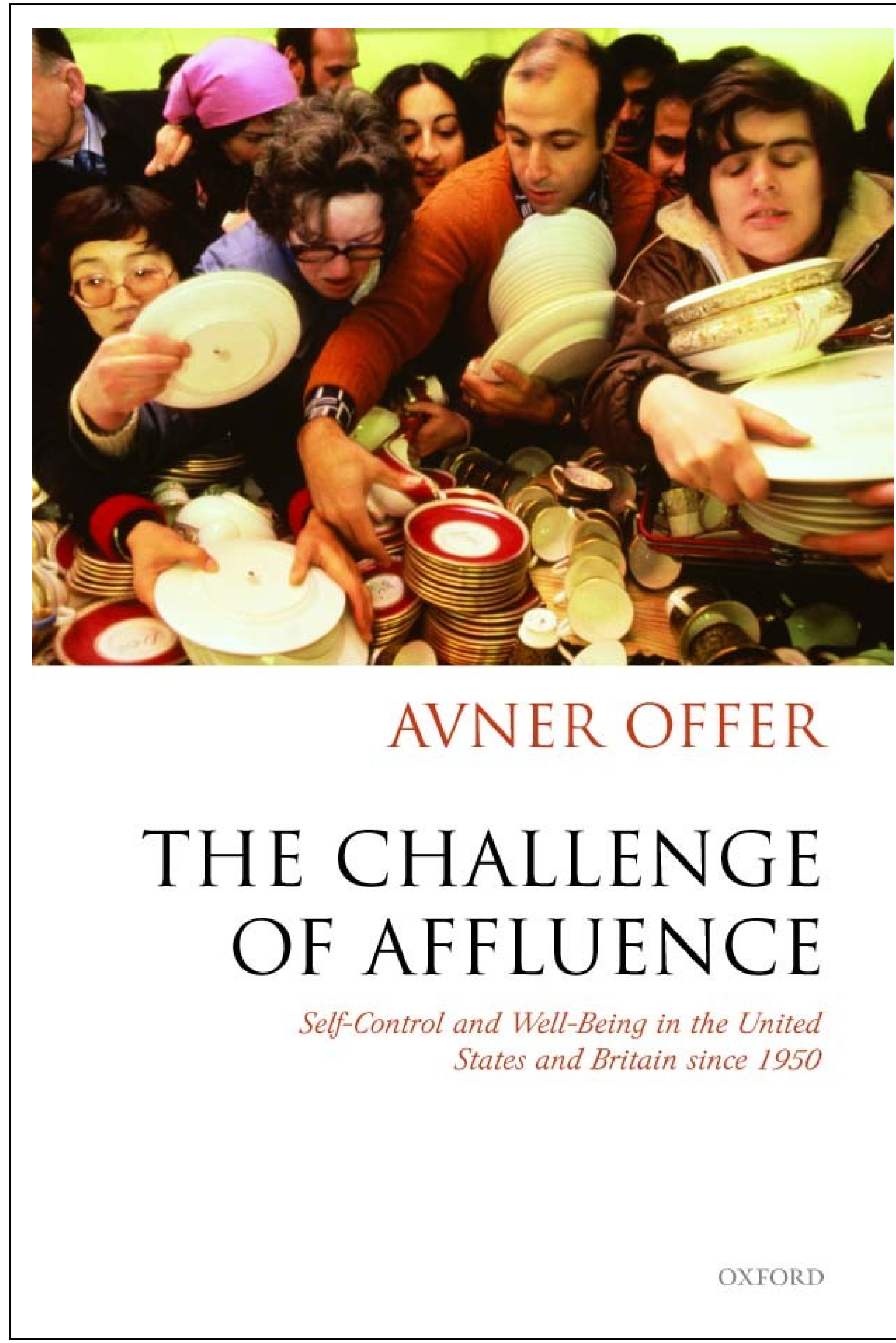
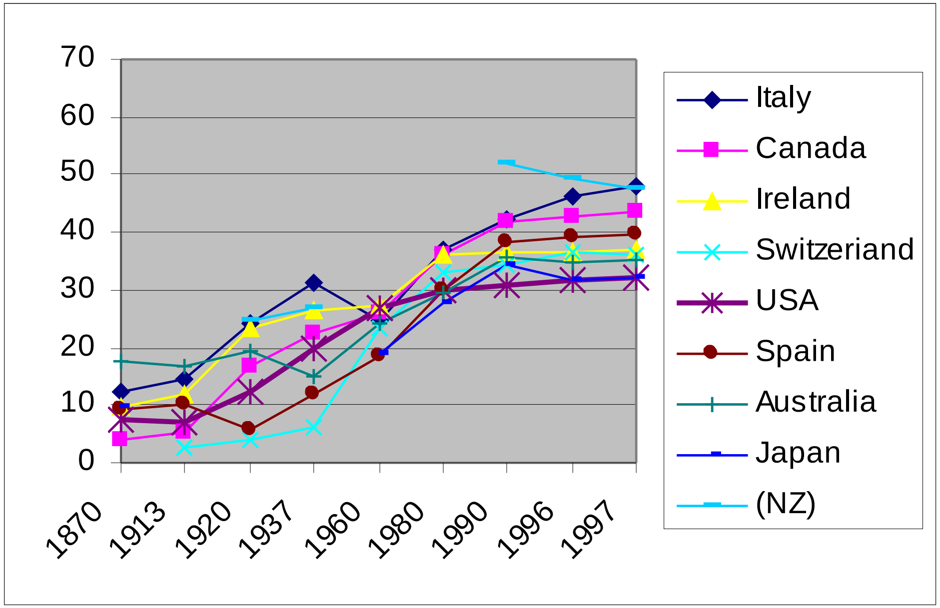
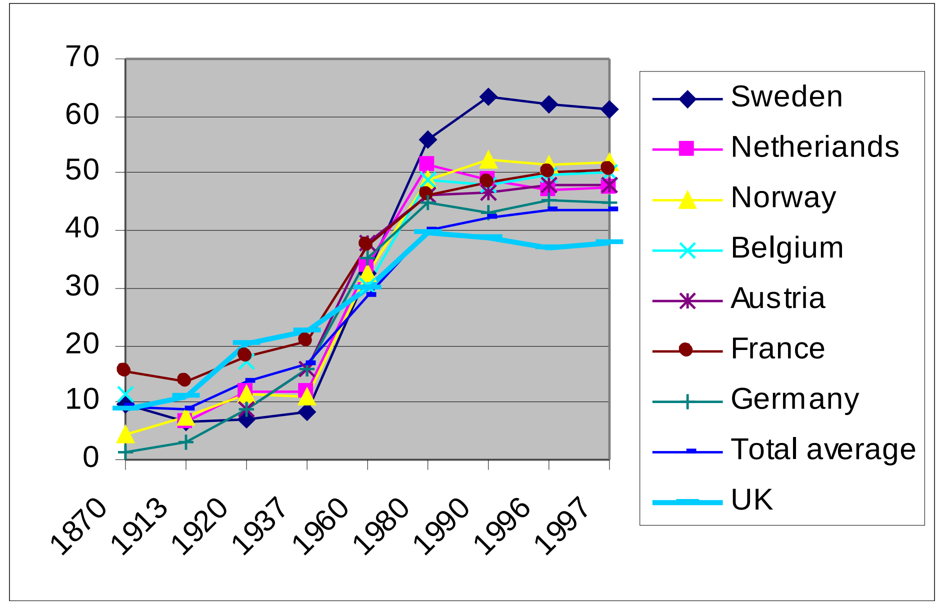
The role of the state:—a contracting perspective

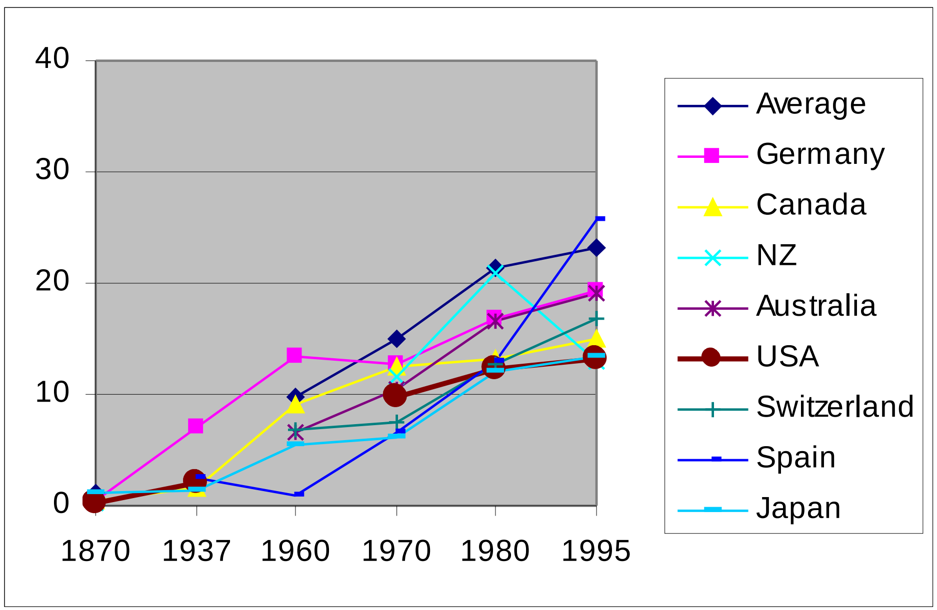


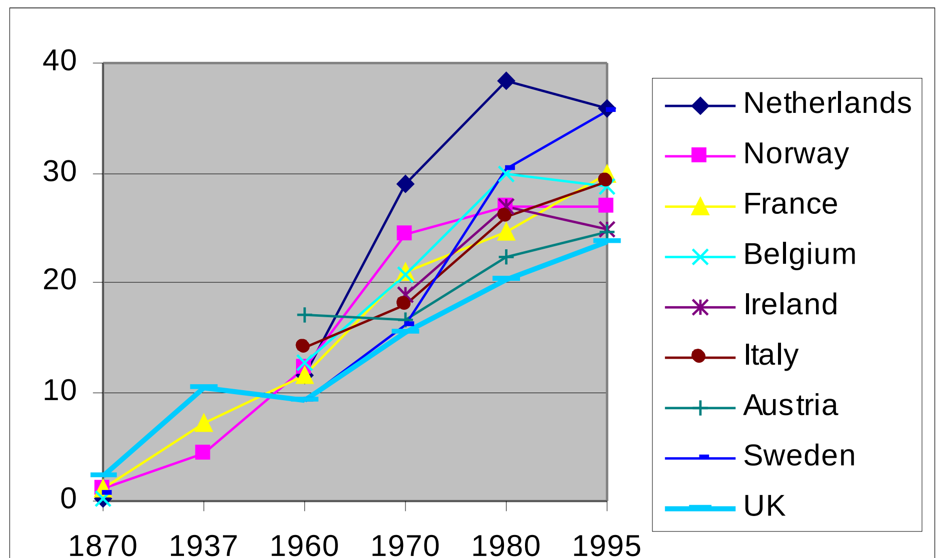
GENERAL GOVT EXPENDITURE % OF GDP





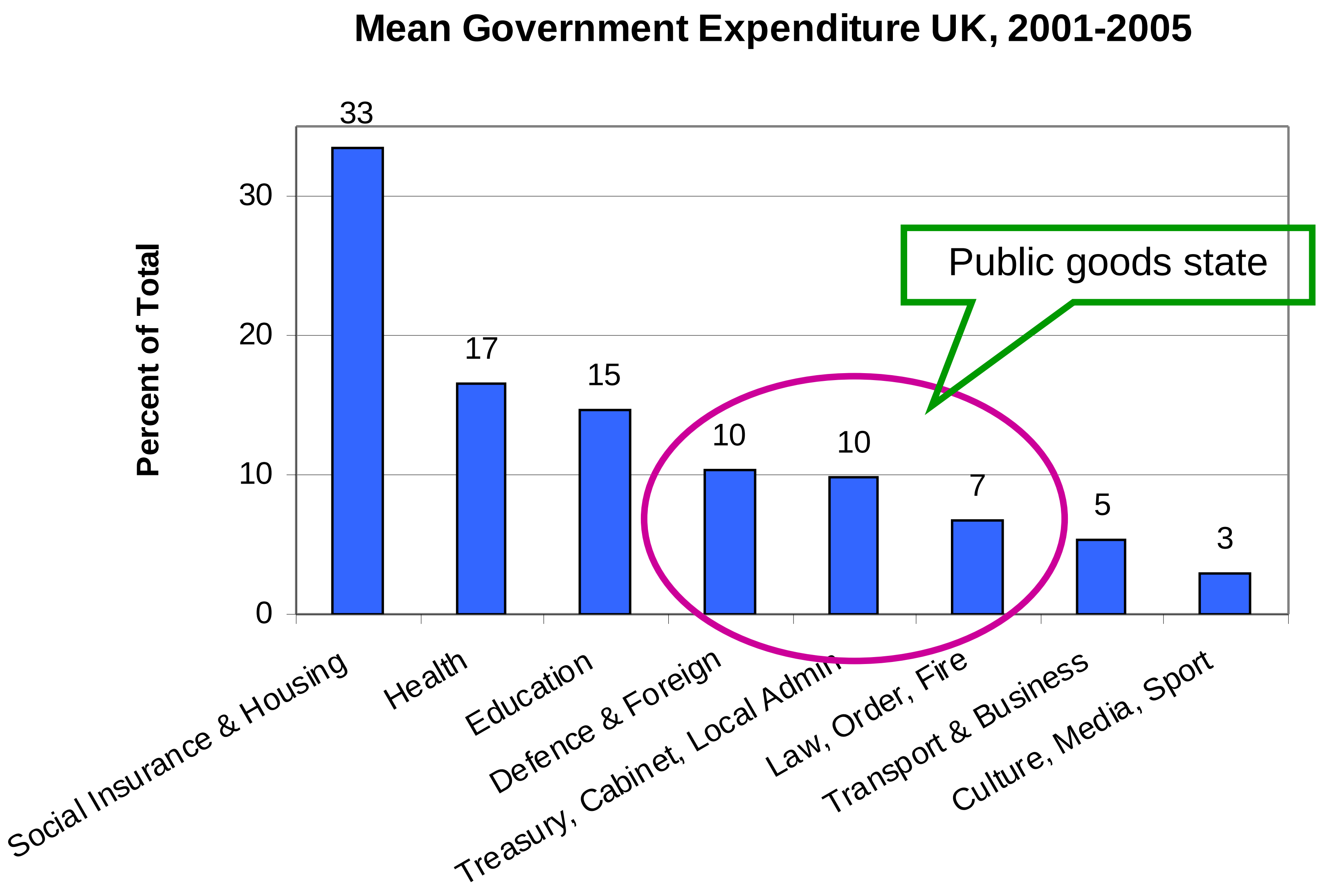
Low WELFARE TRANSFERS **High**





Tanzi & Schuknecht, 2000, table II.4, p. 31

What does the state do?



Why?

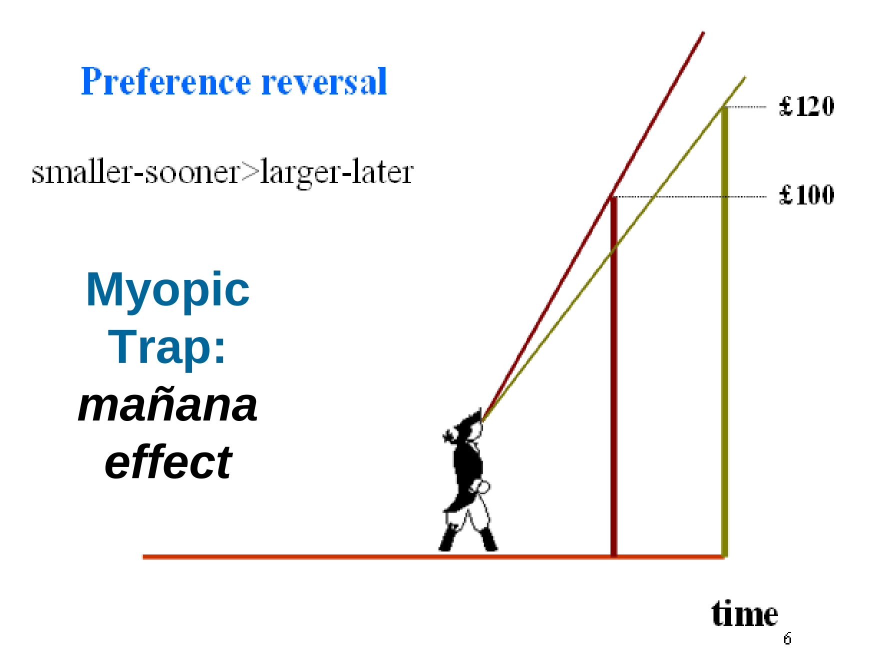
HM Treasury, Public Expenditure Statistical Analysis 2007, National Statistics, Local Govt. Financial Statistics

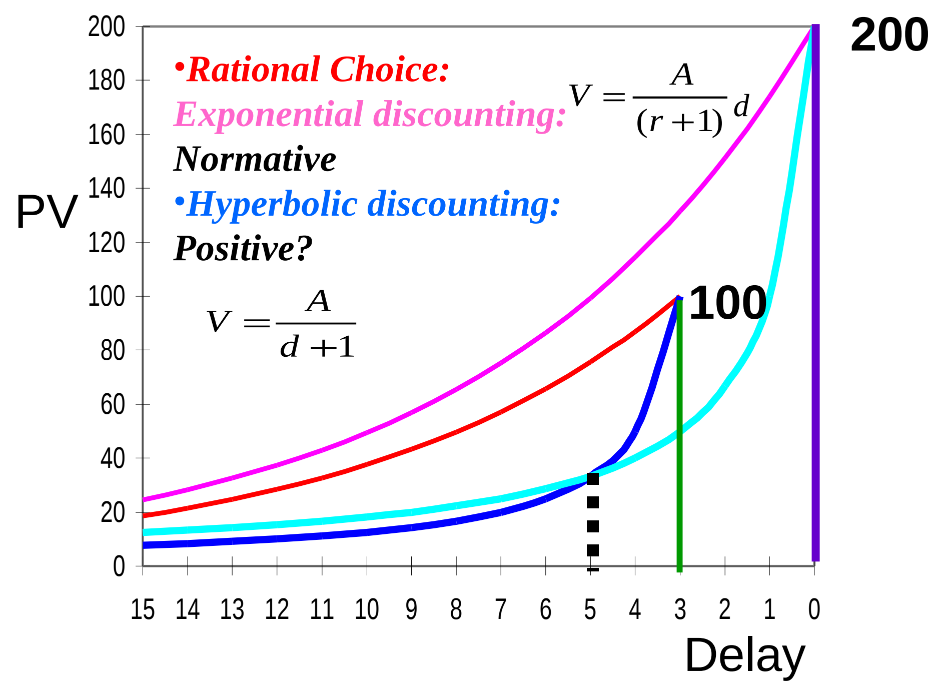
Behavioural economics: cognitive bias of time-inconsistency

Myopia gives rise to bad choices:

'There is no quality in human nature, which causes more fatal errors in our conduct, than that which leads us to prefer whatever is present to the distant and remote.'

[David Hume, *Treatise on Human Nature*]





- Commitment problem: sacrifice now for something better later?
- Calculation intractable. Other problems too – future radically inscrutable.
- No algorithm available, so fall back on tried and tested 'commitment devices', like education, insurance, marriage.
- Role of **government** – to act as commitment agent for society. Long-term.

Why not the market?

- Difficult to write a long term contract
  - Contracts incomplete
  - Future inscrutable: ‘unknown unknowns’
  - Management costly
- Market discount horizon less than one generation
- Contract Risks:
  - market cycles
  - Currency risk/inflation
  - Fraud
  - Default
  - Small print (contract ambiguity)
- An inter-temporal form of market failure

How is the state able to do it?

- Not about compassion or fairness. Brown/Cameron’s babies.
- State acts as commitment agent for individuals, to overcome private myopia
- But does not write long-term contracts
- Operates on pay-as-you-go basis
- Bypasses the contracting difficulty
- Intertemporal allocation converted into cross-sectional transfers
- Transfers from producers to dependents.
- Equilibrium achieved by means of politics.
- In democracy, by voting. In non-democracies, by quest for sustainable equilibrium (Bismarck, Olson’s ‘stationary bandit’)
- Founded on normative consensus of reciprocal obligation
- State can enforce equilibrium (& not bound by contracts)
- **Pay-as-you-go is self-regulating: can be re-negotiated**
- USA welfare state expanding.

Hence growth of public sector in *all* modern societies

- Wagner's Law: public services driven irresistibly by 'the desire for development of a progressive people'. Public sector grows faster than income c. 1870-1970.
- Arises in response to challenge of urbanism
- Affluent people live longer, have longer time horizons, depend more on reciprocity and co-operation.
- State's role of commitment agent a crucial innovation of twentieth century.
- From 1970s state focuses on 'commitment' functions.

Challenge of market liberalism

- Assumption that state has restricted legitimate role
- **A bid by financial industry to take over management of social risk.**
- Consider experience: ‘Successful’ long-term contracts:
  – ***Life insurance.*** Claimants dead: cannot work out whether they had a good deal. Also dependent on tax benefits.
  – ***Mortgages:***
    - de—mutualisation of mortgage and life insurance 1980s. Distribution of £35 billion of society reserves – 7 percent of GDP. ‘De-commitment’
    - Privatisation: conflict of interest between savers and lenders
    - Mis-selling of endowment mortgages. (UK)
    - Sub-prime mortgages. (USA)

  – Forward contracts also eventually require current transfers from producers (with bargaining power) to beneficiaries.

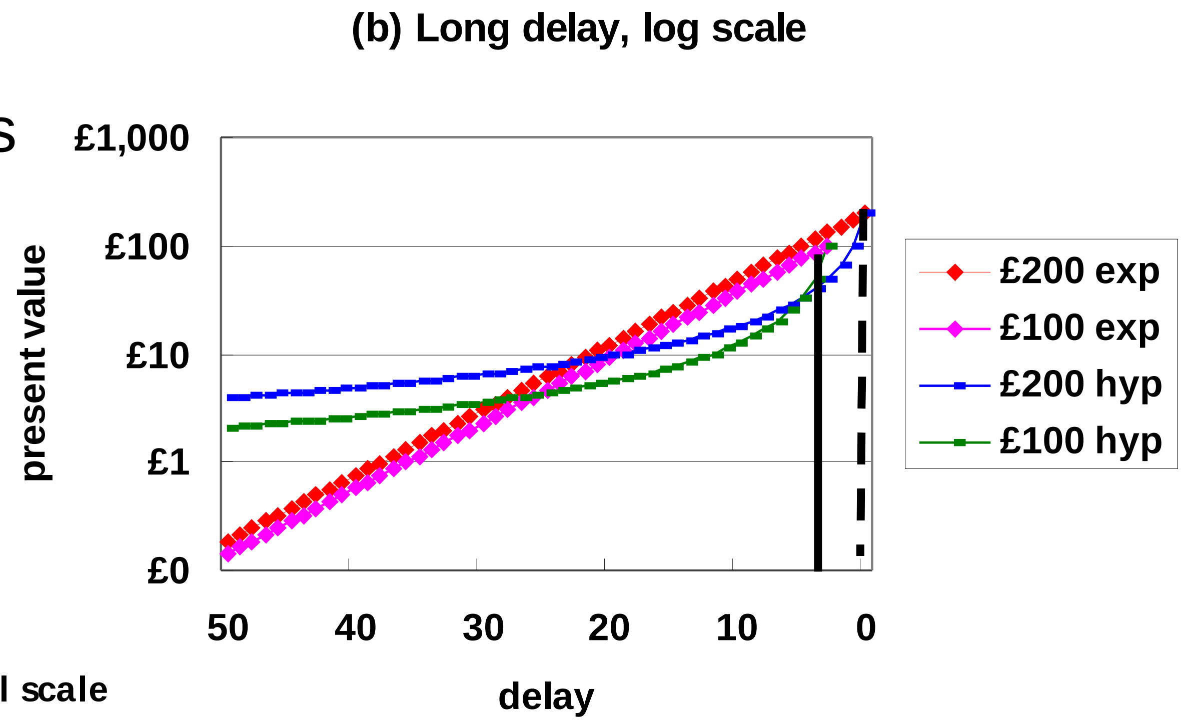
Natural Experiments: *Pensions* etc.

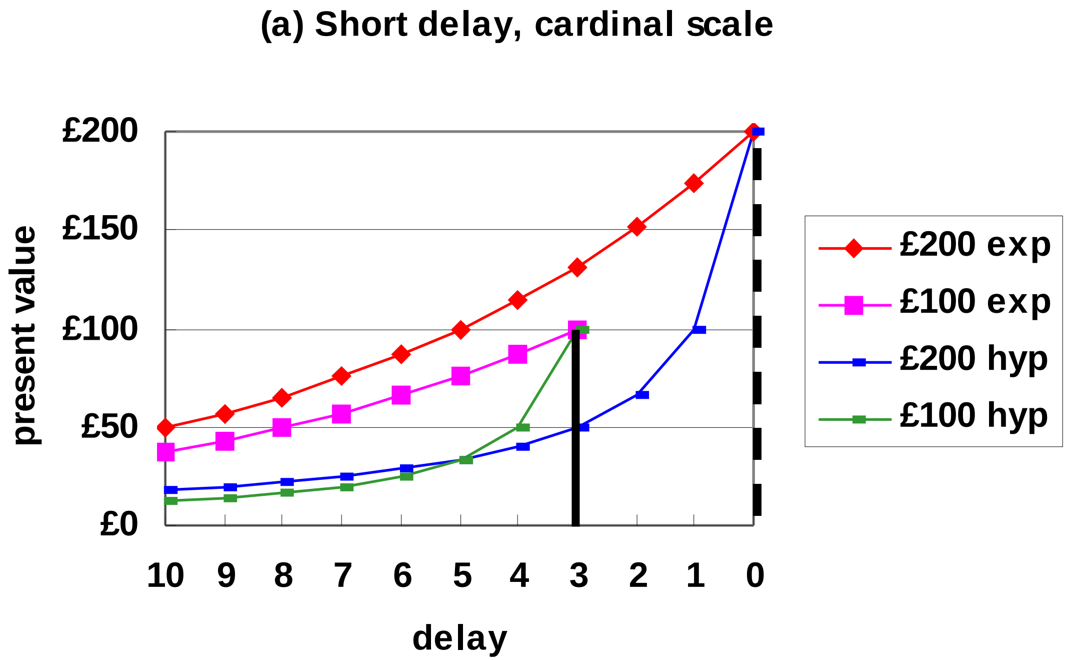
- **Thatcher: incentives for marketised pensions**
  - State-pension de-linked from incomes, incentives for private pensions.
  - Pensions mis-selling
  - High cost of financial intermediation: even ‘simple’ stakeholder products.
- **Failure of corporate pensions**
  - Maxwell fraud/ Equitable Life contract risk
  - Bankrupt companies pensions lost.
  - Corporate withdrawal from defined benefits – transfer risks to individuals
  - American pension guarantee – gamed by corporate bankruptcy strategies
- **Social pensions**
  - USA social security. ‘Looming’ crises –decades away
  - Political failure of Bush partial privatisation
  - UK – de-facto pension restoration by means of income support
  - European pensions. Can’t be paid, won’t be paid – will be renegotiated.
- **American health care:** market competition more costly, less fair
- **Private Finance Iniative (PFI):** long-term contracts are poor commitment devices

Is state robust in agency role?

- State can fail as well. Politicians, voters myopic too.
- Quest by finance to capture the state. Convert tax revenue into corporate cash flow. Crony capitalism [state privileges financial sector]
- Propaganda: Spread belief in self-sufficiency (‘American dream’). Competition suits the winners. ‘Homer’s tax cut’ [Bartels, 2004]
- Attempt to disable/discredit the state in its commitment agent role
  - ‘starve the beast’/ ’dumb the beast’
  - Financial sector rewards drain off talent from public sector
  - ‘New Public Management’ – individualised incentive structures
  - Crowding out of public service ‘intrinsic motivation’/ Undermining public service ethos/Weberian meritocracy
  - Government defection: Privatisation – PFI/PPP
  - Moral hazard: Market risk management relies on implicit taxpayer guarantee
- Market reliance on contract problematic for long-term commitment. If it succeeds, we will be the poorer—including business itself.
- Pending commitment challenges: global warming, energy crunch, ageing etc.

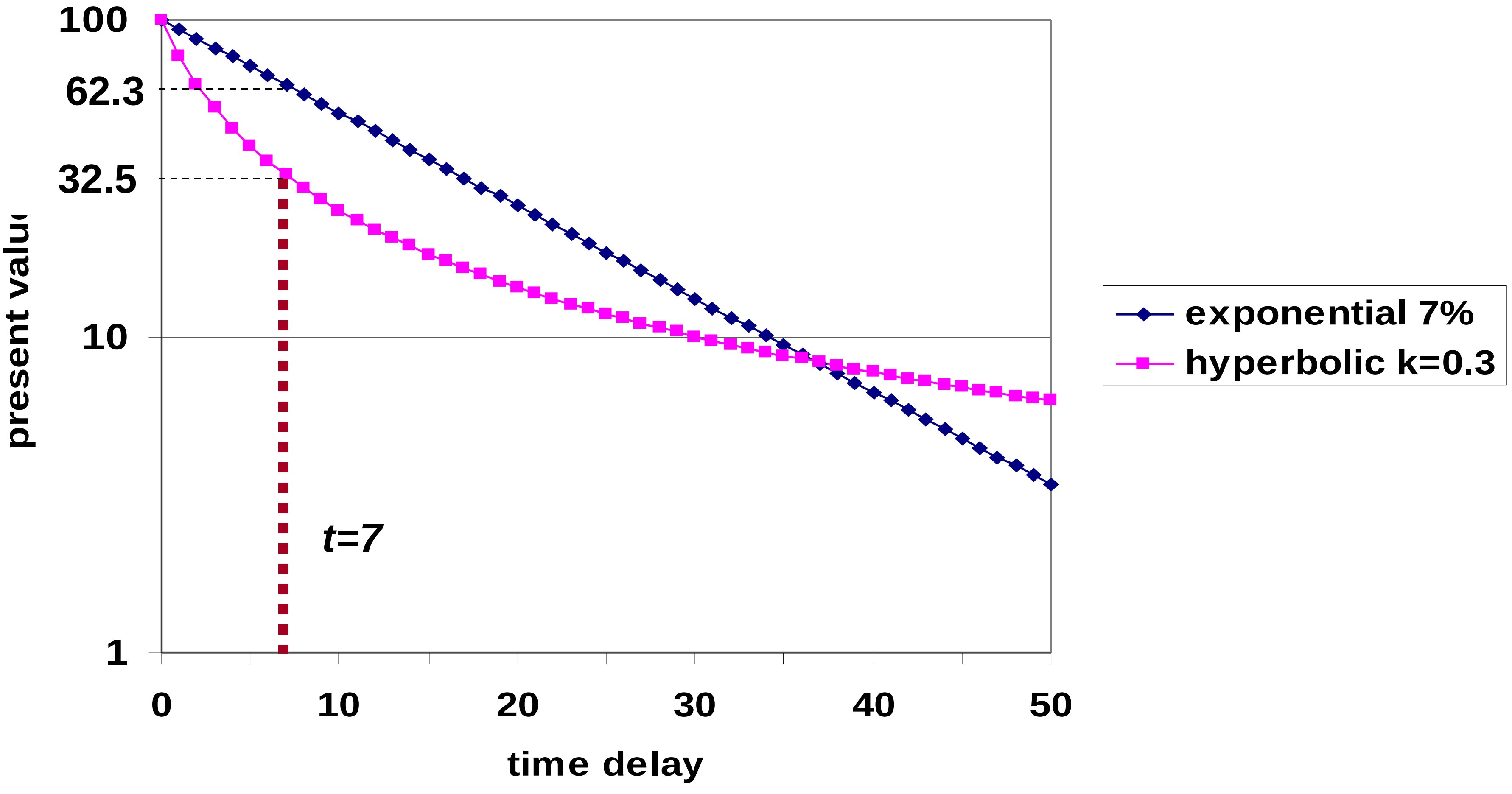
Time Inconsistency:
Variable discount rates





Time Inconsistency

- Short-term sacrifice smaller, long-term benefit greater
- Pre-commitment easier than acting immediately



Acknowledgments to Barnaby Marsh