

Translating new economic thinking into public policy

Tony Dolphin explains why insights from new economic thinking need to be taken seriously, and argues for policymaking which takes heterodox economic thinking into account.



The events of the last five years or so have thrown mainstream economic thinking into disrepute. When the Queen asked why economists had not foreseen the collapse of Lehman Brothers and the drying up of credit markets, she was told, in the words of the Nobel Prize winning economist Robert Lucas, that based on contemporary economic theory 'no one could have predicted it'.

A market collapse of the sort that happened in autumn 2008 is essentially impossible in mainstream economics, which has led many to question its usefulness, not just in explaining economic developments in the real world, but also in drawing up the appropriate policy responses to these developments.

One result is that a little more attention is now paid to new heterodox economic theories as a better way of understanding how the economy really works. Although they pre-date the financial crisis, complexity economics, evolutionary economics, institutional economics and behavioural economics are the subject of increasing interest, not least because of their critiques of neoclassical economic thought and the abstractions and mathematical models that lie at the heart of general equilibrium theory.



Lehman Brothers UK Staff Canary Wharf London, 2008. Credit: Conor with one n (CC-BY) via Flickr

Yet, with the important exception of behavioural economics, practitioners of these new ways of thinking about economic problems have been rather good at demolishing traditional economic thinking and developing a new understanding of the way the economy works but rather less willing to offer thoughts on what heterodox economics has to say about policymaking. The upshot is that orthodox economic remains the only game in town for economic policymaking.

For this reason, IPPR asked a number of prominent economists associated with 'new economic thinking' to specify what their ideas might mean for policy in one particular area. The results can be found in the recently released book: [Complex New World](#). This book starts from the premise that insights from new economic thinking need to be taken seriously. It seeks to bring new economic thinking to the attention of policymakers and to reappraise the ways in which policy is designed and implemented when real-world economics is taken into account.

Defining new economics is not easy. In fact, it is easier to say what it is not based on. New economic thinking does not accept that humans are perfectly rational, that markets are perfectly efficient and that economies inevitably move toward an equilibrium that maximises social welfare. These assumptions produce models that are poor descriptions of the real world. New economics is about explanations of how the economy works that have empirical validity.

New economics has a number of different starting points, but generally reaches two conclusions. First, patterns and outcomes at the macro level can only be understood by an appreciation of activity at the micro level. This cannot be deduced by analysing individual economic agents in isolation, their interactions, i.e. networks, are crucial to their behaviour. Second, the non-stop and unpredictable interactions and adaptations that occur mean economies at the macro level are volatile and likely to display periods of chaos and calm. Economies are complex systems characterised by feedbacks, increasing returns to scale and network effects; they display emergent properties and non-linear dynamics; and they are seldom if ever in equilibrium.

Each of the chapters in the book is worth reading for the new insights it provides, but we identified six common lessons that emerge from them. First, the assumption that free and unfettered markets lead to the best economic outcomes for society is fundamentally flawed. Any attempt to build a policy based on this assumption is likely to unravel and could have disastrous consequences. Similarly, the state cannot just step in and correct 'market failures' without appreciating the complexity of economic activity.

Second, a more integrated and holistic policy approach towards economic systems is likely to produce the best results. Policymakers and regulators misunderstand network dynamics at their peril (as was dramatically illustrated by the decision to let Lehman Brothers become bankrupt). Policy interventions need to seek to alter the behaviour of networks and systems, not just focus on the behaviour of individual agents.

Third, there are no silver bullets in policymaking. The success of policy interventions will depend on a diverse range of factors and these will vary from circumstance to circumstance, and over time. Policy needs to be tailored to specific problems. Experimentation, innovation, discovery and effective monitoring and evaluation are all important elements of arriving at the best policy solution.

Fourth, greater decentralisation of policymaking is needed. Policy is more likely to be successful if it is aware of local conditions and locally administered and evaluated. Decentralisation also helps to shorten the feedback loops that inform decision making.

Fifth, policy outcomes are inherently uncertain. This poses a massive challenge for conventional macroeconomic policymaking, which relies heavily on the ability of the Office for Budget Responsibility and the Bank of England to forecast economic developments, and the response of the economy to changes in fiscal policy and interest rates.

Sixth, policymakers have to accept that policy failure happens and understand how to learn from it. Many successful private companies have experienced failure at some stage, but they became successful because they had robust strategies to deal with it. Policymakers also have to take risks and this requires an acceptance that failure can be healthy, rather than something to be afraid of.

Those looking in our book for a list of policy recommendations to put in a political manifesto will be disappointed. Drawing lessons and policy ideas from new economic thinking is still a task that is in its infancy. There are many important ideas in the book, but perhaps fewer concrete proposals than we hoped for. Hopefully, however, heterodox economists will continue to develop their thinking, overthrow traditional ideas that are based on flawed understandings of the way the economy works and change economic policymaking for the better.

Note: This article gives the views of the authors, and not the position of the British Politics and Policy blog, nor of the London School of Economics. Please read our [comments policy](#) before posting.

About the author

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