

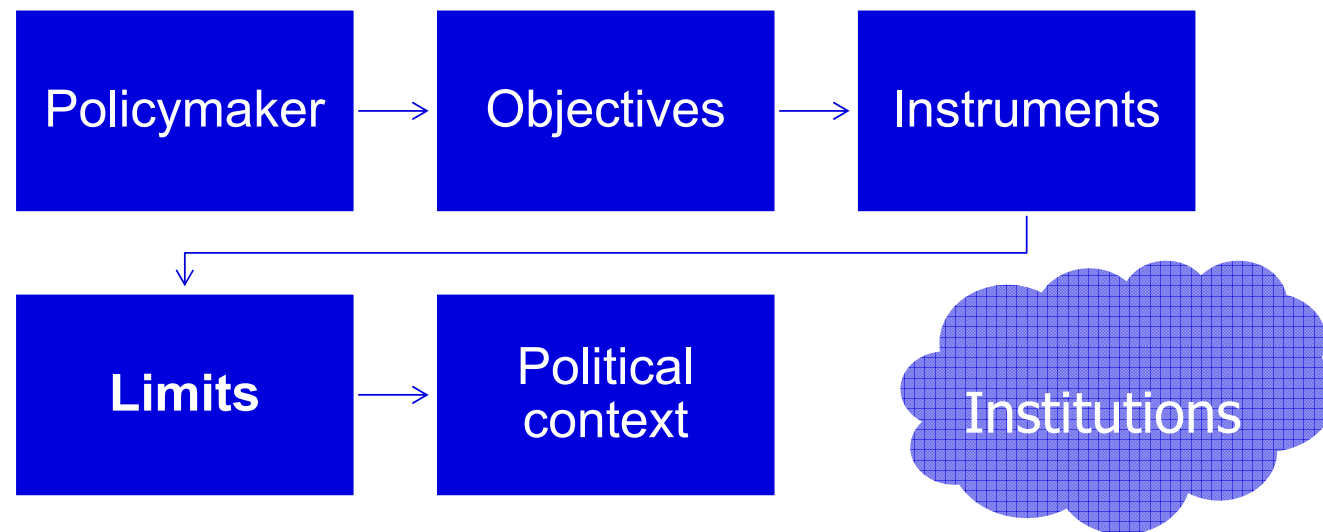
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Economic Policy

Limits of Economic Policy

Economic Policy

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

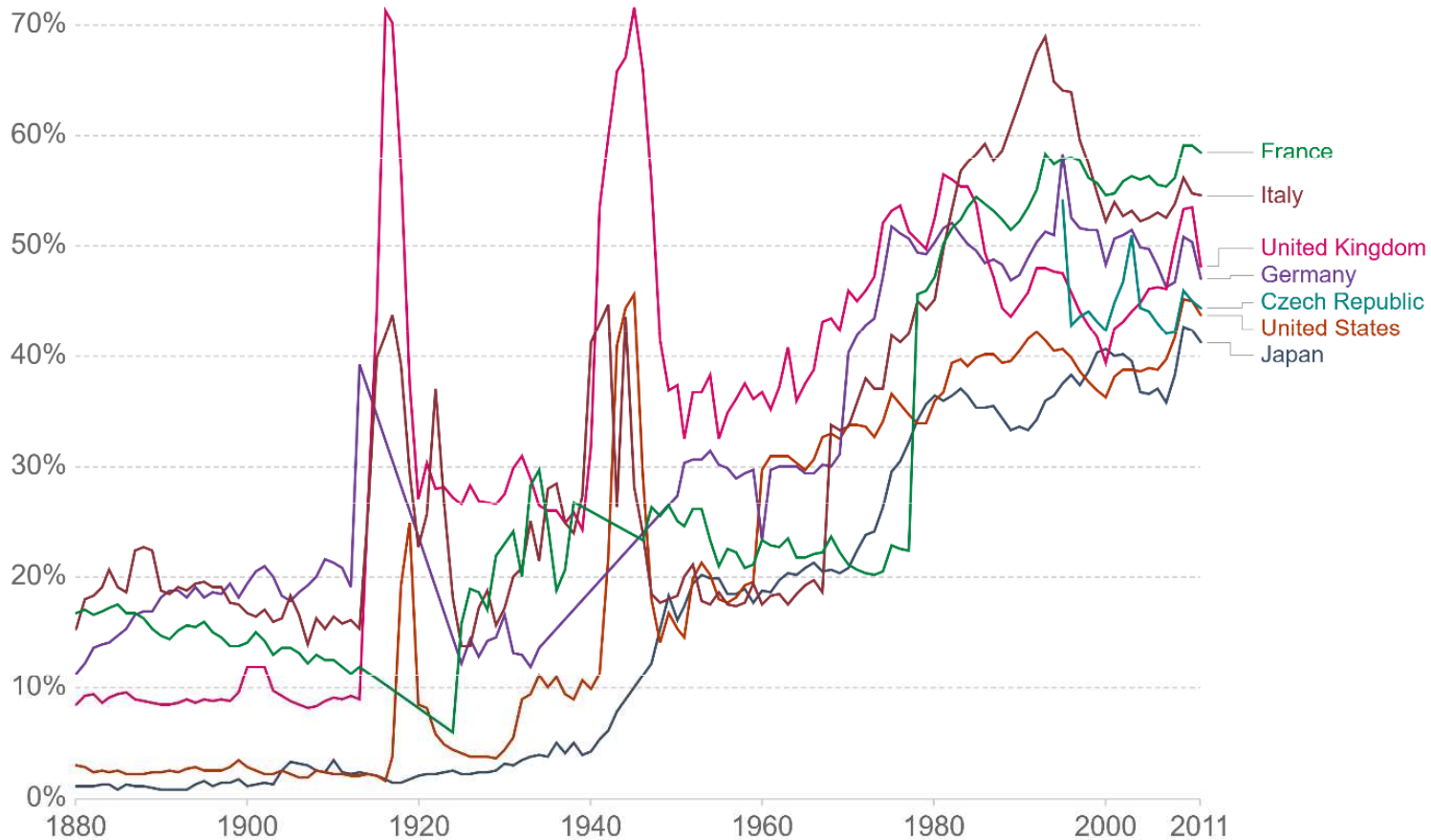


The expansion of the role of the public sector

- The 20th century saw a gradual but large expansion in the role of the state in the economy because:
 - Political and ideological factors
 - Marxist and socialistic thinking (government should play significant role in redistributing income, shift toward and „mixed“ economy)
 - Keynesian thinking (countries with large public sector were believed to be less subject to business cycles)

Government spending, 1880 to 2011

Total government spending, including interest government expenditures, as share of national GDP



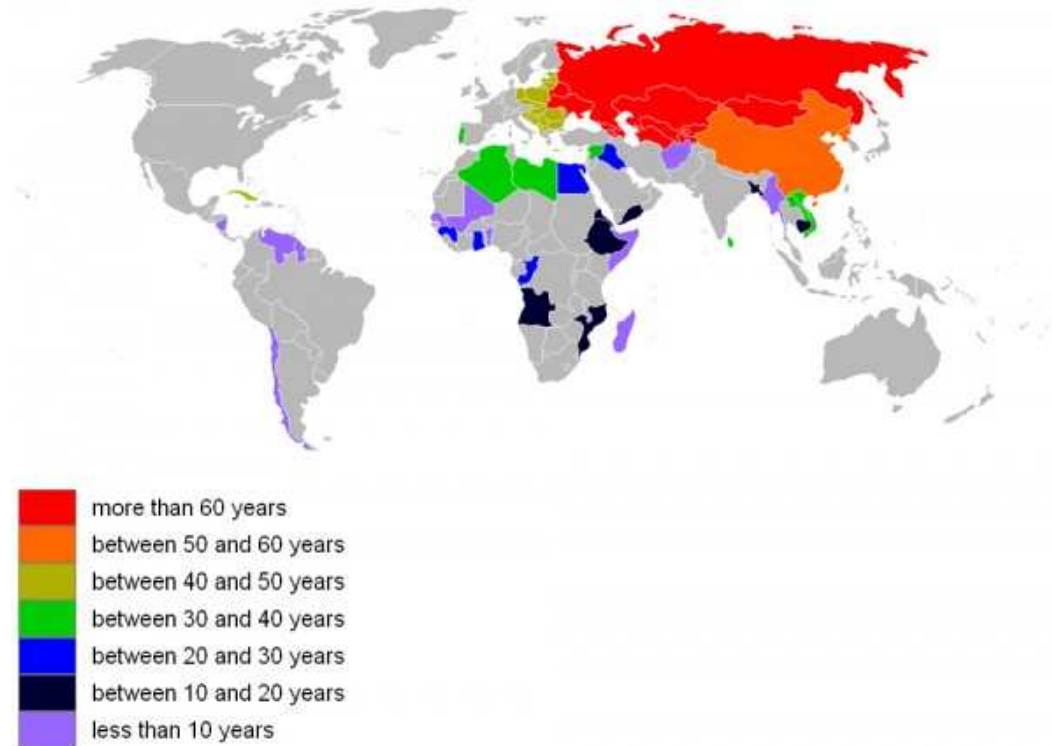
Source: IMF Fiscal Affairs Departmental Data, based on Mauro et al. (2015)

OurWorldInData.org/government-spending • CC BY

The expansion of the role of the public sector

- 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
 - Economic decisions were made in rational and transparent way
 - Policymakers have all relevant info and full control over the policy instruments

Socialist economy at some point



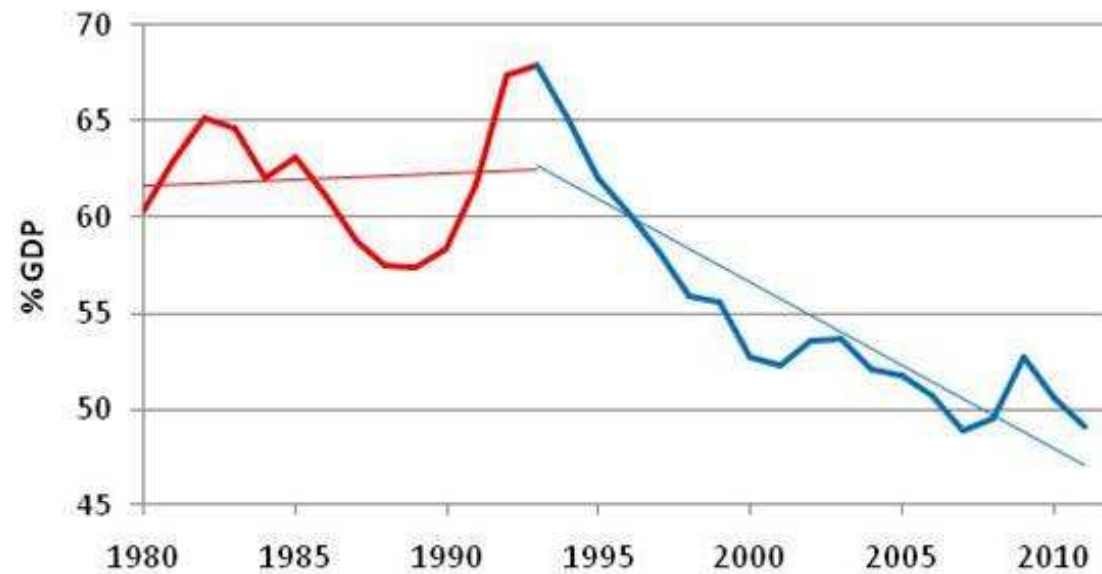
Nationalization in Western Europe

- France
 - 1945: Crédit lyonnais, Société générale, Renault
 - 1946: Electricite de France, Gaz de France
- Spain
 - 1944: Iberia
 - 1945: 79 % of Telefónica
- Sweden
 - 1939-1948: private railway companies
 - 1957: the mining company LKAB
- United Kingdom
 - 1946: Coal industry
 - 1947: Central Electricity Generating Board
 - 1948: National rail and inland water transport
 - 1967: British Steel Corporation

The end of naive picture

- Governments are not as omniscient and omnipotent as was implicitly assumed after WWII till 1970s.
- There are five main limits to the “traditional” approach to EP:
 - Governments have imperfect knowledge about the structure of economy and of future risks
 - Firms and households devise they own strategies and they react to (and anticipate) economic policy measures
 - Governments may not be able to convince private agents that they will actually do what they have announced
 - Policymakers may not have the information they need to take decisions
 - Policymakers may not pursue the general interest

Sweden's government spending



The limits of knowledge: uncertainty and risk

- The government does not have all the information to take action, but it cannot wait until it has all the information.
- 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
=> e.g., joining Eurozone

Uncertainty and risk

Table: Main Macroeconomic Indicators

		2016	2017	2018	2019	2020	2021	2022	2021	2022
							Current forecast		Previous forecast	
Nominal GDP	bill. CZK	4 797	5 111	5 410	5 790	5 695	6 048	6 431	5 932	6 257
	nominal growth in %	3.7	6.5	5.8	7.0	-1.7	6.2	6.3	4.9	5.5
Gross domestic product	real growth in %	2.5	5.2	3.2	3.0	-5.8	3.2	4.2	3.1	3.7
Consumption of households	real growth in %	3.8	4.0	3.5	2.7	-6.8	2.3	5.5	0.1	5.7
Consumption of government	real growth in %	2.5	1.8	3.8	2.5	3.4	2.4	0.4	3.4	0.9
Gross fixed capital formation	real growth in %	-3.0	4.9	10.0	5.9	-7.2	6.0	4.9	3.8	4.5
Contribution of net exports	pp	1.4	1.2	-1.2	0.0	-0.5	-0.6	0.3	0.4	-0.2
Contrib. of change in inventories	pp	-0.3	0.5	-0.5	-0.3	-0.9	0.7	0.0	0.9	0.0
GDP deflator	growth in %	1.1	1.3	2.6	3.9	4.4	2.9	2.1	1.8	1.7
Average inflation rate	%	0.7	2.5	2.1	2.8	3.2	3.2	3.5	2.5	2.3
Employment (LFS)	growth in %	1.9	1.6	1.4	0.2	-1.3	-1.0	0.4	-1.4	0.0
Unemployment rate (LFS)	average in %	4.0	2.9	2.2	2.0	2.6	3.0	2.7	3.6	3.7
Wage bill (domestic concept)	growth in %	5.7	9.2	9.6	7.8	0.2	2.9	3.9	0.7	2.3
Current account balance	% of GDP	1.8	1.5	0.4	0.3	3.6	1.1	0.5	1.3	0.5
General government balance	% of GDP	0.7	1.5	0.9	0.3	-6.1	-7.7	-5.0	-8.8	-5.9
Assumptions:										
Exchange rate CZK/EUR		27.0	26.3	25.6	25.7	26.4	25.7	25.3	25.9	25.5
Long-term interest rates	% p.a.	0.4	1.0	2.0	1.5	1.1	2.0	2.6	1.5	1.8
Crude oil Brent	USD/barrel	44	54	71	64	42	69	68	64	60
GDP in the euro area	real growth in %	1.8	2.7	1.9	1.4	-6.5	4.9	4.3	3.8	3.6

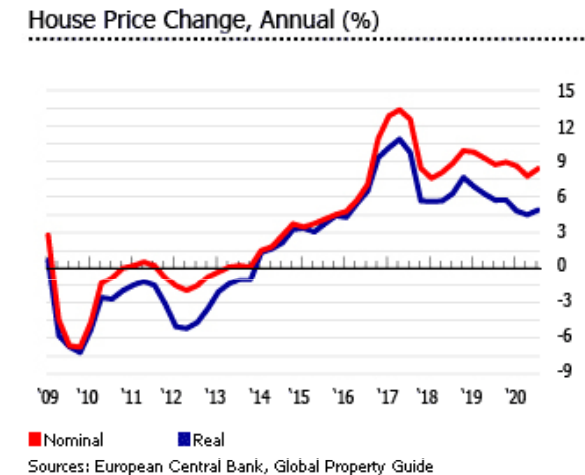
Source: CNB, CZSO, Eurostat, U. S. Energy Information Administration. Calculations and forecast of the MoF.

Exchange rate: 25,3

Crude oil Brent: 83 USD

Current forecast risks and uncertainty

- epidemic situation
- global supply chains
- structural changes in the economy (Green Deal)
- deferred consumption
- overvaluation of property prices



Time lags

- Cognitive delay
- Planning delay
- Administrative delay
- Implementation delay
- Efficiency delay
- Monetary Policy – 18 months time lag
- Fiscal Policy 6 – 24 months time lag

CS: Next Generation EU

- EU's recovery plan from the pandemic
- over €800 billion
- The aim is to mitigate the economic and social impact of the coronavirus pandemic, to make European economies and societies more sustainable and resilient, and to prepare them for the challenges and opportunities of the green and digital transformation.
- The first money will arrive in the 2nd half of 2021
- Do economies need fiscal expansion?

CS: Next Generation EU

Country	GDP		
	2020	2021	2022
Belgium	-6,30%	5,40%	3,70%
Germany	-4,80%	3,60%	4,60%
Estonia	-2,90%	4,90%	3,80%
Ireland	-3,40%	7,20%	5,10%
Greece	-8,20%	4,30%	6,00%
Spain	-10,80%	6,20%	6,30%
France	-7,90%	6,00%	4,20%
Italy	-8,90%	5,00%	4,20%
Netherlands	-3,70%	3,30%	3,30%
Austria	-6,30%	3,80%	4,50%
Slovakia	-4,80%	4,90%	5,30%
Czech Republic	-5,60%	3,90%	4,50%
Sweeden	-2,80%	4,60%	3,90%
EU	-6,00%	4,80%	4,50%

The limits of confidence: credibility problems

- ***Credibility problems*** arise from intertemporal inconsistency (***time inconsistency***)
- time inconsistency: 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 scarp taxes on fixed capital to encourage investment. Then forgive 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, management of the public debt
- Unfulfilled promises undermine confidence in EP and hamper its effectiveness.
- How can the credibility problem be solved?

The limits of confidence: credibility problems

- Solutions:
 - Delegation to independent agencies: central banks, regulatory agencies,...
 - Banish *discretionary policies* and follow fixed *policy rules*: inflation targeting, fiscal rules, agreements for the promotion and protection of investments
 - Transparency

Examples of Agreement for the promotion and protection of investments

**AGREEMENT
BETWEEN THE GOVERNMENT OF THE CZECH REPUBLIC
AND THE GOVERNMENT OF THE MONGOLIA
FOR THE PROMOTION AND RECIPROCAL
PROTECTION OF INVESTMENTS**

The Government of the Czech Republic and the Government of Mongolia (hereinafter referred to as the "Contracting Parties").

Desiring to develop economic co-operation to the mutual benefit of both States,

Intending to create and maintain favourable conditions for investments of investors of one State in the territory of the other State, and

Conscious that the promotion and reciprocal protection of investments in terms of the present Agreement stimulates the business initiatives in this field,

Have agreed as follows:

**Article 1
Definitions**

For the purpose of this Agreement:

1. The term "investment" shall comprise every kind of asset invested in connection with economic activities by an investor of one Contracting Party in the territory of the other Contracting Party in accordance with the laws and regulations of the latter and shall include, in particular, though not exclusively:

/a/ movable and immovable property as well as any other rights in rem, such as mortgages, liens, pledges and similar rights;

/b/ shares, stocks and debentures of companies or any other form of participation in a company;

**AGREEMENT
BETWEEN THE CZECH REPUBLIC AND
THE DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA
FOR THE PROMOTION AND RECIPROCAL PROTECTION OF INVESTMENTS**

The Czech Republic and the Democratic Socialist Republic of Sri Lanka (hereinafter referred to as the "Contracting Parties").

Desiring to develop economic co-operation to the mutual benefit of both States,

Intending to create and maintain favourable conditions for investments of investors of one State in the territory of the other State, and

Conscious that the promotion and reciprocal protection of investments will stimulate business initiatives, the flow of private capital and the economic development of the Contracting Parties

Have agreed as follows:

**Article 1
Definitions**

For the purposes of this Agreement:

1. The term "investment" shall comprise every kind of asset invested in connection with economic activities by an investor of one Contracting Party in the territory of the other Contracting Party in accordance with the laws and regulations of the latter and admitted in accordance with such laws and regulations, and shall include, in particular, though not exclusively:

/a/ movable and immovable property as well as any other property rights, such as mortgages, liens or pledges;

/b/ shares, stocks and debentures of companies or any other form of participation in a company;

/c/ claims to money or to any performance under contract having a financial value associated with an investment;

/d/ intellectual property rights, which mean trade marks, patents, industrial designs, technical processes, know-how, trade secrets, trade names and goodwill associated with an investment;

/e/ any right conferred by laws or under contract pursuant to laws, including the concessions to search for, extract, cultivate or exploit natural resources.

Any alteration of the form in which assets are invested shall not affect their character as investment.

**PROTOCOL
BETWEEN THE CZECH REPUBLIC AND THE REPUBLIC OF ALBANIA
ON THE AMENDMENT TO THE AGREEMENT BETWEEN
THE CZECH REPUBLIC AND THE REPUBLIC OF ALBANIA
FOR THE PROMOTION AND RECIPROCAL PROTECTION OF INVESTMENTS, SIGNED
ON 27 TH JUNE, 1994 AT PRAGUE**

The Czech Republic and the Republic of Albania (hereinafter referred to as "Contracting Parties") have agreed to amend the Agreement between the Czech Republic and the Republic of Albania for the Promotion and Reciprocal Protection of Investments, signed on June 27th, 1994 at Prague (hereinafter referred to as "the Agreement") as follows:

ARTICLE 1

Paragraph 3 of Article 3 of the Agreement is deleted and replaced by new paragraphs 3 to 5, as follows:

" 3. The National Treatment and Most-Favoured-Nation Treatment provisions of this Article shall not apply to advantages accorded by a Contracting Party pursuant to its obligations as a member of a customs, economic, or monetary union, a common market or a free trade area.

4. The Contracting Party understands the obligations of the other Contracting Party as a member of a customs, economic, or monetary union, a common market or a free trade area to include obligations arising out of an international agreement or reciprocity agreement of that customs, economic, or monetary union, common market or free trade area.

5. The provisions of this Agreement shall not be construed so as to oblige one Contracting Party to extend to the investors of the other Contracting Party, or to the investments or returns of such investors, the benefit of any treatment, preference or privilege which may be extended by the Contracting Party by virtue of any international agreement or arrangement relating wholly or mainly to taxation."

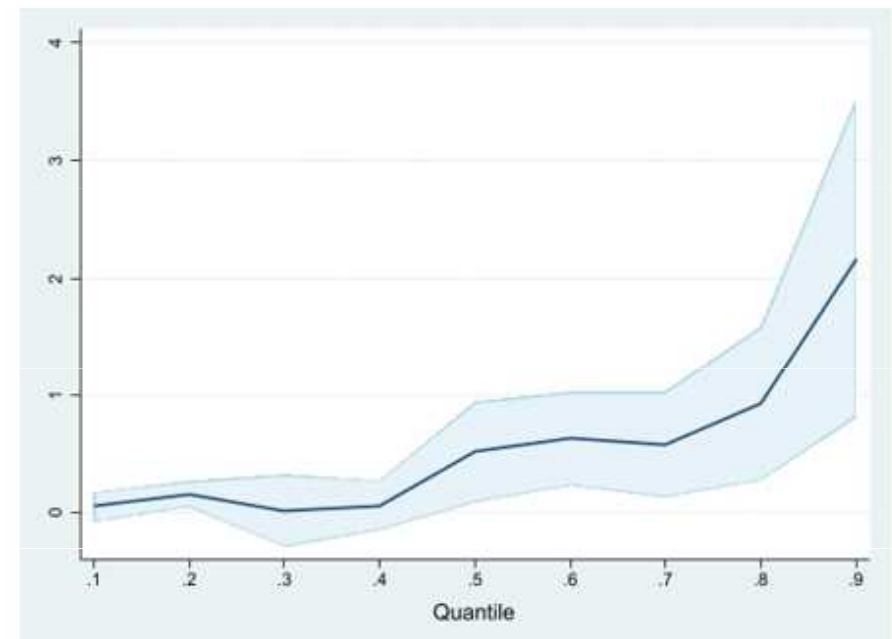
The limits of confidence: moral hazard

- **Moral hazard** problems arise when probability of government intervention changes private behavior and induces more risk taking
- *Examples:* IMF interventions in emerging countries, role of lender of last resort of the central bank, public insurance schemes...
- How can the credibility problem be solved?

The limits of confidence: moral hazard

- Solution:
 - make public intervention rare and costly

The impact of supplementary health insurance on doctors' visits



Hansoo Ko 2020

The limits of information

- Policymakers do not have full access to all information
- Information is used strategically by those with access to it
- Risk of *regulatory capture* (regulatory agencies may come to be dominated by the interests they regulate and not by the public interest)
- 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: example

- Gosplan – central planning commission in Soviet Union
- Information had companies:
 - Over-estimated their need for inputs
 - Under-estimated their productivity
- Friedrich A. Hayek: The Use of Knowledge in Society

The limits of information: example

- Principal-agent model
- Relationship between lenders and borrowers, producers and consumers,...

The limits of information

– 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 (such as performance-related compensation and promotion, e.g., Walsh contract for central bankers – wage negatively dependent on the difference between the actual and the target inflation rate.)

Conflict of interests

- Why may politicians deviate from general interest?
 - short-sightedness (electoral cycles)
 - pressures from interest groups
 - re-election motivation (political business cycles)
 - partisan behaviour (favour the majority that supports political parties in government)

Conflict of interests

- Solutions:
 - Incentive contracts for politicians
 - Procurement rules
 - Anti-bribery laws
 - Delegation to independent agencies

Evidence of politically-motivated decisions

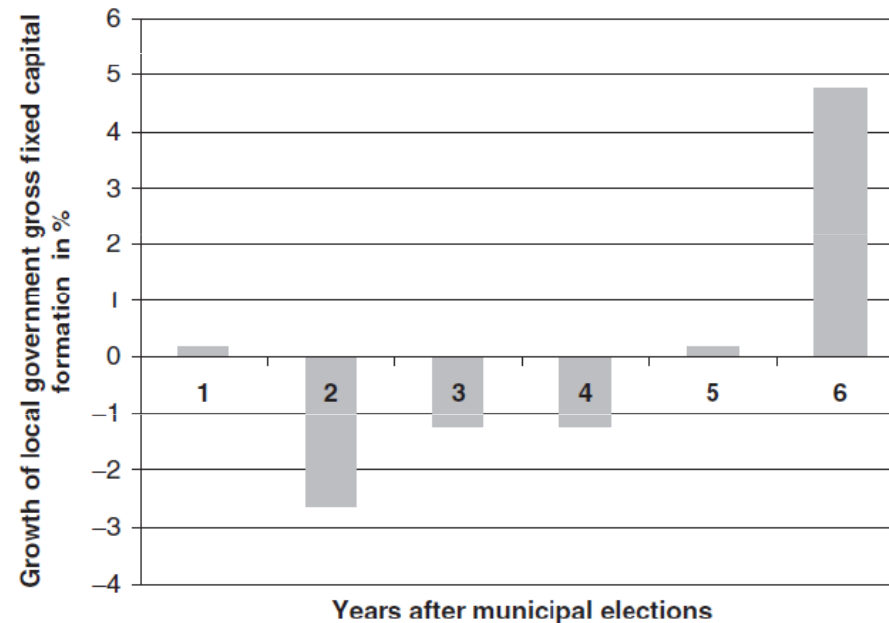


Figure 2.3 Electoral cycle and local investment in France.

Source: Besson (2002).

Note: Contribution of the municipal electoral cycle to gross fixed capital formation, averaged over 1965–2000.

The median voter theory

- 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 .

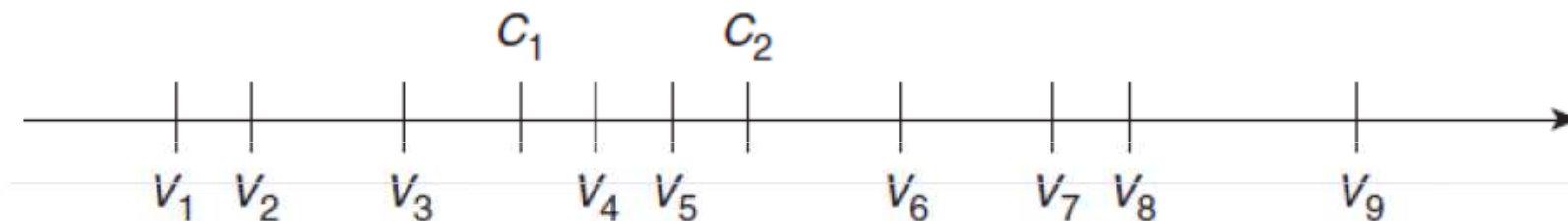
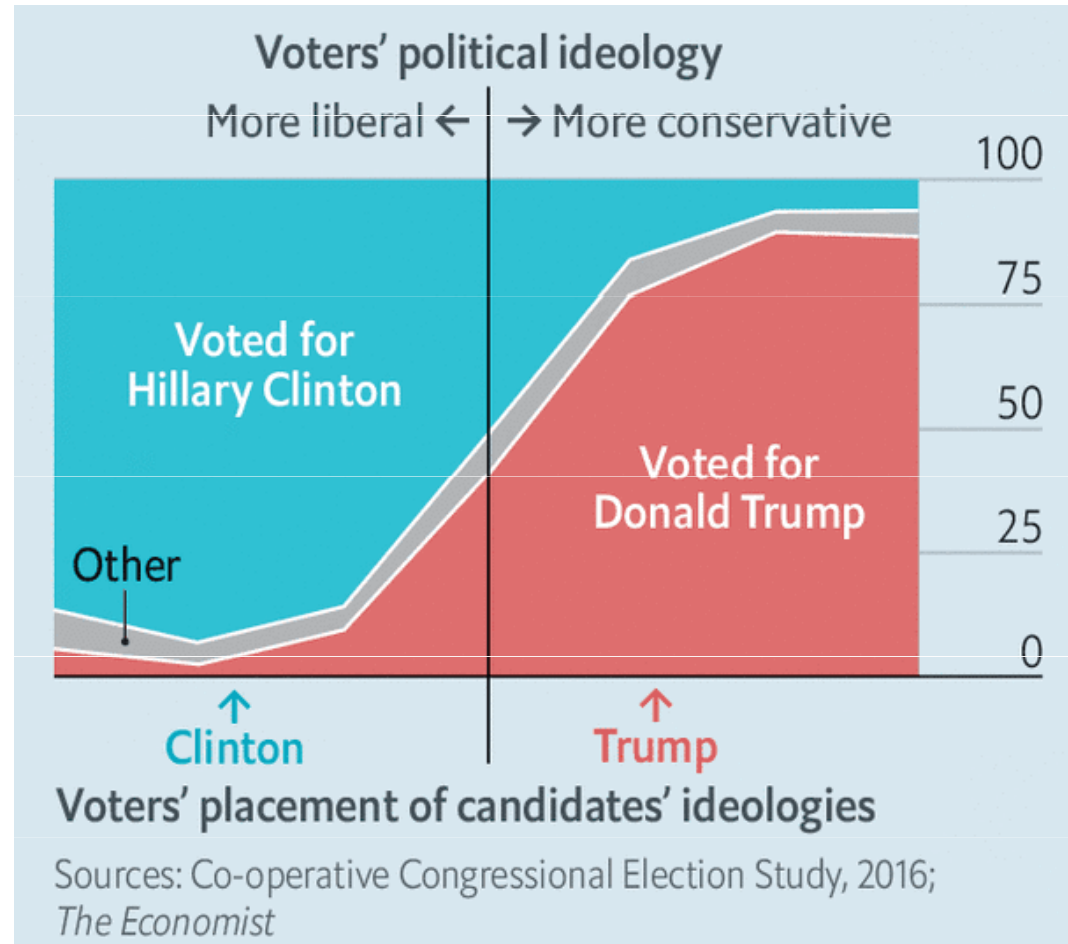


Figure B2.10.1 Preferences, votes, and the median voter.

- 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**

The median voter



Should policymaking be delegated?

- Technocrats are better in presence of:
 - technical complexity (e.g., financial/safety regulation)
 - stable social preferences
 - the decisions in question and their effects are not easily observable by voters (merger control)
 - the decision with vulnerable to time inconsistency
 - the decision affect the distribution of income between generations

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

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

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