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Economic Governance: Changing Phenomenon (the U.S. case)[1]

Introduction

Economic governance is a phenomenon that has been recently raised in discussions both in the national and global context. The debate reflects the fact that an optimal economic process requires, on the one hand, a spontaneous market development, but on the other, some control or regulation activity performed by different entities (private individuals, governments and other economic institutions or organisations, etc.).

Originally in the economic sense, the term 'governance' was often connected to the microeconomic area and described as *corporate* governance. Nowadays, the term is understood and used broadly as *national* (regional or local) or even *global* economic governance.

Generally speaking, the term 'governance' refers to the manner or the act of governing or exercising control, or authority over actions taken up and performed by different entities. Thus, it is a system of regulations. The emphasis is on how people and entities are ruled and, how affairs of a state, or even interstate affairs, are administered or regulated[2].

Definition

According to recent research, governance is defined as processes and institutions, by which an authority is exercised to manage social and economic resources and this way to provide for the economic development. On the one hand in the political sense, governance is a process, by which governments are selected, held accountable, monitored, and replaced. On the other hand in the economic sense, it is the capacity of governments to efficiently manage resources, and formulate, implement, and enforce sound policies and regulations[3].

Institutions are an important element of the governance structure. As they represent formal and informal rules in each society they are central to the way a country is governed. The formal rules are set by the state through laws and regulations. The informal rules come from culture, history and experience of each society or culture area, and are reflected in codes of conduct and belief systems. There is an interaction between the two groups of rules that finally determines the institutions in a society. These enable incentives for people to be shaped. Their social behaviour is determined as well as economic outcomes[4].

As each society is unique in its political, social and cultural system, the economic and social outcomes, and hence experience of each, are different. Economic governance is strongly dependent on forms of politics and the type of state. It encompasses a lot of elements: the state macro and micro policies, institutional and legal environment that includes some basic economic functions, government economic agencies and regulatory bodies, commercial laws and legal institutions, etc. Naturally, these elements may vary from country to country. Thus, the final shape of economic governance depends on the nature of each particular society and its will to choose tools and manage the national economy.

Governance works well if the country's environment is sufficiently dynamic. It means that the price to be paid for prosperity is the permanent transformation of institutions. New institutional arrangements should be implemented from time to time (governmental administrative structure, policy rules such as taxation, etc.). A sound governance system can be developed if the country lets its institutions evolve so that the formal rules line up with the informal rules and norms.

Governance can be considered in terms of **economic, legal and civil** elements. In practice, however, those particular elements overlap and interact with each other. For example, bankruptcy laws are an element of legal governance. Financial markets and the economy as a whole cannot, however, function well without these laws – a fact that makes them essential to economic governance, as well. By the same token, social safety nets that are an element of civil governance have a large impact on incentives and hence the economic performance.

Governance involves, however, many other elements and processes. Governmental policies, programmes and regulations have to be translated into legislation, implemented and enforced. Rules and regulations have to be predictable and clear. A government that implements policies needs to be accountable to people through a transparent and participatory process. **Predictability, accountability, transparency and participation** are described by the World Bank as the four pillars of governance. What is more, good governance requires positive interactions between the state, the private sector and the civil society that are critical to the achievement of a balanced socio-economic development[5].

Growing International Character of Governance

Taking into account the evolving nature of the world economic system, governance cannot be achieved only through governmental activities of individual states. Though, the world system of entities that influence the world economy or affairs of single states consists in particular of the states themselves, large private companies, multilateral or other organisations, groupings of private individuals, including NGOs, etc. Therefore, good governance requires co-operation (at best even partnership) among particular governments as well as between governments and the civil society, including transnationals, local companies and NGOs. Governance can be addressed not only with reference to national systems, but indeed with reference to international economic and political relations seen through their links to law, public administration, stakeholders and the general public. The interactions among all of those entities result in goal setting and further co-operation to achieve the goals set. Thus, under the appropriate conditions, governance can work at the local, national, regional or even the global level[6].

The potential players of the global governance system can be identified at different governance levels. Besides national governments (ruling more than 200 world states) or subnational (local) governments or authorities (German Länder or U.S. states) and private governance (global companies, self-regulatory organisations, pressure groups like e.g. Greenpeace) there is a higher basic governance level of (macro)regions, where stronger (like in the EU) or weaker (like in the ASEAN countries) interventions or regulations are implemented. Sometimes, governance assumes an inter-regional form (APEC, Transatlantic Partnership). And finally, the top forms of governance on the global scale are the international associations (G8, OECD, and NATO) and multilateral organisations (WTO, IMF, the World Bank, and United Nations).

Reforms of Economic Governance

The forms of governance change in line with the character of an economic process. A strong tendency to lower the economic role of the state appeared in 1980s reflecting the developments in the world economy. At that time, the crisis of Keynesianism escalated in the Western countries as a result of growing state bureaucracy as well as resurgence of the free market conservative ideologies. The turn towards economic liberalisation undermined the state power. The privatisation of the public sector economic activities and cuts in fiscal capacities diminished the state influence and deregulated the economic process in general.

This was also reflected in the academic sphere, mostly in the U.S.A., through a shift from development economics towards open macroeconomics, a renewed emphasis on the international trade theory, or a shift towards rational expectations in economics. A general emphasis on the supply side economics replaced the preceding Keynesian emphasis on the demand management. The result was the so called *Washington Consensus*, the inauguration of which was assisted by political authorities and strongly supported by the IMF and the World Bank[7]. In 1990s, the Consensus became the central platform in the Central and Eastern European countries that at that time entered a transition path towards the market economy. The transition as well as structural adjustment programmes applied also in Africa, Latin America and parts of Asia involved elements of a governance reform. Typically, the efforts aimed the size of government rather than the need to encourage good governance. The growth of the state was to be limited: the key governance elements have been reduced in particular in the area of bank supervision, consolidated budgeting, monetary policy, reform and privatisation of public enterprises, including adjustments in the number of civil servants.

Therefore, in accordance with the neoclassical economics exemplified in the Washington Consensus most governance reforms were intended to create boundaries around the activities of the state (through large privatisation and deregulation) with the aim to downsize the government by both redefining its functions and reducing its resources[8].

The general downsizing of the economic role of states or governments since 1980s has been a natural response to the growth of state bureaucracy that began after the World War II. On the other hand, many key economic institutions (e.g. United Nations, the World Bank) admitted in their documents that the role of the state cannot be omitted or even strictly eliminated. That fact was taken up as an issue in 1990s parallel to the Washington Consensus appearance and its practical policy implementation mostly in the transition countries of the Central and Eastern Europe. The discussion acknowledged the inevitable and even increasing position of the state in several areas, at least:

- passing adequate legislation; shaping a competitive market environment,
- organising education and training or retraining of qualified and flexible labour force; implementation of a rational social security system,
- assisting the integration of the national economy on its way towards international division of labour,
- protection of the environment and natural resources.

Therefore, in response to the Neoconservative wave of 1980s, some opinion synthesis occurred in 1990s that selectively integrated the elements of the preceding economic models (Keynesian and Neoclassical). Thus, in that synthesising process such a form of economic governance has been established, in which a new relation between the state and the market is sought: the state should **selectively but effectively complement and optimise the market environment functions.** Although the new platform does not need to be generally accepted, it seems to probably meet the demands of the new economic period[9].

Despite the increasing role of the market in the world economy since 1980s, the state role remains important. However, in comparison to the post-war period it has been transformed into a different form, where the state is a supportive element enabling some smoother market functioning. The relations between the state and the market seem to have been reshaped into a more balanced arrangement. This resulted from the growing recognition of the serious problems associated with the original ideas of the *Washington Consensus.* In 1998 a *'post-Washington Consensus'* was declared by Joseph Stiglitz, later the World Bank Chief Economist and the Nobel Prize laureate.

Stiglitz emphasises that it is not the policies based on the free market ideology but the policies based on understanding the limitations of markets and of the government that would most likely produce sustained economic prosperity. The right balance means strengthening the role of governments in some areas and weakening it in others[10]. Thus, good economic governance does not mean stable state regulations but their adjustments in response to changing economic conditions.

Economic Governance Implementation: the United States Case

As far as the national states are concerned, there are, of course, very different approaches to economic governance. A country's governance system involves different economic, social, cultural and historical experience of its nations. Consequently, the economic governance is ultimately influenced by people's opinions (embodied e.g. in programmes presented or pursued by political parties). Thus, the mass opinion is pushed through as a set of political and economic measures within a concrete policy pursued by the state.

In all, economic governance generally reflects:

- culture and traditions of a particular country or region,
- general character of natural conditions and resources, especially demographic, which are available for the country development,
- existing philosophical systems including the opinion of nations' personages,
- changing theories and economic forecasts,
- voters' feedback on politicians and government decisions or the way they control the economic path direction[11].

One of the most typical systems that for many years serves as a benchmark for economic governance is the U.S. model. The governance system in the U.S.A. has been formed as a liberal one from its very beginnings. Private individuals and economic entities have been enjoying considerable freedoms within the U.S. economy. The Federal Constitution adopted in 1787 provided only for the general rules, by which the entire economy was to be regulated. The Constitution defined in particular the rules of trade with other nations and among the Union states, bankruptcy laws, money print and its value regulation, patent and copyright laws. Although A. Hamilton, the 'founding father' of the U.S. governance system, tried to make use of subsidies to assist infant industries, any considerable governmental support to corporations was strongly opposed by Hamilton's adversaries.

Therefore, despite the fact that the government played an unavoidable basic role in the original expansion of the U.S. economy, economic entities, individuals and companies in the U.S.A. have been traditionally referred to as being fiercely independent and strongly opposed to governmental control and interference[12]. Considering those convictions, the U.S. government has been mostly reluctant to become involved in the private sector. In general, the federal government is influenced by the concept of laissez-faire economy and runs the policy of 'free market companies'.

It was only several times in the history that the government receded from this attitude. At the turn of 19th century the government involved itself more actively in the regulation of business practices and the enforcement of competition. Later on, general involvement in the economy increased dramatically for a short time during the Great Depression, though the regulation was purpose-made and selective.

Contrary to the rest of developed countries and despite that selective intervention, the U.S. system of governance maintained its quite liberal character. For example, the post-war economic reconstruction after the World War II required much more intensive state participation in the Japanese as well as European economies. In Japan, the economy supply side, the manufacturing sector in particular, was to be restored. Unlike in the U.S.A., Japanese economists consider the market power as insufficient to regulate the economy. A special kind of the state intervention is therefore required to create the desired branch structure of the national economy. The direct and indirect intervention (e.g. indicative planning, structural policy implementation) does not only concern the domestic economy itself, but the targets are also set in the import and export area to optimally integrate the economy into the international division of labour. What is more, Japan developed country specific forms of co-operation between the government and the private sector as well as labour force participation in the corporate governance. The West-European countries needed more intensive state intervention after the War, too. Besides the above mentioned reconstruction controlled by governments, the welfare state was built in line with the left-wing shift of political arrangements. Therefore since the War, most of the western European countries have been referred to as mixed economies. New forms of economic governance appeared there (including the direct ones) such as considerable state ownership and massive GDP redistribution.

Of course, the U.S.A. cannot be excluded from the mixed economies group completely. But in comparison to Japan and Europe, the instruments of governance applied in the U.S. have been rather indirect after the War. State ownership as well as indicative planning never developed to such an extent if they had existed at all. Thus, the indirect forms of intervention, such as monetary and fiscal policy, have remained the main instruments of the economic governance there.

Fiscal Policy. Generally, fiscal policy serves the regulation of aggregate output and income redistribution. Fiscal policy works through the process of taxation put on economic entities and governmental spending. The policy is demonstrated in the state budget. Originally, the budget was balanced; nevertheless during the 20th century deficits have been gradually taken into account as a legitimate measure of the policy.

After the World War II, the U.S. fiscal policy developed into a system of state economic regulations usually strengthening the governmental spending and setting tax rates adequately to the economic situation. The policy usually targeted the sustained economic growth and full employment. Generally, until 1980s the redistribution of GDP through the budget increased, including expansion of budgetary deficits as a result of the growing state intervention into the U.S. economy.

The changes in the fiscal policy appeared in 1980s reflecting the Neoconservative wave that began with the R. Reagan's presidency. Within the general deregulation trend the government spending as well as the tax rates should have been downsized. As a result, the GDP redistribution and state intervention should have diminished. In addition, an important goal was to eliminate both the huge federal budgetary deficit and the U.S. public debt. Unfortunately, as far as the budget consolidation is concerned the neo-conservative administration was not very successful in its efforts. Therefore, the new governance could not have been developed thoroughly earlier than in 1990s, when the budgetary deficit problem was solved and some new space appeared for the government to restart selective activities. So, the post-Washington Consensus mentioned above was established and gradually replaced the original Washington doctrine.

In 1990s, the lowered deficit opened new opportunities in the economy. On the one hand, the state finance settlement facilitated the reduction of the private savings draw out. Thus, the investment process was strengthened considerably especially in the area of progressive technologies (ICT, etc). On the other hand, the consolidated budget also allowed developing of some selective state activities to support smooth functioning of the market economy under the new technological conditions. Within those activities since 1990s, education, training and retraining have been emphasised in the U.S.A. to improve the quality and flexibility of the labour force. Additionally, the support of research and development has been strengthened, especially the civil one, to activate progressive technologies development.

Unfortunately, the U.S. federal budgetary situation has worsened again since 2001 under G. Bush jun. administration as a result of tax cuts, state support to the sluggish economy as well as extraordinary military and safety expenditures. Therefore, the deficit and its economic impact on the U.S. economy are being now discussed as an instrument of economic governance[13].

As mentioned above, the deficits (in particular those measured in hundreds of billion dollars) can produce a crowding out effect injuring private investment. As a result, the total expenditures on progressive technologies to support structural changes could decrease in many branches of the economy. Simultaneously though, the deficit is a common instrument to support a weak economy. It created, for example, an additional demand after 2001 recession. There were also other reasons of a political rather than an economic nature behind the deficit spending such as military and safety actions. Moreover, some selective areas of the U.S. economy had been subsidised more intensively to encourage their performance and satisfy the interests of some sensitive economic branches and entities (e.g. agriculture)

To conclude, as many authors noticed[14] the government role in the U.S. economy could expand to encourage the economic growth as well as to ensure the U.S. safety situation and powerful world position. The present focus on the deficit could be evidence that new forms of governance are up to meet the economic challenge. While the state influence in some areas decreased in 1980s and partially in 1990s, it strengthened in others.

Monetary Policy. Monetary policy participated considerably in the U.S. economic success of the 1990s. The U.S. policy in monetary area is considered to be rather flexible[15]. The lowest inflation has not been however the exclusive goal followed by the U.S. Federal Reserve System (FRS). The inflation rate has been treated as a factor of the overall macroeconomic balance, i.e. in the broad context of economic growth, employment, consumer demand, etc. Thus, the FRS inflation approach is more complex and less strict than those of many other monetary institutions, e.g. the European Central Bank (ECB).

Under its former chief Allan Greenspan the U.S. monetary policy was able to change flexibly the key interest rate (Federal Funds Rate) in the short-time as well as long-time horizon, especially between 1993–2000. On the one hand, that rate movement was a response to inflation development as well as to the situation in the U.S. stock markets. On the other hand, the economic growth and unemployment were taken into account. Having eventually accepted the productivity increase and technological shifts, the monetary policy gradually provided the necessary conditions for economic growth supporting both key investment in progressive branches and innovation processes. Nevertheless, despite its flexibility the policy kept its consistence in the basic effort to control inflation.

Apparently, there is a relatively strong determination of the policy to keep the level of economic dynamism; therefore, the attitude towards inflation is not considered very orthodox. Thus, the U.S. monetary policy is different from the ECB policy, which, being quite strict, is often blamed for weak investment and insufficient economic growth of the old EU member countries in the short-time as well as long-time horizon.

Recently, the future character of the U.S. monetary policy under its new chief B. Bernancke is at focus. The question is posed as to whether the continuity of the 1990s policy could be kept or the policy might be expected to become more conservative with inclination to the ECB strategy of concrete inflation goals.

It is true that though it did not use inflation targeting strongly, the new U.S. governance of monetary policy ensured relative price stability in 1990s. The policy was prepared to undergo the risk of some inflation in the expectation that this would facilitate the acceleration of investment and encourage structural changes in the U.S. economy. Undoubtedly, the future policy development will depend not only on the country economic conditions but also on the political courage to continue a sufficiently flexible approach.

Conclusion

As shown, the post-war development of the U.S. economy, since 1990s in particular, has stimulated new forms of governance. The new governance is considered to be a synthetic reflection of the past experience. The increasing performance of the U.S. economy over the last decade could have been explained through the process of technological and structural changes as well as through the modified economic governance model.

The first step taken in 1990s was rationalisation of the fiscal policy oriented towards budgetary spending as well as tax burden reductions. Though tightened, the policy supported necessary changes in the area of both human and physical capital. Secondly, monetary policy being consistent but flexible has proved its positive influence. By means of monitoring the economic situation it can prevent (or lower) inflation and simultaneously stimulate the economic growth.

We can assume that after the long-time search for a sound form of economic governance, the U.S.A. are now heading towards a balanced model that will create conditions to better exploit the effects of economic and technological progress in the country. Nevertheless, only the U.S. future economic development can prove the new economic governance to be successful.

Endnotes

[1] This article has been prepared within the research objective of the Faculty of International Relations, University of Economics, Prague, No. MSM6138439909 *Governance in the globalised economy contex.*

[2] Governance for a Sustainable Future. Reports of the Commissions of the World Humanity Action Trust, p. 17. www.earthsummit2002.org/es/issues/Governance/governance.html. 11.2.2007.

[3] See: D. Kaufmann, F. Recanatini, S. Biletsky, Assessing Governance: Diagnostic Tools and Applied Methods for Capacity Building and Action Learning. The World Bank, Discussion Draft, June 2002, p. 7. http://www.worldbank.org/wbi/governance) 7.2.2007.

[4] P. Lloyd, P. Smith, Global Economic Challenges to ASEAN Integration and Competitiveness: A Prospective Look. REPSF Project 03/006a, Final Report, September 2004, p. 6. http://ausaid.gov.au/publications/pdf/global_econ_challenge.pdf 11.2 2007.

[5] P. Lloyd, P. Smith, op. cit., pp. 7, 9.

[6] See: Governance for a Sustainable Future. Reports of the Commissions of the World Humanity Action Trust, p. 18.

[7] K.S. Jomo, Economic Reform For Whom? Beyond The Washington Consensus, "Post-autistic Economic Review", No. 35, December 2005. http://www.paecon.net/PAEReview/issue35/Jomosr.htm 12.2. 2007.

[8] See: C.M. Satish, The economics and politics of 'good' governance: notes towards an anatomy. Presentation to BAPPENAS, Jakarta, August 2000. http://www.goodgovernance-bappenas.go.id/kom_bahan_dis_1-2.htm 12.2. 2007

[9] The later 1990s are treated as the age of the so called new economy start bringing the revolutionary changes in investment and technologies as well as in forms of economic policy, especially in the U.S.A. (See

in particular: P. Neumann, Ekonomika a hospodářská politika USA: vnitřní a vnější dimenze jejich změn v kontextu tzv. nové ekonomiky v 90. letech a na počátku nového tisíciletí. Thesis for docent habilitation. Praha: VŠE; FMV; KSE, 2006.

[10] J.E. Stiglitz, The Roaring Nineties. New York, London: Norton & Company, 2003, p. 291, 293.

[11] See also J.Q. Wilson, Jak se vládne v USA. Praha: Victoria Publishing, 1995, p. 238.

[12] R.L. McCan, An Outline of American Economics. Washington: United States Information Agency, 1981, p. 6.

[13] See: e.g. Do budget deficits affect long-term interest rates? "The International Economy", Vol. 17, Issue 3, Summer 2003.

[14] T. Gallagher, Is Big Government Back? "Business Economics", Vol. 38, Issue 3, July 2003, p. 25.

[15] E.g. the Federal Reserve System strategy was noticed as a *flexible commitment*. (See A.M. Santonero, Flexible Commitment or Inflation Targeting for the U.S.? "Vital Speeches of the Day", 1.7. 2003, Vol. 69, Issue 18, pp. 548–549).

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