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 maximalisation 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 Ω . 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 quantitative and 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 Ω should be calculated and the alternative showing the highest Ω value be chosen.

The fixation of the function Ω 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 Ω 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.