Economic Policy and Business Activity

LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT
UNIVERSIDADE DE LISBOA

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2nd Semester

Chapter 1

Introduction to economic policy

Theory Lecture 1

1. Introduction to economic policy

1.1. A primer on economic policy

1.2. The whys and hows of public intervention

1.3. Economic Policy Evaluation: Decision Criteria

1.4. Conclusion

1. Introduction to economic policy

1.1. A primer on economic policy

1.2. The whys and hows of public intervention

1.3. Economic Policy Evaluation: Decision Criteria

1.4. Conclusion

1.1. A primer on economic policy

1.1.1 Three alternative approaches to economic policy

1.1.2 What do policymakers do?

1.1.3 The objectives, instruments and institutions of EP

1.1.4 Trade-offs, structural reforms and better institutions

Learning outcomes for lecture 1

- Define and compare the three approaches to economic policy
- Explain the main activities of policy makers
- Describe the main objectives and instruments of economic policy
- Define institutions and their role in economic policy

Three alternative approaches

1. Positive economics

2. Normative economics

3. Political economics

The three approaches coexist in practice.

1.1.1 Three alternative approaches

1. **Positive economics**: the economist limits herself to the study of the effects of public choices on the economy – *objective, fact-based, statements should be tested and accepted/rejected*

2. **Normative economics**: the economist seeks to influence public choices by making recommendations based on her expertise – *opinion or ideology-based*

3. **Political economics**: the economist takes political decisions as a topic for research and attempts to identify and explore the determinants of economic policy decisions. *It analyses how public policy is developed and implemented*

Three alternative approaches

Which type of approach?

- “governments should provide free education to all students”
- “government should ban fast food from schools to prevent child obesity”
- “free education increases public expenditure and adult literacy”
- “government should ban airbnb from Lisbon in order to prevent an increase in residence rents”
- “bike-sharing schemes will increase cycling in cities”

Positive economics

- The economist **measures and examines the effects of different policy measures on economic variables**

- Economic policy choices and policymakers are treated as exogenous: they impact on the outcome economic variables (e.g. prices, output, or employment) without being influenced by these variables

- Ex: increasing public spending on schools and hospitals, increase fuel tax, increase university fees, increase interest rate, etc.

Normative economics

- The economist acts as an adviser to the Government / policymaker and examines which set of decisions can best serve explicit public policy purposes

- Normative economics **relies on the tools from positive economics to assess the effects of different possible policy decisions, but the economist now manifests specific social preferences towards the alternative policy outcomes (normative value judgements)**

Normative economics

- The public decision-maker / government is regarded as a social planner, and the economist as a engineer who tells him which measures to select for reaching certain goals

- Normative economics frequently implies giving up the first-best solution for a second-best solution because of informational, institutional, or political constraints

Normative economics

- Normative economics has to overcome difficulties that positive economics does not need to address, essentially due to three reasons:
  - The need to define policy objectives and to trade-off for alternative objectives
  - Uncertainty about correct decision in a second-best world
  - Information asymmetries between policy-maker and private agents

Political economics or political economy

- Strand of research that **explores systematically the political determinants of policy decisions**
- Instead of considering the political decision-makers' behaviour as exogenous (as in the case of positive economics), it treats it as endogenous and makes it subject of research
- The **government is regarded as a machine directed by politicians, i.e. by rational players whose behaviour follows specific objectives and faces specific constraints** – the government is no longer regarded as a benevolent dictator

Political economics

- It seeks to model the behaviour of governments (technocrats and politicians) in order to determine how the governance and the mandate of these agents influence economic performance

- The choice of a policy regime regarding product, capital, and labour market regulations involves preferences and trade-offs between efficiency and equity; economic interests of different players; etc.

- Political economy is essential from a positive point of view (to understand why economic policy does not achieve its objectives) and from a normative one (to evaluate the chances of success of different interventions)

Three approaches to economic policy

- Positive economics, normative economics, and political economics coexist and the modern approach of economic policy draws on all three

- Positive economics remains necessary to the understanding of the likely effects of public decisions

- Normative economics poses the issue of policy choices and addresses the trade-offs between these choices

1.1.2 What do policymakers do?

(in the context of national and regional policy)

- Who are they?

- What do they do?

1.1.2 What do policymakers do?

Who are they?

- At national level: ministers, their advisers, civil servants, Chief Scientific Advisers, Parliamentary Committee members, advisory staff, etc.

- It can also include the staff of government agencies (environmental agencies) with expert knowledge and a policy mandate on a specific area.

- It also includes local administration (municipalities, metropolitan region mayors, etc.)

- At the supra-national level it can include EU commission, ECB, IMF, etc.

European Commission

1.1.2 What do policymakers do?

The main tasks of economic policymakers can be grouped into six categories:

1. Set and enforce the rules of the economic game
2. Tax and spend
3. Issue and manage the currency
4. Produce goods and services
5. Fix problems or pretend to
6. Negotiate with other countries

What do policymakers do?

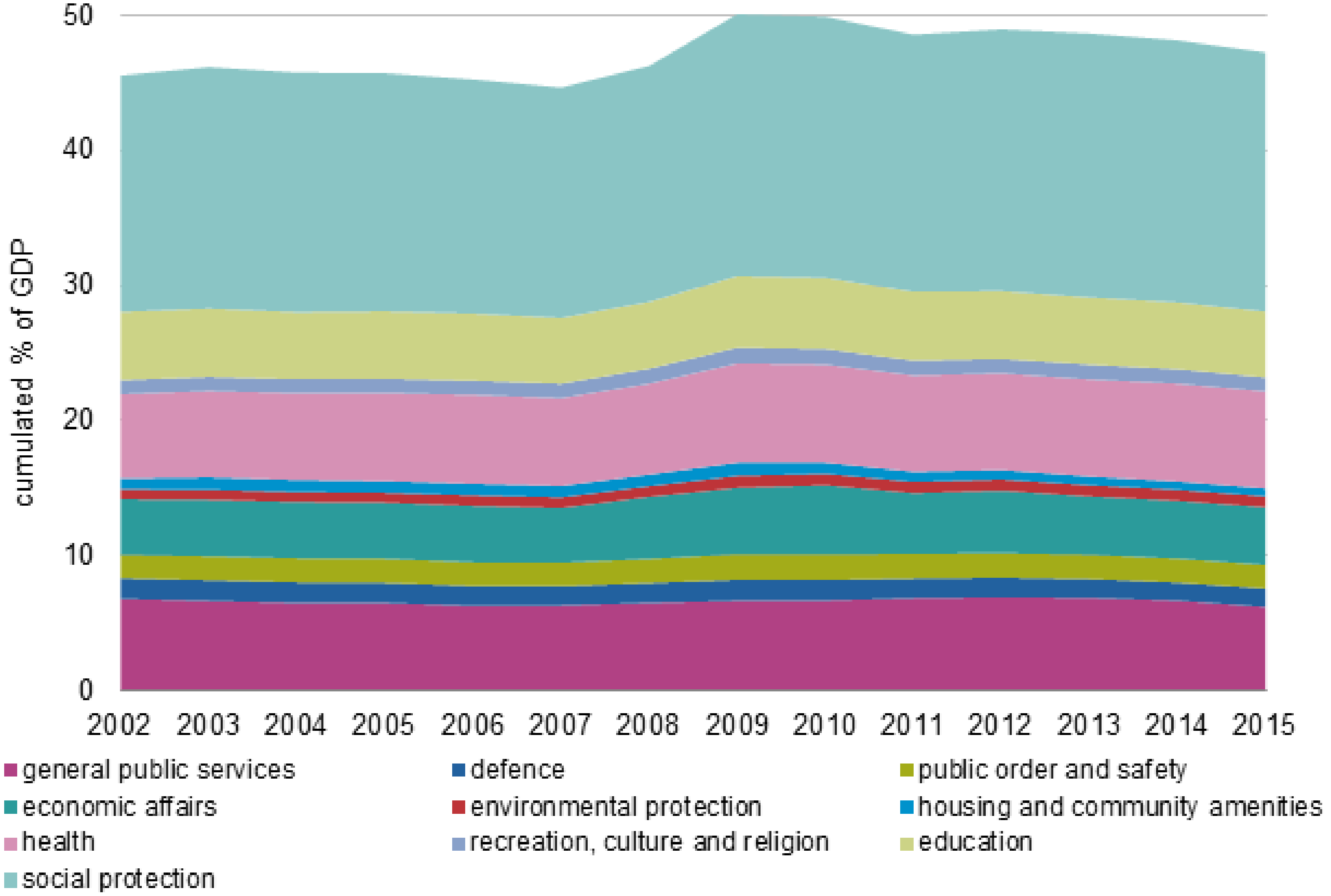
1. Set and enforce the rules of the economic game

- Economic legislation provides the framework for the decisions of private agents.
- Enforcement covers competition policy and the supervision of regulated markets such as banking and insurance.
- In EU member countries national economic legislation is increasingly determined by EU law (e.g. free movement of goods, people, capital; competition law, labour rights, etc.)

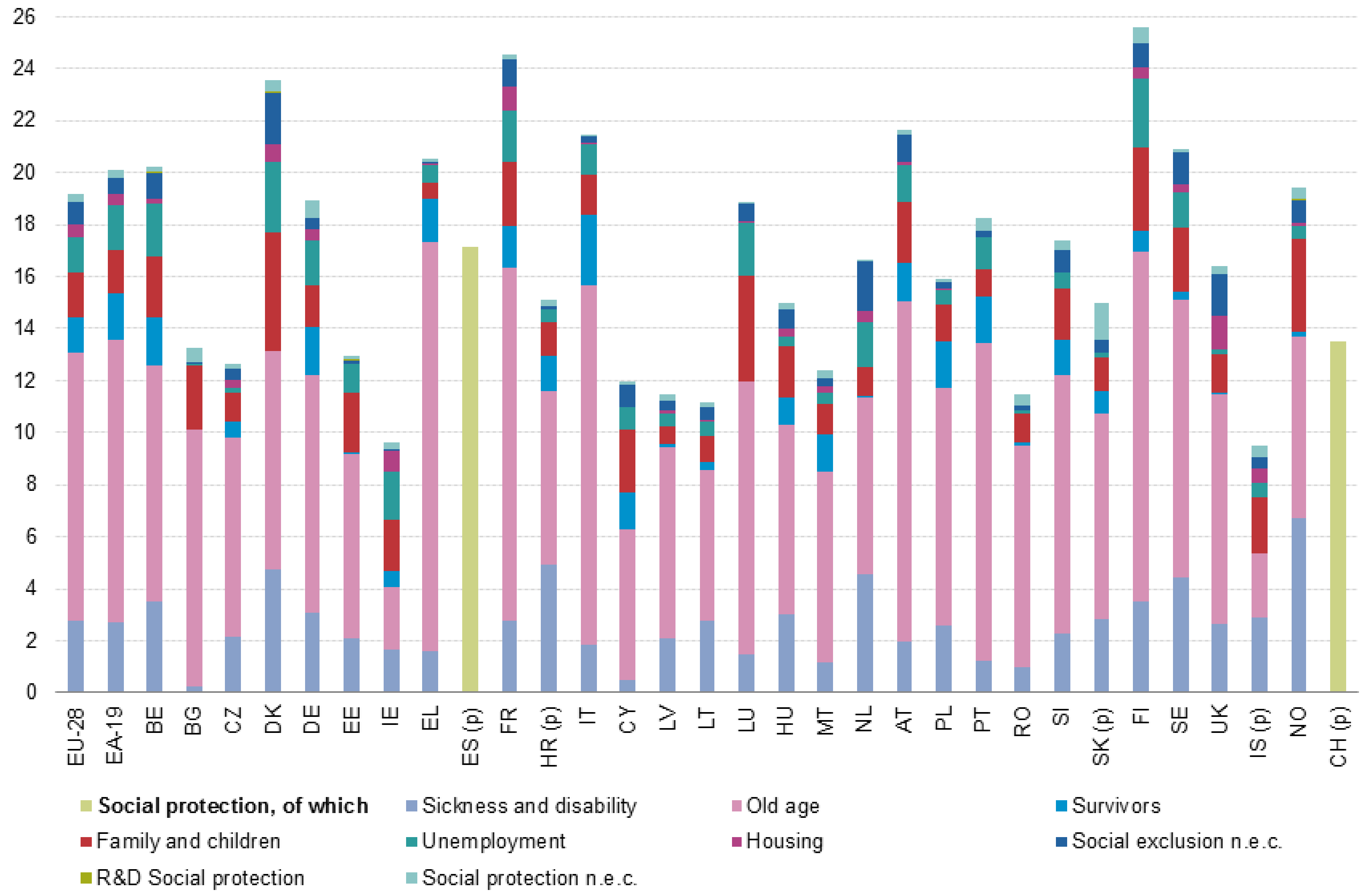
What do policymakers do?

2. Tax and spend

- Government spending by type of function (EU-28, 2002-2015, cumulated % of GDP)

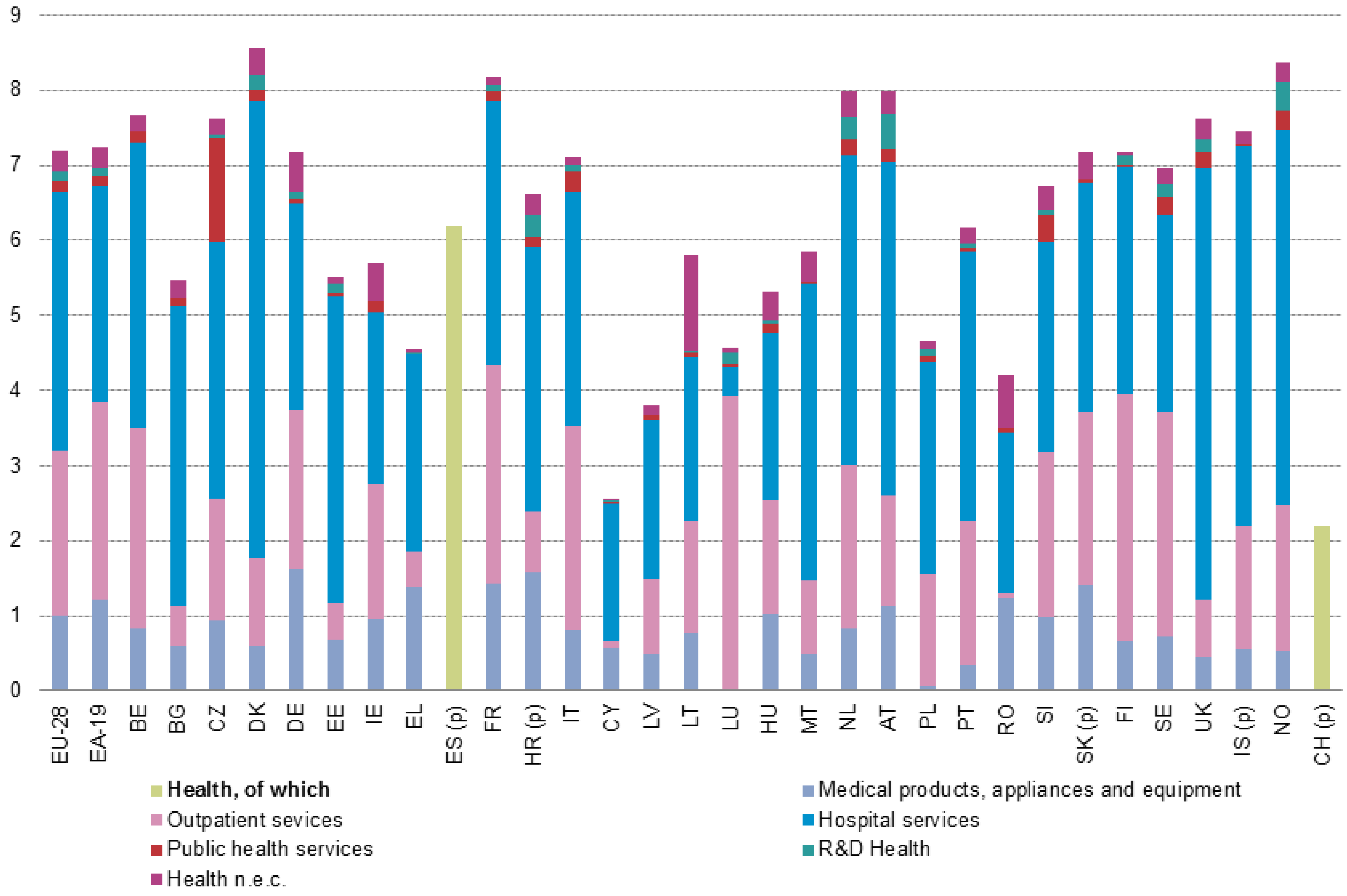


Total general government expenditure on social protection, 2015 (% of GDP)



http://ec.europa.eu/eurostat/statistics-explained/index.php/Government_expenditure_by_function

Total general government expenditure on health, 2015 (% of GDP)



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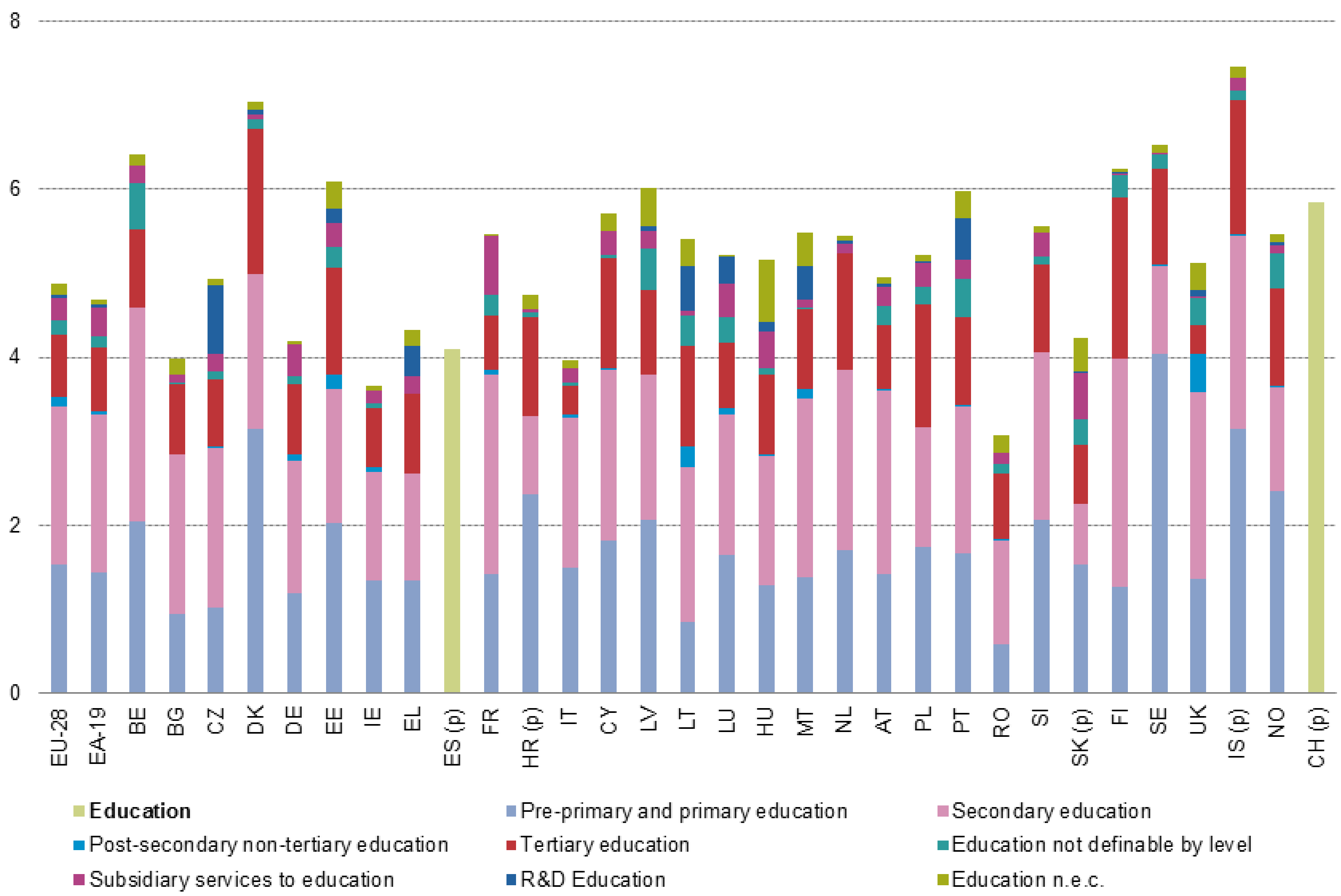
Total general government expenditure on education, 2015 (% of GDP)



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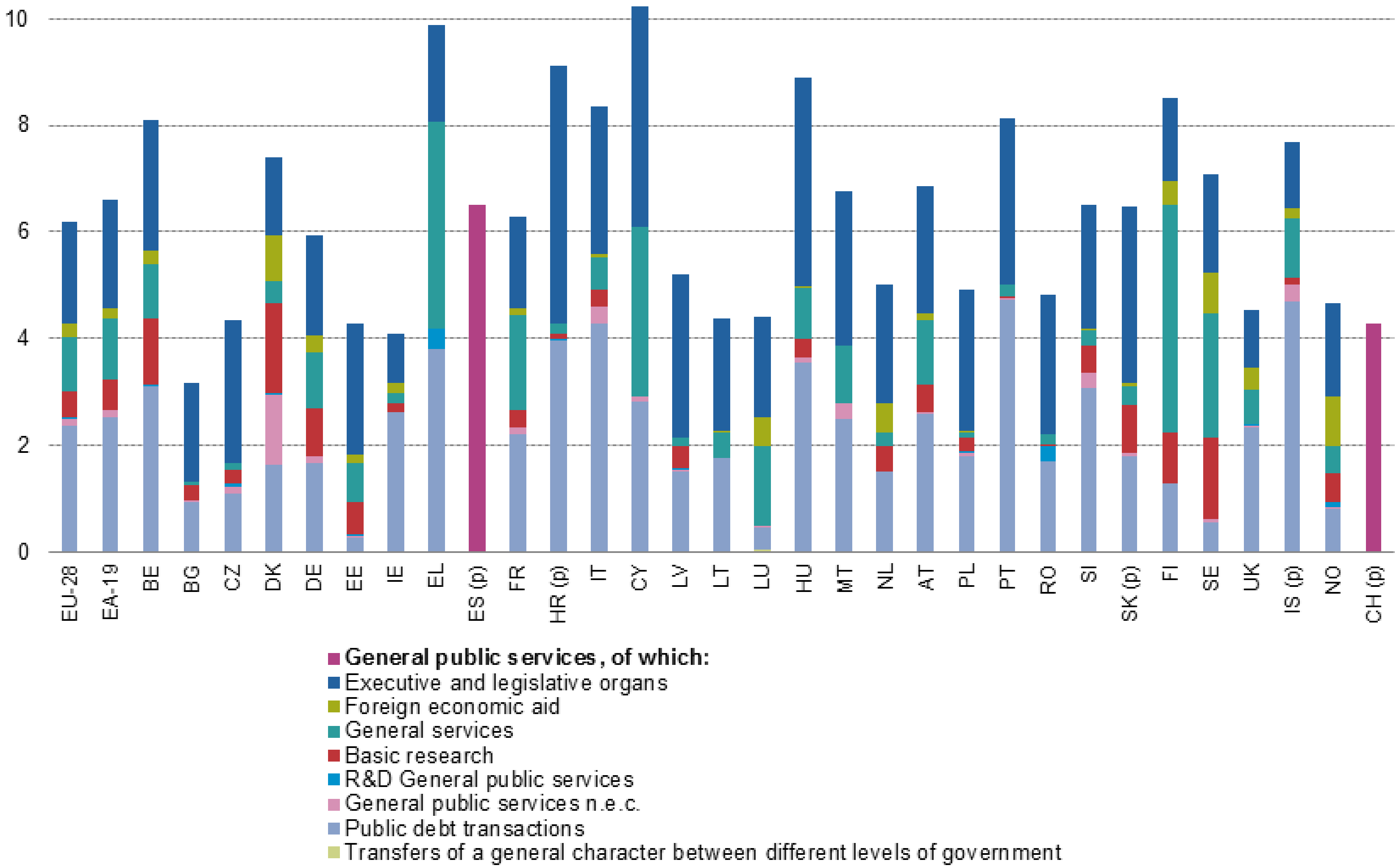
Total general government expenditure on general public services, 2015 (% of GDP)



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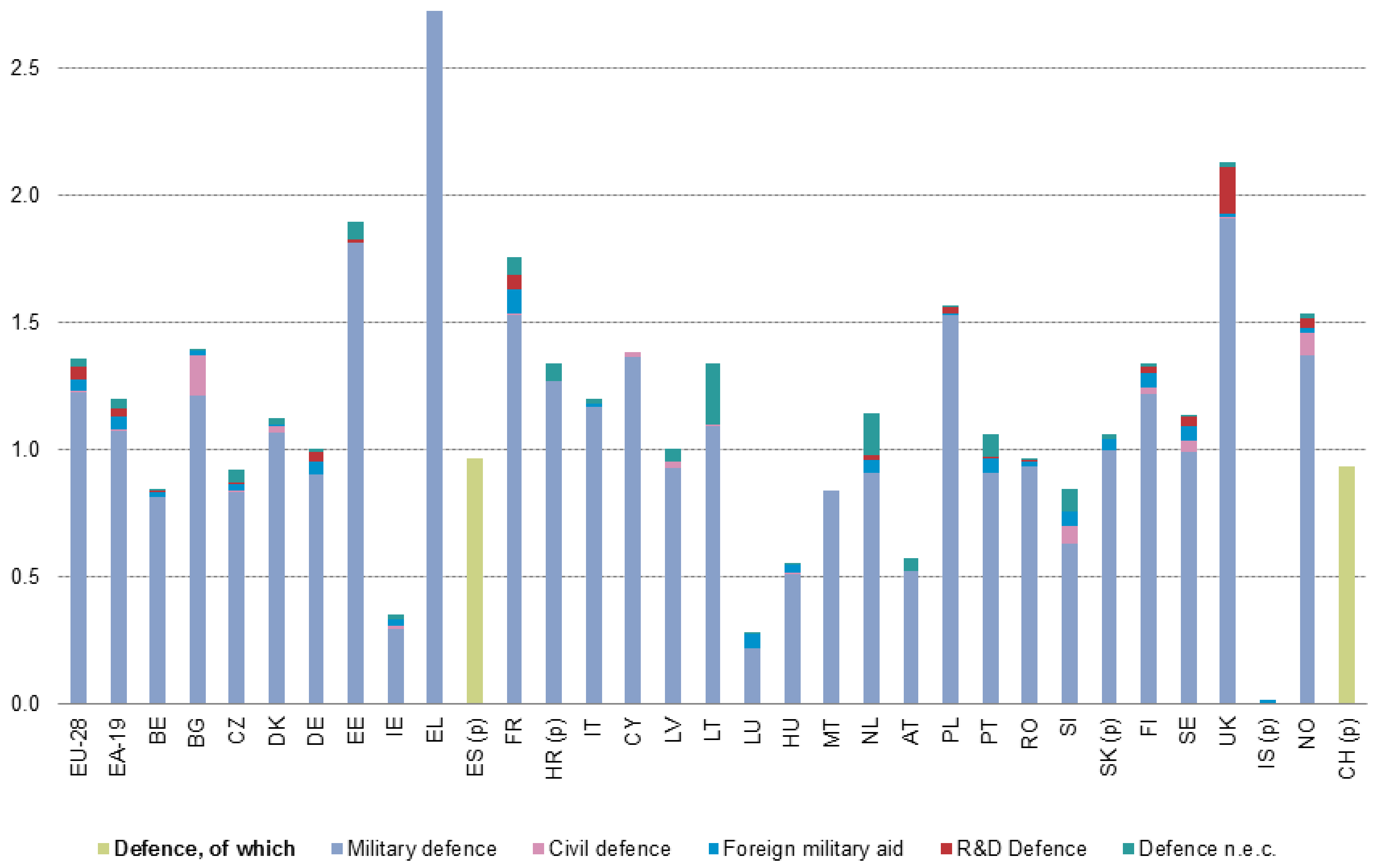
Total general government expenditure on defence, 2015 (% of GDP)



http://ec.europa.eu/eurostat/statistics-explained/index.php/Government_expenditure_by_function

What do policymakers do?

2. Tax and spend

- Government spending by type of function
- Budgetary decisions affect:
  - households’ and firms’ income and behaviour through taxation and social insurance
  - productivity through infrastructure, research, and education spending
  - aggregate demand through changes in spending or overall taxation

What do policymakers do?

3. Issue and manage the currency

- The choice of a monetary and exchange-rate regime is one of the most important single decisions a government can make
- Defining and implementing monetary policy is the function of the central bank, which is responsible for setting interest rates, maintaining the value of the currency, insuring that the banking system does not fall short of liquidity

What do policymakers do?

4. Produce goods and services

- This is much less a government responsibility today than it used to be in the first decades after World War II
- However, most governments are still responsible for providing health care or education services, and some still own public enterprises in sectors like transport or energy

What do policymakers do?

5. Fix problems or pretend to

- Ministers are frequently held responsible for a vast array of issues, from financial market turmoil to wage negotiations, company mergers, and plant closures and relocations
- Many problems are beyond their means, but they can still try to influence private decisions – or at least pretend to

What do policymakers do?

6. Negotiate with other countries

- Governments negotiate with other countries on trade liberalisation and the definition of global rules
- They participate in the governance of global and regional institutions (IMF, WB, WTO, EU)
- They participate in informal forums (G7, G8, G20, etc.) to hold discussions on global problems such as development, global warming, etc.

1.1.3 A simple representation of economic policy: objectives, instruments and institutions

To provide a simple representation of the common features of economic policy we can focus on its:

- Objectives
- Instruments
- Institutions

Objectives

- The objectives of economic policy are numerous and sometimes contradictory. Common examples include:
    - improving the standard living of population,
    - achieving full employment,
    - maintaining price stability,
    - reaching a fair distribution of income,
    - alleviating poverty, etc.

- Economic policy has several objectives generally with ambitious targets, irrespective of the difficulty of reaching them simultaneously

- Objectives are often stated in government manifestos

NATIONAL PERFORMANCE FRAMEWORK

THE GOVERNMENT'S PURPOSE
To focus government and public services on creating a more successful country, with opportunities for all of Scotland to flourish, through increasing sustainable economic growth

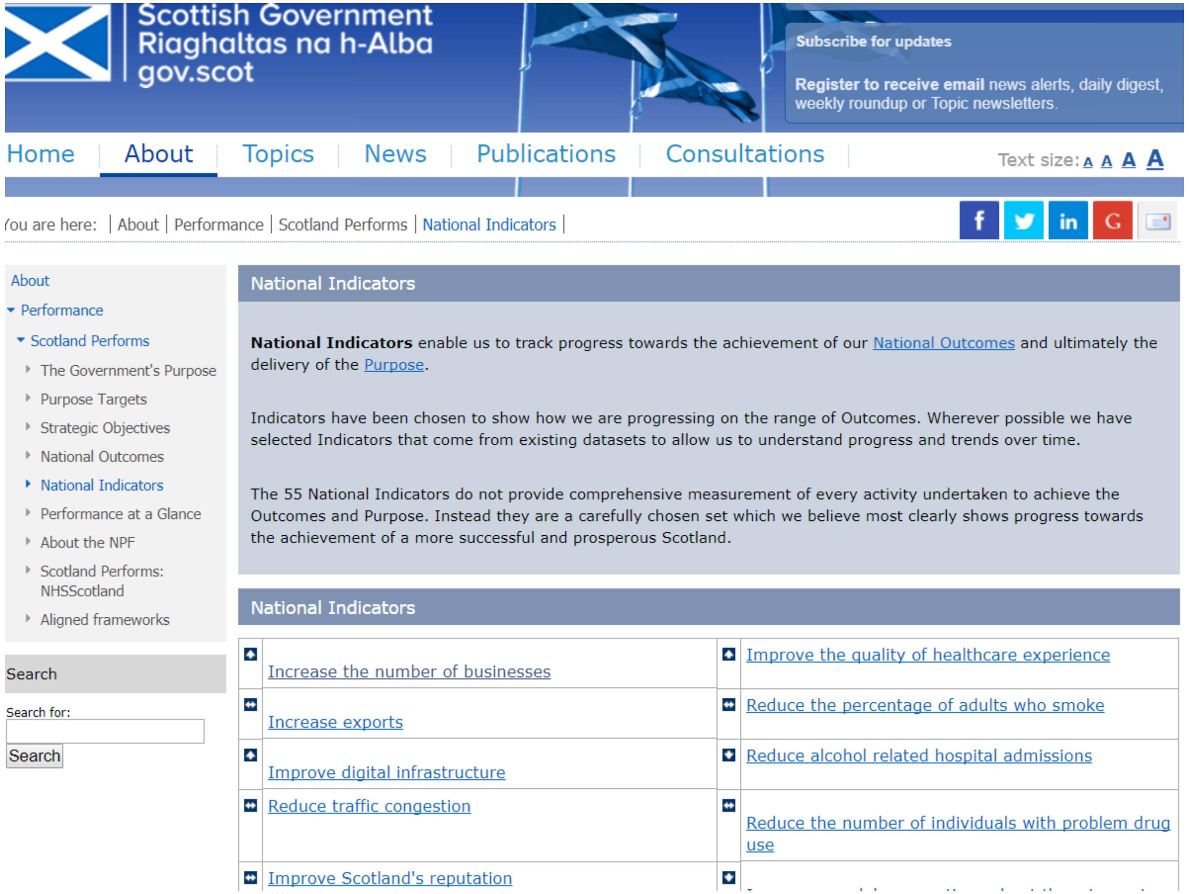
HIGH LEVEL TARGETS RELATING TO THE PURPOSE
Growth | Productivity | Participation | Population | Solidarity | Cohesion | Sustainability

STRATEGIC OBJECTIVES
WEALTHIER & FAIRER | SMARTER | HEALTHIER | SAFER & STRONGER | GREENER

NATIONAL OUTCOMES

- We live in a Scotland that is the most attractive place for doing business in Europe
- We realise our full economic potential with more and better employment opportunities for our people
- We are better educated, more skilled and more successful, renowned for our research and innovation
- Our young people are successful learners, confident individuals, effective contributors and responsible citizens
- Our children have the best start in life and are ready to succeed
- We live longer, healthier lives
- We have tackled the significant inequalities in Scottish society
- We have improved the life chances for children, young people and families at risk
- We live our lives safe from crime, disorder and danger
- We live in well-designed, sustainable places where we are able to access the amenities and services we need
- We have strong, resilient and supportive communities where people take responsibility for their own actions and how they affect others
- We value and enjoy our built and natural environment and protect it and enhance it for future generations
- We take pride in a strong, fair and inclusive national identity
- We reduce the local and global environmental impact of our consumption and production
- Our people are able to maintain their independence as they get older and are able to access appropriate support when they need it

NATIONAL OUTCOMES



http://www.gov.scot/About/Performance/scotPerforms/indicator

Instruments

- Instruments are also numerous, ranging from micro to macro.
- Traditional instruments include **monetary policy** (the setting of official interest rates) and **fiscal policy** (the choice of the levels of public expenditure and taxes). Economic policy is often presented as a combination of these two policies only…
- However, it can and must rely on a variety of **microeconomic instruments**: **regulation, direct and indirect taxes on households and companies, subsidies, social security transfers, competition policy, etc**

Institutions

- Institutions refer to the **rules and legislation governing the relationships and contracts between agents as well as the frameworks for economic policy decisions**

- Include **formal constraints** (rules, laws, constitutions), **informal constraints** (norms of behaviour, conventions, codes of conduct), and the **ability to enforce them**

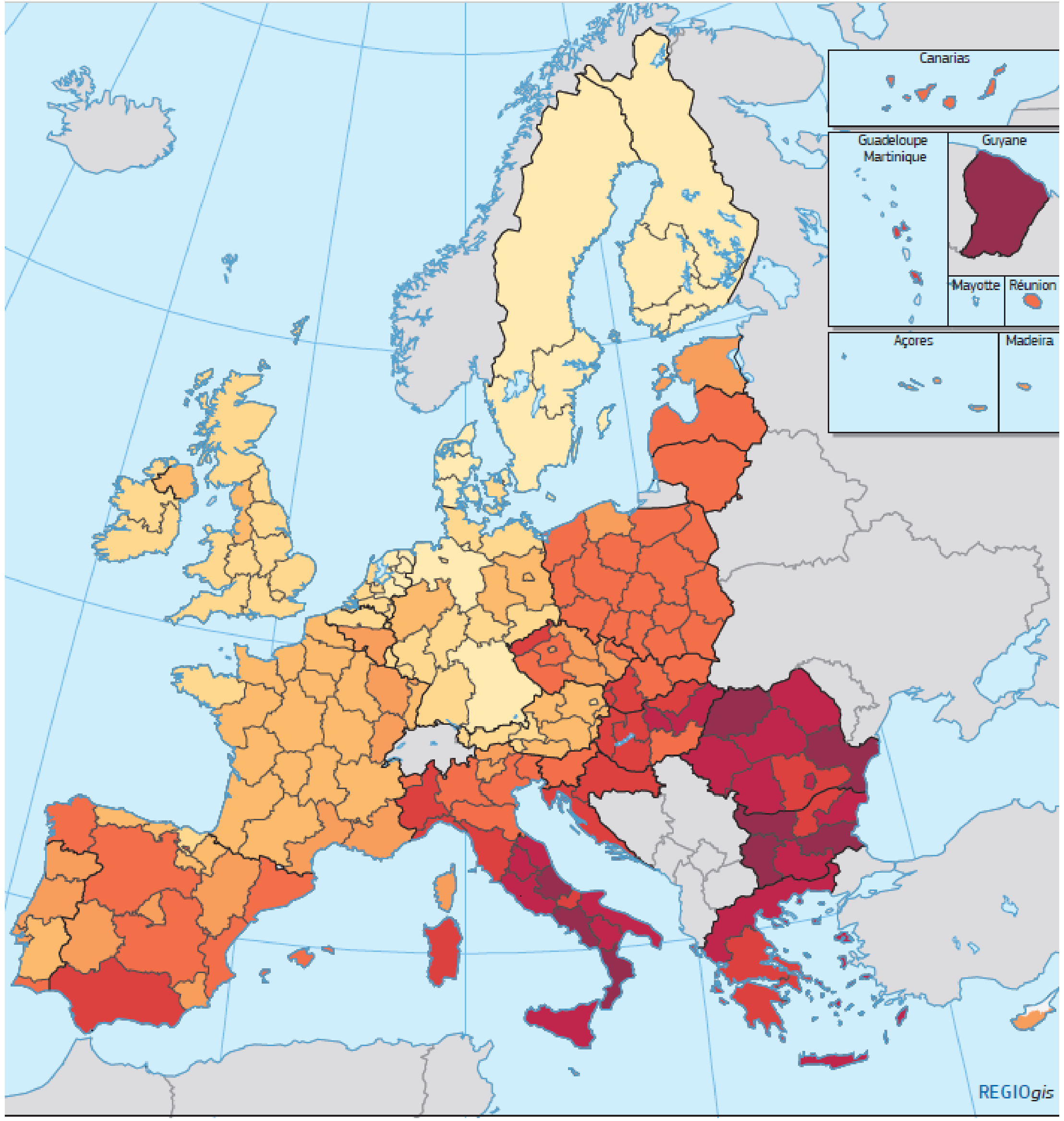
- Institutions affect directly market equilibrium and the **effectiveness of policy instruments, and hence economic outcomes**, e.g. FDI, economic growth

Institutions

- Institutions represent a kind of social capital (informal institutions, norms of behaviour, codes of conduct)

- They are not eternal and can evolve, can be reformed, or can disappear, but they have some permanence and can be taken as given for the traditional analysis of policy choices

- There is evidence that the quality of government and its institutions matters for social and economic development across the EU and that it is an important determinant of regional growth (Chapter 4 of EU's 7th Report on economic, social and territorial cohesion)



Map 4.1 European Quality of Government index, 2017

Standard deviation, range from poor quality (negative) to high quality (positive)

- < -1.75
- -1.75 – -1.25
- -1.25 – -0.75
- -0.75 – -0.25
- -0.25 – 0.25
- 0.25 – 0.75
- 0.75 – 1.25
- > 1.25
- no data

EU = 0
Source: World Bank data and a regional quality of government survey.

Figure 4.2 Citizen's confidence in institutions, 1996 and 2015

Source: World Bank Rule of law 2015

Institutions

Examples of institutions:

- Features of the organisation of products, labour, and capital markets (i.e. the bankruptcy code, the rules governing employment contracts, the legislation on takeovers)

- Framework for economic policy decisions (i.e. budgetary procedures, the statute of the central bank, the exchange-rate regime, the rules governing competition, etc.)

- This definition includes non-public institutions such as trade unions, which are private association but affect the functioning of labour markets

- Includes institutions and rules governing the legal system, social security, health, education, etc.

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