CHAPTER I

DEFINITION OF ECONOMIC POLICY: QUANTITATIVE VS QUALITATIVE POLICY; PREFERENCE INDICATOR; THE THEORY OF ECONOMIC POLICY

1. By "economic policy" certain acts of economic behaviour are indicated. In its broadest sense therefore the phrase includes the whole subject-matter of economic theory. This is particularly true with regard to the "economic policy" of individuals or individual firms. This economic policy is directed towards the maximisation of the ordinary ophelimity functions. In a narrower sense we may restrict the meaning of the term "economic policy" to the behaviour of organised groups, such as trade unions, agricultural or industrial organisations, etc. Here some collective ophelimity function will be the object to be maximised. In its most specific and most relevant sense the notion of economic policy will, however, refer to governments. This booklet is primarily devoted to a discussion of government economic policy.

Whereas in the nineteenth century governmental behaviour was perhaps almost restricted to a fiscal activity, since then the development has ever been more into the direction of an attempt at looking after the "general interest", in whatever sense that may be taken. We shall indicate this entity by the symbol $\Omega$. It is a function of a certain number of variables which we will call "target variables" and throughout this book indicate by $y_k$ or in vector form by $y$. A certain numerical value of some $y_k$ will be called "a target". These targets will be chosen so as to make $\Omega (y)$ a maximum. Acts meant to attain this maximum may also be referred to as the optimum policy, as far as it makes sense to conceive of other policies as well.
2. The object of economic policy may be aimed at with the help of two different kinds of acts, to be distinguished as \textit{quantitative} and \textit{qualitative policy}. By qualitative policy we mean the changing of certain qualitative aspects of economic structure; by quantitative policy the changing, within the qualitative framework of the given structure, of certain political parameters or political instruments, to be discussed later. The boundaries are not always clear, but the distinction nevertheless seems useful and may be explained by some examples. Examples of qualitative changes are:

(i) the creation of a monopoly where a competitive market existed before, or, the other way round, the dissolution of a monopoly in existence before;

(ii) the introduction of a customs union or

(iii) the nationalisation of an industry or a number of industries.

An example of a change that may be considered as a qualitative change, but as well as a type of quantitative policy is the introduction of an education system free of charge, if previously rates were due. This policy may be said to be quantitative since a certain "price" is put down to zero.

In principle the determination of the optimum policy, if only qualitative policies are considered possible, is one of choice from a finite number of alternatives. For each conceivable policy the result of the structural changes for the target variables should be known. In principle, the corresponding values for $\Omega$ should be calculated and the alternative showing the highest $\Omega$ value be chosen.

The fixation of the function $\Omega$ is a difficult matter; generally it will not be considered consciously but intuitively by those responsible for the policy. In principle it must not only depend on the individual ophelimity functions, as estimated by the policy-makers, but on a certain measure of combining
and hence the weighing of these individual "interests" as well. In practice the stage of fixing $\Omega$ and trying to maximise it will often be passed over and the targets $y$ chosen directly.

Some schools of thought on economic policy believe that an optimum policy is guaranteed by a qualitative choice only. One example in such a case is that of the Manchester school of liberal economic policy; their choice being that of "laissez faire". They believed they could prove that the maximum of general well-being would be automatically obtained by complete freedom of economic activity. Another example of a certain a-priori belief of this type is the extreme socialist opinion that only state ownership can be a guarantee for the maximum of general well-being. This example is, however, only a partial one, since this policy would, the state ownership once established, involve a large number of quantitative decisions to be taken in consequence.

Both these cases are examples of an "aprioristic policy", based on theories rather than on empirical research. Their counterpart is represented by "empirical policies" based on experience with alternatives. In fact there are not only these two extremes; one can imagine choices based on considerations that are neither completely aprioristic nor merely empiric. Most of the examples of economic policy to be dealt with in this book are of the intermediary type: they are based on knowledge of economic behaviour of an econometric character. In chapters II–VIII we will deal with problems of quantitative economic policy; some general observations on qualitative policy will be made in chapter IX. In the concluding chapter (X) a brief sketch of the extra-economic factors involved in practical policy-making will be added.

3. As the broadest object of the theory of economic policy we consider the determination of the optimum policy, given the individual preference indicators of the citizens of a
community. The object is very broad indeed and implies, among other things:

(i) the fixation of a collective preference indicator;
(ii) the deduction, from this indicator, of the targets of economic policy generally;
(iii) the choice of "adequate" instruments, qualitative and quantitative;
(iv) the determination of the quantitative values of the instrument variables, as far as such instruments are chosen and
(v) the formulation of the connections between (a) the relation between targets and quantitative values of instrument variables on the one hand and (b) the structure of the economy studied on the other hand.

These five items are by no means independent of each other: the choice of the instruments e.g. cannot be separated from the targets and hence from the form of the indicator. In its broadest sense, also, the theory of economic policy involves the theory of economic reform, a question into which we will go somewhat further in chapter IX. Sometimes the problems may be simplified by making simple and somewhat arbitrary — though often realistic — choices as to the first three points and concentrating upon items (iv) and (v), which may be said to represent the problems of quantitative economic policy, or rather the quantitative elements of the theory of economic policy. The procedure followed amounts to assuming as being given: (1) the structure of an economy, (2) the target variables, (3) their numerical values and (4) the nature of the instrument variables.¹) The problem then consists in (A) finding the numerical values of the instrument

¹) Choosing the numerical values of the target variables of course means the elimination of the maximum problem as such. The logical consequences of this setup will be mentioned where they diverge from the exact setup (cf. Ch. V).
variables as functions of the targets and certain structural data, and (B) indicating the connection between these functions and the structure of the economy. The main part of this booklet is devoted to a somewhat more systematic treatment of those problems than is customary nowadays.
CHAPTER X

THE REALITY OF ECONOMIC POLICY

1. The reader should not be deceived by the preceding chapters and believe that the formulae tell all about economic policy. Economic policy, like any real activity, has to reckon with many aspects originating from very different realms of life, and hence certainly not only economic viewpoints: institutional, juridical, technical in the widest sense of the word, and psychological (apart from that restricted psychology taken as the basis for usual economics). Of course, these other factors have been included in our models if they are of primordial importance. Otherwise the models would not have been realistic ones. But nevertheless a number of such factors have necessarily been neglected. We propose in this chapter to go into the implications of the existence of these other factors, if only in outline. It seems useful from the outset to make a distinction between autonomous problems of economic policy and the complications created by negotiations about economic policy.

2. When speaking about autonomous policy it seems useful again to make a distinction between the contents of this policy and its organisation. The contents of economic policy are influenced by a considerable number of non-economic factors. Some of these factors may be considered to co-operate rightly: they are necessary elements in a realistic policy. Other ones seem to intervene wrongly and should be eliminated if a correct tradition of economic policy is to be established.

Examples of institutional factors that rightly co-determine the shape of economic policy seem to be the following. A
sound policy has to satisfy certain principles set by or accepted by the majority of parliament, and to express some aspects of what the people consider to be the basis of the nation's public life. A number of such principles have been laid down in the constitution or in the laws: equality of all citizens in questions of jurisdiction generally, and to quote an economic example, in taxes or, to quote another example, the principle of the right to strike or the principle of an eight hour working-day. Some of them may be unwritten rules of social decency, or vaguer: principles such as some notion of social equilibrium.

An example of a purely juridical factor that will often be the determinant for certain acts of economic policy is the necessity to respect contracts or agreements, national as well as international.

Examples of psychological factors may be seen in the need for continuity as a basis for confidence that is so well expressed in the famous administrative respect for "the precedent". The whole complex of psychological factors known as "confidence" no doubt plays a considerable rôle in the shaping of many elements of economic policy that may be labelled as the foregoing of panics or upheaval.

Technical factors rightly influencing the final shape of measures of economic policy may be the costs of their realisation, the delays to be expected or the number of subjects to be affected. The cost factor may be a reason for not taking certain measures that otherwise seem quite sound; or it may be that parts of a possible government task are entrusted to private organisations because the latter are considered more efficient than government agencies. An example presents itself, if there is a choice between two measures of which one hits a large number of people and may therefore be costly, and the other affects few and therefore is less costly, as e.g. allocations or taxes (think of the sugar excise) with regard to commodities produced in few, but large establishments.
Other factors of a technical nature may influence economic policy which are of a more doubtful nature, but whose presence cannot be denied. Lack of data is one of them. It often means that rather arbitrary decisions have to be taken instead of decisions that are based on economic principles. Economies effected by the government are often for lack of better data distributed proportionally over a number of items; or intuitive methods are applied to estimate priority in this respect.

Uncertainty may be another factor: if there are several equivalent methods to reach a certain end, the choice has to be based on some arbitrary procedure. Uncertainty sometimes is removed by (a) choosing some average (say, if the exact level of a tax cannot be determined), or (b) waiting for some important decisive factor that is as yet unknown, or (c) the application of the rule of simplicity (e.g. taking an integer number for a price to be fixed by government if the relevant interval is only known approximately).

3. Non-economic factors influencing economic policy but wrongly doing so, are in the first place all elements that are just errors made by persons inside or outside the administration. But there are numerous other factors of this kind. Personal hobbies or aversions; animosities between various offices, directorates, ministries or countries; all of them happen to have their influence and sometimes even an influence on important matters.

Different forms of rigidity as to norms are another example. A particularly important case of this rigidity may, for instance, be seen in the application of standards such as those for building which e.g. may be too luxurious for the present time or which are based on antiquated views concerning solidity of structures.

Personal or institutional inertia and the tendency to maintain the existent are other frequent factors which often impede the execution of a rational policy.
The aversion of the complex seems to represent another factor: many officials not acquainted with modern developments of economic science dislike to accept somewhat more complicated reasonings or the results of calculations even if from the scientific point of view they are decidedly better than the rules of thumb often accepted before.

A further factor, no doubt considerably influencing practical decisions, is the way of presentation chosen by each of the advocates of competing counsels. As far as this presentation inflates or deflates the real contents of the alternative proposals, it is possible that it leads to a wrong decision.

4. Negotiations when necessary in the process of realisation of a certain economic policy, require in the formulation of such a policy separate elements that are only too well-known. The result to be obtained by negotiations certainly depends on the ability of the negotiators to range the arguments, to use new facts, the exploit unknown data, etc. Part of these factors may be considered undesirable in the long run as well as from a broader point of view that places itself above the parties. But for those involved in negotiations they are more or less data and that must by no means be neglected. An interesting supplementary factor that may be less inattractive to most observers is the human want even with the "toughest" negotiators, not always to obtain concessions, but also to grant some concessions from time to time, in order not to spoil the atmosphere of the negotiations.

Apart from these factors specific to negotiations most of the other factors described in the preceding sections are present. Not very much need to be added to make it clear which of these factors seem to be necessary and which unnecessary.

5. A few words may be added about the organisation of economic policy as distinct from its contents. This chiefly
influences its speed of reaction. Economic policy nowadays is nearly always — in totalitarian as well as in democratic countries — a question of team-work. Large numbers of experts are co-operating and the numbers of those affected and interested is usually large too. This raises the question of the efficiency of meetings. Efficiency evidently may be hampered by too large meetings or delegations, by various of the factors listed in section 3, and by such rules as the rule of unanimity as a base for decision.

These scattered remarks may be helpful, it is hoped, to the reader in completing the picture of what economic policy really is. This may contribute, therefore, to the understanding of the real character and the requirements of a well-devised system of economic policy.
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