Chapter 3
Institutions and Economic Policy

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ABSTRACT

This chapter discusses the problems associated to an inadequate theory of economic policy. It begins by presenting the mainstream and heterodox approaches to policy. It contends that, according to the mainstream, policy must guarantee efficiency or, at the very least, consider it a key constraint, whereas according to heterodox economists, it may have a broader variety of goals. The latter's open system perspective implies that changes in the structure of the economy eventually feedback both on how people conceive of the economy and social welfare and on how the economy itself functions. The relevance of this issue, which is understated, emerges from the subsequent discussion of how neoliberal policies have changed the structure of the economy, the way people conceive of the economy, and even their voting behavior.

INTRODUCTION

In late 2008, Queen Elisabeth II asked economists at the London School of Economics an embarrassing question: why nobody saw the financial crisis coming. The question was embarrassing from two points of view. First, it pointed out that many leading economists actually failed to understand what was going on at the time. Second, although the Queen presumably was unaware that some economists actually saw the crisis coming (e.g. Keen 1995; Minsky 1984), her question prompted another question: why did most economists disregard what their colleagues were foreseeing?

Both questions should have led to a reassessment of the (neoliberal) theories and practices that had dominated most economies during the previous decades. Counterintuitively, this did not happen. Albeit with a few exceptions – the most authoritative is Posner (2009) - most economists and policymakers did not question their views of the economy. Indeed, the situation was aptly depicted as “the strange non-death of neoliberalism” (Crouch 2011).

This situation raises various issues. Was the crisis an accident - a “black swan” - that policymakers and their economic consultants could hardly foresee, or was it determined by wrong policies? If policies were wrong, was it because of the theories that supported them? Considering the dramatic consequences

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the crisis led to, why did policymakers not change their economic consultants and why did voters in democratic countries not oust the policymakers that allowed the crisis to occur? Why were alternative perspectives on economic policy not convincing?

The aim of this chapter is to deal with these issues by contending that a major problem is the mechanistic and linear view that most economists have of economic policy. It does not expect to provide a full-fledged answer to all of the above questions. It nevertheless intends to frame them in what is likely to be a more fruitful way. Rather than dealing with specific models, it focuses on the assumptions and general theoretical frameworks that lie in the back of the minds of economists and that they, often unwittingly, tend to take for granted. In other terms, it focuses less on what they look at than on the "lenses" they use to look.

The standard approach to economic policy that emerges from most economics textbooks is that its aim is to deal with the shortcomings of the economy. Policymakers must understand what these shortcomings are and act upon them in order to achieve the best possible economic performance. The role of economic theory is to help them achieve this task. The problem they must face, however, is that different strands of economic thought provide distinct outlooks both on those shortcomings and on the effectiveness of public action. Most discussions about policy focus on which theory provides the best account for extant problems. It is generally understood, however, that once this issue is clear, it is possible to devise the appropriate measures.

The above approach to policy is based on a range of extremely restrictive assumptions, which, at the very least, need to be made explicit. They have to do with how the coordination of economic activities occurs. More specifically, mainstream economics – which, from the perspective of this chapter, includes the different strands of neoclassical economics along with Austrian economics – emphasizes the coordinating function of relative prices. Although it generally acknowledges that institutions must complement prices, the latter are what ultimately characterizes an economy. Policy must either allow prices to work properly or make up for their shortcomings.

Heterodox approaches provide a different outlook. Schools of thought, such as, amongst others, Original Institutional Economics, Post Keynesianism and Marxism share the view that, while prices are important, they can operate only as part of an institutional setup that is a prerequisite for their existence. Contrary to the mainstream, prices are not the means to assess economic performance.

The difference between the mainstream and heterodox approaches to economics may appear subtle but it has important implications for a proper understanding of the scope for policy, that is, its goals and its means. In particular, it allows for a reassessment of the notion of development. It suggests that the constraints to economic change vary significantly, depending on whether they are associated to markets or to historically determined institutions.

The chapter is structured as follows. The next two sections discuss the role of policy in the light of the mainstream and heterodox approaches respectively. According to the first one, policy may be required when either prices do not function properly - and private agents are unable to provide an alternative - or when social issues, such as equity, are in order. As for the heterodox approach, it claims that what appear to be mere imperfections in the mainstream's price mechanism actually reflect interdependences among economic actors and between the economy and society. The coordination of these interdependences implies the existence of institutions that structure both the economy and society. Prices function only subject to this structuration. Policy is one of the means to establish institutions.