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Economic rationalism

Social philosophy masquerading
as economic science

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1. Introduction

Future economic historians will note three major themes in economic policy in Australia in the last quarter of the 20th century. They are: deregulation of the financial system, privatisation, and microeconomic reform. The last includes a range of measures including tariff reductions, taxation reform and changes to Australia's traditional and unique labour market institutions. In all three cases great changes were made in the 1980s and l990s. The financial system was transformed. The exchange rate was floated and exchange controls were abolished. There were mergers among Australia's large banks, building societies transformed themselves into banks, and foreign banks entered the Australian retail banking market. There were also important technical changes which altered the way monetary policy was conducted and put great weight on interest rate changes as the major instrument of monetary policy.[1] Both Federal and State governments engaged in what seemed like an orgy of privatisation. Government enterprises that were sold to the private sector, including overseas buyers, included institutions that had previously been icons of pride in public assets, such as Qantas and the Commonwealth Bank. They also included State banks originally set up to help rural Australia. In the name of microeconomic reform tariffs were drastically reduced. There was almost continual discussion of taxation reform, with the introduction of major changes such as dividend imputation, fringe benefits tax and capital gains tax. The award system was shifted from centre stage in the wage fixing process and enterprise bargaining was encouraged.

The election of the Howard Government made change even more wide ranging. The Accord, the major exception to the policy trend, was immediately abandoned and enterprise bargaining given a boost. The first stage of the privatisation of Telstra passed through the Senate, and one of the first acts of the Howard Government was to set up yet another inquiry into the financial system.

All these changes were the visible result of the ascendancy among both politicians and bureaucrats of the ideology known as economic rationalism in Australia and market liberalism in other English-speaking countries. The term ‘economic rationalism’ has become a catch-all term of abuse in some circles, but since it is so influential it is important to realise what its tenets actually are. Economic rationalism is not a very

[1] Monetary policy is no longer directly concerned with determining the volume of money in an economy but rather with the ease and cost of borrowing. This can be done by regulations and quantitative controls on banks, but in a deregulated economy monetary policy works mainly through the price of borrowing or the interest rate. Monetary policy is one of the two conventional arms of policy at an economy-wide level. The other is fiscal policy, which is concerned with the economy-wide effects of government expenditure and revenue raising.

tightly knit school of thought but it has an essential core which is outlined in Section 2 of this paper.

The success of economic rationalism has been remarkable, with many previously held verities turned on their heads. This was not the result of advances or of new discoveries in economic theory. All around the world there was a deliberate political campaign to change the prevailing political ideology to that held by economic rationalists. This is spelt out in Section 3.

One of the tricks of many economic rationalists is to present their policy recommendations as no more than the logical consequences of orthodox economics. This is very far from the case. Section 4 shows that the policy prescriptions of economic rationalism depend more on the values held by economic rationalists than on the theorems of economics. In any case, orthodox economics is very clear that policy recommendations must rest on both economic analysis and a set of values.

The changes resulting from the implementation of economic rationalist policies were very widespread. However, the most important was the loss of full employment as a goal of public policy. The unemployment rate rose from an average of 2.0 per cent over the five years ending in 1974 to an average of 9.4 per cent over the five years to 1994. Economic rationalism was not the only cause of this increase in unemployment but it certainly contributed to it, in ways which are discussed in Section 5. The most important is the abandonment of a commitment by government to maintain or restore full employment. The Howard Government has an explicit quantitative target for low inflation. It has no quantitative goal for reducing unemployment. Economic rationalism has reversed the priorities of the ideology it replaced.

2. The definition of an economic rationalist

Non-economists tend to define economic rationalism in far too sweeping a fashion. For example, Battin, a political scientist, maintains that the key tenet of economic rationalism is 'the belief that the market is the only legitimate allocator of goods and services in *society* at large not just in the *economy'* (1991: 296, emphasis in the original). I know of no economist who believes this or even believes that the unfettered market is the only legitimate allocator of goods and services in the economy. For example, economic rationalists do believe that society should keep from starvation those whom the market leaves without income, whether this be done through the state or through voluntary organisations. They do believe that government should intervene to prevent, or at least discourage, private enterprises from polluting the environment. They do believe that the state, not the market, should provide public goods[2] such as defence, and so on. A better description of an economic rationalist is one who believes that there are very few exceptions to the rule that the market is the best way of deciding what is to be produced and how it is to be produced. Moreover, an economic rationalist holds that even when market failure exists (i.e. when the market is not the best way of deciding what is to be produced and how it is to be produced) the consequences are usually of less importance than those of the government failing in this respect and are easier to correct.

This definition of an economic rationalist places emphasis on production, on what is to be produced and how it is to be produced. While some economic rationalists argue that unequal income distribution is important to create the right incentives, generally in Australia economic rationalists say little explicitly about income distribution, about who gets and who should get the goods and services that are produced. Certainly they argue that market incomes should be determined by the market; for example, that wages should be fixed by market forces with no interference in the form of minimum wage laws or award wages and conditions laid down by the Industrial Relations Commission. However, they tend not to comment on the role of social security or the social wage, and hence on the final pattern of income distribution, except perhaps to leave a vague impression that social security will take care of those whom market forces leave living in poverty.[3]

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[2] In this context. a public good is defined as a good which cannot be provided to one person without simultaneously providing it to others.

[3] This is the major way in which economic rationalism in Australia is at variance with the writings of those who inspired it. Friedman, for example, has stated:

In the past, many economic rationalists argued that the adoption of the policies they advocated would raise total production so rapidly that even those at the bottom end of the income distribution would secure rises in real income (through market forces) and hence poverty would be a diminishing problem. Today those with intellectual honesty acknowledge that counter examples, such as the cases of the United States and New Zealand, show that this is unlikely to happen, at least for a generation or two. All that is left to counter poverty is the social security system, but economic rationalists do not, in general, discuss how this role for the social security system is to be reconciled with the push for low taxation and minimal government. Overseas writers who have inspired Australian economic rationalists do comment on how income should be distributed, but in Australia economic rationalists tend to focus on production, arguing that in general the questions of what is to be produced and how it is to be produced should be left to the market.

One further point about economic rationalism should be noted. Those in this camp are almost always more concerned to keep inflation at a very low rate than to reduce unemployment substantially. Perhaps this is because economic rationalism downplays the existence of market failure —and involuntary unemployment is traditionally associated with market failure— whereas inflation can, if one wishes, be blamed on government failure. One school of economists, the new classical school, even argues that involuntary unemployment does not exist and that it is possible through tight monetary policy to reduce inflation without affecting the level of unemployment —though, to be fair, I can think of only one economist responsible for giving advice to those determining economic policy who ever held such beliefs. In any case, the conventional wisdom now is that it is not possible to avoid a short-run trade-off between unemployment and inflation when monetary policy is used as the principal anti-inflationary instrument.[4] Economic rationalists are opposed to using policies such as the Accord as a weapon against inflation, as that involves substantial intervention in market processes. Hence their emphasis on keeping the rate of inflation very low does involve a cost in higher unemployment. This is discussed in Section 5.

The ethical principle that would directly justify the distribution of income in a free market society is 'To each according to what he, and the instruments he owns, produce. (1962: 162).

[4] In summing up the discussion at the conference reported in Blundell-Wignell (1992), Max Corden stated: 'Consensus did not exist on three crucial matters... [of which the first was] you can not deflate without some cost' (p. 341).

3. Economic rationalism as a political program

Economic rationalism is the Australian version of a political movement known in other English-speaking countries as market liberalism. As Marginson (1992) points out in his study of the works of Hayek, Friedman and Buchanan, the father figures of this movement wrote primarily not to increase knowledge but to change the world. They were laying the foundations of a political crusade rather than trying to establish a new school in economics. Hayek's best known work is not that for which he received the Nobel Prize for Economics but his 1944 classic in political philosophy, *Road to Serfdom.* In the next few years he saw that post-World War II society was indeed moving away from individualism, and lamented that

> under the sign of 'neither individualism or socialism' we are in fact rapidly moving from a society of free individuals towards one of a completely collectivist character (1949: 1).

Hayek acknowledged that this movement away from individualism was due to politicians implementing what the public desired, but argued that public opinion should be changed through the writings of himself and like-minded economists and political philosophers.

> what to the politicians are fixed limits of practicability imposed by public opinion need not be similar limits to us. Public opinion on these matters is the work of men like ourselves, the economists and political philosophers of the past few generations who have created the political climate in which the politicians of our time must move. (1949: 108).

In his Nobel Prize speech, Buchanan criticised the economists of his time as 'ideological eunuchs' and elsewhere stated that the only purpose of science is to assist in developing propositions about how the world ought to be (Marginson 1992: 7). Friedman drew inspiration from Hayek, whom he praised for his 'influence in strengthening the moral and intellectual support for a free society', and in turn threw himself wholeheartedly into the movement to change public opinion, with numerous magazine articles, TV appearances, and the famous book *Free to Choose,* written with his wife, in which he exulted that the tide of public opinion was turning (1980: 7).

In Australia, economic rationalists are equally open about the fact that their objective is to change society. For example, King and Lloyd describe economic rationalism as ‘a microeconomic *agenda* that focuses on reducing government intervention in markets’ (1993: ix, emphasis in the original).

The political program called economic rationalism, or market liberalism, is firmly based on a social philosophy sometimes called libertarianism. This social philosophy places great emphasis on the freedom of the individual. To quote Friedman,

> As Liberals, we take freedom of the individual, or perhaps the family, as our ultimate goal in judging social arrangements. (1962: 12).

And he makes it quite clear that ‘freedom’ has nothing to do with freedom from want etc., but with freedom to do as one wishes without restraints imposed by other people. Constraints imposed by lack of means do not raise problems of freedom. Robinson Crusoe could have no problem of freedom while he was alone on his island, even if he starved to death. (The example of Robinson Crusoe is taken from Friedman himself, 1962: l2). Monopolies —but not lack of resources or capabilities or talents— are thought of as limiting freedom. Consequently, for Friedman the role of government is strictly limited.

> Its major function must be to protect our freedom both from the enemies without and from our fellow citizens: to preserve law and order, to enforce private contracts, to foster competitive markets. Beyond this major function, government may enable us at times to accomplish jointly what we would find it more difficult or more expensive to accomplish severally. However, any such use of government is fraught with danger. We should not, and can not avoid using government in this way. But there should be a clear and large balance of advantages before we do. (1962: 2-3).

This political philosophy, rather than economics, is the basis of the economic rationalists’ crusade for minimal government.

This political crusade was very successful, especially in English-speaking countries. The detailed reasons for success varied from country to country, though there were many common factors. It is interesting to speculate on what were the significant factors in Australia. In my view the six most important were:

1. the events of the 1970s, which showed that the conventional economic wisdom of the l950s and 1960s was no longer adequate as the basis of policy in the new circumstances;
2. the attractiveness of elegant economic theory based on the assumption of perfect competition leading to a belief that policy problems can be treated as if the real world conformed to this assumption (Nevile 1994: 32-3);
3. the desire of 'young turks' to embrace new ideas rather than follow tamely in the footsteps of their seniors, and the fact that many influential people in universities and the public service took PhD courses in economics in the United States at a time when (what we call) economic rationalism was very much the new intellectual wave in that country;
4. the fact that government interference with market activity has not had a good track record in many areas of economic activity in Australia;
5. political considerations in Australia; for example, the desire of the first Hawke Government to be seen as an economically literate and responsible government; and
6. greed.

4. Economic rationalism is not the logical conclusion of mainstream economics[5]

Due usually to lack of caution rather than a desire to deceive, a number of prominent Australian economic rationalists have stated that their policy prescriptions follow inevitably from standard economics, depending only on the propositions of economics and not on the values of the particular economists advocating the policies. For example, Sloan (1993: 132), describes those opposed to the ideas of economic rationalism as 'anti-economists', and Anderson and Blandy (1992: 36) describe an assault on economic rationalism as 'an assault on economics itself'. This identification of particular policies with the conclusions of an objective study of economics is not only wrong; it is counter to the whole tradition of economics, which states firmly that virtually any policy

[5] This section is a revised version of previously published material of mine (Nevile 1994: 30-2).

prescription must rest on values. There is almost always a cost as well as a benefit, and the relative weight given to each depends on one's values.

Mainstream economic thought around the world divides economics into two streams: positive economics, which is the study of what is; and normative economics (including all policy advice), which is concerned with what ought to be or what is desirable. Since normative economics takes into account what is considered desirable, it depends on value judgements on which men and women may continue to differ however intelligent and knowledgeable they may be. On the other hand, according to conventional wisdom, positive economics is value free, so that any two intelligent people should be able to reach agreement on the correctness or otherwise of a proposition in positive economics through rational discussion and empirical observation.

Although most economics departments teach that positive economics is value free, this can be, and is, challenged. I argue that positive economics is not free of value judgements in at least two respects. Deductive reasoning should conform to the rules of logic, which are certainly value free. But, in general, positive economics is not just a matter of deductive reasoning. It also requires an appeal to empirical studies. Moreover, the facts that an economist studies are not facts produced in carefully controlled conditions in a laboratory. They are facts thrown up by real world situations, and some judgement is required in interpreting the facts. This judgement is heavily influenced by the values of the person making the judgement. The case for reducing government regulation of, and intervention in, the economy rests on the empirical judgement that cases of market failure are uncommon; that is, if left to itself, it is very unusual for the market not to produce an efficient outcome. Economic rationalists who place a high value on political and personal liberty are suspicious of government intervention and regulation, which they see as reducing personal liberty. It is perhaps not surprising that such economists generally make the professional judgement that market failure is rare. Given the values that they hold, the costs of unnecessary government intervention are high. From their viewpoint it is responsible to be very cautious in claiming that market failure exists.

Other economists are more concerned about the costs of not intervening when to do so would be beneficial to the economy. If there is market failure, the people who suffer are usually the economically weak, who may well experience very real poverty. This is particularly true of the labour market, where a major symptom of failure is involuntary unemployment. Economists who put a high value on economic security for all, on preventing anybody from falling below a certain level of income, are far more likely to make the professional judgement that market failure is an important problem in an unregulated capitalist economy than are those with a libertarian social philosophy.

For those who know statistical jargon, it is all a matter of type 1 and type 2 errors. Economic rationalists, and others, who believe that positive economics is value free forget that there is no objective way of deciding whether type 1 or type 2 error is more important. It is a matter both of the consequences of each type of error and of one's value judgements about the relative undesirability of each set of consequences. It is entirely proper for economic rationalists to allow value judgements about freedom to influence their policy prescriptions. It is improper and, more importantly, incorrect for them to claim that these policy prescriptions flow simply from the laws of economics. It is very important for the rest of us to realise that their policy conclusions flow as much from their social philosophy as from their economics.

The second reason why positive economics is not value free is the very human tendency to give more weight to empirical observations that tend to support one's preconceived ideas than to those that tend to disprove them. Those who doubt this should contrast the frequency with which media commentators who are economic rationalists point out that in the United States, where there is a deregulated labour market, there was only a small rise in unemployment in the 1980s with their failure to ever mention that when Mrs Thatcher deregulated the labour market in the United Kingdom there was a very large rise in unemployment in that country.

In many circumstances, this very human tendency to give more weight to observations that tend to support a position already held is not improper. It may be appropriate, especially when one's preconceived ideas rest on a firm empirical foundation. But it is important to realise that in practice one's preconceived ideas often rest on the values that one holds, as well as on deductive reasoning and empirical observation. Because many economic rationalists transfer some of the value they place on freedom to the market itself, they often discount evidence that the market does not work well.

In short, the policy prescriptions of economic rationalists do rest to a large extent, more in some cases than others, on the values held by economic rationalists. And the over-riding value, which greatly influences the results they obtain, is the worth given to individual freedom from so-called arbitrary restraint on individuals by other individuals, notably those in government.

I have spent some time presenting the argument that positive economics is not value free because I think it is important. However it is a controversial point, and it is necessary to emphasise that the proposition that the policy prescriptions of economic rationalists do not flow automatically from mainstream economics does not depend on whether or not positive economics involves value judgements. If it does, the case for the misleading nature of economic rationalists' claims is even stronger. But irrespective of that, it is clear that economic rationalist policy prescriptions are not just orthodox economics. For those who may think that the strength of this statement comes from my ideological bias, let me quote Brennan, the most eminent Australian economist espousing the Buchanan school of economics, who argues: ‘there is no presumption in ... economics in favour of a minimal state’, and concludes:

> Welfare economics after the public-goods revolution is as much a catalogue of possible market failures as of general market success. To argue that mainstream economics argues for a minimal state is in that sense simply a mistake. (1993: 7).

5. Economic rationalism and unemployment

The dramatic rise in unemployment over the last twenty years was noted in Section 1 of this paper. Economic rationalism is implicated in many ways in this. In the short run, microeconomic reform has increased unemployment, and this has also proved to be true in the longer run since financial deregulation has reinforced pressures to give priority to low inflation, except for brief periods where unemployment is unusually high and progressive deregulation of the labour market has made increasing reliance on unemployment necessary to control inflation.

A fundamental problem is the emphasis on low inflation as a policy goal, which is a feature of economic rationalism. It is natural for an ideology which plays down the existence of market failure to be less concerned about involuntary unemployment, which is a consequence of market failure, than with inflation, which, if one wishes, can be blamed on inappropriate economic policies.

It was pointed out in Section 2 that it is impossible to avoid a short-run trade-off between unemployment and inflation when monetary policy is used as the principal anti-inflationary instrument. The argument is whether there is also a long-run trade-off. There is increasing evidence for the proposition that not only is the current unemployment level determined in part by the previous year's level, but also that the level of unemployment which is high enough to prevent inflation is determined by past levels. Hence more and more economists are coming to the view that there is a long-run trade-off between inflation and unemployment when monetary policy alone is relied on to control inflation. It is no longer possible to take the easy way out and maintain that tight monetary policy to reduce inflation will not also increase unemployment. Nevertheless there is continual pressure from financial markets to make low inflation the over-riding policy goal.

Neither economists employed in the financial sector nor financial journalists necessarily argue that reducing inflation is costless. Sometimes they argue that interest rates should rise to reduce the rate of growth of employment because falling unemployment is producing unacceptable inflationary consequences (see e.g. Walsh 1995: 21). More often they omit consideration of unemployment. Consider the following quotation:

> given that monetary policy is an anti-inflationary tool and fiscal policy is useful as a medium term determinant of national savings...the most important question...is how do we address periodic balance of payment crises. (Walsh 1994: 47).

Max Walsh, being a humane and intelligent, if sometimes pessimistic, observer of the economy, probably meant: how do we address balance of payment crises without causing unacceptable increases in unemployment, but many in financial markets may not pick that up. Apart from that point, it is significant that the quotation gives a simple anti-inflationary role to monetary policy and does not assign to any policy instrument the task of reducing unemployment. Indeed, some financial journalists and spokespersons for the private business sector believe that reducing unemployment is not a proper concern of macroeconomic policy and should be tackled through microeconomic reform, which in this context is largely a euphemism for cutting wages for the less skilled.

It may be that institutions in the financial sector have always placed much more weight on controlling inflation than on reducing unemployment. The point is that because of financial deregulation, driven partly by technological change but also by the ideology of economic rationalism, financial market institutions now have much more power to impose their views on government. Financial deregulation has both hastened and heightened the decline in power and influence of governments, and of authorities like the International Monetary Fund, in global financial markets. Governments have lost control over the exchange rate for their currency —probably the most important single price in the economy.

The Economist (14 Jan. 1995: 48-9) speaks of a government being punished by financial markets, and similar language is used by Australian financial journalists. The language may be extravagant but the underlying point is correct. The exchange rate has such a widespread influence on the economy that governments must be constantly looking over their shoulders with concern about the effects of policy actions on financial markets.

The corollary to this is obvious. The priority given by financial institutions to anti-inflationary policy now has a real influence on government actions and is an important factor in the persistence of unacceptably high levels of unemployment in Australia. Moreover, it has prevented unemployment caused by other economic rationalist policies from being reduced. In particular, structural unemployment caused by microeconomic reform, especially the removal of tariffs and the corporatisation of government business enterprises, has not been effectively tackled for fear of inflation. The situation was summed up by Bernie Fraser, the former governor of the Reserve Bank of Australia, who is reported to have said that monetary policy was becoming the hostage of influential financial markets with a vested interest in making the Reserve Bank give greater weight to low inflation than to employment and growth, and that it would be 'ironic ... if the short-termism of politicians were to be replaced by the short-termism of the financial markets' (*Sydney Morning Herald,* 16 Aug. 1996: 25)

Moreover, the situation has become worse with the demise of the Accord, the increased emphasis on enterprise bargaining and the consequent removal of centralised constraints. In the 1980s centralised wage fixing under the Accord enabled a marked decline in both unemployment and inflation and laid the basis for the very low levels of inflation in the early 1990s. This restraint on inflationary wage pressure will become much less potent as the labour market is further deregulated and enterprise bargaining is further developed. It is to be replaced by the fear of unemployment. Unemployment will have to be high enough to make that fear credible. There could not be a more pointed contrast with the commitment to maintain full employment in the era when Australian governments had a Keynesian ideology.

6. Conclusion

Economic rationalism is often described as gross intellectual imperialism, as economists apply economic ideas to social issues to such an extent that social and political ideas are excluded from the discussion. While superficially this may be true, when one probes below the surface the reverse is true. Economic rationalism is the result of economics being taken over —hijacked one might say— by a particular social ideology. As it happens, I think some of the policies advocated by economic rationalists are good, some are appalling and some do not make a great deal of difference to general economic welfare. But, while it is important to evaluate individual policies, it is also important to look at the nature and characteristics of economic rationalism as a whole. I have tried to show that the term 'economic rationalism' is a misnomer. Economic rationalism does not, in any fundamental way, spring from economics but from social philosophy. Thus, the type of society which emerges when thorough-going economic rationalism is applied is not one ordered by economic principles, but a libertarian one. Moreover, it is a society which has explicitly removed a previous foundation —a social contract to maintain full employment.

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