The Case for Deregulation: Economic Science or Ideology?*

by J.W. Nevile**

Abstract

Economists tend to have a bias towards faith in market forces. For many economists this is re-enforced by a libertarian social philosophy. Professional judgements made by such economists often reflect their socoal philosophy as much as the conclusions of purely economic analysis.

1. Introduction

In the last decade or so economic issues have come to dominate the political agenda, and professional economists have come to have a great influence on public policy on a wide range of issues. Economists now comprise nearly three-quarters of the senior executive staff in the three central coordinating departments of the federal government, the Department of Prime Minister and Cabinet, the Treasury and the Department of Finance (Pusey, forthcoming). To the outsider at least, it appears that the advice given by these economists is virtually uniformly along the lines of reducing government intervention, moving towards a level playing field and installing

* *This is a revised and abridged version of the "Sir Robert Madgwick Lecture" given at the University of New England in May 1990. The original lecture has been published by the University under the title "Economics and Ideals: Has the Age of Chivalry Gone?". I am indebted to Ken Rivett and Peter Kriesler for commenting on a draft of the paper but the usual caveat applies*

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user pays as a paramount principle, with any subsidies to deserving groups given explicitly from public funds. It is true that economists have a reputation for never being unanimous, and a few economists, mostly in universities, still argue that there is more to economic policy than deregulation, even in the areas of industry policy and labour market reform. Nevertheless, the major voice of the economics profession in public debate, as well as in policy advisory circles, strongly supports the push for deregulation.

It is a matter of considerable interest and importance whether the case for deregulation stems validly from the arguments of economic science or whether it depends heavily on the values of those interpreting what economic science has to say on the matter. This paper argues that while, in a variety of circumstances economic science does provide valid arguments in favour of deregulation, this is by no means universally the case. The eagerness to prescribe deregulation as the appropriate policy in most circumstances owes as much to ideology as to economics.

Much more often than not economic theory does not, and can not, give a clear guide to whether deregulation is beneficial or harmful. The answer to this question will depend on empirical judgements. The paper gives a number of reasons why the majority of economists in Australia today are biased in their empirical judgements towards those which support the case for deregulation. Moreover, many economists in Australia are unaware of this bias. They deceive themselves, as well as others, when they claim the backing of economics for statements which depend on much more than economics.

2. Positive Economics is Not Value Free

The distinction between positive economics, the study of what is, and normative economics, the study of what ought to be, or what is desirable, is supposed to make economists alert and sensitive to what can be said with the authority of the discipline and what depends on the value judgements of the person making the statement. According to conventional wisdom, positive economics is thought to be value free so 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. On the other hand, propositions in normative economics depend in part on value judgements on which men and women may continue to differ however intelligent and knowledgeable they may be.

The distinction between positive and normative economics was originally emphasised, I think, because of the way Marxian economists mixed up ideological axioms, deductive reasoning and empirical observation in one statement. It is obviously easier to hold a discussion if one can unpack the three different elements in the argument. Of course, Marxian economists were, and are, not the only type of economists to present as "scientific" propositions, statements which depend on ideological assumptions. Economists of many schools tend to do the same thing. One of the greatest 20th century Australian economists, after his conversion to Roman Catholicism, was noted for his support of the proposition that, if properly managed, the world economy could support all those likely to be born so that there was no economic justification for artificial birth control. He may or may not have been correct, but it is difficult not to think that his conclusion owed more to his religion than to economic science.

However understandable are the origins of the distinction between positive and normative economics, this distinction has led the profession in the wrong direction. Positive economics is not value free. The belief that it is has led economists to claim the full support of their discipline for statements which reflect their own values. It has also encouraged economists to believe that by concentrating (qua economists) on positive economics they can concentrate on efficiency questions, on ways of making the total amount produced bigger, and opt out of the discussion on how it should be divided up.

Positive economics is not just a matter of deductive reasoning. It also requires an appeal to empirical studies. But the facts 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. To give a simple example, 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 unusual for the market not to produce an efficient outcome. Economists 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 this 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 will be beneficial to the economy. If there is market failure, the people who suffer are usually the economically weak, who may experience very low levels of real income. 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 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.

Earlier generations of economists were always very aware of the possibility of market failure. Adam Smith, whom libertarians in Australia have somewhat incongruously adopted as their patron saint, remarked that if you see three or four businessmen eating together, it is probable that a conspiracy in restraint of trade is being hatched.

Certainly those in Australia who stress the virtues of the free market realise the need for more rigorous measures to promote competition. But, although intellectually they may agree that such measures may require government intervention in the market place, almost all their public advocacy is for measures which increase competition by reducing intervention, e.g. tariff reductions. In this respect it is interesting to consider discussion of the apparently intractable problem of a relatively high inflation rate in Australia. What is usually emphasised is the need to deregulate the labour market, despite the fact that the share of income going to wages has declined for eight years. The possibility that oligopolistic and monopolistic profit taking may be an important factor in sustaining inflation is not even raised. More generally, in the discussion of the virtues of deregulation and reducing government intervention in the market place, there is often no recognition that the case for deregulation rests on the assumption of widespread competition and that reliance on unregulated market forces may do more harm than good in a situation in which oligopoly or outright monopoly is the predominant market situation.

3. The Bias Towards Reliance on Market Forces

It is easy to understand why the emphasis on the virtues of unregulated market forces arose in Australia. Because such a large part of economics is devoted to the study of market forces, economists will probably always have some bias towards faith in market forces. In Australia, over the last 15 years or so, this bias has been greatly strengthened by the widespread influence of libertarian social philosophy. Largely imported by graduate students returning from the United States and also the London School of Economics and Political Science, this philosophy has had a major influence in the economics profession in Australia in the seventies and eighties, and helped the establishment of the current conventional wisdom that the cure to all economic ills is deregulation and reliance on market forces.

Secondly, there is the awkward fact that interference with market forces has not had a good track record in many areas of economic activity in Australia. Whatever we think about the achievements of MITI in Japan or of the National Industrial Board in Sweden, in Australia protection of the manufacturing sector became more and more an expensive failure in the seventies and eighties, and the records of various state instrumentalities notably in Victoria and Western Australia, are an object lesson of the apparent inability of Australian governments to pick winners.

In addition to these two powerful influences, there is a third factor leading economists to emphasis the virtues of a free market. This stems from a mixture of a desire to capture some prestige akin to that associated with the natural sciences plus, in some, a genuine humility about the limits of the discipline of economics, and how much it is proper to say, as economists. These motives have led a number of economists to concentrate on, retreat into if you prefer, so-called positive economics. By avoiding any discussion of normative economics these economists hope to be rigorous and scientific, and to leave discussion of questions about how the cake should be divided to ethicists and others (even politicians) who might be thought to be expert in this area. Positive economics, however, is solely concerned with efficiency. It focuses on the market mechanism and the more rigorous one tries to make it, the less likely the possibility of market failure is included in the analysis. Economists find it much easier to model situations where the market is working in a competitive fashion than they do oligopolistic market structures. This leads attention away from situations of market failure.

This, however, is not the whole story. At the core of positive economics is a theory which states that a free well-functioning market will produce an optimum result - optimum in the sense that it is impossible to make anyone better off without making at least one other person worse off. On the other hand, according to this theory, if the market is constrained by government intervention it is possible to change the situation so that someone is made better off without anyone being worse off. Such an improvement may require the winners to compensate the losers and the theory is silent on how this compensation is to be induced. But if the compensation occurs, after it has happened the potential losers are no worse off and the winners are better off.

Now any competent economist knows that this theoretical result depends on a large number of restrictive assumptions which are not fulfilled in any actual economy. However, there are questions to which useful answers can be obtained by assuming that the real world is like that postulated by this economic theory. It is easy to slip into the false belief that this is almost always the case. Many economists, proud of their theory and their ability to manipulate it, assume that this theory can be applied in any situation they wish to discuss, without carefully checking if a particular issue is one in which the theory provides a useful framework of analysis. Once this occurs it is not unfair to say that the ensuing discussion owes as much to ideology as to economics.

4. The Dangers of Zeal for Deregulation

The reasons discussed make understandable the zeal for deregulation and reliance on free or unfettered market forces; they do not make this zeal desirable. The unfortunate consequences are greater because it is not only academic and business economists who advocate deregulation. A large majority of economists, close to government decision making in the public service, also believe in deregulation. A very good illustration of how far belief in market forces pervades economists in the public service is given by a survey of senior executive service officers (Pusey forthcoming). Of 108 officers with economics or business degrees, 72% were in favour of deregulation of the labour market. (This compared with 53% of the other officers surveyed, who had degrees in humanities, social science or law.)

The date the survey was carried out makes this result even more striking.It was done in 1986, when the Accord had been in place for three years and had delivered simultaneously a substantial fall in both inflation and unemployment. Perhaps equally striking is the fact that so many economists in the public service believed that the Australian labour market needed to be deregulated to promote flexibility and productive efficiency when the OECD rates the Australian labour market as one of the more flexible in the OECD membership (Henderson, 1989, p.22).

The danger of the zeal for deregulation is that it will be applied indiscriminately in situations where it is harmful as well as in situations where it is appropriate. Because protection of manufacturing industry has not worked well one is justified in pursuing deregulation in international trade, but not deregulation in the labour market where the Accord has worked remarkably well. The market is certainly a good servant, but equally it is a bad master.

5. The Case of Labour Market Deregulation

The particular question of labour market deregulation is worth considering in a little more detail, as it highlights the issues involved in the maxim of making the market your servant and not your master. Although the Australian labour market is more flexible than many, deregulation would certainly make it yet more flexible. It would give employers much more

https://doi.org/10.1177/103530469000100205 Published online by Cambridge University Press

power to determine working conditions. It would enable employers to attract more quickly the types of workers they need by offering higher wages. The extra rewards to those with skills in high demand would lead more people to acquire these skills. There would be more incentives for workers to change geographic location as well as occupation as needed, and so on.

All these things would increase productive efficiency, but there would also be substantial costs stemming from labour market deregulation. My judgement is that output would end up lower not higher. Income distribution would certainly become much more unequal and poverty would increase.

First, there would be the transition costs of getting from the present system to the new deregulated system. The immediate effects of deregulation would be a considerable increase in strikes, not only more strikes, but, more seriously, longer strikes like the pilots' strike last year. The advocates of deregulation admit that this would be a short run cost but argue that the continuing long run benefits make such a cost worthwhile.

Unfortunately, there will also be longer run costs. Economists only know of two ways to prevent inflation. One is through an incomes policy such as the Accord. The other is to dampen down economic activity from time to time, to prevent the economy overheating to use the euphemistic jargon, or to precipitate a recession to put the point more starkly. Advocates of deregulation of the labour market do not often tell us that, if it is to work, it will require a substantial recession when it is introduced and further recessions from time to time to keep it working.

Australia provides a good case study of the two methods of fighting inflation. The successive Fraser governments fought inflation through restricting aggregate demand in the economy; successive Hawke governments through the incomes policy known as the Accord.

As soon as he came to office Fraser put considerable emphasis on "fighting inflation first" as his Treasurer, Lynch, put it at the time. "Fighting inflation first" was a euphemism for macroeconomic policy which restricted aggregate demand to control inflation without much regard for the effects this had on unemployment.

Fraser continued the very tight monetary policy instituted by Hayden until 1978. He then relaxed it somewhat for three years - although it was still tight. In 1981 monetary policy was noticeably tightened again. Except for the years 1977-78 and 1978-79 fiscal policy was tight throughout Fraser's period of office until the last six months when there was a dramatic turnaround.

Fraser was lucky in a sense in that he inherited a high but falling rate of inflation. The rate continued to fall until 1978-79 when it got down to nine per cent for the year as a whole. This was the lowest it reached while Fraser was Prime Minister. For the rest of his period of office it drifted upwards and was almost 12 per cent when he left office.

The effects of this policy of "fighting inflation first" were that the Fraser government did little to reduce unemployment, and indeed the unemployment rate drifted upwards until the last six months of his government when it rose rapidly. When Fraser came to power unemployment was just below five per cent. If it had not been for the constitutional crisis, economic activity would have certainly picked up at the end of 1975 and the unemployment rate would probably have fallen in 1976. As it was, the unemployment rate remained more or less constant for a year or so, and then, with the primary thrust of macroeconomic policy being towards restraining aggregate demand in order to fight inflation, the unemployment rate started to rise. Despite a slight fall in the 1980 boom, the unemployment rate trended upwards for six years until it rose very rapidly during the last months of the period Fraser was Prime Minister.

The very rapid rise in unemployment at the end of Fraser's period of office was not due to "fighting inflation first", but the upward trend in unemployment over the previous six years was. Even using only criteria concerned with increasing the size of the cake without worrying about its distribution, the sort of policy pursued from 1976 to 1982 is inefficient, because of the lost output and decline in work skills.

The first Hawke government had a policy of fighting both inflation and unemployment equally through expansionary fiscal policy and an incomes policy known as the Accord. As employment rose substantially, unemployment dropped and world events caused the balance of payments situation to deteriorate markedly, fiscal policy changed from being expansionary and was progressively tightened. The Accord was also modified, but always remained the cornerstone of economic policy. The details of the various phases of the Accord are not important. What is important is the flexibility that has been shown and the willingness of the unions to exercise a degree of wage restraint which would have been thought unbelievable, even in the first year or two of the Accord itself.

We cannot be completely sure what would have happened if the policy of fighting inflation first had continued after the 1983 election, but the actual outcomes with respect to both unemployment and inflation of the seven Fraser years and the first seven Hawke years provide a remarkable contrast.

It is true that Hawke could also be considered lucky. In his case it would be because he came to power in the middle of a severe recession which made the unions eager to change to a new system and made it relatively easy to change the movement in unemployment from an upwards one to a downwards one. However, Fraser also came to power when unemployment was very high by the standards of his time, and his policies did not reduce it at all, quite the contrary. Moreover, Hawke's policies not only succeeded in reducing unemployment as the economy came out of recession, but maintained the downward trend in unemployment in succeeding years. This remarkable record will probably be blemished, to say the least, by a substantial rise in unemployment in 1990-91, but nevertheless it has been a "fat" seven years as far as growth in employment and output is concerned.

Perhaps this is not surprising in that Hawke governments were explicitly fighting unemployment as well as inflation, whereas Fraser governments concentrated on fighting inflation until a few months before Fraser lost office. However, the Labor policies also have a better record on the inflation side than do those of the previous Coalition Governments. In his first two years, Fraser Government policies maintained the downward movement in the rate of inflation initiated when Hayden was Treasurer. But then they ceased to be effective in reducing inflation. Indeed, the increases in indirect taxes imposed in the name of tight fiscal policy were a significant factor in raising the rate of inflation after 1978. When Hawke came to office the rate of inflation was nearly 12 per cent. That rate was halved over the next two years. It then tended to rise slowly again, but never, over a period as long as a year, was it as high as the lowest rate of inflation over a whole year while Fraser was Prime Minister.

6. Conclusion

All this was possible, precisely because the government intervened very extensively in the labour market. This was done despite the conventional wisdom among economists in favour of deregulation, a wisdom which as we saw prevailed among the majority of economists in the public service even after the Accord had proved its worth. The example of the Accord is an extreme case, but a very telling one, of how, among many economists, the tendency to rely on theory favouring market solutions is strong enough to override empirical evidence on the benefits of government intervention. For many economists, this theory is no longer a helpful tool to be used when appropriate. It has become "the theory" to be applied in all circumstances. Lester Thurow, the Dean of the Sloane Management School at M.I.T. may only have been exaggerating slightly when he remarked,"in economics today "The Theory" has become an ideology rather than a set of working hypotheses used to understand the behaviour of the economy found in the real world". (1983, p.xv).

https://doi.org/10.1177/103530469000100205 Published online by Cambridge University Press

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