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Redescovering economic policy as a discipline: A note

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Abstract

The reasons for the demise of economic policy as a value-laden normative theory, within the Frisch-Tinbergen-Theil approach, and those for its reappraisal are very important for academic research. They are critically analyzed in this note which discusses some arguments made in the last Nicola Acocella's fully-fledged book Rediscovering Economic Policy as a Discipline. He defends the status of Economic Policy as a proper normative discipline of Economics aimed to the foundation, coordination and reach of government action claiming that the two vital critiques to the effectiveness of macroeconomic policy actions, i.e. the Arrow's Impossibility Theorem and the Lucas Critique, may be overcome by a theory of economic policy in a strategic setting. So doing, though, he cuts across several important issues like the formation of economic expectations, the aggegation problem, the Public Choice hypothesis of self-interested policy-making, the necessity of microfoundations of macroeconomics taken for granted, the basic characteristics of the positive method based on empirical observation and analytical consistency, overall the hypotheses on which the economic policy models are based. Well, Acocella's strategic setting approach is interesting but the two vital critiques and the other problems remain.

Keywords: Aggregation Problem, Economic Methodology, Economic Policy, Macroeconomics, Strategic Setting

Abstrak

Alasan-alasan runtuhnya kebijakan ekonomi sebagai sebuah teori normatif yang sarat nilai, dalam pendekatan Frisch-Tinbergen-Theil, dan alasan-alasan untuk peninjauan kembali sangat penting untuk penelitian akademis. Hal-hal tersebut dianalisis secara kritis dalam catatan ini yang membahas beberapa argumen yang dibuat dalam buku Nicola Acocella yang berjudul Rediscovering Economic Policy as a Discipline. Dia membela status Kebijakan Ekonomi sebagai disiplin normatif yang tepat dari Ilmu Ekonomi yang bertujuan untuk fondasi, koordinasi dan jangkauan tindakan pemerintah dengan menyatakan bahwa dua kritik penting terhadap efektivitas tindakan kebijakan ekonomi makro, yaitu Teorema Ketidakmungkinan Panah dan Kritik Lucas, dapat diatasi dengan sebuah teori kebijakan ekonomi dalam sebuah pengaturan strategis. Dengan begitu, ia memotong beberapa isu penting seperti pembentukan ekspektasi ekonomi, masalah aggegasi, hipotesis Pilihan Publik tentang pembuatan kebijakan yang mementingkan diri sendiri, perlunya dasar-dasar mikro ekonomi makro yang diterima begitu saja, karakteristik dasar dari metode positif yang didasarkan pada pengamatan empiris dan konsistensi analitis, secara keseluruhan hipotesis yang menjadi dasar dari model-model kebijakan ekonomi. Pendekatan pengaturan strategis Acocella memang menarik, namun dua kritik penting dan masalah-masalah lainnya tetap ada.

Kata kunci: Masalah Agregasi, Metodologi Ekonomi, Kebijakan Ekonomi, Ekonomi Makro, Pengaturan Strategis

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1. Introduction

Economic policy may be intended either as a government practice or as a discipline derived from the specializations of economic science, which studies the effects of that practice carried out by the institutions. In Europe, the first concept may be traced back, through the history of economic doctrines, from the Mercantilism of the Absolute States to the actual economic forms of Liberalism. Economic policy as a discipline starts with Keynes General Theory, which introduces full employment as a policy goal and debates the neutralities of money and public finance (Keynes, 1936).

This note takes the cue from the title of the last Nicola Acocella's book which has the merit of supporting Economic Policy as a proper normative discipline of Economics aimed to the foundation, coordination and reach of government action (Acocella, 2018). The volume is articulated into two parts. The first one, covering the first four chapters, is dedicated to "Economic Policy as a Discipline" and deals mainly with the methodological necessity of both economic policy models and institutions in the moments of theoretical and empirical analyses which guide the policy decisions. The second one, covering the last three chapters, is dedicated to "Economic Policy in the Present Tense" and deals with the measures undertaken against the Great Recession and the institutions which are necessary to build a fair society.

The objective of this note is to dispute the relevance of the advances claimed by Acocella's strategic setting approach, which is equivalent to the rational expectation assumption, to overcome the two "vital" theoretical objections to the core of Economic Policy, i.e. the Arrow's Impossibility Theorem and the Lucas Critique. Besides pinpointing their limits, this note reminds that several important problems remain to be faced appropriately like the formation of economic expectations (Bao et al., 2021), the aggegation problem, the Public Choice hypothesis of self-interested policy-making (Longley, 2022), the necessity of microfoundations of macroeconomics taken for granted (Duarte, 2014), the basic characteristics of the positive method based on empirical observation and analytical consistency, overall the hypotheses on which the economic policy models are based. The note concludes that Acocella's strategic setting approach is interesting but the two vital critiques and the other problems remain.

2. Research Method

The observance of the basic characteristics of the positive method, i.e. empirical observation and analytical consistency, with regard to the hypotheses choice in the economic policy models has often been neglected with the mitigating circumstance of its elusiveness. It has also been authoritatively argued in favour of its arbitrariness and even of its pointslessness. The *F(riedman)-Twist* (Samuelson, 1963) about the irrelevance of the hypotheses realism indicates the exchange of a necessary condition with a sufficient one. For this reason we do not share the Friedman's position (Friedman, 1953): "Economics, being a positive science, is, or may be, also an objective one in the same sense of a phisical one". Furthermore, the methodological position defended here is again in contrast with the Friedman's presumption that the model prevision accuracy, more than the realism of the hypotheses therein adopted, be the distinctive character of positive economics. This position, infact, leaves free access to whatever hypothesis in economic policy models and finalises the scientific method to its capacity to predict a future variable value, that is an accident, not the outcome of the positive method applied to the phenomenon under study.

3. Results and Discussion

For Acocella, market failures, either micro or macroeconomic ones, represent the "logic of economic policy". They justifiy government action in many areas to correct or substitute the market in spite of the existence of government failures. This is the "first pillar of the discipline". Facing the numerous tasks arising from the market failures – and thus the rise of multiple targets- requires a number of effective policy tools as well as a coordination of their use to guarantee the attainment of policy goals. This is done in the "theory of economic policy", which constitutes the "second pillar" of the discipline.

In the past, Economic Policy as a discipline, together with Economic Programming, underwent a number of objections embodied either in the Lucas critique or in the "Neoclassical Synthesis", a research program (critical of Keynes model) which started in 1937 with the Hicksian IS-LM model and ended with the New Classical Macroeconomics model emerged in the Seventies as a response to stagflation (Hicks, 1937). Thereafter New Classical and New Keynesian Macroeconomics have substantially shared the same assumptions on the expectation formation and differed only on the nominal rigidities and the prevailing market regimes. Both of them conclude on the "divine coincidence" i.e. that there is no trade-off between the stabilization of inflation and the stabilization of the welfare-relevant output gap (Blanchard & Gali, 2005).

Acocella argues that the two "vital" theoretical objections to the core of Economic Policy i.e. the Arrow's Impossibility Theorem and the Lucas Critique, which threatened its foundations and validity, were not addressed for too long so leading to the demise of the discipline. The first critique threatened the possibility of tying government goals to the preferences of the citizens and therefore the democratic system. But now, in his view, these objections have been eventually overcome also thanks to his contribution. In his opinion, the "impossibility objection" has been disposed of by introducing the "implementation theory" referred to the Sen's idea of justice (Sen, 2009), as a "preferred principle of fairness" which emphasises the importance of public reasoning in achieving justice and its application to real-world injustices. According to Acocella, the social choice paradox may be solved thanks to the resurgence of Economics as a moral science in establishing what can make societies less unjust, a practical approach focusing on individuals' capabilities, meaningful freedoms and expansion of individuals' opportunities.

The second vital critique to the effectiveness of macroeconomic policy actions has been overcome with the theory of economic policy in a strategic setting, where the outcome of a player's strategy depends not only on her/his own action but also on the actions of other players. After Lucas raised the issue that the private sector could react to the policymaker's decisions, most policy problems have been discussed in terms of policy games, thus introducing the possibility of settling conflicts among different players. This approach lets the economic equilibria be influenced by policy actions as those postulated by the classical theory of economic policy. But, to overcome the Lucas Critique through a rational expectations model, Acocella leaves no room for time inconsistent policies like the stabilization ones, which may be crucial to face economic crises.

Acocella's book underlines the innovations introduced in the last two decades into micro and macroeconomic analysis to contrast the preference of rules vs discretion (the surprise effect, the non-vertical long run Phillips Curve, the optimal inflation rate, the political independence of Central Banks, the conservative central banker, the fiscal multipliers in the business cycle, the crisis induced by the Great Moderation encouraging greater financial risk taking). These innovations have pointed out either the fragilility or the limits of the critique of the ineffectiveness of discretionary economic policy and of the idea of a superiority of markets and of strict policy rules. It remains untouched, anyway, one of the leading issues of the economic policy setback i.e. the Public Choice hypothesis of self-interested policy-making underlined in the Buchanan's Paradox (Buchanan, 1992) which indicates to rent-seeking politicians interested in maintaining their "seats", i.e. their rents, the necessity of keeping apart from efficient and redistributive measures in their government actions.

Acocella moves in the wake of New Keynesian Macroeconomics developed through its microeconomic foundations. Infact, he claims that both the two vital critiques mentioned above may be overcome by accomodating the two pillars of economic policy in a strategic setting, thus re-establishing its role as in the traditional stabilization policies. This theoretical position, though, neglects that in Economics the relationships between micro and macro variables work either way, i.e. from the individual choices of the agents towards the economy as a whole, and viceversa (Duarte, 2014; King, 2012). In particular, the aggregation of individual actions entails complex methodological problems associated to the theoretical foundations which enable to reveal the relationships between individual and aggregate behaviours (Klein, 1946). A similar problem is given by the microfoundation of macroeconomic theories because the individual behaviours interactions at the micro level engender regularities at the macro level which cannot be traced in the individual actions. In other words, the economic operators may behave rationally at the individual level but this does not guarantee that the economic system, as a whole, produce rational results for the community. In macroeconomic models, the aggregation problem is bypassed, but not solved, by the adoption of the representative agent hypothesis from which the aggregate behaviour is derived (Chakrabarty & Schmalenbach, 2002). It ignores behavioral variance to favour a convenient formalization.

Furthermore, as it has already been observed, a theory of conflicts between two heterogenous agents, as the public and the private sectors, is interesting but it assumes that the individual choices are attributable to a representative agent with rational expectations indicated by the game's value. But when the game is not two-players zero-sum, none of these theories actually tells the players what to expect.

In order to lessen the deviation between reliable economic structures in different times, it is necessary to introduce expectations characterised by uncertainty and informative asymmetries which influence the decisions taken by heterogenous economic operators - not all profit or utility maximisers - confronted with newly announced economic policy measures. In other words, the rationality hypothesis should be derived, as all the hypotheses of the models used for political decisions, from behavioural uniformities observed in similar situations. This position, which is consistent with the positive method, is not compatible with the abstract dynamic-competitive selection process proposed by Friedman (1953), whose motivations have been convincingly contested by Robinson (1962).

For these reasons, we wonder here whether the main problems of economic policy, as a distinct discipline from economic analysis, be given by the objections to its effectiveness in terms of money neutrality or the main questions have rather to do with the assumptions of mainstream economics. In this sense, the main target of Acocella's book, i.e. the controllability of the economy in a strategic context, leaves untouched the problem of the expectations formation which are axiomatically assumed rational. In fact, these expectations are often extraneous to the individuals.

Furthermore we do not share Friedman (1953) and Boland (1982) presumption that even if the assumptions of a theory are false this does not prevent its statements to be true. In fact the validity test by implication is not sufficient for accepting a scientific proposition. The test for hypotheses realism cannot escape factual observations even if we are conscious that all the observations are theory-laden (Popper, 1963). If a hypothesis is not realistic, the logics wants that the prevision accuracy of the model is to be associated either to compensatory errors, chance or irrelevance. In this case, Friedman's methodological position maintains the weakest point of radical apriorism. It implies the super-imposition to the observed reality - though a subjective one - of a theoretical explanation not derived from it and therefore extraneous to it. An analytical procedure which is not confronted with the observation the positive method, in spite of its possible relevance, since it lacks one of the necessarily interrelated moments of observation and analytical consistency. Finally, we observe that the acceptance of the Friedman methodological position entails a major and relevant consequence which has to do with the transfer of the doctrinal dispute from the theoretical context to the empirical one. This position entails a scientific evaluation, instead of a political one, on the normative consequences of the different readings of the economic reality.

The presence of behavioural variance, associated to limited autonomy and rationality in the human action, does not deprive the systematic study of economic policy of either significance or usefulness. In fact, limited autonomy and rationality are compatible with different reactions to the same incentives and are defined on the base of the partial repeat of behaviours in similar conditions. But this derives from learning by experience rather than from aprioristic and abstract judgements, though suitable for a convenient formalisation.

In the second part of the volume, Acocella introduces elements of realism in the conception of the economic discipline, discusses some policy solutions to ensure a proper working of the capitalist system, and deals with the institutions as the ring connecting the logic, the theory and the solutions offered by economic policy to real-world probems. He analyses many important actual ones: the Great Recession, the macroprudential instruments for dealing with crises, the budget policy which should escape partial equilibrium constraints, the redesign of the global public goods like inequality, poverty and digital divide, secular stagnation, the search for right signals in a market economy, the need for more realistic assumptions about effective policymaking (let alone the economic expectations which are assumed "rational") and eventually the search of a proper and effective way to regulate markets by public action. There come out his indications for the design of the optimal institutional mix in a democratic society together with the need for worldwide antitrust laws and institutions.

In conclusion, Acocella laments the little effects of conventional and non conventional monetary policies (Quantitative Easing, forward guidance, negative interest rate among central banks, etc.) against the adverse shocks of the Great Recession which lasted longer and became more severe, prolonging and deepening it.

4. Conclusion

The relevance of the advances in the theory of economic policy claimed in the Acocella's book has been discussed here, also pinponting the importance of some fundamental issues to be faced for a real rediscovering of economic policy as a discipline. They have to do with some crucial assumptions on the formation of economic expectations, the representative agent solution to the aggregation problem, the Public Choice hypothesis of self-interested policy-making, which is at the base of the Buchanan Paradox. Most of all, the theory of economic policy cannot do without the positive method based on the two fundamental moments of observation and analytical consistency.

The two vital critiques to the effectiveness of macroeconomic policy actions, i.e. the Arrow's Impossibility Theorem and the Lucas Critique, cannot be overcome by a theory of economic policy in a strategic setting aimed to the controllability of the economy where more than two players act in a non zero-sum game.

In order to lessen the deviation between reliable economic structures in different times, instead of relying on rational choice theory, it is necessary to introduce, into the economic models, expectations characterised by uncertainty and informative asymmetries which influence the decisions taken by heterogenous economic operators - not all profit or utility maximisers - confronted with newly announced economic policy measures. In other words, the rationality hypothesis should be derived, as all the hypotheses of the models used for political decisions, from behavioural uniformities observed in similar situations.

Finally, the presence of behavioural variance, associated to limited autonomy and rationality in the human action, does not deprive the systematic study of economic policy, as a discipline, of either significance or usefulness.

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