

FACULTY OF ECONOMICS STUDY AIDS 2018

ECT1 Paper 4 Political and Social Aspects of Economics
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Also note that the Faculty will not respond to any queries regarding these solutions.

Part I Paper 4

Political and Social Aspects of Economics

Exam answers 2018

1. 'The conventional view is that most of today's rich countries have used free-market, free-trade policies to develop their economies. The reality is the opposite.' Discuss with reference to historical examples.

The conventional wisdom is that most of today's rich countries have developed thanks to free-market, free-trade policies. The active role of the state in economic development in countries like Germany, Japan, and South Korea is often – although not always – acknowledged, but these are treated as exceptions and it is argued that most rich countries, especially led by Britain and the US, have developed thanks to free-market, free-trade policies.

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. There were countries like Switzerland and the Netherlands, which used few of these measures and largely practiced free-market, free-trade policies, but these were the exceptions, rather than the rules.

Candidates are expected to outline the above, while providing some concrete examples. Prominent (but by no means the only possible) examples include: (i) the fact that Britain and the US were the most protectionist countries in their world in their respective times; (ii) the East Asian economies, such as Japan, South Korea, Taiwan, and Singapore, used interventionist policies most extensively during their 'miracle' years; (iii) Germany used state-owned enterprises to kick-start industrialization in the early 19th century and protectionism to promote heavy and chemical industries in the late 19th century; (iv) France heavily used state-owned enterprises, indicative planning, and sectoral industrial policy after World War Two.

Superior answers may provide discussions on at least one of the following additional aspects. First, they may discuss the economic logics behind the historical acts of intervention, especially the infant industry argument but also various forms of 'market failure'. Second, they may discuss how state intervention has continued to play an important role in sustaining economic development, not just kick-starting it. The important role that state-owned enterprises has played in a number of countries in the post-WWII period (e.g., Singapore, France) or the massive role that the US government has played in promoting cutting-edge technologies through public R&D spending during the post-WWII period are such examples. Third, they may discuss that, even though most of today's rich countries have extensively used state intervention, the exact ways in which they have done it are significantly different across countries, suggesting that there is no single best recipe for economic development.

2. ‘Despite the aspiration of the free-market economists, it is not possible to rid the economy of politics.’ Discuss.

Since the rise of the government failure approach, the dominant view has been that politics corrupts the rationality of the market and therefore its influence on the operation of the economy needs to be minimised.

There are broadly three reasons why this proposal cannot be achieved. The answer can be based on only one of the reasons, although superior answers are expected to discuss at least two of the three reasons.

The first reason why the proposal for ‘de-politicisation’ is not feasible is that in most economies the government, whose operation is inevitably political, already plays an enormous role and it is simply impossible to radically reduce it – the best example of this being the continued expansion of the welfare state in most countries even throughout the neo-liberal era. Superior answers may also discuss how the proposals to reduce the influence of politics in government policy-making by creating ‘politically-independent’ agencies with narrow mandate and little discretion (e.g., the independent central bank, independent regulatory agencies) does not eliminate politics from policy-making but only substitutes one type of politics with another (e.g., politics surrounding the central bankers vs. politics surrounding the officials at the ministry of finance).

The second reason is that the economy inevitably embodies various power relationships, which will not be eliminated even if all government regulations are abolished: (i) structural power coming from imbalances in income and wealth; (ii) the power to discriminate; (iii) the power to dictate things within organisations (such as corporations and the government); and (iv) the power to make people think what you want them to think. Superior answers may discuss at least some of these power relationships in detail.

The third reason why the economy can never be free of politics is that markets themselves are political constructs, in the sense that 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. This means that we see a particular market as ‘free’ only because we so totally approve of the institutions that define its boundary. Superior answers may give some examples of these institutions: (i) who can participate (e.g., stock market listing rules, professional qualifications, immigration control, social conventions); (ii) what can be traded (e.g., ban on trading of child labour, human organs, firearms); (iii) the rights and the obligations of the market participants (e.g., restrictions on what you can do with your land); (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 political views and therefore different notions of what a ‘free market’ is.

3. Given the political constraints, there will never be a coherent system of economic governance in the European Union.' Discuss.

The political imperative to retain national sovereignty and thus retain the confederal structure of the EU means that there will not be full fiscal union and thus with a heterogeneous Eurozone economic structure, there will not be effective fiscal transfers to create an optimal currency area. Also, without a fully federal administrative system, there cannot be effective enforcement of any initiative to establish a coherent system of economic governance. Given the imperative of the domestic political agenda, national governments will always vitiate EU regulations when these are inconsistent with national political objectives.

Given the inefficiency of the wage-price adjustment mechanism due *inter alia* to social legislation, an optimal currency area cannot be accomplished by the free-market, *viz.* price adjustments to alter the real exchange rates of Eurozone countries, and so compensate for the heterogeneous economic structure of the Eurozone. Given that migration is limited, and is predominantly comprised of the prime working age group, migration has not solved the Eurozone's problem. So, neither of these mechanisms can create a coherent system of economic governance as alternatives to fiscal union.

4. 'The political accord in British politics between 1945 and 1979 proved to be effective in delivering the outcomes which the electorate and the politicians wanted.' Discuss.

Candidates need to define the political accord. It is in part a consensus on the principal policies and a limited ideological convergence on the economic and social policies from the later 1950s. There were disagreements on industrial and education policies between the major parties.

The accord broke down before 1979 in respect of economic policies with the failure of state planning in the 1960s and stagflation from the mid-1960s, which the Keynesian paradigm could neither explain nor yield a policy prescription to solve. Also, the accord had been vitiated with the cancellation of the all British nuclear defence programme and a reversal of European policy by the beginning of the 1960s, and an acceptance of the end of empire once the 'illusion of grandeur' had been dispelled by the Suez crisis.

The desired outcomes were not delivered as stagflation grew, real wages stagnated and the incidence of strike action grew. Britain's decline as a great power was also a negative outcome.

5. 'Margaret Thatcher's government was a radical one, but Tony Blair's New Labour government was much more in accord with the wishes of the electorate.' Discuss.

Thatcher's government was only radical in terms of economic policy, and despite alienating parts of the electorate with the 'shock-therapy' introduction of her economic policies, the fact that the Conservative government lasted 18 years indicates there was some accord with the wishes of the electorate. In terms of foreign, defence and to some extent European policy, Thatcher's government was not radical, continuing policies of predecessor governments.

New Labour's economic and social policies were perhaps more in accord with the wishes of the electorate as Thatcher had moved policy further right than the median voter. However, Blair and President George W Bush's wars in Iraq and Afghanistan would discredit Blair and define his legacy. These wars were not consistent with the wishes of much of the electorate.

6. In what ways was the Great Recession of 2008 different in nature, and in how it was dealt with by British governments, from other major economic challenges Britain has faced since 1945?

Candidates need to give some interpretation of the pertinent characteristics of 'economic challenges'. The great recession of 2008 had causes outside of the purview of the British government, whereas for most of the earlier economic challenges, this was not the case. However, the deregulation of the financial services industry and the already (pre-2008) expansionary fiscal stance of the Brown government (which limited a counter-cyclical expansion) contributed to the extent of the Great Recession in Britain.

Although the magnitude of the GDP contraction was massive as the result of the Great Recession, the level of unemployment and levels of social distress were lower than during previous challenges.

The 'productivity deficit' of the British economy as reflected in the devaluations of sterling in the Bretton Woods system in 1949 and 1967 was a challenge, as was stagflation from the mid-1960s. The OPEC oil price hikes of the '70s made stagflation worse, but it was already occurring domestically.

The greatest post-war unemployment levels and social distress occurred in the early-mid 1980s as a consequence of the 'shock-therapy' introduction by Thatcher of her neo-liberal economic policies.

7. (a) How do legal institutions affect economic development?

(b) What is the difference between common law and civil law legal systems?

(c) Does the empirical evidence suggest that legal systems explain differences in economic growth across countries?

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.

8. (a) What is social capital?

(b) In order to measure social capital, is it better to use attitudinal data or participation data? Please provide examples to illustrate your argument.

(c) How does social capital affect human capital in the economy?

Debate about definitions, but social capital can be thought of as norms and networks organised on the basis of communities. Need to discuss trust data, membership data and problems with all of these. Putnam's work is important here. Evidence from Knack and Keefer study and others that social capital increases growth and is important for it, in addition to physical, natural and human capital. Relationship between social capital and human capital is that they are strategic complements. More human capital increases social capital and vice versa.