AFTER Rationalism

Is ‘economic rationalism’ really about economics?
Tony Aspropourgos is unsure. Is it rational? Probably not. But he cautions that its failings don’t let its critics off the economic hook.

As an economist, the rise of ‘economic rationalism’ in Australia in the 1980s was a source of some bemusement and irritation to me. I do not know precisely what it is. I am not sure that it is economics, but I am certain that it is not rational.

I have the impression that the term—used to embrace a loose collection of policy views with no very obvious unifying core—has had the effect (whatever the intention) of conveying to the general public the conception that in some sense this grab-bag of policies carried the imprimatur of economic science. This is the irritating aspect of ‘economic rationalism’. Even if one remains entirely within the confines of orthodox (marginalist) economics, it is not evident that theoretical economics endorses ‘economic rationalism’. The academic economists and other economic ‘professionals’ or ‘experts’ who are regularly dragged out of their cupboards and draped over a microphone, or broadsheet, to endorse ‘economic rationalism’ are very little different from the clergy of earlier (and some current) generations who bless the canons of one side or another of various conflicts—in our case, public policy conflicts.

This is not to say that economists do not have the right to participate in public policy debate—they have as much right as anybody else. But they should not be permitted to get away with projecting views which are essentially a product of their wider political and social values, rather than their professional expertise, as if those views had the status of scientific or some other intellectual authority. In fact, their wider social and political values are of no greater interest than those of an unemployed manufacturing worker in Wangaratta or Wollongong.

Much the same could be said of the economic journalists who cultivate an image of residing above the myriad of vested or particular economic interests and offering ‘unsoiled’ advice, presumably in the service of some ‘common good’ or ‘national interest’. Yet this common interest, if it exists, remains entirely unelaborated in their entirely
derivative writings. In fact, these self-proclaimed crusaders are no more devoid of particular interests and controversial social values than anyone else.

To a large extent, then, 'economic rationalism' is actually a product of social and political values rather than economic science. Thus an explanation for its rise to dominance must be sought elsewhere than in economics alone. I do not mean by this to absolve academic economics of all culpability. Yet to locate the problem in the university training of our bureaucrats or businesspeople is too easy. Those who believe that the dominant economic beliefs of the ruling elites—either in government or private business—are largely derived from their university training in economics need to explain how it happens that academic economists (whatever their other defects) on average are considerably less conservative than their former (or current) students. It would be obvious to any academic of even moderate perception that the social values of those who pass through the academy on their way to joining the elites are already solidly formed before they enter the academy. Of those who enter with such conservative beliefs, most leave with them largely intact. In short, it is not good enough merely to point the finger at 'economics'.

For in truth economic science provides little warrant for any economic policies of any kind. To the extent that economics limits itself to explanatory propositions about how economies actually behave, it can say little about desirable policies—only, at most, that if certain policy levers are pulled, then certain outcomes will result. In this purely explanatory realm, orthodox economic analysis is indeed deeply suspect; but that is not the point I wish to pursue here.

Yet despite these various misapprehensions there is a connection between orthodox economics and the bundle of policies associated with the term 'economic rationalism'. On one definition the core of 'economic rationalism' is the notion that competition and 'flexibility' of market processes will produce optimal economic outcomes—or at least, superior outcomes to any other (government-manipulated) regime. Yet again this is far from self-evident. A number of related postulates are required for a proposition like this to be plausible. Explaining them is somewhat technical, but worth following.

Even in the limited domain of price and wage flexibility, prices would have to simultaneously achieve three distinct goals. On the production side, market processes would have to proportion prices to costs. At the same time, on the demand side, prices would have to adjust so as to ensure that supplies balance demands and markets 'clear'. Finally, the resulting prices would have to exhibit certain additional optimal properties; in particular, prices would have to fully incorporate all social costs and benefits of economic activity. It turns out to be remarkably difficult to demonstrate just how market processes are to generate these various results.

Two examples may help to illustrate the difficulties involved. The first is related to the public debate on tariff policy and the best allocation of national economic resources. Here the usual procedure adopted by the econometricians is to 'assume' full employment, and then analyse the possible alternative outcomes from reallocating those fully employed resources to different uses. (All the models contrived by the Industry Commission are of this kind.) The notion that resources (and in particular labour) in previously protected industries might find no alternative use is simply not taken seriously. Yet, to put the point mildly, it may not be so easy to transform a middle-aged male manufacturing worker in Geelong into a waitress in a Japanese restaurant in Cairns. If this is rationality, economic irrationality must be terrifying.

The other example is the parallel public debate over deregulation policy and the economic role of competition in general. Let us suppose for the sake of argument that a completely deregulated and competitive economy will generate superior social outcomes to a regulated and non-competitive system. This does not guarantee that any particular deregulatory reform aimed at providing greater competition will improve social welfare. The economic 'Theory of Second Best' upon which this conclusion rests is highly abstract, but the following illustration helps to suggest its significance.

Suppose that both rail and road freight are subsidised and cost inefficient. Suppose also, following the logic of orthodox economics, that removing subsidies from the costs of both rail and road freight will generate a superior social outcome. It nevertheless may easily be the case that if one removes subsidies from rail freight, but leaves road subsidies unchanged, the result will actually be greater inefficiency and thus a worse social outcome. Why? Because if rail freight becomes relatively more expensive than road freight, the effect will be to encourage more resources into road freight—and this will lead to an inferior, rather than superior, allocation of resources. In other words, removing subsidies from rail freight while subsidising road freight, according to this analysis, is actually worse than the situation of subsidising both.

It would not be all that difficult to provide a comprehensive and devastating critique of orthodox economic notions of the ability of the market mechanism to efficiently and spontaneously direct resources to the best ends—concepts which underpin (albeit in vulgarised forms) the rationales for 'economic rationalism' in Australia. But that sort of critique would suffer from the intrinsic limitation of any negative argument: repudiating one set of arguments for a policy position does not remove the possibility that another set of quite valid arguments exists for the same policy. Or, to put
the same point slightly differently, a sufficient rationale may not be, at the same time, a necessary rationale.

This brings us to the real core of economic policy debate in Australia today. We are confronted with a fundamental dilemma. On the one hand we need a growth rate of the economy capable of systematically reducing unemployment towards the ultimate goal of full employment. On the other hand, and at the same time, we need to stabilise foreign debt and our current account deficit at levels which are sustainable. This means, in rough terms, that we need a persistent real GDP growth rate of upwards of 3.5-4% at the same time as generating a trade surplus of around 1.5% of GDP. The crucial question here is whether it is possible to achieve these results by relying wholly on the spontaneous mechanism of market forces. It is because I do not believe that spontaneous market forces are capable of generating these results that I favour interventionist industrial policies.

The dramatic changes in structural economic policy wrought by the Hawke and Keating governments since 1985-86 have essentially—if not entirely consciously—been driven by this fundamental difficulty of reconciling full employment growth and long run external balance. The internationalisation of the economy and aspects of deregulation have been driven by this imperative. That it is of prime importance to generate a persistent trade surplus of the order of magnitude indicated above—if full employment is ever to be revived as a serious policy objective—is at least loosely understood, and accepted, across the political spectrum. Less widely understood, particularly on the left, is that this also has definite and largely inescapable implications for the balance between public sector expenditure and revenue, and thus for the level of public expenditure itself.

Why is this so? The current account deficit is by definition equal to the private sector deficit plus the public sector deficit. In other words, Australia’s deficit with the rest of the world is equal to the excess of our expenditure over our income in the public and private sectors taken together. Hence, if government policy is aimed towards achieving a desired current account balance and a desired level of private investment—as is presently the case—then (given a certain level of private saving) this very largely determines the balance between income and expenditure in the public sector. In other words, if the current account is a primary target of government policy, the level of expenditure in the public sector is directly constrained by that policy objective. And this is true for the public sector as a whole; that is to say, all of the three tiers of government, including government trading enterprises. The consequences of this, though real, are unpalatable to many on the left.

This much is clear at the level of principle. In practice, public sector budgetary restraint has become synonymous with expenditure restraint, not least because of the current government/opposition bidding war on tax cuts. But budgetary restraint could equally well be achieved through tax increases. This would mean shifting the burden of economic restraint towards the reduction of private consumption and/or investment. (However, the reduction of private investment is obviously economically unattractive, unless it is somehow or other the result of efficiency gains.)

I cannot conclude without a note of warning. I have argued above that the bundle of economic policies described as ‘economic rationalism’ lacks any robust general rationale in economic theory. This may be of some comfort for the Left, given that this selfsame range of policies stands at odds with many of its traditional beliefs. However, this does not somehow absolve the Left from the real policy dilemma I outlined above. In particular it should not obscure the fact that any plausible policy stance by the Left must be dominated by the two compelling requirements I outlined above. The first is that we require a trade surplus which allows both employment growth and the stabilisation of foreign debt as a percentage of GDP. The second is a public sector budget in line with the level of private investment and private savings, and with the aforementioned trade surplus (and, by implication, the current account deficit).

‘Economic rationalism’ is a vague and rubbery term which covers a multitude of intellectual and ethical sins. But this is no excuse for dismissing every policy associated with the term out of hand. It does not remove the necessity for the Left to consider case by case the usefulness of various policies which find a place under this idiotic rubric. The alternative is to make the same mindless error as our adversaries—an irrational a priori commitment to all the policies clustered under ‘economic rationalism’ confronting an equally irrational a priori rejection of all those same policies. The policies labelled as ‘economic rationalism’ are not a seamless robe of indivisible doctrine. Many of them may be the result of blind economic faith or prejudice. But equally some may be the result of compelling economic forces.

The Left needs to debate these issues further. In doing so it should not lose sight of two further considerations. First, no political body of opinion can ignore the economic constraints now confronting Australia and hope to remain a relevant intellectual force in public policy debate. There is a widespread diffidence, not to say antipathy, on the Left towards economics as such. For some, ‘economic rationalism’ seems to be simply a synonym for economic analysis. Second, elaborate critiques of market processes and powerful arguments for their failure are not sufficient to justify vaguely conceived policies of government intervention. There is government failure as well, as the Victorian experience of the 1980s makes transparently clear. It is necessary to provide policy responses which are reasonably likely to generate superior outcomes—and this in turn requires a more thoroughgoing commitment to policy debate and development.

TONY ASPROMOURGOS teaches in economics at Sydney University. This is a longer version of a paper delivered recently to a Left forum in Sydney.