

Irrational Expectations? John Quiggin's Critique of Microeconomic Policy in Australia

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*John Quiggin, Great Expectations: Microeconomic Reform and Australia,
Allen & Unwin, Sydney, 1996*

THIS is an important book. Its critique of microeconomic policy is rooted fairly and squarely in mainstream economic theory. This distinguishes it from a great many tirades against so-called 'economic rationalism'. It is also the first attempt by an able and informed economist to challenge the current conventional wisdom in the Australian economic policy debate about the desirability of microeconomic reform. Many Australian economists have studied individual issues associated with such reforms. But their contributions are mostly scattered. Quiggin's book provides the first overview of many key issues in the professional economic debate. Quiggin, a professor of economics at James Cook University, does not argue in a political vacuum: as he writes, 'it is, perhaps, impossible to undertake policy analysis in a way that is completely free of ideological preconceptions' (p. 64).

Quiggin's particular view is that 'the policy elite displays a clear consensus that microeconomic reform is both urgently needed and beneficial' (p. viii); 'the problem with the current Australian policy debate is not an excessive reliance on economics but the substitution of dogmatic precommitment for objective analysis' (p. ix). Primarily, 'Economic policy is based on a combination of *a priori* theory and an emotional rejection of the policies of the 1950s and 1960s' (p. 5). Quiggin tries to differentiate his critique from the considerable amount of root-and-branch criticisms of current economic policies that has been proffered by sociologists, political scientists and other social scientists: 'much criticism of current economic policy is based on nostalgia for the "good old days" of full employment and rapid growth without any clear analysis of what made those "good old days" possible' (p. 5).

My contention here will be that Quiggin is not wholly successful in differentiating himself from this literature; that he himself does not succeed in providing a convincing analysis of what made those good old days possible, how we could re-

turn to them, or whether they truly existed.¹ On the other hand, I argue that Quiggin scores some telling points in his critique of the current policy consensus.

An Overview of *Great Expectations*

The first third of the book provides an historical discussion of microeconomic reform in Australia and internationally, an outline of the theoretical economic issues the author regards as relevant, and a discussion of the changing theories of government among mainstream economists: in particular, the move from the 'public interest' to the 'private interest' approach to government.

This is followed by the main section of the book. Eight chapters discuss various types of microeconomic reform, and deal with financial deregulation, airline deregulation, telecommunications, tariff reform, privatisation and private infrastructure, competitive tendering and contracting, and (relatively briefly) the Hilmer reforms.

The two concluding chapters occupy about one-eighth of the total space. They attempt to assess the benefits and costs of microeconomic reform, and make some final observations regarding competitiveness, choice, the intensification of work and the outlook for the future.

As Quiggin recognises, the most obvious omissions are labour market deregulation (which, he suggests, would require a different author) and changes in tax and welfare arrangements. Nevertheless, Quiggin is justified in arguing that he has given us an overview of some of the most important issues which arise in assessing microeconomic reform.

What Is the Counterfactual?

To assess the effects of microeconomic reform, we have to attempt to ascertain what would happen in its absence. Even where microeconomic reform has already taken place, it is often not possible to provide a conclusive assessment of its effects. Quiggin provides a schematic example of what we should be measuring or assessing (p. 203), reproduced here as Figure 1.

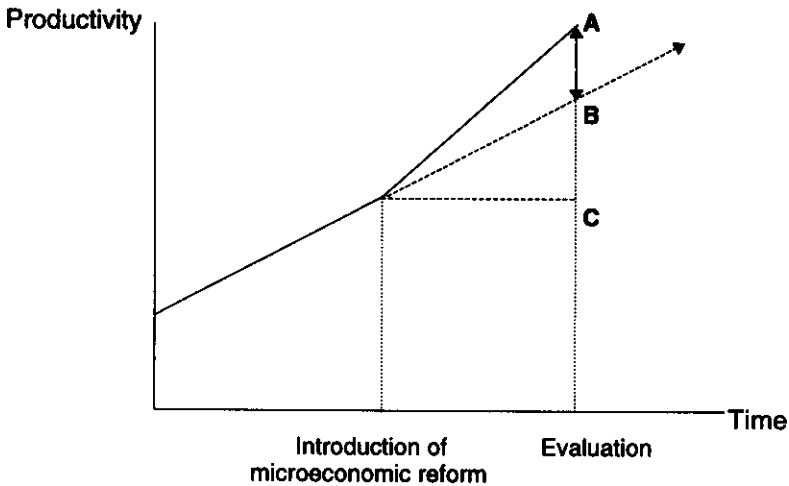
If there has been a steady increase in productivity before the introduction of microeconomic reform, the productivity gains attributed to the reform should be equal to AB. But occasionally gains equal to AC are attributed to the reform, as they are by the Industry Commission in its assessment of the benefits of microeconomic reform of the postal system, and by AUSTEL in its ascribing all price reductions in telecommunications to the benefits of competition, even though such reductions were frequent before any competition was introduced into the telecommunications industry.²

¹ One of the commentators on an earlier draft suggested that they were not in fact such 'good old days' since productivity growth was well below OECD norms for most of the post-war period.

² For references to these studies see Quiggin (pp. 203-4).

Figure 1

Counterfactuals and the evaluation of microeconomic reform



In fact, the real world is usually not so simple that one can project past productivity (or price) trends and argue that this is what would have happened in the absence of some type of institutional reform. After all, mechanical projection of past trends is basically an admission of ignorance.

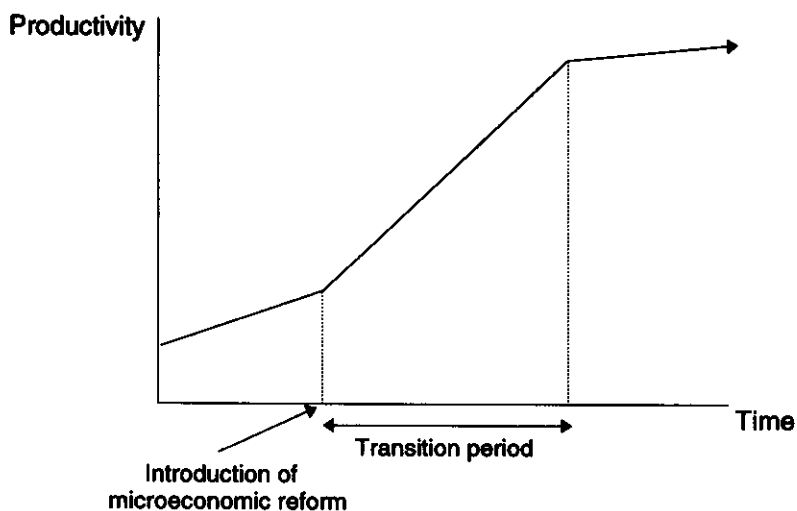
This is not to deny the validity of Quiggin's basic point: namely, that it is necessary to examine what would have happened in the absence of some institutional change in order to assess what the likely effects of the institutional change under consideration are likely to be. Past changes in prices and/or productivity are obviously relevant; on the other hand, so is other suggestive evidence (such as international comparisons). On the whole, Quiggin seems reluctant to use international comparisons and tends towards too mechanical a use of projection of past trends.³ In most cases it will not be possible to arrive at completely clear-cut quantitative assessments of the effects of an institutional change such as the introduction of microeconomic reform. We cannot usually conduct controlled experiments in the social sciences to settle such matters beyond reasonable doubt.

However, it would have been useful if Quiggin had made a couple of other important distinctions. Under what conditions would one expect institutional changes to have primarily level effects with little or no effect on the longer-term growth rate (as shown in Figure 2)?

³ There is also relatively little reference to the work on international benchmarking by the old Bureau of Industry Economics (BIE). This was quite a distinctive and useful contribution which may suffer from the dismantling of the BIE and its incorporation in the new Productivity Commission.

Figure 2

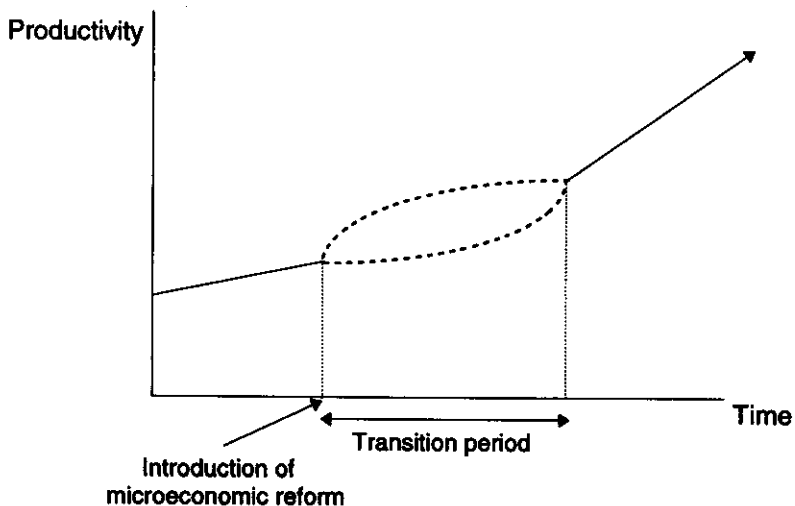
Microeconomic reform and the level of economic output



Thus, one would expect the Hawke Labor Government's attempt to remove excess labour from the Australian waterfront in 1989 to have had primarily such level effects. As suggested later, those who regard trade liberalisation as primarily a resource allocation issue (as does Quiggin) should also believe that it primarily has level and not long-run growth effects.

Figure 3

Microeconomic reform and the transition period



Again, after the introduction of microeconomic reform, there is often a period of heightened uncertainty and increased and unsustainable competitive pressure before those in the industry become familiar with the new rules and with what is now practical and profitable. For example, after financial deregulation and airline deregulation (especially in the US) quite some time elapsed before the longer-term effects of microeconomic reform became clearer.

This heightened uncertainty is shown in Figure 3 by the oval dotted line for the transition period. For this period it is difficult, if not impossible, to forecast productivity developments. After the transition period, the productivity growth rate can be expected to rise above the previous rate. Ideally, an assessment of the impact of microeconomic reform should consist of an examination of both the transition and the longer-term effects.

Shonky Quantification

The quantification of the benefits of microeconomic reform got off to a bad start when the first systematic program for microeconomic reform in Australia was presented in *Australia at the Crossroads: Our Choices to the Year 2000* by Kasper et al. (1980). These authors contrasted alternative paths which they called 'mercantilist' and 'libertarian'. The mercantilist path would produce a per capita GDP growth rate of 1.7 per cent a year over the period 1973-2000, while the libertarian path could be expected to more than double this to 3.8 per cent a year, implying a cumulative gain of 77 per cent relative to the base scenario. These figures were picked out of thin air, using selective international comparisons. Quiggin is kinder in saying they were based 'on judgement rather than formal modelling' (p. 200).

Since then, a plethora of models of the effects of microeconomic reform has appeared, often using ORANI or other general equilibrium models. One problem with these models is that they require a large number of guesstimates of the numerical values of the many parameters which are used to grind out final numerical results of the effects of particular types of microeconomic reform. The most professional outside review of ORANI concluded, a decade ago, that 'the likely variation in parameter values is such that ORANI should always be subjected to some sensitivity analysis' (Pagan & Shannon, 1987).

To the best of my knowledge, no sensitivity analysis using ORANI has been published by the many agencies cited by Quiggin who have used ORANI to examine the effects of microeconomic reform (such as the Bureau of Industry Economics, the Business Council of Australia or the Industry Commission).⁴ This is despite the fact that the Industry Commission, at least, has drawn attention, in its 1989 study on the electricity supply industry, to 'the limitations of the model and the un-

⁴ However, the EPAC study of the economic effects of microeconomic reform, which used the then recently developed AEM-CGE model, employed sensitivity analysis for some impact parameters (Filmer & Dao, 1994).

certainties of the data base' on one occasion when ORANI results clashed with its *a priori* expectations (quoted in Quiggin, p. 209).

As a result, the estimated benefits from different types of microeconomic reform are subject to a very wide margin of error. For instance, the Industry Commission estimates the direct and final benefits of the Hilmer reforms at 2.3 and 5.5 per cent of GDP, while Quiggin's estimates are around a third and a tenth of those respective gains (p. 214). I am not in a position to adjudicate between these widely different estimates, but I suspect that the two estimates might represent upper and lower bounds.

One reason why I am inclined to treat Quiggin's estimates of the benefits of microeconomic reforms as lower-bound estimates concerns his treatment of the gains from lowering tariffs and border protection generally. Here, Quiggin relies on Harberger triangle estimates which suggest that a 40 per cent tariff is associated with a decline in GDP of around 1–3 per cent (p. 134).⁵ If tariff reduction is associated with an increased dispersion of rates (as it was in Australia from the mid-1970s to the early 1990s), tariff declines on average can even be associated with *declines* in GDP (p. 137).

From the late 1950s to the 1970s, a variety of relatively new perspectives came to suggest that the allocative efficiencies at the heart of traditional economic analysis were only a part — and possibly quite a small part — of the productive benefits of market competition and trade. These perspectives raised the prospect that the greatest gains from trade liberalisation might come from X-efficiencies, scale economies, lower rent-seeking expenditure and dynamic economies associated with knowledge creation through learning by doing and research and development (Abramovitz, 1956; Solow, 1957; Arrow, 1962; Leibenstein, 1966; Vernon, 1966; Krueger, 1974).⁶

While Quiggin mentions the thesis that there may be both dynamic and X-efficiency⁷ gains associated with the move to free trade, he tends to dismiss both (pp. 128–30); but, later, he is concerned that 'the extent of intra-industry trade remains a puzzle for trade theorists, and there is no general agreement on how it should be modelled' (p. 138). Intra-industry trade is particularly relevant to the assessment of trade liberalisation, since it expands greatly when trade restrictions are removed and may hold the key to the typical adjustment process of an industry subjected to reduced protection.

⁵ Dani Rodrik (1996:14) recently argued, 'In traditional economic theory trade restrictions have *level* effects but no growth effects. That is a 20 per cent tariff may reduce real income by, say, 0.5 per cent of GDP (permanently), but it will not affect the economy's long run growth rate'. Rodrik qualifies this statement with respect to endogenous growth theory. To my mind, another important qualification is that, after trade liberalisation, governments generally cease to cushion industries that find themselves under stress. That, after all, was originally a major rationale for 'made-to-measure' protection.

⁶ I am indebted to Nicholas Gruen for making this point in one of his unpublished papers.

⁷ X-efficiency theory presents a line of reasoning differing from standard economic theory by relaxing the maximising behaviour assumption, as a result of either inertia, discretion or incomplete contracts. See Leibenstein (1966).

Finally, Quiggin falls back on casual empiricism of a kind which might even be labelled 'shonky quantification': 'Experience since the move to free trade has done little to support optimistic predictions of large dynamic gains' (p. 138). A recent EPAC (1996) study, published perhaps too late to be considered fully in Quiggin's book, uses cross-country regressions with 14 OECD countries and suggests that Australia's previous and announced tariff reductions could be expected to increase GDP by around 15 per cent by 2020: nearly 0.5 per cent in annual per capita GDP over the period 1990-2020. As with most empirical work of this kind, one can find reasons for dismissing the numerical estimates. The point to be made here is that such empirical estimates are as suggestive as is theoretical reasoning based on comparative static models: models which we know to be incomplete in explaining the real world. Needless to say, even if the EPAC (1996) estimates are near the mark, they could still be swamped by other changes in economic performance and would thus not be noticeable if one adopts the type of casual empiricism which Quiggin displays in the above quotation.

Quiggin is, however, on firmer ground when he disputes the widely cited Prices Surveillance Authority estimate that the real cost of air travel has declined by some 24 per cent since airline deregulation. While this is what has happened to the average revenue per passenger kilometre, that measure is not a normal price index like the CPI or the GDP deflator. According to Quiggin, what has happened is that discount fares have fallen substantially (by 18 per cent), and now account for some 70 per cent of all tickets sold (compared with 45 per cent before deregulation), while normal economy and premium fares have risen by some 10 per cent in real terms. Averaging all this out suggests that average real airline prices have changed only modestly since airline deregulation.⁸ But, with the large growth in discounting, the choices of those flying have greatly increased, though hardly anyone in the Australian microeconomic debate evaluates these policies in terms of the increased freedom they can produce. As Quiggin maintains elsewhere,

The advocates of microeconomic reform have shown surprisingly little concern with designing reform in a manner that maximises the benefits in terms of consumer choice ... For example the deregulation of shopping hours and liquor licensing over the past 20 years has greatly expanded the freedom of choice available to consumers. Yet it has taken place largely independently of the microeconomic reform movement. (An exception is Hogbin, 1983.) (pp. 225-6)

Microeconomic Reform, Income Distribution and Employment

Economists used to attempt to avoid interpersonal comparisons. The literature told us to advocate policies only in cases where one could make Pareto improvements:

⁸ Using the Laspeyres price index, Quiggin suggests an increase of 2 per cent; using the Paasche index, it becomes a 4.5 per cent decrease.

that is, changes which made at least one person better off and no one worse off. Unfortunately, few, if any, policy changes could be advocated under such a severe constraint. The Kaldor-Hicks criterion advanced in the 1930s argued, plausibly in my view, that economists should also recommend policies which produced *potential* Pareto improvements — policies which raised aggregate real incomes sufficiently so that gainers could potentially be made to compensate losers with something left over.

At least until the early 1970s, this seemed a sensible criterion. During the long post-World War II boom, most Western countries enjoyed full employment, and income differentials were generally declining. While no attempt was made to compensate everyone for any government action which might have affected them adversely, most people's real incomes were increasing fairly steadily; even if, occasionally, some were adversely affected by particular government policies (such as the lifting of import restrictions in the early 1960s).

Quiggin objects to the exclusive concentration on efficiency in the microeconomic reform literature and to the corresponding neglect of equity (and employment) considerations. Such concentration has been broadly justified on two grounds: (i) that equity is difficult to define (and, one might add, it is often defined in such contradictory ways that it is impossible to meet the various conflicting criteria at the same time); and (ii) that greater efficiency, once achieved, implies a greater capacity to do more about social justice, poverty, community objectives, and so forth. 'In practice, advocates of microeconomic reform undertaking analysis of any policy issue tend to assume that equity will be dealt with "somewhere else"' (p. 45).

Redistribution 'somewhere else' in practice means through the tax and welfare systems. Given that such redistribution is costly, Quiggin makes the eminently valid point that 'redistribution through pricing [for example, in telecommunications] should be pursued up to the point where the marginal cost, in terms of efficiency losses, is equal to the marginal efficiency cost of pursuing redistribution through the tax-welfare system' (pp. 120-1). In other words, once it is accepted that redistribution is not costless, the complete separation between efficiency and distributional criteria cannot be justified. Again, in a world where there is a good deal of unemployment and underemployment and where there is evidence that such slack labour markets are not wholly the result of labour market rigidities (Cross, 1995; Ball, 1996), microeconomic reform measures leading to more short-run unemployment should not be evaluated purely on the basis of any efficiency improvements which have been achieved. Evaluations in terms of efficiency alone implicitly assume that workers displaced during microeconomic reforms are able to obtain alternative jobs. Quiggin cites a 1993 ABS survey originally provided in evidence to an Industry Commission inquiry to the effect that some 50 per cent of Victorian workers made redundant by reform were still unemployed three years later. As labour's share of output in the economy as a whole is around 70 per cent, this suggests that 35 per cent of the total productivity gains from microeconomic reform will be lost as a result of labour force withdrawal (p. 213).

Privatisation and the Equity Premium Argument

Quiggin argues against privatisation on a number of grounds, but

by far the most important ... is the equity premium. Because the rate of return demanded by holders of equity is well above the government's cost of funds, a sale at full market value will, other things being equal, leave the public worse off. (p. 159)

The equity premium argument has been around at least since a seminal paper by Mehra and Prescott (1985) suggested that the average real rate of return on American equities (over a period of some nine decades) has been 6 percentage points higher than the risk-free average real return on bonds.⁹ The equity premium is too big to be explained by plausible levels of risk aversion, suggesting that private capital markets are unable to diversify risks efficiently.

This does not seem a valid argument against the privatisation of the Australian National Line, the Commonwealth Bank, Telstra or other government agencies. First of all, there are other, important, considerations dealing with the relative virtues of public versus private ownership which seem of major importance in deciding this issue. Thus, some commentators have reluctantly qualified their support for public enterprise because of endemic and chronic problems of overstaffing and unprofitability in many cases (see for example Rowthorn, 1989). Second, there is still a good deal of argument about the statistical validity of the equity premium argument across the world's major equity markets — even though it may be true for US equity markets. Third, even if the argument is sound, does it follow that governments should hold equities in the proportion in which a particular government has inherited them? If there is a general equity premium, it is an argument for governments selling bonds and investing the proceeds in a fairly wide spread of equities, rather than concentrating equity holdings in some very specialised equities which history (or certain political leaders such as King O'Malley) has bequeathed to these governments. Again, if there is a general equity premium, it may be sensible for central banks to hold some part of a country's external reserves in the form of equities rather than either foreign exchange and/or foreign fixed-interest securities.

The privatisation of infrastructure raises further issues over and above those arising from the privatisation of such government enterprises as the Commonwealth Bank. In particular, infrastructure projects such as roads often form part of a network. In such cases, as Quiggin points out, 'The risk associated with many infrastructure projects depends more on public policy decisions than on the management skill of the operator ... [as a result] ... [t]he private operator must either demand a large risk premium in addition to the usual equity premium, or must demand guarantees of favourable treatment' (p. 166). It appears that both the Sydney Harbour tunnel and the Melbourne CityLink road are examples of private operators receiving such favourable treatment. It is difficult not to agree with Quiggin that

⁹ For a recent summary of the debate, see Kocherlakota (1996).

'many current proposals for private sector involvement in infrastructure provision appear to be generated by the inappropriate incentives associated with global borrowing limits' (p. 171) rather than by an in-principle decision that private-sector ownership and operation of a given infrastructure project is socially optimal.

Where Does Quiggin Stand?

Enough has been said to give a broad flavour of Quiggin's critique. This account might lead the reader to believe that Quiggin is opposed to most microeconomic reform. But this is not the case.

Quiggin is opposed to turning the clock back and abandoning microeconomic reform:

... it is difficult to sustain the view, implicit in much criticism of 'economic rationalism', that microeconomic reform has caused large reductions in social welfare. *The major economic factors reducing social welfare over the past 20 years have been the slowdown in productivity growth and the rise in large scale unemployment. These developments have been common to the majority of OECD countries, including those that have undertaken no systematic program of microeconomic reform.*

The primary contributions of microeconomic reform to higher unemployment in Australia have been indirect ... *although the benefits of microeconomic reform have been systematically overstated, they are still positive and significant in many, perhaps most, cases.* (p. 222, emphasis added)

Given that the benefits of many, perhaps most, examples of microeconomic reform are 'still positive and significant', one might puzzle about Quiggin's earlier statement that the Australia's policy debate has substituted 'dogmatic precommitment for objective analysis'. On the other hand, it is hard not to agree with Quiggin that, in the case of natural monopolies in such areas as road and telecommunications networks and other infrastructure services, the pendulum has now swung too far against government and in favour of simplistic *laissez faire* remedies. As Krugman (1994:181) puts it, 'markets are not magical. They can work well when conditions are right, but leaving a natural monopoly free to do its worst is blind ideology'.

Quiggin rightly draws our attention to some examples of waste currently incurred in the name of microeconomic reform. Prominent among these is the duplication of networks by the present telecommunications duopolists, Telstra and Optus. According to *The Australian Financial Review* (23 November 1996, p.13) some \$4 billion has been spent on this virtual duplication exercise with a good deal more to come in capital cities such as Adelaide, not to mention further duplication of existing networks in Sydney, Melbourne and Brisbane. One of the main findings of King and Maddock (1996:3) is that 'national competition policy does not eliminate the desirability of some regulatory controls over infrastructure industries; access to essential infrastructure does not guarantee and, by itself, is unlikely to achieve any significant improvement in economic efficiency; reliance on access

terms which are negotiated privately ... cannot be expected to produce any significant improvement in the wellbeing of final consumers'. In other words, while microeconomic reform is a useful tool in our armoury, it is neither a cure for all our microeconomic problems, nor can we be sure that what is simplistically promulgated as 'microeconomic reform' will always live up to its name.

Yet I am not convinced by Quiggin's claim, quoted earlier, that current economic policy is based primarily on a combination of a *a priori* theory and an emotional rejection of the policies of the 1950s and 1960s. There were some good reasons why economists in the later 1960s and early 1970s started to doubt that stimulatory macroeconomic policies could always be relied on to solve growing unemployment. In most OECD countries, the Phillips curve trade-off between inflation and unemployment seemed to become more and more unfavourable. It was the experience of these years which convinced the economic policy establishment to take microeconomic issues and 'supply-side economics' more seriously. After all, the committed anti-Keynesians of their day (such as Milton Friedman and Friedrich Hayek) had begun to propagate their message a couple of decades earlier — with relatively little effect on the policy establishment.

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