

# Economic Policy and Business Activity



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# Theory Lecture 5

# Chapter 2

## **Limits of Economic Policy in a Complex World**

## **2. Limits of Economic Policy in a Complex World**

- 2.1 Limits of knowledge**
- 2.2 Limits of representation**
- 2.3 Limits of confidence**
- 2.4 Limits of information**
- 2.5 Limits of benevolence**
- 2.6 Policy responses**

# Learning outcomes for lecture 5 (today)

- Explain the five main limits of traditional view of economic policy
- Describe the two main policy responses, their main advantages and disadvantages

## 2. Limits of Economic Policy in a Complex World

- The (traditional) view that EP is carried out by a single **omniscient, omnipotent and benevolent policymaker** who engages in optimization, taking social preferences as given, based on correctly estimated parameters is at best unrealistic and at worse misleading
- Since the 1970s, this view of EP has been challenged as a result of the **limitations faced by EP in an increasingly complex and uncertain world, with increasing levels of interdependence** (international, national, sub-national)
- In chapter 2 we discuss the **main limitations of the traditional description of economic policy and their consequences for the design and implementation of government intervention**

## 2. Limits of Economic Policy in a Complex World

- “The theories developed since the 1970s model the decision-maker as interacting in an imperfect information context with other players, who are themselves imperfectly informed but are able to anticipate ..., and whose behaviour depends on their expectation of the decision-maker’s not-always-benevolent action.”
- In summary, 5 limitations:
  1. Policymakers have **imperfect knowledge** of the economy and future risks
  2. Economic agents **react** to economic policy measures **by anticipation**
  3. Economic agents **may not trust** what policymakers say they will do
  4. Policymakers have **imperfect information** to take decisions
  5. Policymakers interest may not be in favour of **society’s general interest**

## 2. Limits of Economic Policy in a Complex World

- Five main limits to the traditional approach to economic policy:
  1. Governments have **imperfect knowledge** of the economy and future risks
  2. Firms and households **react** to economic policy measures **by anticipation**
  3. Private agents **may not trust** that policymakers will do what they say
  4. Policymakers have **imperfect information** to take decisions
  5. Policymakers may **depart from society's general interest**
- Two main policy responses (i.e. tools to address the limitations):
  1. Creation of independent agencies or institutions
  2. Creation of policy rules to influence policymakers behaviour



## 2.1 Limits of Knowledge

- EP takes place in an uncertain environment and the government does not have extensive knowledge of the preferences of economic agents and the structure of the economy. This is because there is:
  1. Uncertainty about model and parameter estimates
  2. Lack of knowledge about the distribution of risk
  3. Failure to appropriately take risk into account (i.e. rare but damaging events)
  4. Absence of the precautionary principle of EP (the option value of waiting)
- Uncertainty and risk have strong potential policy implications: errors have been made because governments based policies on wrong parameters or did not properly take risk and uncertainty into account

## 2.1 Limits of Knowledge

1. **Uncertainty** about model and parameter estimates: which models are appropriate and how to specify them using real world data?

2/3. Lack of knowledge about the distribution of **risk** and failure to take risk into account: most economic models rest on the assumption that shocks are normally distributed, but often shocks may be skewed or their distribution may exhibit fat tails -> rare events are more likely to occur than assumed

4. Little attention given to the **timing of EP interventions**, however, in a world where decisions are irreversible or involve fixed costs, policymakers should adopt precautionary principle with respect to timing of policies. It can be optimal to wait until new information is available on their costs and benefits (e.g. UK and Sweden “wait and see” approach to joining the euro). However, doing nothing can also have irreversible effects, e.g. climate change)

## 2.1 Limits of Knowledge

- Uncertainty vs. risk in economics

*“risk is present when future events occur with measurable probability”, so we don’t know the outcome but can measure the odds or probability of different outcomes*

*“uncertainty is present when the likelihood of future events is indefinite or incalculable”, so we do not know the information needed to measure the odds*

## 2.2 Limits of representation

- That is: of the representation of agents behaviour and how they react to policies
- **Rational expectations hypothesis:** agents are rational, learn from past behaviour and mistakes, and react in anticipation to economic policies consequences, making them less effective

Examples: *permanent income hypothesis* (tax cuts do not increase consumption and AD because permanent income expectation remains unchanged and so does consumption); *Ricardian equivalence* (Japanese government increased public spending considerably in 1980 and 1990 to promote economic recovery, but households responded by reducing consumption and increasing savings in anticipation of future tax rises to pay public debt). In both cases, public intervention is not very effective at stimulating economic growth

- More recent insights from behavioural and experimental economics have also been incorporated in policymaking and challenged the RE hypothesis

## 2.2 Limits of representation

- **Lucas critique:** it is incorrect to use macroeconometric models' parameters estimated using past information to assess the effects of systematic EP changes; changes will be incorporated into agents' expectations, which in turn affect their behaviour. This implies a change in the models' parameters, which are thus inappropriate to predict future policymaking.
- Notice the link to limits of knowledge (2.1): **Uncertainty** about model and parameter estimates: which models are appropriate and how to specify them using real world data?

## 2.2 Limits of representation

- Macroeconometric models remain relevant to the study of the effects of policy decisions that are non-permanent or remain within a range of policy changes observed in the past, for example, small-scale changes in public expenditures, tax rates or the interest rate. However, they cannot/should not be used to evaluate the effects of a change in the policy regime, which means a change of the principles and rules governing economic policy.
- The policy implications of the Lucas critique: it contributed to making governments and central banks aware of the limitations of quantitative policy evaluations. By diminishing confidence in those evaluations, it has contributed to weakening the technocratic approach to policy choices that prevailed in 1970s.

## 2.3 Limits of confidence

### Credibility

- Lack of credibility of public intervention reduces EP effectiveness because private agents do not behave as governments expect (they react by anticipation changing the effects of EP)
- Lack of credibility is generally associated with time inconsistency of public policies
- Examples: *inflation bias, ricardian equivalence*

### Moral Hazard

- Economic policy often provides insurance (e.g. when the central bank assists banks facing a liquidity shortage or when the government rescues a distressed firm or bank). However, by reducing the expected cost of future damages, government may induce more risk-taking by banks and firms, making EP inefficient.

## 2.3 Limits of confidence

### Time inconsistency

- Lack of credibility and moral hazard are examples of time inconsistency and emphasise the inter-temporal dimension of policy decisions
- One way reduce the time-inconsistency problem is to rule out discretionary policies. That is, economic policy should follow fixed policy rules that leave very limited discretion to the policymaker.
- This view of economic policy has been influential:
  - Rules-based policymaking after 1979 (first in monetary policy and later in budgetary policy)
  - Independence of central banks (from early 1980s) to improve credibility



## 2.4 Limits of information

- Existence of **information asymmetries** between agents (imperfect information). When public or private agents have privileged information and use it strategically, the decision-maker is in a situation of inferiority and his decisions are sub-optimal (e.g. **principal-agent contract problem** in contract theory)
- **Incentive-compatible contracts** in public service delivery have an important role in the context of asymmetric information (i.e. set contracts that align incentives of principal and agents)
- Common examples include public-private partnerships in the fields of infrastructure, health, education

## 2.5 Limits of benevolence

- Five reasons why government may depart from society's general interest:
  1. Exposure to opinion polls, short mandates, or threat of losing a majority in parliament makes politicians vulnerable to lack of credibility and time inconsistency
  2. Exposure to pressures from interest groups (e.g. trade unions, farmers, lobbying from private companies)
  3. Governments are subject to re-election and may act in an opportunistic way to seek re-election by lowering taxes just before poll, by increasing its expenditures, or by delaying difficult decision (see political business cycle theory)
  4. Governments are not only accountable to citizens but also to their supporters and parties –so, they can be partisan and favour the majority that supports them rather than general interest. This can lead to excessive public spending and debt
  5. Divisions between regions, ethnic or social groups may lead to inefficient spending, and excessive public spending and debt

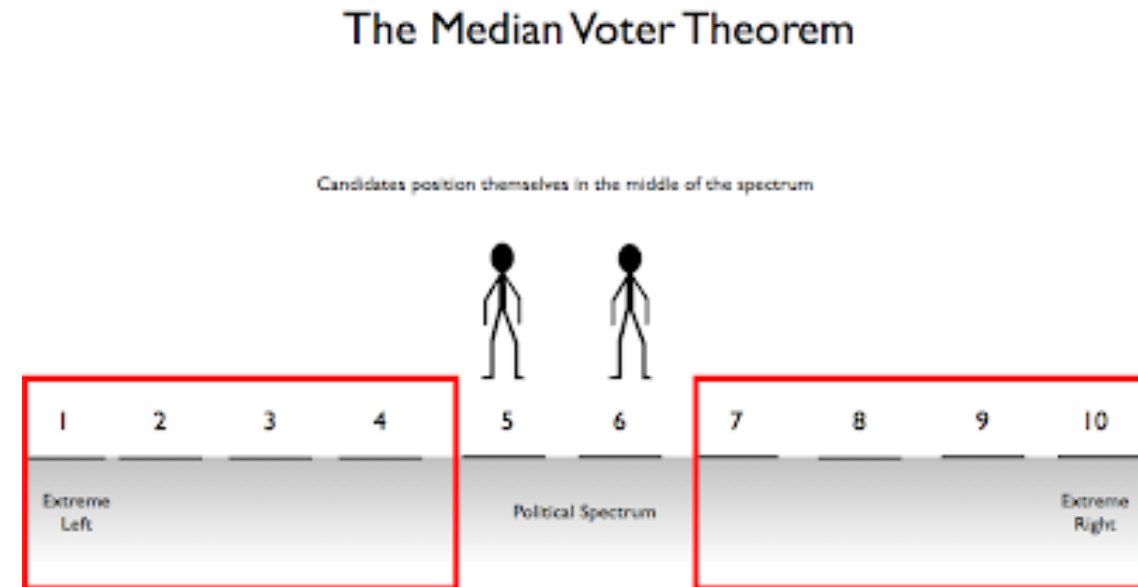
## 2.5 Limits of benevolence

- Modelling politicians' behaviour: a popular model is the median voter model

If left-wing and right-wing parties disagree on the level of government transfers, voters will choose the median level of transfers, when half of the voters would like the level to be lower and half of them would like it to be higher

Assuming only two parties, the tendency for these two is to have political programs which are closer to the preferences of the median voter

This is a logical outcome in a democracy, but generally does not coincide with the social choice objectives from Chapter 1 (“Benthamian” choice and “Rawlsian”)



## 2.5 Limits of benevolence

Implications for policy:

- Realisation that **political institutions shape economic outcomes**, which means they should be structured so that the outcome of political processes corresponds to that of the general interest
- The **political economy approach can help in designing and adopting policy institutions that are conducive to socially desirable outcomes**

## 2.6 Policy responses

- The limits of economic policymaking lead to the necessity of creating adequate institutions
- The last quarter of the XX<sup>th</sup> century saw two major governance technologies:
  1. creation and development of a number of specialised agencies or institutions with independent policymaking or monitoring power
  2. a significantly greater reliance on rules that constrain the behaviour of policy authorities (rules-based policy making)

## 2.6 Policy responses

### 1. Delegation to independent agencies

- This has become a dominant model for central banking, competition and sectoral regulation. It raises two questions:
  1. Why and when is it preferable to remove certain fields of public decision from direct political influence?
  2. How to conduct economic policy in a system where policy instruments are in the hands of independent bodies that may or may not coordinate with each other?
- In addition, we need to acknowledge the fact that **independent institutions are also subject to failures as governments**, e.g. insensitivity to the society's expectations, inability to trade-off between objectives, and lack of legitimacy to deal with decisions that involve a distributional dimension, etc

## 2.6 Policy responses

### 1. Delegation to independent agencies

It is generally accepted that technocratic decision is preferable when:

1. The economic matter is very technical
2. Social preferences are stable and performance criteria are well-defined
3. The decisions in question and their effects are not easily observable by voters
4. The decisions are highly vulnerable to time inconsistency
5. The decisions have a limited impact on income distribution within generations
6. The decisions do not affect the distribution of income between generations
7. The decisions do not involve trade-offs between incompatible objectives
8. The decisions benefit groups that are likely to be involved in political lobbying

## 2.6 Policy responses

### 1. Delegation to independent agencies

- no economic policy issue completely meets the eight criteria, but they provide a useful analytical framework
  - monetary policy meets all the criteria except the 7 and perhaps 5. However, the weighting of objectives can be specified in the statute of the central bank
  - fiscal policy does not satisfy criteria 2, 3, 5 and 7. These are strong reasons to keep fiscal policy within the realm of political decision-making
- the choice between political and technocratic governance is not clear-cut. Intermediate solutions include having elected officials choose the objectives and the responsibility for implementation assigned to technocratic bodies granted operational independence



## 2.6 Policy responses

### 2. Rules-based policymaking

- Rules are prescriptions for policymakers and other economic agents. They are **stable across time, avoiding the problem of lack of credibility and time inconsistency**
- Rules-based governance has received much attention in the field of firm regulation, with debate on rule- vs. principles-based regulation
  - regulatory rules are complex and it is difficult to monitor their implementation. They also can present ambiguities that can be exploited
  - principles-based (risk-focused) regulations allow more discretion and may be less transparent, but under a strong, independent regulator, can deliver results that conform better to a set of social objectives embodied in those principles

## 2.6 Policy responses

### 2. Rules-based policymaking

- The argument for rules-based governance in the area of macroeconomic policy has evolved over time: from a focus on the lack of knowledge of policymakers to a focus on credibility and the time inconsistency of optimal policies (remember Lucas critique)
- First tried with monetary policy in late 70s and early 80s, with limited success. It revived in 90s when an increasing number of central banks adopted explicit inflation-targeting strategies
- It was introduced to budgetary policies later, but nowadays many countries have defined policy rules, e.g. euro area stability and growth pact targets.