

Trying to Make Sense of Economic Policy - Part 2: Why is it so Difficult to Get it Right?

By Kevin Bucknall

The ten main economic goals for any government were discussed in *Trying to Make Sense of Economic Policy - Part One: What Do Governments Try to Do?* Here we look at why the task of achieving these economic goals can be formidable.

There are at least a dozen reasons why it is extremely difficult - in fact impossible - to achieve all of our economic goals simultaneously

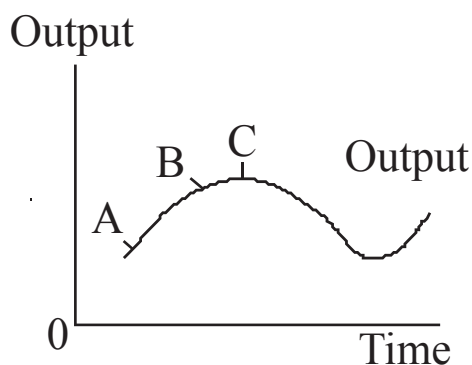
First, resources are limited so that the government cannot afford to place a huge effort on all of the goals at the same time. This means that a choice must be made about which of the goals are the more important and should be pursued avidly, and which can be downgraded to a lower position, or be placed on the back-burner and ignored for some time.

Secondly, we simply are not good enough, or know enough, to attain most of these goals at the same time. Perhaps we will get better with time and technology; we can but hope.

Thirdly, there are statistical and interpretation problems. The statistics we have to work with are not perfect and some are simply wrong. It is common for official statistics to be published once, then revised later and republished; but the policy decisions have to be taken at the time of the earlier, and quite likely inaccurate, figures. There are also lags before many of the statistics become available, and even then not all of the relevant series appear at the same time, as some are slower than others to compile. This means that a policy decision may be made with statistics of different reliability and referring to different periods.

Fourth, economic growth does not proceed steadily at an unchanging rate, so the economy often includes cycles. In view of the statistical problems of point four (incorrect data and lags), we often do not know exactly where we are in the cycle. If we think something is happening but we are in fact wrong, efforts to deal with this "something" are likely to make things worse. The diagram explains this. The curve of output graphed against time shows what can be expected to happen naturally, if the government takes no action.

If our latest statistics refer to time period A, when growth is rapid and inflation is probably high, the government might take strong action to rein in the economy and slow the economic growth. That's fine if we are actually at A, i.e., there is no time lag on accurate statistics. The result would be we would get it right, manage to moderate growth, and with any luck prevent the downswing that would naturally start after C.



If, however, the statistics are a bit out of date - say we are not at A but are actually at B where the economy has already begun to slow down - then the action taken is likely to be too strong. In this case, government intervention would reinforce the slowdown and push us into a downswing earlier than

otherwise would have happened. The downswing is also likely to be greater in depth, and possibly in length of time, before the next upswing can be expected.

A worse scenario would be if we are actually at C, with statistics still coming in from the period A. In this case the government action to restrain the economy, based as it would be on well out of date statistics, would force a major downturn and could push us into a recession, or even a depression which is an even worse state of affairs.

Governments always face time lags in some statistics and have to take decisions knowing this; to try to get it right they examine several different series - perhaps the most recent figures they can get on unemployment, inflation, production, and exports and imports, as well as surveys of moods of business people, and then compare these with changes from the previous period. Sometimes some of the figures conflict, some indicating a slow down is coming, others suggesting the reverse, so that fine judgement is required. On occasion it is not clear whether the best course of action would be to expand the economy, contract it, or simply do nothing. It is not easy!

The fifth problem with attaining the economic targets is connected with the main policy instruments available to the authorities - fiscal policy and monetary policy. Both instruments have problems attached that may prevent the attainment of desired economic goals.

Fiscal policy: this means using taxation, and to a lesser extent subsidies, usually with the aim of affecting the overall growth of the economy, and in particular the level of inflation and the rate of unemployment. In addition to these targets, it can be focused directly on altering the distribution of income, the allocation of resources, and increasing the protection of the environment.

In many countries, fiscal policies are generally implemented in an annual budget although a second mini-budget in a year is possible. An annual event is not a very flexible way of dealing with arising issues and the budget is something of a blunt instrument. It probably works better at altering the distribution of income, the allocation of resources, and protecting the environment than at the overall macroeconomic policies of inflation, unemployment and growth.

Other than this inflexibility, a major problem is that many tax and subsidy levels are difficult to change for social and political reasons; for instance it can be difficult or even impossible to reduce the level of pensions or other welfare payments, or to increase the rate of income tax. Some taxes and subsidies might have been fixed for a given period by previous announcements, or cannot be changed owing to international obligations. The discretionary element, the part that the authorities can actually alter, may be quite small.

Monetary policy: this means using changes in the rate of interest and the supply of money to alter the level of aggregate demand. This policy is largely used for the overall macroeconomic targets of inflation, unemployment and growth. In contrast to fiscal policy, monetary policy can be altered quickly, perhaps monthly or quarterly as needed, and therefore is flexible. However, the affects can be slow to arrive and some of them may take a year or more to filter through, reducing the immediacy of their impact.

A sixth and related problem is that at the time the actual decision has to be made on whether take action at all, and what particular action to take, the full effect of measures already taken in the past has probably not yet been felt, and things are still working their way through. Allowance may be made for this but in ignorance of how much has actually worked through.

A seventh problem consists of the issues of recognition, decision, and implementation.

- It takes time before people become aware that a problem exists, or might shortly come into being; the statistical problems mentioned above are largely responsible for this.
- It takes time to make a decision about what, if anything, to do about it; meetings may have to be organized, stakeholders consulted, and possibly objectors may need to be pacified
- Once a decision is reached, it takes time to put policy into practice, make the necessary changes, and then await the results.

An eighth reason is that we are dealing with human beings who have the ability to change their behavior or responses and may no longer follow the pattern established in the past. This suggests that the statistics on previous behaviour that we have accumulated may no longer apply quite as well. If people alter their behaviour patterns, it may affect the accuracy of the authority's decision.

Another reason for it being difficult to devise accurate solutions to tackle and solve economic problems is that we are not always dealing with hard statistics. Part of the information used may consist of projections or estimations rather than statistics as such. By their nature, projections and estimations are less reliable than facts and might more easily let us down.

A tenth problem is that while we can expect the unexpected, we never know what this will actually be. A sudden external shock can occur - they often do - and it is impossible to build this into the decision-making process. Events around us conspire to get in the way, especially international ones: we can scream "Help! We've been hit by a stochastic variable!" but it does not help much.

In eleventh place, we face the cock-up factor. Human beings are fallible and make mistakes; systems are often imperfect; computer programs can contain errors or be unable to cope with an unexpected event; and so forth. This suggests that Murphy was probably right when he formulated his famous Law: "What can go wrong, will go wrong."

And finally, it is always impossible to achieve all ten goals simultaneously for the simple reason that some of them interact: to do well at one often means doing badly at another.

Which of the economic goals interact, so that an effort to pursue one can have an impact on and prevent the achievement of another?

Inflation versus Unemployment

Fighting inflation is likely to clash with a full-employment policy: to reduce the rate of inflation a government might raise interest rates, reduce the money supply, and/or increase the level of taxation. This would have the desired effect of lowering the level of demand but would also have the undesirable effect of increasing unemployment. The opposite is also the case: striving for full-employment can cause inflation. A common problem is for a country, or even many countries, to face inflationary pressures (which might suggest the government should *increase* interest rates) and at the same time high or rising unemployment levels (which might involve *lowering* interest rates).

Unemployment versus the balance of payments

Following a policy of full-employment can adversely affect the balance of payments by causing more imports of consumer goods (because more people are in work, the level of total income is higher, and people spend more) and also of producer goods and raw materials (to make some of the things people are now buying). It may also be harder to increase exports if people are consuming more of what is being produced. If the government is worried about the balance of payments and decides to tackle it by deliberately reducing the level of demand, we would face higher levels of unemployment.

Economic growth versus the balance of payments

Achieving high levels of economic growth automatically sucks in imports and worsens the current account on the balance of payments. Any action taken to improve growth naturally worsens the balance of payments. The imports consist of consumer goods for the increasing levels of income and the newly employed, as well as raw materials and capital goods to fuel the growth.

A higher standard of living versus the balance of payments

As the people of a country grow richer they tend to alter their pattern of demand away from basic survival items, such as simple food, clothing and shelter, towards luxury imported goods and services, such as posh motor cars and foreign holidays. The increase in imports then worsens the current account of the balance of payments.

Economic growth, or the balance of payments, versus the value of the currency

Pursuing growth can affect the value of the currency. The most likely outcome of a higher rate of

growth would be to strengthen the value of the currency, as foreigners appreciate that growth strengthens the country. However, as the growth will probably be accompanied by a worsening balance of payments, this can frighten some foreign investors who may ditch the currency - and these currency sales then *lower* the value of the currency. People abroad make their own assessment and act accordingly. Their expectations of the future of the country and its currency play a major role. If the balance of payments worsens without being caused by successful growth, this tends to lower the value of the currency.

Taking care of the environment versus resource allocation, the distribution of income, the standard of living, and inflation

Taking an action to help protect the environment can have many effects. As an example, if the act involves raising taxes on fuel to reduce vehicle emissions and hopefully reduce global warming a little, this would alter the allocation of resources - some would argue for the better, others for the worse. It would also affect the existing pattern of income distribution; reduce the standard of living of motor car drivers immediately and increase the cost of transporting all goods, thus pushing up prices generally and violating the anti-inflation goal.

Improved resource allocation versus many other goals

Resources can be altered in a variety of ways, so that generalizations are difficult. If incomes are made more equal it would improve the standard of living of many (but by a tiny amount each), while worsening it for a few (but by a lot more each). In rich countries this might mean fewer luxury items demanded, such as Porsche motorcars, and more mobile telephones bought. Each particular way of altering resource allocation would have its own effects and would need analyzing separately. Against this, improved resource allocation is usually good for growth and higher living standards overall.

Conclusion

Given all the above difficulties of achieving what we want and reaching most of the more important economic goals, the biggest wonder is that the authorities ever get it even remotely right and yet they do! Those guys do their best and really are good, especially when one imagines that they need to know economics, mathematics, statistics, a bit of psychology and, most important of all, have a lot of luck!

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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.

It can be obtained directly from the publisher www.keweipress.com for £9.95 (including postage within the UK) in which case you get a free bonus CD with 19 articles covering things such as how to study more easily and get better results as well as more economics-related items. This site also contains a free book *An Introduction to Economics* which you can download. Alternatively, *Going to University: the Secrets of Success* can be obtained from Amazon and elsewhere, including UCAS, but you will not then get the free CD or a signed copy of the book.

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