ECONOMIC POLICY

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BASIC ALLOCATION PROBLEM

- Scarcity of resource: most people cannot get as much as they want
- Allocation problem: What system is used to allocate something, if more than one person would like to have it?
  - Questions:
    - What: the decision is made over what good
    - Who: who gets the good, and who are those, who don't get it
    - How: what method is used to decide on the above two
  - Possible allocation methods:
    - Sheer force: ‚Bellum omnium contra omnes' – The war of all against all, Thomas Hobbes
    - Random: names are drawn randomly – Efficiency, legitimacy problem
    - Meritocracy: who deserve it most? – Legitimacy
    - **Plan**: a wise dictator makes all the decisions – How to be wise without proper information
    - **Market**: those who can pay the price, will get it – Is it fair?
- The market-trade method can be reasonably efficient but it is also unfair at times. Planning and hierarchical decisions can bring some fairness into the system, but usually the are inefficient.
  - Combination of the two: Leviathan – the state

ECONOMIC POLICY

- Economic policy deals with the decisions of the state that are carried out in order to achieve a favourable resource allocation
- Collective decisions:
  - Responsibility is dispersed
  - Incentives and benefits are also dispersed

ACTORS OF ECONOMIC POLICY

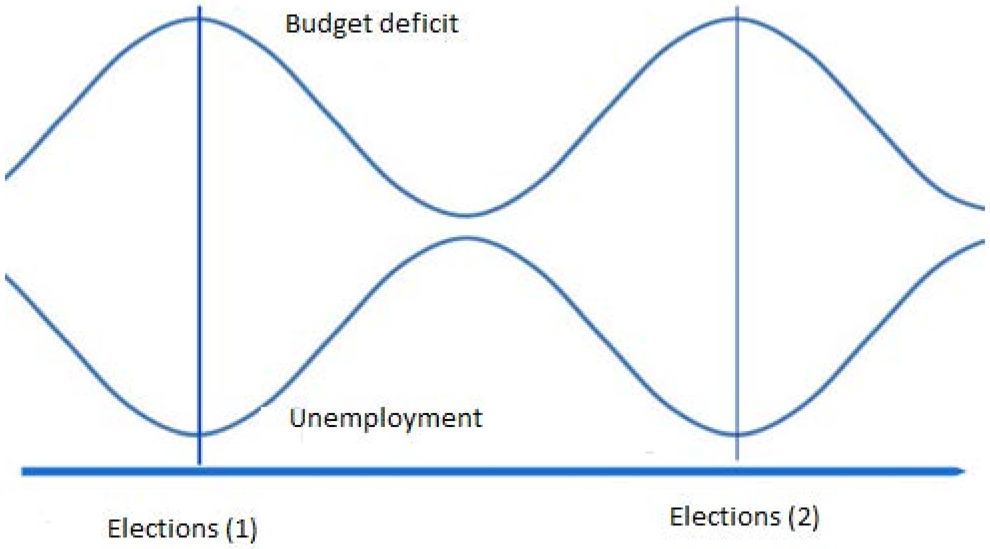
	Local	Foreign
Direct (make decisions)	Government Central bank Regulatory authorities	European Union WTO IMF
Indirect (influence decisions)	Parties Trade unions Chamber of commerce	OECD Credit rating agencies Investors

MAJOR FORCES BEHIND ECONOMIC POLICY

1. Political environment
2. International environment
3. Theoretical background – schools of economics
4. Institutional environment – traditions

1. POLITICAL ENVIRONMENT

- Political business cycle: A business cycle that results primarily from the manipulation of policy tools (fiscal policy, monetary policy) by incumbent politicians hoping to stimulate the economy just prior to an election and thereby greatly improve their own and their party's reelection chances



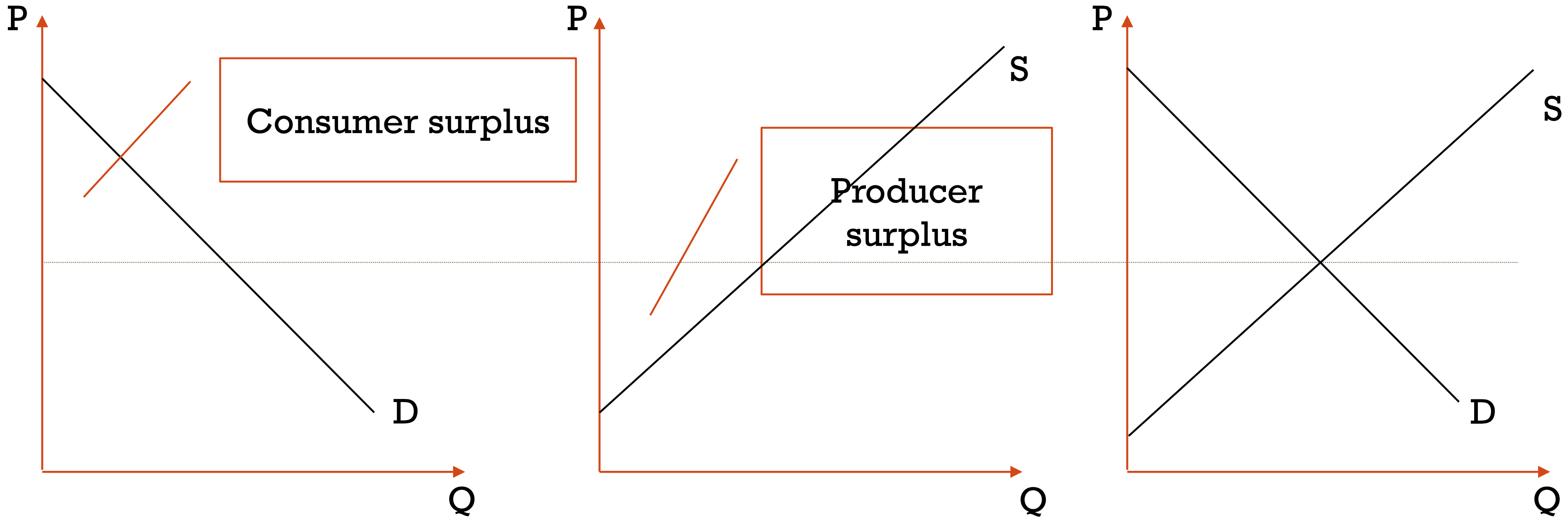
2. INTERNATIONAL ENVIRONMENT

- International organisations and agreements
  - EU
  - GATT-WTO
  - IMF
- Professional associations
  - Investors
  - Credit rating agencies
    - Standard and Poor's sovereign ratings
      - France AA
      - Germany: AAA
      - Greece: B
      - Hungary: BB
      - Italy: BBB-
      - Poland: A
      - Spain BBB

3. THEORETICAL BACKGROUND

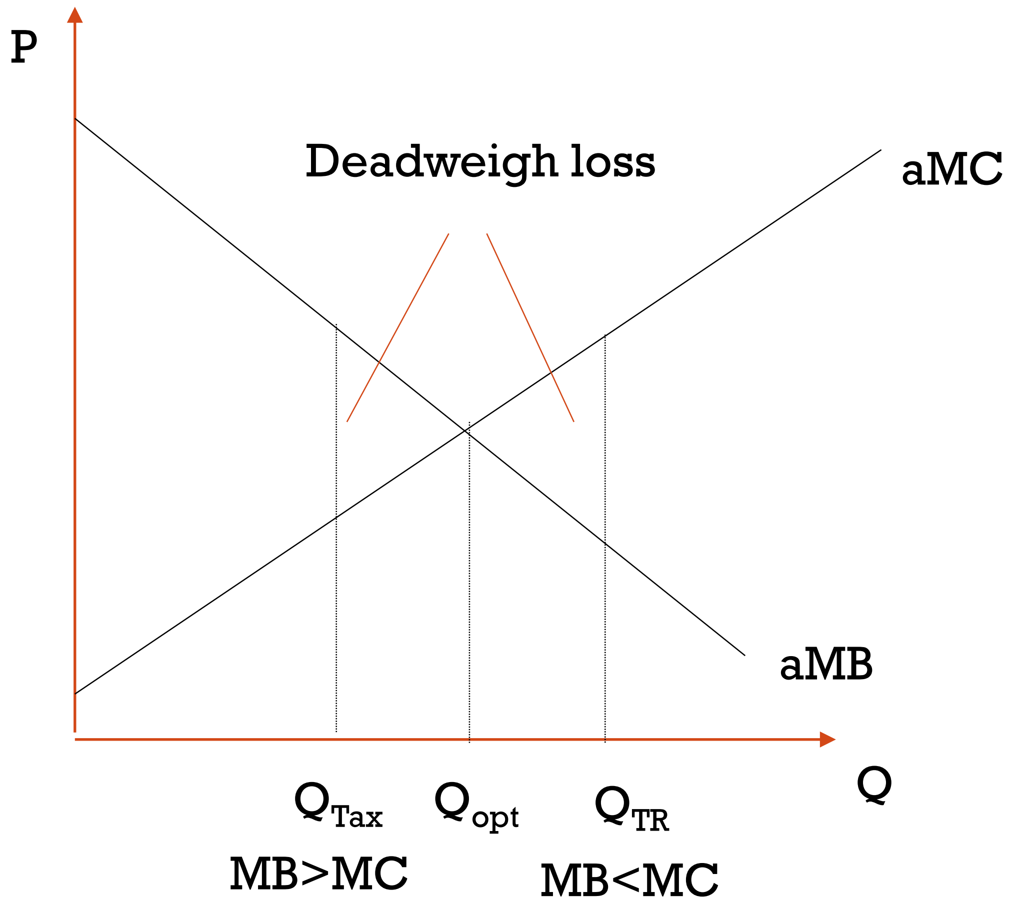
- Mainstream economics – based on microeconomics
- Consumers: $U(x,m)=B(x)+m=B(x)+w-px \rightarrow$ maximising: $B'(x)-p=MB-p$
- Firms: $F(x,k,l)=pq-c(q) \rightarrow$ maximising: $p-c'(q)=p-MC$
- Key idea: consumer and producer surplus – social surplus
  - Consumer surplus: the difference between the maximum price the consumers are willing to pay and the actual price they do pay
  - Producer surplus: the difference between the minimum price the producers are willing to accept and the actual price they receive
  - Social surplus: consumer surplus + producer surplus

SOCIAL SURPLUS



THE EFFECT OF INTERVENTION

- Deadweight loss: a loss of economic efficiency that can occur when equilibrium for a good or service is not Pareto optimal



POSSIBLE INTERVENTIONS

- Try to figure out the effect of the following
  - A consumption tax imposed on the consumers
  - A carbon tax imposed on the companies
  - A transfer paid for the consumers
  - A transfer paid for firms
  - A price ceiling

4. INSTITUTIONAL ENVIRONMENT

- Path dependence: the decision alternatives one faces in the present are limited by decisions made in the past
  - The present outcome is a result of previous decisions
  - Different decisions in the past in different countries lead to different socio-economic environment in the present
- Planned economy: most economic decisions are made by the planner
- Market economy: all economic decisions are made by market agents, and are based on the prices
- Mixed economy: intervention + prices
  - Types:
    - Market oriented economies: the intervention of the sate is minimal
    - Statist economies: the state intervenes on a lot of markets, central regulation is strong
    - Neo corporatist economies: most important decisions are made by a triad formed by the government, the representatives of the firms and the employees

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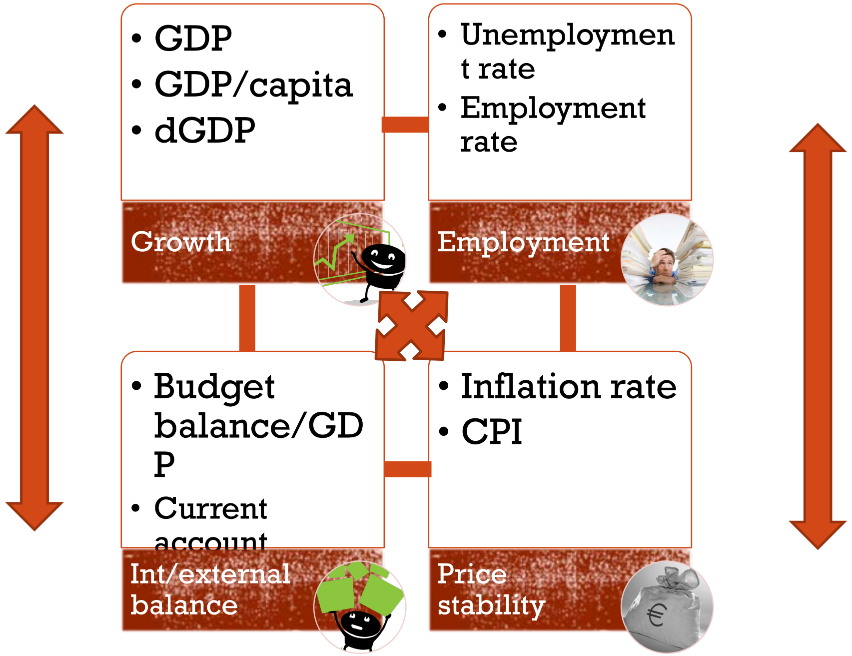
THE MAGIC QUADRANGLE

What are the goals of economic policy?

MACROECONOMIC POLICY

- The set of government rules and regulations to control or stimulate the aggregate indicators of an economy
- What indicators?

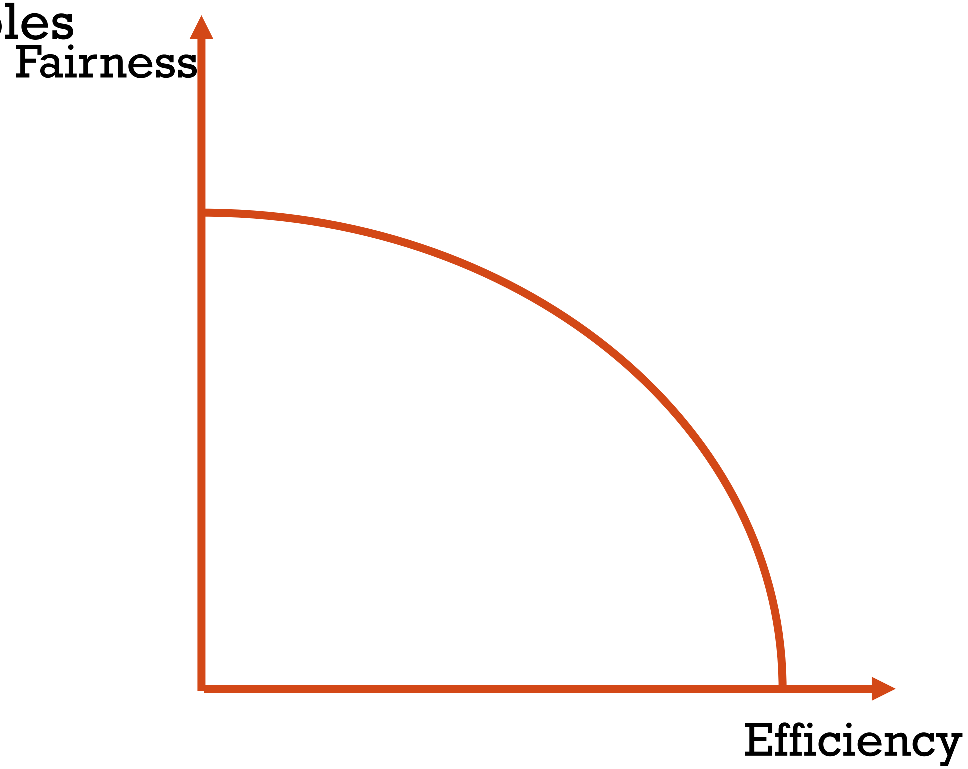


SOME TRADE-OFFS

- Phillips-curve: inflation and unemployment
- Expansive policy: growth and internal/external balance
- Growth and inflation

FAIR AND EFFICIENT?

- There is always a trade off between fairness and efficiency – Try and find a few examples



Efficiency: lack of waste in production and consumption
Distributive justice: Is the distribution of resources fair?
Procedural justice: Is the process used to reach a desired allocation fair?

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MARKET FAILURES

Why do we need the state at all?

FWT: FIRST WELLFARE THEOREM

1. If all goods that there is a need for have a market,
2. If these markets are all made up competitive consumers and producers (nobody can have an effect on prices),
3. If all agents are rational,
4. If there are no externalities and everybody has perfect information,
5. Then the allocation of goods in equilibrium is Pareto efficient (there is no waste)

Market failure: a situation in which the market fails to allocate goods and resources efficiently, because one or some of the above conditions do not apply.

The role of the state is to try and make markets more efficient by eliminating some of the barriers that prevent the markets from working perfectly. Note: state intervention also has its costs!

NONRATIONAL DECISIONS

- Homo economicus vs. Homo sapiens
- Limited intelligence
  - Can you calculate everything?
  - Can you handle so much information?
- Addiction
- Emotional decisions

- State's role:
  - Simulators and calculators
  - Default options in difficult decisions

TRANSACTION COSTS

- The costs other than the money price that are incurred in trading goods or services
- Examples
  - Acquiring and handling information
  - Coordination costs
  - Transfer costs
  - The cost of enforcing the laws and regulations

The role of the state:

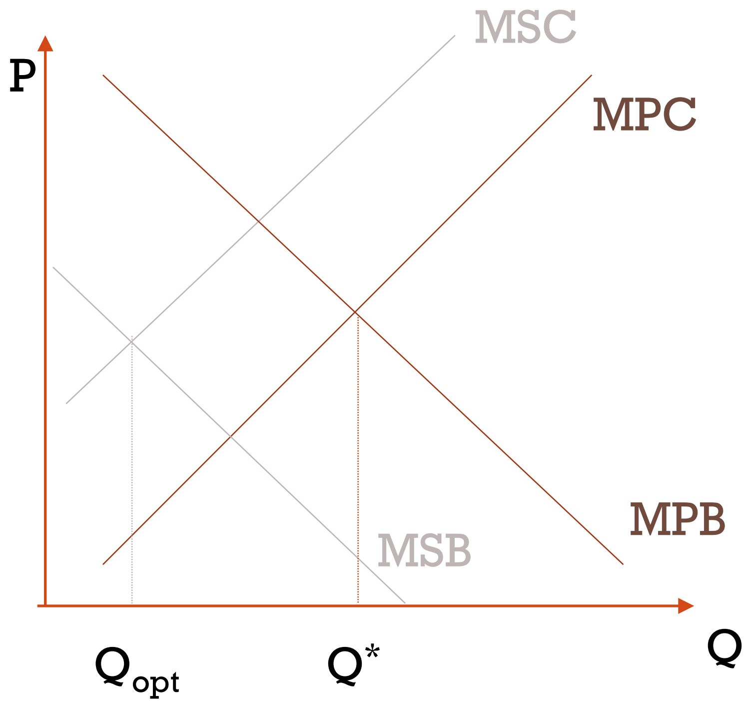
- Provide infrastructure
- Provide information
- Provide smooth services (cheap, quick, no queues)

EXTERNALITIES

- What is an externality?
  1. The steps taken by an agent (consumer or firm) directly influence the utility or production function of another agent (without any market transaction)
  2. Either a cost or a benefit that affects someone who did not choose to incur it
  3. When social benefits or social costs exceed private ones
- Two types of externalities
  1. Positive
  2. Negative

NEGATIVE EXTERNALITY

- Example: CO_2 emission
  - When cars are produced, the firms pollute the environment: MPC < MSC
  - When people use their cars, they also pollute the environment: MPB > MSB
  - The optimal quantity for society: MSC=MSB
  - The actual equilibrium: MPC=MPB

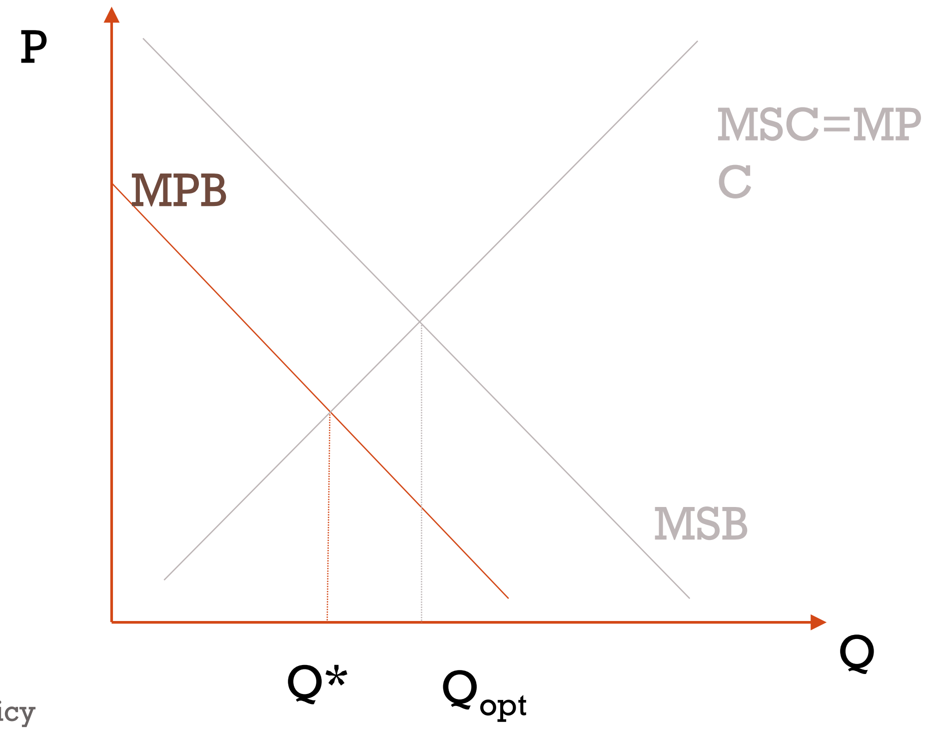


Problem: $Q_{opt} < Q_{actual}$ (Q^*)

Solution?

POSITIVE EXTERNALITY

- Example: Education
  - Being qualified not only benefits you, but also benefits the society: MPB<MSB
  - The optimal quantity for society: MSB=MSC
  - The actual quantity: MPB=MC (this time: MSC=MPC)



Problem: O_{opt} < Q*

Solution?

PUBLIC GOODS

- Public goods are non-excludable: non-paying consumers cannot be prevented from having access to it
- And non-rivalrous: the marginal production cost is zero; the utility of the consumer is not affected by the number of people that have access to the good at the same time
  - Usually non-rivalrous goods become rivalrous after a certain tipping point

	Excludable	Non-excludable
Rivalrous	Private goods	Common goods
Non-rivalrous	Club goods	Public goods

MONOPOLIES

- Monopolies have the option to affect prices – price discrimination
- If the price set by a monopoly is anything other than the market equilibrium prices, the market is not efficient

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GOVERNMENT FAILURES

Why does too much state hurt efficiency?

GOVERNMENT FAILURE

- A government intervention in the economy (to correct a market failure) creates inefficiency and leads to a misallocation of resources

OMNIPOTENT STATE?

- High consumption taxes → Black market
- High payroll taxes → Unofficial/illegal employment
- Prohibition of gambling → Illegal gambling market
- Prohibition of drugs → Illegal market

NONRATIONAL DECISIONS

- Friedman's 4 different ways of spending money
  - Spend your own OR someone else's (incentive to economise)
  - Spend on yourself OR on someone else (knowledge about preferences)
  - Where would you put the government?

	On yourself	On someone else
Own money	You buy a car	You buy flowers for your girlfriend
Foreign money	You go on a business trip	You take your business partner to a night club

RATIONALLY UNINFORMED

- Is it worth spending any time finding the right political candidate before the elections?
  - It is actually rational for people to be ignorant about politics because the act of voting itself is irrational. One voter is unlikely to influence an election or lead to improvements in government performance.
  - Rationally uninformed electorate
  - Rational ignorance
- What are the typical messages during a campaign?

INFORMATION ASYMMETRY

- Transactions where one party has more or better information than the other
- Principal agent problem: the difficulty in motivating one party (the agent), to act in the best interests of another (the principal) rather than in his own interests
  - Elector vs. bureaucrat
  - Bureaucrat vs. politician
  - Within bureaucracy: manager vs. employee
- The principal-agent problem is a lot more severe in the government than it is in the market
- Moral hazard: a tendency to be more willing to take a risk, knowing that the potential costs or burdens of taking such risk will be borne, in whole or in part, by others
  - Sometimes bureaucrats and politicians have the tools to veil their own mistakes
- Solutions?

VOTE SWAPPING

- A coalition of parties passes regulation that is favourable for their supporters, but lowers the wealth of the whole community

Parties	Proposition 1	Proposition 2
A	-10	-10
B	+6	-2
C	-4	+10
Change in net social welfare	-8	-2

RENT SEEKING

- When a certain group of individuals (lobby group), tries to obtain benefits for themselves through the political arena
- The benefit can be a direct subsidy (money transfer), but it can also be a government regulation that limits market competition and leads to artificially high prices
- Examples

GOVERNMENT ACTIVITIES IN SHORT

- Income redistribution
  - Setting of taxes
    - Income tax: flat rate vs. progressive vs. digressive rates
  - Government transfers/subsidies/allowances
  - Special methods: e.g. affirmative action
- Resource allocation
  - Goods and services provided by the state
  - Police, juridical system, schools, hospitals, public transportation, motorways etc.

Wellfare functions

- Macroeconomic stabilisation
  - Moderating the economic cycles (steady rate GDP growth/low unemployment/price stability)
  - Fiscal policy (controlled by the government) and Monetary policy (controlled by the central bank)
  - Expansionary vs. contractionary policies
- Regulation

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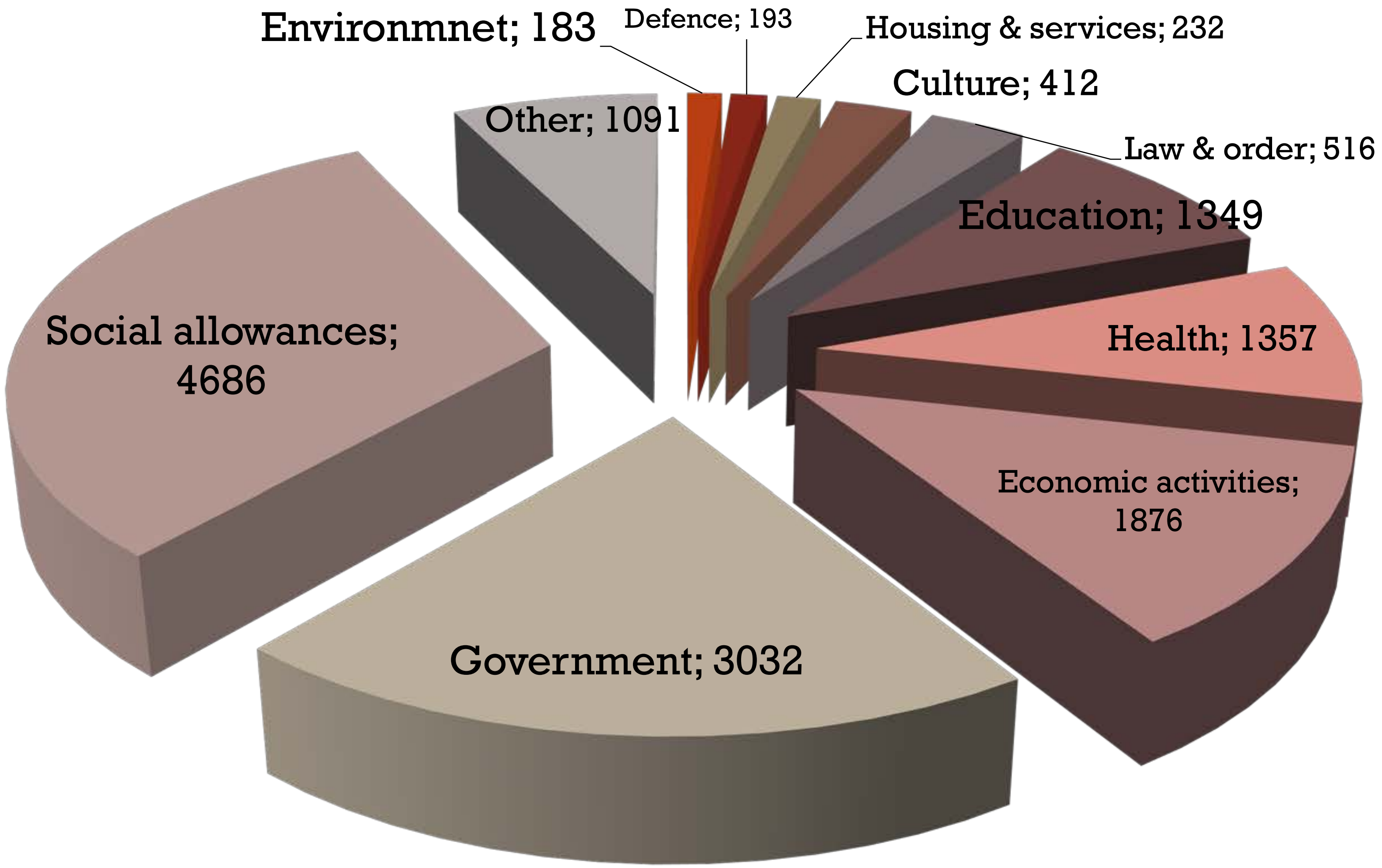
FISCAL POLICY

How does the government attempt to stabilise the economy?

CENTRAL BUDGET

- A summary or plan of the intended revenues and expenditures of the government
  - It makes government finances more transparent
  - The best indication of the government's plan to influence the economy/society
  - Usually is compiled by the ministry of finance
- How is the budget prepared?
  - Incremental budgeting: based on the structure of previous budgets – baseline
  - Zero-based budgeting: starts from a „zero base" and every function within an organization is analyzed for its needs and costs; budgets are then built around what is needed for the upcoming period
  - Programme budgeting: objectives, outputs and expected results are described fully as are their necessary resource costs

BUDGET STRUCTURE

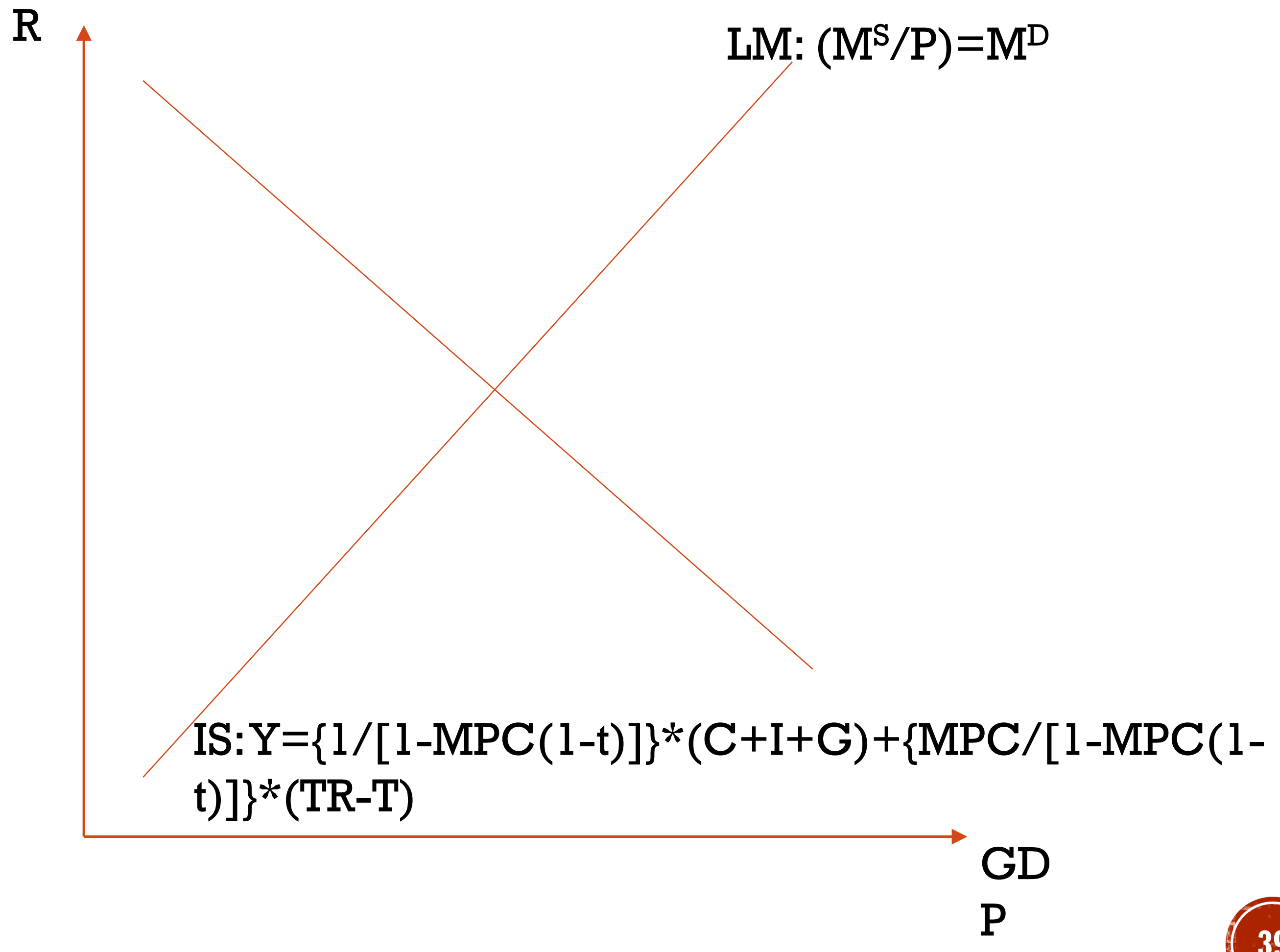


PARTS OF THE BUDGET

- Social security funds
  - Pension fund
  - Health care fund
- Local governments
- Separated government funds
  - Labour market fund
  - Cultural fund
  - Etc.
- Central budget

FISCAL POLICY

- The use of the revenues and expenditures of the central budget to influence the economy
- Expansionary fiscal policy: changes in the budget structure that boost economic growth
  - anything that moves IS upwards or to the right
- Contractionary fiscal policy: changes in the budget structure that limit economic growth
  - anything that moves IS downward or to the left



TAX POLICY

- Deciding on the nature of the tax structure, and the effect of it on individuals and businesses
- Structure: What do you tax heavier?
  - Personal incomes: wages or capital incomes as well?
  - Businesses: they cut into the profits of companies
  - Consumption: they raise prices
- Income effect: Net taxes (TR-T) change the disposable income of individuals
  - Do income levels affect savings rate?
  - What is the ideal tax rate – the Laffer curve
- Distortion effect: Taxes influence the supply and demand of goods → the ideal (Pareto optimal) quantities cannot be reached

GOVERNMENT SPENDING

- An increase in the budget spending creates extra market demand, and that increases the GDP (if not all resources are in use)
- Lower taxes or increase public spending?
  - Can the government spend our money more efficiently than we could?
  - Can there be situations when individuals just sit on there money doing nothing with it?
- What should public money be spent on?

PUBLIC DEBT

- If the central budget has a deficit (expenditure > revenues), the government needs to find extra money to cover it
  - Print money
  - Sell public property – privatisation
  - Borrow money
    - Who to borrow from
      - Organisations or individuals
      - Other governments or businesses
      - Locals or foreigners
- If there is a constant deficit in the central budget for longer periods (many years) public debt is accumulated
  - It is the sum of all previous budget deficits
  - It is the current value of all the future liabilities of the state
- Implicit debt: long term promises of social payments

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MONETARY POLICY

How can the central bank stabilise the economy?

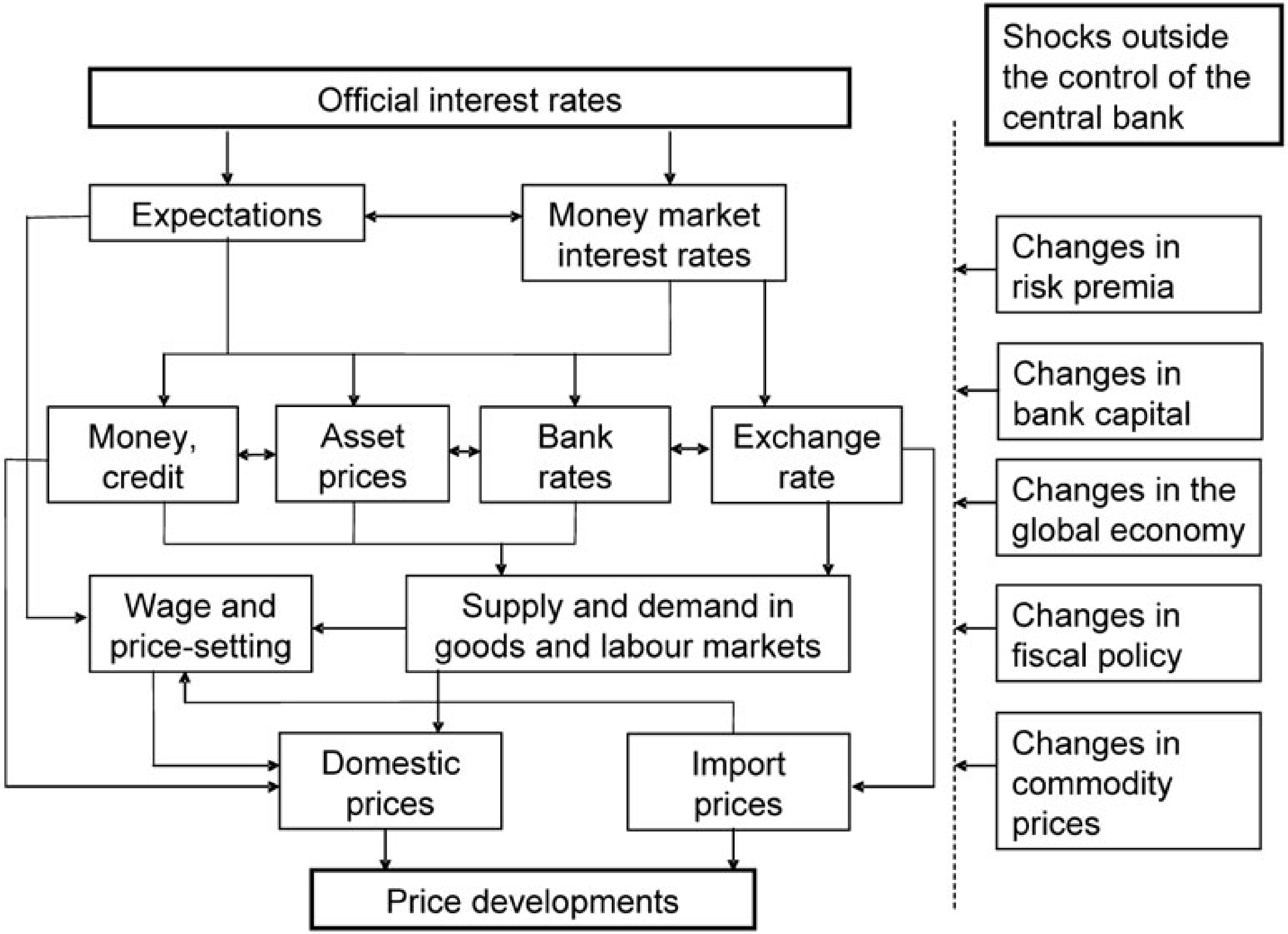
FINANCIAL GOVERNANCE

- The financial system is key to the whole economy: the majority of the payments in all market transactions are done through commercial banks
  - If a bank becomes insolvent, a lot of market transactions cannot be completed
- Financial governance: the passive and active regulation of financial and capital markets
- Lead by the central bank
- Central bank functions
  - Printing money
  - Banker of the state
  - Banker of the commercial banks
  - Controlling exchange rates
  - Ensuring the stability of the financial system
  - Making monetary policy decisions

MONETARY POLICY

- The process by which the central bank controls the supply of money (the value of money in circulation), which is done through the transmission of the financial system
- What the money supply is controlled for?
  - Single mandate: guarantee price stability
  - Dual mandate: price stability and low unemployment
  - Hierarchical targets:
    1. Price stability
    2. Unemployment/economic growth

MONETARY TRANSMISSION



A CHANGE IN OFFICIAL INTEREST RATES

- Affects banks and money-market interest rates → lending and deposit ratess
- Affects expectations: about medium- and long-term interest rates, and future inflation
- Affects asset prices: lower deposit rates channel savings toward other financial asstes; lower lending rates raise the demand for investment assets and houses
- Affects saving and investment decisions: it can be more benefitial to invest in case of low interest rates
- Affects the supply of credit: borrowers are more likely to become insolvent at higher interest rates
- Leads to changes in aggregate demand and prices

INFLATION TARGETING

- The most commonly used method by central banks
- Steps:
  1. Set a medium-term inflation target (usually it is a range, say 1-3%)
  2. Create a public macroeconomic model that is used to predict future inflation rates
  3. Make changes in the official rate if the predicted inflation rates are not in the target range

- Independence of the central bank
  - Credibility is very important:
    - What are the real goals of the central bank?
    - Are the measures taken by the central bank valid (in accordance with the goals)
  - It was found that independence boost credibility