

# **FACULTY OF ECONOMICS STUDY AIDS 2021**

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| ECT1 Paper 4 Political and Social Aspects of Economics |
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The Faculty Board has agreed to release outline solutions to the 2021 examinations as a study aid for exam revision. They are abridged solutions, and not 'definitive', and should therefore not be considered as an exemplar for 'complete' answers.

Note that the Faculty will not respond to any queries regarding these solutions.

## Part 1 Paper 4 Questions & Abridged Answers

### 2021 Exam

**1. “The fact that today’s rich countries used policies that go against the free-market doctrine in becoming rich does not mean that today’s developing countries should also use them.” Discuss.**

Ans. The conventional wisdom is that most of today’s rich countries have developed thanks to free-market, free-trade policies – with the possible exception of a few countries, like Germany in the late 19<sup>th</sup> century or Japan and South Korea in the post-WWII period.

However, a closer look at the historical evidence shows that most – although not all – of today’s rich countries, including Britain and the US, used a wide range of interventionist measures, including trade protectionism, government subsidies, state ownership of enterprises, and regulations on foreign direct investments in the early days of their economic development.

Superior answers may not just list the countries that used interventionist measures for economic development but may mention some concrete examples of policies that were used by certain countries – for example: (i) high tariffs in the UK in the 18<sup>th</sup> and the early 19<sup>th</sup> century or the US in the 19<sup>th</sup> and the early 20<sup>th</sup> century; (ii) extensive use of state-owned enterprises in Japan and Germany in the 19<sup>th</sup> century or in France, Austria, Taiwan, and Singapore in the post-WWII period; (iii) use of indicative planning and sectoral industrial policy in France, Japan, Korea, and Taiwan.

After outlining the historical experiences of today’s rich countries, the answer should engage with the main topic in the question – whether those historical experiences can and should be emulated by today’s developing countries.

One obvious reason why the historical emulation may not be desirable, which was explicitly covered in the lectures, is that those interventionist policies are not what made the rich countries rich – correlation does not mean causality. The rich countries may have become rich despite, rather than because of, those interventionist policies. For example, the US may have succeeded despite having very high tariffs because it had ‘countervailing forces’ that more than cancelled out the negative effects of intervention – large markets, rich natural resource endowments, or high-quality immigrants.

Superior answers may provide other reasons, which were not explicitly covered in the lectures. For example, it could be argued that ‘times have changed’ and that what used to be good policies may have become bad. For example, production is more globalized in today’s world, and therefore protectionism may make foreign investors more reluctant in countries

with high tariffs while strong regulation of foreign companies in a globalized world would make them move to another country.

Even superior answers may then provide critical reflections on these arguments. For example, it could be pointed out that the ‘countervailing forces’ argument does not quite work because countries with very different conditions used the same policy and succeeded – if large internal market was so important in countering the negative effects of high tariffs in the US, how do you explain the success of tiny Finland with high protectionism? For another example, it may be argued that, even in a globalized world, countries that regulate foreign investments cleverly to maximise technology transfer and spill-overs – like China and Singapore – have done better than countries that regulate them minimally. These examples show that there are certain economic principles – such as infant industry argument – that hold across time and space, although the exact manner of their application may differ according to time and space.

Whatever the exact conclusion may be, a good answer should show a clear recognition that policies cannot simply be copied across time and space while also acknowledging that there are certain economic principles that apply across time – for example, the infant industry argument.

## **2. “There is no such thing as a free market because all markets are in the end political constructs.” Discuss.**

Ans. The implicit and widely adopted view among economists is that there exists an objective way that can define a ‘free’ market – that is, a ‘pure’ market which is free from the influence of politics.

However, no market can be free (from politics) because all markets are based on politically-determined institutions that regulate all aspects of their operations – what can be traded, who can participate, what rights and obligations market participants have, how the process of exchange may be conducted, and so on.

Superior answers may give some examples of these institutions: (i) who can participate (e.g., stock market listing rules, professional qualifications, immigration control, gendered conventions on occupational choices); (ii) what can be traded (e.g., different degrees of restrictions on the sales of child labour, human organs, firearms); (iii) the rights and the obligations of the market participants (e.g., zoning laws and planning permissions that restrict what you can do with your land, workers’ rights regarding paid holidays or maternity leave); (iv) the process of exchange itself (rules regarding, e.g., fraud, breach of contract, bankruptcy).

Superior answers may also point out that the political nature of the market is why different societies (across time and space) have different notions of what a ‘free market’ is – and

therefore what constitutes state intervention – because they have different political views. For example, the ban on child labour was considered to be very intrusive state intervention during Victorian times but is not even thought of as state intervention in today's UK.

Superior answers may point out that we see a particular market as 'free' only because we so totally approve of the politically determined institutions that define its boundary and its functioning.

**3. To what extent was a new political arrangement established between the major political parties in post-1945 British politics?**

Ans. The adoption of the National Insurance Act and National Health Service Act of 1946 by the subsequent Conservative governments was crucial in completing the welfare state. Churchill had been a significant social reformer before and after World War 1 and thus had contributed to the development of the welfare state prior to Clement Attlee. Although Churchill opposed nationalisation in principle, MacMillan and other leading Tories embraced it. Keynesian economic theory was the dominant economic paradigm and so had to be adopted by both Labour and Conservative governments. The Foreign and Colonial policies were set prior to Attlee (partially by Churchill) and the Labour government was obliged by electoral opinion to follow these (in part). Attlee started the atomic bomb programme and the Conservatives continued it.

**4. "Margaret Thatcher's Conservative government established a new type of politics in Britain, but there was nothing new about the New Labour government." Discuss.**

Ans. Neoliberalism created a transformation. Thatcher largely maintained the non-economic policies of her predecessors. Low direct taxation was continued by New Labour from Thatcher. The privately owned economy was continued. The constraints on the trades unions were continued. The tax burden (stealth taxes) was increased: a new policy. Government expenditure on the NHS and state education grew as deliberate policies: a socialist informed policy. The industrial economy was reregulated: a socialist informed policy. The neo-conservative wars in Iraq and Afghanistan were a new phenomenon in the post-colonial era.

**5. "Economic problems have beset Britain since 1945, the sub-prime mortgage crisis, viz. 'The Great Recession' and the COVID-19 crisis only differed from the rest in terms of their origins." Discuss.**

Ans. The productive efficiency of the economy at the micro-level was deficient post-1945 compared to the USA, West Germany, & Japan. The application of fiscal demand management increased inflation and tended to create trade deficits which reduced industrial

competitiveness. Friedman argued that the application of fiscal demand management created the very stagflation which Keynesian theory could neither explain nor yield a policy prescription to resolve. State planning failed to correct the deficiency in productive efficiency. Supply-side reform subsequently partially corrected the deficiency in productive efficiency.

A countercyclical fiscal expansion to address the 2008 Recession and the COVID-19 crisis was constrained due to the already expansionary fiscal stance prior to the Recession. Monetary policy has no such constraint but the effects of QE are themselves limited in expanding the economy. Governments can (and do) implement increased regulation of the commercial banking sector after economic shocks, but this reduces economic growth.

**6. (a) How is freedom of the media in an economy related to political accountability?**

**(b) How is the role of the media important for economic development more widely?**

Ans. Need to discuss why the media play an essential role in democracy. As countries make the transition from autocracies to democracies, they affirm press freedoms in equally strong terms. But is formal media freedom enough to guarantee the free press? The role of media has been studied in terms of its impact on government transparency, accountability, solving the principal (citizens)-agent (government) problem, corporate governance and the state of the media industry in specific countries. Can discuss causality, media autonomy, Besley-Prat model. As well as evidence from Djankov, Leeson and Olken in Indonesia.

**7. (a) What are the differences between common law and civil law legal origin systems?**

**(b) Do different legal origins account for differences in economic growth across rich and poor countries?**

Ans. Need to discuss Anglo-American common law systems compared to European civil law systems. Role of judicial independence, constitutional review and procedural formalism. Evidence suggests that legal origins are important for growth, but not when you control for human capital, and that the main channel through which they work is financial development (investor protection). Evidence from Djankov paper and La Porta et al paper would be appropriate.