GOVERNMENT, WELFARE AND POLICY

ECO-6006Y

Time allowed: 2 hours

Answer THREE questions, ONE from each section. Each section has equal weighting.

Notes are not permitted in this examination.

Do not turn over until you are told to do so by the Invigilator.
SECTION A

1 Discuss the advantages and disadvantages of presidential versus parliamentary systems, with reference to economic theory and evidence.

2 Most rich countries are democratic. Why?

SECTION B

3 Use economic theory to discuss the effects of labour immigration on workers’ wages and on output in the receiving country, and compare the theoretical predictions with the existing evidence.

4 Define insurance, and discuss at least one argument for and against government provision of insurance. Give an example to illustrate your arguments.

SECTION C

5 “Cost-benefit analysis is a flawed procedure, which should not be central to public policy decisions” [Frank Ackerman, economist]. Evaluate the merits of this claim.

6 Successive reforms of Higher Education policy in the UK have increasingly transferred costs away from the public, towards students. Why have governments done this? Is the transfer of costs justified?

END OF PAPER
ECO-6006Y Exam Feedback

General comments:

Overall, performance on the exam was very good. The mean mark was 65.12, with 78% of students achieving a 2.1 or above. No-one failed the exam.

Q2 and Q6 were clear favourites in their sections, while section B is nearly evenly split between the questions. Average marks across questions are very similar; there was no one question that students struggled with, indicating that the choices provided within sections were sufficient, and that students had a good grasp of a wide range of concepts taught.

Many students demonstrated a very good understanding of the theory behind public policies, and quite a few were able to (correctly) recall (some of) the evidence discussed in the lectures and seminars, which gave extra marks. Too many however were not clear in definitions of basic concepts like what an insurance or a presidential system or a democracy is. It is important to clearly define concepts in a discussion.

Guideline answers:

SECTION A

1. Discuss the advantages and disadvantages of presidential versus parliamentary systems, with reference to economic theory and evidence.

A good answer will:

Describe the key differences between presidential and parliamentary systems. A leader who is elected separately from the legislature, typically with fixed terms, and can veto but not usually propose legislation (but may have other executive powers); versus a leader who is elected from within the legislature, governments can fall by a no-confidence vote.

Give some theory on what we might expect. One good source is Persson and Tabellini 2003.

- Presidential systems have more checks and balances; policymaking may be more public; this could improve accountability.
- Direct election of president could also improve accountability.
- Parliaments may have more cohesive parties, since losing a vote can lead to losing power. This may reduce pork-barrel spending on individual districts (and perhaps increase spending targeted to a party’s broad support base).

Discuss the empirical evidence:

- Cross country evidence on corruption, e.g. Treisman 2007, is weak.
- P&T 2003 find presidential regimes have less government spending. Be aware of caveats about the evidence. Cross-country regressions with
small N; countries have other features like FPTP vs proportional representation; correlations with e.g. culture and geography.

- A really good answer might mention some attempts to avoid these problems, e.g. looking at US mayors which can be council-manager or mayor council (roughly like presidential vs parliamentary)

2. Most rich countries are democratic. Why?

A good answer will:

Discuss issues of definition and measurement of democracy; ideally, mention narrow vs broad definitions

- narrow definitions treat democracy as regular elections, broad ones consider supporting institutions like free speech, ease of participation, the rule of law. Perhaps mention e.g. Polity.

Consider how non-democracies might work (unconstrained autocrat? Rule by a rich elite?)

Be aware of some basic facts: the number of democracies has increased over the past 200 years and simultaneously countries have got richer; most rich countries are indeed democratic and most very poor ones are autocratic. There’s no correlation of growth rate with democracy, however.

Consider the possible explanations. Democracy -> wealth; wealth -> democracy; or an unmeasured third variable (e.g. long ago critical junctures). And discuss some theory:

- Olson (1993) roving bandit theory which argues that democracies are (potentially) more encompassing, hence tax less.
- BdM’s selectorate theory argues that winning coalitions are smaller in non-democracies, so rulers can keep their w.c. happy by redistribution rather than efficient public goods.
- Other arguments are possible – e.g. that democracy leads to short-termism or inefficiently high taxation.

Ideally, be aware of the different empirical attempts to discover a link from democracy to growth, including modern fixed effects approaches.

Better still, be aware of some models and/or empirics on the causes of democratization, e.g. Acemoglu and Robinson on the West and the franchise.

SECTION B

3. Use economic theory to discuss the effects of labour immigration on workers’ wages and on output in the receiving country, and compare the theoretical predictions with the existing evidence.

Answer: Economic theory predicts that wages in the receiving country will go down in
the short-medium run, as the factor labour becomes more abundant and cheaper with immigration. In the long run, wages should be unaffected as production of labour-intensive goods increases (Rybczynski theorem in Heckscher-Ohlin model of trade). (Bonus points for differentiation between short and long term.) The empirical evidence usually differentiates between skill levels of immigrants and native workers, and also looks at previous immigrants. The overwhelming evidence for the US is that effects on native workers’ wages fluctuate around zero, even when considering the most vulnerable groups (those directly competing for jobs with immigrants). Students might describe the study on the Mariel Boatlift that we discussed in a seminar. The smaller literature on Europe tends to be more pessimistic, i.e., there is often a small but significant negative effect on native workers’ wages. This effect tends to be especially pronounced in countries with more rigid labour regulations that make it more difficult for firms to respond to changes in the labour market. Several studies for Germany show that the negative wage effects of immigration have gone down over time as labour market rigidities have lessened (bonus points for this). In general, results for Europe and the US also find that the biggest (negative) wage effect is felt among previous immigrants. As regards production, both theory and evidence show that overall output increases in the short and long term. Bonus points if the student differentiates between economic sectors.

4. Define insurance, and discuss at least one argument for and against government provision of insurance. Give an example to illustrate your arguments.

Answer: Insurance is a promise to make some payment in case of a particular event, in exchange for a payment, called a premium. Social insurance aims to protect individuals against income loss from various causes. Arguments for government provision include those based on market failure: information asymmetry leading to adverse selection; externalities; administrative costs and returns to scale; redistribution and equity; paternalism. The big argument against government provision is moral hazard. There are many examples, from healthcare to pensions to social care…

SECTION C

5. “Cost-benefit analysis is a flawed procedure, which should not be central to public policy decisions” [Frank Ackerman, economist]. Evaluate the merits of this claim.

Cost-benefit analysis is a tool that monetizes all costs and benefits of a public investment or policy intervention, with the aim of aiding governments to make best possible use of public funds, thereby ensuring efficiency of public investments. The Green Book states that all investment decisions should be subject to a CBA. Theoretically, all projects that have a positive net present value should go ahead, as this will ensure increases in social welfare. Practically, it can also be used to compare different methods to achieve a particular goal, ensuring the best alternative is chosen. The issue – and the critical factor upon which a successful CBA depends – is an accurate monetization of all costs and benefits of the project. Monetization is crucial as it provides a common currency for comparison of all of the impacts of a project. For example, it allows one to compare changes in utility between two people using WTA/WTP, or between monetary costs and environmental benefits.
Issues with CBA:

**Discounting:** Usually, the majority of costs for a project are felt early on in the project, but the benefits can accrue over a long time period. Therefore, an appropriate discount rate must be chosen for valuing the future. However this is not always that simple – the case of Nordhaus vs Stern on the impact of climate change shows that very different valuations arise from different ethical positions on how the future is valued.

**Non-market valuations:** Whilst it is easy to value goods that are traded openly on a market, many of the impacts of large projects are not reflected through a direct price mechanism. Whilst prices of some goods can be inferred using revealed preference methods through marginal changes in, e.g. health (value of a statistical life), risk (hedonic pricing) or environment (travel-cost), other goods cannot. Even using these methods are subject to some inaccuracy in estimation – very rich data is required to accurately measure these sorts of impacts. Where revealed preference methods are not possible, it may be that a contingent valuation (i.e. a hypothetical survey) is the next best approach – however there is evidence that valuations by individuals in surveys can be inconsistent and prone to bias. The second issue here is for impacts that result in non-marginal changes. Whilst marginal changes can be compensated for to ensure increases in social welfare, non-marginal changes may not. Loss of life, for example, is non-marginal and non-reversible. More generally, there is still some controversy about whether some impacts can or cannot be valued in monetary terms, or may be viewed as priceless.

**Uncertainty:** In many cases, the impacts of projects cannot be predicted with certainty, or there may well be unintended consequences that are not taken into account in the evaluation. This will affect the accuracy of any CBAs.

Finally, some projects are so complicated that human error in determining all of the costs and benefits may result in incorrect conclusions. It is very difficult to map all benefits and costs.

However, despite these flaws CBA is still used to evaluate investment projects. The requirements are that all reasonable costs and benefits are included and valued as accurately as possible – because, if carried out correctly, it is the best method we have for impact assessment.

There are no alternatives that are as comprehensive as a CBA. Students may include more detail by giving examples from the lecture (lecture 1 in Spring) about valuing certain types of goods or methods used.

6. Successive reforms of Higher Education policy in the UK has increasingly transferred costs away from the public, towards students. Why has the government done this? Is this justified?

Over the past 20-30 years, the UK has experienced increasing participation in Higher Education, partly driven by demographic changes, but also in part due to reforms of education policy. Students should give a brief account of policy changes to provide
context of increased participation. The expansion of HE to include polytechnic colleges and the introduction of tuition fees in 1997 (Dearing Review) provided the support for more young people to go to university. The Labour Government set a target of 50% participation rates, generating social norms around going to university, and improved access to loans lead to greater participation rates over the 2000s. However, increased participation put pressure on government budgets at a time when HE was heavily subsidized, therefore funding per student – and consequently the quality of HE – fell as participation increased. To ease the pressure on public finances, the tuition fee was raised to £3000, and then £9000, with a restructuring of how this was repaid in the Browne Review. At the same time as the Browne Review, the public spending review taking place at the same time (and in the time of the Great Recession) recommended that public spending on university teaching should be cut to include only STEM subjects. Therefore, almost all of the cost of tuition has been transferred to students from 1997 to 2013.

In order to determine whether this is justified, one needs to consider the distribution of benefits that result from HE investment. Human capital theory states that investment in education results in increased productivity, and therefore higher wages in the labour market. Research on the returns to education shows this to be true; in the UK, returns to HE are consistently estimated to be between 16-25%; and this has remained stable (at the mean) despite the increasing participation in HE. Note that here students may discuss that the variation in returns, due to over-education and over-skilling, has increased. There are also a significant range of private non-monetary benefits to education; for example – less likely to be unemployed, longer life expectancy and improved health outcomes.

Positive returns to education provide some evidence, at least, that individuals should bear the cost of HE, as they receive a significant benefit from doing so. However, there is evidence of significant social benefits to HE as well. For example, higher educated workers are less likely to rely on the state, improve social cohesion, are more likely to volunteer and contribute to charity, and have positive spillover effects on their work colleagues through improved productivity. Higher education is also a strong determinant of economic growth and technological change. (Note that students may list some, but not all, or suggest other social benefits not listed here). Therefore there is evidence that society benefits from HE participation as well as the individual, and therefore there is a strong argument that HE should be subsidized – in part – to encourage participation and reflect the distribution of benefits accrued.