

When is a Problem  
of Economic Policy  
Solvable ?

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## THAMES PAPERS IN POLITICAL ECONOMY

### WHEN IS A PROBLEM OF ECONOMIC POLICY SOLVABLE?

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The title of this paper is the same as one written some 25 years ago by the late Oskar Morgenstern.<sup>1</sup> Despite the fascinating nature of the question and the important and interesting attempt Professor Morgenstern made to answer it, his contribution has been neglected, and the subject has not attracted the attention of many other economists. I propose, therefore, to summarise what he had to say, and then to criticise and extend his argument somewhat in the light of more recent experience.

Morgenstern stated five conditions for the solvability of a problem of economic policy. The are set out as follows:

- (i) the corresponding theoretical problem must be solved in general terms;
- (ii) it must be possible to calculate the corresponding numerical solution;
- (iii) the policy problem must be correctly stated and formulated, but, "The formulation of the problem may itself be a matter of such magnitude that when it is achieved it is practically identical to the solution of the problem itself;"<sup>2</sup>
- (iv) the solution must be arrived at in good time;
- (v) appropriate side effects must be taken into account.

He pointed out that a solution may not exist at all, that there may be multiple solutions, or there may be many solution sets. (The last of these considerations corresponds to the notion of solution set in  $n$ - Person Game Theory). He also argued that the existence of a solution would depend on the admissible set of means, and that the "inclusion of political, historical, and psychological considerations may annihilate the fact of solvability which has only been established for the simpler conditions of the purely (economic) theoretical model."<sup>3</sup>

The Morgenstern approach was essentially to associate a set of criteria of evaluation with a piece of theoretical analysis. The problem of policy was defined as "the problem of application"; thus, the existence of some satisfactory theorem is postulated and then, ". . . it should be possible to obtain a concrete result in correspondence with the theorem. This would be the task of economic policy."<sup>4</sup>

Now, of the five key parts of the Morgenstern answer, the last three are surely acceptable. Correctness of formulation, a sufficiently broad perspective, and timeliness make good theoretical sense, even though their practical applicability may be difficult and subject to controversy. It is the first two which are not wholly compelling. This is not to say either that the theoretical solution of policy problems is unimportant, or that no



attention should be paid to numerical calculation of solutions. Certainly theory is important to avoid the "black box fallacy" of confusing the apparent empirical correlation between target and instrument and knowing why the instrument works. It is also important to differentiate between the advocacy of an instrument (such as public works in the 20s and 30s), and being able to argue theoretically as to its efficacy. But it is doubtful whether the problem of policy may usefully be approached in terms of the applicability of much of what is actually called economic theory, let alone be based on the numerical calculation of typical theoretical propositions. The following points are worth noting:-

- (i) Much existing theory is so abstract and has got itself so far removed from reality that there is no way of retracing its steps;
- (ii) Many problems arise from observed phenomena, which theory itself may not yet have encompassed;
- (iii) An approach based on the applicability of existing pure theory is in danger of ignoring the extent to which the economic system is working all the time and solving problems, so to speak. It confuses economics with the economy.
- (iv) It is important not to abstract from institutional reality, and especially the structure of decision making in practice.

Thus, the task of the policy maker and his advisers will frequently be one of inventing applicable theory in the first place. Of course, sometimes the relevant question will be: What are the consequences for policy of this piece of theory? But also, and perhaps more often, the point of departure will be the problem of policy itself. A need for action emerges and the policy maker looks to theory, estimation, computation and the like to see if they can be of any help.

In this connection it is important to emphasise the limitations of our knowledge of how the economy solves its problems, but it should not be inferred from this that the system does not work at all. The correct starting point for policy is not one of constructing an economic system from scratch, but of modifying an existing system that works, albeit only imperfectly. What is required, therefore, is a theoretical capacity and an investigative and computational facility which enables the economy to be controlled to some degree in the hope of improving its performance.

It might be argued that this distinction is chiefly a matter of degree. It could be said that "starting from scratch" is a limit case which envisages a much broader and more powerful set of means than would be required to adjust the existing functioning system. This is all very well as long as the mistake is not made of asserting that all systems (or parts of the system) below the level of the policy-maker, so to speak, are not solving

problems of an economic nature. More to the point, a problem of policy within a purely theoretical system (e.g. whether it converges to an equilibrium) is not a problem of policy in the real world unless the theoretical system itself is (or gives rise to) a satisfactory explanation of the real world.

We have argued that policy is typically reactive to circumstances. Problems of policy arise because the state of the world actual or potential, appears different from what we would like it to be. The key questions are, What **should** we do in this instance?, and, What **can** we do in this instance? Whether the topic is rising prices, unemployment, monopolistic exploitation of the consumer, wage rates below a subsistence level, or the disappearance of a local corner shop, the problem is initially defined with respect to **this** example in **this** place at **this** time. It will hardly be satisfactory to regard the problem of policy as being solved, however, when the specific instance has been dealt with. The particular phenomenon may go away of its own accord, its disappearance having nothing to do with policy. More importantly, although problems arise as specific instances, these instances are to be regarded as examples of a general class of problems. Thus, in saying that it is possible to solve a problem, what is really meant is that the capability exists for dealing with it in general. Even though (say) the problem of unemployment became pressing as a result of experience of the early 1930s, to claim that it is now solved does not mean that the unemployment of the 1930s has been removed, but rather that the government knows how to remove unemployment in a wide variety of circumstances as and when it arises. A key topic for current debate is whether solutions in that general sense can exist in economics. I return to this below.

Actually, the position is even more complicated than simply postulating a solution as being able to answer the question: What is to be done in the general case? Note must also be taken of the distinction between knowing what to do, and having a procedure for deciding what to do. Apart from the questions of: What do we do in this case? and What do we do in general? there is: How do we set about deciding what to do at all? This leads to a very useful classification of concepts of solution:

- (i) an action,
- (ii) a rule.
- (iii) a procedure for deciding a rule.

Related to this is a classification of what constitutes a correct solution:

- (i) the disappearance of the actual problem under consideration;



- (ii) the capacity to make this and similar problems disappear;
- (iii) the capacity to devise a procedure for making this class of problem disappear.

Consider, as an example, the solution to the inflation problem. This may be thought of in terms of preventing prices rising this year, or, more realistically, bringing the inflation of the '70s to a quick end. But it may be objected that what is really meant by saying that the inflation problem is solved is that it is now possible to remove inflation at any time and we can state precisely what must be done to achieve that end. If, however, as is most likely, inflation has many different characteristics and many possible causes, the claim to have solved the inflation problem must be interpreted as having the capacity to deal with the many different specific examples as they occur. (This, incidentally, means that it will not be necessary or even possible to state the precise policy to be followed before it is needed.) Using a medical analogy, in the field of virology we can distinguish between an antidote which destroys a specific virus, a class of antidotes which destroys a whole set of viruses, and a capacity rapidly to analyse any virus of a broad type and construct an antidote to it. (This formulation will take into consideration the extent to which viruses develop immunity and need to be attacked in new ways.) The main argument of the present paper is that this last concept of solvability may be more relevant to economics than the others which normally appear in the textbooks. The reasons are twofold; (a) ignorance of the way the economy works, which means that there can never be certainty whether only one facet of a problem has been seen or there are many new facets yet to appear, (b) as opposed to the physical world, there is a significant feedback from policy to the economic system via the flow of knowledge. Both the attempt to solve a problem and the claim that the solution exists create new problems, or render the problem immune to the old policy, so to speak. This may mean that there exist insoluble problems or even that all our problems are ultimately insoluble.

Since inflation has been mentioned, it is worth noting that it is a good example of the problem of timing, or events happening in due time. Policy failure may be due to the consequences of actions occurring too early or too late. Obviously, the possibility of fiscal or monetary instruments destabilising the economy is partly due to errors of timing.<sup>5</sup> Destabilising macroeconomic policy may be regarded as an example of correct general formulation of a policy problem coupled with an inability to calculate the numerical solution to a sufficient degree of accuracy. Nonetheless, the tendency remains to ignore the broader timing aspects of policy. Thus, in some parts of contemporary monetary economics there is an excessive focus on long run equilibrium outcomes combined with too little attention to the paths by which they are reached. To say that a particular policy which, starting from an inflation rate of 20% per annum will *eventually* lower it to 5% per annum, is a solution to the

inflation problem is to accept that eventually is soon enough.<sup>6</sup> Moreover, to accept that kind of solution without asking what else happens to the economy will not be satisfactory; thus, if the conditions of solution are more precisely defined such as getting from an inflation rate of 20% per annum to one of 5% per annum within six quarters and without the unemployment rate rising above 3% of the labour force, the solution may cease to exist. (Not to take account of time or of extreme side effects is equivalent to the well known aphorism in surgery, "the operation was a success; unfortunately, the patient died".)

The inflation example is also relevant to Morgenstern's point concerning the availability or admissibility of instruments. How is the price level to be kept under control? can be answered in one way if policy is limited to orthodox monetary and fiscal instruments, but in another if instruments of direct control are allowed. In addition, the restraining nature of the instruments, and the permissible range of variation of side effects, may depend on the initial position of the economy when the policy is introduced. To get to a given inflation target will vary in difficulty according to the starting rate of inflation, the starting rate of change of the inflation rate and inflationary expectations. Starting from inflation at 20% per annum, which is rising and is expected to go on doing so, being subject to the constraint that the unemployment rate must not exceed 3%, and being asked to reach an inflation rate of 5% within a year without any direct controls may be an impossibility. But, starting from an inflation rate of 11%, with optimistic expectations, being unconstrained with respect to any instruments or unemployment targets and being given (say) two years, a 5% inflation rate may easily be achieved.

A final point to be made in this context concerns the level of solution of problems. The economist typically thinks of doing the best he can in the circumstances, i.e. he may optimise relative to the constraints as he perceives them. This does not mean that he has solved the problem, however, if the required solution has already been specified in other terms. As an example, if we are constrained by a particular rate of inflation and a particular state of the balance of payments, we still may be able to devise a policy which sets the unemployment path as one falling from a present level of (say) 1.5m. to a level of .75m. in five years time. This may be demonstrated to be the best path possible, and in that sense the claim could be made that the policy problem has been solved. But if, for other reasons, the desired unemployment level has been set at .5m., the claim is an invalid one, for no way has been found of reaching the target that was set in the first place. Efforts may be made to devise new policy instruments for reaching that target. Social security payments may be improved to alleviate the personal cost of unemployment, but this expedient does not solve the problem; it merely mitigates its side effects. Optimisation or respecification of a problem can be immensely useful, but they are not, in all cases, the equivalent of a solution. To the man in the street solution means achieving what he has in mind, not



something else. (To offer another medical analogy, a cure for polio means precisely that. It is not the same as learning to live with polio or demonstrating that in the circumstances, i.e. up to the 1950s no cure was possible.)

There are two aspects of the policy problem which have received great attention in literature, and which can be dealt with very briefly at this point. One is the relationship between targets and instruments, and the other is to do with risk and uncertainty.<sup>7</sup>

A problem may be solved in a technical sense of knowing what to do about it, but remain unsolved in practice because of the shortage of available instruments. The policy maker may be confronted with many theoretically solved problems, but left with a choice of which problems to deal with in practice. He must decide which targets to go for, or, in optimisation terms, to what extent should each objective be underfulfilled.

It is true that many problems exist because of instrument shortage. (Indeed, in a trivial sense all problems do.) Thus the proposition that high employment and low inflation cannot simultaneously be achieved may be regarded as equivalent to stating that a single instrument of macroeconomic policy set at one level reduces unemployment and raises inflation and at another reduces inflation and raises unemployment. What is lacking is a second instrument which permits a separation of the two phenomena, their levels then being set independently. Another way of putting this which is relevant to current controversy is that our instruments may enable us to start to deal with inflation now leaving unemployment until later or the other way round.

The consequences for policy making of the existence of risk and uncertainty are well known. It could be argued that all problems of policy arise from lack of perfect information. The economic system requires policy makers at all levels to make up for its deficiencies, these deficiencies arising in the broad sense from lack of information on the part of other participants in the system. More generally, the problem may be seen as arising from lack of information conveyed by price and quantity signals, an inability to comprehend that information, and an inability to act on what is comprehended.

The limits to policy, the potential insolubility of problems, may lie especially in an inability to acquire sufficient relevant information in time. This may apply to the recognition of changes in exogenous variables. In addition, the structure of the economy, in an econometric sense, may be changing more rapidly than available capacity to estimate it can cope with. (Even if there were an underlying stable structure, it has long been emphasised that there may not be enough variation in individual variables to allow the kind of estimates needed at the

appropriate time.)

But it is possible to go further and assert that many choices in the system are genuine, and, therefore, that they are unpredictable *a priori*. The uncertainty confronting the decision maker can change the very nature of the control problem. The point is not that the problem of policy would be solved if enough were known, but rather that *in principle* such knowledge may not be available. This does not make the problem insoluble in the sense of there being nothing for the policy maker to do. It does make it insoluble in the sense of there being one single action which deals with the problem once and for all. The concept of solution must be reinterpreted, therefore, as a rule or more likely as a strategy, which itself may change over time.

If it is accepted that some problems of policy are game theoretic in character, it must be recognised that it is not only the central policy maker who has genuine choices available to him. Furthermore, it will be incorrect to make the assumption that each decision maker can or does always take the actions of others as given. The technical problem for the policy maker remains in that he will wish to predict the consequences of his actions predicated on various assumptions about the actions of others. (He will wish to determine and evaluate the contents of each box in the pay-off matrix, so to speak.) But he is still left with the choice of strategy.

Reference has been made to some policy problems as being essentially insoluble. Such examples in the theory of games as the battle of the sexes and the prisoner's dilemma may be regarded as insoluble problems if the participants are left to themselves.<sup>8</sup>

The employment-inflation problem seems to me to fall into this category. The role of policy here is to find a solution better than the participants can reach themselves. Creating a suitable monetary and fiscal environment may be part of the solution, but so also may incomes and prices policy.

Insolubility can emerge when the solution to a problem contradicts the conditions on which it was based. The reason is the well known but insufficiently appreciated one of the influence of knowledge on social behaviour.<sup>9</sup> Thus, the effects of a policy may depend on, firstly, whether it is known to be being used, and, secondly, whether it is thought to be effective. More generally, the effects of a policy may depend on how it is perceived by other decision makers. The influence of X on Y may depend on whether X is thought to happen by chance, is a result of the automatic workings of the economic system, or been brought about by design, (i.e. is the result of policy). The best known example is the Phillips Curve. It is perfectly possible, and reasonable within economic theory, for fluctuations in unemployment over some range to vary inversely with the rate of increase in money wages. But, once the government attempts to make use of this relationship to choose a particular level of



unemployment with a particular rate of wage inflation in mind as a target, the whole system of wage determination may change and the target may not be reached.<sup>10</sup>

A second example of a more topical nature is most instructive. Suppose (independent of whether it is ultimately true or not) that dealers in foreign exchange believe that domestic credit expansion is inflationary. When they observe such expansion, it will then pay them to sell sterling which will cause its foreign exchange value to fall. This will then increase the domestic price of tradeables, and with other prices inflexible in a downward direction, the general level of prices will rise. All of this can happen even if there is a margin of spare capacity in the economy, and the balance of payments on current account is in surplus.

The best known example of how a solution to a problem may itself create other problems concerns the Keynesian revolution. The point is frequently made that the ability to manipulate the level of economic activity and reach a position of full employment has led almost inexorably to over full employment and inflation. The pursuit of full employment, at the very least, would underwrite the cost push activities of trade unions and monopolistic employers. Although the government would not directly cause inflation, they would validate the activities of those that did.

Another side effect of the successful pursuit of full employment and stable growth is the reduction of the risk and uncertainty that accompanies private investment. Thus, investment itself may rise and become more stable, which in turn may diminish the need for a full employment policy. Of course, the same point holds in reverse. A diminution in the commitment to full employment, for anti-inflation reasons, may reduce the average level of private investment and increase its variance. A failure to deal with a problem may actually make the problem more difficult to deal with.<sup>11</sup>

Before concluding this section, a microeconomic example from the area of imperfect competition may be cited. It is that legal restraint on or prohibition of one class of anti-competitive activity leads to a search for others. Firms prevented from colluding explicitly will collude implicitly by introducing parallel pricing and price leadership. If separate firms are inhibited from concerted action, this will encourage them to merge. A policy problem of cartels will be replaced by the policy problem of mergers and covert agreements.<sup>12</sup>

One is reminded here of the classic comment of Adam Smith's:

"People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise

prices. It is impossible indeed to prevent such meetings, by any law which either could be executed, or would be consistent with liberty and justice. But though the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies; much less to render them necessary."<sup>13</sup>

Smith here is not what might be called a policy optimist and one would not necessarily follow him in accepting the impossibility of regulating implicit collusion. Nonetheless his emphasis on a permanent propensity to collude is important, for it tells us that policy, if it is applied at all, must be permanent and constantly changing in detailed character. Another example of caution or lack of policy optimism is provided by Lord Robbins:

"To spell out in advance all the possible categories of blameworthy or defensible action is a task which hitherto has defied the best efforts of legislative draughtsmen. To define the not infrequently unique circumstances of potential monopolistic situations and to judge their status from the point of view of the public interest is a problem not yet solved."<sup>14</sup>

My agreement with this comment derives from the view that solutions create problems, but I do not accept the conclusion that a solution should not be attempted.

Monopoly appears to be a problem of policy because economists have said so. From the most commonsensical level of analysis up to (or down to, according to taste) the most abstract level arguments are put forward about various welfare losses attributable to monopoly. But we may also ask whether monopoly becomes a policy problem for other reasons. One obvious example is the consumer detriments that have already been referred to. Consumers do not directly experience the relationship between marginal costs and price, and, therefore, are unlikely to see a divergence between the two as a reason for demanding government intervention. They do, however, experience some of the detriments referred to; such as misleading advertising, or products which do not correspond to what they expected. They may also have some sense of monopoly price and profits being too high. Thus, monopoly may become a problem of policy for consumer reasons which are not precisely the same as those which exercise the economist.<sup>15</sup>

Another important point to bear in mind which has significance well beyond the monopoly problem is that policy action may arise from the demand side rather than the supply. Politicians, and civil servants, do not merely solve problems as they arise, but also search for them. (What comes first, policy making or policy problems?)



This means that when there are other more pressing issues around, scarce political time and energy will be devoted to them, but when these issues become less pressing, there may be administrative room to consider monopoly. (We have here a new kind of crowding out!)<sup>16</sup> Related to this is the possibility that the problem of monopoly policy appears as a by-product of some other problem. Inflation provides yet another good example. In dealing with inflation the proposition may be put forward that monopoly is conducive to rising prices, because (say) of a cost push propensity on the part of monopolists, especially those who have not yet fully exploited their monopoly power. Thus, monopoly may become part of the agenda for action, i.e. a problem of economic policy, because it fits into a larger strategy.

It may now be seen that the notion of solvability and the nature of a solution may well be connected to the origin of the problem. If it is the economist's assessment which has been correct and which is influential, something like the Morgenstern approach may define the nature of the solution. It will be necessary, for example, to examine the costs and pricing policies of monopolists with a view to estimating the deadweight loss from misallocation of resources. Attempts may also be made to calculate X-inefficiency, the costs and benefits of advertising, and the propensity to innovate. Second best considerations may be taken into account so that the solution may be formulated in terms of a price equals marginal cost rule modified to take account of other monopoly elements in related markets; and research programmes may even be mounted to monitor continuously such divergences and other phenomena which are deemed to be pertinent to the overall optimum. The problem of economic policy for monopoly may then be said to be solvable when theory and method have so far advanced to facilitate the appropriate analysis and calculation; and may be said to be solved when such analysis and calculation is actually undertaken and leads to changes in monopolists' behaviour. At a lower level it might be recognised that much of this research at the present time is impossible to undertake successfully, especially if the dynamic aspects of monopolised markets have to be taken into account.

The problem of policy, however, may still be regarded as solvable if it were originally formulated in terms of removing particular abuses. Machinery may be invented to identify the abuses, estimate their cost to the economy, and possibly remove or regulate them. The problem may be deemed to be solvable and solved in those terms even though in a more high powered sense nothing of the sort has taken place.

Thirdly, the problem may be solved in an entirely different and more political sense. Having appeared pressing, and having been subject to considerable criticism, the evidence may not have been forthcoming on a sufficient scale to justify immediate action. At the same time other problems may emerge as much more important within the political

arena. Thus, and somewhat paradoxically, just as it was argued earlier that some economic problems may arise as a result of the existence or even the solution of others, it may also happen that economic problems disappear as a result of the emergence of others. Of course, they are not solved in a technical sense, but as a matter of practical policy making they certainly are.

Naturally enough, all three "solutions" of the monopoly problem are inter-related. Constructive action to remove part of the problem, especially the easily identified consumer detriments, coupled with theoretical and empirical action to assess the significance of what remains, coupled with broad regulations, coupled with a change in interest on the part of decision makers, especially politicians, may all comprise the solution. What must be appreciated, however, as an important answer to the main question is that a problem of economic policy is solvable when politicians can be persuaded to solve it.

Reference has already been made to the proposition that policy contains the seeds of its own destruction, so to speak. A problem that was once solvable may cease to be so, or its solution may change. Consider again, for example, the effects of devaluation. A country out of equilibrium, in order to improve its balance of payments, or add to its reserves, may have to enhance its competitiveness. This may imply an increase in the relative price of tradeables at home so as to encourage their production and exports and discourage consumption and imports. In most cases this means that the general level of prices must rise relative to after tax wages. It used to be taken for granted that this condition would be met, and, perhaps in the past there did exist the appropriate degree of money illusion or, what is nearly the same, the strongly lagged effect of prices on wages. What has to be recognised now is that, while the assumption may have been valid at one time, trade unions learn from experience so that money illusion or the lag in the effect of prices on wages may disappear. At the very least wages may react much more rapidly to price changes. Thus, it is perfectly possible to argue that in one historical epoch a devaluation of a given magnitude would work, and, therefore, be part of the solution to a balance of payments problem, and at another time it may cease to work. For all we know matters may become even worse than that. Workers may switch from money illusion to something that might be called real income illusion. In this case wage earners may attempt to overcompensate for price changes, giving rising to a prices acceleration and an actual worsening of the balance of payments. If expectations are taken into account, workers may observe a balance of payments deficit, anticipate a devaluation, and demand compensation or over-compensation for a real wage reduction that has not yet occurred.

This takes us into the general area of what has become known as the theory of rational expectations.<sup>17</sup> At the very least we must concern ourselves with the information available to decision makers in the



economy, what new information they acquire, and how their information differs from that of the central policy maker. Related to this are such questions as how they react to the information, and whether their own predictions of the policies to be followed centrally will affect the outcome of those policies. An emphasis on the importance of such interrelationships, however, does not lead, as some theorists have argued, to the conclusion that macroeconomic policy is either impossible or unnecessary. Quite the contrary, the correctness of the expectations of private individuals is likely to depend on government policy being both correct and successful. Of course, theoretical models of the economy can be constructed in which demand management is unhelpful or unnecessary, but there is no reason to believe that these are a correct characterisation of an actual economic system.<sup>18</sup>

So far attention has been devoted to several possible interpretations of solvability. There is one more to be dealt with which might be called pseudo solvability. Consider firstly the approach expressed in the form of "if only, or suppose that". This is a fallacy that may be exposed most easily by an example, such as the Phillips curve. This had the form:

$$(1) \quad w = a + bp + cU$$

where  $w$  is the percentage change in wages

$p$  is the percentage change in prices

$U$  is a measure of excess supply (or negative excess demand)

$$a > 0$$

$$1 \geq b > 0$$

$$c < 0$$

Suppose  $U^*$  is the desired state of excess supply. In addition, as a simplifying assumption, let the percentage rate of increase of the real wage,  $w - p$ , be given as  $r$ .

We can then replace  $w$  in equation (1) by  $p + r$ , and obtain equation (2).

$$(2) \quad p^* = \frac{a - r + cU^*}{1 - b}$$

Suppose  $p^*$  is greater than the desired rate of inflation,  $\hat{p}$ . It is then natural to examine equation (2), and note that the larger is  $r$  and the smaller is  $a$ , the lower will be the inflation rate. The temptation immediately exists to treat  $a$  and  $r$  as policy instruments, and to use

arguments like "the way to solve the inflation problem is to raise the rate of increase in productivity, or to reduce the time trend in the Phillips curve by means of an incomes policy". Now, if this proposition is regarded as an agenda which will guide us towards an examination of possible new policy instruments, it may be helpful. But, if the  $a$  and  $r$  are mistaken for actual policy instruments, we have substituted self-delusion for rational action.

Reference may also be made to the related fallacy of "change of attitude and opinion". Earlier, in discussing Adam Smith and Lord Robbins, the expression 'policy optimism' was used as a contrast to their own emphasis on the limitations of policy making in certain circumstances.<sup>19</sup> Contrasted with them there does seem to be a large class of economists who can be called policy optimists and who really do believe that all problems have technical solutions. Moreover, they have a second belief, namely that once these technical solutions have been arrived at and their existence made known to politicians, officials and perhaps the general public, there will be no major obstacle standing in the way of putting them into practice. An important weapon in the armoury of the policy optimist is his view that attitudes can be changed, and that powerful interest groups in society can be approached on the basis of argument, and pure reason.

An example of this kind of argument is to be found in a recent book by Professor Meade which is quoted not because of its uniqueness, but because of the eminence of its author.<sup>20</sup>

Meade says, ". . . the decent, free, prosperous society which modern science has undoubtedly brought within our grasp can never be achieved if powerful monopolistic bodies are unwilling to accept social control over their actions. This doctrine must be accepted by powerful labour unions as well as by large industrial concerns; but this cannot be done in the absence of a widespread change of public opinion. . . . We are a long way from this state of affairs at the moment; but the intelligent radical does not despair. . . . He will peg away using reasonable arguments to persuade reasonable citizens to accept reasonable policies."

Nothing in this essay should be interpreted to being opposed to technical analysis of problems and the use of pure reason. It must be recognised, however, that the same technical analysis has to be applied to the interest groups themselves. It may then become clearer why they reject the seemingly reasonable solutions to problems. This is presumably that in their own terms these solutions are not so reasonable. More to the point, until steps are taken to make these interest groups and their leaders "more rational", surely policies should proceed on assumptions corresponding to their actual behaviour.

The conclusions to be drawn from this paper are simple and



straightforward. It has been demonstrated that there are many different concepts of solution which are relevant to the problem of economic policy. Particular attention must be paid to the level at which it is claimed that the problem has been solved and to the degree of permanence of the solution. Many problems may have no permanent solution because people become aware of, adjust to, and may, therefore, become inured to a specific policy. There is a tendency, in other words, for problems to build up a degree of resistance to solution; and in changing their own nature, change the nature of the solution that must be devised for them. This suggests that a particular concept of solution which is relevant to the economy is that of the solution procedure rather than simply a straightforward answer to a clear question. General theories are intended to encompass the broadest range of data, but, as a result, they often tend to ignore evidence and experience altogether. The point of a solution procedure is to take full account of changing economic circumstances, which, themselves may arise from theory and policy. It devises theory which is actually relevant to the case under consideration, rather than relying on theory which, being relevant to everything, also throws light on nothing!

Economists, as would be expected, do place considerable emphasis on the technical solution to a problem. They are aware, however, that all policy making takes place within a political and administrative context. It follows that another kind of solution concept would be a political one which, while it may be dependent on the technical economic one, is not identical to it. Problems may exist in economic terms but not in political ones, and they may persist in the former terms but disappear, possibly to reappear again, in the latter. On the more methodological side, there is an important distinction to be made between the theoretical analysis of policy problems, and the applicability to problems of policy of existing theory, specially so called pure theory. The sense of this paper has not been anti-theoretical, but it has certainly been anti certain kinds of economic theorising, which are popular in the profession today. It is, perhaps, in this connection more than in any other that it diverges from Morgenstern's seminal work.

## FOOTNOTES

1. Morgenstern, "When is a Problem of Economic Policy Solvable?" in *Wirtschaftstheorie und Wirtschaftspolitik. Festschrift für Alfred Amonn*, Bern, 1953, pp.241-249. (The argument is also repeated briefly in *The Accuracy of Economic Observations*, 2nd ed., 1963, pp.124-127.)
2. *Ibid.*, p.241
3. *Ibid.*, p.245
4. *Ibid.*, p.244
5. The classic references are M. Friedman, "The Effects of a Full Employment Policy on Economic Stability: A Formal Analysis", in *Essays in Positive Economics*, 1953; and A. W. Phillips, "Stabilisation Policy and the Time Form of Lagged Responses", *Economic Journal*, 1957.
6. Morgenstern makes the additional, more methodological comment, "Clearly if something will happen only in an indefinite future, nobody now living would be able to check on the event unless there are preliminary events leading uniquely to the desired end-effect". *op.cit.*, p.242. This seems to me to be quite decisive with regard to many recent discussions of inflation.
7. For a textbook account of these matters see M. H. Peston, *The Theory of Macroeconomic Policy*, 1974, C.4 and C.5.
8. *Vid.*, R. Luce & D. Raiffa, *Games and Decisions*, 1957, C.5.
9. This, of course, lies at the centre of Professor Popper's contributions, for example, *The Poverty of Historicism*, 1957.
10. *Vid.* H. G. Johnson, "A Survey of Theories of Inflation", *Indian Economic Review*, 1963.
11. For a more extensive discussion of this topic, see M. H. Peston, *Whatever Happened to Macroeconomics?*, 1980.
12. Extensive discussion of these issues is to be found in *A Review of Monopolies and Mergers Policy*, H.M.S.O., 1978, and *A Review of Restrictive Trade Practices Policy*, H.M.S.O., 1979.
13. A. Smith, *The Wealth of Nations*, ed., E. Cannan, 1961, Vol.1, C.X, p.144.
14. L. C. Robbins, *Political Economy Past and Present*, 1977, p.57.
15. A. K. Cairncross makes the point, "Our concern for the maintenance of effective competition extends beyond purely economic considerations. Competition is one of the foundations of an open society in which all member countries of the European Community have a substantial stake . . . It is, therefore, necessary to weight against the gains from industrial concentration the socio-political consequences of concentration of private power, which could discredit property-owning democracy." A. K. Cairncross et al, *Economic Policy for the European Community*, 1974, p.143.
16. A vast literature had developed in recent years on the economics of political behaviour. The original work was, of course, A. Downs, *An Economic Theory of Democracy*, 1957
17. J. F. Muth, "Rational Expectations and the Theory of Price Movements". *Econometrica*, 1961.



18. For a bibliography and further discussion see M. H. Peston, *op. cit.*
19. A discussion of optimism appears in an excellent recent book by Professor Hutchison, *Knowledge and Ignorance in Economics*, 1977, C.4. He is there discussing and casting doubt on "the optimistic method" of simplification and abstraction in economic theory especially as set out by N. Kaldor and J. Robinson. Charles Goodhart also distinguishes between "market optimists" and "market pessimists" in his contribution to the NIESR conference on *Demand Management*, ed., M. Posner, 1978.
20. J. E. Meade, *The Intelligent Radical's Guide to Economic Policy*, 1975, p.17. Note also Sir Henry Phelps Brown, "What is the British Predicament?", *The Three Banks Review*, 1977. He says, "the remedy for the long term is, in a word, to change our culture. This is not to be done by exhortation. The misfit between our traditional values and attitudes, and the way of life by which we get a living in the world, is a question of fact. Given the facts, people will draw their conclusions." p.27.

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