

# Keynes, Pigou, Wicksell, Kahneman—and Fiscal Affairs

Ravi Kanbur

[www.kanbur.dyson.cornell.edu](http://www.kanbur.dyson.cornell.edu)

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# Introduction

## (1)

- It is a great pleasure to speak at this conference to mark the 50<sup>th</sup> anniversary of the Fiscal Affairs Department of the IMF.
- I have had a long standing relationship with FAD and with the IMF—not going back 50 years of course, but going back 30 years.
- In this talk I will start with a brief bout of self-indulgence and speak about my own relationship with FAD so you know where I am coming from.

# Introduction

## (2)

- After that I will move to locate FAD and FAD's work through the lens of relating it to the work of some great economists, the giants of our discipline: Keynes, Pigou (and Meade), Wicksell (and Buchanan), and Kahneman.
- Although my charge is Expenditure what I have to say will also apply to other aspects of FAD's work. However, I will focus primarily on the analytical rather than the institutional and management aspects of fiscal affairs.

# Outline

- FAD and me
- Keynes, IMF and FAD
- Pigou and FAD
- Wicksell, Kahneman, and FAD
- Conclusion

# FAD and me

## (1)

- I first came to FAD (and to the IMF) in 1985 at the invitation of Vito Tanzi, as a Visiting Scholar to work on Poverty, Income Distribution and Macroeconomic Adjustment.
- FAD took the lead at that time in breaking the taboo on discussing distributional issues as part of the Fund's work. My paper "The Measurement and Decomposition of Poverty: With an Application to the Impact of Macroeconomic Adjustment," was published in the IMF Staff papers in 1987. It has the dubious distinction of being the first paper in the IMF Staff Papers with the word Poverty in the title.

# FAD and me

## (2)

- A decade later I was on the staff of the World Bank as Chief Economist for Africa and interacting closely with the IMF on the joint Bank-Fund task force which designed the HIPC debt relief initiative. Although PDR was the lead department from the Fund side, FAD provided inputs on specific revenue and expenditure aspects of the fiscal dimension.
- We produced joint Board papers for the Boards of the Bank and the Fund which underpinned the subsequent negotiations.

# FAD and me

(3)

- Most recently I have again been a Visiting Scholar at FAD working with Mick Keen on informality in the fiscal context. We are arguing that nostrums such as “fiscal policy should aim to reduce informality” are analytically incoherent and deeply misleading for policy formulation.
- In between these three engagements I have had many other interactions with FAD.
- I have come to appreciate deeply the FAD ethos of technical excellence in the service of addressing concrete policy problems.

# Keynes, IMF and FAD

## (1)

- We are celebrating the 50<sup>th</sup> anniversary of FAD.
- But it is also the 70<sup>th</sup> anniversary of the IMF (and indeed of IBRD).
- It took twenty years for consolidation of fiscal affairs into a dedicated department.
- What would Keynes have said about fiscal affairs being an important and integral part of the IMF's mandate? Surprisingly perhaps, not as much as one might think.

# Keynes, IMF and FAD

## (2)

- Recall his famous 1943 International Clearing Union Paper.
- “...the nature of the problem and the experience of the period between the wars suggest four main lines of approach:
  1. The mechanism of currency and exchange;
  2. The framework of a commercial policy...
  3. The orderly conduct of production, distribution and price of primary products....
  4. Investment aid.....”

# Keynes, IMF and FAD

## (3)

- It is striking how little attention Keynes gave in his discussion of the Clearing Union to fiscal matters and indeed to internal matters:
  - “There should be the least possible interference with internal national policies, and the plan should not wander from the international terrain.”
- This should not surprise anyone familiar with Keynes’s response twenty years earlier to the Dawes Plan of 1924/5:
  - “The Dawes Committee divided the problem of the payment of German Reparations into two parts –into the Budgetary Problem of extracting the necessary sums of money out of the pockets of the German people and paying them to the account of the Agent-General, and the Transfer Problem of converting the German money so received into foreign currency.”

# Keynes, IMF and FAD

(4)

- Keynes's focus, in his debates with Ohlin for example, was almost entirely on the Transfer Problem, the "international terrain", rather than the internal policies needed to raise the resources domestically. Perhaps he felt that he had already made his point about the Budgetary Problem in *The Economic Consequences of the Peace*.

# Keynes, IMF and FAD

## (5)

- In any event, fiscal matters seemed to play little role in his (the UK Treasury's) 1943 White Paper on the Clearing Union, although of course he does say:
  - “the Governing Board may recommend to the Government of the member State any internal measures affecting its domestic economy which may appear to be appropriate to restore the equilibrium of its international balance.”
- This could be the entry point for Fiscal Affairs, but little further is said on the matter.

# Keynes, IMF and FAD

## (6)

- However, in a couple of places Keynes' 1943 plan touches on matters that are now recognizably FAD concerns:
  - “There is no country which can, in future, safely allow the flight of funds for political reasons or to evade domestic taxation or in anticipation of the owner turning refugee. Equally, there is no country that can safely receive fugitive funds, which constitute an unwanted import of capital, yet cannot safely be used for fixed investment.”
- To conclude then, it is perhaps not surprising that it took 20 years for FAD to be established, since fiscal affairs per se did not appear to exercise Keynes himself greatly in his design for the Bretton Woods Institutions.

# Pigou and FAD

## (1)

- Although the intellectual father of the IMF is Keynes, in many ways the intellectual father of FAD is Pigou rather than Keynes.
- Indeed, it would not be too much of an exaggeration to say that much of what FAD does on the analytical front is in effect implementing the framework of Pigou's 1920 classic, *The Economics of Welfare*.
- This is true whether we look at the taxation side or the expenditure side (assuming the distinction can be made)

# Pigou and FAD

## (2)

- This is not surprising since it can probably be argued that the whole of public economics is in effect implementing Pigou's 1920 framework:
  - “In Part I. it is argued....that the economic welfare of a community of given size is likely to be greater (1) the larger is the volume of the national dividend, and (2) the larger is the absolute share of that dividend that accrues to the poor.
  - Part II. is devoted to a study of certain principal influences of a general kind by which the volume of the dividend is affected, and
  - Part III. to a study of influences specifically connected with labour.
  - In Part IV. the question is raised in what circumstances it is possible for the absolute share of the dividend accruing to the poor to be increased by causes which at the same time diminish the volume of the dividend as a whole....”

# Pigou and FAD

## (3)

- Following Part I, those implementing this agenda see themselves, in effect, as the guardians of a broadly Benthamite Utilitarian social welfare function which exhibits egalitarianism. I think this would be a fair description, by and large, of FAD staff as well.
- However, the Pigouvian framework has also exercised a strong influence on Public Economics with its twin tendencies to (i) postulate a trade off between efficiency and equity and (ii) view the advancement of either as compartmentalized in terms of policy instruments.

# Pigou and FAD

## (4)

- The tendency to separate out efficiency from equity is seen in James Meade's "The Intelligent Radical's Guide to Economic Policy."
  - "The intelligent radical is at heart an incurable egalitarian and is appalled by the gross inequalities which he observes in modern society. But he desires to cope with them by methods which are compatible with the maintenance of a free and efficient economic system. . . ."
- This deep rooted tendency in economics to separate out efficiency from distribution in the policy domain is of course crystallized in the modern twin fundamental theorems of welfare economics, in particular the second theorem. Given the conditions of the theorem, including a sufficiently rich set of lump sum transfer instruments, efficiency can indeed be separated from distribution.

# Pigou and FAD

(5)

- But the point is that the conditions don't hold, so that for every policy targeted at efficiency there is a distributional consequence, and for every policy targeted at distribution there is an efficiency consequence.
- To its enormous credit, FAD recognized early on that some efficiency enhancing policies can have negative distributional consequences, and that some distribution enhancing policies can have positive efficiency consequences.

# Pigou and FAD

## (6)

- I have already mentioned how its work in the 1980s and the 1990s broke the taboo in the Fund on bringing distributional considerations to the table in Fund programs.
- And its work in the 1990s and the 2000s on food and energy subsidies has drawn attention to the efficiency enhancing possibilities of targeting subsidies more sharply to the poorest.
- The most recent work on energy subsidies brings us back full circle to Pigou, showing how these subsidies are wrong on distribution but also wrong on efficiency—they are subsidizing an activity on which there should in fact be a Pigouvian tax.

# Wicksell, Kahneman and FAD (1)

- So far so good. FAD, in my view, has been exemplary in implementing the Pigouvian framework applied to the concrete policy problems of the late twentieth and early twenty first centuries. And in doing so, it has pretty much been in step with public economics more generally.
- So what's not to like?
- There are, I believe, two areas where FAD will need to advance in the years to come: political economy, and behavioral public economics.
- But this is also where public economics needs to advance, and is advancing.

## Wicksell, Kahneman and FAD (2)

- I argued earlier that those who follow the Pigouvian paradigm see themselves as the guardians of a social welfare function. It was this presumed role which was questioned by James Buchanan in his Noble Prize winning life's work. Buchanan acknowledged his debt to Wicksell's writing from the late 19<sup>th</sup> century in his Nobel lecture:

# Wicksell, Kahneman and FAD (3)

- “One of the most exciting intellectual moments of my career was my .....discovery of Knut Wicksell's unknown and untranslated dissertation, Finanztheoretische Untersuchungen, buried in the dusty stacks of Chicago's old Harper Library.... Stripped to its essentials, Wicksell's message was clear, elementary, and self-evident. Economists should cease proffering policy advice as if they were employed by a benevolent despot, and they should look to the structure within which political decisions are made”

# Wicksell, Kahneman and FAD (4)

- Neglect of this political economy dimension can perhaps be pointed to as the reason for repeated failure of IFI advice, and conditionality, on subsidy removal in the 1980s and the 1990s, when the expression “IMF riots” was first coined.
- More recently, FAD and the IFIs in general, have become more nuanced in their analysis, their advice, and their conditionalities on removal of subsidies.
- However, it can perhaps still be argued that this is an underdeveloped part of FAD’s analytical arsenal, especially since the “new political economy” part of public economics has advanced rapidly in the last two decades.

# Wicksell, Kahneman and FAD (5)

- What is needed is to combine the sort of incidence analysis on subsidies for which FAD is now well known, with a detailed specification of political constraints and opportunities, to fashion packages of instruments (some of them new) which can help policy makers navigate between the Scylla of excessive deficits and the Charybdis of political meltdown.
- This is a challenge, I believe, on par with the challenge FAD faced in the 1980s and 1990s to take on board and to analyze the distributional consequences of Fund programs.

# Wicksell, Kahneman and FAD (6)

- So much for Wicksell (and Buchanan). Where does Kahneman come in?
- All of the above, from Pigou on down, is based on the standard homo economicus model, a model which has increasingly been questioned in the last two decades, not least in the Nobel Prize winning work of Daniel Kahneman (and in the Clark Medal winning work of Matthew Rabin, and the MacArthur Award winning work of Sendhil Mullainathan).
- This flowering of work in behavioral economics is now seeping through to the sub-disciplines, and has led to work for example on behavioral development economics, behavioral labor economics, behavioral financial economics, and of course behavioral public economics.

# Wicksell, Kahneman and FAD (7)

- It would have to be said that the work of FAD, whether on the taxation side or the expenditure side, is somewhat innocent of the behavioral revolution in economics.
- To illustrate why it matters, consider one of the basic empirical regularities identified in the behavioral literature, that individuals appear not to operate with a unified budget constraint, but that they operate with a set of overlapping “mental accounts”.
- Consider also a second empirical regularity, the “endowment effect”, whereby an individual puts a higher negative value on an existing benefit being taken away, than the positive value he puts on the same benefit being given to him de novo.

# Wicksell, Kahneman and FAD (8)

- These and other descriptions of how human beings actually behave and respond to economic stimulus may fundamentally change the way we think about public economics.
- For example, the standard approach in subsidy reform, is to present policy makers with a removal of the subsidy in question plus transfers to compensate some of the affected (the poor, or the powerful, or both). But these transfers are calculated with the conventional integrated budget constraint, and without the endowment effect. This could well lead to inaccurate calculations of compensation, and thus inappropriate policy advice.

# Wicksell, Kahneman and FAD (9)

- The same applies to tax reform or to a range of other policy analyses in which FAD engages. Departures from the standard model of inter-temporal preferences (bringing in hyperbolic discounting, for example), or the introduction of interdependent utility functions, could again change fiscal policy conclusions significantly.
- And yet, this perspective is by and large missing from FAD's work.

# Conclusion (1)

- So, how do the giants of our discipline mentioned in the title relate to FAD's work?
- Keynes had a detailed proposal for the IMF, but FAD seemed to have been largely missing.
- Pigou is the real intellectual father of FAD, and indeed of public economics as it is currently practiced.

# Conclusion (2)

- Wicksell's political economy perspective is beginning to make an appearance in FAD's work, but in small steps.
- Kahneman is largely missing from FAD's portals.
- So, the future for FAD: Hold on to Pigou, but engage vigorously with Wicksell and Kahneman. That's the public economics of the future.

Thank You!