1 Introduction

1.1 Economic policy

The reader about to embark on the study of economic policy will very probably already be familiar with the principles of economic analysis, and it is to this discipline that we will turn to introduce our subject.

Economic analysis examines the *individual or aggregate decisions of private economic agents* about what they produce, exchange and consume. These decisions are taken with specific objectives in mind, objectives that represent criteria for ordering the various possible situations in which agents might find themselves. For example, according to neoclassical theory consumers choose the combination of goods that maximises their utility, while entrepreneurs choose the quantity of output and the combination of inputs for each good that maximises their profit.

Economic analysis does not usually examine the behaviour of 'public' economic agents, which are attributed with collective aims. The choices of the latter – for example, government decisions regarding the level of expenditure or taxation – enter the macroeconomic and microeconomic models of economic analysis as simple data. At most, alternative hypotheses regarding the level of government expenditure or taxation[1] are considered in order to acquire some indication of what changes there would be in the performance of individual economic agents or the economy as a whole. Our study of economic policy must therefore complete many aspects of this analysis on three different levels:

(1) First and foremost, we must seek to understand the process by which government makes its choices, taking as given its objectives and the roles and scope of different institutions[2] and assuming that we know how the economy functions. This is the **'current' choices level**.

[1] In this case the variables are said to vary parametrically.
[2] The term '*institution*' has been given a variety of meanings in the social sciences. However, these can be reduced essentially to the following two. First, the term may indicate a set of 'rules' that regulate, in a lasting manner, the relationships within a group of agents; in this sense, for example, marriage, private property and the market are all institutions. A second meaning extends the definition to include the *agents* involved in implementing the rules and the *resources* necessary to do so; in this second sense, the government, the family and the Mafia are all institutions. We will use the term in both senses.

(2) A second level of analysis concerns the very existence and respective structures of government and the market. In standard economic analysis both of these institutions are considered 'natural', the latter perhaps more so than the former. The scope of each is given and possible areas of overlap and relationships of substitutability or complementarity do not emerge. In other words, economic analysis does not address questions about the extent to which government replaces the market – and vice versa – or the degree to which government is necessary for the market or reinforces it. Beyond the specific case of government and the market, a more general issue regards the types of higher-level economic institutions that are necessary or useful in governing a society. This is the level of **institutional (constitutional) choices**, which we reach once we know society's objectives and how the economy functions under different possible institutions.
(3) The final level of analysis concerns the identification of socially desirable goals. A similar problem is dealt with in economic analysis when the firm is realistically conceived as a combination of diverse interests rather than in terms of the classic figure of the entrepreneur (who is both owner and manager). Simplifying, it can be argued that a firm is composed of the owner, who seeks to maximise profits; the manager, who instead seeks to increase the firm's size (sales) or its rate of growth, since his income, power and prestige (the manager's ultimate objectives) depend on these variables; and workers, who are primarily concerned with the level of their real wages. An attempt to define a preference function for the firm must take account of the preference functions of the economic agents that operate within it. Similarly, for society as a whole we seek to derive a system of preferences (and hence objectives) from the preferences (objectives) of the various components of the community. This level of our study of economic policy therefore seeks to identify social goals (the **social choices level**).

Without going into further detail here, we can define **economic policy** as the discipline that studies public economic action, inasmuch as it studies all three levels: the 'current' choices of the government, the choice of higher-level institutions (i.e. the definition of society's 'economic constitution') and the identification of social preferences or objectives. Economic policy thus complements the analysis of the behaviour of economic agents and the functioning of economic systems conducted in economic analysis. Economic policy and economic analysis have in fact been conceived as separate disciplines for the sake of convenience within the more general framework of economic science to enable a more in-depth analysis of the issues involved. Just as in economic analysis it is essential to understand government action, drawing from the discipline of economic policy, in the latter it is equally crucial to understand the functioning of the private economic system, borrowing this knowledge from economic analysis.

Two clarifications are in order. First, economic policy can serve as a guide to public action only with the help of a variety of disciplines: in addition to economic analysis, these include philosophy, political science, constitutional and administrative law, statistics, econometrics and many others. With this in mind, we must caution that the

knowledge provided by economic analysis cannot usually be used as a guide to action without the qualifying and mediating contributions of these other disciplines.[3]

The second clarification regards the possibility (or necessity, as some would argue) of widening the definition of economic policy to include any conceptualisation that uses the knowledge of economic analysis (and other disciplines) as a guide to action for any economic agent whatsoever, especially the largest and most powerful. This would comprise not only government and other public bodies but also big business and industrial associations or lobbies, as well as 'big labour' (Caffè, 1966, I, pp. 13–14). Such a broad range of study would correspond to the second of the two ultimate tasks of economic science identified by Knight (1952): first, understanding and explaining certain phenomena, and, second, using that understanding to guide our action.

This broader definition has only recently received significant attention, but it will be largely reappraised in the light of the approach we adopt in chapter 9, where we characterise economic policy as a *strategic game*.

1.2 Economic reality and social preferences

A question that will recur throughout this book is why and under what conditions we require the presence of an economic agent with social or collective objectives in an economic system composed of individuals who essentially pursue their own interests. The need for such an agent is clearly related to the possibility that the operation of the economy may be judged unsatisfactory in some way; that is, it fails to satisfy certain wants. Such a judgement requires a comparison of reality and desires: if, for example, we have (involuntary) unemployment in a system based entirely on private action and this state of affairs is considered socially undesirable, intervention by an agent that pursues social aims is required.

This text has no intention of explaining further how economic systems work. Although we will draw on the relevant areas in economic analysis, our focus will be on social (or public or collective) *desiderata*, especially the way in which these are (can be, must be) formulated, which is the subject of social choice theory. We can then proceed with a comparison of desires and reality to derive society's institutional choices (what role to assign to different institutions) and government's current choices (the specific economic measures to be taken).

Bear in mind that the validity of many of our conclusions regarding institutional and current choices closely depends on the validity of the analytical tools employed, in particular the theories adopted to explain the performance of the economic system. At least as much as other sciences, economic analysis does not offer, nor can it offer, a body of objectively true statements (Myrdal, 1953, 1958). Each economic theory highlights

[3] For example, in Keynesian economic theory an increase in investment, whether public or private, causes income to increase by some multiple. Income could be increased by raising public investment. However, the precise amount of such investment can be established only if we know the value of certain parameters, which calls for statistical or econometric investigation; at the same time, the feasibility of increasing public investment must be assessed in both political terms (the possibility of winning parliamentary approval) and administrative terms (the possibility of effective and timely implementation).

certain more or less important aspects of reality, and the economic policy scholar must exercise special care in choosing a reference model. More specifically, we will see that two opposing 'visions' underlie the different theories: one that casts its gaze on economic reality through 'Panglossian' lenses, emphasising the 'harmony' and the ability to adjust (perhaps hidden but undoubtedly present) of certain institutions, such as the market; and another more pessimistic (or simply more realistic) view that underscores the negative aspects of those institutions in terms of 'failures' and instability.

1.3 Outline of the text and organisation of the discipline

In introducing the issues of economic policy, the three levels of choice examined by the discipline were presented in the following order in section 1.1:

(a) current choices
(b) institutional choices
(c) social choices.

Note, however, that the logical order of these issues is precisely the reverse. No institutional or current decision can be taken without first establishing social preferences; given these, institutional choices at the various levels can be taken. Once our higher-level institutions have been established, current choices can then be made.

The text normally follows the logical order. However, we do not deal with social choices, for which we refer the reader to Acocella (1998). Part I (chapters 2 and 3) deals in a highly abstract way with the institutional choices consequent upon the various possible social aims, principally with reference to the government–market dichotomy. We frequently return to the question in more realistic fashion later in the text. Social choices and institutional choices constitute the branch of economic policy known in the literature as **welfare economics**.

Part II (chapters 4 and 5) also examines general issues regarding institutional choices. More specifically, it examines policy models: given the social preferences that are to guide public action, as well as the analytical models developed by economic analysis, we must deal with the problem of planning – i.e. coordinating the use of available tools to satisfy those preferences, achieving the multiple objectives of government action. This (normative) approach to public intervention is then compared with the actual process of public decisionmaking (the 'positive' theory of economic policy). This part belongs to the **theory of economic policy**, which addresses questions regarding the definition and structure of government intervention.

Current choices can be divided into:

(a) 'structural' choices (such as those regarding the type of financial system), which are decisions on institutional, but not constitutional, matters; and
(b) 'corrective' choices (for example, a change in income tax brackets).

The *theory of current decisions* is examined in the remainder of the book. In parts III, IV, V and VI we examine, respectively: microeconomic policies (chapters 6, 7, 8

Table 1.1 *An overview of the discipline of economic policy*

Part of discipline	Subject matter	Parts and chapters of the book
(1) Welfare economics	(1) Identification of social preferences	Part I Chapters 2, 3 (brief references)
	(2) Identification of optimal institutions at the constitutional level	Part I Chapters 2, 3
(2) Theory of economic policy	(1) Planning criteria (design and structure of public intervention)	Part II Chapter 4
	(2) The actual process of public decisionmaking	Part II Chapter 5
(3) Theory of current decisions (corrective and structural)	(1) Microeconomic policies	Part III Chapters 6, 7, 8, 9
	(2) Macroeconomic policies	Part IV Chapters 10, 11, 12, 13, 14, 15
	(3) Private and public institutions in an international setting	Part V Chapters 16, 17, 18
	(4) Globalisation and the quest for a new institutional setting	Part VI Chapters 19, 20

and 9); macroeconomic policies (chapters 10, 11, 12, 13, 14 and 15); issues involving existing public institutions at the world or regional level (chapters 16, 17 and 18). In part VII we consider the globalisation of markets and production and the quest for a new institutional setting (chapters 19 and 20).

An overview of the content of the discipline is given in table 1.1. The plan of the book and its division into parts and chapters is also presented here.

1.4 Summary

1 Strictly speaking, economic policy is the discipline that studies *public economic action*. It examines the process through which social preferences are formed (social choices), the choice of institutions and the current decisions of government.

2 More generally, the field of economic policy comprises any discipline that uses the knowledge of economic analysis and other disciplines as a *guide to action for any economic agent*.

3 The question that recurs at each of the levels noted in point 1 above is that regarding the foundations of a *social (or collective) point of view* distinct from individual preferences.

4 These foundations are to be sought in *economic analysis* and other social sciences.

5 The parts of this book are arranged in decreasing order of abstraction. Part I deals with the process through which social institutions can be defined, in particular as far as the choice between government and the market is concerned. Part II outlines the structure of rational public action and provides a more realistic picture of the agents that form society and the process of defining and implementing government action. Parts III and V examine government action in various fields at both the microeconomic and macroeconomic levels and in closed and open economies. Part VI deals with the adaptation of existing international public institutions required by the globalisation of markets and production.

I The market, efficiency and equity

2 Market failures: microeconomic aspects

2.1 The role of the market and government

This part of the book addresses the problem of how different economic institutions – i.e. different 'rules' or procedures governing economic interactions among individuals – enable society to best satisfy those principles and the objectives derived from them. Limiting our discussion to the 'constitutional' aspects of economic institutions (setting aside consideration of current choices), we find two principal 'rules' of social interaction: the *market* and *government*. Obviously, other institutions may also have economic importance, such as *firms*[1] and **non-profit organisations** other than households and government. Focusing on the market and government, we intend to direct our attention to the extreme aspects of the contrast between institutions oriented towards the pursuit of individual and collective interests, respectively. In reality, the contrast is not as sharp as it might seem. There are organisations, such as firms, that in their most abstract form also pursue private aims, or other organisations with social ends that do not share the features of government, such as voluntary non-profit groups. We address non-profit institutions only briefly (see sections 6.5 and 8.5).

This part of the book offers a preliminary examination of how and under what conditions the economic results that can be achieved through the market (intended as a specific expression of private interests) or government (intended as a particular expression of collective interests) ensure that the principles of efficiency and equity are respected.

At this point in our analysis the distinction between market and government can be made only with regard to the private or public nature of the interests represented by the institution. Later (from chapter 5 on) we will also consider the difference between the two in terms of the nature of the *allocative mechanism* and, more generally, the *decision process* typical of – but not exclusive to – the institution: voluntary in the case of the market, coercive in the case of government (see, among others, Hirschman, 1970; Stiglitz, 1989; Holcombe, 1994). In any case we use the term 'market' to include

[1] Firms do not play any substantial (realistic) role in general equilibrium theory, even if this formally takes account of them. The problem was first raised by Coase (1937) and, more than sixty years on, we still do not have a comprehensive framework for the analysis of the market, the firm and other institutions.

private firms (unless otherwise specified), whereas the term 'state' includes all public organisations. We deal specifically with non-profit institutions in section 6.5.

2.2 Criteria for the choice of institutions: efficiency and equity

Social institutions can be assessed on the basis of two essential criteria: efficiency and equity.[2] In choosing between institutions directed at the pursuit of individual interests and those directed at the achievement of collective interests, we might therefore prefer the market or government on the basis of one or the other criterion.

One position broadly favourable of the market was expressed by Adam Smith. As is well known, the founder of economic science was a convinced believer in the 'virtue' of the (competitive) market as a social institution. His 'invisible hand' aphorism sought to express the ability of the market to ensure that economic choices made by individuals in the pursuit of their personal interests and preferences would have a beneficial effect for society as a whole. Smith (1776, p. 409) argued:

> As every individual, therefore, endeavours . . . to employ his capital . . . and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He . . . neither intends to promote the publick interest, nor knows how much he is promoting it . . . he intends only his own gain, and he is in this . . . led by an invisible hand to promote an end which was no part of his intention. (Smith, 1776, book IV, chapter II, p. 456)

Smith does not specify either the meaning of 'public interest' (efficiency or equity) or the type of market that would ensure pursuit of the public interest itself. Before we can analyse the terms of the choice of institutions in detail, we must clarify the concepts of efficiency and equity, and the types of market.

There are many concepts of **efficiency**. Among others, we can name allocative (or Pareto) efficiency, '*x*' efficiency and dynamic efficiency.

In order to define **allocative efficiency**, we need to introduce the concept of the *Pareto principle*. According to this principle, a *group* of individuals increases its welfare in moving from *a* to *b* if at least one individual is better off in *b* and no individual is worse off. This proposition allows us to classify the two situations *a* and *b* from the point of view of society as a whole.

It should be emphasised that this proposition is a value judgement;[3] it is a valuation *criterion* that might not be shared by everybody.[4] For example, before accepting the proposition, we might want to know something about who will benefit (e.g. whether the beneficiary is rich or poor), or how much some individuals (e.g. the rich) might

[2] We clarify the meaning of these terms shortly. For the moment, we appeal to the reader's intuition.

[3] **Value judgements** are ethical, religious or political judgements of a personal nature. They express a subjective view of *how things should be*; by contrast, **factual judgements** are claims (whether correct or not) about *what is*.

[4] Sen (1970a, p. 57) argues that a value judgement remains a value judgement even if nearly everyone in a society accepts it.

expect to benefit. However, the way the criterion is formulated does not allow us to take account of such additional information. Moreover, the Pareto principle implicitly assumes that the community must tend to satisfy the preferences of individuals however these are formed and whatever their content (the **liberal-democratic principle**, or **ethical individualism**, or **welfarism**, as Sen (1987) terms it). In other words, there are no needs worthy of protection other than those expressed by individuals. This is a postulate that some would not be willing to accept in every case.

Despite its status of a value judgement, the Pareto principle has an important role in economic science in that it represents a concept of **efficiency**: the possibility of one or more individuals obtaining more of something (in our case, utility) without forcing other individuals to do with less (and perhaps giving them even more) of the available resources.

From the concept of Pareto *principle* we can derive that of a **Pareto optimum** (see Pareto, 1906). A social state *a* is Pareto 'optimal' if in moving from that state *to any other state* it is not possible to increase the welfare of one member of society without worsening the condition of at least one other.

We can show that a Pareto optimum in a production and consumption economy requires:

(a) the *efficient allocation of consumption of goods*, which is achieved when the marginal rates of substitution (MRS)[5] for each pair of goods of all the consumers in society are equal
(b) the *efficient allocation of production inputs*, which is achieved when the marginal rates of technical substitution (MRTS) between each pair of inputs in the production of different goods are equal
(c) *general efficiency*, which is achieved when the marginal rate of substitution between each pair of goods for all individuals is equal to the marginal rate of transformation (MRT).[6]

We should note that the term 'optimum' is an entirely unsatisfactory choice of terminology (see Cornwall, 1984, p. 402). Since it is derived from the Pareto principle, so-called 'Pareto optimality' carries with it all of the limitations of the principle itself, limitations that are masked by the use of a term ('optimality') that implies desirability. We will see that such an association is not well founded. The use of a less value-loaded term, such as 'Pareto efficiency' or **allocative efficiency**, would have been more appropriate. Nevertheless, we will follow the dominant usage in this text, using 'optimality' rather than 'efficiency'.

'X'-efficiency is the ability of firms to select technically efficient production plans: after having chosen efficient production techniques (in particular, after having selected

[5] The **MRS** between, say, cloth and bread, can be defined as the reduction in the quantity of bread needed to offset the increased utility of an infinitesimal rise in the quantity of cloth if we wish to maintain the satisfaction of an individual unchanged.
[6] The **MRT** between cloth and bread is the reduction in the amount of bread that can be produced for each infinitely small extra unit of cloth production, given the quantity of inputs.