What Is Necessary and What Is Possible in Today's Economic Policy: The Incentive Effects of German Economic Stimulus Packages

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Politik ist die Kunst, das Notwendige möglich zu machen.[1]
(Herbert Wehner, German politician, 1906–1990)

Richard Musgrave argued that government intervention needs justification (Musgrave 1959). In short, governmental economic activity should be structured around market failure. Reacting to such market failures is intervention motivated on efficiency grounds – politics then makes possible what is necessary. At the same time, it must be recognized that intervention is often subject to the same limited information that causes market failure. Moreover, a government managed by officials is often weak in the sense that actions are biased to serve short-term political interests. The current financial crisis is a good example of market failure and poor government performance. Necessary regulation of the financial sector, which was introduced to fight imminent market failure in the early days, became weaker – or, arguably, too weak – due to governments' choice to relax the level of intervention. As is evident by now, governments' choice to reduce intervention has created the failure of regulation. In the following, we briefly recapitulate the government failure that caused the crisis in order to lay the foundation for a better design of public interventions in the aftermath of the crisis.

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[1] Politics is the art of making possible what is necessary.

The roots of the crises: a brief overview

Let us distil complicated reality down to comprehensible patterns. It is well understood that the recent financial collapse has been caused by a policy package designed to encourage banks to give credits especially to those US individuals whose income situation is generally not sound enough to qualify for conventional loans. In other words, the problems on financial markets we observe today have their roots in the large scale deregulation of financial markets that has triggered a substantial increase in private income and wealth for a politically relevant number of people for an intermediate period of time. Deregulation of credit markets has resulted in increased private consumption and high inflows of capital and investment goods into the US economy.

The international repercussions were twofold. Germany as a major exporting country benefited from the international market imbalances. At the same time, German financial institutions suffered from a decline in the return on equity as a consequence of international competitive pressures in the banking industry. Accordingly, German banks prompted the German government for deregulation to increase their profitability and to reduce the likelihood of takeovers. Similar to other European countries in a like situation, the government pursued short-term national interests. Only recently has the failure of deregulated credit markets become public knowledge. The dilemma now is that a collapse of the financial system provoked by lax public regulation can only be prevented by drastic public intervention in financial markets. Moreover, consumers' higher exposure to the risk of credit default has reduced private consumption in the United States. The result is a drastic decline of incoming orders for the German export industries that had profited from the trade imbalances during the years of the credit boom in the United

States. Politicians now argue for government rescue packages to stabilize these so-called "core" industries.

Government objectives and incentives

The above summary of events is surely too brief. Nevertheless, it clearly demonstrates that any level of (de)regulation or fiscal policy is obtained as the outcome of a political process. Major players in this process are non-benevolent officials who choose policy instruments as to maximize support. Note that diverse government instruments are often substitutable in a second-best setting, albeit at some economic cost. Thus it is not only the set of available instruments that determines outcomes but also incentives. Public economic activity is often fuzzy and complex because complicated structures may be designed to serve special interest groups. This, in turn, creates a problem for policy evaluation, as an isolated view of a subset of public activity is meaningless. It is clear then that one should not celebrate the diverse public packages that have recently been adopted in many countries as the triumph of the welfare state over the market system, or as the triumph of collective action over anonymous markets. In politics it is often unimportant how one arrives at a specific allocation as long as one (at least roughly) achieves the politically desired outcome. As an example, the beneficiaries from capital market deregulation before the crisis now seem to opt for more regulation and more government intervention in order to externalize the costs of their actions. This turns out to be a truly Panglossian view on the world, as Cohen (2008) argues, as actors aim at making the best out of today's situation, thereby shirking any responsibility for the economy's problems in the first place.

Turning back to politics, surely there does not exist a system of imposed order in the Hobbesian sense; the representative democracies we observe today are naturally second-best since the Lockesian case for a government that respects individual freedom is imperfectly implemented. The political process creates a prisoners' dilemma in the sense that the government might prefer to offer deregulation as part of a policy package serving important particular interests. Even worse, the resulting consequences for efficiency and distribution are amplified by a second prisoners' dilemma resulting from the strategic policy choice to attract economic activity in international competition among governments. It seems reasonable that both dilemmas lead to a failure of governments in terms of standard welfare economics.

Given these very basic insights, the first question in the context of the present economic situation is whether economics is able to identify measures that are useful in reducing the negative consequences of the current crisis, given the absence of strong governments. The second question is whether the recommendations can, in fact, be implemented. The answer to the first question requires a ranking of measures, the answer to the second question requires mechanisms designed to ensure that politicians meet their participation constraint. As a matter of course, the answers to both questions are interdependent, and separate answers are only acceptable on the grounds of tractability and the convenience of the reader. The following discussion uses examples and is not meant to be exhaustive.

A short evaluation of German state guarantees and economic stimulus packages

In Germany we currently observe huge efforts to stabilize the banking system. To be sure, it is advisable to prevent a collapse of financial markets and avoid a bank run. Nevertheless, one should bear in mind what standard economic theory suggests: the short-sighted agents tend to externalize the costs of their own actions in a repeated game if they do not have to face a loss of reputation or some other penalty. More specifically, bank managers will clearly continue to pursue short-run optimization strategies in the absence of the risk of bank failure or negative effects on reputation. This is evident in the broad utilization of public guarantees by the banking industry that prevents bank failures and, at the same time, makes any individual bank almost undistinguishable from its competitors. The broad use of guarantees makes individual banks immune to the risk of reputation loss.

As a matter of course, the recent guarantees provided to the banking industry may be justified on the grounds of economic stabilization; the point here is that a corner solution where no bank fails is as undesirable as a corner solution where a bank run occurs. One should additionally note that an outcome with public guarantees that avoids bank failures might indicate that public intervention is designed to secure the market shares of domestic

banks in international governmental competition. In fact, attempts to harmonize banking regulation internationally to create a level playing field seem to have received substantial political attention in Germany only at the beginning of the crisis. Given that other countries have similar incentives, one should not be overly optimistic with regard to international harmonization.

Turning to economic stimulus packages, Germany has seen a substantial increase in government spending as a consequence of the economic stimulus packages I and II designed to dampen fluctuations in output and employment. One of the measures contained in these packages is a subsidy provided in 2009 and 2010 to workers on short-time working, aimed at avoiding spells of unemployment. Economic research documented in Sørensen and Whitta-Jacobsen (2005) and elsewhere suggests that the welfare costs of unemployment fluctuations are substantial and highly unevenly distributed across skills, with particular losses for low-skilled, low-paid and young workers. Not only because of these welfare costs, but also in view of the upcoming federal elections, providing this subsidy appears to be a reasonable choice of economic policy instrument from the government's perspective. Fast increasing unemployment rates tend to be adverse to incumbent government's electoral outcomes (Mueller 2003).

More generally, the underlying incentive problem of politicians with regard to several measures in the economic stimulus packages may be described as a divergence of private benefits and social costs. Politicians and parties gain political support from public spending which imposes a social – and usually higher – cost on tax payers. The political benefits may also explain why the German government, which usually tends to glorify the export-bias of the German economy (Germany – in a somewhat mercantilistic manner – prides itself to be the world's export champion), suddenly turns to stimulate notoriously weak domestic consumption rather than free-riding on other countries' efforts to stimulate their economies.

A similar reasoning applies also to the second measure that we would like to bring to attention: the wrecking bonus *(Abwrackprämie)*, a subsidy of 2,500 euros for scrapping and replacing used cars that is only paid out in 2009. It goes without saying that this subsidy is designed to increase the demand for cars in an attempt to stabilize the – highly important – German automobile industry in times where there is a dramatic drop in orders from the United States. This measure is already problematic *per se* because of – among other things – its adverse effects on environmental protection (gains in fuel efficiency of new cars are completely offset by the new cars' greater weight) and on used-car exporters: in 2006, these firms earned almost six billion euros in revenues by exporting more than 500,000 cars (Sinn 2009). The government's prioritizing is rather obvious here.

However, the consequences of the subsidy are more subtle. Consider a consumer who is exposed to the risk of getting unemployed. The consumer wishes to smooth his consumption path over time because of a declining marginal utility of consumption. The subsidy is only paid in 2009, implying that many consumers will revise their consumption plans. Those consumers stop saving and accumulate debt, especially in the low-income strata, who demand relatively inexpensive cars because the marginal effect of the subsidy is highest for those cars. Less savings mean that less collateral is accumulated. Hence, consumers make riskier decisions, anticipating that debt cannot be repaid in times of unemployment. To conclude, the simple model sketched here has the subtle effect that the subsidy targeted at the automobile industry to stabilize industry sales causes low income types to take up more debt (at least, welfare recipients are excluded from applying for the wrecking bonus – however, only after some political struggle). Furthermore it remains to be seen whether the scrapping certificates needed to receive the subsidy cannot be forged. Otherwise used cars will illegally be sold in other parts of the world. These considerations lead to the question of whether the political payoff generated by the wrecking bonus justifies its economic costs.

Finally, in Germany we have seen a dramatic decrease of incoming orders, especially in the export sector. This means that credit constraints may in fact become binding as expected future profits decline. However, the mere fact that debt financing becomes more expensive when expected future profits fall does not constitute a market failure that justifies public intervention. It has been argued, however, that present and future economic environments are characterized by uncertainty resulting in dysfunctional credit markets (Gonzales-Paramo 2008). While uncertainty could potentially constitute a market failure and might induce support for government intervention, it is also true that the distinction

between risk and uncertainty is hardly operational, since the probability distribution of profits is often – at best – private information. The firm will have little interest in making its private knowledge about true economic profits publicly available, as this would ultimately eliminate potential gains from strategic behavior. To see this we should understand that information is asymmetrically distributed between private agents and the public administration. Any signal given is thus not verifiable by the public, making it profitable for private agents to provide highly diffuse or strongly biased evidence of their future prospects in an attempt to attract resources from the public administration. It then seems obvious that any distinction between risk and uncertainty that is based on publicly available information is very likely strongly biased; this is creating a risk, namely that the definition of uncertainty is wide open for political capture.

Summary

The present discussion attempted to evaluate the benefits and costs of public intervention from the point of view of welfare economics. We tried to clarify that the political process might lead society to a different evaluation of public economic activity, with the risk that government caters to special interest groups and engages in international competition for economic activity. It should also have become obvious from the discussion that it is of primary importance to harmonize banking regulation provisions at an international level to guarantee an efficient functioning of financial markets. Public spending programs such as infrastructure programs are timely and can easily be ceased. Society that cares about distribution should stabilize employment with measures that do not have a large effect on firms' operations. Against this background the subsidy for short-time working is appropriate. Other measures appear to be less appropriate and rather driven by problematic incentives for specific actors in the political process – somewhat contrary to the idea that politics is the art of making possible what is necessary.

A measure that has not been used so far in Germany is broad-based tax cuts. It is certainly true that tax cuts might not have a large-scale effect on private spending; and broad-based tax cuts, almost by definition, cannot be targeted to help specific sectors. On the other hand, tax cuts lead to an increase in savings and investment; and, most importantly, broad-based tax cuts seem to be less vulnerable to political capture. However, taxpayers constitute a large and heterogeneous group, which may be one of the major reasons why tax reforms are currently not high on the political agenda.

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