The role of the state:—a contracting perspective

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GENERAL GOVT EXPENDITURE % OF GDP

WELFARE TRANSFERS

Tanzi & Schuknecht, 2000, table II.4, p. 31
What does the state do?

Mean Government Expenditure UK, 2001-2005

Social Insurance & Housing
Health
Education
Defence & Foreign
Treasury, Cabinet, Local Admin
Law, Order, Fire
Transport & Business
Culture, Media, Sport

Percent of Total
0 10 20 30

33 17 15 10 10 7 5 3

Why?

Public goods state
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]

Preference reversal
smaller-sooner > larger-later

Myopic Trap: mañana effect

• Rational Choice: Exponential discounting: $V = \frac{A}{(r + 1)^d}$
• Hyperbolic discounting: Positive?

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

- Arises in response to challenge of urbanism
- Affluent people live longer, have longer time horizons, depend more on reciprocity and cooperation.
- 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.
• **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 Initiative (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

(a) Short delay, cardinal scale

(b) Long delay, log scale
Time Inconsistency

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

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