**Rediscovering Economic Policy as a Discipline**

Government interventions in market failures can encounter objections from those who doubt their efficacy. Acocella, a leading expert on economic policy, counters these unfounded criticisms, making the convincing case for the foundation, coordination and reach of government action through economic policy. Arguing for the governmental potential to devise democratic, fair and effective institutions and policies, this book also demonstrates the validity of the principles outlined by Frisch and Tinbergen, amongst others, for controlling the economy, in a strategic context, equivalent to the rational expectations assumption. Demonstrating how unconventional monetary policies and other policies (such as macro-prudential regulation, new fiscal rules and new forms of international policy coordination) can offer an effective response to the multiplicity of current economic issues, the recent financial crisis arguably indicates that economic policy must once again take centre stage as the applied complement to mainstream economic theory.

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This series of annual lectures was initiated to honour the memory of Federico Caffè. They are jointly sponsored by the Department of Public Economics at the University of Rome, where Caffè held a chair from 1959 to 1987, and the Bank of Italy, where he served for many years as an advisor. The publication of the lectures will provide a vehicle for leading scholars in the economics profession, and for the interested general reader, to reflect on the pressing economic and social issues of the times.

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CAMBRIDGE
UNIVERSITY PRESS

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UNIVERSITY PRESS

University Printing House, Cambridge CB2 8BS, United Kingdom

One Liberty Plaza, 20th Floor, New York, NY 10006, USA

477 Williamstown Road, Port Melbourne, VIC 3207, Australia

314–321, 3rd Floor, Plot 3, Splendor Forum, Jasola District Centre, New Delhi – 110025, India

79 Anson Road, #06–04/06, Singapore 079906

Cambridge University Press is part of the University of Cambridge.

It furthers the University's mission by disseminating knowledge in the pursuit of education, learning, and research at the highest international levels of excellence.

www.cambridge.org
Information on this title: www.cambridge.org/9781108470490
DOI: 10.1017/9781108556705



First published 2018

Printed and bound in Great Britain by Clays Ltd, Elcograf S.p.A.

*A catalogue record for this publication is available from the British Library.*

*Library of Congress Cataloging-in-Publication Data*
Names: Acocella, Nicola, 1939– author.
Title: Rediscovering economic policy as a discipline / Nicola Acocella, Sapienza Universita di Roma.
Description: Cambridge, United Kingdom; New York, NY: Cambridge University Press, 2018. | Includes bibliographical references and index.
Identifiers: LCCN 2017061451 | ISBN 9781108470490 (hardback)
Subjects: LCSH: Economic policy. | Economics.
Classification: LCC HD87 .A2856 2018 | DDC 338.9–dc23
LC record available at https://lccn.loc.gov/2017061451

ISBN 978-1-108-47049-0 Hardback
ISBN 978-1-108-45491-9 Paperback

To Federico Caffè, anticipator of economic policy
as a discipline, educator of thousands of students
and my mentor

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# Preface

In the process to specialisation of the unitary economic science that had developed since Adam Smith's *Wealth of Nations* (1776), at least three economic disciplines have arisen over time, each with some degree of autonomy, albeit linked one to the other. Adam Smith's analysis contained the seeds for all future developments. First, it was economic analysis, which progressively proceeded towards a highly abstract set of principles, after other economic disciplines had developed. Then, public finance emerged as a necessary step for designing the main task of a modern state, i.e. to levy taxes to meet public expenditures. This discipline arose by the end of the nineteenth century, but some bricks were laid well before. Economic policy – which had a limited role for Adam Smith and other classical writers – arose only later, as we will see.

What differentiates the various disciplines is their different degree of abstraction or remoteness from reality, economic analysis being the most theoretical one, followed by economic policy, encompassing the action of government in all economic areas and, then, public finance, confined to the action of government for taxes and expenditures.

The seeds of economic policy were laid from the end of the nineteenth century to World War II, but the discipline can be said to have been 'officially' established only by the end of the 1950s. Market failures were first identified through a microeconomic lens only, by what is now termed 'social choice and welfare theory', and then, by Kalecki, Frisch, Keynes and others, also in macroeconomic terms. As I will say, market failures represent the 'logic of economic policy', which justifies the existence of government action in many areas to correct or substitute the market for its failures. It constitutes what I call the 'first pillar' of the discipline.

Facing the numerous government tasks arising from 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 goals. This is done in the 'theory of economic policy', which constitutes my 'second pillar' of the discipline of economic policy.

Economic policy has also a third branch, applying the concepts of its two pillars to given historical and institutional contexts. I call it 'applied economic policy'.

This book is organised as follows: Chapter 1 traces the development of economic policy as a discipline, which concluded in the 1950s. Chapter 2 deals with the progressive dismantling and the demise of this conception of economic policy for a long time. Specifically, the discipline as sketched in Chapter 1 became obsolete as a result of many critiques addressed to it. Some of these critiques were 'minor', as they could rather easily be incorporated in the realm of the classical version of economic policy.

'Vital' critiques, instead, referred to the central aspects of the two pillars and threatened their foundations and, thus, their validity. If they are unaddressed, the whole discipline – or at least a part of it – collapses. The first such vital critique was advanced by Arrow in 1950–51 and concerned the impossibility of defining social targets starting from individuals' preferences (Arrow's critique). This critique threatened the possibility of tying government goals to the preferences of the citizens and, thus, the possibility of their democratic derivation.

The second vital critique referred to the ineffectiveness of macroeconomic policy action and derived from the introduction of 'rational expectations' in the 1970s. Rational expectations implied that any government action could be foreseen and neutralised by the private sector. This deprived government action of a set of relevant macroeconomic policies, even if it retained some degree of acceptance of microeconomic policy intervention as a way to influence the structure of the economy.

These critiques were not addressed for too long, which led to the demise of the discipline. Chapter 3 investigates the long process of rehabilitation of economic policy as a discipline. After a couple of decades, the first critique was overcome, which required an appeal to the need for a theory of justice. The rehabilitation of the second pillar needed even longer. It passed through a silent and slow revolution, laying down various pieces that contributed to clarifying the rationale – and conditions – for the effectiveness of public policy. Around a decade ago, this finally led to a statement of the theory of economic policy in a strategic setting, rather than in a parametric context, as in the classical theory.

Chapter 4 describes the content and methodology of the theory of economic policy in a strategic context. It indicates static and dynamic conditions for the controllability and stabilisability of an economy that go back to the well-known Tinbergen rule of the existence of at least so many instruments as targets. The theory also states the conditions for the existence of an equilibrium or multiple equilibria when more than one agent satisfies the rule. It can therefore be depicted as a theory of conflicts among agents having competing targets or target values and their resolution – thus a 'theory of conflicts' and a 'theory of consent'. It is thus useful for model and institution building, i.e. it can help both researchers – in devising suitable models – and policymakers – in successfully coping with real problems, which imply total or partial convergence of interests and/or

Cambridge University Press
978-1-108-47049-0 — Rediscovering Economic Policy as a Discipline
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conflicts. It also deals with announcements that can help in finding one equilibrium out of many.

Chapters 5 and 6 apply the tools developed by the theory of economic policy in a strategic context. Chapter 5 provides several practical examples on how the theory works. It applies the theory of economic policy to a number of fields, in particular, to the main current problems, the economic crisis, inequality, stagnation and globalisation. Chapter 6 reveals the helpfulness of the new theory of economic policy in laying down signals that provide sufficient information for pointing out economic conditions in general and imbalances in particular that can be useful for preventing crises. The chapter also discusses the realistic assumptions and the political economy concepts that should be incorporated into economic policy for effective policy action.

Finally, Chapter 7 explains the crucial role of institutions when conceiving economic policy as an autonomous discipline. In fact, institutions underlie and link together the two pillars of economic policy, as well as the third part of the discipline, applied economic policy. Institutions thus constitute the glue of the three parts of economic policy, the logic of economic policy (notably social choice and welfare theory), the theory of economic policy and the applications of these two pillars to a given situation.

# Acknowledgements

In preparing this book, I was greatly assisted by the advice and criticism of many friends and colleagues. Some parts of this book draw on the results of my previous research, such as many of my papers and books, sometimes jointly authored with others. I therefore thank the co-authors with whom I wrote: Giovanni Di Bartolomeo, Douglas A. Hibbs, Andrew Hughes Hallett, Giovanni Paolo Piacquadio and Patrizio Tirelli. Giovanni Di Bartolomeo and I first devised the new theory of economic policy that overcame radical objections to the classical theory, reestablishing what I call the 'second pillar' of economic policy as a discipline. I still remember how excited we were when we realised the innovative character and deep implications of the new theory.

Joint works are all cited in the relevant parts of this book where they are used and are included in the References. In some cases, the parts drawn from these papers are rather long, and I have asked permission from the co-authors to reproduce them. Anyway, the sources of these parts are not only quoted, as usually, but explicit mention of them is made at the beginnings of the relevant sections.

I must thank the friends and colleagues who have read the whole manuscript or parts of it and suggested a number of changes, in some case of perspective. Among them I must recall Alberto Baffigi, Guido Candela, Giovanni Di

Bartolomeo, Andrew Hughes Hallett, Reinhard Neck, Michele Raitano, Roberto Schiattarella, Mario Tiberi and Ignazio Visco.

I am grateful to the members of the committee selecting the contributors to the Federico Caffè Lectures and the Bank of Italy for supporting the initiative. Cambridge University Press did a great job in preparing this book to be published. I am grateful, in particular, to Phil Good, who took over the editorship of the Federico Caffè Lectures from Chris Harrison, who first supported the initiative of a dedicated series. As in the past, Veronica Fedeli helped me in carefully checking and editing the whole manuscript.

Finally, I am mostly grateful to Federico Caffè, my mentor, whose memory this book intends to honour. He first introduced me to the wonderful world of economic policy as a discipline.