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## **REVIEW ARTICLE**

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# **A Consumers' Guide to Recent Critiques of Economics**

**Tom Valentine**

*John Langmore and John Quiggin, Work for All: Full Employment in the Nineties,  
Melbourne University Press, Melbourne, 1994*

*Paul Ormerod, The Death of Economics, Faber and Faber, London, 1994*

*Brian Toohey, Tumbling Dice: The Story of Modern Economic Policy,  
William Heinemann, Melbourne, 1994*

**T**he near-simultaneous publication of these three books and the substantial overlap in their content suggest that they reflect a basic trend in the discussion of economic questions. Most people would probably not want to read more than one of them. This comparative review will therefore provide a 'consumers' guide' to them.

At the core of all three books is a critique of economics. In some cases (such as Langmore and Quiggin) the criticism is directed towards 'rational economics', but this term seems to denote no more than the application of mainstream economic theory to policy questions. The authors use the word 'rational' in a pejorative sense, apparently because it invokes impressions of such horrors as expenditure cuts and reductions in employment. In the remainder of this review the adjective is dropped and the term 'economics' is employed alone.

### **Myths and Misconceptions**

One myth common to Langmore and Quiggin and to Toohey should be exposed at the outset. These authors claim that policy-making in Australia over the 1980s was dominated by economic theory. This assumption is convenient because it allows the authors to conclude that our economic problems, including the present high unem-

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ployment rate and large current-account deficit, can be attributed to this application of economic theory, particularly in the form of deregulation. In fact, significant deregulation and microeconomic reform has occurred in only a few areas; and if any problems should be attributed to these reforms, a detailed analysis is necessary to show why. In particular, it would be necessary to establish that the lack of reform in other areas is not the problem.

Toohy claims that the Canberra press gallery has played a major role in spreading economics doctrines. His analysis of the alleged 'capture' of these journalists by the government, so that they tend to act as publicity agents for it, is compelling. But the proposition that the journalists have become apostles of economics is ludicrous. Most members of the Canberra press gallery have no knowledge of economics and even less interest in the subject. They are fixated on politics, and attempt to personalise economic issues as they do other issues. Their treatment of the National-Liberal coalition's *Fightback!* manifesto at the 1993 federal election hardly suggests that they are apostles of economic reform.

Economics receives extensive coverage in the Australian media. But, with a few notable exceptions, the discussion is ill-informed. This is largely because journalists see themselves as reporters, not as economic analysts or experts in any of the other areas that they cover. This leads them to rely heavily on financial market economists for their information. As Ormerod notes (p.67), the major role of these economists is to obtain publicity for their employers. In addition, they will always 'talk their book': predict the developments that will make the positions taken by their employers profitable.

At times, the Australian authors are quite abusive about economics and economists. Take this example (which particularly grated with me) from Langmore and Quiggin:

It is time for the uncritical enthusiasm for so-called free markets to end. Such enthusiasm is characteristic of first year undergraduates who have just learned the elegance of the introductory neo-classical model. This naivety has no place in government. (p.109)

A preference for market outcomes over the results of bureaucratic intervention has a much broader basis than 'the introductory neo-classical model'. It is based, for example, on observation of the past results of the two approaches. As well, undergraduates, particularly Arts ones, are much more likely to share the preconceptions that Toohy and Langmore and Quiggin reflect than to admire markets.

Indeed, these authors can be seen as defenders of the current 'politically correct' paradigm in Australia against the inroads of well-established economic ideas. As such, the paradigm is a form of fundamentalism (another pejorative term that Langmore and Quiggin use to describe economics) rather than a desire to apply economic theory to the formation of economic policy. The expectation that this term raises of a selective approach to evidence and choice of arguments is certainly satisfied both by Toohy and by Langmore and Quiggin. One aspect of their fundamentalism is their as-

sumption that, if economics is wrong, their own views must be right. This one-sided approach is not acceptable: whatever the faults of economics, the superiority of their views to it must be demonstrated, not assumed.

### **The Critique of Economic Theory**

The three books cite many criticisms of mainstream economic theory. First, Ormerod describes in some detail the very strict and unrealistic assumptions that must be made in order to establish the existence of an equilibrium in the competitive model.

Second, all three books list the ways in which the real world fails to satisfy the assumptions of a formal competitive model. The deviations include the existence of external economies and merit goods; the impact of expectations on markets; the prevalence of increasing returns to scale; the dynamic (not static) nature of the world, which is therefore in constant disequilibrium (not equilibrium); and the dominance of various forms of imperfect competition, including monopoly, in the industrial structure of most countries. Toohey in particular tends to exaggerate the ubiquity of deviations from the basic assumptions; but there is no doubt that these often do occur.

Third, the books criticise the concept of 'rational economic man', arguing that individuals react to many incentives apart from economic benefits or costs.

Fourth, they cite the theory of the 'second best', which implies that the achievement in one part of the economy of the conditions for an optimum derived from the competitive model may not be desirable if the conditions are not satisfied in other parts of the economy. (Note that the theory says that the achievement of a 'partial optimum' *may* not be desirable, not that it clearly is undesirable.)

The first thing to note about these criticisms is that they are not new. The points have been raised and discussed in economics textbooks and courses for as long as I can remember, and probably for a lot longer. Economists have made many attempts to overcome the problems by developing alternative models, such as the theory of imperfect competition. More important, however, is the fact that proponents of microeconomic reform do not base their recommendations on the abstract competitive model. Rather, they attempt to evaluate the costs and benefits of any proposed changes. This approach was taken, for example, by the Campbell Committee (Australian Financial System Inquiry, 1981:Chapter 1) as an explicit response to the 'second best' problem. And while it is true that the evaluation of any proposal for economic reform is complicated by the 'second best' problem, the same applies to proposals for *not* reforming. Many of the policies that Toohey and Langmore and Quiggin espouse have been subjected to cost-benefit analysis and found wanting.

The model of 'rational economic man' is an abstraction that facilitates analysis of the way in which people react to economic incentives. No economist believes that people react *only* to economic incentives. Toohey and Langmore and Quiggin appear to believe that this means that people do not react to economic incentives at all. This is quite incorrect: economic factors do have an important influence on human behaviour, and the authors accept this view themselves when it is convenient. For example, Langmore and Quiggin recommend an increase in the Austudy allowance so as to encourage students to undertake education to increase their skills. Toohey fa-

vours government support for research — so long as it does not go to economic models (such as the IMPACT model) that produce results that contradict his preconceptions.

Economists have recognised the importance of expectations and they have devoted considerable effort to modelling them. This has proved difficult, but Toohey, who raises the problem, does not provide any suggestions at all for dealing with it.

Toohey rejects the notion of efficient markets on the basis of ‘the identification of “bubbles” and other phenomena which suggest that the massive speculation that accompanied deregulation can be destabilising’ (p.119). Two definitions of efficiency are relevant to markets. The first is informational efficiency, which requires that all available information be reflected in market prices. The second is allocational efficiency, which requires that prices reflect underlying fundamentals so that they give the correct signals to market participants. Informational efficiency is not necessarily absent at times of speculative volatility, although it must detract from the allocational efficiency of the market. Presumably, it is the allocational efficiency that concerns Toohey, and most economists would agree with this emphasis. Markets have been widely tested for their informational efficiency, and the hypothesis has received substantial statistical support. Nevertheless, it seems likely that the interest in the hypothesis arises more from its ability to generate additional results than from its practical implications. A market subject to considerable volatility may still do an adequate job of allocating resources. More important: does any other arrangement give superior results? It is unlikely that an administered price will adequately reflect fundamentals. As well, markets that are tightly controlled often generate more volatility than free markets because frequent readjustments are necessary when the administered price deviates from the market price. A free market is likely to allocate resources better than one subject to heavy government intervention.

These points are relevant to Toohey’s discussion of floating exchange-rate regimes. He fails to put forward a convincing alternative, that is, a regime that produces a rate reflecting fundamentals with less volatility than the floating regimes. Toohey notes, for example, the recent failure of administered exchange rates in Europe.

Toohey’s criticism of the misuse of mathematics in economics is sounder than many of his other criticisms. The use of mathematics facilitates communication and enables us to test the logical consistency of models. In order to use mathematics, it is always necessary to make some significant abstractions. The success of this approach rests on the appropriate choice of simplifying assumptions. A good model should provide insights into real-life economic processes, but in many cases assumptions are chosen not because they are relevant but because they produce models capable of generating additional mathematical results and require the use of sophisticated mathematical techniques.

In the space of this review it is not possible to consider all of the practical questions raised in the three books. Instead we will look at a few examples. This approach is particularly unfair to Langmore and Quiggin, who include an extensive discussion of policies to deal with unemployment. An evaluation of their proposals must be left to more detailed analysis. But it is worth noting here that these authors do not

cost their programs in any detail. Indeed, some of their proposals, such as a 'job guarantee', involve open-ended commitments. They do recognise the need to fund them and suggest areas in which increased taxation revenue can be obtained. But they do not analyse the impact of their tax and expenditure proposals on the economy.

### **Monetary Targeting**

Ormerod develops a fairly detailed critique of the traditional 'quantity equation'. Once again, the criticisms would be quite familiar to economists. All three books are critical of monetarism and of its expression in the form of monetary targeting. So are many economists. The most recent example has been the widespread criticism of the Australian federal government's reliance on interest-rate policy, which, though not pure monetarism, puts an undue emphasis on monetary policy. This dependence can be reduced only if the government makes use of other policy instruments, such as fiscal and wages policies. Yet Toohey and Langmore and Quiggin resist this.

Toohey sees some kind of contradiction in the fact that 'supporters' of Milton Friedman have not argued for the latter's proposed negative income tax. This suggests that supporting an economist should be like supporting a football team, a case of unconditional loyalty. But it is quite possible to agree with Friedman's proposals for such things as the negative income tax and vouchers for education without accepting his views on monetary policy. (That is my own position.)

Does Toohey recognise the implications of the negative income tax, which he seems to support? It involves doing away with the existing welfare system, including 'middle-class welfare'. It also means removing the inefficient subsidies to the less well-off that private industries (especially banks) are expected to provide. It is certainly desirable that these forms of support disappear, because they are targeted badly and they force the recipients to receive support in a specific, and perhaps not highly valued, form. I doubt that Toohey would accept these implications, especially as he appears to think the negative income tax is inconsistent with 'the "targeted" approach to welfare that many of Friedman's supporters advocated with considerable success during the Hawke/Keating decade' (p.120). But the negative income tax is highly targeted.

### **Wages and Unemployment**

Both the Australian books reject the proposition that wages are an important determinant of unemployment and that unemployment can be reduced by increasing wage flexibility. This is interesting, because Ormerod does not appear to share their views:

In Germany, the workforce recognised very quickly that this [an increase in oil prices] meant their living standards had to fall. The nation as a whole had lost part of its income to OPEC, so workers could not regain their real living standards by putting in claims for higher money wages. (p.134)

Nevertheless, Ormerod does reject the concept of a 'natural rate of unemployment'. One element of this rejection is a refusal to accept the rational expectations hypothesis (REH). The other two books also reject this theory, but, once again, many economists do as well. The REH can be regarded as an example of assumptions adopted because they make it easier to obtain elegant results rather than because of their empirical relevance.

Toohy and Langmore and Quiggin reject the impact of wages on unemployment on a number of grounds. First, they argue that lower wages will lead to a fall in aggregate demand. According to Langmore and Quiggin, 'The principal determinant of employment is not the price of labour — wages — but the demand for labour, and this is derived from the national level of economic activity' (p.51). Stated in this form, the proposition is difficult to understand. The demand for any product depends on its price as well as income. The idea that aggregate demand is highly dependent on wages has been debated at least since the 1930s, and, not surprisingly, it is popular with union leaders. But little empirical evidence supports it. As part of this discussion, Langmore and Quiggin argue that the question of whether wages affect exports is an empirical one, but nevertheless reject the hypothesis on the grounds that exports constitute only 20 per cent of national expenditure and are largely commodities that are not labour intensive. This hardly constitutes an empirical analysis. It also neglects the impact of wages on import-competing industries.

Langmore and Quiggin also present a graph showing that long-term unemployment increased in New Zealand after the introduction there of the Employment Contracts Act, which made wages more flexible. This 'empirical evidence' is very selective. Long-term unemployment depends on past levels of unemployment and will increase even after total unemployment has begun to fall. Data given in recent issues of the *Bulletin* of the Reserve Bank of Australia show that the unemployment rate in New Zealand fell from 10.3 per cent in 1991 (the year the reforms were introduced) to 7.8 per cent in September 1994. Over the same period the Australian unemployment rate fell from 10.4 per cent to 9.5 per cent. Langmore and Quiggin's own graph shows a fall in the growth rate of the number of long-term unemployed in New Zealand at the end of the period.

Langmore and Quiggin suggest:

The results of the recent election, and in particular, the referendum leading to the abandonment of the first-past-the-post voting system, represent a rejection of ordinary New Zealanders of the two-party system and the policies it has imposed upon them. (p.55)

They fail to mention that the government was actually re-elected in 1993. This is not, however, an argument for the policies concerned, any more than the Coalition's narrow loss in the 1993 Australian federal election is an argument against the policies embodied in *Fightback!* A vast majority of people once believed that the world is flat. That did not make it flat. Langmore and Quiggin confuse success in political marketing with economic soundness.

Langmore and Quiggin also launch a vicious attack on a straw man: the suggestion that real wages should be reduced by 30 per cent. So far as I know, no economist has advocated this policy. Any substantial reduction in wages would be disruptive. Economists who are concerned about reducing unemployment argue for restraint, in terms of both wage increases and increases in the on-costs attached to employees. Sloan (1994) examines the effects of the Industrial Relations Reform Act, which has increased the long-term costs of employing workers. Most important, Langmore and Quiggin argue that wages should be more sensitive to economic conditions. Ormerod's comment cited above illustrates the advantages of this approach.

This point also provides an answer to Langmore and Quiggin's view that wage reductions are out of the question because they would lead to a substantial lifetime loss of income for employed workers. Wage flexibility would at times lead to short-term income losses, but it would promote higher income over the longer term. In addition, it is not clear why a loss of income through higher taxation is acceptable whereas one caused by a fall in wages is not.

Langmore and Quiggin also say: 'The leadership of the union movement would be unlikely to countenance claims that undermined a concerted attempt to restore full employment' (p.139). Recent events cast serious doubt on this assertion.

### **The Results of Deregulation**

As already noted, Toohey and Langmore and Quiggin attribute all our problems to the relatively few attempts that have been made to apply economic principles. A leading example is financial deregulation. The authors see little benefit from it. For example, Langmore and Quiggin fall back on bank interest-rate margins as an indication that deregulation has not been beneficial. The evidence on bank interest-rate margins continues to be hotly debated. More important, the methodology is itself badly flawed. Judging bank profitability on the basis of interest-rate margins is equivalent to judging BHP's profitability on the basis of the margin between the price of iron ore and the price it charges for its final products. Such a comparison ignores all other costs.

To examine bank profitability, we should look at profitability itself. The Martin Committee did this and concluded that bank profitability has fallen since deregulation (House of Representatives Standing Committee on Finance and Public Administration, 1991:100).

Toohey and Langmore and Quiggin condemn the imputation system of corporate taxation as 'regressive'. Its introduction actually removed an inequity in the former taxation system: the double taxation of income earned through corporate entities. It allows income from various sources to be subject to the same tax rates as income received in the form of wages and salaries, subject to whatever degree of progression exists in the income taxation system. It is true that the introduction of this system of taxation has removed an incentive for businesses to retain profits, but this actually removed a distortion in the allocation of capital. There is no reason why the companies making high profits should be the ones with access to the most productive investment opportunities.

### Suggestions for Improving Economics

Toohy and Ormerod, particularly the latter, pay some attention to developments that might make economics more useful. Both of them turn to recent developments in the physical sciences, specifically the mathematics of chaos and complexity. Toohy's earlier rejection of mathematics as a tool of analysis in economics makes his attraction to this technique surprising. His reasoning appears to be that since the world is non-linear, the non-linear approach of chaos and complexity theory must be useful.

Ormerod actually provides an unemployment model based on this approach. This is an interesting idea, but it remains to be seen whether it provides a satisfactory empirical explanation of past movements in unemployment and whether it is capable of producing insights with useful policy implications. The approach is very mechanistic — it is not unlike the charting and technical analysis used in financial markets — and there is a good chance that it will prove to be nothing more than a transient fashion.

### Conclusion

These books are useful for providing a comprehensive exposition of the ideas that currently dominate non-economists' views about economic questions. It may therefore be worth reading one of them. Ormerod's *The Death of Economics* provides the most sophisticated critique of modern economics. Langmore and Quiggin's *Work for All* includes a survey of most of the policies for dealing with unemployment currently under discussion, although the presentation is hardly a critical evaluation of the alternatives. Toohy's *Tumbling Dice* is well written and is certainly the most entertaining of the books; but that is largely because it is also very superficial and a good deal sillier than the others.

### References

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