March, 1999
revised

PROGRESS IN THE THEORY OF ECONOMIC POLICY [1]

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1 Introduction

By providing governments with simple models that capture the essence of macro-economic interactions in an open economy, Robert Mundell has greatly contributed to shape successful economic policies. He has disseminated ideas on the appropriate use of monetary and fiscal policies in the open economy that have proved to be not only resilient over the years, but robust to very different national environments, including industrial and developing countries. In this paper we examine, from the perspective of Mundell's contributions, the state of the theory of economic policy, and ask what might be the areas of progress in this field.

Our (limited) experience with the government of a large industrial country–we are aware that the experience in developing countries and in transition economies might be quite different–suggests that while the influence of economists in shaping stabilization policies is often critical, their success at bringing forward the need for structural reform based on economic principles has been more limited. The fruitful collaboration that so often develops between economists and governments in the design of appropriate macroeconomic policies--but also in thinking about how to structure new institutions, as has been the case in Europe with the single currency project–is seldom reproduced in the area of market reform or in addressing the distortions caused by special interest groups.

We are aware that labor market reform, a sound financial system, action on property rights and corruption, an efficient judicial system, effective public administrations, are all non-starters when inflation and the budget deficit are out of control. Macro stabilization is the precondition for structural reform. But when this is achieved, and the time comes to address structural reform, the lively interaction between academics and policymakers which is often instrumental at adopting a stabilization program--the Israeli stabilization of 1985 is one of the best examples of such a fruitful interaction—seems to come to an end.[2]

This is not because the normative analysis that lies behind structural reforms is too technical or obscure to have an impact on policymakers. Rather, we believe that this is because a government and the institutions (both non-physical institutions, such as rules and regulations, and physical ones, such as roads and railways) that affect economic interactions in an advanced society are not the product of *tabula rasa* design: they are inherited from the past. Adaptation to new circumstances is much more difficult in the government than in the rest of society--for example because special interest groups can lobby more effectively than a dispersed group of consumers.[3]

One example is the different speed in the response of governments and markets to a financial crisis. It takes little time for speculators to form a view on the sustainability of a currency peg. But it may take months for a government to convince parliament to adopt the legislation that is necessary to change economic policies in a way that would convince markets that the peg sustainable.

In the first two sections of this paper we review the areas of success in the theory of macroeconomic policy, and identify a few problem areas as well. In a nutshell, we find that economists are most influential when countries are in deep trouble, either because they entered a financial or foreign exchange crisis, or because they are following an unsustainable path, in domestic public finances or in foreign accounts, and need some form of stabilization. These are situations where the problems a country faces are too big for an interest group, no matter how powerful, to be able to influence policies. Therefore, the advice economists give is not only valuable, but also effective. By contrast, in the drudgery of the day-to-day work of governments, when the pressure of special interests often wins the day over the best analytical arguments, economists are much less effective.

Economists, however, are not only ineffective in situations where interest groups are powerful. Often their advice is ineffective simply because they ignore the distortions which affect the economic environment. Policy economists have GDP statistics, interest rates, the rate of unemployment, the exchange rate at their finger tips: little they know, for example, about the time it takes to settle a civil law suit and the extent to which such delays affect the cost of borrowing: this undermines the effectiveness of their analyses. How many policy economists would be able to answer the following question with reference to a specific country: Which are the five most glaring distortions that prevent a proper functioning of the economy ?

We argue that the simplest set of ideas which justify the role and scope of government in market economies have been largely excluded from the process of policymaking, at least in the country we know best – but we suspect that this is the case in the world as a whole. We offer our own explanation for this: the combination of small interest groups generating large distortions, with the absence of proper incentives on governments to adapt to technological progress and other changes in circumstances, is such that public policies are almost doomed to be inefficient. We survey three areas where, in Europe at least, these problems appear to be more serious: property rights, the labor market and capital markets. Our illustration of the problems in Europe is hopefully suggestive of a pattern that appears to be more general and involve a large number of countries. We conclude discussing possible initiatives.

2 The "Mundell tradition" in the theory of economic policy

Robert Mundell's research has inspired generations of economists as a model for the analysis of economic policy in open economies. Much of Mundell's work (for early contributions see Mundell 1960, 1962, 1963, 1965) has three distinguishing features: it discusses problems of significance for economic policymakers, it employs simple and elegant mathematical models, and it explicitly accounts for the openness of the economy, and for the role of international capital markets.

Mundell's research reflects and adds to the strong intellectual tradition of Chicago and Cambridge. Like many of his colleagues and precursors (among them Haberger, Machlup, Meade, Alexander, Tsiang, Cooper, Metzler) Mundell contributed to the refinement of the Keynesian analysis of an open economy with the inclusion of a consistent monetary analysis. Like many of his followers, he paid keen attention to the connections between financial markets and the macroeconomy.

The successful integration of money—through the so-called neo-classical synthesis—into the Keynesian model, the emphasis on financial markets through the international interest-rate and exchange-rate linkages and the resulting attention to the formation of expectations, and in particular expectations on economic policies, set the stage for the developments of the following thirty years.[4]

Tobin and Buiter (1976), and Buiter (1981) extended the model to recognize the intertemporal aspects of fiscal policy. Bruno (1976), Kouri (1976), Mussa (1980), Dornbusch and Fischer (1980), Sachs (1981), incorporated the dynamics of the current account and analyzed the link between the exchange rate and the current account, which had been weakened by the assumption of perfect substitutability among financial assets–an issue first investigated by Branson (1972) and Frenkel and Rodriguez (1975). The analysis of expectations was pioneered by Dornbusch (1976). Hamada (1976) extended the two-country model to allow for strategic interactions among monetary authorities, an avenue subsequently pursued by Rogoff (1985) who showed the open economy implications of the Barro-Gordon "games" between the private sector and the monetary authorities. Krugman (1979) inititated the study of why fixed exchange rate regimes may collapse, while Dornbusch (1980) first addressed the role of the exchange rate regime in a disinflation. These articles, and many more, have advanced our understanding of important issues, in particular in the areas of: optimal monetary policy and the design of monetary institutions; monetary and fiscal policy interactions; monetary and fiscal policy rules; and gradualism versus "cold turkey" economic policies.

Much of this literature has taken inspiration from the rational expectations results, which had sharpened the analysis of the interactions between authorities and markets.[5] The Mundell/Chicago/Rational Expectations approach, by emphasizing budget constraints, the link between inflation and monetary policy, the role of financial markets in triggering crises, and the limits of economic policymaking, has underlied many of the stability-oriented policies undertaken in a large number of countries, industrial and developing.

This phenomenon, no doubt, has also a generational aspect. After the 1960's the number of foreign students enrolled in US economics departments has increased very significantly.[6] Many of these students, after obtaining their Ph.D.'s have become deeply involved in economic policies in their own countries, either directly or through international institutions like the IMF and the World Bank. Their cultural influence in the economic policies pursued by a wide array of countries, including former communist countries, is all too evident.

Central banks have been among most powerful supporters of the Mundell/Chicago/Rational Expectations approach. Indeed, many refinements of the models of macroeconomic policy have been triggered by the questions posed by central banks -- examples are the work of the International Finance Division of the Board of Governors of the Fed and, in Europe, the ongoing collaboration between Cepr and EU central banks. The interaction between academics and central bankers has had the very positive effect of furthering research and making it more relevant, as well as sharpening the actions of monetary authorities. In addition, the close relation of academics and central bankers has been central to important developments in institutional reform, like for example the process of monetary union in Europe.

Thus a happy situation was established. The model was intellectually kept alive by ongoing research: at the same time, constant use of the model as an analytical framework for policymaking made sure that the ideas would not go out of fashion.

3 The Mundell tradition and the reality of policymaking

The cultural influence of the Mundell/Chicago/Rational expectations approach has done a lot to help policymakers build a stable macro environment. But when this is achieved, why is the lively interaction between academics and policymakers which is often instrumental at adopting a stabilization program, so rarely reproduced in discussing structural reform ?

The two most respected, policy-oriented economic research groups, the NBER in the United States and the CEPR in Europe, show a clear bias towards the analysis of macro issues. Out of 528 working papers published by NBER between January 1996 and August 1997, only 41 address issues such as regulation and liberalization of markets, in particular credit markets, privatization of pension funds, health reform, firms' access to the capital market, training, competition policies, banking reform –although many more address traditional public finance issues. At CEPR discussion papers on similar subjects were 27 out of 306 published over the same period. Economic Policy, Europe's leading journal specializing in the analysis of policy-relevant issues, has done slightly better: since its beginning, in 1985, the journal has published 120 articles: among them, no more than one out of three addresses issues such as those indicated above. The apparent lack of interest in the working of markets reflected in the NBER papers could be a US bias, the product of an economy in which, by and large, markets work relatively well; this however does not apply to continental Europe where most markets are quite far from efficiency.

In his 1984 "Mais Lecture" Nigel Lawson, Chancellor of the Exchequer in Mrs.Thatcher's second government, clearly stated the limits of macroeconomic policy: "The conventional post-war wisdom was that unemployment is a consequence of inadequate economic growth, and economic growth is to be secured by macroeconomic policy (...) The conclusion on which the present government's economic policy is based is that there is indeed a proper distinction between the objectives of macroeconomic and microeconomic policy, and a need to be concerned with both of them. It is the conquest of inflation, and not the pursuit of growth and employment, which is or should be the objective of macroeconomic policy. And it is the creation of conditions conducive to growth and employment, and not the suppression of price rises, which is or should be the objective of microeconomic policy."

Lawson's views were echoed in Jacob Frenkel's remarks during the roundtable discussion at the 1997 IMF Conference on EMU: "Economic policy should no longer be concerned with countercyclical actions. Rather it should simply provide the framework within which markets can operate efficiently." (Frenkel, 1997). Of course Robert Mundell himself has recognized the importance of efficiency in our economies. His policy advice to the so-called supply-siders of the early 1980s is inspired by the awareness of the issues that we want to discuss here.[7]

The World Bank and the IMF have recently put new emphasis on structural reform. The IMF has been advocating a "second generation" of reforms: "Argentina has been successful largely because sound macroeconomic policies have remained firmly in place for a number of years, and considerable progress has been made on what might be described as the "first generation" of structural reform. (...) But clearly a situation where unemployment is high and not all are sharing fully in the benefit of stronger growth, calls for further action. (...) The crux of the "second generation" of reforms concerns completing the transformation of the state's role in the economy." (Camdessus, 1997. For a discussion of the reform process in Latin America see also Naim, 1995). The IMF identifies a number of issues on which a government should focus its action: establishing a simple and transparent regulatory system that ensures equal access to markets, and encourages competition; upholding the independence and the efficiency of the judicial system; improving the quality of public expenditure, reducing unproductive expenditure to make room for investment in human capital and basic infrastructure. “The second generation of reforms requires good governance in all its dimensions, including, in particular, effective and reliable public institutions”. (Camdessus, ibid.).

Which areas should economic policy, in particular, target ? Financial markets, “increasing the flow of timely, comprehensive and accurate information between banks and supervisory authorities, between borrowers and lenders, between financial institutions and their shareholders to encourage better governance”. Fiscal reform “improving tax administration and tax compliance, thus creating room to reduce tax rates, especially payroll taxes that discourage job creation”. Labor market reform understanding that “the key to preserving and expanding employment, particularly among the less skilled, is a flexible labor market that encourages mobility and keeps labor costs in line with labor productivity.” (Camdessus, ibid.).

The World Bank, in the 1996 and 1997 editions of the World Development Report, has attracted our attention to the importance of the state, asking what should governments do, how should they do it, and how can they do it given the situation from which they start. The reports suggest that:

- countries should focus the state's activities to match its capabilities. Many states try to do too much with few resources and little capability. Governments should enhance the state's effectiveness by concentrating on core public activities;
- a state can improve its capability by re-invigorating public institutions, in particular looking for mechanisms that give public officials the incentive to do their jobs better and to be more flexible, but which also provide restraints to check arbitrary and corrupt behavior.

One recent European example that parallels Camdessus’ discussion of Argentina can be found in Italy. After a failed exchange-rate-based stabilization--which failed essentially because it was not accompanied by a consistent fiscal policy-- the Italian government opted for flexible exchange rates, and a combination of a monetary anchor and sharp fiscal consolidation: Mundell’s assignment problem in action. The policy-mix worked: inflation, the fiscal deficit, the current account imbalance, all soon disappeared. However, none of the country’s deep-seeded problems was addressed. Fiscal consolidation occurred thanks to an exceptional increase in tax rates, including on labor, and to the fall in interest rates, without addressing the spending side of the budget. Lack of competition, suffocating regulation, tax distortions, corruption, an underdeveloped financial market: none of these issues was addressed. As a result, rampant, regionally-concentrated, unemployment was unaffected by the stabilization.

Throughout the Italian stabilization economists (both from Italy and elsewhere) have contributed to, and sometimes influenced, a lively debate on the appropriate macroeconomic framework. Their success at bringing forward the micro issues, however, has been much more limited – a surprising outcome considering that some of the best known Italian contributions to economics are precisely in the public finance field: from Francesco Ferrara, Matteo Pantaleoni, Antonio De Viti de Marco in the 1880s, to Amilcare Puviani who in 1903 first criticized the view that governments set taxes according to optimal taxation theorems, suggesting that politicians may be driven by self-interest.

The Maastricht Treaty offers a remarkable example of the consequences of fiscal rules that are not supported by consistent analysis of the role of the state in an economy. By the end of 1997 most EU countries had satisfied the 3 percent deficit rule, but none of them had addressed the reasons that underlie the increasing share of government spending in GDP, nor the efficiency of such expenditure. Fiscal retrenchment occurred mostly as a result of increases in tax revenue, reclassifications of public expenditure and by releasing Treasury funds in accordance to incoming revenues rather than spending commitments. In some cases this has produced the accumulation of arrears that impose high social costs and breed cynicism about the ability of the government to stand up to its commitments – a problem well know in transition economies (see World Bank, 1996, chpt. 7.)

The inability of economists to get across to policymakers the importance of well functioning markets and of a scientific approach to government spending is a common feature in continental Europe. In Germany, the documents regularly produced by the "5 Wisemen" (the government's economic advisers), which command a lot of attention throughout the country, typically concentrate on monetary and fiscal policy, rarely address the operation of markets. Policymakers keep relying on economists whose advice was very valuable when their primary concerns were macroeconomic stability, or the choice of an international exchange rate system, but who are not very perceptive to the "second generation of reforms" and thus are unable to convince policymakers of their importance.[8]

We find the initiatives at the World Bank and at the IMF extremely promising: they correctly identify a major area of initiatives for policy reformers; as institutions, they are also ideally suited being the most independent government bodies that exist and having a large accumulated knowledge both across countries and time. Yet, we feel uneasy about the "laundry list" character of many of the problems identified and about the lack of analysis underlying many of the common-sensical prescriptions. These initiatives may also come too late: financial crises of the late 1990s are also a result of the lack of progress on structural reform: in the area of bankruptcy procedures, corporate governance, regulation and supervision of financial intermediaries.

4 The roles of government in the economy

A logically consistent and reliable set of principles to guide economic policymaking should be based on an analysis of the economic role of government in a country and in the world economy. The theory of general equilibrium, welfare economics and public finance have all provided a wealth of propositions based on which an active role of government in the economy is justified. More importantly, economic theory has also provided guidelines on the nature of the appropriate intervention of government in the economy.

In our discussion on the state of the science of economic policy we find it natural to start from the best known and most general theorems justifying government intervention as the fundamental elements from which to build both a critique of current policy practice and suggest some proposals for improvement. Such theorems are so well known that they are taught in introductory economics or public finance courses in undergraduate programs. Thus, we use a standard textbook catalog of justifications of government intervention (Stiglitz, 1986):

1. *Failure of Competition*: Natural monopolies need to be regulated to ensure marginal cost pricing. Governments should sanction anti-competitive behavior, collusion. Failure of competition justifies granting regulatory powers to governments. This is an area of tremendous importance in countries, such as Italy, where a plethora of services are offered under government-sponsored cartel agreements.

2. *Public Goods/Services:* Public goods/services (goods/services that can be enjoyed by individuals at zero marginal cost, and goods/services whose consumption cannot be rationed by the government) are usually not supplied efficiently by the private sector, since the private sector

cannot ensure the revenue it needs to cover costs. Notice that the criteria for the definition of a "public" good or service are quite stringent: in particular, they are often not satisfied by what usually are referred to as "public services" like electricity, garbage collection, etc., which can perfectly well be provided by the private sector.

3. *Externalities:* Pollution, congestion, overexploitation of natural resources are all examples where optimizing private behavior cannot achieve the first best. In these examples the role of government is one of providing either regulatory constraints or tax/subsidy incentives to offset the externalities. One good example is the case of multiple equilibria in the banking industry, where runs can occur due to the relative illiquidity of banks' assets compared to their liabilities. Deposit insurance (which does not have to be provided by the government but the government can make mandatory) is one solution to this problem.

4. *Incomplete Markets*: Financial markets are usually cited as examples where private individuals find it difficult or unprofitable to run businesses that are good for the community as a whole. Insurance is an example of a business where a government could very efficiently pool risks which the private sector might find it more difficult to bear at a fair price. Many of the examples of incomplete markets, however, are taken from an era of widespread financial regulation, which provided a number of constraints to the private sector, thus making it difficult, if not impossible to enter into businesses that were both good for the community and profitable. The removal of many regulations affecting financial institutions has opened up new markets in areas where private activity was difficult to conceive in the past (catastrophe insurance is one good example).

5. *Information Failures*: Information has sometimes the features of a public good: it is difficult to restrict its dissemination and the private sector does not have the incentives to provide the adequate amount of it. Thus, just as in the case of public goods, there is a role for government either in the direct supply of information that has public-good qualities, or in the enforcement of information supply by private market participants.

6. *Redistribution:* The five preceding arguments for government intervention are based on the premise that, if the economy were left to itself, it would not reach a Pareto-optimal allocation of resources. There are, however, other reasons, based on ethical arguments, for government intervention in the economy. These are usually cast together under the label of redistribution. The idea is that some individuals in the population live in conditions that grant support from the rest of society. Their support, inevitably, comes from the better-off classes.

Notice the important difference between principles 1. to 5. and the sixth principle. Government intervention under 1. to 5. is directed at correcting market failures: it does not entail, necessarily, redistribution of resources. The provision of public goods could be financed by estimating the normal rate of consumption of public goods by different classes of citizens, and imposing taxes on them such as to cover their respective estimated consumption rates.

It is difficult a priori to determine what should be the relative weight of redistribution versus correction of market failures in government activities. What we observe in most countries is that redistribuion[9] takes up the lion's share although we suspect that the amount of resources actually redistributed is very seldom if ever know or publicized, both in the aggregate and in per-capita terms. We suspect that this is not the result of optimal design and is produced by the working of interest groups in a democratic system.

The importance of the principles 1. to 6. cannot be over-emphasized, especially by economists. They are, unarguably, a very powerful set of ideas on which to base economic analysis of government. Indeed, we know of no other set of ideas on which to base policymaking.

It is thus rather surprising that, in the actual practice of government, economic policymaking issues are not systematically argued with reference to principles 1. to 6. It can not be that these propositions are difficult to understand by non-economists. The superiority of free trade over protectionism is as difficult, if not more difficult, and yet it has had tremendous influence on policy choices during the past two centuries.

There are two possible explanations to this. The first is the knowledge gap: macro-inspired economic policies are typically not based on micro foundations, hence they are difficult to rationalize on the basis the above principles. The second is what we regard as a failure of the democratic process: spelling out the rational for government intervention, and quantifying the effects of redistributive policies, would make the job of special interest groups much more transparent, hence much more difficult. We turn to these issues in the next sections.

5 Why economic principles so rarely make it to policymaking?

Two explanations can be offered for the fact that the economic principles discussed in the previous section are so seldom applied in the design of government policies and/or institutions. One is that these ideas are too technical and obscure, and are only a device used by organizations like the World Bank in part to justify their existence. We object to this, because we think that, with the obvious complexities, these ideas are as powerful and effective as any other economic ideas which are routinely applied in the conduct of business and government.

Another explanation, which we subscribe to, is that two classes of distortions account for the very large gap between the ideal world spelled out in the previous section and reality. The first is the problem of small interest groups causing large distortions. The second, related, is the problem of inertia in the economic functions of government. These are powerful ideas to understand why, in the case of government, adaptation to new circumstances is much more difficult and slow than in the rest of society. History matters. Government in industrial countries and elsewhere is not the product of tabula-rasa design. It is what is inherited from the past.

A very superficial survey of the history of governments in industrial countries shows that many of them experienced socialization of means of production and regimes of command economy during the two World Wars. The Great Depression fueled the view that markets are inefficient, and government intervention is desirable. These ideas were still powerful in the early postwar period, and underpinned the creation of the welfare state and of mixed economies, characterized by a deep and pervasive presence of government in economic activity. It thus comes as no surprise that the general economic principles we listed above find no significant role in government institutions and seldom provide guidance in economic policymaking.[10]

One should, however, recognize that there are institutions where policymaking is guided by a “scientific” approach: international organizations like the World Bank systematically use cost-benefit analysis, a method of evaluation of government-sponsored development projects solidly grounded on microeconomic analysis. The IMF, as discussed above, has recently put new emphasis on structural reform. The Fund has traveled a long way since the days of financial programming, when the working of financial institutions was never perceived as an important issue; it has promoted new research on financial markets and banking supervision, and it has increasingly drawn the attention of its members to the importance of sound financial institutions.

Examples of national governments that customarily apply a scientific approach to government are however less frequent. One exception from the 1970s was the *Regulatory Analysis Review Group* created and chaired in the Carter White House by Charles Schultze, then Chairman of the Council of Economic Advisers (Eizenstat, 1992): the Group submitted to the President proposals on ways to reduce the cost of regulations, while adhering to the requirements of the law. In Europe the UK Treasury is the exception. As far as we know it is the only government agency in the EU which bases fiscal policy decisions on a microeconomic analysis of public expenditure.

The European Commission constantly attempts to base its decisions on economic principles, in particular in its efforts to promote competition and the efficiency of markets. The elimination of capital controls, the first steps towards the liberalization of the telecom market, the gradual reduction of state aid to industry, all came mostly as a result of action from Brussels. It is interesting to note that in the areas where the Commission has executive powers, and can thus take decisions by issuing Directives and Regulations, progress has been relatively fast. Where instead, as in the area of tax competition, it can only submit proposals to the Council of EU Ministers, progress has been much slower. The explanation for why the Commission is more interested in promoting markets than national governments, is likely to rest with the incentives of the Brussels bureaucracy. The power of a national bureaucracy often depends on the extent to which is can control economic activities, either through direct state ownership of firms or through a system of regulations and authorizations. The Brussels bureaucracy does try to impose its own regulations, but in order to do that it must first dismantle national ones. Capturing the Brussels bureaucracy is also more difficult: interest groups must first coordinate among themselves across national borders. The outcome is a net increase in competition. More fundamentally, the *raison d'etre* of the European Commission is the single European market: if this failed, the Commission itself would fade away. With these qualifications we now turn to the role of interest groups and inertia.

6 Interest groups

The phenomenon of interest groups, even small ones, causing large distortions is well known from the international trade literature. Political-economy models of trade and tariffs often use the following parable. Trade liberalization is a reform that benefits "the economy as a whole": by increasing the purchasing power of earnings it improves the consumption possibilities of all consumers. At the same time, however, trade liberalization tends to shrink the import-competing industry, and causes a loss of income to those who own the factors of production that are used relatively more intensely in the import-competing industry.

The question, in a democracy, is how to efficiently trade-off the interest of the entirety of consumers with those of the much smaller group of owners of the factors used intensely in the import-competing industry. What complicates the question is that, in most cases, the per-capita gains to the population of consumers are a tiny fraction of the per-capita losses of the owners of the factors of production in the import-competing industry. What incentives do consumers have to get organized and lobby for the efficient solution ?

The political economy of distortions from international trade barriers is one of the most popular models among economists, and the problem of incomplete participation in lobbying is well known in the literature. The parable described above has nothing to do with international trade per se, and can be applied in any situation where special interest groups can make themselves heard by those who set laws and regulations.[11]

The distortions that special interest groups (that is groups which have gained special privileges for their members) bring to a country depend on their number, on the pattern of their activities and on the magnitude of the distortions they cause. The 1997 *World Development Report* (see Table 9.1 and the references quoted thereabout) lists many examples of interest groups and discusses the distortions they give rise to.

Contrary to the often dispersed constituencies that would benefit from change, interest groups have strong incentives to organize in order to resist fiercely any change in government policies which might decrease their privileges. Special interest might cause, initially, only small distortions which, however, with economic progress, become enormous.

An illuminating analysis of the distortions associated with interest groups is provided by Hernando de Soto (1989). His research with the Instituto Libertad y Democracia (ILD) has systematically studied the features of the Peruvian legal system that represent hindrances to efficient economic activities. De Soto's study should not be dismissed by scholars of advanced industrial democracies as one that raises problems which are special to developing countries like Peru: many of the general pathologies that De Soto identifies are also present in industrial countries.

For example, the ILD has considered in detail legislative production in the economic field by the Peruvian lawmakers and concluded that the quasi entirety of it is redistributive in nature. The prevalence of rules whose effects are redistributive raises a number of distortions in a democracy, caused by the proliferation of pressure groups aimed at affecting such redistribution to their own favor. The result is overspending by the government, a manifestation of the "common pool" problem well known in the economic literature (see for example Persson, 1998).

The problem is not redistribution per se, which is a legitimate role of government. Rather, it is redistribution induced by lobbying that takes place without full awareness by citizens, and often even by government and parliament.

7 Inertia

A second class of distortions, related to the problem of interest groups, pertains to the dynamics of government. Consider the following problem: assume that a government in a democracy were able to achieve a Pareto-efficient allocation of resources through the appropriate combination of taxes, subsidies and regulations. Suppose that the economy is subject to a shock which makes the current allocation Pareto-inefficient. What takes the government to the new Pareto-efficient allocation? The answer is: nothing that we know.

This state of affairs is in striking contract with the dynamics of responses to shocks by the private sector (see Giovannini, 1997). In a competitive private economy Pareto-efficient allocations are reached through the working of the market mechanism. In other words, individuals have an incentive to recontract, and their recontracting leads to a new Pareto-efficient allocation. By contrast, the response of governments to changes in economic circumstances has to come from the initiative of governments themselves. In addition governments, unlike the private sector in competitive economies, have to see the full picture of the new allocation of resources, and they have to know how to get there: a very big task indeed [12]. In the private sector, when conditions change, individuals have an economic incentive to trade again, and the combined effect of these trades will be an efficient response to the new circumstances. Thus, individuals do not need to know the grand scheme that will bring about the optimal allocation, they just need to follow their own interests. A government, instead, can only adapt by sheer enlightenment, that is, only by seeing the problems and tackling them in the most appropriate way.

This observation should now be combined with the discussion at the beginning of this section to explain the dynamic evolution of governments. Not only governments do not have incentives to adapt to changes in economic conditions, and might have problems in determining what the most appropriate changes should be: a number of powerful forces might actually militate against such changes. These are the special interest which have been successful in securing economic privileges to their own members.

Box: A partial and imbalanced list of distortions affecting European economies

One illuminating example of the power of small interest groups is the peculiar institution of *notary publics* in Spain, France, Germany and Italy. Created in the Middle Ages to enforce property rights in a technologically backward society that lacked proper civil law procedures, notary public have resisted change and developed into a powerful impediment to efficient transactions. But the damage produced by this small interest group may be even bigger. In Italy, for instance, by providing a formal certification of property rights, it has relieved the pressure for the reform of civil law procedures which remain slow and unreliable, and substantially weaken the enforcement of property rights.

One of Europe's objectives, written in 1958 in the Treaty of Rome, is to preserve its *agriculture*, in particular individual farmers. There are two ways to do this: with direct subsidies to farmers, or through a tariff. It is well known that direct subsidies (as used for example in the UK before it joined the EC) are less distortionary, however they are also more visible because anyone who looks at the government budget can immediately see how much of her taxes are spent on farmers. Mainly for this reason the European Union runs a complicated, and much more distortionary, system of agricultural tariffs, and has so far been unable to change it: farmers have blocked any reform of the system.

Reform in the area of the *fiscal treatment of income from financial assets* is another example. There are two countries in the EU where non residents can avoid tax on such income: Austria and Luxembourg. Because any change of EU legislation in the fiscal area requires unanimity, reform has so far been impossible. A shift to decisions through qualified majority, as opposed to unanimity, was proposed in the drafting of the Amsterdam Treaty, but blocked by the two small EU members. Reform could still happen finding a way to compensate Austria and Luxembourg, but apparently other EU governments believe that such compensations would be politically unacceptable in their own countries.

The *labor market* is perhaps the example best know to economists. The idea that unions are controlled by "insiders" who give limited consideration to the impact of labor contracts on the "outsiders" has been formalized by Lindbeck and Snower (1989). The decisions of the French and Italian governments to give in to the request to introduce a 35-hour work week at unchanged pay, when both countries experience unemployment rates in excess of 12 percent, is just a recent example of the power of "insiders".

The debate on labor market inefficiencies has been paralleled by a similar debate on the inefficiencies of capital markets. The history of capital markets in Europe and elsewhere is one of pervasive controls and regulations lasting well into the 1980s, and often designed to protect individual groups in the market. One set of issues involve the rules affecting *corporate control and shareholders' rights*. Influential observers have argued that the current set of rules are, in the case of Italy in particular, strikingly at odds with the objectives of shareholders' value, management incentives and contestability of corporate control (see Bragantini, 1996, Marchetti 1996). As these authors argue, the Italian stock market is characterized by a number of rules that allow very efficient control of large corporations by small (economically) shareholders. Such control is efficient (from the viewpoint of the controllers) also because it prevents external bids. A by-product of this system is that the universe of "minority" shareholders often receive abnormally low returns on their investments without being able to affect the decisions of management.

Lack of contestability of corporate control induces distorted incentives and sub-optimal investment decisions. However, as in the examples discussed in the previous section, reform has long been postponed largely because of the effective lobbying of organized interest groups. Privatizations are one area where this problem can produce large distortions. Privatizations have been hailed by policy economists, who saw them as a way to eliminate inefficient government control of economic activities, when it is not justified by the criteria listed above in section 4. However, in the presence of capital markets that are distorted by the mechanisms described above, privatizations provide only a limited Pareto improvement. This applies in particular to the effectiveness of corporate governance procedures: weak boards offer no guarantee that the transfer of property rights from the state to the private sector will result in improved management and more efficiently run companies.

At least in Italy, the role of economists as "advocates" of reform (see *e.g.* Associazione Disiano Preite, 1997) has recently been influential in building the consensus that made possible a first reform of corporate governance rules.

8 An agenda for initiatives

In this paper we have argued that a reliable and effective theory of economic policy should be firmly based on the economic analysis of distortions. To paraphrase, we advocate more microfoundations to economic policy. In principle, our position is not very different from that of macro-theorists who in the past advocated more microfoundations to the field of macroeconomics. In practice, however, the research agenda we propose differs markedly from that pursued by some macroeconomic theorists.

The microfoundations approach to macroeconomics has spawned a family of computable general equilibrium models, which generate dynamic fluctuations in model economies where individuals and firms consistently optimize over their planning horizons.

What we would like to propose here is a very different and probably more ambitious research program. Such program should be first and foremost empirical: information and hard data on the main inefficiencies in modern, complex industrial economies is largely unavailable. Collecting such data and information is likely to be extremely expensive, and governments should spearhead this effort. We suggest a way to induce governments to undertake such a program: to insert a requirement that every law or act of government contain an explanation of its economic rationale based on an analysis of how principles 1. to 5. apply. In addition, there should be a requirement that every law or act of government clearly explain and quantify the envisaged re-distributive effects, both in the aggregate and in per capita terms.

This simple reform would have two effects. On the one hand, they would force more transparency in economic policymaking, and render the job of special interest groups harder. On the other hand, it would spawn an economic culture of lawmaking, which would trigger large efforts at collecting the data and information that are the necessary conditions for such "technological" progress in economic policymaking to take place.

Our approach complements the current wave of political-economic models. These seek to explain the origin of observed distortions by explaining the interactions among interest groups that caused them; they also suggest institutional arrangements that would make it easier to avoid these problems. We think that economists can and should do more. Governments need all the good advice they can use, and academic economists are ideally equipped to provide it, but such advice need to be based on a detailed knowledge of the facts.

Dixit (1997) has pointed to two different roles that economists can play as policy advisers: “They can limit themselves to quantify the gains and losses that are at stake in a particular policy decision. Alternatively they can directly participate in the debate using strategic moves of their own.” In the first case economists provide politicians with a base for evaluating the tradeoffs they face; thus they help them to strike a deal among opposing interests. The second role is more active: in the free trade debate, for instance, they could “stake out a pure position in favor of free trade and try to align public opinion on their side by creating a status quo favorable to free trade.”

We would like to go beyond the observation made by Dixit, and suggest that the two roles are not equivalent. In the battle to get rid of the distortions caused by the presence of special interests, economists can be instrumental in tilting the balance in favor of the removal of the distortions. This requires an active role as “advocates”, trying to enlist the support of the public in favor of policies that benefit the majority of the population. In other words, they can do a lot to remove the inefficiency caused by the free rider problem that prevents the majority from carrying the day, and thus allows interest groups to prevail. But this, as noted by Dixit, requires “direct participation in the debate using strategic moves of their own.”

Parallel to their role as advocates, economists can help improve the working of existing institutions by introducing a more “scientific approach” to policymaking. We have proposed what we believe would be a powerful innovation of the current set of rules, in many countries: a requirement that new legislation be justified on the basis of the principles laid out in section 4 which represent the state of our knowledge on what governments should do. Such a requirement would provide the best guide of public (parliamentary) debate on new proposals in the area of economic policy.

These proposals, of course, do not in any way renege the importance of sound macro-stabilization policies in the Mundell tradition. But both to make those policies more effective, and to move further, we believe in progress in the theory of economic policymaking.

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Endnotes

[1] A first version of this paper was presented at the Festschrift Conference in honor of Robert A. Mundell, held in Washington on October 23-24, 1997. We thank Rudi Dornbusch, Mario Draghi, Luigi Spaventa, Guido Tabellini and an anonymous referee for their comments on an earlier draft. The views expressed in this paper are those of the authors only and not those of Long-Term Capital Management.

[2] Elhanan Helpman has often made this point in connection with economic policy in Israel after the 1985 stabilization.

[3] Recent research (see, e.g. Persson, 1998, Persson, Roland and Tabellini, 1997, 1998) has advanced our understanding of the reasons why, for instance, public policy is often shaped by special interest groups. This work points to institutional arrangements that could correct such distortions, making a “scientific approach” to government policy possible.

[4] For a review of these developments see for example Dornbusch and Giovannini (1990) where all the references cited in this section can be found.

[5] The rational expectations literature has been influential in changing policymakers’ attitude toward markets: “The relationship between the policymaker and the market is not what it used to be. In the old days, policymakers thought that to be effective, they had better surprise the market. Announcements should be made when the markets were closed. Everyone had to be surprised. The markets were adversaries to the policymakers. However, it is a new world now. Now, the role of policies is a dialogue with the markets; but in order to have a dialogue, your actions must be transparent, clear, accountable, and predictable. You must have an open way of policymaking." (Frenkel, 1997).

[6] At MIT, for instance, the number of foreign students who received a Ph. D. in economics has increased from 22 percent of all economic students in the 1950s, to 25 percent in the sixties and

seventies, to 36 percent in the past fifteen years. Moreover, while in the earlier period many of the foreign students were Canadians, over time their countries of origin have spread the entire world.

[7] See *e.g.* Mundell (1994) and the discussion of taxation and growth in Mundell (1971).

[8] Recent work on "Transition economies" is an important exception. The challenge posed by the need rebuild a market economy from scratch has forced macroeconomists to think about institutions, property rights, the legal framework and the enforcement of laws, budget procedures, the design of regulatory agencies, etc. An example are the NBER volumes on Eastern Europe, see Blanchard, Froot and Sachs, 1994. On budget procedures and budget institutions see Alesina, 1996.

[9] In most G7 countries redistribution is largely across generations.

[10] Even free trade had a hard time being accepted as the guiding principle of economic policy in the early postwar. During the negotiations leading to the Mutual Aid Agreement between the United States administration and the British government Keynes "shocked American officials by making a strong statement about Britain's postwar economic policies. He declared that the British government would find itself beset by such grave economic difficulties at the end of the war that it would be forced to resort to bilateral arrangements and other forms of outright discrimination against the US". Only at the insistence of the State Department the final text of the Atlantic Charter expresses the desire of the two countries "with due respect for their existing obligations, to further ... access, on equal terms, to the trade and raw materials of the world." (Gardner, 1980).

[11] Persson (1997) provides an extensive discussion and a transparent analysis of the role of special interest politics in modern democracies.

[12] See the debates on central planning during the 1930s and 40s: *e.g.* Lange and Taylor (1938), Lerner (1946).