Teaching Economics: the Failure of Macro-economics

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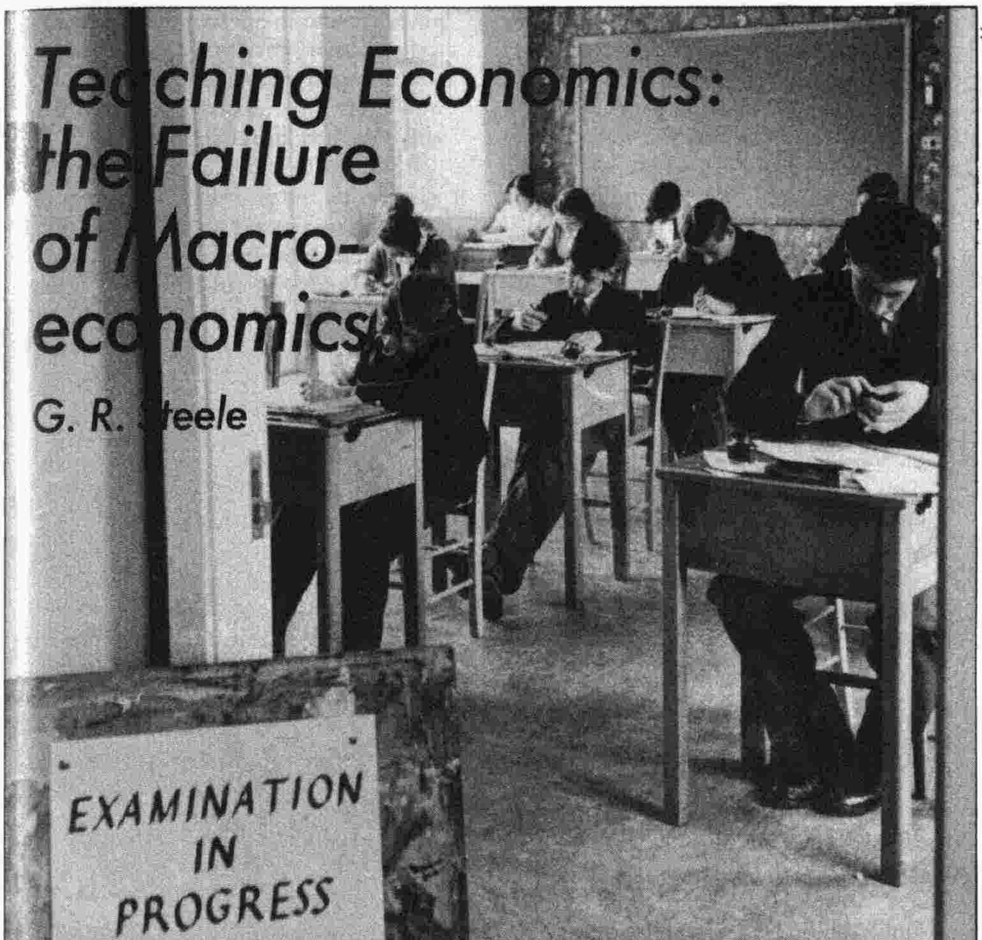

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The teaching of economics has for decades been dominated by macro-economic analysis — the study of output, employment, investment and other economic indicators in aggregate — to the neglect of the micro-economic emphasis on price. G. R. Steele, Lecturer in Economics at the University of Lancaster, contends that the predominance of macro presents students of economics with an essentially false picture of the way in which an economy functions.

Economics is widely conceived by non-economists to concern itself with inflation, unemployment, balance of payments, exchange rates and so on. Students of economics recognise these topics to be within the purview of macro-economics, the branch of their subject which attempts to provide an analytical base for the interaction of such large-scale phenomena. Macro-economic analysis is relatively

industrialisation

new. Its development over the last fifty years or so may be understood as a concomitant of rapid scientific and technological advance. Societies were transformed by the pace of change, and so too the pattern of socio-political representation as governments became more willing to accept responsibility for overseeing the general state of trade and business.

With industrialisation, the organisational structure of commerce was continuously forced by the market process to adjust itself to new specialisations and growing interdependence. Man's abilities to harness nature's energies, to adapt himself quickly from peace-time to wage large-scale wars, and then to revert to peaceful co-existence, was a striking, if not wholly beneficial, feature. Yet the contrast between the productive efficiency of war-time economies and the wasteful unemployment experienced during times of peace was unsettling. While human ingenuity seemed capable of finding rational solutions to technological problems, the promotion of employment, economic growth, sound currencies, and international trading arrangements satisfactory to all, appeared elusive goals.

The attention given to these problems became focussed in 'technocracy', the belief that — set free from political value-judgements — science could provide solutions to social problems; only the right expertise was required. A growing mood favoured planned economic development, the obvious sequel to the successful co-operation of the Allies during the Second World War and — notwithstanding the East/West split — the period of reconstruction immediately after the War.

Experience began to weigh against the market economy. The failure of market forces to remove chronic unemployment was a shared experience of the 'capitalist' Western democracies. It may be argued with hindsight that specific alternative monetary strategies would have prevented the widespread economic malaise which occurred. Although more influential than most economists, John Maynard Keynes failed to convince the UK government of the implications of its deflationary policies in the mid-1920s; and later, faced by the awesome repercussions of the collapse of the New York Stock Exchange in 1929 and the Great Depression which followed, he formed the view that changes in monetary policy would no longer be adequate to deal with the situation.

A *theoretical* justification for programmes of government expenditure was put forward by Keynes' *General Theory* in 1936. Not only did this analysis become the material of academic study, the focal point of debate, and the central tenet of post-war Western economic policy; it was the advent of modern macro-economics.

Mobilisation for war had been immediately responsible for removing the forced idleness of millions during the 1930s. Its success, the ethos of technocracy and rational planning, and the promised reward for war-time sacrifices, induced many democratic governments after World War II to bind themselves to the goal of full employment.

In financing government expenditure during the initial post-war boom, the Keynesian principle was adopted of 'closing the inflationary gap', whereby the pent-up demands of consumers and investors were constrained by the discretionary application of taxation of

buoyant demand

various kinds. In this period, government-sector budget surpluses were expected, by and large, to be sufficient to finance budget deficits required in other times to offset business recession. Of course, if the deficits were to turn out generally larger than the surpluses, the burden of outstanding national debt might grow to unmanageable proportions.

It was fortuitous that buoyant demand required no supplement from government expenditure programmes in the 1940s and 1950s, so that demand management appeared to be a successful strategy which could guarantee full employment. Although the net impact of budgetary policy during this period was deflationary, the mood of Keynesianism was in the air and UK governments were inexorably caught up with the vagaries of economic management.

The degree of involvement of government in the affairs of a free society is an important political question with

micro-economic analysis

many economic dimensions. Whether on balance society gains from the state provision of education, health services, pension schemes and so on, are matters for *micro*-economic analysis (to investigate the trade-off between efficiency and equality) and political judgement. In *macro*-economic analysis the assessment turns on the balance between aggregate amounts of government income and expenditure, and on the sources and magnitudes of tax receipts, new borrowing and maturing debt.

Against a background of prolonged recession and deeply depressed business confidence, Keynes had argued that it would be appropriate for government expenditure to exceed tax revenue, and for monetary expansion to provide the balance. In different circumstances, where price inflation would be the likely consequence of monetary expansion, borrowed funds would be raised from the market. Keynes' belief, that government expenditure might become a permanent feature necessary to sustain the aggregate output of an advanced economy at a volume that would ensure full employment, is consistent with that alternative; but if government expenditure fails to generate a rate of return sufficient to cover interest on borrowing, and eventually to repay the principal itself, the government is left with few options. It can default on its creditors, or it can tax the people, but neither is consistent with the promise of sustained high aggregate demand.

Such difficulties were put to one side. The implicit assumption was that government investment projects would achieve a net rate of return — if not at market values, some net 'social' rate could be concocted. There were few initial problems: agreeably surprised by the persistence of low unemployment, economists gave more attention to Keynes' own prescriptions for an era of mild business cycles, in which budgetary policy would be used to restrain too rapid expansion or otherwise to stimulate a mild recession.

Keynes had made an early statement of the possibility of such demand management in three articles written for *The Times* in January 1937, where he argued that aggregate demand could be dampened by increased taxation, postponement of capital expenditure by government, and the encouragement of imports. With the onset of recession, these policies could be reversed. Notwithstanding the formal inconsistency between these policy recommendations and *The General Theory,* which emphasised uncertainty, unexpected change and shifting expectations,[1] this strategy was to epitomise Keynesian economics.

With the bulk of tax revenue provided from earned income, the volume of resources accruing to the government varies as income changes. Revenue falls during a recession, while government expenditure on social and welfare benefits increases. Taken together, these adjustments provide automatically for the budget surplus to vary inversely with the business cycle. Such 'automatic stabilisers' — helped, perhaps, by discretionary adjustments — would smooth cyclical peaks and troughs. The prize to be gained was permanently full employment with no periods either of unemployment or of inflationary excesses.

Early doubts about the efficacy of this approach centred upon the difficulties in the exact *timing* of discretionary intervention. The changing amplitude of cyclical fluctuations, and the time taken for information to be analysed and assessed before decisions could be taken, inevitably led to measures being adopted belatedly, with perverse effects.

A further inhibition to fine-tuning arose from the importance of accurate

'fine-tuning'

information. In 1966, for example, the Wilson Government was provoked into deflationary measures by the reported deficit for the balance-of-payments current account. In the following year, the official figure for that deficit was given as £61 million. Fifteen years later, the final published revised estimate for that same year was given as a *surplus* of £113 million.

Lastly, the timing of general elections added a purely political dimension to government calculations of the most appropriate moment to stimulate economic activity. And so the failed attempt to 'fine-tune' economic activity gained notoriety and the description 'stop-go', as expansion produced trade deficits which required deflationary measures which, in turn, raised unemployment and demands for reflation.

In the early 1960s, in an attempt to achieve a more rapid response to changing circumstances, the Chancellor acquired the power to vary all the main indirect taxes without having to bring these changes before Parliament. There was little success and a succession of trade crises followed (1961, 1966 and 1973) at the same time as the trend of inflation and unemployment continued upwards. In each successive boom/slump, the peak of inflation/unemployment was ever higher.

It was the last of these cyclical episodes which was to result in quite spectacular excesses. In making its 'dash for growth' in 1972, the Heath Government announced that the exchange rate would be allowed to float. This device, it was hoped, would remove the impediment of recurring sterling crises. A depreciating pound would automatically offset the tendency (with fiscal expansion) to

the 'Barber Boom'

trade deficits. Although without any theoretical base, this strategy had a certain appeal. Less popular was the infamous U-turn of November 1972, when an incomes policy was seen as the only measure left to combat rising inflation, and (despite the plummeting value of sterling) persistent trade deficits.

The 'Barber Boom' had caused economic growth to accelerate from 1.3% (1971–72) to 7.7% (1972–73), and unemployment to fall from 3.7% (1972) to 2.6% (1973). These remarkable results were produced by unprecedented budgetary profligacy: from surpluses in both 1969 and 1970, the deficits in the following four years were respectively £1.4 billion, £2.1 billion, £4.2 billion and £6.4 billion. All were financed largely by bank borrowing which caused rapid growth in the supply of money. In the three years to 1974, domestic prices rose by 35.8% while the effective exchange rate index for sterling fell by 15.2%. These events were to prove a watershed for Keynesian macroeconomic demand management.

Before this episode, certain key variables — government expenditure, taxation, interest rates and exchange rate adjustment — had come to be regarded as admissible instruments of policy. Indeed, the expansion of economics teaching in sixth forms and universities was driven by this push-button view of the economy. Academic and government economists, trained to construct Keynesian models of the economy with dubious assumptions about aggregate marginal propensities to consume, save, eat, sleep and drink, were able to provide numbers, percentages and rates of return which were deceptively convincing.

The idea that such aggregates might be manipulated to bring a prosperity which is denied to the market process has no empirical and little theoretical support. Furthermore, the commitment to full employment undermined the discipline of market forces, with the effect of slowing the pace of technological change and economic advance. This consequence was inevitable, given the framework of Keynesian analysis, which takes full employment and not efficient production as its goal. Socialist republics demonstrate that full employment is not difficult to achieve, providing there is no requirement to provide the goods and services which would be available under a market system.

The attempt to maintain output and employment regardless of performance removes incentives and the stimulus to change. Support for regional policy is only one category of government expenditure which warrants this criticism. Investment and employment subsidies were designed to entice firms from their preferred locations, but the net impact of bureaucracy and the burden of taxation upon general industrial competitiveness was incalculable, and generally ignored.

During election campaigns from the 1950s through to the 1970s, a common complaint was that it mattered little which party was elected. That was true. Labour and Conservative governments were drawn inexorably deeper into the mire of expenditures to support welfare and 'full employment measures'. Expenditure plans were expressed against over-optimistic projected rates of growth for the economy, and so they required an ever-increasing percentage of GDP, rising from 35% in 1960 to a peak of 48% in 1975.

The transfer of expenditure from private to government control retards efficiency and growth; but it certainly creates jobs. In only five years to 1978/79, employment in the National Health Service rose by 22%, in the civil service by 6%, and in local government by 15%. The number lost to the private sector was literally incalculable, which largely explains how such transfers can avoid arousing the wrath of the electorate.

As damaging in its impact upon the market process was the effect of policy upon money and prices, for the *interdependence* of monetary and fiscal policy implies that fiscal deficits necessarily involve government borrowing, monetary growth and inflation. The market operates by price signals, feeding information to producers and consumers, without which balance between supply and demand is unattainable. By distorting those price signals, inflation

demand management

disrupts the market process with the consequence of unwanted surpluses of some commodities and shortages of others. Far from achieving positive results, macro-economic demand-management has introduced inefficiencies and distortions which have left the economy materially worse off than it otherwise would have been.

There was no easy retreat from the consequences of the Heath-Barber excesses. Following upon a change of government, there came a belated announcement in September 1976, when the Prime Minister, James

Callaghan, informed the annual Labour Party Conference that government expenditure and tax cuts to boost employment was an option which no longer existed: that if it ever did exist, it created inflation and higher unemployment. Even so, the pace of erudition is ever slow. The first signs of stagflation (the co-existence of high unemployment and inflation) had been in evidence a decade earlier; and a decade later, the voices for the implementation of fiscal expansion continue to be heard. It is not so much that macro-economics has misled the economics profession, rather that the profession attracted those with a leaning to this particular brand of socialist intervention. Though their intellectual investment is now demonstrably redundant, vested interest in the universities, schools, government, research institutes, and elsewhere will ensure the promotion of this wasted creed for many years to come.

Macro-economics came close to providing the intellectual justification for a corporate tyranny. Whether arrived at from capitalism, through the intermediate stage of the mixed economy, or more directly through national socialism, the centralised direction of consumption, savings and investment decisions destroys individual liberty in its pursuit of an asserted national interest. When governments assume responsibility, it is inevitable that business, organised labour and the public at large will come to rely upon the guarantee of no failure, a sure path to mediocrity.

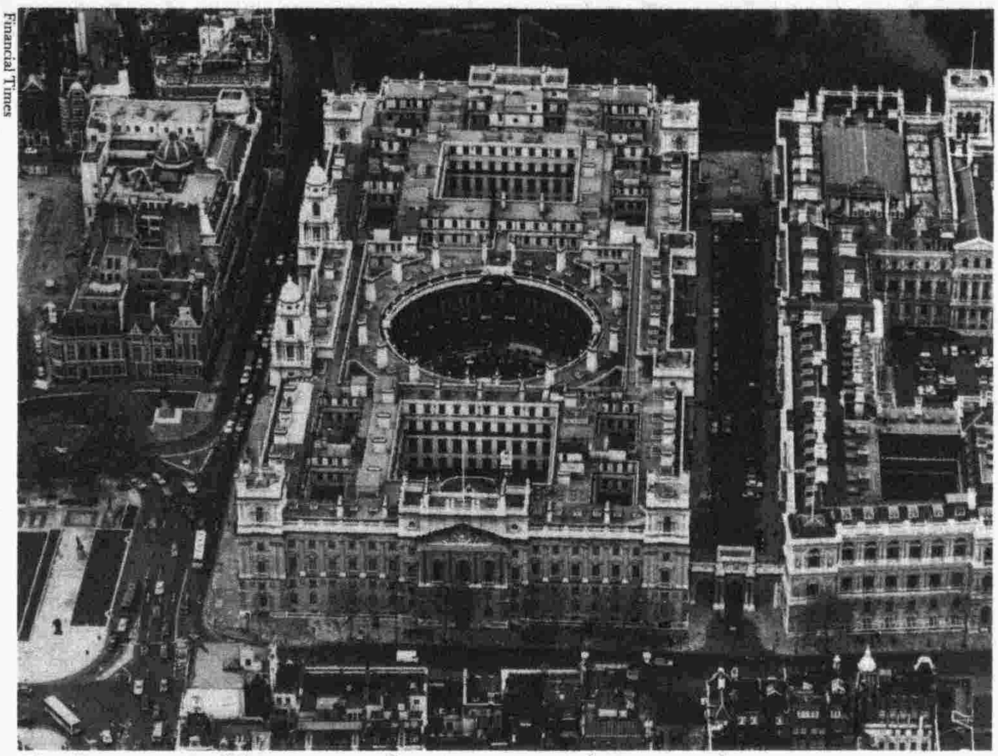
technology

There is one resounding irony. In an era when demand-management and wider economic planning was inspired by belief in 'technocracy', the pace of technological advance was out-stripping the capacity of the economy to provide enough resources to reap the full potential of scientific research. This imbalance is most evident in both national defence and medicine, which currently account for 12.6% and 15.1% of government spending respectively. It is a convenient escape for Neil Kinnock to defend an individual's right to private medical treatment for his family, on the grounds that funding for the National Health Service is inadequate. The reality is that funding at many times the volume of National Income would leave many treatable cases untreated. So who, if not the individual on the basis of his own resources, is to make the hard choices?

For fifty years economics was mesmerised by the idea that planned intervention by government can maintain national output at rates which cannot be sustained by the free market. It was suggested that government intervention could achieve use of land, labour and capital where entrepreneurial activity can devise no useful schemes. What was on offer was *not* a compassionate framework for social policy, but the suggestion that a larger *economic* benefit could somehow be achieved.

In itself, this is a rather charitable interpretation of the strategy of government. A more cynical view is that self-interest is as much the prime mover of political parties, government departments and agencies as it is of private business. If so, the direction of policy will tend to favour producer-interest groups rather than consumers. This inequity happens because most voters earn their living from one activity while their expenditure is spread across a wide range. Producer-interest is more likely to be cost-effective in influencing government than that of consumers, who have no organisational base to compare with that of trade unions and employers' groupings. Furthermore, where there is a common interest, government departments and agencies may combine with producer groups to exert concerted pressure upon government policy. For example, a large defence budget benefits both Ministry officials and suppliers of arms.

producer interests



Financial Times

The Treasury: fifty years of government intervention

Learning has been the hard way, from experience rather than from thought. The return to the private sector of large areas formerly taken into state control offers considerable gains. In this debate the electorate has understood more than politicians of the left, and even the majority of the academic economics profession. Government is not simply impotent: its intervention in the economy impedes efficiency. Although a role remains for government, it is modest and it is related exclusively to *micro*-economics.

Without some amount of state-imposed rules there can be little doubt that colluding business and powerful groups of organised labour contrive to fetter the free market to further narrow sectional interests. So it is necessary for the government to establish a legal framework to preclude such behaviour. In addition, a legislative role may be necessary to compensate for glaring instances of market failure, although they will be limited in extent. Too easily market failure can be replaced by government failure. It has also a duty to administer its welfare system and to raise its tax revenue in a manner which, by avoiding the poverty trap, maintains the incentive to work. This much is required in order to gain economic efficiency at its highest. More than that ensures that it can never be attained.

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[1] *cf.* John Burton, 'Fifty Years On: Background and Foreground', in John Burton *et al.*, *Keynes's* General Theory: *Fifty Years On*, Hobart Paperback 24, IEA, 1987.