economic Shocks

Defining a Role for Government

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Policy Study 35

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The Study in Brief

The objective of this study is to ascertain the appropriate role for government in responding to economic shocks. Economic changes can be thought of as lying along a continuum, from those that affect only an individual (such as loss of employment) to those that affect a significant subset of the population. Although this continuum suggests that a precise definition is unavailable, for the purposes of this monograph a change is considered an *economic shock* if it results in acute economic dislocations that are correlated across a significant portion of the populace of a region or economic sector. Thus, economic shocks lie at the extreme end of the continuum of change. Such a definition is appropriate for the study because far-reaching economic effects of this kind may, on a variety of normative rationales, be seen as too harsh for those affected for society to do nothing in response.

The study embarks on four main avenues of inquiry. First, it develops a taxonomy of shocks according to their source. Second, it outlines a variety of normative rationales that may, depending on the circumstances, justify some form of government intervention in response to a shock. Third, it describes the policy tools that are available to governments considering intervention. Then, it presents five case studies of shocks and governmental responses. The conclusion draws on the theoretical and empirical discussion to offer some lessons for policymakers.

Analysis reveals three sources of economic shock: nature, the market, and government. In the category of natural shocks lie natural disasters such as floods, earthquakes, and droughts, each of which can lead to extreme economic hardship for an entire region. Domestic and international markets can lead to economic shocks in a variety of ways. Domestic shifts in supply, such as those resulting from a change in technology, can be a boon for some people but a bane for entire sectors of the economy. Shifts in domestic demand can also lead to a shock. Internationally, shocks may arise because of shifts in comparative advantage or because of changing economic conditions, such as recessions, abroad. The final category of shock arises when a change in government policy harms a sector of the economy. For example, trade liberalization can create significant hardship for those industries that lack a comparative advantage relative to the new trading partner. Government mismanagement can also create economic shocks, as has been the case in the east coast cod fishery.

A variety of normative rationales are relevant to the case for government intervention in the face of shocks, and the study examines several. An efficiency perspective may favor intervention if market failures (such as insurance market failures) are present. Proponents of distributive justice tend to favor intervention if the shock harms those who are already not well off. The libertarian and corrective justice rationales generally oppose intervention unless the shock is caused by a wrong, perhaps on the part of government. Advocates of compensatory justice may support intervention to redress historical wrongs to groups that continue to suffer from them. Finally, communitarians are concerned about the preservation and encouragement of communities, which an economic shock may threaten.

The case for intervention depends on both the motivating normative rationale and the type of shock. Natural shocks, for example, are unlikely to attract interventionist recommendations from those who hold a libertarian or corrective justice viewpoint. On the other hand, shocks caused by government negligence may attract support for intervention from both perspectives. Efficiency advocates are unlikely to intervene in the face of most market shocks, given that the market is generally more effective than government in maximizing wealth. They may, however, recommend intervention in the face of natural shocks if market failure, particularly in insurance markets, precludes private preparations for the shock. Communitarians probably care least about the source of the shock, concerned as they are with its consequences for the vibrancy of an existing community.

A sizable range of policy tools is available to governments considering intervention. *Ex ante* tools — such as floodworks, subsidized information provision, and tax incentives — are implemented ahead of the shock to avoid or at least mitigate its effects.

Ex post tools — such as relief payments, retraining, and relocation assistance — come on the heels of the shock. Just as the normative case for intervention depends on the type of shock, the appropriate policy tool depends on the normative rationales relevant to the case for intervention. For example, *ex post* tools such as relief payments tend to run afoul of efficiency, given that parties anticipating such relief may not adjust their behavior to mitigate the effects of a future shock. On the other hand, communitarians, concerned about the preservation of a community's way of life, may view *ex post* relief as optimal.

The case studies reveal that governments, when intervening in the face of shocks, often do not succeed in advancing any of the rationales that would support such action. In examining natural shocks, we consider the experience in dealing with floods in the United States and Canada. In both countries, *ex post* government relief, in the form of subsidies and payments, has tended to crowd out private means (such as insurance) of dealing with potential flood damage. On the other hand, *ex ante* structural measures, such as the floodway in Winnipeg, seem to be effective in limiting the damage of flooding.

In responding to the two types of market shock this study examines — the 1970s' oil shocks and agricultural price volatility — governments did not do particularly well. As a response to the 1973 oil shock, price controls tended to exacerbate the dislocation by diminishing incentives to find new sources of energy. Moreover, controls could advance distributive justice concerns only crudely, given that they kept oil prices low for everyone, not just the poor. Marketing boards, the policy instrument of choice in dealing with agricultural price volatility, tend to favor large commercial farms, thus failing to advance communitarian and distributive concerns.

Government negligence in managing the cod stock was an apparent cause of the collapse of the east coast cod fishery, which the study consequently considers to be a government shock. Government is probably justified in providing fishery workers with some relief, perhaps to deter future negligence, perhaps as a matter of corrective justice, perhaps as a matter of distributive justice. Relief designed simply to preserve fishing communities, without addressing the problem of unemployment, has not proven successful, and these communities continue to shrink. Assistance with relocation or retraining is more likely to be successful, although experience with such programs reveals that they tend to have high numbers of dropouts and low job-placement rates.

Another government shock comes from trade liberalization. Easing the transition to freer trade through compensation of those harmed may be pragmatic in increasing support for welfare-enhancing liberalization; it may also be justified on distributive or communitarian grounds. Retraining has often been the policy tool chosen to ease the transition but, as noted, these programs are rarely unqualified successes.

In conclusion, a variety of normative rationales may justify government intervention in the face of natural shocks, market shocks, or government shocks. The means of intervention are also varied. Case studies of floods, oil and agricultural price volatility, mismanagement of the cod fishery, and trade liberalization reveal that governments often do intervene in the face of shocks. The most successful interventions do not attempt to defy an efficient allocation of resources in response to a shock. Thus, the evidence does not support relief payments after a flood; they simply result in higher costs from floods, since inhabitants of a floodplain anticipate the payments and do not adjust their behavior. A floodway, particularly if financed by those living on the floodplain, is more likely to offer an efficient solution. Interventions may be justified on the basis of distributive justice, but the case studies suggest that governments often fail to target assistance. For example, support to farmers historically has failed to target family farmers but rather has benefited both small farms and large commercial farms. Finally, while communitarianism may justify intervention in some instances, assistance designed to preserve a community without addressing long-term adjustment issues is probably doomed to failure. Cash transfers, rather than retraining, are unlikely to solve a community's problems.

Empirically, government programs in the face of shocks have not always been successful, and an omnipresent risk is that governments, perhaps because of interest group capture, will do society more harm than good when intervening. Nevertheless, we conclude that there will inevitably be some government intervention, often with a normative justification. Interest group influence will also tend to result in intervention. Policymakers and their scrutineers should, however, discipline the process by asking the right questions. First, what is the normative objective of the intervention? Finding the answer entails asking whether intervention is justified at all and whether government has available policy instruments that will advance the normative goal in question. Second, what policy instrument is most appropriate? Will it further the normative objective or hinder it? And what public and private costs will arise with its use? Although no one can guarantee that governments will not act in perverse ways, asking the correct questions can help to discipline them in responding to shocks. The case studies reveal that such discipline is needed.

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