

**MUNI**  
**ECON**

# **Economic Policy**

The Concept of Economic Policy

# Assessment methods

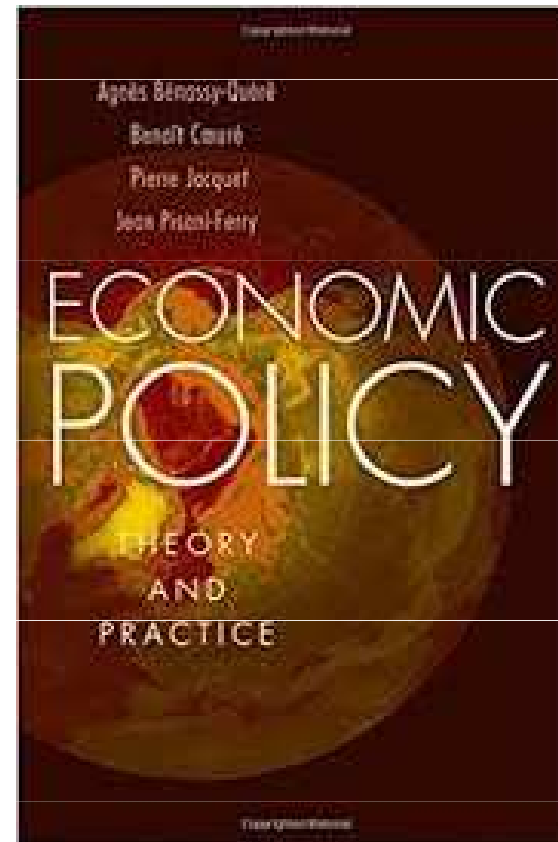
- Policy presentation (1/2)
  - during the last 3 classes
  - topic list will be published, students will enroll
  - each presentation should last around 15' and be based on ppt or equivalent handout
- Final written exam (1/2)
  - list of questions is in the interactive syllabus

# Course contents (subject to change)

- Concepts of Economic Policy (L#01) – Foreign Economic Policy (L#06)
- Limits of Economic Policy (L#02) – Growth Policies (L#07)
- Fiscal Policy (L#03) – Labor Market Policy (L#08)
- Monetary Policy (L#04) – Social Policy (L#09)
- Competition policy (L#05) – Policy seminars (L#10-12)

# Recommended literature

– HPO-832

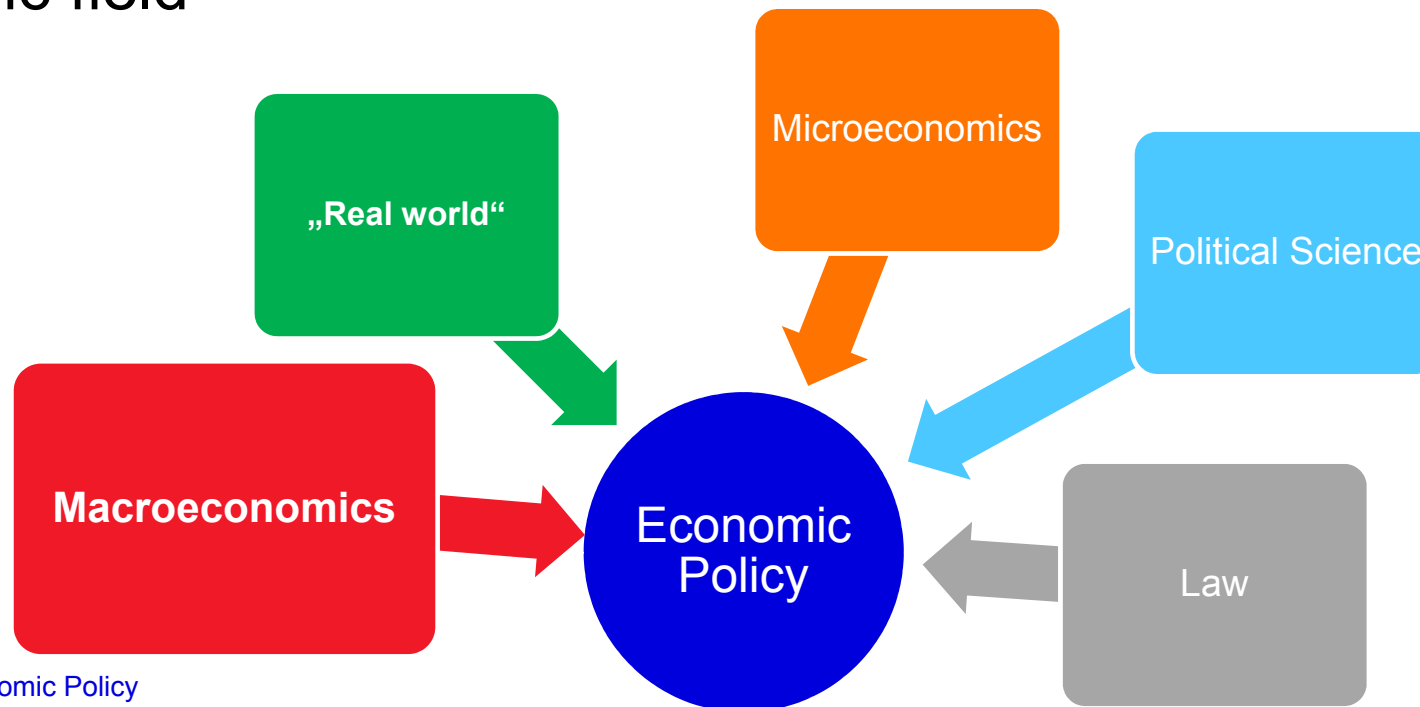


# The Concept of Economic Policy

- Approaches to economic policy
- Objectives of economic policy
- Functions of economic policy
- Why intervene?

# Economic Policy

- the actions that states (governments, central banks) take in the economic field



# Three approaches

## – Positive economics:

- economists are outside observers
- 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:

- economist is adviser
- making recommendations to the Prince
- based on positive-economics results
- needs other instruments to compare alternative solutions

# Three approaches

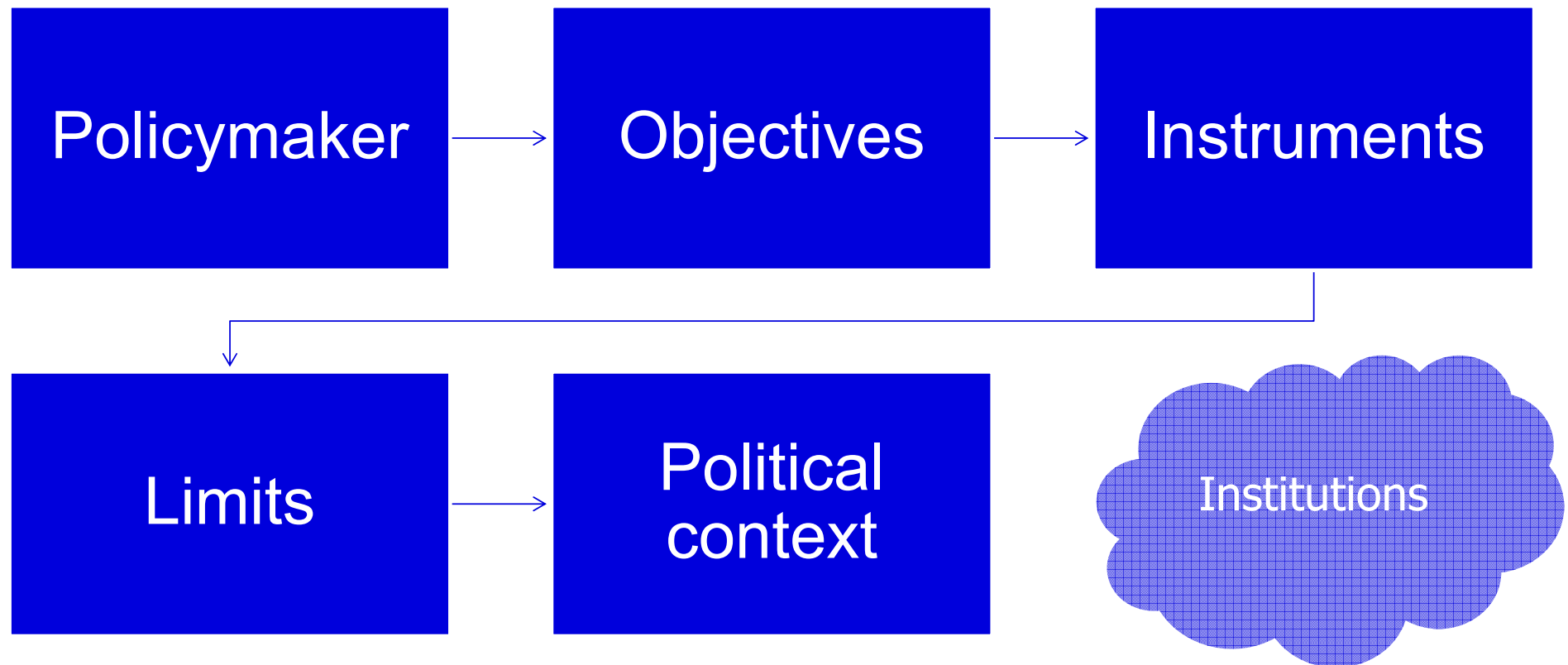
- Political economics
  - viewpoint of an external observer
  - political decision-maker is part of the market
  - government is a machine directed by rational players with specific objectives and facing specific constraints
    - e.g. objective of politicians is to maximize their re-election chance
  - role of economist is to study processes and the incentives, which influences the economic policy



# The main tasks of policymakers

- set and enforce the rules of the economic game (competition policy, bank regulation, protection of private property etc.)
- tax and spend (governments spend 35-50 % GDP)
- issue and manage the currency (central banks)
- produce goods and services (health care, education)
- 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.”*

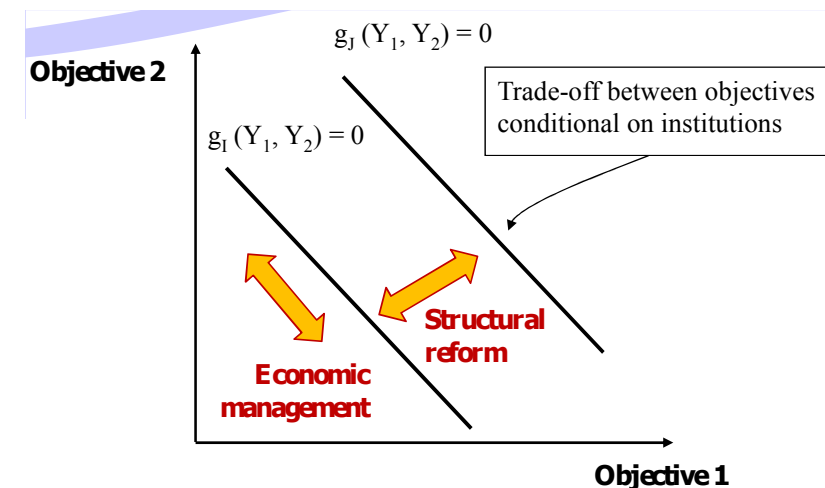
=> Objectives of EP are numerous and sometimes contradictory.

# EP as a succession of trade-offs

- Number of instruments  $<$  number of objectives  
=> there are inevitable *trade-offs*
- to reach an independent objectives government needs at least an equal number of EP instruments
- => *Tinbergen rule*: to reach an independent objectives government needs at least an equal number of EP instruments.

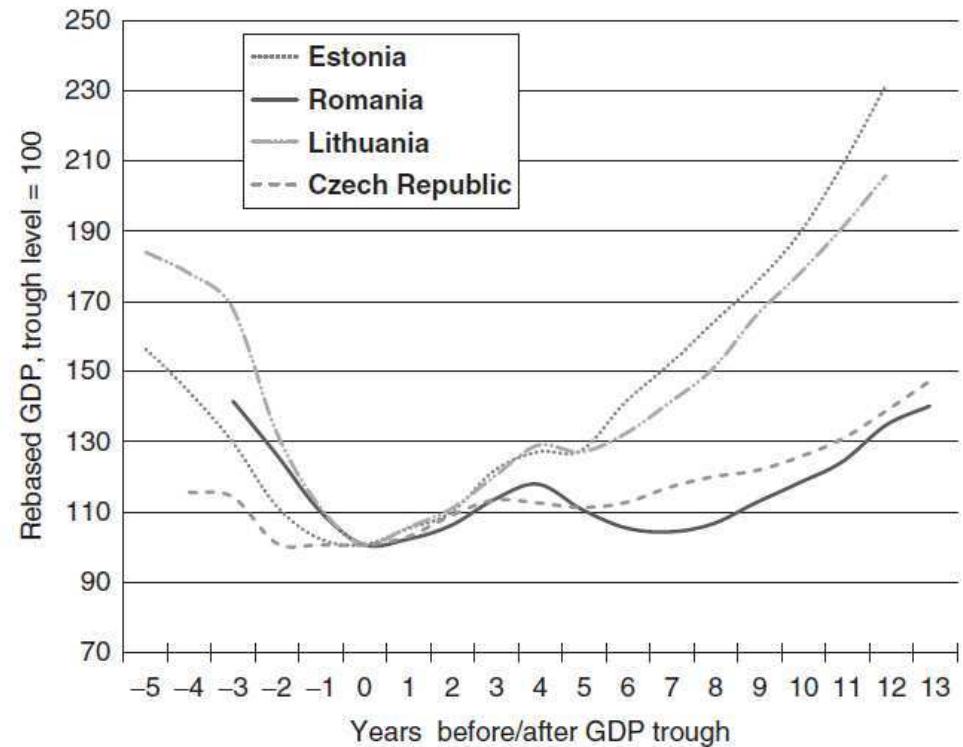
# Economic management vs. structural reform

- Economic management uses standard instruments 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.)



# Structural reforms in post-communist countries

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



# Functions of economic policy



**Allocation**



**Macroeconomic stabilization**



**Income redistribution**



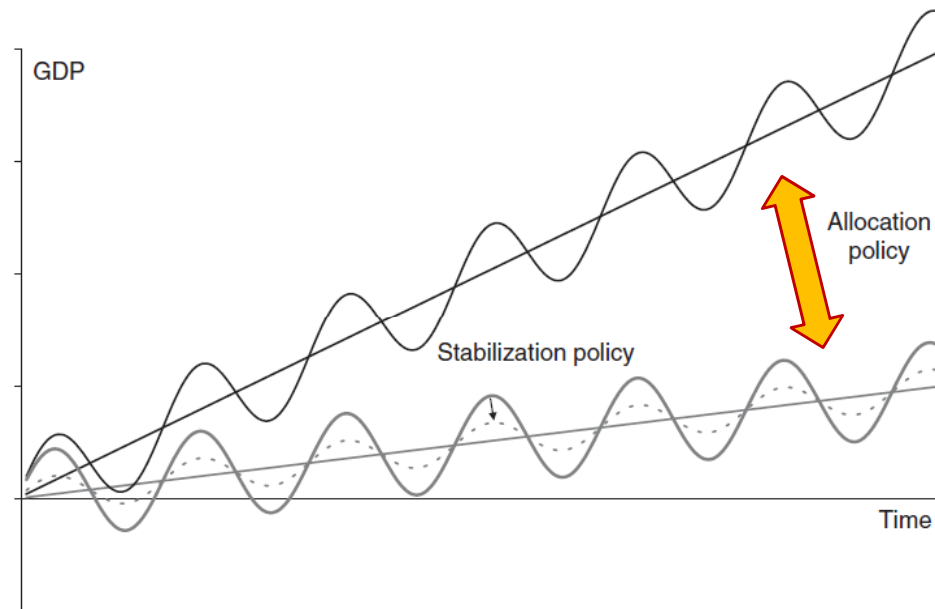
# More on allocation

- assignment resources to alternative uses which should help to market efficiency (state intervention is justified when it can remedy market failures)
- **Imperfect competition:**
  - Instruments: antitrust, intellectual property, regulation etc.
- **Externalities** (an effect of production or consumption on agents who were not participate in the decision to produce or consume):
  - Instruments: regulation, taxes
- **Imperfect information:** innovation rents, consumer illiteracy, moral hazard, conflicts of interest
  - Instruments: mandatory financial disclosure, financial regulation, etc.

# More on stabilization

- 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.

# Stabilization vs. allocation policies



- Allocation policies impact potential output
- Stabilization policies impact the output gap

# More on redistribution

- Two arguments:
  - Pareto optimality does not ensure social justice
  - Efficiency-enhancing policies (e.g., free 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

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