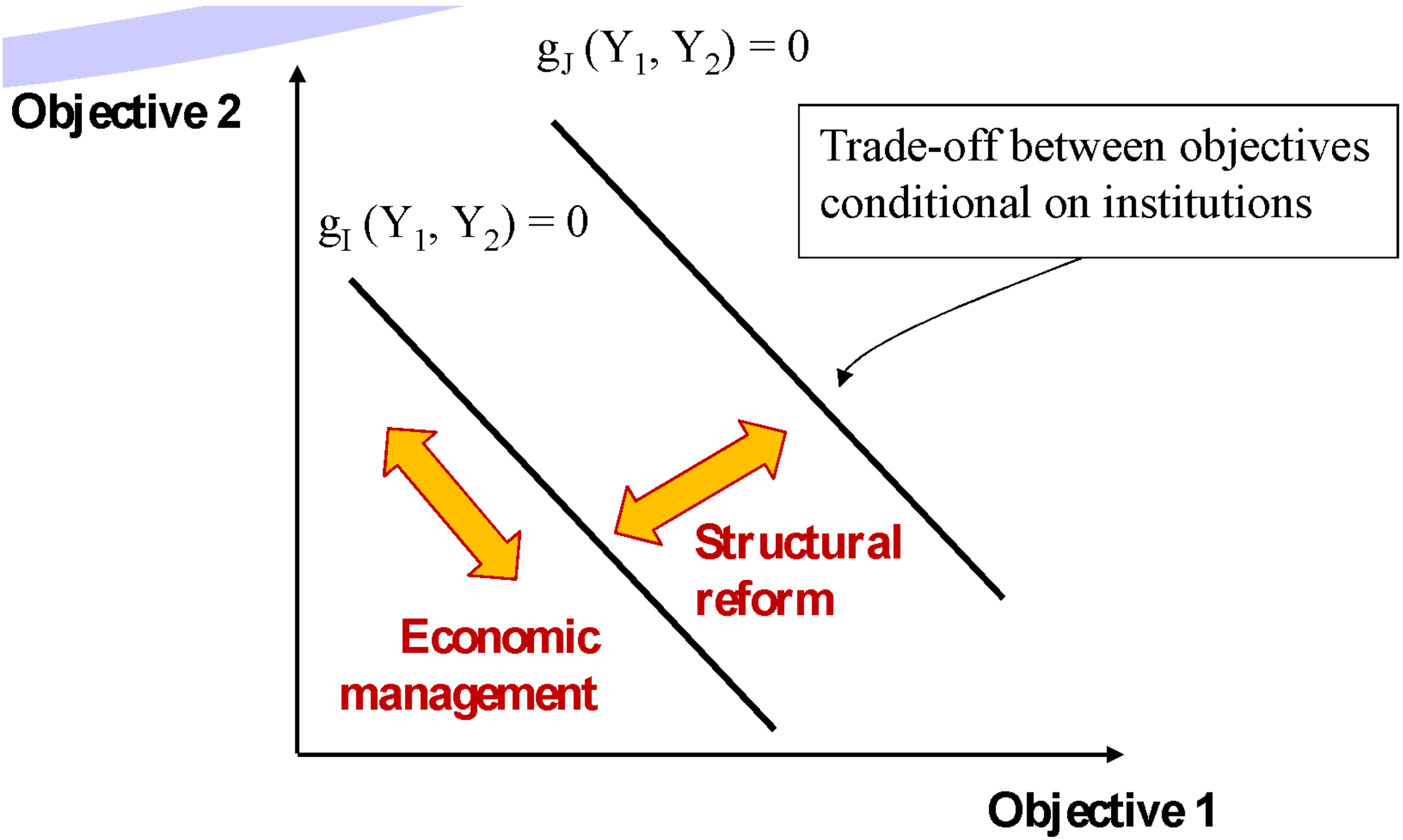
EP as a succession of trade-offs

- *Tinbergen rule*: to reach an indepedent objectives governents needs at least an equal number of EP instruments.



- In reality, number of instruments < number of objectives
  => there are inevitable ***trade-offs***

Economic management vs. structural reform #1



Economic management vs. structural reform #2

- *Economic management* contains various levers such as tax rates, interest rates and public spending.

- *Structural reforms* aim to modify EP trade-offs by changing the institutions (CB independence, choosing a currency regime, adopting framework for budgetary policy etc.)

The employment-productivity trade-off

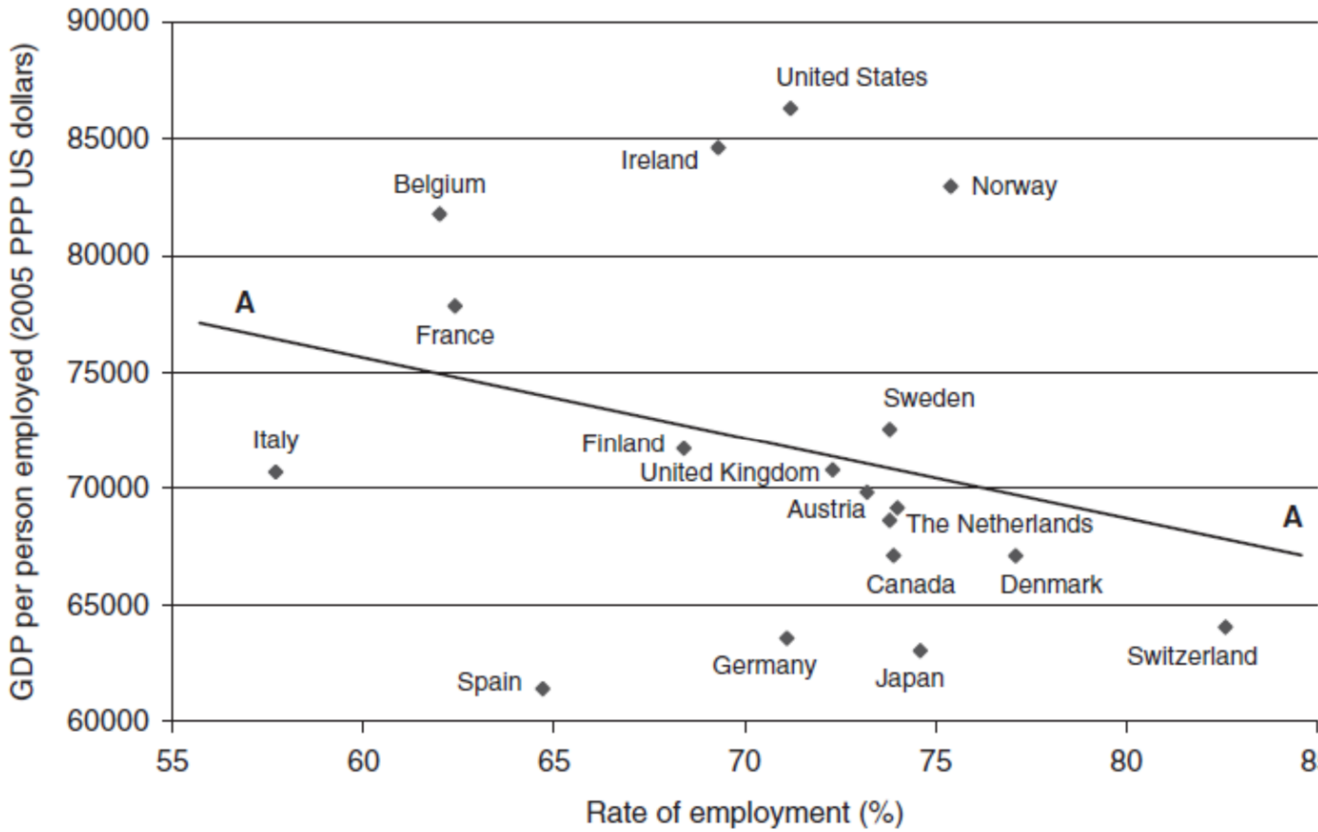
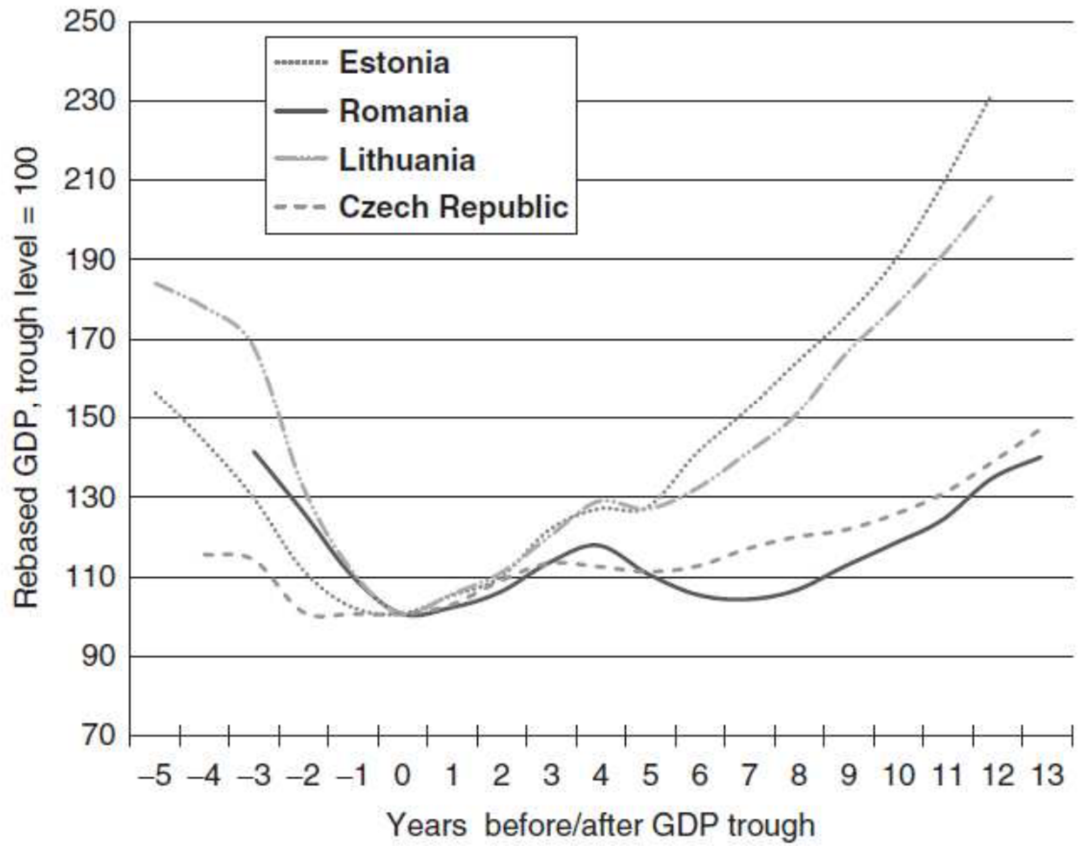


Figure 1.2 The employment–productivity trade-off in 2005.
Source: Authors' calculations using Groningen Growth and Development Center and OECD data.

Structural reforms in post-communist countries



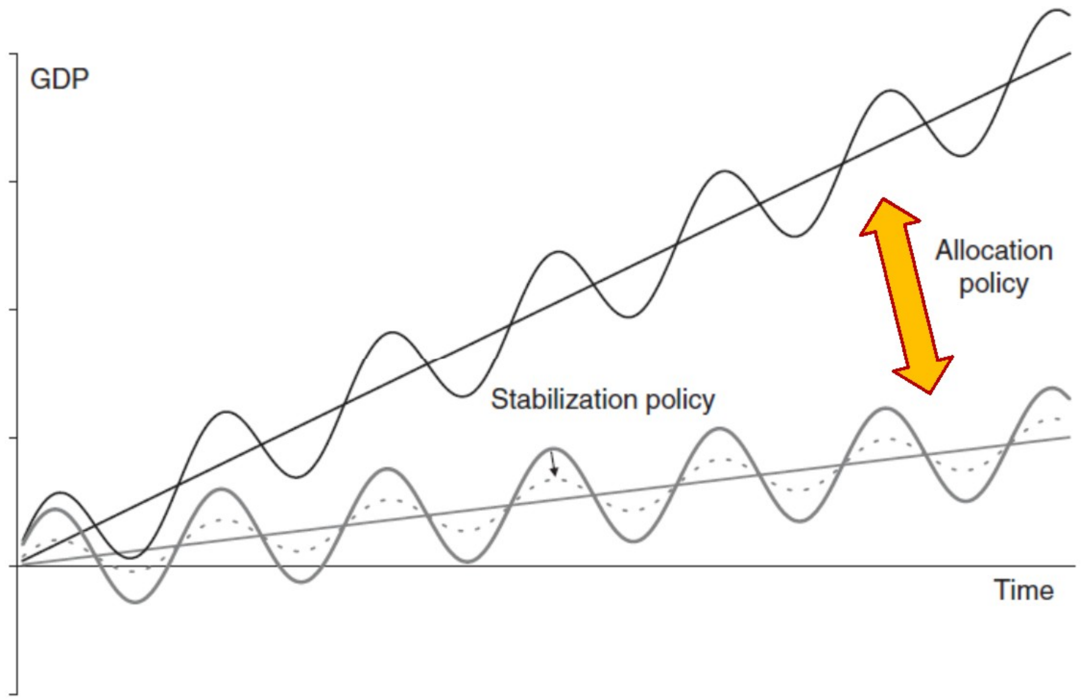
Structural reforms often have negative short-term, but positive long-term effects.

The Whys and Hows of Public Intervention

Three functions of economic policy (Musgrave&Musgrave, 1989):

- ***Allocation*** ⇔ market inefficiency (ex. competition, education, climate)
- ***Macroeconomic stabilization*** ⇔ nominal rigidities (ex. monetary and fiscal policies)
- ***Income redistribution*** ⇔ corrects the primary distribution of income (eg. taxation, social transfers, housing)

Stabilization vs. allocation policies



=> Allocation policies impact potential output

=> Stabilization policies impact the output gap

More on allocation

- ***Imperfect competition***: fight market power, regulate innovation rents and natural monopolies
  - Instruments: antitrust, intellectual property, regulation etc.
- ***Externalities***
  - Instruments: regulation, taxes
- ***Imperfect information***: innovation rents, consumer illiteracy, moral hazard, conflicts of interest
  - Instruments: mandatory disclosure, financial regulation, etc.
- ***Incomplete markets***
  - Instruments: public education, credit enhancement

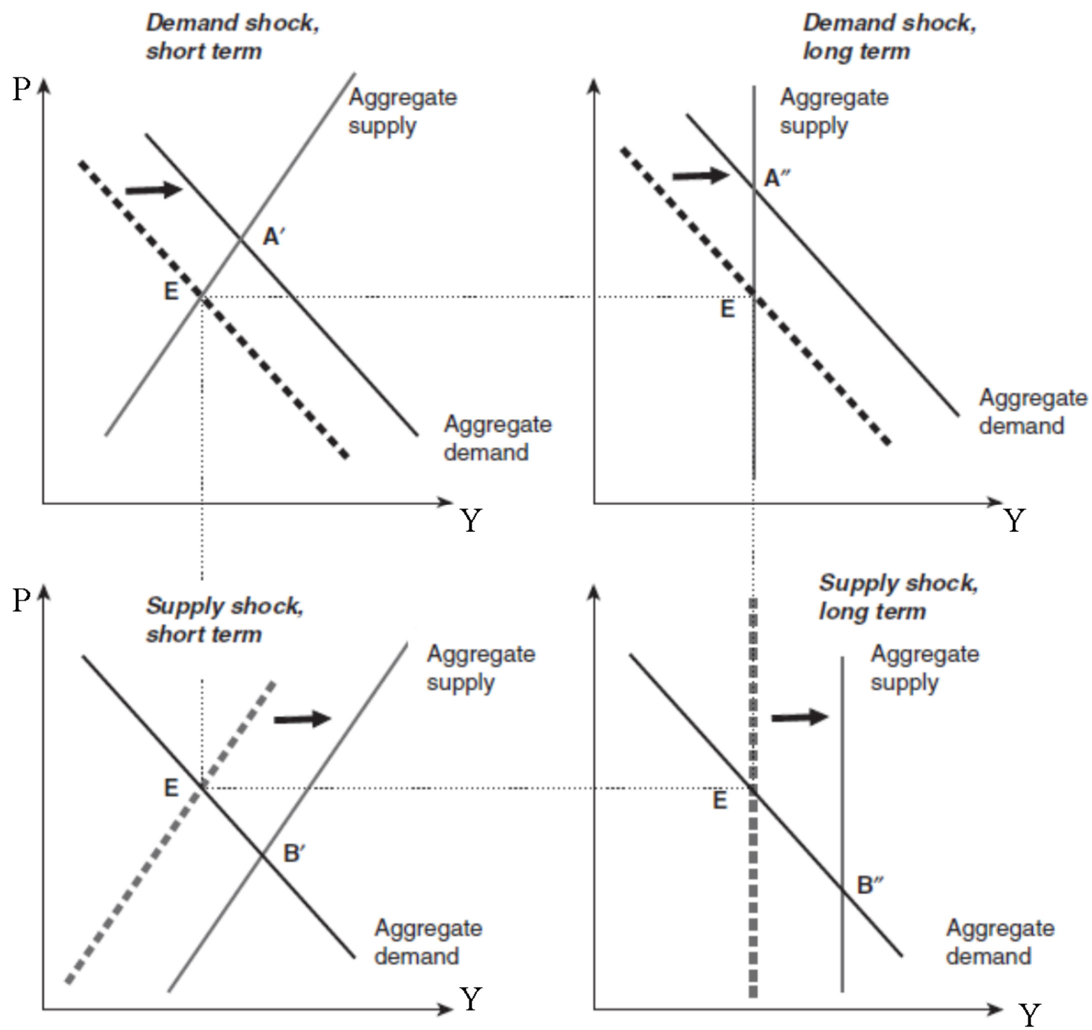
More on stabilization #1

J. M. Keynes (1883-1946):

private instability (‘*animal spirit*‘) + ineffective self-correcting mechanisms (nominal rigidities)

=> need for *counter-cyclical policies* to smooth out economic fluctuations and prevent economic depressions.

More on stabilization #2



More on redistribution

- Two arguments:
  - Pareto optimality (resulting from first welfare theorem) does not amount to social justice
  - Efficiency-enhancing policies (e.g. trade) make winners and losers
- Income distribution can be corrected in a non-distortionary way through lump-sum transfers
- Difficult to implement in practice => frequent *equity-efficiency trade-offs*

Reference textbook

Bénassy-Quéré, A. et al. *Economic Policy : Theory and practise*. Oxford University Press, 2010. ***Chap. 1.1. -1.2***