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## Paradigm Shifts in Economic Theory and Policy

This paper seeks to understand the processes of paradigm shifts in economic ideas and policy. We begin with an explanation of the concept of a “politico-economic paradigm”, with reference to the theory and history of the two paradigm shifts occurring in the 20th century. We then examine how the second of these, the shift to “neoliberalism”, occurred. The final section assesses the degree to which economic and political conditions since the financial crisis offer an opportunity for a new paradigm shift away from neoliberalism.

### Politico-economic paradigms

Modern economic history can be roughly split into different eras in which certain sets of ideas have dominated politics and policy. We shall refer to a dominant group of ideas as a politico-economic paradigm. Such paradigms generally encompass political/economic goals, analytical/theoretical frameworks for understanding the functioning of economies and societies, narratives which describe and justify the goals and analytical framework, as well as economic and social policies, based on the analytical framework, that seek to achieve specific goals.

Politico-economic paradigms can exert a powerful influence over academic and media debates, as well as on policymaking institutions, both national and international. Over the last hundred years, Western political economy has broadly experienced two major periods of breakdown and transition from one politico-economic paradigm to another.<sup>1</sup> The first was from the laissez-faire paradigm

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<sup>1</sup> Our analysis in this section is based on A. Stirling, L. Laybourn-Langton: Time for a New Paradigm? Past and Present Transitions in Economic Policy, in: *The Political Quarterly*, Vol. 88, No. 4, 2017, pp. 558-569.

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to the post-war consensus, covering the period from the Wall Street Crash of 1929 to the implementation of mainly Keynesian economic orthodoxy and policy approaches in the post-war period. The second was from the post-war consensus to neoliberalism, starting with the currency and oil shocks of the early 1970s and the adoption of free market economic policies in the 1980s, ushering in the current period of neoliberalism.<sup>2</sup>

### Theoretical models of paradigm change

Each period of change featured a series of economic and political crises, the failure of orthodox ideas and policies to explain and respond to them, and the resultant replacement of the orthodoxy by a new approach. A body of literature has sought to understand this change process, influenced by Kuhn’s theory of paradigm shifts in the natural sciences. According to this theory, change occurs when two conditions are met: first, a critical mass in the number or importance of “anomalies” which contradict the dominant paradigm, and second, the successful development of an alternative theory that better explains the prevailing evidence.<sup>3</sup>

Lakatos built on these ideas, arguing that changes in science could be seen in terms of “research programmes” that are either “progressive” or “degenerating”.<sup>4</sup> Progressive programmes advance new theories and adopt ideas that better explain reality. In contrast, degenerating programmes persist with old theories and ideas, despite their failure to explain the available evidence, and so eventually abdicate their previous status as progressive programmes. Degenerating programmes can have undue staying power, enjoying an incumbency advantage underpinned by the vested interests of leading scientists. A shift in paradigm only occurs when progressive programmes gather sufficient support to overcome the hold of a de-

<sup>2</sup> The term “neoliberalism” is controversial in some circles, since it can carry strongly pejorative rather than merely descriptive connotations. We use it here as a conveniently descriptive term to characterise the dominant set of “free market” theories, values and policies. For more on the uses of the term “neoliberalism”, see O.M. Hartwich, R. Salliy: Neoliberalism: The genesis of a political swearword, CIS Occasional Paper No. 114, 2009.

<sup>3</sup> T. Kuhn: *The Structure of Scientific Revolutions*, Chicago 1962, University of Chicago Press.

<sup>4</sup> I. Lakatos: Criticism and the Methodology of Scientific Research Programmes, in: *Proceedings of the Aristotelian Society*, Vol. 69, 1968, pp. 149-186.

generating programme and a tipping point is reached, after which the old programme is superseded.

While providing useful heuristics, these theories nevertheless need careful application in the field of economics and public policy, which is fundamentally uncertain and in which hypotheses can never be irrefutably falsified. Economic policy is developed through a process of political choices and “social learning” in which policymakers decide on new goals and methods with only partial reference to academic theory or evidence. The inherent uncertainty of economic prediction and the political nature of policymaking make it easier for degenerating programmes to retain their incumbency advantage, aided by vested interests. Hall argued that economic policy can exhibit three “orders” of change, increasing in their magnitude: adjustment of an existing policy, change in the policy and change in the goals of policy altogether.<sup>5</sup> In Hall’s conception, it is the third order of change which corresponds to a paradigm shift in the politico-economic orthodoxy.

#### Characterising the shift to the neoliberal paradigm

Similar patterns of change can be observed in both of the politico-economic paradigm shifts which occurred in the 20th century. Here, we use the theories described above to set out the key characteristics of the shift process, illustrated by the transition from the post-war paradigm to neoliberalism in the 1980s.

*The prevailing orthodoxy:* Since WWII, rising economic growth and incomes cemented the social democratic consensus into a Kuhnian worldview. Keynesian demand management led to the targeting of full employment as the primary indicator of economic success. By the 1960s, policymakers were placing considerable weight on the Phillips Curve – the apparent trade-off between unemployment and inflation – to guide the management of the economy. The fixed exchange rate regime of the Bretton Woods settlement and financial regulation provided stable conditions for the growth of international trade.

*Economic shocks and crisis:* The breakdown of the international monetary order in the wake of the US leaving the gold standard led to a deterioration in several countries’ balance of payments positions, driving inflation higher. The decision by oil producers to raise oil prices added to the inflationary shock, precipitating recessions. A long-term decline in the competitiveness of significant industrial sectors and poor industrial relations exposed severe

weaknesses in the productive capacity of economies, particularly in the UK.

*Breakdown and transition in orthodoxy:* The phenomenon of stagflation (simultaneously high inflation and unemployment) contradicted the Phillips Curve, while the failure of policies targeting prices and incomes to control inflation, or currency devaluation to restore competitiveness, left few available policy options within the Keynesian framework. Overall, a critical mass of Kuhnian anomalies led to the degeneration of the incumbent politico-economic paradigm. An alternative progressive programme emerged, marking itself in opposition to Keynesian collectivism. As politicians and policymakers cast around for solutions to the crisis, the proponents of this new approach seemed to offer an escape from instability.

*New economic policy:* Following continual growth in support from policymakers throughout the 1970s, the elections of Margaret Thatcher in 1979 and Ronald Reagan in 1980 marked the full-fledged emergence of a new paradigm. To a lesser extent, this new paradigm also entered into German and French politics with the election of Helmut Kohl and after President François Mitterrand’s “socialist experiment”. New governments precipitated a third order change in policy, switching the principal object of macroeconomic policy from unemployment to inflation. While monetarism was soon abandoned, the wider neoliberal worldview took hold. The state’s economic role was drastically diminished to a guarantor of stable economic conditions, alongside significant reductions in taxes and spending, the deregulation of markets, and curtailment of trade unions.

#### Understanding the neoliberal shift

The shift to neoliberalism was not an accident of history, but the partial result of the efforts of an elite movement, initially comprising a small group of academics organised in the Mont Pèlerin Society (MPS), founded in 1947. The Society served as the nexus through which a critique of the post-war settlement and the diverse tenets of neoliberalism were generated, as well as a concerted programme of institution-building and political strategy. To understand the way in which the paradigm shift occurred, it is helpful to disaggregate it into three components or levels:

- a. its intellectual and academic underpinning, particularly within economics;
- b. the discourses and narratives through which it was expressed in the wider public domain;

5 P. Hall: Policy Paradigms, Social Learning, and the State: The Case of Economic Policymaking in Britain, in: Comparative Politics, Vol. 25, No. 3, 1993.

- c. the political policies and processes – notably the elections of governments – which enabled it to be implemented.

The neoliberal movement started with an intellectual and academic component through the MPS. It then built a coherent narrative and policy proposals to spread its ideas, performed by a well-resourced ecosystem of institutions and networks mobilised to influence public debate and political processes. Though the academic level is often thought of as most important to the rise of neoliberalism, the shift was actually weakest there; some neoliberal ideas were powerful but never became hegemonic. It was stronger at the level of discourse and narrative, where it came to dominate the way in which economic analysis and policy were discussed in public debate. It was only decisive at the level of politics and policy: the election of neoliberal-influenced governments ensured a full paradigm shift.

#### The academic level: multi-disciplinary, not hegemonic

The MPS always stressed the need for the neoliberal intellectual project to be multi-disciplinary. From the start, philosophical, historical, legal, political and natural science concepts were used alongside economics. Inevitably, this resulted in differing paths of development across disciplines and countries. For example, there was a considerable difference between the first Chicago School of Frank Knight, which had similarities with ordoliberalism in Germany, and the second Chicago School of Milton Friedman, whose more radical critique of the state came to underpin the development of Anglo-American capitalism.

In the US and the UK, Friedman's monetarist theory was joined by a number of other socio-economic theories that spanned disciplines. New Classical economists suggested that macroeconomic models must include rigorous microeconomic parameters that reflected the decision-making behaviours which, in their view, governed human beings and societies. This required a return to neoclassical foundations, eventually emerging in the theory of rational expectations. In game theory, the rational expectations assumption was given a theoretical underpinning that drew on the natural sciences. Though early game theoretic models appeared only to be applicable in extreme circumstances, their assumptions and theoretical insights were soon adopted by those modelling the behaviour of institutions. Public choice theory condemned the idea of the "public interest" as a subjective hypocrisy used to mask the self-interest of bureaucrats and politicians, suggesting that government should operate a system of incentive struc-

tures that would harness the inevitable self-interest of public servants. Theories of regulatory capture used the public choice assumption to conclude all regulators are self-interested.

These insights added up to a coherent whole with a power greater than the sum of its parts. Not only did it provide a counter-narrative to the failures of the mainstream politico-economic paradigm in the 1970s, but the combination of these ideas appeared to offer a more "scientific" analysis of the economy and society than offered by the Keynesian orthodoxy. Moreover, it presented plausible solutions at a time when the previous policy was failing – a result in part of the pleasing inner logic of much of neoliberal thought. Importantly, these analyses and their attendant policies were attractively sold as having a universality that would serve different times and places and which allowed for better understanding of economic actors.

While hegemonic across politics and policy, it is important to recognise that neoliberalism was never all-encompassing within the academic realm. Whereas in the natural sciences, a Kuhnian paradigm shift will lead to the near-universal adoption of the new theory, this is less likely in the more uncertain social sciences. The neoliberal framework gradually came to dominate leading economic journals and textbooks, but significant debate remained within disciplines, and in macroeconomics in particular there were accommodations between old and new approaches. In the case of new classical economics, the attempt to change macroeconomics in both theory and practice only led to victory in the latter. In general, hegemonic change in academia is neither likely nor necessary to generate a paradigm shift in the wider world. For such a shift to occur, sufficient change at an opportune time must be combined with attractive and seemingly coherent concepts and narratives.

#### A coherent narrative

The MPS members' initial ideas were marked by dispute, contradiction and divergence – but they ultimately led to the emergence of a coherent narrative. Hayek founded the MPS to create a safe space for those with shared philosophical ideas and political ideals to learn, educate and strive toward a common cause. In doing so, he followed a reflexive model for changing the intellectual and practical elements of a paradigm. Academia creates the tools for and legitimises the cause of a political project, which, in turn, influences academia through social learning, morality and values, and material factors, such as increases in funding and other incumbency advantages resulting from a higher profile and greater influence. Two conditions are

essential to realising change through this model. First, ideas must form part of a coherent narrative that can be easily shared and adapted without central control. Second, an extensive, well-resourced ecosystem of enabling institutions and networks must be developed.

In the 1940s and 1950s, the MPS coalesced around an opposition to “collectivism”, concluding that an increased role for the state in economic and social management was incompatible with individual freedom. Recognising that they shared a critique of the new social democratic order, the early years of the MPS were dominated by the development of a statement of aims to act as a focal point for those seeking to move from opposition to proposition. Crucially, this statement of aims is political and defines a clear ideological direction; it is neither an academic nor a technical document, and it does not focus purely on a critique of the incumbent paradigm. This allowed the statement to provide a clear signal to those with views sympathetic to those of the MPS and a focus for the movement’s activities. In doing so, it allowed for the decentralisation of both the development of the intellectual component of a new paradigm and the ecosystem that would bring it into practice.

### A supporting ecosystem

A common narrative based around the MPS statement of aims helped bind the incipient movement together. But it needed an ecosystem of people, networks and institutions to propagate it within the public sphere. This ecosystem was developed by key individuals with a strong understanding of power and how knowledge is transmitted into action. Its leading figures were Hayek and Friedman, who effectively acted as nodal points, connecting different elements of the ecosystem.

This was an elite theory of change that focused on influencing current and future opinion leaders. The transmission mechanism from ideas to practice started in private via platforms, such as the MPS, that afforded security and limited scrutiny. After building coalitions, many members of the MPS went back to academia, from where they predominantly originated, to promote and develop neoliberal ideas. Soon, the support of wealthy interests – including the Volker Fund, Reim Foundation, General Electric and DuPont – enabled more meetings, networks and academic work. These resources were soon used to create a new breed of “knowledge professional” located within the new institutional form of the modern think tank – politically partisan and focused on strategic influence as well as policy development. Journalists then provided the means by which neoliberal ideas could enter wider circulation.

By the early 1970s, the neoliberal counter-orthodoxy had organised into a transatlantic network. Its members were well-resourced and mobilised, influencing elite groups, political parties and individuals, seeking out and assimilating allied concepts, and fashioning narratives to appeal to political needs. In doing so, they soon led the critique of the incumbent paradigm as it began to falter in the 1970s.

### From crisis to government

By the late 1970s, this network and its ideas had increasingly populated political parties and government institutions, developing strong networks of individuals that spanned important sectional interests. This ecosystem created the intellectual conditions for change, ensuring that the neoliberal movement was prepared to capitalise on crisis. The policy impotence of the incumbent post-war paradigm gave the movement its chance. In the end, successive crises both intellectually and politically delegitimised the post-war consensus. But it was the elections of right-wing political parties under Thatcher and Reagan that enabled the political displacement of the post-war paradigm in practice. Explicitly influenced by neoliberal networks, the Republican and Conservative governments of the 1980s gradually introduced policies of deregulation, privatisation, tax reductions and labour market “flexibility”, radically changing the political economy of the US and UK, and eventually, by wider transmission, that of most other Western nations.

Meanwhile, changes to the economic curriculum in universities and the adoption of neoliberal assumptions across the field of economic understanding and practice had a deep socio-cultural effect, entrenching the idea that economic and political freedoms can be equated and elevating deregulated markets as the only efficient mechanism for allocating resources. A crucial result was the acceptance by previously oppositional parties of key aspects of the neoliberal consensus. Consequently, by the end of the 1980s, even the elections of more left-leaning governments did not alter some of the fundamental tenets of either ideas or policy. The shift in economic thinking has often been seen as less pronounced in continental Europe than in the US and UK. But it has nevertheless been significant, particularly in Germany, with the 1982 *Wendepapier* (reform paper) and the election of Helmut Kohl precipitating a neoliberal turn.<sup>6</sup>

6 T. Fricke: Altes Einheitsdenken oder neue Vielfalt? Eine systematische Auswertung der großen Umfragen unter Deutschlands Wirtschaftswissenschaftlern, FGW Studie Neues ökonomisches Denken 03, 2017, Forschungsinstitut für gesellschaftliche Weiterentwicklung.

It is also vital to recognise that neoliberal governments and policies were sustained by powerful economic interests. It is not a coincidence that deregulation, privatisation, tax reductions and labour market flexibility benefit large corporations, financial firms and wealthy individuals. Their support for such policies is manifested both politically, in extensive lobbying activities, and in donations to the neoliberal ecosystem. For example, the Atlas Network today provides international support and coordination for around 400 think tanks in over 90 countries, with many now working to discredit the scientific consensus on anthropogenic climate change.

### The return of social democracy: a modified paradigm?

By the 1990s, the conservative governments of the 1980s had all been defeated. New centre-left governments made significant changes to the economic policies of their predecessors. Yet each retained key elements of the neoliberal consensus. Indeed, it has been widely argued – despite their own claims that they were following a new, “Third Way” approach – that the policies of the social democratic governments of the late 1990s and 2000s were essentially continuations of the neoliberal project.<sup>7</sup>

There is not space here to adjudicate opposing claims about specific governments. But at an analytical level, it may be helpful to introduce the concept of a “modified paradigm”. It is hard to sustain the claim, for example, that New Labour was simply a Thatcherite government in disguise. In fundamental respects, it broke with the conservative consensus. Public spending was dramatically increased to pay for the policy priority of improving public services. Major changes were also made in areas such as climate change and energy policy. Yet many key features of the neoliberal consensus remained. Privatisations were continued and further developed as outsourcing of public sector functions. The regulatory agenda in financial services and other business sectors was left unchanged. There were no reversals of laws placing burdens on trade unions or promoting the “flexible” labour market. Until a significant shift that began after the financial crisis, direct interventions in private sector investment through a more active industrial strategy were eschewed.

This is why it may make sense to speak of Third Way governments as executing a “modified” version of the neo-

7 A. Glyn (ed.): *Social Democracy in Neoliberal Times: The Left and Economic Policy Since 1980*, Oxford 2001, Oxford University Press; and S. Hall: *The Neoliberal Revolution*, in: *Soundings*, No. 48, 2011, pp. 9-27.

liberal paradigm rather than simply continuing the same one they inherited. The idea of modification allows for the fact that change can and does occur in the nature of a paradigm without resulting in its complete replacement. Of course, the dividing line between modification and replacement can always be contested.

### After the financial crash: a new paradigm shift?

To what extent do today’s economic and political conditions offer parallels with previous shifts? We can use the schematic from above to examine both similarities and differences.

#### The prevailing orthodoxy

It is not hard to show that the neoliberal consensus – albeit in a modified form – has remained dominant in public discourse and policymaking in most developed countries since the early 1980s. Contrary to many people’s expectations, it largely survived the financial crash, with the short period of Keynesian stimulus in the immediate aftermath of the crash in 2007-08 quickly replaced by austerity policies. These have been based on the orthodox view that public borrowing and spending are not appropriate instruments to ameliorate recession when public debt is high. While there has been some reform of banking regulation to reduce systemic risk, there has been little wider reform of the financial sector. In most countries, economic policy has failed to deal with continuing weaknesses in productivity, earnings and investment since the crisis. Given the scale of the crash and the slowness of recovery, the lack of economic policy innovation over the last decade is testament to the endurance of the neoliberal consensus.

#### Economic shocks and crisis

There can be little doubt that the financial crash of 2007-08 constituted a shock to the global economy on a similar scale to the Wall Street Crash of 1929 and the oil price hikes of 1973. In 2009, output fell in 34 out of 37 advanced economies, and the global economy as a whole went into recession for the first time since the Second World War. The resulting economic crisis has continued well beyond the initial events and, indeed, it continues a decade later.<sup>8</sup> The post-crash recovery has been the slowest in modern times, and a sense of continuing economic crisis has had significant political consequences. Most developed countries have experienced a rise of populist political par-

8 M. Jacobs, M. Mazzucato: *Rethinking Capitalism: An Introduction*, in: M. Jacobs, M. Mazzucato (eds.): *Rethinking Capitalism*, Chichester 2017, Wiley Blackwell.

ties seeking to channel dissatisfaction with the economic status quo. There have been both right-wing and left-wing manifestations, from Podemos to Trump. There has even been a revolt of the centre, in the form of Emmanuel Macron. While these movements differ in their degree of electoral success, they have stimulated a debate on the adverse impacts of globalisation and contemporary capitalism.

### Breakdown and transition in orthodoxy

If the economic shocks and crises of the last decade are the precursors to a shift in the politico-economic paradigm, it is clear that we are in its earliest stages. In most countries, mainstream economic policy has not yet undergone any significant change, and there is little consensus on what, if anything, ought to replace it. However, there are some signs of an emerging transition, at several levels. First, debate in the economic policy community, both among academics and in international institutions and think tanks, has begun to change. Modern economics is more pluralist than it was a generation ago. In recent years, the Nobel Memorial Prize in Economic Sciences has frequently been awarded to practitioners working outside the neoliberal orthodoxy. In the English-speaking world, many of the most prominent economists contributing to public debate, such as Dani Rodrik and Mariana Mazzucato, are trenchant critics of neoliberal theory and policy. This is much less true, however, in other countries, notably Germany – though even here recent surveys of economists have shown a significant shift towards a less orthodox view.<sup>9</sup>

Yet at the same time, it is clear that no overarching “alternative” paradigm has yet emerged. While many prominent economists today share a critique of neoliberal orthodoxy, there has been little effort to articulate a shared alternative view which might incorporate and bind together elements of the new pluralism. This is partly because there are significant differences of approach between different kinds of heterodox academic economists. The neo-Keynesian tradition disagrees with the free-market objectives and principles of neoliberalism but has an understanding of economic theory and policy that is otherwise recognisably mainstream. Others, including those drawing from complexity theory or ecological economics, for example, seek a more radical reappraisal of economic theory.

Second, there is increasing interest in a significant shift in approach to policy within mainstream economic institutions. Three of the major international leaders in economic thought and practice – the OECD, the World Bank

<sup>9</sup> T. Fricke, *op. cit.*

and the World Economic Forum – espouse a narrative of “sustainable, inclusive growth”, based on an acceptance that the neoliberal model has generated both rising inequality and unsustainable environmental damage. At present, it would be hard to say that the consensus has gone beyond an acceptance of the failures of the dominant model and agreement on a set of broader objectives for economic policy, but the OECD “New Approaches to Economic Challenges” initiative is now seeking a more coherent theoretical and policy response.

The UK is now perhaps the country furthest advanced in this field. It has a number of think tanks and campaigning organisations more or less explicitly committed to the idea of a paradigm shift. Major think tanks, from the New Economics Foundation to IPPR, are calling for a fundamental reform of economic policy. Philanthropic foundations, including the Friends Provident Charitable Foundation, support projects promoting economic systems change. There is an active student movement, Rethinking Economics, campaigning for a reform of economic teaching, and an alternative economics curriculum, CORE, which is gaining considerable attention.

The third level is that of political parties and governments. Here it is hard to discern any significant paradigmatic transition in progress. Macron’s economic reforms are an attempt to modify the neoliberal orthodoxy. In Germany, neither the SPD nor the Greens have established a coherent alternative economic platform – arguably one of the reasons for their relatively poor showings in the 2017 general election. In the US, the Democratic Party remains split between the largely orthodox centrism of its Clintonite wing and the radical yet incomplete economic programme of Bernie Sanders. It is arguably only the UK Labour Party that has committed to a radical break from neoliberalism and has a chance of winning power.

### Conclusion

The parallels between present economic conditions and those in the two periods of the 20th century when major paradigm shifts occurred are striking. History does not repeat itself, as Mark Twain supposedly said, but it often rhymes. There is certainly no guarantee that we will see a paradigm shift in economic thought and policy in the coming years. But the evidence that major reform is required is powerful, and there are clearly dynamics in academic economics, within economic institutions and in civil society tending in that direction. For those who would welcome change, the present moment offers both opportunity and challenge.