

Recent controversies in neoclassical modelling and developments in Evidence-Driven Policy

Topic: Historical perspective of input-output analysis

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The use of Computable General Equilibrium modelling in evidence-based policy requires an advanced policy making frame of reference, advanced understanding of neoclassical economics and advanced operations research capabilities. This paper examines developments in the policy making frame of reference. The process of evidence-driven policy places importance on the validation of potential policies using models. At national, bilateral and multilateral levels, policy analysis has increasingly relied on neoclassical computable general equilibrium models having substantial precedence. Bayesian analysis suggests that a policy which survives a validation test using such a model has a much better chance of being successful than a policy that fails such a test. Yet the 2008-9 Global Financial Crisis demonstrated that policies verified with neoclassical models neither predicted the Global Financial Crisis nor were able to address it. Governments across the world used massive Keynesian stimulus to restabilise economies. Neoclassical models became much maligned within Keynesian and behavioural economics circles. This paper investigates the continuing role of neoclassical models in evidence-driven policy with reference to the deductivism of Sir Karl Popper and Thomas Kuhn, inductivism and the controversial objective theory of evidence. While policy making has always been messy, in recent decades policy makers may have succumbed to the human fallibility of justifying pragmatism with simplified ideological paradigms that inappropriately place over-reliance on neoclassical free market mathematical models because these models are self-reinforcing of the ideology. It is suggested that future policy making will be even messier, with policy makers placing less importance on such simplified paradigms and taking more responsibility for managing plurality in the political process. It is concluded that neoclassical models will continue to have a role in testing policies but those features of neoclassical models that led to the failures in understanding the Global Financial Crisis will need to be addressed. For example, to be relevant such models will need to close for both households and investment and be cognisant of distributional effects such as the sweep of income to the top 5% of consumers through wage and taxation policies.