

# Trying to Make Sense of Economic Policy - Part 1: What Do Governments Try to Do?

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There are several areas of concern for the leadership of a country. Domestic politics obviously loom large and are the main area of concern but there are other important areas, such as economics, foreign affairs, defense, and social issues. A major reason for taking economic policy seriously is that economic growth provides the extra resources that are needed to spend in the other areas of interest. In a very poor country with little or no growth it is difficult to have much by way of government spending. To develop a comprehensive welfare system or engage in domestic or foreign wars requires a lot of resources which implies there must be a reasonably strong economy. Without this, the people of the country would suffer undue deprivation in order to pay for such things.

All governments need to have some idea of an economic policy, however vague or ill-defined it might be. Having achieved power (the first law of politics) and then kept it (the second law), then those in charge will wish to use this power to some purpose. Whether power was gained through a democratic process, taken by military force, or inherited, does not affect the fact that power, once achieved, has to be used to do something or other. Even if a leader is a simple dictator with few aims outside power for its own sake, he still has to make decisions about what is good or bad, what is desirable or not, and so forth. Such matters might be given consideration in their own right or else the views might arise as a simple reaction to events arising. The events might arise domestically, within the country, or abroad but have an impact on the country.

In the economic sphere there are ten areas of concern that governments in all countries might consider and for which they can develop policies or goals. Each government need not have a strong interest or indeed any interest, in each of the ten areas but whether the government has or not, the matters do not go away. If what is happening in that field is acceptable to those in charge, they can choose to ignore it completely. However, when something goes wrong or events occur that the ruling elite do not like or want, then a policy is needed to deal with the issue. Refusing to develop a policy is itself a decision to let things slide.

## What are these ten fields which can require economic policies and decisions?

Listing them, although not in any priority area, the first seven are domestic-related, numbers eight and nine are foreign-related, and the last one is general.

1. Inflation
2. Unemployment
3. Economic growth
4. Taking care of the environment
5. The allocation of resources
6. The distribution of income
7. The standard of living
8. The balance of payments
9. The value of the currency
10. Avoiding unnecessary and undesired fluctuations in the above nine points.

How to prioritize these is an issue for the governing authority, i.e. what order should they be placed in, as is how strong an effort should be placed on each. There is no “one size fits all” answer to these issues and the authorities in each country can make up their own minds on this. In the real world, it is often the case that inflation and unemployment are often taken more seriously and so are higher on the list.

Many governments appear to pursue some or all of the possible goals in a somewhat uncoordinated fashion and some decisions that help the achievement of one goal can easily make it harder to achieve another. A recent British government, realizing the possibility of such contradictions, came up with the slogan of “joined-up government” which meant that a set of coordinated policies should be adopted in which contradictions and anomalies should have no part. The outcome was that the slogan proved much easier to invent than implement and eventually the slogan was quietly dropped.

The way many government approach their job seems to be to start by establishing a few main economic policy areas of central concern; in a democracy, these may appear in an election manifesto and, once elected, a government can claim that it posses a mandate for them. The other economic areas tend to be put to one side and almost ignored until some event, possibly a disaster, focuses attention on that area. In this case a government is reactive in some areas, i.e., responding to events, rather than being proactive and setting things running in a certain direction by means of a definite and acknowledged policy.

One rule of thumb is that governments tend to place a higher value on domestic affairs than foreign ones, largely because in democracies at least, voters care more about domestic issues, especially those that affect them directly. These often include health, education, schooling, taxation levels, inflation and unemployment. The first three are matters of resource allocation, the fourth is concerned with raising money to spend (again resource allocation) and the final two are what they say.

## **The ten economic policy fields in more detail**

### *1. Inflation*

The aim is often to prevent it from happening or to contain it to some acceptably low figure. A total absence of price increase is often not wanted as it is easier to make economic adjustments, such as producing a bit more or less of some product, if prices are not totally static. Slowly rising prices also make it slightly easier for firms to achieve a profit, as raw materials may have been bought earlier and wage increases often lag behind price increases. Easier profits encourage a happier climate of business opinion and cause entrepreneurs to be more optimistic and active, which may promote investment.

More investment means faster economic growth. Growth then makes it easier to reallocate resources from where they are less needed to newer areas where they are more needed. Such changes are common, the result of consumer taste and fashion altering, as well as the emergence of new inventions and technology. This means that what was produced or made available in the economy ten years ago, or even last year, is unlikely to be exactly what is wanted now.

In the UK in the early twenty-first century there was a strong interest in avoiding inflation and the policy is to try to contain it to 2 per cent, which is defined as “price stability”. A figure higher or lower than this is not wanted. In Zimbabwe, by contrast, there is little or no interest in this goal, or the economy in general, and by 2008 the rate of inflation was probably in the region of 100,000 per cent,; this is clearly hyperinflation. Domestic politics, i.e. his own survival, appears to be the sole interest of President Mugabe so that a series of unfortunate and disastrous political, social, and economic decisions have adversely affected the economy and brought intense social suffering in its wake.

## *2. Unemployment*

Most governments prefer to keep unemployment at a low level, partly for economic reasons – more people working means more output – but probably the main motives are political and social. The government can lose the support of the people if unemployment is high; and large numbers of the unemployed can cause social unrest and a danger of people taking to the streets. This can be a problem in both democracies and less liberal countries.

Despite this, many governments are prepared deliberately to increase the level of unemployment in the short term in order to help the attainment of other goals. The rate of inflation and the level of unemployment tend to move in opposite directions, so that if the government wishes to reduce the level of inflation, it might intentionally increase unemployment levels, using fiscal policy (mainly taxation changes) and monetary policy (mainly the money supply and the rate of interest). If the economy is considered to be overheated, with the level of aggregate demand being too high, increasing the level of unemployment is one solution.

It is less easy these days to talk in terms of old-fashioned left wing and right wing politics, as the differences between political parties has often blurred to some extent. Still, using such terms, the left wing or more radical labor party members, as well as trade unionists, tend to regard keeping unemployment low as a more important priority than the right wing or conservative party members might adopt. Similarly, the left might be prepared to accept slightly higher levels of inflation, rather than increase the level of unemployment. In the United States, the Republican Party tends to be right wing, and Northern Democrats more liberal or left wing. Southern Democrats are often conservative. As far as priorities are concerned, factions within a party can be important, as different groups with different ideas struggle to take over the leadership.

## *3. Economic growth*

As a long term goal, most governments seem to like economic growth and try to adopt policies to promote it. A higher rate of economic growth means that we can enjoy a higher standard of living, gives us a greater ability to improve resource allocation, and also provides the surplus out of which we can take better care of the environment. Against this, the process of economic growth is frequently bad for the environment, particularly by causing pollution of the air and water, as well as noise. Environmentalists are particularly worried by the consequences of growth, particularly the short term ones which are quickly encountered and easily visible; they doubt that governments will restrain growth where it is really needed and are dubious that the extra surplus will actually be used to deal with environmental issues.

## *4. Taking care of the environment*

This is a relatively new goal, but one that is rapidly increasing in importance, particularly as evidence of global warming increases. In recent decades, several international conferences have led to agreements, such as the Kyoto Protocol, and many, although not all, national governments have signed up to it. Each country, and political party within it, often have their own degree of willingness to cooperate with the Protocol. The environmental economic goal often involves changing resource allocation, for example from oil-fired power generation to wind power, or taxing vehicle fuel at higher rates in an attempt to reduce private use.

## *5. Improving the allocation of resources*

Improving the allocation of resources means using land, labor and capital in a different way. The changes are often marginal. Sometimes, however, they can have a major impact on a particular group of people, such as coal miners and steel workers, or geographical regions, especially if a particular industry is heavily concentrated in one or two specific areas.

In a dynamic economy, resources are constantly being adjusted as producers react to the changing demands of people and new technology emerges. For an economist, an improvement in resource allocation often means moving towards a more competitive market-determined solution and away from distortions caused by monopoly elements or laws and other restrictions.

But the government has its own agenda too. It has its own policies that it wishes to implement and nearly all of these affect or alter the allocation of resources. It may, for instance, wish to strengthen education, defense, or improve the standard of the health of the nation. Each government will have a different agenda and any one government is likely to change its mind and alter its priorities over time in light of new information, emerging events, or realignments in the power holders within the party itself.

Government efforts to alter the allocation of resources can include the passing of laws and regulations that promote or limit certain activities; the establishment of quangos (quasi-autonomous non-government organizations); the awarding of contracts; subsidies to various groups of people or industries (e.g., the UK Disability Allowance which affects labor directly by reducing the pressure on those with physical or mental problems to go out and work or subsidies to agriculture); and taxation. If the tax on certain products or industries is increased for example (or subsidies reduced), it might lower the demand for the products and in turn reduce the number of firms and workers in that area.

A major advantage of allocating resources better is that this can improve the standard of living of the people and enhance the rate of economic growth.

#### *6. The distribution of income*

Income distribution refers to the proportion of people within the country who are rich, in the middle, or poor. It is often measured as percentiles or deciles, or perhaps more commonly by journalists as how much of the country is owned by what per cent of the people. As an example, in the USA in the year 2001, the top 10 per cent of the people of the country owned 69.8 per cent of the wealth, compared with 56.0 per cent in the UK in the year earlier. Strictly speaking this is wealth distribution, rather than income distribution, but the two are closely related.

Improving the distribution of income often means trying to make it more equal or at least paying lip-service to this goal. We regularly read that despite efforts there has been little or no “improvement” in the distribution of income for several decades.

Some see “improvement” differently: it does not involve making the distribution more equal, but rather it means providing greater rewards for those who strive hard and succeed. This often seems to mean entrepreneurs and high-ranking executives in private industry in particular. The group supporting this view is frequently either conservative or a believer in economic freedom and liberalism. The normal result of adopting this view is to widen the distribution of income.

#### *7. The standard of living*

A high standard of living is preferred by almost everyone to a low standard, so that increasing the level is a goal. One notable exception to this occurred in socialist countries, such as the Soviet Union in the past, where the state had a strong preference for promoting industrialization and economic growth. As a result, wages and prices were fixed at a low level to ensure a just-about adequate standard of living for all, and the surplus was extracted for reinvestment in the economy. Forced industrialization of this kind is only possible with strong central control and restricted levels of freedom and does not occur in Western-style democracies with free voting. Any government attempting it would be voted out at the next election. It is now widely accepted that the process of forced industrialization ensures poor resource allocation as well as low living standards.

### *8. The balance of payments*

The balance of payments is the account that shows a country's dealings with the rest of the world. It is commonly divided into the Current account, revealing the value of the flow of goods and services, and the Capital Account, which roughly shows how the current account is financed and deals with capital flows. Many governments wish either to balance the current account or perhaps aim for a small surplus. A deficit on current account, particularly if large and continuing, lowers the value of the currency (goal nine) and this weakening is often regarded as a bad thing, especially it seems by some politicians. The word "weaker" carries negative connotations, although under certain circumstances a lower value of a currency can be a good thing as it promotes exports and can raise both living standards and the rate of economic growth.

Even with a substantial current account deficit, if other countries are willing to hold the currency in quantity as part of their gold and foreign exchange reserves, the deficit need not be a problem. This was the case for the United Kingdom before the Second World War; since then the USA has been like this, running current account deficits and the rest of the world holding dollars. By 2007 the dollar had weakened notably and the USA appears to be in the process of losing this ability.

### *9. The value of the currency*

In the USA it refers to the value of the dollar, in Mexico the value of the peso, and so forth. As mentioned, many politicians, and some others, regard a strong currency as a mark of strength and hence it is felt to be desirable. A strong currency is one that buys a lot of units of other currencies. What can make it strong?

- The country is successfully exporting a lot, so the Current account is in surplus.
- Foreigners trust the currency and are willing to hold it as part of their reserves of foreign currency.
- People expect a rise in the value of the currency will occur and buy in, as an investment in order to make a profit.

### *10. Avoiding unnecessary and undesired fluctuations in the above nine points.*

Stability and security are usually preferred, so that fluctuations, especially unexpected, large and frequent ones, are not desired. The authorities often try to prevent or offset a fluctuation, for example, if the American dollar starts to slide in value, the Federal Reserve might raise the rate of interest in order to attract foreigners to buy dollars and slow, then reverse, the fall.

As globalization proceeds, it is hoped that the allocation of resources will improve at the world level, which would improve economic growth and the standard of living generally, and hopefully it will help improve income levels in poorer countries. The latter point is disputed, and the possibility of achieving faster global growth and a higher standard of living for richer countries which is accompanied by little change in, or an actual fall in, income levels and living standards in poorer ones has been mooted. Some believe that this is already happening.

Increasing globalization appears to transmit international shocks more rapidly than previously and might increase the frequency and size of undesirable fluctuations, even for rich countries, in the future.

## **Conclusion**

Of these possible economic goals, only a few are likely to be central and of major importance to the authorities; and what is regarded as central can change over time. It is not possible to achieve all of

these economic aims at the same time, either because some goals clash with others, or the available resources are too small to allow the pursuit of more than a few of them. For such reasons, a choice must be made and the goals placed into some order, however vaguely defined, so that policies can be framed to tackle what is felt to be the core government intentions of the day.

**The author's latest book is *Going to University: the Secrets of Success*, Second Edition revised and expanded. It has a 5-Star Amazon review. The book aims to help students to improve their results in essays and exams, and to make the transition from high-school to university both easier and more enjoyable.**

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