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REDISCOVERING ECONOMIC POLICY AS A DISCIPLINE[1]

Abstract. After a decades-long gestation period, economic policy finally emerged as an autonomous discipline in the 1950s. It was founded on two pillars: the logic of economic policy, dealing with the development of democratic policy choices in the event of market failures; the theory of economic policy, focusing on ways of obtaining optimal policy plans. The paper investigates the critical assessments made of both pillars and a present-day analysis which fully validates these components parts.

Keywords: economic policy, logic of economic policy, theory of economic policy, critique, strategic theory of economic policy.

An overview of the evolution of economic policy as a discipline

Adam Smith was the founder of economics as a science. This later branched out into three semi-autonomous economic disciplines - economic analysis, public finance and economic policy. Adam Smith's analysis sowed the seeds of public finance and economic policy. Public finance was the first to emerge, towards the end of the 19th century, though the foundations had been laid well before then. It addressed the main tasks of a modern state in terms of levying taxes and regulating public expenditure. Economic policy arose later, as we shall see, to address the activities to be carried out by governments to regulate the economic system. For Adam Smith and other classical writers, government activity played a limited role.

These three branches are differentiated by their degree of abstraction or remoteness from reality, economic analysis being the most theoretical, followed by economic policy and then public finance.

The seeds of economic policy were sown between the end of the 19th century and WWII, when indications for microeconomic market failures were developed, in terms of inefficiencies and inequality, based on what is now termed 'social choice and welfare theory'. Then, Keynesian analysis led to the development of indications for macroeconomic market failures, throwing light on issues such as unemployment, inflation or deflation and stagnation. Microeconomic and macroeconomic policy form the 'logic of economic policy', justifying the existence of government action in many areas to correct or substitute the market in the event of failure. This constitutes what we shall call the 'first pillar' of the discipline.

Governments have to perform numerous tasks in the event of market failure, involving multiple policy targets, which require the implementation of coordinated

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[1] This paper draws from my Caffè lectures (Faculty of Economics, Sapienza University of Rome, 13-14 December, 2016).

policy tools to guarantee the attainment of goals, as suggested by the 'theory of economic policy' (Frisch, 1949; Tinbergen, 1952; Theil, 1956). This constitutes 'the second pillar' of the discipline of economic policy. The logic and the theory of economic policy form the 'core' of the discipline, addressing the conditions for effective policy action. Economic policy also has a third branch - applied economic policy - which draws on concepts from the two pillars within given historical and institutional contexts.

Economic policy can be said to have been 'officially' established only at the end of the 1950s. As a discipline, it emerged in a number of European countries - Scandinavia, the Netherlands and Italy, where Federico Caffè anticipated the contents of the two pillars (Acocella, 2014). Outside Europe, the main country where it developed was Australia. Elsewhere, impact was limited, especially in the US, where it was found mainly in textbooks. Specific circumstances had helped the discipline emerge and flourish in the aforementioned countries. These countries shared some common traits, distinguishing them from other nations: the influence and left-wing orientation of the 'intelligentsia', the political parties in government, major opposition parties and institutions (such as trade unions). There was also a conviction that public happiness should be served by a visible hand. For Italy, other circumstances also contributed: the idealistic epistemological attitude of the Italian scientific community; the importance at the time of the Marxist and Catholic credos – which were both pro-government; and the influence of civil society. To explain why the idea of economic policy did not catch on in other countries – and indeed did not survive in the countries where it had flourished for some time – many factors can be offered.

As a discipline, economic policy drew on the evolution of economic and social systems, as well as various innovations that had been introduced in different fields of economics: mathematics and statistics, insofar as the 'theory of economic policy' is concerned (see Preston and Pagan, 1982); political philosophy and political science (see Pigou, 1920) as regards welfare economics and social choice, i.e. the 'logic' of economic policy.

An analytical discipline cannot be conceived if some minimal conditions are not satisfied, especially if the abstract pre-conditions for its existence are absent or insufficient or defective. In particular, economic policy as a discipline needs two such pre-conditions: i) the existence of market failures requiring institutional intervention based on a logic other than self-interest; ii) the validity of what we have called its 'core' elements, allowing for market decisions to be supplemented (or substituted) with consistent and effective public actions (as an expression of people's preferences).

Critiques of the concept of economic policy arose at the end of the 1950s. Some of these concerned 'political economy' and emphasized the existence of a 'positive' theory of economic policy (Persson and Tabellini, 2000; Mueller, 2003). This predicates that policy actions in real life are different from those indicated by normative theory, due to the personal or 'political' interests of policymakers and the influence of interest groups in society. These critiques are certainly helpful, as they enrich our knowledge and underline the need for realistic assumptions and the introduction of relevant concepts that should be incorporated into economic policy for effective policy action.

Other, 'vital' critiques, instead, focus on the 'core' components of the discipline. They leave the logic of economic policy untouched insofar as the existence of market failures is concerned, thus setting, from this point of view, the stage for government intervention to address such failures. The first 'vital' objection postulated that people's preferences could not be used as a reference point for public action (Arrow, 1951). The second questioned the effectiveness of public action (Lucas, 1976) and was based on the introduction of rational expectations into the analysis, together with

other assumptions. These types of expectations implied that government action could be foreseen and neutralized by the private sector. If left unaddressed, these critiques would undermine attempts to tackle market failures in democratic societies, by delegating the definition of society's goals to political institutions and politicians, thus severely limiting the range of public action and confining it to a rule-making role. These critiques can partly explain why the discipline did not catch on in other countries and did not survive, even in Europe and Australia, after the 1970s or, in some cases, the 1980s.

For a time, these critiques were not addressed, which led to the demise of the discipline. As to the objections to the first pillar, a pragmatic solution was provisionally adopted. However, one based on logical, political and philosophical premises was put forward only over a decade later. First Leibenstein (1962), then Sen (1970) showed that Arrow's apparently 'neutral' postulates hide value judgements, and a social choice rule can be derived from individual preferences if a value judgement, or, better, a theory of justice, is chosen. Re-establishing the second pillar took longer, beginning only some decades after the initial critique, and required a number of steps the last of which was accomplished only quite recently.

The rehabilitation of the effectiveness of policy actions included the following crucial points:

1) the limited practical relevance of Lucas's surprise effect (see Mishkin, 1982, 2011);
2) the theoretical and practical limits to time inconsistency and thus to related prescriptions of monetary policy rules that should replace discretionary action (Acocella et al., 2013, 2016);
3) the existence of a non-vertical long-run Phillips curve (see for example Benigno and Ricci, 2011; Di Bartolomeo et al., 2014);
4) the need for a more active fiscal policy (see for example Auerbach and Gorodnichenko, 2012; Mittnik and Semmler, 2012) and regulation (especially of financial markets and institutions; see for example De Nicoló et al., 2012), once some unrealistic assumptions of current models are ruled out;
5) a critique of the arguments in favour of the political independence of central banks (for example, Hayo and Hefeker, 2007);
6) the sub-optimality of a conservative central bank in a monetary union with active trade unions (Acocella et al., 2007);
7) a critique of the Friedman rule and the need for an inflation target well above zero in the presence of public transfers (Benigno and Woodford, 2004; Di Bartolomeo et al., 2015).

About one decade ago, Acocella and Di Bartolomeo (2005, 2006) rehabilitated the 'classical' theory of economic policy in a strategic context, in particular Tinbergen's 'golden rule', which requires a sufficient number of instruments to control the economy. This invalidated Lucas's critique, since this context is equivalent to assuming rational expectations.

The theory of economic policy in a strategic context accomplishes a number of tasks. First, it indicates static and dynamic conditions for controlling and stabilizing an economy. These conditions go back to Tinbergen's well-known rule of having at least as many instruments as targets. The theory also states conditions to achieve equilibrium or a multiplicity of equilibria, when more than one agent satisfies the rule. It can therefore be seen as a theory of conflicts among agents having competing targets or target values and how to resolve them. It is thus useful for model and institution-building, i.e., it can help both researcher (to devise suitable models) and

policymaker (to address real problems successfully), which implies a total or partial convergence of interests and/or conflicts. It also deals with announcements that can help find one equilibrium out of many.

The theory of economic policy can be applied to a number of fields, and in particular to the main problems of today: the economic crisis, inequality, stagnation, globalization.

The recent economic crisis (or Great Recession, as it has been called) has created a number of new issues ('the bad news'). On the one hand, its length and profound impact have threatened the effectiveness of traditional policy tools (fiscal policy, since it has hit the upper limits of public debt and deficit, and monetary policy, stuck by contrast at its zero lower bound). On the other hand, the crisis has added to the other current problems we have just mentioned or has compounded them. This has reduced the number of instruments available whereas targets have increased, making it difficult to control and stabilize the economy. New policy tools have had to be found, such as unconventional monetary policies, macro-prudential policies and new fiscal policy rules ('the good news'). The new theory of economic policy can help establish indications that point to imbalances, to help forestall new crises.

Economic policy as a discipline has then been rehabilitated and enriched in content. In this new setting, institutions play a major role. They are relevant from many points of view. In fact, institutions permeate the whole discipline of economic policy, being of the utmost importance when identifying goals to direct public policy according to citizens' preferences (the procedural equivalent of Arrow's postulates, establishing, for example voting procedures). They also affect the general nature of the performance of the system and condition current policies and their effects (Acocella, 1994, pp. 1-2, English edition). They are a necessary ingredient for all three parts of economic policy as a discipline. In fact, they underlie the two pillars, the logic and theory of economic policy, as well as their practical applications, which can be defined only in given historical and institutional contexts.

Thus, institutions constitute the ingredient that holds together the discipline and differentiate it from other branches of economic science, such as economic analysis, which largely neglects them, and public finance, which focusses on specific rules and the activities carried out by public bodies[2].

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[2] See Acocella (2018, ch. 7) for an in-depth discussion.

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