Economic Policy #2

Limits of Economic Policy

Limits of Economic Policy

- Uncertainty and risk
- The limits of confidence
- The limits of information
- Conflicts of interests
- Solution
- External limits

Motivation

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

Government interact with other players in imperfect information world and their EP have been deeply affected by the rise of international interdependence.

Uncertainty and risk

Government doesn’t have extensive knowledge of the preferences of economic agents and of the economic structure

=> 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

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.

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.

Responsible and irresponsible credible behaviour #1

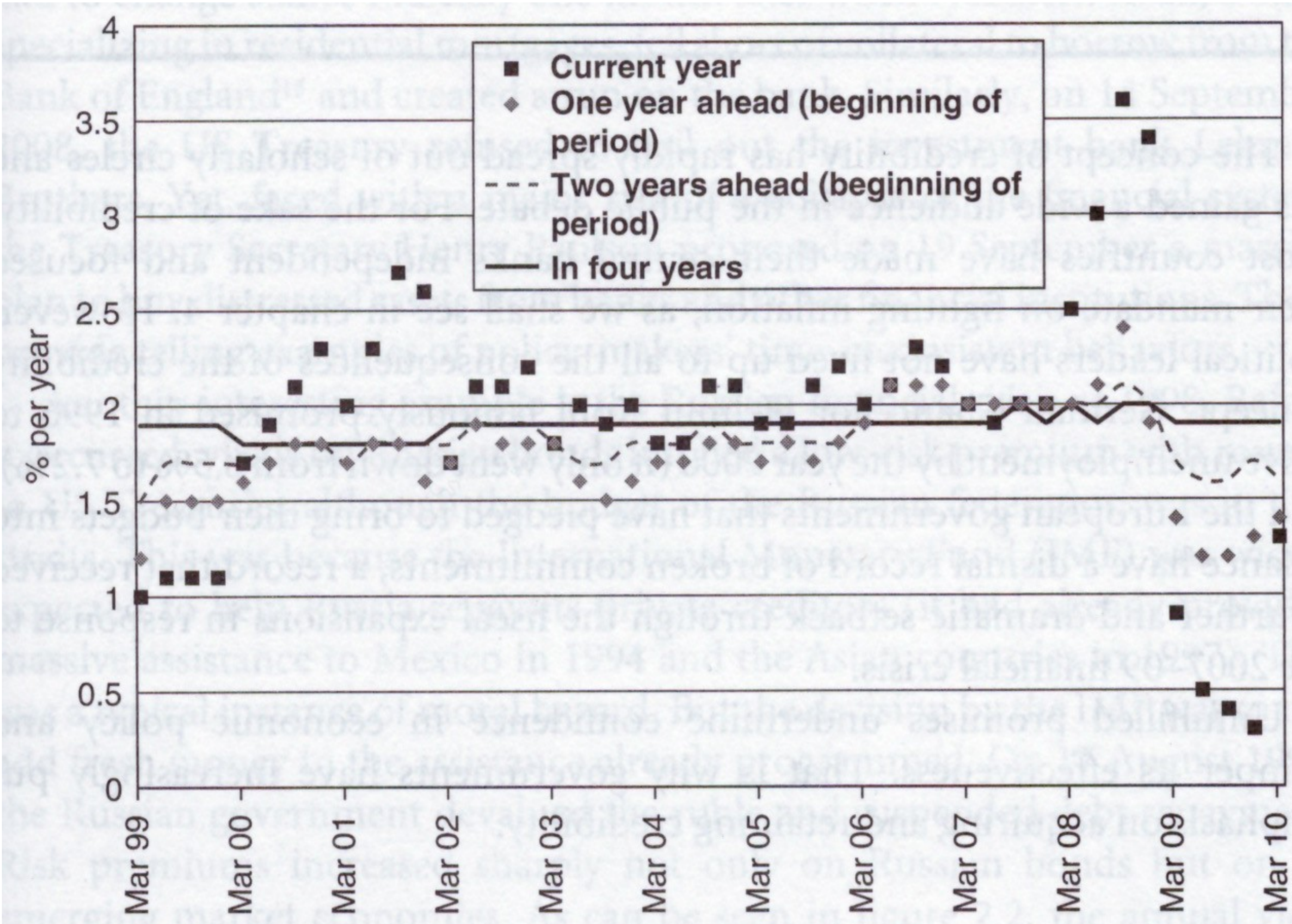


Figure B2.7.1 Inflation expectations in the euro area.
Source: ECB Survey of Professional Forecasters, April 2010.

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)

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)

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

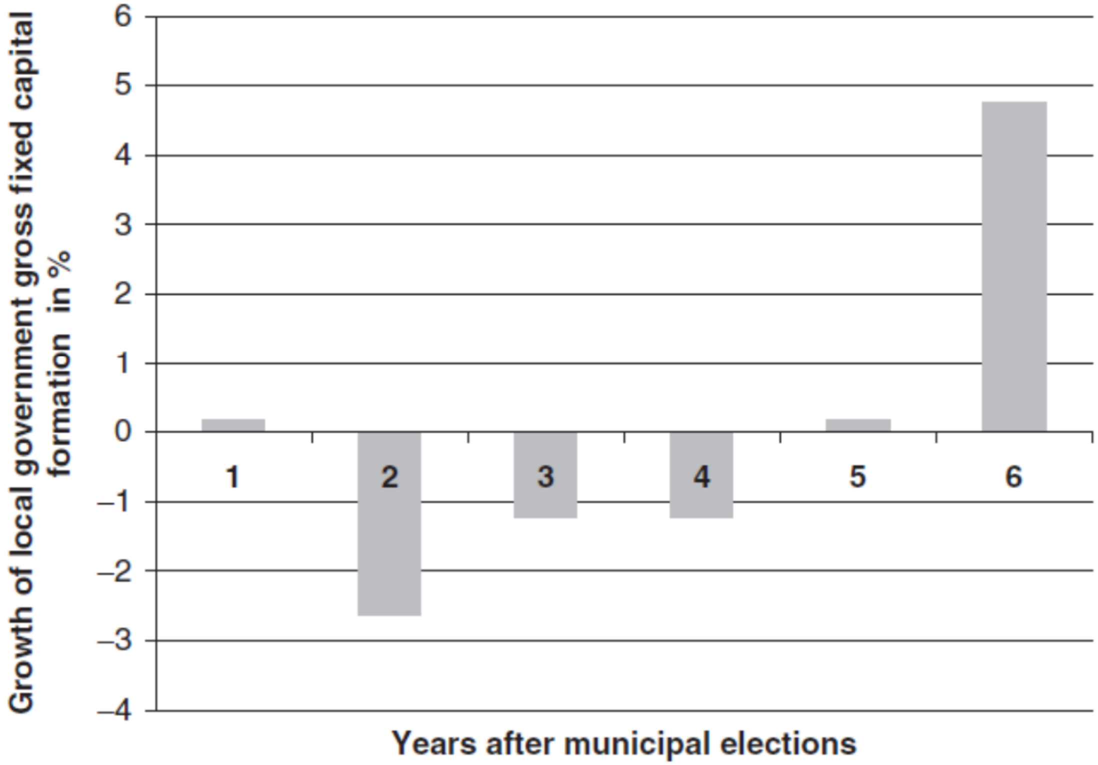


Figure 2.3 Electoral cycle and local investment in France.
Source: Besson (2002).
Note: Contribution of the municipal electoral cycle to grass fixed capital formation, averaged over 1965–2000.

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.

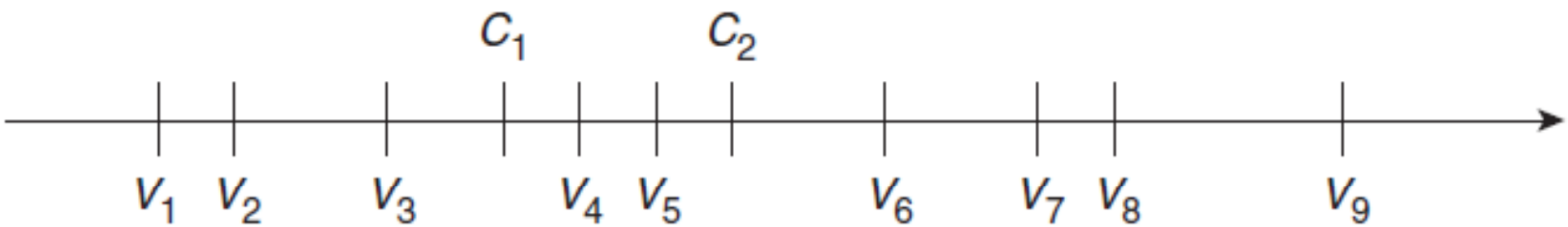


Figure B2.10.1 Preferences, votes, and the median voter.

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?

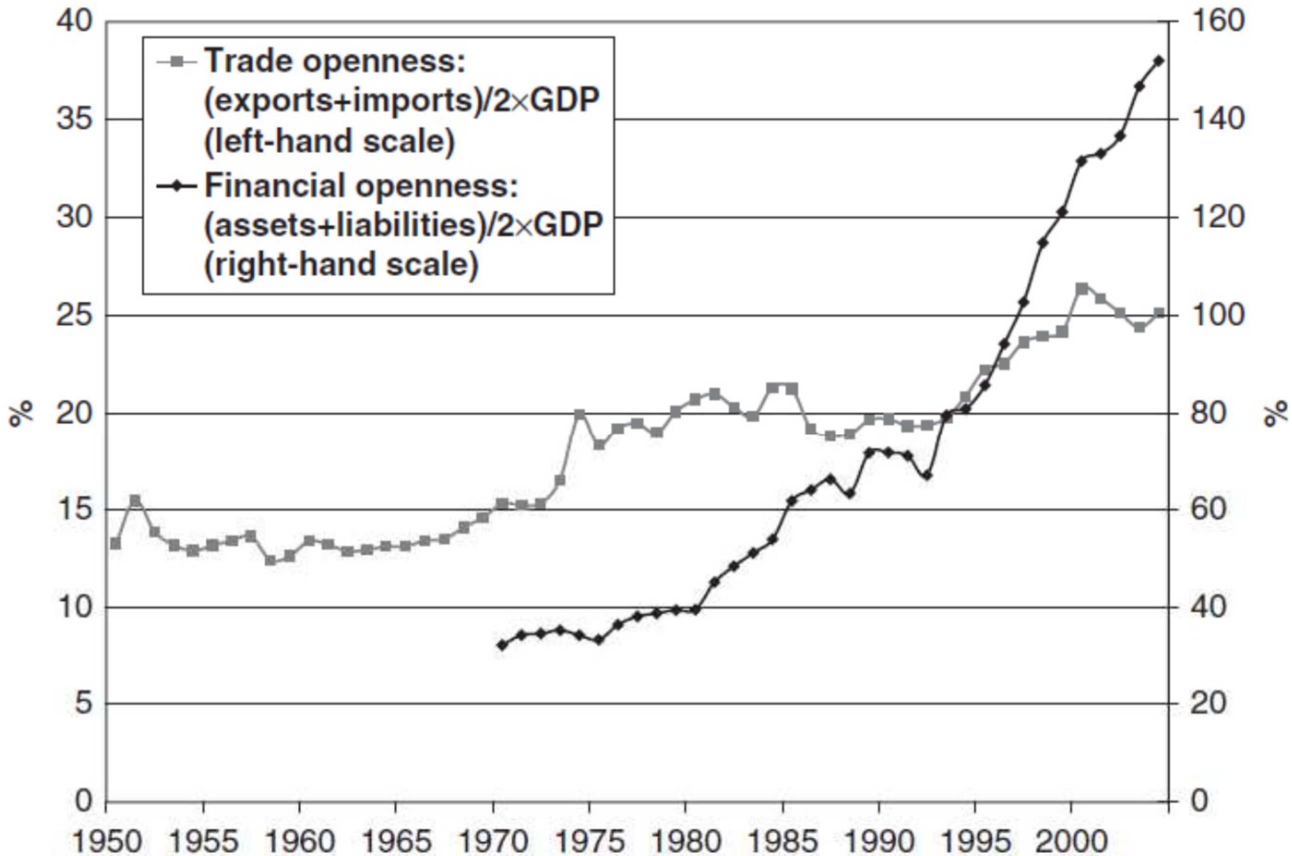
- Technocrats are better in presence of:
  - technical complexity (e.g. financial/safety regulation)
  - judicial nature of decisions (merger control)
  - undesirable trade-offs (public health and safety)
  - intertemporal concerns (distributions across generations)
  - significant international independence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

Living with interdependences



Some indicators of international integration exceed level before WWI (e.g. trade openness), others do not (international migration flows).

The pros and cons of coordination #1

- ***Arguments for coordination***
  - Global public goods

	Excludable	Nonexcludable
Rival	Private good *Ex: Shoes*	Common good *Ex: A lake's fish resources*
Nonrival	Club good *Ex: Patentable inventions*	Public good *Ex: Financial stability*

  - Policy spillovers
    - Demand, price and interest rate spillover
    - Competitiveness and the '*n*-1' problem (if all n countries behave the same way, the economic indicator (e.g. exchange rates) will remain unchanged

      => beggar-thy-neighbor policies

The pros and cons of coordination #2

- ***Arguments against coordination***
  - Commitments not followed by actual policy decision
  - Model and parameter uncertainty: imperfect information may lead to wrong choices
  - Coordination as a form of collusion when seen as a coalition among policymakers to weaken market discipline
  - Partial coordination (e.g. within a subset of countries) may worsen policy outcome