Can Economic Performance be Measured and Evaluated?

What economic objectives do governments have? How can we measure whether they are achieving these objectives? **Keith Brunskill** *investigates.*

Government Objectives

Macroeconomic performance can only be evaluated against the background of the Government's declared objectives. The goals are considered to be:

- Maintaining a low rate of inflation.
- Achieving a low level of unemployment or moving closer towards full employment.
- Obtaining high and stable rates of economic growth.
- Reaching a balance of payments equilibrium.
- Reducing the degree of inequality in the distribution of income.

Straight away, even with such simple statements, there is a problem with the language used. What is meant by a low rate of inflation? Do we have a universally accepted definition of the term full employment? Apart from the present annual inflation target for RPIX (Retail Prices Index excluding mortgage payments) of 2.5%, there is an unwillingness to put specific numerical targets to each of these objectives. Whilst there is general agreement about these goals, the more controversial one concerns the distribution of income. There is disagreement over the definition of a poverty line when discussing absolute poverty. Any policies aimed at reducing poverty will be difficult to evaluate if we cannot agree on measurement. Relative poverty, where some groups are poorer than others, will always exist in a free market economy. The big question is what degree of poverty is acceptable and what is the best way of tackling the problem.

According to the 2003 Yearbook published by the Office for National Statistics, the main elements of the present government's economic strategy set out in the 2002 budget are:

- Delivering macroeconomic stability.
- Meeting the productivity challenge.
- Increasing employment opportunity for all.
- Building a fairer society.
- Delivering high quality public services.
- Protecting the environment.

Can we Evaluate Vague Objectives?

If economic objectives are expressed in a vague way, it is no surprise that there is room for disagreement among commentators when it comes to assessing current economic performance against the declared objectives. We all realise that some of the factors influencing economic performance lie outside the control of national governments. Events such as the process of globalisation and the creation of larger political units such as the EU can reduce the scope of governments to act effectively on an individual national basis.

Also, supply side shocks, either natural or man made disasters, can easily throw the economy off course by reducing the productive potential or injecting higher rates of inflation into the economic system. Countries which have a significant international trade sector, may experience instability on the demand side of the economy due to the fact that economic recessions can be contagious between countries. Sometimes, international events can be used as a scapegoat for a poor economic performance. The Chancellor downgraded his forecast for economic growth this year to 2.0-2.5% in the light of international economic performance.

Although the broad objectives stated at the beginning may not be controversial, there is room for differences in opinion regarding:

- The priority that is given to the objectives.
- The best way of achieving them.
- The cost of particular policies, particularly if there is a conflict between the objectives e.g achieving low inflation and at the same time reducing unemployment. If policy conflicts exist, there is always room for value judgements when assessing economic performance.

Greater investment and innovation will allow the UK to become more competitive.

Supply side policies can offer the prospect of lower inflation, higher employment, faster growth and an improvement in international competitiveness. The problem in evaluating these policies is that they are essentially long term in nature and economic commentators often focus on short term analysis. Manipulating the components of aggregate demand may be necessary in the short run to lower inflation or to boost an economy which is experiencing economic recession. The toolbox available to governments consists of fiscal and monetary measures. Altering the flows of government expenditure and taxation, changing interest rates or even exchange rates may all improve current performance. The objective of all government intervention in macroeconomics must be to secure economic stability, efficient use of resources and a rise in the general standard of living.

Governments choose economic growth i.e. the increase in the GDP of an economy in real terms over a period of time, as the main indicator of economic performance. The case for using this is based on the idea that the ultimate test of a government's macroeconomic management is what happens to the living standards of the population. The concept of the standard of living is tricky to define and difficult to measure. Economic growth creates winners and losers and is only a valid objective if the benefits outweigh the costs. The achievement of growth does not guarantee that the other macroeconomic objectives will also be met. For example, growth may be

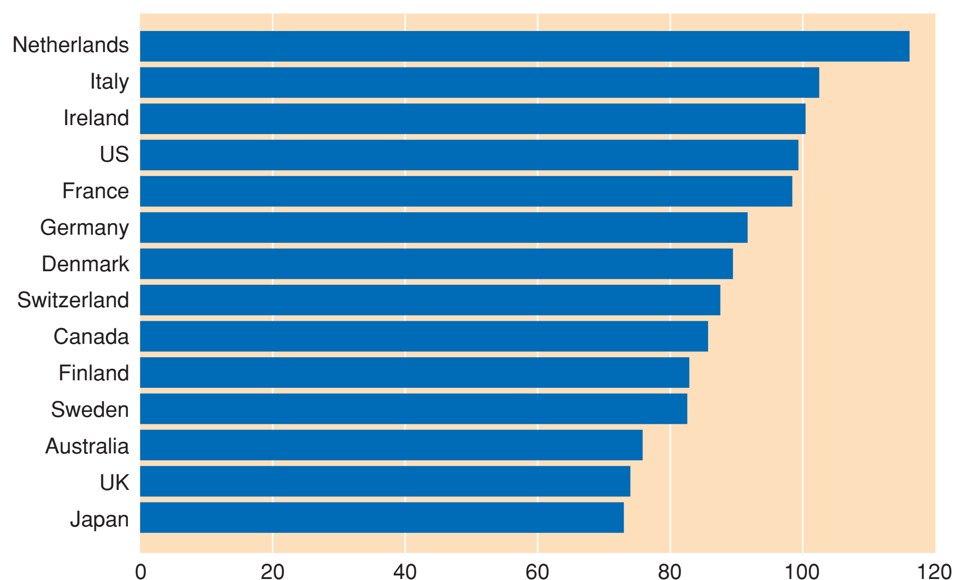
Problems of Measurement

The approach of positive economics, when considering economic performance is to collect data which will prove how well, or badly, the economy is performing. Unfortunately, the data is not always available or the basis on which it is collected can change. This makes it difficult to compare current with past economic performance. An example of this is the changes that were made to the collection of unemployment statistics in the 1980s. It is now fashionable to present data in the form of international league tables. Assuming that all countries collect the data in the same way, there is some value in making comparisons of current economic performance between different economies. However, such comparisons can be misleading because the players are not all starting from the same base. There is also an implication that those who are performing less well can easily improve their league position.

Bearing in mind the limitations, we can now access data on unemployment rates, growth rates, inflation rates trade and capital flows and the distribution of income. This will give a general impression of how the economy is performing against the past record and against others with whom we have an economic interest.

Governments try to improve general economic performance by a mixture of supply side and demand side measures.

Figure 1: GDP Per Hour Worked 2000 (US = 100)



Source: CBI

accompanied by some demand pull inflation. Also, the process of growth may temporarily or permanently add to unemployment, as a result of structural change and there is always the danger that in the UK, rapid growth can cause a deterioration in the balance of payments as more imports are demanded. Nevertheless, if we have to pick a single indicator of economic performance this remains the best one.

Comparing Competitiveness

Recently a new emphasis has been placed on international competitiveness as an economic indicator.

In December 1999, the first ever set of competitiveness indicators was designed to allow comparison with the economic performance of other advanced economies. The indicators were divided into the so called drivers of productivity i.e.:

- **Investment:** measuring physical capital and ICT.
- **Innovation:** measuring the science and technology base, its commercial exploitation and research and development.
- **Skills:** measuring human capital.
- **Enterprise:** measuring business formation, entrepreneurship and finance.
- **Competitive markets:** measuring the openness of labour markets, flexibility, regulation and the institutional environment.

Figure 1 shows how the UK is lagging behind many of our competitors in terms of GDP per hour worked, and in July 2003 the government launched a drive to improve productivity.

Efficiency of Firms

This is because international competitiveness will only improve when the firms responsible for domestic output are operating as efficiently as possible. The economic performance of firms must be evaluated against their objectives. In economic theory, it is assumed that firms are profit maximisers. The real world situation is more complicated. Firms may have a range of objectives and be prepared to sacrifice some short term profit in order to increase their sales revenue and get a greater market share. There is a theory that some firms prefer a satisficing strategy. This means that they seek to make reasonable profits whilst taking account of the interests of the workforce and customers. Firms may want to avoid unwanted attention from rivals or government regulatory bodies. Governments may take a direct interest in the economic performance of firms in order to raise the level of economic efficiency and to protect the public interest.

Firms are considered to be productively efficient in the short run, when they are operating at lowest unit cost. The problem is that this output may not coincide with the profit maximising one. In the long run, the most efficient output will be where firms have exploited all the cost reductions they can and are producing at the minimum efficient scale.

Firms are considered to be allocatively efficient if they charge a price which reflects the true marginal cost of making the last unit. In addition, the price must reflect the satisfaction the consumer gets from the last unit.

Using these measures of efficiency, the only efficient firms would be those operating in the theoretical model of perfect competition. We have to accept that real world competition occurs between players with differing degrees of inefficiency. Abnormal profit is considered to be the economic reward for risk taking and the search for it is assumed to be the major motivator for entrepreneurs. One difficulty in assessing firms' performance here, is that we cannot agree on what is an acceptable level of profit. There is now some concern over the way that company accounts can be presented. The amount of declared profit can be manipulated, making it difficult to compare the real trend of profits over time. When the Competition Commission investigates a firm's performance, it must decide if the social benefit of its activity exceeds the social cost. If so, it is clearly operating in the public interest. A wide variety of factors other than the level and use of profits are taken into consideration. Firm's performance indicators may include:

- Profits expressed as a percentage return on capital employed.
- Share prices.
- The proportion of income devoted to research and development.
- The amount of capital investment.
- Contribution to national employment.
- Contribution to exports.
- Labour productivity.

Conclusion

There is now an attempt to measure firms economic performance in an international context. A company wealth creation league table of the 500 largest UK firms and the 300 largest European companies by added value may tell us something about relative economic performance.

In a world of increasing economic rivalry, it is fashionable to discuss Britain's relative economic performance. As all students know, a perceived poor performance can be a demotivating experience. But such comments are only valid if we agree on what it is we are measuring and have policies in place that will improve the performance of firms and the national economy.

Questions for Discussion

1. Are there any agreed economic objectives which should be accepted by all governments? If not, why not?
2. Should reduction in income inequality be a standard macro-economic objective?
3. What are the problems with evaluating government performance?
4. Why do firms not necessarily try to maximise profits?
5. Why should governments be concerned about evaluating their performance compared with other countries?

Summary of Key Points

- We can only measure macroeconomic performance against the declared objectives of the government.
- Often objectives are expressed in a way which is too vague to evaluate.
- It is often difficult to compare an economy over time and with other economies, because of differences and changes in measurement definitions.
- Firms within an economy often have conflicting objectives.