CURRENT FINANCIAL CRISIS AND ECONOMIC SLOWDOWN: DISCUSSION ON THE ECONOMIC ROLE OF GOVERNMENT

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Abstract

The majority of developed economies are currently facing the economic slowdown, which has its roots in global financial crisis, caused predominantly by mispricing in the (credit) markets. Accordingly, there has been a growing tendency for increased governmental interventionism in order to help overcoming the current financial and economic crisis. However, although it may seem plausible, under current conditions, to adopt more economic interventionism in order to correct market outcomes, it should be noted that also government failures exist, which can be quite substantial and can even outweigh the benefits of interventionism. Therefore, although governmental interventionism may be warranted to promote stabilisation of the existing economic situation, we should be aware of its perils and limitations. The purpose of the paper is to discuss those perils and limitations of governmental interventionism in the context of the preferred economic role of the government in the future.

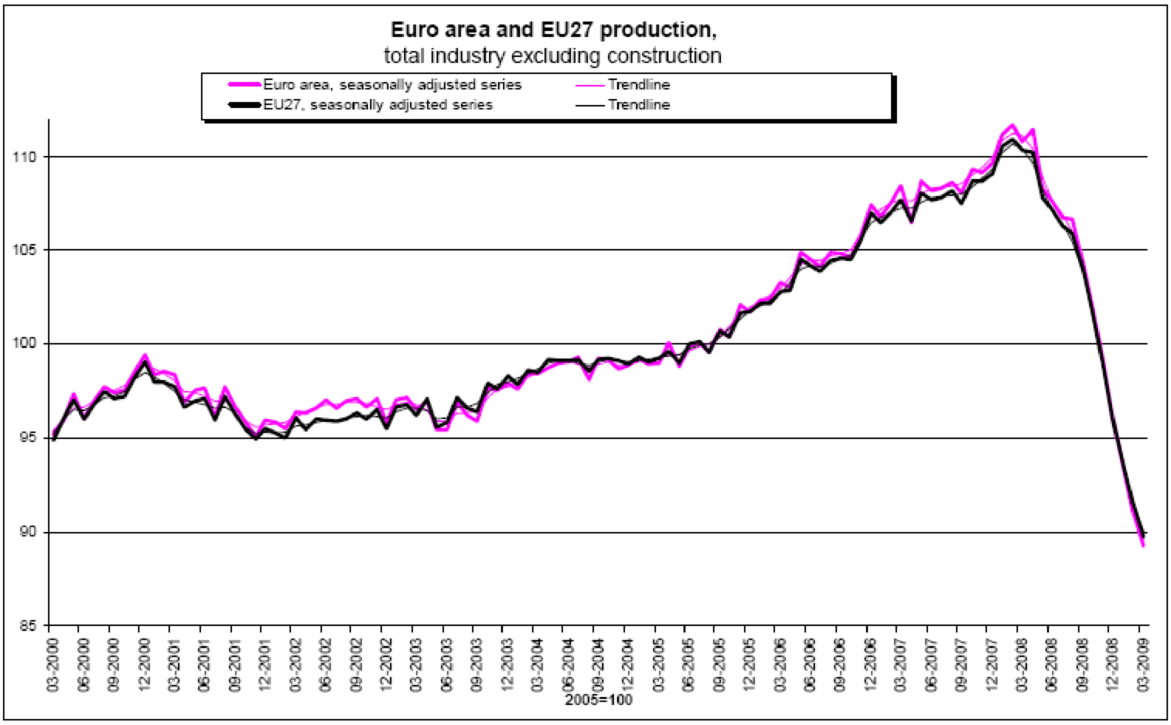
Keywords: *economic slowdown, market failures, governmental failures, interventionism*

JEL codes: *H10, E62*

1. Introduction

The majority of developed economies are currently facing the economic slowdown, which has its roots in global financial crisis, caused predominantly by mispricing in the (unregulated) (credit) markets, especially in the United States. As already pointed out, the fundaments of financial crisis can be found, among others, in pretty much unregulated markets for credit default swaps, which caused their mispricing and resulted in so-called credit bubble. Namely, the investors hedged their debt investments with the insurance of the credit default swaps to reduce their risk at abnormally low costs, so they were able to borrow at extremely low premiums to default-free interest rates. However, mortgage defaults, as side-effect of unrealistic expectations of ever increasing real estate prices, caused that systematic risk premiums began to rise across all debt instruments, resulting in a fall in debt prices, which led to financial crisis.[1] Consequently, the liquidity squeeze and credit crunch affected also the overall economy, causing its slowdown. Although the crisis began in the United States, the openness and mutual interdependence of global economies contributed to its spread with certain time-lag to other (developed) economies. For instance, in the EU industrial production also declined by almost 20 % in March 2009 compared with March 2008, as can be seen from figure 1.

Figure 1 Industrial production in the EU, 2000-2009



Source: Eurostat (2009)

2. Policy-making in current economic situation

As a consequence of economic slowdown, the majority of affected countries started with plans to stimulate the economic activity, both with monetary and fiscal policy instruments. For instance, the central banks try to increase the credibility, reliability and liquidity of banking and overall financial system, whereas governments are trying to reduce taxes, subsidise the enterprises, increase public spending and investment activities etc. For instance, European Commission prepared in 2008 the European Economic Recovery Plan in order to fight the economic slowdown on common European level. Its basic idea is to increase the demand and confidence in the economy by increasing purchasing power, thereby

[1] More on the background and the effects of 2008 financial crisis see Murphy (2008).

stabilising the economy. The plan focused on increased public transfer expenditure in order to stimulate the consumption of low income groups, which have higher tendency to consumption, lower (income) taxation and social contribution to decrease the labour costs and thereby increase the employment, lower consumption taxation (and increased subsidisation) in order to increase the consumption, increased credit guarantees and subsidies in order to compensate for high interest rates and ease the credit crunch etc.

Notwithstanding, these activities, more philosophically termed as governmental economic paternalism, have roots in Keynesian economic theory, where economic slowdown can be seen as the reason for governmental interventionism in the economy in order to stabilise it and promote its growth (see Keynes, 1936/1987). This theory prevailed in economic policy making from 1930's, which were the times of great economic depressions, such as that in the United States[2]. Although the theory lost its ground and effectiveness in policy making in the 1970's, when stagflation was the major economic problem of society, and was subsequently marginalised by more effective supply-side economics and policy-making, it seem that is now gaining its ground again.[3] Namely, the recovery plans of the majority of countries are more or less demand-side oriented – basically, economic stabilisation should be assured by maintaining adequate demand for goods and services by appropriate changes in taxes, government spending, and borrowing.

3. Rationale for governmental interventionism in crisis situation

In the period of economic crisis the focus on governmental interventionism is quite natural as governmental spending, tax and regulatory programmes can be changed drastically and quickly. In contrast, any attempt to foster greater business investments, such as by lowering corporate income tax rates, allowing faster depreciation of capital goods, or by lowering interest rates, would require both appropriate and time-lagged decisions by businesses (Greenhut and Stewart, 1983). Similarly, it is often assumed that economic crisis shows that private sector lacks certain abilities to run the economic activity efficiently – in

[2] During the Great Depression in the 1930's in the United States, output fell by 30 percent and unemployment rose to 25 percent (see Colander, 2001).

[3] It is worth mentioning that the “antagonism” between government and market, which has characterised recent decades, is a relatively new phenomenon. Over the history, one very important task of the government has been to create well-functioning markets by providing legal framework, standards, credit, physical infrastructure and, if necessary, to function temporarily as an entrepreneur of the last resort. It was recognised by Keynes that the more troubled the times, the worse does a laissez-faire system work, meaning that targeted government action is needed. However, as Reinert implies, in the case of both the business and the government, the problem of its growing size and complexities causes diseconomies of scale, which in turn limits their organisational capabilities. Therefore, the real issue nowadays is that targeted government action requires a strong, but not necessarily a big government (for further reading see Reinert, 1999).

this context, government should intervene as it has (somehow) abilities to run the economy that are lacking in the private sector and it (somehow) knows what is the best for the economy through so-called incentive legislation (Tanzi, 1997). However, the literature can provide various examples of pitfalls of demand-oriented policy making in practice (also called government failures). Those failures can be contributed to (Stiglitz, 2001):

- Limited control over private market responses and limited information. Namely, the consequences of many governmental policies are complicated and difficult to anticipate (i.e., increased health care spending in recent years), notwithstanding the fact that the problem of free-riding and rent-seeking exists.
- Limited control over bureaucracy and limitations imposed by political institutions. Namely, government designs legislation, but implementation of it is handed to government agencies, meaning that the principal-agent problem occurs. Besides, politicians tend to act in order to satisfy special interest groups, as well as voters that usually prefer simple and quick solutions to complex and long-range problems.

4. Some possible perils and limitations of governmental interventionism

In the context of previous chapter, it should be noted that governments can have a crucial role to play in accelerating economic stabilisation and development through their spending and regulatory activities, thereby overcoming market failures. However, distortion and misallocation of government expenditure and regulatory activities is common, reducing the extent to which government interventionism can play a positive role in the stabilisation and development process. The common observation exists that there is substantial government failure, for instance in various subsidies and investments in large infrastructure projects, two most common tools of stabilisation policies, which among others allows also political rent extraction (Keefer and Khemani, 2003). Following, the discussion is focused on several possible perils and limitations of demand-side oriented policy-making, especially in the long run, although, it should be stressed again, it is quite suitable in current economic situation.

First of all, it is to be taken into account, that some historical facts, combined with current organisation and economic conditions in modern societies, show the limited ability of government to stabilise the economy, meaning that there should be some scepticism about the possibility of government to substitute markets. For instance, a lot of evidence exists about the (in) efficiency of state-led development in practice, a system that was extensively exercised in the 1960s and 1970s in some group of less developed countries – those policies considered state control and economic planning, public investment and protection from the volatility of the world market as the key elements in economic development. Namely, those policies had poor dynamic properties and failed in the 1980s with debt crisis (Paldam, 2003). Consequently, the process of privatisation was initiated.

Second, today's fiscal situation of the majority of governments is quite different than it was almost century ago. Namely, the vast majority of countries has experienced considerable growth in government expenditure (both in absolute as well as in relative terms), as can be seen from table 1. The problem is that increased government spending in crisis usually cannot be simultaneously decreased in periods of economic growth. For instance, Hercowitz and Strawczynski (2001) have developed an interesting hypothesis when studying the role of business cycles in the phenomenon of increasing government spending/GDP ratios in the OECD countries. They observed that so-called cyclical ratcheting exists, describing the fact that while countercyclical spending is performed in recessions, high tax revenues in expansions make it difficult for governments to resist pressure from interest groups to reduce spending symmetrically. Namely, Keynesian economic policies should be affected by short-sighted considerations, where increased spending during recessions is likely to be politically attractive, but in expansions usually various interest groups prevent decreasing of spending.

Table 1 General government expenditure as a share of GDP in selected industrial countries, 1870-2000

Country	*Late 19th Century (1870)*	*Pre World War II (1937)*	*1990*	*2000*
Australia	18.3	14.8	37.7	33.7
Austria	10.5	20.6	49.3	48.0
France	12.6	29.0	49.9	48.9
Germany	10.0	34.1	45.7	43.3
Italy	13.7	31.1	53.8	44.6
Japan	8.8	25.4	31.9	36.8
Norway	5.9	11.8	51.3	40.8
Sweden	5.7	16.5	60.8	52.5
Switzerland	16.5	24.1	30.9	34.1
United Kingdom	9.4	30.0	42.3	37.6
United States	7.3	19.7	34.8	33.3

Sources: Tanzi and Schuknecht (2000); Gwartney, Holcombe and Lawson (1998); OECD (2001)

Besides, empirical research seems to present strong evidence that a large government sector negatively affects economic growth. For instance, Barro (1990) or Dar and AmirKhalkhali (2002) predict that the negative effect should be expected in countries where the size of government sector exceeds a certain threshold, meaning that a complex and non-linear relationship between government spending and growth exists. Barro (1990) pointed out that different sizes of government have two effects on growth rate. Namely, an increase in taxes reduces growth rate through disincentive effects, but an increase in government spending raises the marginal productivity of capital, which raises the growth rate. He argues that the second force dominates when the government is small, and the first force dominates when the government is large. Consequently, the effect of increased government spending on economic growth should be non-monotonic and some optimal size of government should exist. He showed that the government services are "optimally" provided when their marginal product equals unity (so-called Barro rule). Interestingly, based on empirical findings Barro plotted an inverted U-shaped curve showing the relationship between growth rate and government expenditure ratio, latter popularised as the Armey curve. As can be seen from Table 2, the calculations indicate that the majority of analysed European countries find themselves on the downward sloping part of their Armey curve, meaning that government spending ratio is above its appropriate level. This should indicate very limited possibility for governmental interventionism in the economy, although it would seem possibly plausible in current situation. Besides, the real issue in the majority of developed countries is to insure long-term sustainability of their government finances, as the increased pressure exists on the growth of expenditures, not just by current economic situation, but predominantly due to demographic changes with their pressures on health and social security spending.

Table 2 Armey curve peak (1950-1996) and the size of government expenditure

Country	*Size of government, % of GDP in 1996*	*Armey Curve peak (% of GDP)*	*Percentage change (current to peak)*
Austria	50.80	41.00	-19.29
Belgium	52.97	41.89	-20.92
Denmark	59.80	46.43	-22.36
Finland	58.74	39.38	-32.96
France	54.73	42.79	-21.82
Germany	48.72	38.45	-21.08
Ireland	39.60	42.48	+7.27
Italy	44.90	37.09	-17.39
Netherlands	51.97	44.86	-13.68
Norway	46.62	47.16	+1.16
Sweden	65.02	44.40	-31.71
United Kingdom	43.82	43.19	-1.44

Source: derived from Pevcin (2008)

Third, economic globalisation of the last decades has, according to Lipsey (1997), dramatically changed the ability of national governments to control domestic economy, basically putting the government from „driver's seat“ to „back seat“ in its ability to control the economy. Namely, the number and the amount of cross-border economic transactions as well as international spill-over effects have increased, thereby very limiting the ability of government to control the economy. Basically, globalisation more or less requires international coordination of activities, even those emerging by global economic slowdown, meaning that the role of international and transnational institutions increases, predominantly in the form of various clubs. Governments alone are often helpless when dealing with external shocks. Besides, as Ott (2002) stresses, there are more weak than strong governments today, which is, according to Reinert, great obstacle for implementing efficient policies. As Ott points out, the weakness of governments can be seen from numerous protests accompanying the meetings of government officials – protesters do not blame markets for the rise in differences in the distribution of income and wealth due to globalisation, but governments for their inability to correct their own failures.

Fourth, in the years of economic expansion, the majority of government did not solve the problem of fiscal deficits and public debt, meaning that they did not prepare the states for possible bad times. Namely, it should be noted that one of the main implications of high government spending in the crisis situations is that large probability exists that government expenditure will exceed tax revenues, which usually decrease in economic slowdown, meaning that budget deficit occurs that attributes to increased public debt. Over the long run, persistent deficits result in structural gaps in government finances, meaning that they become increasingly unsustainable.[4] Besides, structural gaps can cause fiscal insolvency, which could be ceased by servicing government debt on contractual terms. It is very likely that non-payment of debt has macroeconomic consequences for economic growth in the form of “debt overhang” effects on domestic investment and capital flight (Montiel, 2003).

Fifth, the voters are becoming less and less benevolent to increased governmental spending activities, especially to those that are redistributive or stabilising in their nature. The causes for this decreased benevolence can be found predominantly in political and social factors, as modern societies are becoming more and more heterogenic, meaning that voters are less inclined towards redistribution and spending activities that favour minority or special

[4] Evidence suggests that, by comparing both expenditures with tax revenues and debt with capital expenditures, increasing structural gaps after the mid-1970s have existed in developed OECD countries (see Bailey, 2004). Those gaps were not present in 1930’s.

interest groups. This can be pointed as one of the socio-political factors for pressures on welfare state decomposition in modern societies (see Pevcin, 2009).

Sixth, as Morck (2009) recognises, large pyramidal controlled business groups are today the predominant form of business organisation, in particular in smaller (but industrialised) countries. The problem is that such business organisations are subjected to agency problems and rent-seeking activities, even possibly becoming an obstacle to development of market institutions and promoting growth – namely, those organisations can enlarge the economic volatility and instability due to the possible systematic, and not just firm-specific, corporate misgoverning.

5. Concluding reflections

The majority of developed economies are currently facing the economic slowdown, which has its roots in global financial crisis, caused predominantly by mispricing in the (unregulated) (credit) markets. Accordingly, there has been a growing tendency for increased governmental interventionism in order to help overcoming the current financial and economic crisis. However, although it may seem plausible, under current conditions, to adopt more economic interventionism in order to correct market outcomes, it should be noted that also government failures exist, which can be quite substantial and can even outweigh the benefits of interventionism. Those failures can be found, for instance, in increased rent-seeking activities of the individuals, the possibility of inconsistencies of policies in space and time, the irreversibility of policies and limited control of policy instruments. Furthermore, it should be also acknowledged that the majority of developed countries are fighting to insure their fiscal sustainability, meaning that the expansion of interventionism can be limited due to the fiscal constraints. Therefore, although market failure argument as the background of governmental interventionism may be warranted to promote stabilisation of the existing economic situation, we should be aware of its possible perils and limitations.

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