INSTITUTIONS, POLICIES AND EFFICIENCY IN ECONOMIES

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Abstract: There are cases where the governments may not always serve the public interest. The implication seems to be that governments can help out but only if properly constrained. The impact of these ideas on monetary policy led to creation of Central banks. As far as fiscal policymaking is concerned, the evolution has been slower. It would seem that we are now ready to move to the next step, replacing rules with adequate incentives backed by institutions - fiscal policy committees.

Keywords: policies, institutions, rules.

The methods of correcting balance-of-payments disequilibria are classified as automatic or policy. An automatic adjustment mechanism is one that is activated by the balance-of-payments disequilibrium itself, without any government action, and operates until the disequilibrium is eliminated (unless the government takes specific steps to avoid its operation if there are unwanted side effects). On the other hand, adjustment policies are specific measures adopted by the government with the primary aim of correcting a balance-of-payments disequilibrium. Whereas automatic adjustment mechanisms are triggered as soon as disequilibrium arises and continue to operate (if unhampered) until the disequilibrium is eliminated, adjustment policies involve a time lag. That is, it takes time for the existence of a balance-of-payments disequilibrium to be recognized, for the government to adopt the appropriate policies, and for these policies to take effect. However, automatic adjustment mechanisms can have serious negative side effects, which the government may attempt to avoid by using adjustment policies.

Automatic adjustment mechanisms are subdivided into those that operate on prices and those that operate on incomes. In addition, there are automatic monetary adjustments. The automatic price adjustment mechanism relies on price changes in the deficit and surplus nations to bring about adjustment. The mechanism operates differently under a flexible exchange rate system than under a fixed exchange rate system such as a gold standard. The automatic income adjustment mechanism relies on induced changes in the national income of the deficit and surplus nation to bring about adjustment.

The most important economic goals or objectives of nations are: internal balance, external balance, a reasonable rate of growth and an equitable distribution of income. Internal balance refers to full employment or rate of unemployment of no more than 2 or 3 percents per year (the so-called frictional unemployment arising in the process of changing jobs) and a rate of inflation no more than 2 or 3 percent per year. External balance refers to equilibrium in the balance of payments (or a desired temporary disequilibrium such as a surplus that a nation may want in order to replenish its depleted international reserves). To achieve these objectives, nations have the following policy instruments at their disposal: expenditure-changing, or demand, policies, expenditure-switching policies, and direct controls.

Expenditure-changing policies include both fiscal and monetary policies.

Fiscal policy refers to change in government expenditures, taxes, or both. Fiscal policy is expansionary if government expenditures are increased and (or) taxes reduced. These actions lead to an expansion of domestic production and income through a multiplier process and induce a rise in imports. Contractionary fiscal policy refers to a reduction in government expenditures and (or) an increase in taxes, both of which reduce domestic production and income and induce a fall in imports.

Monetary policy involves a change in the nation's money supply and affects domestic interest rates. Monetary policy is easy if the money supply is increased and interest rate fall. This induces an increase in the level of investment and income in the nation and induces imports to rise. On the other hand, tight monetary policy refers to a reduction in the nation's money supply and a rise in the interest rate. This discourages investment, income, and imports, and also leads to a short-term capital inflow or reduced outflow.

Expenditure switching policies refer to changes in the exchange rate. A devaluation switches expenditures from foreign to domestic commodities and can be used correct a deficit in the nation's balance of payments. But it also increases domestic production, and this induces a rise in imports, which neutralizes a part of the original improvement in the trade balance. A revaluation switches expenditures from domestic to foreign products and can be used to correct a surplus in the nation's balance of payments. This also reduces domestic production and, consequently, induces a decline in imports, which neutralizes part of the effect of the revaluation.

Direct controls consist of tariffs, quotas, and other restrictions on the flow of international trade and capital. These are also expenditures-switching policies, but they can be aimed at specific balance-of-payments items (as opposed to a devaluation or revaluation, which is a general policy and applies to all items at the same time).

Faith in the ability of macroeconomic policies effectively to erase business cycles has long been oscillating. From the enthusiastic hopes of the 1960s that we could erase business cycles (Tobin, 1972) to the view of the 1980s that policies are ineffectual, the tendency seems to be moving to an intermediate position that emphasizes incentives and institutions. This evolution can be traced back both to facts and academic research (Wyplosz, C. 2005).

Monetary policy can be used for two different purposes; in the long run it is required to deliver price stability, in the shorter run it is asked to help stabilize output over the business cycle. The challenge is to deliver on the short-run objective without giving up the long-run objective. In the 1970s and 1980s, many central banks failed to meet this challenge. As they struggled to meet various contractionary shocks – including the infamous oil shocks – they gave up on inflation. The initial response to this failure was to adopt monetary aggregate growth rules. Inflation receded but the rules were soon found to be too rigid, in particular in the face of sharp changes in financial markets that modified the behavior of monetary aggregates. The next step was to replace rules with new central banking institutions following incentives. The third step was to delegate monetary policy to an independent group of unelected experts, usually identified as the Monetary Policy Committee (MPC). This committee is given a clear mandate (price stability, generally, sometimes quantitative inflation targets) by the political authorities. The committee has full authority to carry out monetary policy, nowadays it means setting a short term interest rate. Finally it is *ex post* accountable to a political body for its performance, and often regularly required to explain its actions and thinking to the broader public. MPCs are not known to have an inflation bias and they have been highly successful both in 2005 achieving their mandated objectives and in being transparent to the public and accountable to the political authorities.

Fiscal policy can be set in the same mould. The long-run objective is fiscal discipline, i.e. debt sustainability. In the short run, fiscal policy may also make a contribution to output stabilization over the business cycle – in the European monetary union it is the only stabilization tool available at the national level. Many countries have followed the logic of adopting rules that aim at constraining fiscal policy decisions: limits on public spending, budget deficit rules, debt rules. The next step is to establish a commitment to a debt level target (as a proportion of GDP) over the relevant horizon, and to remove political pressure from those who undertake this task. The latter requirement calls for the establishment of new institutions. The most radical institutional solution is to mimic fully the approach adopted in the case of monetary policy, to set up Fiscal Policy Committees (FPCs).

The FPC members could be unelected experts appointed for a fixed duration, long enough to make them fully independent and to exceed the horizon of the policy target. The FPC could be given by the relevant political authorities a debt target to be achieved over a given horizon that is commensurable with business cycles as well as the authority to decide on the budget balance on the basis of an explicit GDP growth forecast. The FPC could be accountable to parliament. Each of these characteristics needs detailed elaboration.

The events of 2003–2004 have amply demonstrated that annual budget deficit ceilings are bound to be counterproductive. So they should be replaced by debt commitments. The debt targets should be established country by country and enforcement should be carried out at the national level. On the other hand, the Maastricht Treaty has established the principle that national fiscal discipline is a matter of common concern, hence the Excessive Deficit Procedure. Thus, any national solution must be made compatible with the solutions in other members of EU. The natural solution is the mandatory establishment of national FPCs. Each country would be required to create an FPC that meets common requirements, pretty much as each national central bank has to satisfy a common set of features. Each country would propose its own budget target, which would be negotiated with the other union members with a view of achieving consensus. Such an arrangement would go a long way towards guaranteeing fiscal discipline by removing the deficit bias while preserving sovereignty. Currently, monitoring by the Commission and externally-imposed sanctions are both perceived as intrusive. National FPCs with a clear mandate and associated formal or informal authority would achieve the same aims while leaving the fiscal policy instrument as an effective tool of output stabilization now that monetary policy is not available at the national level. At a later stage, granting the national FPCs the authority to decide on annual budget balances would be accompanied by a less formal role for the Commission. In all cases, sanctions must be abandoned, formally or informally.

A FPC should be effective only if the specialists who works there are of best quality. This means that there must be a system of looking for and educating the best specialists in macroeconomics. This means to create a clear system of rules for compensation of their labor as well as a system for monitoring the Committees and analyzing their mistakes. This is an extremely difficult task having in mind the corruption among the clerks and politicians of higher level and the usual practice of pressing the experts. Let us do not forget the experience of the former socialist countries where planning, monetary and fiscal institutions was under the pressure of the semi-literate activists of the communist parties.

Competent and dedicated policymakers are better able than quantitative rules to exercise good judgment and deliver an adequate mix of restraint and flexibility. To do so, however, they must be shielded from the temptation and pressures that are part of political life. This is the approach that has been adopted for monetary policy by an increasing number of countries, so far successfully. Fiscal policy has not yet benefited from a similar treatment both because of traditions and the perception that fiscal policy belongs exclusively to the political sphere. The challenge for a new type of fiscal policy to emerge is to recognize that spending and taxation ought to remain in the political sphere, but that the deficit and the debt level ought to be delegated to independent experts. The natural implication is that the institutions adopted for monetary policy can and should be applied to fiscal policy as well. Independent Fiscal Policy Committees can play the same role as Monetary Policy Committees, deciding on deficits and the evolution of the debt. To deliver good results, they need to be given a clear mandate, debt sustainability, so that they are freed from the time inconsistency problem that leads to a deficit bias.

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