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INTERNATIONAL ECONOMIC CONFLICT  
DISCUSSION PAPER

NO.56

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POLICY MAKING

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# ECONOMIC THEORISING AND POLICY MAKING \*

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## Abstract

This paper relates economic theorising and policy making in a context of people's changing behaviour, which makes economy to work in a different way. As economic theory is not adapting to these changes, it produces false predictions. Also institutional factors and their changes are not usually taken into account. Disagreements among economists play a vital role to this. They mainly arise from the existence of value judgements. Although usually exaggerated, disagreements can be minimised if value judgements are formed by using the whole set of the available information about the function and needs of the society. And this can be done only if economists can have a global view of the other social disciplines.

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\* Many of the ideas developed here, can be also found in Vliamos, 1991. However, here they are developed in a different context.

# 1. Introduction

During the 70's, the evolution of the economic aggregates, the appearance of some "new" phenomena such as stagflation, and the demise of the celebrated Phillips curve, made apparent that economic policy was not delivering the promised stability. A major implication of this was the realisation of the serious limitations on the applicability of traditional keynesian policies. Academic economists responded to that either by bringing in to prominence alternative theories of economic policy which lay neglected in the shadow of keynesian orthodoxy, such as monetarism, or by putting forward new theories as they were seeking urgent solutions for long-lasting problems.

There, by that time a radically new view emerged trying to explain how economic fluctuations are generated and how they can be moderated. This new view, based on the observation that expectations are formed rationally, argues that the policy is not an event, in the sense that a certain well-defined policy action occurs, but it is rather a process. This process has to be decomposed into an anticipated and unanticipated component, so as a particular policy event, examined within the framework of the entire policy process, may be identified as anticipated, unanticipated, or partly one and partly the other. According to this argument, the meaning of process is two-fold: First, it is necessary to have a model of the evolution of the policy instruments that enables the policy instruments of any particular time to be decomposed into their anticipated and unanticipated components, and second it is also necessary to examine the broader institutional and political setting within which policies are being made. It is the entire policy process which, influences the quality of macroeconomic performance<sup>1</sup>. Because, expectations are formed by taking into account the whole environment. For the former to be changed towards the desired direction through the design and application of a specific form of economic policy, the agents of this action should take into account the whole of the factors determining this environment.

This simply says that rational expectations can be based on any information, provided that information can be demonstrated to be relevant to the forecasting of the future value of the variable of interest. For forecasting to be made "there must be a body of science, and a systematic observation process to inform that body of science, to enable the scientific community to make the relevant predictions. The rest of people can then consume the fruits of that scientific activity" (Parkin, 1982, p. 385).

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1. For a further development of this argument, see Parkin & Bade (1982) p. 486-7.

Therefore, we need to have theories able to analyse people's behaviour as members of the society, and also to have models, based on those theories, designed in such a way so as to accept all available information which is also used by people to shape their behaviour to external shocks. However, it is admitted<sup>2</sup> that it is, in general, very difficult to incorporate all relevant information that is used by economic agents within a simple econometric model.

This evolution in the conceptual framework within which economic policy should be formulated and applied, makes it rather weak for policy to influence the course of events, towards the desired direction. The problems economic policy has to face are of multidimensional character while the decisions are taken by the planners under conditions of uncertainty, as they operate in a very unstable environment. The environment is becoming unstable as people now learn quickly due to the spread of information. As people learn, they change their behaviour and make the economy to work in a different way.

In this paper, we examine the relationship of economic theorising and economic policy making within this dynamic environment. At a second stage, we refer to the role economists can play in organising things and formulating economic policies.

## 2. Economic Theory and Human Behaviour

Every society needs its economy. And this is the meeting ground for the production, exchange and consumption of the products. Since, people understand that there are always unfilled wants for more, products are always offered under scarcity. And economics studies the economy of scarcity. Economics possesses all the characteristics of the science as far as its positive propositions are concerned: There is hypothesis of the outcome of the relations concerned, and there is also testing of these hypotheses by logic and by observation (Lord Robbins, 1984, p. xiv, and Gemtos, 1984, pp. 37-46). However, even though many hypotheses can survive the test of verification and therefore can be regarded as provisionally applicable, the methods and problems of economic science are substantially different from those of the natural sciences. And this is because the subject-matter of the former is human action and therefore must be conceived as including purpose. In other words explanations for economic phenomena must be teleological (Vliamos, forthcoming).

This difference in the subject-matter of the economics and natural sciences causes sig-

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2. On this point see also Darnbusch & Fischer, 1990, p. 458.

nificant differences in the ability of the two scientific categories to explain phenomena (Lord Robbins, 1984, p. xvi onwards): First, in natural sciences, once causal connections have been established, the quantitative relationships can usually be assumed to persist, other things being equal. This is not so in economics, as tastes change quite often. Second, as human beings are capable of learning, their behaviour is affected in many ways.

Changes in knowledge may affect human action through changes either in the possibility of technology or the way expectations are formed, or both. Knowledge concerning the results of such behaviour can affect future behaviour. With respect to the last point we must bear in mind that an economy in which agents (being either producers or consumers) have information and accessibility to economic data, makes forecasts and analyses in a different way, from one in which these matters are known only to a tiny minority. If many individuals have an understanding on the way the economy works, or they can acquire economic expertise and advice, then the way they react or form expectations is not entirely random or ignorant<sup>3</sup>.

Therefore, at least the broad policy options that are available can be assessed by the informed people, even if the policy measures to be pursued at any time cannot be predicted accurately. This means that while in the past people largely reacted to events (and especially those that impinged on them directly) now they endeavour to analyse and predict events in the large, trying to improve their position in some way. But by doing this they influence the way the economy works<sup>4</sup>. Withing this reasoning we can say that some of the old good prescriptions of the economic theory will turn to be invalid, with respect to prespecified goals. Who can tell that a currency devaluation can meet its goals nowadays, when people react to this quite some time before the government itself even thinks to take such a measure?

We realise therefore that the economic behaviour of the individual is a dynamic and not a static one, and it progresses subject to the social control and social psychology (Houmanidis, 1988, p. 23).

In that case then economics must be better viewed as a way of thinking about certain kinds of problems arising as people change their attitude towards given circumstances, than a certain body of knowledge based upon well specified and generally accepted theories which most of the

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3. See also Peston, 1980, p. 56

4. M. Peston 1980, p. 58, considers the example of a trade Union. If prices go up, and then want to keep a constant real wage level, they will take action to increase their money wages, after a lag of course. But if due to past experience, workers do not have any money illusion at all, action will be taken at once, changing thus the way the economy works.

times are influenced by ideological and methodological biases.

And as Clower (1988, p. 86), asserts, we can hardly be surprised, under such circumstances, if the public at large is disposed to view economists' work with a certain amount of suspicion. Or to put it in another way, economist ideas are not generally held in high esteem. But whose really fault is this? Is it due to the fact that economics differs from natural sciences in outlook, method and logical structure, or is it simply due to that economists by disagreeing among themselves have somehow failed to convey the general public an accurate impression of the nature of their discipline and the reliability of the conclusions and predictions to which it leads? Granted that the nature of economics as a science differs, as we saw, from the natural sciences and by attributing to this very nature its fair share for the mistrust of the economic propositions by the public, let us proceed by examining the arguments of the second question in the reverse order, starting from the ability to predict, and going on to the disagreement of the economists.

Predictions are the result of econometric models with the help of the application of statistical methods. But many times statistical testing can produce results that make people think that they see much more than what they really get. "Much econometrics is no doubt formal-mechanical, inappropriately grounded, out of touch with real economic beliefs", Solow argues (1988, pp.33-34).

Thus, since predictions are the results of the working of Econometric models, then, given Solows argument one should question the consistency of those models with the way the economy works. But we have just argued that the way the latter works is affected by the way people predict events in the large. And the way people predict is possible to be affected by some now type of policy. Thus it matters how policy-makers respond to disturbances. And this information is essential for the predictions mechanism to work well. But who can predict with accuracy how policy formalisers will respond. And even if this can be done let us not forget the "Lucas critique" according to which the way private agents respond to changes in income and prices depends on the types of policy being followed. Therefore, econometric models should be redesigned with the scope in mind to include the responses of the agents to changes in policy. They should bear a consistency between the way people think the economy works and the theory at hand, that is the assumptions on which these models are based. Otherwise people's different responses from what the models predict will lead to deviations between forecasts and facts. After all the effectiveness of economic policies depend on economic agents' reactions to specific circumstances. If the latter change, their reactions will change also. They will not react every time the same way. This is equivalent to the arguments as Peston (1980, p. 64) also puts it, that a theory about the way the economy works must be compatible with the determination of expectations, which gives rise to actual human beings' behaviour, since the latter determine at a large extent the success of the exercised economic policy. All this amounts to say that the behaviour and thus expectations an econometric

model is based, should not differ from the forecasts produced by the model itself<sup>5</sup>.

Moreover, it is needless to say that the forecasting ability is further hindered by the existing institutions and ethics, and these things must be continually born in mind. These aspects are examined by the Political Economy. Political Economy focuses on economics in the grip of scarcity, where some resource limits are limiting the Economy's capacity to satisfy the wants for the goods it produces, leaving unfilled wants for these goods.

Political Economy recognises the fact that the performance of the economy depends only for a small part on nature factors, i.e. natural resources, and largely upon the institutional mechanisms that society chooses to use, as a matter of Policy, to motivate and to co-ordinate the participation of resources, in the social economy.

Let us go on now dealing with the second issue that is disagreement between economists. Outstanding and brilliant economists disagree fundamentally on theoretical and empirical questions, on policy proposals, and on the ways economic issues should be studied and settled. In positive statements these disagreements are solved by the empirical evidence. But what should be said about those subjective or ideological statements which come down to matters of opinion or intellectual preferences?

The whole matter boils down to the question: "Why economists agree or disagree with a give position? (Klamer, 1985, p. 237). In the absence of uniform standards and clear-cut empirical tests, economists have to rely on judgements. And they try to make their judgements persuasive. After all economics involves the art of persuasion. This process leaves room for nonrational elements, such as personal commitment, and social discipline. Therefore, based on personal commitments such as ideology, style and own history, economists build their models, which reflect their own views about the function of the economic system. They always look for a systematic theory to support their opinion on the conditions under which an event takes place. And this theory usually being built in isolation from the other social sciences facilitates further arguments in academic discourse. It has been argued (Klamer, 1985, p. 240) that learning economics is learning how to articulate theoretical arguments in support of one's ideas. However, economists do not only construct models and perform empirical tests. They also argue on what a good model should look like and on how does a change in assumptions affect the outcome of the model. But a change in the assumptions means change in the theoretical backing of the model, (although some models incor-

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5. The interested reader can go deeply in the analysis of this argument in Peston, 1980, p. 65 onwards.

porate so many ad hoc assumptions that it is unclear which economic theory they test)<sup>6</sup>. And as theory changes along with the assumptions, economists use labels to distinguish their own approaches from others. So, they speak of "Classical", "Neo-classical", "Keynesian", "Neo-keynesian", "Marxian" etc economics. After all, it has been said that a label is significant in persuasion.

However, this battle of schools should be ended somewhere. It is the belief of many, shared also by the present author, that disagreements among economists are commonly exaggerated, even by economists themselves (Klamer & Mc Closken, 1988, p. 3). However, this battlefield had become in the 80's more warlike than fifteen years before. Take the two simplest and well known models which we deal with at textbook level: the income-expenditure and the quantity theory model. Very simple but still they can represent quite well the battle between "Keynesians" and "Monetarists". Though different at first sight, they can be written in a way that all their similarities can be obvious. Peston (1980 p. 10) argues that "from the methodological point of view, the theories are surprisingly similar". So similar that they can bear a common approach, so as to make Hicks and Modigliani to claim that the two theories can be integrated into a single approach without contradiction (Peston, 1980, p. 13).

Having said all that, we can safely ask: What is the bearing of Economic Theory on practice today?

Economics, like any other scientific subject, lives by its unsolved problems. In the words of Joan Robinson "... the purpose of economic theory should be to try to throw some light on the world we are living in." (Robinson, 1980, p. ix). R. Clower (1988, p. 97) reflecting to this statesman he writes: "In no sense, however, is contemporary economic theory a suitable instrument for elaborating positive programs of social reform and economic control. For that purpose, we need a body of knowledge that has far more empirical content than the theory we currently possess - a body of knowledge that permits us to predict major features of the economic future ... with at least as much accuracy as meteorologists are currently able to predict the general character of next month's weather".

We have seen above that accurate prediction depends on the accurate knowledge of the human behaviour. But many economic theories may be criticised on the grounds that being mechanical pay too little attention to the nature and therefore the reactions of human behaviour. In other words, many of them rest on the assumption that people do not learn from experience, and their experience is not the result of all the forces that shape the environment they live in.

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6. This should not be taken as meaning that we favour simple models without assumptions. Because in such a case only the econometrics and not the economics hypothesis matters.

Since we referred above to the quantity theory of money and the income - expenditure models, we can consider them as a good example subject to this criticism. M. Peston (1980, p. 19) would perhaps add to that, that some theories which consist of what he calls "the fundamental micro-economics" "tended to be very much theoretical or analytical" in that they do not proceed prematurely to the empirical relevance and application. To quote him: "The role of the interest rate for example in generating enough investment to take up full employment saving is considered in the abstract, and persists in this literature separate from empirical studies of the interest elasticity of private investment. A similar point may be made about the real balance effect on private expenditure".

But, some developments in Economic Theory seem to be able to set norms capable of providing a basis for political practice as they seem to rest on the individual behaviour and experience. The Law of Diminishing Marginal Utility for example, is held to provide a criterion of all forms of Political and Social activity affecting distribution (Lord Robbins, 1984, p. 136). In other words it helps tackling problems met in public finance. However, much economic theory ends up in a blind alley, because it does not originate from actual economic problems (Robinson, 1979, p. 1). Even the aforementioned Law of Diminishing Marginal Utility which provides the theoretical base for the theory of distribution, presents deficiencies which weaken its provisions. More specifically, it rests on assumptions, does not matter whether true or false, which cannot be verified by observation or introspection. It rests on the scientific comparability of different individual experiences. However, the political economist cannot make interpersonal comparisons, with respect to happiness and welfare. All he can do is to compare opportunities. He cannot say that a fair redistribution of income increases total utility in the society, in the same way that he cannot say that disabled people are less happy than the abled-bodied. They are unhappy in terms of what? They are simply less advantaged. Therefore, we cannot infer that the justification for any propositions and the undertaken policy dictated by those is in any way scientific. It can be justified on grounds of general convenience or by appeal to ultimate standards of obligation. But not by appeal to any kind of positive science.

Hence, one cannot use this Law, which many economists accept as axiomatic, to base a policy favouring the argument that a graduated income tax is less injurious to society than a non-graduated poll tax, or that transfers from the rich to the poor will increase total satisfaction<sup>7</sup>.

Therefore, contemporary economic theory leads to disagreements as it approaches current problems by inevitably making extensive use of subjective factors, value judgements. The discus-

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7. For an excellent and detailed discussion of these matters, see, Lord Robbins, 1984, pp. 136 onwards.

frenzy from some academic scribe of a few years back". (Keynes, 1957, p. 383).

Therefore given this influential power which economists have and the multidimensional characters of the problems arising in modern sociopolitical environments, economists need to communicate not only with colleagues of the same discipline but also with them of the other social sciences.

Keynes prescribed that "..... the master-economist must possess a rare combination of gifts. He must teach a high standard in several different directions and must combine talents not often found together. He must be mathematician, historian statesman, philosopher - in some degree. He must understand symbols and speak in words. He must contemplate the particular in terms of the general and touch abstract and concrete in the same flight of thought. He must study the present in the light of the past for the purposes of the future. No part of man's nature or his institutions must lie entirely outside his regard. He must be purposeful and disinterested in a simultaneous mood; as aloof and incorruptible as an artist, yet sometimes as near the earth as a politician". (Keynes, 1963, pp. 140-141). Within the same context, professor L. Houmanidis (1988, p.13) argues that the economist should be a very well educated person, and should examine all the economic phenomena within the sphere of the other social phenomena ... because the Economic Science is not concerned only with the economic behaviour of the individual, but with that of the social group. And this is true as all social sciences, to whom Economics is a part, have different scope and methodology from all the other sciences, and the evolution of one does not proceed independently from all the others.

But how do economists react to this advice? Klammer and McClaskey (1988, p. 4) summarise the point: "Economists are deaf on the job to history or philosophy; most of them yawn at talk of geography or psychology; they do not take seriously the incantations of anthropology or sociology; although they want to speak to law and political science, they do not want to listen ..... The suggestion that the study of literature or communication or even the nonliterary arts might speak to them would be regarded by many economists as absurd .... Yet it is also true that the conversations outside economics are so varied so close to life as lived, that an economist who writes them off as emotion or non science or pictures at an exhibition irrelevant to the real thinking at hand will lose a lot. He will lose in fact the same thing the outsiders lose: a chance to think clearly about economic growth or social justice. A lot can be gained if economists break their isolation".

All these mean that while a good knowledge of the basic economic theory is a necessary precondition for every economist, the sufficient conditions which will shape his value judgement and allow him to contribute substantially to the formation of a correct economic policy is an open and critical mind. However, the acquisition of such an ability presupposes three conditions:

First, the existence of a broad University and other education for the economist, compris-

ing topics from other disciplines of Social Sciences. Because, as it has been already referred, the latter are not developed independently from one another.

Second, an inducement towards freedom of thought, which is only realised when education is organised within a free environment, in the sense that it is free from any dependence either political party it is or personal attitudes.

Third, the ability of a continuous development of intellectuality and information, which is only possible when the educational system as well as the overall professional appearance of the economist is not influenced by any economic and/or political circumstances.

Oscar Morgenstern (Peston, 1979) specifying the five conditions which are necessary for the solution of a problem of economic policy, argued that "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."

And this is possible only through a global perspective of the human behaviour within the society. For, otherwise, there is always a danger for the problem to be captured exclusively in economic terms while its other dimensions are ignored, ending thus to a one-sided confrontation of it. Within a society characterised by a net of interdependent activities, economists should be induced to widen their views on the economic problems, deepening their knowledge in the yet unsettled and uncertain state of contemporary intellectual understanding of forces governing the co-ordination of economic activities in the world.

## 4. Conclusions

In the previous analysis, we saw that economics ability to explain phenomena differs from that of the natural sciences due to its nature and the way people form their expectations and hence behaviour. These make economics to possess limited prediction ability. Although much of the economic theory provides the basis for political practice, it sometimes rests on assumptions which cannot be verified by observation and introspection. The propositions made can be justified on grounds of general convenience and not by appealing to any kind of positive science.

Hence, value judgements play an important role in the policy formation, since policy involves politics and politics ideology. This means that there is not such thing as "purely economic" problem which can be settled by purely economic logic, free, of political interest and political prejudice. Therefore, policy and propaganda are linked together.

Within such a political environment, economists should tackle policy problems by communication and co-operation with their colleagues of the other social sciences, to whom

economics is a part. And this because the evolution of each one of them does not proceed independently from all the others.

Economists therefore require an open and critical mind acquired by a broad and independent education, resulting to the adaptation of a global perspective of the human behaviour within the society.

However, communication is also necessary, towards colleagues of the same discipline. Economists disagree because they have to rely on judgements. Sometimes though, they place considerable emphasis on the technical solution to a problem, ignoring that all policy making takes place within a political and administrative context.

Let me conclude by recalling another remark by R. Clower (1988, p. 96, 98) "The foundations of contemporary economic analysis are, in truth, remarkably similar to those laid down originally by Adam Smith. Specifically, it must be recognised that at the present time, just as in Adam Smith's day, what we have by way of theoretical understanding of the working of a market economy is strictly in the nature of a magic castle: satisfying to the imagination but not much use for solving a housing shortage ..... we do not know enough to distinguish cases of economic toothache from cases of social lockjaw ..... Intelligent diagnosis is a prerequisite for effective treatment. Lacking a secure basis for such diagnosis we are about as likely to maim as cure the patient." Personally I think that economics can convince people and therefore can produce results and help. The sense of this paper, has not been against the ability of the economic theory to help with the tackling of the current problems society faces today, but it has certainly been against the view, unfortunately popular in the profession today, that economic theorising alone can meet the requirements of the policy procedures, without taking full account of the changing social circumstances.

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