MARGINAL NOTES

OFFLINE ESSAYS IN ECONOMICS AND POLICY

ALEX MARSH

About the author

Alex Marsh started his blog – *Alex's Archives* – in October 2010. The blog's audience has grown steady over the last two years. During 2012 it was regularly found among the Top 100 politics blogs in the UK on the ebuzzing.com monthly ranking. The blog covers a wide range of topics, but it returns regularly to issues relating to housing and social policy, economics and public policy, and political processes under the Coalition government. Alex's posts also appear on group blogs including Dale&Co., the Guardian Housing Network blog, and LSE British Politics and Policy.

Outside the blogosphere Alex's day job is as Professor of Public Policy at the University of Bristol, where he is currently Head of the School for Policy Studies. He has published articles in a variety of housing and policy journals. His most recent book is the *Sage Library in Housing Economics*, which he edited with Ken Gibb of Glasgow University.

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Preamble

My blog covers quite a wide range of topics. I write about whatever happens to be interesting or preoccupying me at the time. Posts are often triggered by an issue currently in the news or by something I've read. If a piece in the mainstream media or a post on someone else's blog is my starting point, then I may well try to link my discussion, explicitly or implicitly, to an argument or a concept from a relevant academic literature. This is always done informally.

One of my blog's recurring themes is the nature of economic knowledge and the practices of economists. My blog also reflects my interest in the way economics is applied to policy or is used during the policy process. These themes feature prominently in this collection.

This collection brings together a selection of my posts on economics, economic ideas and the nature of economics. My aim is to make the arguments available to readers who prefer to digest their reading material in more conventional form and to make the arguments accessible to those who have little interest in rummaging around in my blog archive. The posts touch on microeconomics, macroeconomics, and the philosophy and methodology of economics. Underpinning several of the posts is the aim of bringing theory into dialogue with real world economic examples and situating the economic arguments within a broader political economy.

For this collection I've edited the posts slightly for grammar and punctuation. I've added annotations and references where that seems appropriate. Otherwise, the posts are presented here pretty much as they can be found on the blog.

Alex Marsh, Bristol
December 2012

Who's wrong? The Government or the Economists?

30th November 2010

Where should we draw the boundaries of the state? When should Government take responsibility for providing or funding services? And when should it be left to the market to sort out? One characteristic of the current government is that it has destabilised well-established understandings of where the boundaries lie. Most prominently we have the debate over higher education funding. But there is a range of other fields – including social care, rail pricing, school sports, arts funding and library provision – where central or local government is stepping back from funding and/or provision. While the financial crisis is typically invoked as the trigger for this, there is more than a suspicion that this can act as a handy pretext for furthering an agenda of state retrenchment, leaving more to the market, the voluntary sector or informal provision.

From the point of view of economists interested in social policy and social problems this is intriguing. Many economists who concern themselves with such matters tend to operate from a social liberal or social democratic position – they tend to favour a mixed economy and acknowledge a significant role for the state, if only in funding rather than provision. This is in part because they are a self-selecting group. The dyed-in-the-wool market fundamentalists don't tend to spend too much time thinking about the role of the state. Rather, they tend to assume that Milton and the Public Choice boys have put that particular question to bed – the state should keep well away from just about everything.

But those of us who do spend a bit of time thinking about the role of the state tend to frame it in terms of technical and political factors shaping the appropriate boundary with the market. In fact, at more sophisticated level, it is recognised that this is largely a false opposition. The "free" market, unencumbered by state intervention, is a creature of the textbooks that cannot exist in the wild. Real markets do not float independent of extensive state action. Similarly, apart from the command economies of the twentieth century – and typically not even there – state provision is interwoven with market relations of various types.

Anyway, I'm going to leave the political arguments around state action – arguments primarily associated with a concern for equity – for now. That is a whole other story. When we consider the technical dimension of the issue there is a concern for market failure, on the one hand, and government failure, on the other. Even when pure market provision is identified as problematic this doesn't lead automatically to the conclusion that government should step in. Only if the risks associated the government failure are not too severe is it likely that government provision will enhance welfare. Also, with the rise of behavioural economics and "nudge" policy, individual failure is increasingly entering the discussion alongside market and government failure. These discussions are fundamentally comparative. It is not that there is a perfect solution to most problems of provision. It is a question of assessing which institutional arrangement – the market or the state or some hybrid – is comparatively advantageous.

Technical arguments for state action rest on the identification of market failure, which can arise for a number of reasons. The sources of market failure are usually categorised something like: externalities, information failures, failures of competition, public goods, missing markets, and systemic risks. It can also be helpful to draw ideas such as transaction costs or principal-agent theory from industrial economics to explain why certain activities are better performed through hierarchical organisations of significant size, while others can safely be left to markets. It is largely a question of relative efficiency and appropriate incentives.

If we take the example of higher education funding, a typical justification for rejecting a reliance on pure market provision rests on some combination of externalities (some of the benefits of higher education accrue to society in general not just the person being educated) and capital market failures (people for whom higher education would deliver a net benefit may not be deemed an appropriate risk by private lenders – lenders won't rely upon unsecured assurances of increases in future income contingent upon completing higher education – and so students cannot finance their studies). There can also be arguments about information failures – those whose parents or friends have not experienced higher education will have less understanding of what it entails and are less likely to risk incurring large debts to find out. Occasionally there might be arguments about rationality, although those tend to apply more forcefully to students at younger ages.

These arguments lead to the conclusion that it is appropriate for the state to at least partially fund higher education through prices, student maintenance or both. That is the case pretty much everywhere in the developed world.

Except, apparently, Britain in 2010. In fact, it isn't even the whole of Britain because the Welsh have now announced that they are not planning to follow the path laid out by Cable and Willetts. Policy is withdrawing state support for teaching and passing pretty much all the cost to the consumers studying most subjects. It would appear to be intent not only on throwing the whole system into reverse, but also, in the process, to challenge our very understandings of who benefits from higher education and the capabilities of markets to ensure that those who can benefit from higher education are able to benefit.

A similar story could be told in a number of other policy sectors where the government appears intent on shifting the burden of costs away from taxation and on to the individual user, and to encourage or enforce the withdrawal of the state from provision.

So is the government right to ask these big questions? Has there been a cosy and relatively unquestioning consensus on these points among economists of social policy? Because some of the policies currently being pursued fly in the face of well-established arguments as to why you can't leave these things to the market and expect a socially optimal outcome. If policy persists in this direction then you'll just end up with some sort of undesirable outcome. The result could be no provision, under-provision, widely differing levels of provision over space as a function of things like population density or income profile, and social advantage or divisions being further entrenched.

Or, on the other hand, have the economists got it right? If so then the government is heading from some fairly disastrous social outcomes if it carries on with some of the policies it is seeking to pursue, precisely as the theory would predict.

Another way to approach this issue is to ask why an activity is being provided by the state in the first place. Productive activities end up in the state sector for all sorts of reasons.

In some cases a company is failing and the state takes it over to stop it going under. That was part of the story of nationalisation in Britain in the 1960s and 1970s. It is most recently part of the story of the fallout from the credit crunch. In this situation there is no technical economic reason why the activity could not be in the private sector – it is just a question of a private firm having got into difficulty either because it was not competitive or made bad decisions resulted in poor performance. And the government of the day felt it could not ignore the situation.

Other activities are in the state sector precisely because without state provision there would be no uniformity of coverage and services were, typically, only available to the rich. That is the pre-history of the National Health Service.

If the trigger for state provision was a failure of the market to provide adequately then an incautious return to the market, or to the voluntary sector or civil society, is likely to be accompanied by a re-emergence of the problems that led to state involvement in the first place.

Another example of where these arguments are likely to play out in practice again is public libraries. It appears that many local authorities are considering swingeing cuts in their library provision. This is accompanied in some cases by arguments about communities who really want to see continued library provision in their area being willing to self-organise to ensure future provision. These are arguments that are pretty much untested, at least since earlier in the twentieth century. Part of the reason why local government got involved in library provision in the first place was a recognition that the reliance on private philanthropy was not sufficient to deliver widespread access, and a recognition that there are considerable social benefits to a literate population with access to appropriate written material. That is, this is a service with a positive external effect that the market will never be able to capture adequately. A loss of social welfare results from leaving it to the market or community self-organisation.

Personally I suspect that the body of thinking underpinning the economists' position is rather more extensive and rather more rigorous than the thought that has been applied to some of the Government's current policy directions. So my money is on the economists. Of course, the negative effects that the economists might predict from some of the policies currently being pursued can always be given a different spin by labelling them the benefits of localism, rather than the products of patchwork market provision. But that is a rather different type of argument.

On the other hand, it is clear that the body of knowledge economists work with evolves over time. A good illustration of that is the way in which Nicholas Barr, in his standard textbook on the economics of the welfare state, dropped the chapter on housing policy between the 3rd and 4th editions.[1] He felt that there was no longer any strong arguments for assuming that markets-plus-income redistribution couldn't deal adequately with housing problems. So perhaps the Government is on to something.

There are a whole host of bigger questions that could be pursued here, but now isn't the time. One such question is whether the premise is right. Is the decision whether to use markets or public provision primarily a technical matter, which has no subtle and not so subtle transformational effects? That is the standard economic position. Decide on your objectives and then look at which institutional arrangement is best able to meet them. It is also a characteristic of many liberal political positions. It is strongly evident in the famous *Orange Book*.[2] Some economists are becoming rather more sceptical about the argument that different provision systems are simply neutral technologies for achieving policy goals. Anyone interested in pursuing that argument might like to dig out a copy of Stephen Marglin's book *The dismal science: how thinking like an economist undermines community*.[3] This position starts to bring economics close to the position of critics of the economization of policy such as David Marquand.[4] But that's a topic for another day.

Magical markets and medical muppets

23rd January 2011

You don't come across that slightly touching, naive market fundamentalism quite as often now as you did a few years ago. The financial crisis and its aftermath has increased the circumspection of some market advocates, at least for the moment. One place you do sometimes come across the dogmatic view of markets is among those who live in former state socialist and communist countries. The other would appear to be the Coalition government.

I quite regularly have the opportunity to discuss the relative merits of the state, the market and points in between with citizens from transition and developing economies coping with the legacy of state socialism. While some have a sophisticated understanding of the issues, others could perhaps engage with the complexities a bit more deeply. There is a strand of very simplistic thinking which sees the public sector as fundamentally corrupt and markets as a solution to most of society's ills. The former view may be born of bitter personal experience, but it is treated as an inherent characteristic. Markets, on the other hand, have almost magical properties. They are the repository of dynamism, entrepreurialism, efficiency. Markets are reified and deified. The idea of private sector inefficiency, monopoly or villainy doesn't compute. Even when the post-transition society they live in might reasonably be characterised as a kleptocracy.

So what about the Coalition? A questionably complacent strand of thinking about market mechanisms runs through policy proposals in a number of policy fields. But it has emerged most clearly in the recent discussions of the proposed reforms to the health service.

These reforms can be criticized from several perspectives. First, we might question their very legitimacy. The Coalition agreement states there would be no top-down reorganisation of the health service and the Prime Minister is on record prior to the election as stating that there would be none. Yet, both the Liberal Democrat and Conservative manifesto hinted at significant change. And it was really no more than a hint. Is there a mandate for such far-reaching change? Both critics and apologists can find fragments of text that support their position.

Second, we might criticize the timing of reform – is it wise to attempt this change, which will cost significant amounts of money in the short term, at a time of fiscal restraint?

Third, we might criticize the speed with which the agenda is being pursued. Anyone who has any familiarity with even relatively small scale organisational change will know that it has to be handled with considerable care and takes many months of careful planning. There are respectable organisational analysts who would argue that it takes up to a decade for significant change to be successfully implemented and embedded. The Coalition approach of lobbing a 'hand grenade' into the heart of the NHS and seeing what happens is, from this perspective, unlikely to end well.

Fourth, we might debate whether it will result in the privatisation of the NHS. The apologists say no. The critics say yes and point to the funding from private health providers that has flowed to the Tories, and the current Health Secretary in particular. Once the NHS is no longer a protected sector and becomes subject to competition law there are no very effective levers for stopping privatisation. And the speed of change suggests that it is big commercial operators who will benefit from restructuring simply because they are more fleet of foot and setting up local not-for-profit alternatives will not happen fast enough (an argument that, in my view, applies to the Big Society agenda more generally, as discussed here). And alongside the question of privatisation is the broader issue of the implications of these reforms for the accountability of health provision. The apologists see them as enhancing local accountability, while the critics point out that GPs, who will drive the service, are private contractors subject to very limited democratic scrutiny.

But there is an equally important critique of these proposals focusing on the logic of the underlying model, which is less than transparent. In *Who's wrong? The Government or the Economists?* I argued that many of the reforms the Government is seeking to implement pose a challenge when viewed from an economic perspective: either they are not going to work as the government claims or the microeconomic theory of markets and market failure is wrong. The situation is not unique. In a recent blog at Progressonline, Rachel Reeves reports Larry Summers, director of President Obama's National Economic Council, as saying in response to a question about the wisdom of Coalition macroeconomic policy: 'Either it will fail or else everything I know about economics will have turned out to be untrue'. If I'm honest, I have more confidence in the economic analysis.

These points were vividly illustrated by the discussion of the health reform proposals on a recent edition of Newsnight. The starting point for reform – in public at least – is a desire to improve UK health outcomes, which are comparatively poor by international standards. This has got to be a laudable objective. The question is how these reforms are going to deliver that objective. The Health Minister at this point reached for the policy buzzword generator and set it to the max. Distilled to its essence the argument was:

> patients + local + choice + empowerment + competition + provider diversity = better health outcomes

The longer version was not much more informative. This doesn't get us much further in answering precisely how the reforms are supposed to deliver the objectives.

Clearly there is some sort of loose idea that patients who are empowered to exercise choice will in some way indicate something about the quality or desirability of what providers are offering – assuming that their choice isn't significantly constrained by gatekeeping at GP level – and that they are better served by having a range of providers available locally to choose from. Resources will be (re)allocated more efficiently as a consequence of such decisions. So in that sense we are asked to accept that a health care market works in the same way as the market for apples or any other private good.

Which is odd, because just about all the economic textbooks on the topic suggest that there are good reasons for thinking that it doesn't. And that isn't something to do with the need for institutional change – for example, an absence of a sufficient variety of providers. It is more to do with the technical nature of 'health care' as a good.

For market mechanisms to deliver a socially optimal allocation of resources various conditions need to hold. And if they don't then there can be a problem. We can summarise the issues in various ways, but one way to think about it is in terms of information, incentives, and institutions.

Consumers need good quality information about both prices and qualities before informed decisions can be made. They also need an understanding of the nature of the goods on offer and the extent to which they are going to satisfy their wants/needs. It is arguable that health consumers are not well placed in respect of any of these key pieces of information. We can argue that league tables of outcomes can be produced to give consumers information. But the problem with that approached – amply demonstrated under Labour in the 2000s – is that it sets up incentives for providers to seek to shape outcomes in order to appear stronger in league tables – eg. by selection of patients and avoiding difficult cases. We could say that health consumers will be able to turn to their GP for guidance on the appropriateness of the providers/procedures on offer. But that sets up an agency relationship and it cannot be assumed that the GP's objectives when presenting the options are entirely aligned with those of the ultimate consumer. That might particularly be the case if the GP is also responsible for managing the budget that will be funding the procedures.

Services are experience goods. You can't fully know how good they are until you've consumed them. Consumers' understanding of the quality of service on offer can be improved by regular participation in a market, shopping around and building up a quality distribution of what is available. But in health care that is only possible for certain chronic conditions. It also needs to be understood in relation to irreversibilities and switching costs. If you buy your apples from supermarket X one week and discover they are not as nice as they look, you are out of pocket and you might avoid them in future but nothing too terrible has occurred. If you go to a restaurant and end up with food poisoning the consequences are worse but not (typically) fatal. You'll avoid it in future. But with health care things are different and rather more serious. Often a course of treatment is a once in a lifetime experience. There is no scope for building up a quality distribution through learning in the market. If a service is poor quality that can have serious and irreversible – indeed literally fatal – consequences. So ideas of switching away from poor quality are rather more problematic.

Indeed, with some experience goods even after you have received the service you are not entirely sure whether you have received good quality. You went to the solicitor for advice but still you lost the case. Weak case or bad advice? The same applies to health care. Did you not recover because your case was too severe or your treatment poor? Sure, a pattern of poor outcomes may emerge such that over time resources and patients are switched away from poor quality suppliers. But that is of little consolation to those who have experienced irreversible poor quality treatment in the meantime.

Another way of looking at the conditions of success for market functioning is to focus on the observability and measurability of service outcomes. If outcomes are not observable then it is difficult to assess whether suppliers offering low priced services are genuinely more efficient or are simply degrading quality. This is vital to the economics of health care. There is evidence that earlier experiments in introducing competition to healthcare in UK urban areas delivered improvements in health outcomes. But in the previous phase of competition, under Labour, it was on the basis of fixed price tariffs. So if suppliers were going to compete they had to compete on the basis of genuine efficiency rather than quality reduction. There was no 'race to the bottom' on quality. In contrast, the current reforms propose abolishing the fixed price tariffs. That takes us back to the internal market of the 1990s. Evidence from that era suggests that buyers will focus on price and as a consequence quality will decline (see CMPO blog and associated references here). This one simple change to the detail of the rules of the game – the institutional framework within which the market mechanism has to operate – will have massive ramifications.

Even when competition delivers a positive impact for health outcomes it is most closely associated with urban areas. Hospitals and PCTs – and no doubt GP consortia in their turn – are often used as examples of spatial monopolies, particularly in rural areas. It can make no sense to have more than one hospital supplying a sparsely populated area. So the idea of competition in the market is a non-starter.

It is possible to develop arguments that while competition in the market is limited the markets are in fact contestable: the incumbent provider must stay competitive in order to deter new entrants to the market. However, health care is not like your local corner shop. So-called 'hit and run' entry and exit are not very plausible, in part because of cost conditions and in part because of reputation effects. One solution to this is franchising or competition for the market (a la rail privatisation), but we're not quite in that territory yet.

One component of this picture that could benefit from further elaboration is precisely what sort of providers the government is anticipating will exist in this more plural health care system. Markets work to deliver socially optimal outcomes, under certain conditions, because providers and consumers are seeking to optimise profit and welfare respectively. In a mixed economy of providers, where there are some that are public sector, some that are not-for-profit and some that are commercial, it is not so evident that the way providers respond to prices will guide the market to the socially optimal allocation of resources. In fact it can be difficult to predict precisely what will happen. This point was made forcefully during the debates over the quasi-market experiments of the 1990s. It is no less relevant now.

I could go on. But I don't think it's necessary. There is plenty of theory, evidence and debate out there to throw into question the Coalition's simplistic assertions about the benefits of marketising health in the way they are proposing. The case being made in favour of the reforms is rather feeble: it demonstrates either no familiarity with the evidence on the subject or a worrying disregard for that evidence.

That isn't an argument against markets in general. Of course not. But good quality economic analysis requires much closer attention to the particularities of the case we are considering, It requires a recognition that markets do not have magical properties. They are created and sustained by social action. And they need to be shaped carefully by policy. Someone once said that all the economics necessary for policy advice is contained in Econ101. That is mainly because that is about as much economics as politicians can digest. I have never agreed with this position. The economics contained in Econ101 is generally too simple to capture characteristics of the real world that are crucially important. The current health reform proposals are grounded in an understanding of markets that would not even score very highly in the Econ101 end of term examination. That there is a strong possibility that it will nonetheless drive policy is just deeply dispiriting. Muppets.

Economists, implicated

19th February 2011

John Maynard Keynes famously wrote that "[i]f economists could manage to get themselves thought of as humble, competent people on a level with dentists, that would be splendid". Many economists, somewhat uncharacteristically, might well be craving that type of anonymity at the moment. Because they've been getting a hard time of it. And the discipline may be about to get even less popular.

The arrival of the film *Inside Job* is likely to fuel the public's anger at bankers for causing the financial crisis. And not only causing the financial crisis, but subsequently carrying on with business pretty much as usual, while the fallout from the crash is felt in public spending cuts, unemployment and welfare benefit reductions.

But the film does more than that. It broadens the scope of criticism to implicate a range of other professionals. It wasn't just the corporate bankers: lawyers, central bankers, accountancy firms, lobbyists and government officials were also complicit in pushing a deregulatory agenda. Their actions magnified systemic risk and increased the instability of the financial system in ways that theory said shouldn't happen. The real world clearly hadn't read the script.

In amongst the culprits identified are academic economists.

Economists in the US come in for particular criticism. There is a cohort of senior academic economists who stand accused of taking large and undisclosed payments from private corporate interests in return for acting as cheerleaders for deregulation. And for providing a veneer of academic respectability to profitable financial instruments of such complexity that regulatory oversight was near impossible.

While the story that implicates economists is only now reaching the public consciousness, it is not, perhaps, entirely news – if you know where to look. Sociologists of knowledge, for example, have spent much of their time studying the way that natural scientists go about their work in the laboratory. But over the last decade they have also turned their attention to financial markets and financial economics. In his brilliant 2006 book *An Engine, not a Camera: how financial models shape markets*, the sociologist Donald Mackenzie provides examples of senior economists, from the 1970s onward, who were not content to restrict their interventions to the academic journals but also felt moved to engage more directly in paid lobbying activity in pursue of changes in the law – generally in the direction of deregulation and creating a more 'hospitable' environment for financial innovation.[5]

The problem isn't one of which the economics profession itself is entirely unaware. I am in the middle of reading George F. DeMartino's recent book *The Economist's Oath: On the Need for and Content of Professional Economics Ethics*.[6] DeMartino is arguing that, in contrast to many other social scientists, economists' prescriptions and actions in applied policy contexts have potentially huge ramifications for the well-being and quality of life of millions of people. He considers a number of concrete cases of economists acting as social engineers – including prescriptions for shock therapy applied to transition economies with sometimes devastating results. DeMartino argues that the discipline's almost complete neglect of ethical questions – again in contrast to all other social scientists – is unacceptable and unsustainable. He advocates for the equivalent of taking the Hippocratic Oath before any economist be allowed to practice.

Apart from the ethical dimension, there is the issue of how the discipline of economics has become quite so closely associated with the rationalisation of policies and social arrangements that have proved so disastrous. That is a whole other question. It is one that can fruitfully be investigated from a sociological perspective. There are at least two components to the argument.

First, it is in part a function of the way the mainstream of the discipline has come to constitute 'valid' economic knowledge. There is a strong strand of abstraction and idealism. If one wishes to succeed within the mainstream of the discipline then there is not simply a reluctance but a positive disincentive to get too involved with data and the real world.

Second, the discipline is the only social science with a clear global hierarchy, and the upper echelons of that hierarchy have been colonised by (typically US) economists who value mathematical and theoretical sophistication over real world relevance. When mainstream economics becomes entangled in social engineering it tends to view the world as something that needs to be reshaped to fit the procrustean bed of the theoretical model, rather than recognising that models are inevitably simplifications that need to be applied, if at all, with extreme care.

There is a letter in today's Guardian by Mike Cushman of the London School of Economics that provides an insight into how these features of the discipline are reinforced.

But is all this inevitable?

In one sense, the scale of the field is so vast it is hard to get a handle on how things are evolving. One can find signs that the grip of the mainstream is strengthening. But equally one can find signs that the mainstream is now more open to recognising the limitations of established modes of analysis – for example, in the willingness to look more seriously at models of bounded rationality. And there continue to be heterodox voices at the margins arguing for different approaches: approaches which recognise the need for a more institutionally sensitive economics more firmly anchored in empirical engagement with the real world economy. It could plausibly be argued that these voices are becoming more numerous and more organised. One place to investigate these views further is through the Real World Economic Review, which also runs a blog (which can be found here).

One problem with economics at the margins is that only occasionally does it offer the sort of concrete and confident prescriptions and predictions that economic advisors to government are typically required to give. When one recognises the open-textured and contingent nature of the economy the enthusiasm for hard prediction is significantly tempered. Yet, as long as there is a demand for spuriously precise economic advice, supply is likely to be forthcoming.

In this respect a recent paper by Charles Manski on *Policy analysis with incredible certitude* – currently available as a working paper – is interesting, important and encouraging.[7] From a perspective within the mainstream, Manski is asking some searching questions about the sort of policy analysis that economists can and should engage in. His concern is very much the misplaced certitude that is too frequently demonstrated.

So maybe there's hope. Perhaps some of the hubris is being knocked out of mainstream economics and there is a future for the discipline in which it is populated by the "humble, competent people" Keynes thought so splendid. There are some there already. But there is plenty of room for more.

Public service reform, zombie economics and the "Great Forgetting"

27th February 2011

In his excellent recent book *Zombie Economics: how dead ideas still walk among us* John Quiggin, of the University of Queensland, provides an accessible account of some key economic ideas.[8] These ideas provided the intellectual rationale for substantial social changes we have witnessed over the last 30 years. Many of these ideas boil down to theoretical justifications for the claim that markets are a better means of allocating resources than all available alternatives. Quiggin also summarises arguments against these theoretical rationalisations. The case against markets can be boiled down to the argument that whatever conventional economics might believe to be the case in theory, the real world just doesn't follow the script. Working on the basis that it does is a recipe for disaster. This raises a crucial question: given that many of these ideas lack strong intellectual support – they are, or should be, 'dead' – why do they continue to exert such influence on policy? Societies are being subjected to "zombie economics".

One of the topics with which Quiggin engages is privatisation. He notes (p193) that:

> … the view that privatization is always, or even mostly, beneficial is not supported by the evidence.

And he goes on to argue (p199) that:

> Some zombies can be killed once and for all. It seems that the Global Financial Crisis may finally have buried the idea of comprehensive privatisation. Throughout the world, the need for governments to act as the ultimate guarantors of economic and financial stability has been evident …

The British Conservative Party, once the standard bearer for privatization under Margaret Thatcher, has announced plans to allow public sector workers to set up cooperatives to run services such a primary schools and job centres. While some have expressed concern that this might be a backdoor route to privatization, the central point is that the idea itself can no longer be defended in public, even by the party that did most to popularize it.

In contrast with some of the other ideas he considers in the book, Quiggin observes (p200):

> With the national exemplars of comprehensive privatization in disarray, and its advocates in full retreat, it seems unlikely that this zombie idea will return from the grave any time soon. That does not mean that we will see no more privatization of government enterprises.

I was reflecting on this argument in the light of the initial discussions of the imminent *Open Public Services* White paper.[9] It struck me that Quiggin is right to say there is little willingness to propound the benefits of privatization directly. But it seems unwise to conclude that we have conquered the idea that it is desirable to turn public services over to commercial interests. On the contrary, it is likely that we are about to enter a phase where this idea is fully reanimated. Quiggin's conclusion seems rather premature: 2010 feels a long time ago.

Earlier this week I posted a couple of pieces on economic liberalism and public service reforms. The original posts over at Liberal Democrat Voice generated quite a bit of discussion. This discussion was fascinating for all sorts of reasons. Three fundamental points arose.

First, the main point of my first economic liberalism post was that only the most simplistic reading of economic theory can be used to rationalise the indiscriminate marketisation of public services. The sort of arguments invoked to justify the marketisation policies – competition = driving down prices = driving up quality = greater social wellbeing – are only true under relatively restricted circumstances. There is plenty of evidence of the difficulties and inefficiencies in relying on market mechanisms such as (incentive) contracting for certain types of public services, particularly where there are information problems. That isn't an argument against markets or the private sector. And it isn't always relevant: contracting out of some blue collar local public services worked perfectly well. But when an appropriate combination circumstances arises it is naive to expect the outcome of marketisation to be anything other than a fundamental transformation in how the system works and the social outcomes it delivers. These points are not all that controversial among economists who specialise in this field. It is an argument about understanding better how markets operate – when they enhance social welfare and when they won't. Yet, it appeared that several of the comments on my original post missed the point and were premised on an extremely idealised understanding of how markets operate.

Second, the discussion of the benefits or otherwise of marketizing public services made relatively frequent reference to the earlier experience of privatisation of public enterprises and public utilities. The implication being that a successful track record of such privatisations would indicate the wisdom of the strategy. Yet this discussion was 'evidence-based' in only the loosest sense. There is a willingness to argue from analogy without recognising that the technical characteristics of goods and services will fundamentally shape whether marketisation is even feasible, let alone desirable. And that is leaving aside the point that the evidence on the benefits of privatisation is considerably more equivocal than many would seem to believe.

Third, we need to be conscious of political economy of the issue. Marketising public services is not simply about pepping things up a bit with an injection of competition. My expectation is that increased marketisation of "public" services will be to the benefit of the multinational corporations that dominate the public service contracting world. It will concentrate economic power. And it is unhealthy for too much power to be concentrated with one sectional interest. The government will come to rely upon these private contractors to ensure that basic needs are met. This will give the private contractors greater leverage. It will mean that the government will be obliged – or indeed willing, in return for appropriate campaign contributions – to pander to these sectional interests because of this reliance. We only have to look at the attempts to deal with the structural problems with the banking system – which have thus far been relatively feeble – to see that such a scenario is entirely plausible. And it would be highly undesirable.

If, in contrast, the White Paper when it arrives proposes that the alternative to our current mixed economy of welfare is one that places more emphasis upon local, small scale social enterprises and not-for-profit private providers, that ensures that the system does not become dominated by MNCs then my reservations would be considerably weaker.

But I do not believe that is what it will propose. And even if it does, I do not believe that it will be able to deliver, for two reasons. First, we do not have a sufficiently robust infrastructure to develop those alternative types of local organisation over the timescale the government will want to see change. Second, once public services are marketised it will be difficult to write legislation in such a way as to exclude domination by MNCs without it being open to challenge under the auspices of competition law. In this sense this issue is something of a Pandora's Box.

Quiggin refers to the "Great Forgetting of the lessons of the mixed economy" (p201). We do not face a simple binary opposition between laissez-faire capitalism and socialism. Yet, the rhetoric of the Coalition government has a strong tendency subtly – and not so subtly – to construct the issue in these terms. Intermediate positions associated with the mixed economy – striking and maintaining a balance of power and provision between the private and public sectors – have been characterised as the "civilization" of capitalism in the post-World War Two period. A significant de-civilization process has already taken place as governments have dismantled the restraints upon the global finance industry, and as a consequence handing much of the power to shape society to the financiers. We are all aware of consequences of such regulatory inattention. What makes us think that the same will not happen in respect of essential public services that are given an ill-advised dose of marketisation?

It seems to me that there are some core liberal ideas about pluralism, decentralisation, and counterbalancing concentrations of power that need to be rediscovered and forcefully rearticulated. The Great Forgetting urgently needs to be superseded by the Great Rediscovery. The costs of doing otherwise could be enormous.

The mundane malfunctioning of markets – a tale of life and death

3rd March 2011

We are currently awaiting the fourth visit from a well-known high street electrical retailer to fit a new hob in our kitchen. The first two visits led to a new hob being fitted, only to discover that the new one was faulty. The third visit occurred on the wrong day. No one was at home. When my partner phoned to point this out the company had no record of the booking. They couldn't revisit on the date we'd agreed (today) because there were now no available spaces. So they are coming next week. Fourth time lucky?

Clearly this is not the end of the world. Rather more salad is being eaten than is normal for this time of year. And there is more oven-based cooking than typically happens. But it isn't a disaster.

This is the mundane reality of markets. They don't always work very well. And sometimes the consequences can be considerably more significant.

There are some exemplary private providers, whose consumer care and professionalism is beyond reproach. But there are some absolute incompetents and charlatans out there. Some of them are long-established high street names. Those harsh winds of competition don't seem to have been sufficient to discipline them into improving their performance over a period of many years.

Anyone who has their eyes open and is paying attention knows this from personal experience.

It is therefore all the more striking that current discussions about provider diversity and the marketisation of public services are being conducted on the basis of caricatures and idealisations. There is the caricature of the Stalinist inflexible and inefficient public sector monopoly and the idealisation of the consumer-focused, responsive, innovative and efficient private provider. The dismantling of the NHS and the attempt to privatize most public services, which is apparently imminent, are driven by discourses operating entirely on the basis of ideal types, not the reality and lived experience of markets.

The failure to install a hob first time round is of no real significance, just inconvenience. But this morning I read Hugh O'Shaughnessy's account in the Guardian of the end of life care provided to his terminally ill wife. An objective of his account was to highlight the contrast between the standard of treatment received from over-stretched public and not-for-profit providers, driven by an ethic of care, and the much poorer standard of service received when private multinational service contractor became involved in the process, apparently driven by an ethic of "don't care". The piece was genuinely moving and thought-provoking. It provides an insight into the mundane malfunctioning of markets in a situation where it has much more profound consequences and human costs. Clearly that is the rhetorical and political purpose of the piece. In one sense the message is simple: if you pay peanuts – unless providers are motivated by something other than money – you get monkeys.

If you haven't read O'Shaughnessy's piece, please do. It does a great job of humanising policy debate. It makes clear what is at stake. It isn't just about the dry technicalities of billions of pounds in spending, or saving, or redrawing organisational boundaries and changing contracts and incentives. It is about all those things and more. It is about quality of life. And death. It is about the respect with which we would expect fellow citizens to be treated in the situations of extreme emotional and physical vulnerability. And about how we would wish to be treated ourselves. It tells us much about the very nature of a society.

And if you are not in the slightest bit moved by O'Shaunghnessy's piece then perhaps it might be a good idea to check your own vital signs.

Economics as a vaccine against economists?

18th September 2011

On Friday a quote from the great Cambridge economist Joan Robinson was circulating on Twitter:

> Purpose of studying economics – to learn how to avoid being deceived by economists

In fact, the full quote is:

> The purpose of studying economics is not to acquire a set of ready-made answers to economic questions, but to learn how to avoid being deceived by economists.

This pretty much sums up the spirit in which I teach economics to policy students, so I thought it was worth a Retweet.

But it triggered a bit of deeper reflection.

In particular, one tweeter queried whether it could be the case. Studying economics, runs the argument, required embracing the values of economics in order to understand the analysis. Through a process of socialisation one becomes colonised by the economic discourse and progressively blinded to the problematic nature of some of the underlying assumptions and values.

This brief Twitter exchange resonates with some of the great debates in the social sciences, anthropology, and the philosophy of science. Is it possible to understand and engage meaningfully with a paradigm/discourse/culture/ontology without complete immersion within it? Or is it possible to stand outside yet still critically engage with it?

This speaks to a major contemporary challenge – what has been termed the 'economisation' of politics and policy. Increasingly policy proposals are being forced on to the procrustean bed of a utilitarian economic calculus. The policy world is increasingly framed from within a mainstream economic perspective. Unless proposals can be couched in the language of market failure, externalities, property rights, information asymmetries and the like they are not to be taken seriously.

A tactic deployed by policy actors operating from within the perspective of neoclassical economics is to deny those outside the discipline the standing to comment on economic matters. You can't have a view because you're not an economist. You don't understand.

Those outside the discipline often feel disempowered when policy debate is conducted on this economics-inflected territory. The arguments come across as complex, heavy-duty scientific stuff. It can often seem to offer the sort of ready-made answers that Robinson warned against:

> We've run the proposals through the model. We've estimated that the policy will cost £300m. It will deliver £200m of benefits. We shouldn't do it.

Those without any feel for what these statements mean may feel forced to accept them as representing something robust. A model sounds pretty scientific. Benefits don't outweight costs. That's got to be bad, right? They may not like the answer they are presented with. But they have no tools for prising apart the case being made. They are blinded by "science".

Yet, there are plenty of threads that you can tug at if you know where they are. What's the assumed discount rate? How are we valuing life? Valuing time? Are there intangibles that have been omitted? How have transfers been dealt with? What are the magnitudes of the elasticities being used? Are they evidence-based or simply conventional assumptions? How are distributional issues being treated, cross-sectionally and longitudinally? Does the model deal with only first round effects or secondary effects? Partial or general equilibrium? Are expectations important in driving market behaviour and how are they treated? What assumptions are being made about rationality? Or information? Or market structure? Or the speed of market adjustment? How sensitive are the results to the key assumptions? And so it goes on.

Which threads are relevant depends on the precise nature of the analysis. But there will definitely be threads. Pulling on some of them can expose something implausible or deeply unpalatable embedded in the assumptions or the calibration that drives the conclusions. It may lead to the whole argument unravelling.

So that brings us back to Robinson. Economics is an art in science's clothing. The frontiers of the discipline can be fearsomely technical. There is no doubt this excludes the non-expert. Yet, the social world the economist seeks to shed light upon is not unintelligible to the non-specialist. When economics is being applied to policy then it is dealing with real issues about which non-economists may well be better informed than the economists. They have standing to challenge the incautious application of inappropriate models.

The mathematical sophistication of economic models is often based upon some questionable foundations – a house built on sand. And the foundations are not too complex. When applied to policy questions the economics needs to speak meaningfully to pressing real world issues. Policymakers are familiar with one half of that process – the issues – they need to assess whether the economic analysis connects plausibly to those issues.

Most people can develop a feel for the way an economic argument is constructed. There are usually a few key assumptions that drive the outcome. So it doesn't require too much knowledge to start to ask intelligent questions to test the robustness of what you're being presented with.

We can draw the analogy with learning a language. It isn't so difficult to learn tourist French or to achieve a competent level for reading or writing. You can get a real sense of what is going on. But that doesn't mean you've got the facility to write cutting edge literary fiction. Or even effective double entendre-laden limericks. To do that requires much greater immersion – and may be inaccessible to the non-native speaker.

It is the same with economics. It is not so hard to get a sense of how economic argumentation works. But that doesn't mean you're going to get a paper published in the *American Economic Review*.

So if economics is studied critically, examining the foundations upon which explanations are built and the grammar of the arguments, it is possible to develop understanding while declining to embrace the values and assumptions that underpin the discourse. And getting a feel for the subject reduces the chances of being deceived. I'm with Joan on that.

On economic amnesia

12th October 2011

Economists, one might assume, have something useful to say about the current problems afflicting the world economy. Yet, since the crash of 2008 there has been a considerable amount of reflection in parts of the discipline about its failure to anticipate the crash and its failure to offer effective prescriptions for getting the economy out of the hole it's in. Of course, elsewhere in the discipline it is business as usual – with a range of prescriptions for privatisation and deregulation at the microlevel and fiscal restraint at the macrolevel.

This week's Nobel announcements are salutary in that respect. Olaf Storbeck described them as a prize for the Ancien Régime. He was criticised for doing so, but his intervention might be better seen as simply the most recent in a chorus of disapproval directed at an approach to macroeconomics that came to dominate the field. Thomas Sargent, who shared this year's prize, did as much as anyone to propel rational expectations and new classical macroeconomic models to the forefront of the field, and his macroeconometric work has been hugely influential. That is why he was awarded the Nobel prize. But that can be separated from the question of whether, looked at from a broader perspective, such models actually shed much light on the way the economy operates.

Some see the solution to the problems afflicting macroeconomics as the need to search for new ideas. Paul Krugman has recently argued, on the contrary, that the problem is that the discipline has amnesia.

The history of economic thought is littered with potentially useful ideas that have been rejected or neglected in favour of new classical or new Keynesian models of complete markets. The problem is that most economists do not get a chance to study these older ideas, rather their education focuses upon the current 'state of the art'. When quite a number of high profile economists have argued that much macroeconomic theorising since the 1970s has been travelling further and further up a cul-de-sac, this is more than simply unfortunate.

In his presidential address to the Eastern Economics Association Paul Krugman frames the point vividly:[10]

> … in responding to the crisis, the profession presented a sorry spectacle of unnecessary ignorance that didn't even recognize itself as ignorance, of bitter debate over issues that were resolved many decades earlier. And all of this, of course, made the profession mostly useless at a time when it could and

> should have been of great service. Put it this way: We would have responded better to this crisis if macroeconomics had been frozen at the level of knowledge it had in 1948, when Paul Samuelson published the first edition of his famous textbook.

This neglect among economists of their intellectual antecedents is not a new phenomenon. It is, however, getting worse. Fewer and fewer economics departments offer courses in the history of economic thought. This means that ideas with great potential lie unexplored. It also means the discipline condemns itself to reinventing the wheel. And it deprives students of an enriching experience. One of the most memorable parts of my own economics education was wading through Roger Backhouse's *A history of modern economic analysis* and marvelling at the twists and turns of the story as successive generations of economists tried to make sense of their subject of study.[11] It also gave a clear sense that the process by which economic knowledge moves forward is not unambiguously a process by which 'better' theory replaces 'worse' theory. There are other things going on.

The neglect of intellectual history sits alongside an intolerance of heterodoxy in many economic departments. People like Krugman and Stiglitz, although Nobel laureates themselves, are routinely denigrated and derided by economists working within the mainstream. No doubt in part that is because of their media profile – after all you can't be a 'serious' scholar and try to engage the public as well. But it is also because they adhere to a broadly Keynesian perspective (for the reason, as Krugman pointed out succinctly the other day on his blog, that it does a better job of explaining what's going on). It is interesting that the ideas of Hyman Minsky, a post-Keynesian economist, have attracted increasing media attention in recent years as people cast around for ways of explaining the financial crisis. Yet, those ideas have had very limited traction in most economics departments.

The neglect of intellectual history and the intolerance of heterodoxy are important because they obviate the need for broad reflection. The evolution of economic thought and the cleavages between contemporary schools of thought rest on questions of ontology and epistemology. But economists tend to spend most of their time on methodology. Fundamental questions about the nature of the economy divide approaches – questions about the nature and implications of time, knowledge, learning, uncertainty, expectations, for example. Or questions about market structure, market adjustment, frictions and transaction costs. Or questions about the nature of economic relationships – their direction, separability, stability, linearity. Different approaches to 'doing economics' often flow from profound ontological differences. Austrian economics, for example, is not more discursive and less mathematically dense simply because Austrian economists don't like maths. It is because their understanding of the economy means the application of the full panoply of technical economic tools is viewed as pointless. The economy, from this perspective, just isn't amenable to that type of analysis. But many economists, well versed in mainstream approaches but little else, would have had no opportunity to reflect upon such issues in anything except the narrowest terms. And it is unlikely that any such engagement is framed explicitly as concerning the ontology of the discipline.

The neglect of intellectual history and the intolerance of heterodoxy are of a piece. They both flow from a process through which a particular perspective and a particular set of values – the so-called values of the maths department – have come to capture the commanding heights of the discipline and to marginalise or silence alternative perspectives. Progress in economic thought has come to be defined in rather narrow terms, and relevance to understanding pressing applied problems does not feature all that strongly. Many within the discipline have been conscious for at least the last two decades that this has been happening. Many have bemoaned it. Movements like post-autistic economics (now, real world economics) have arisen in opposition to it. But they have yet to make serious inroads into thought leadership within the discipline.

How to effect a change of culture within the discipline is a political or sociological question, rather than a purely economic one, although focusing upon incentives would no doubt be fruitful. Krugman concludes his speech on a frank, if slightly defeatist, note which captures the essence of the problem:

> What we really need is a change in the destructive social dynamics that brought us to this point. And I wish I knew how to do that. But my problem is obvious: I'm an economist, and it seems that we need some kind of sociologist to solve our profession's problems.

This captures the scale of the challenge. But before successful change can occur there needs to be broad-based acceptance that it is needed – as those who study organisational change will tell you. I'm not sure we're quite there yet.

On knowing what's going on

5th November 2011

> Leading active members of today's economics profession … have formed themselves into a kind of Politburo for correct economic thinking. As a general rule—as one might generally expect from a gentleman's club—this has placed them on the wrong side of every important policy issue, and not just recently but for decades. They predict disaster where none occurs. They deny the possibility of events that then happen. … They oppose the most basic, decent and sensible reforms, while offering placebos instead.
>
> *James K Galbraith*

Last weekend in a brief post over at Pop Theory Clive poses one of the key social scientific questions of our time – What do economists know? Of course, the answer depends on which economists one is talking about. As the epigraph above notes, the mainstream of macroeconomics largely misses the point. It didn't see the current economic turmoil coming and has little to offer by way of solutions. One striking thing about Galbraith's comment is that it was written in 2000. Not a great deal has changed since then. These deficiencies with mainstream approaches have been recognised by some high profile mainstream practitioners, as I noted in *On economic amnesia* in the aftermath of this year's Nobel prize in economics.

Yet, it is not as if economics has nothing sensible to say on the matter.

For example, in a recent paper Joseph Stiglitz sketches out an argument, based upon the economics of imperfect information and incentives, why many of the problems we have recently encountered should not be a surprise.[12] His point is that modern microeconomics provides tools that are useful in alerting us to potential problems, but that much modern macroeconomics does not make use of those tools. Macro has preferred instead to stick with microfoundations that treat issues such as market-clearing or expectations formation in such a way that, by definition, they render the analysis largely useless for understanding the problems we now face. Stiglitz is particularly scathing about the way in which many mainstream economic models have neglected the financial sector. As a consequence they have no traction on the current crisis because, according to the models, it can't be happening.

Stiglitz argues that economics has spent too much time and energy improving its analysis of relatively modest variations in economic activity, while dismissing truly profound economic dislocations by assumption:

> It was as if we had developed a medical science that could treat individuals' colds, but had nothing to say about serious illnesses. A doctor that said that that was good enough, because most of the time individuals were either healthy or suffering from the sniffles, would not be taken seriously; but that was the position taken by much of mainstream economics (p608)

Stiglitz argues that, in contrast, we should be interested in economic pathologies. It is when the system gets seriously sick that we can start to understand better how it works. We should be focused on the economics of "deep downturns". And the economics of deep downturns bears limited resemblance to the economics of good times.

Clive's Pop Theory post draws on a recent piece by James K Galbraith which points out that if you are willing to look beyond the mainstream there are a number of strands of economic thinking that can not only explain what has happened, but also saw it coming. Galbraith ends his piece with a call to action. Rather than devoting more resources to what he terms the Tweedledum and Tweedledee debates between mainstream schools of economic thought:

> The urgent need is … to expand the academic space and the public visibility of ongoing work that is of actual value when faced with the many deep problems of economic life in our time. The urgent task is to make possible careers in those areas, and for people with those perspectives, that have been proven worthy by events. The followers of John Kenneth Galbraith, of Hyman

> Minsky and of Wynne Godley can claim this distinction. The task now is to increase their numbers and to reward their work with the public recognition and the academic security it deserves.

The question is how? Once the Politburo has a grip on the discipline, how can it be loosened? This is not dissimilar to the challenges Paul Krugman noted in his Eastern Economics Association Presidential Address. Perhaps the answer is that it can't be done from the inside, but must come from beyond.

One interesting, perhaps hopeful, development occurred this week at Harvard. Students walked out of Ec 10, the introductory economics course delivered by Greg Mankiw to students drawn from diverse undergraduate programmes, many of whom won't go on to major in economics. The students released an open letter to Professor Mankiw in which they explain that they were looking "to gain a broad and introductory foundation in economic theory" but felt exposed to "a specific—and limited—view of economics that we believe perpetuates problematic and inefficient systems of economic inequality in our society today". Perhaps this is the start of something significant. Perhaps it needs a new generation – less deferential to conventional expertise – to really shift the terrain.

Yet, equally, this particular action may be no more than youthful exuberance and goes nowhere. It feels similar to the original post-autistic economics protests from back in 2000. While those protests helped to raise consciousness and contributed to the establishment of a much more vibrant global community of heterodox economists, the impact upon the strongholds of orthodoxy has been relatively limited.

But this week's student protestors made reference to the broader *Occupy* movement. They seek to locate the critique of existing economics education as part of a much broader wave of discontent with the established order. This may have the potential to impart further momentum. In higher education systems where we are obliged to weigh student demands and expectations more heavily it may be that change will be forced upon the economics curriculum.

One of the problems for anyone interested in delivering more pluralist economics education is what such a beast would look like. Heterodox economists may rail against 'toxic textbooks' infused with the orthodoxy, but accessible materials for alternative approaches are relatively limited.

This challenge has been picked up. The Institute for New Economic Thinking, for example, has used the Harvard letter as a springboard for an exercise to assemble alternative curricula through which a broader-based economics education can be delivered. So, again, there is potential here for greater momentum to develop.

Perhaps this time the citadels are starting to crumble.

Keen insight into the monetary economy

15th November 2011

Lucas Papademos, former vice-president of the European Central Bank, has now been installed as the new Prime Minster of Greece. The imminent arrival of former European Commissioner Mario Monti as Prime Minister of Italy will get the post-Berlusconi era properly under way. This is to be an era of technocratic policy-making by market-approved placemen.

Defenders of democracy are deeply concerned about the way in which this process has evolved. It is not so much that crisis has precipitated change at the top of national governments. Nor even that these countries find themselves governed by interim governments that are appointed rather than elected. More concerning is the apparent erosion of sovereignty through the overt intervention of foreign governments in domestic affairs, and the apparent concentration of European power in the hands of the eight members of the Frankfurt Group, only two of whom are democratically elected politicians.

But this is not simply a crisis of politics and the economy. It is also a crisis of economic epistemology. Of economic knowledge. Paul Mason, BBC Newsnight's Economics Editor, observed on Friday's programme that "The economic orthodoxy of an entire generation of politicians seems to be failing. And they don't know what to do."

Mr Papademos and Mr Monti, as conventional economists, can be trusted to attempt to deliver the austerity the markets demand as their remedy for current economic ills. But it isn't at all clear that this will improve the situation. We are largely travelling without a map.

Conventional macroeconomics is not a lot of help because its starting premise is that the economy, as a self-correcting system, shouldn't suffer from prolonged recession or depression or generate persistent large-scale unemployment. In order to account for deep economic downturns the models have to be augmented with assumptions such as unexplained changes in preferences for leisure, repeated exogenous shocks, or persistent price rigidities in the labour market. It's all a bit ad hoc.

While conventional economics may be struggling, many are searching for alternative economic theories that can provide a more satisfactory account of what is going on. Steve Keen's work has attracted a lot of attention. He is one of the small number of unorthodox economists who in the early 2000s made a concrete prediction that a crash was coming. He recently received the Revere Award from the *Real World Economics Review* – having been voted the economist who most clearly warned of the coming crisis.

Keen has recently published the second, expanded edition of *Debunking Economics: the naked emperor dethroned?* which represents a robust challenge to the orthodoxy.[13] I read the first edition seven or eight years ago, when this was a topic of interest to a disparate band of dissidents. The second edition will no doubt reach a much broader audience because it speaks to the most pressing economic issue of our time.

Keen's starting point is a rejection of pretty much all the core tools of conventional economics. Static, equilibrium theorising is dismissed. Walrus' law is rejected. Fundamental ideas such as the downward sloping demand curves are argued to be wrong. Not only that but, as Keen rightly points out, orthodox economists have demonstrated this to be the case – they've just kept quiet about it. Rational expectations and efficient markets are dismissed as logically and empirically deficient.

Many heterodox critics of conventional economics feel that its emphasis upon formalism, mathematics and abstraction miss something important in understanding the economy. Keen is not one of them. His view is that economics has stuck with the mathematical approaches of a previous era while thinking has moved on. It is a question of the wrong mathematics.

Keen draws on Keynes – but not Keynesianism – and Minsky to argue for the fundamental importance of time and uncertainty to understanding dynamic economic processes. He uses a top down approach to theorising in the spirit of Keynes, Minsky or Marx. Macroeconomics does not have to be reducible to microeconomics. Methodological individualism – the insistence that our understanding of markets must be rooted in the aggregation of the behaviour of individual actors – is rejected. Markets are seen as having emergent properties that are not susceptible to reductionist explanation. In place of equilibrium theorising and comparative statics, Keen seeks to develop models with rich dynamics drawing upon differential equations and complexity sciences. Such models can be stable but not static. They require simulation rather than analytical solution. Variables can oscillate – sometimes dramatically – around equilibrium values but never settle on equilibrium.

Foundational to Keen's approach, drawing on Minsky, is the argument that an adequate economic theory should make "great depressions one of the possible states in which our type of capitalist economy can find itself". Depressions have recurred over time. There were economic depressions before there was "Big Government" and fiscal or monetary policy on a large scale. So depressions cannot only be about inappropriate government action. They must be a product of the way in which capitalism functions as a system. Neoclassical theories based upon rapid readjustment to equilibrium leave no space for this possibility.

The biggest theoretical innovation Keen seeks – and he is not alone in this – is to argue for the recognition of the financial sector in economic theory and modelling. Not only that, but to recognise that money is different from other commodities. This may seem self-evident to most people. But many dominant economic models abstract from money or the financial system – there is no room for credit or debt. They effectively model barter economies. Given the importance of the financial system in the contemporary economy – and in the origins of the current crisis – this may seem extraordinary. But it is the case nonetheless.

Keen, in contrast, argues that understanding debt dynamics is fundamental to understanding the way the economy functions. More specifically, it is key to understanding both boom and slump. Most importantly, Keen argues it is essential to recognise that debt is privately created. It is the actions of private banks that drive the broad money supply and central banks have to accommodate. This is a complete reversal of conventional explanations that see monetary policy as having no significant effects on the real economy, the monetary base as an exogenous variable under the control of central bankers, and a money multiplier amplifying the effect of monetary expansion. The conventional explanation can give some justification for quantitative easing. The contrary explanation can account for why quantitative easing hasn't (and won't) work.

At the heart of economic dynamics, from Keen's perspective, is the financial sector's "innate desire to create debt", because this is the way it makes money. This is also the reason why attempts to restrain the financial sector by imposing prudence are only ever temporary. Keen argues that "The incentives to create debt are so great for this sector that, over time, a debt-driven culture will replace prudence". The pressures to relax regulatory oversight become irresistible.

This is not an argument focusing on the last few years. The use of debt to allow speculation in a Ponzi economy, rather than to invest in productive capacity, has been a worsening problem since the 1960s. Moreover, governments and monetary authorities have exacerbated the problems of over-indebtedness by seeking to sustain levels of economic activity with more debt and with bailouts that create moral hazard problems. Keen argues (p396) that:

> [t]here is little doubt that [Alan] Greenspan's actions in rescuing the financial sector from itself after numerous crises, … turned a potentially garden-variety depression in 1987 into the near-death experience of the Great Recession. The regulators, by delaying the inevitable for two decades, have made this crisis more intractable than it would have been without them.

It wouldn't, by any chance, be the case that the favoured solution to the current difficulties in the Eurozone involves covering sovereign debt with ever more arcane financial engineering to increase leverage to almost astronomical levels? This is the orthodox response. As Roosevelt observed in his inaugural address in 1933, "Faced by failure of credit they have proposed only the lending of more money".

The alternative is to recognise that this is just another attempt to postpone the inevitable. A more extensive debt jubilee than the Greek 'voluntary' haircut may be the necessary. But that doesn't look politically feasible at the moment.

And institutionally we need not to be seduced by the sectional interests of big finance. We need to recognise that reinstating some of the restraints upon finance that were dismantled during the 1980s and 1990s is essential to reducing the oscillations of the monetary economy. The finance industry may be less profitable as a result. This may pose challenges for the UK in particular. But unless there is some adjustment to structures to curtail excess then excess will eventually return.

Keen's work is a work in progress, as he himself recognises. The models need further development. And because they are simulations they raise epistemological questions of their own. *Debunking economics* is an informal introduction to Keen's views and ideas. There are plenty of other introductions to his ideas knocking around as videos on the internet. A more formal academic statement of his approach can be found in the academic literature.[14]

Keen's argument represents a profound challenge to orthodox economics. He has, perhaps predictably, been dismissed and derided by some of those with a lot of intellectual capital invested in sustaining that orthodoxy. Others in whom the orthodoxy is deeply ingrained no doubt find his ideas incomprehensible. The understanding of the economy being offered is so radically different from their own.

Yet, with its emphasis upon dynamics, debt and disequilibrium – characteristics only too apparent in the real world economy – and its ability to model capitalist dynamics more effectively than conventional approaches it is an approach that demands serious consideration.

On the wisdom of free capital markets

7th December 2011

With the discussions over the future of the Eurozone at a critical phase, David Cameron yesterday started to make helpful noises about exercising a veto if British interests were not protected. And when he says British interests, it seems he primarily means protecting the status of the City of London as the pre-eminent financial centre in Europe. It is, of course, no great surprise that the Conservatives seek to protect the interests of the financial elite who are, after all, their major financial backers. But we need to hold on to the idea that it wasn't so long ago that equating the interests of the City with the interests of Britain was being severely questioned. And those camped out at St Paul's act as a continuing reminder.

Cameron's comments led me to wonder how that rebalancing of the British economy away from finance and an over-inflated housing market was going.

We desperately need to take seriously the broader debate not only about rebalancing but also about the influence of the capital markets on broader social development and human welfare.

This morning I tweeted – for no particular reason other than it struck me as germane – a quote from James K Galbraith, which is part of his discussion of the collapse of the Japanese economy in the late twentieth century:

> There is evidently no development path that an unfettered, liberated, free capital asset market cannot screw up.[15]

He develops the point by arguing that a key reason for the rapid economic development of China is precisely that, while external trade is somewhat open, its financial system is not. He goes on to argue that:

> If China truly lives up to commitments made … to liberalize its financial sector … one may confidently predict that … the Chinese model will go into crisis, and progress will stop – as it did in Latin America, Eastern Europe, and elsewhere in Asia. (2008, p86)

These arguments are hardly unique. The post-Second World War period of economic prosperity was at least in part attributable to widespread capital controls and fixed exchange rates. When this system was dismantled in the early 1970s, to the round of applause from free market thinkers, things went pear-shaped rather quickly. Ha-Jung Chang generalised the argument to economic development more broadly. In *Kicking away the ladder* he points out that all the countries that are now "developed" got to be that way through following various forms of protectionist and state-based industrial policy.[16] The free trade prescribed to less developed countries by international institutions such as the IMF and the World Bank is precisely not the policy that will allow them to develop.

As with so many of today's economic debates, Keynes had something relevant to say. In 1933 he wrote an essay entitled National Self-sufficiency which includes the following passage:

> I sympathize therefore, with those who would minimize, rather than those who would maximize, economic entanglement between nations. Ideas, knowledge, art, hospitality, travel–these are the things which should of their nature be international. But let goods be homespun whenever it is reasonably and conveniently possible; and, above all, let finance be primarily national.

This passage is often invoked in the context of ecological economics as an argument for relocalising economic activity as far as possible. But I am struck by the last statement: "above all, let finance be primarily national". Many of those who watched this week's documentary on the fall of RBS, which in part involved taking several small, stable well-run local banks in various parts of the world and trashing them, might well see the wisdom in keeping banking both local and relatively unexciting.

The real problem – and this is one that we clearly and acutely face at the moment – is getting from here to there. While it is accepted that more restraint is necessary, the signs are relatively weak that policy is being formulated from the perspective of what is best for society rather than what is best for the banks. How does one genuinely tame the system, rather than simply try to curb its worst excesses? How do we move from a hugely powerful but highly unstable international system to something that won't again wreak havoc on society? The passage from Keynes above continues by advising caution, but this is less frequently cited:

> Yet, at the same time, those who seek to disembarrass a country of its entanglements should be very slow and wary. It should not be a matter of tearing up roots but of slowly training a plant to grow in a different direction.

A lot of faith is being placed on the implementation of the Vickers recommendations. And it is good to see that some pressure being exerted to make reforms happen sooner rather than later. But will that get us where we need to be? Or is there a broader sickness in the financial system that needs to be addressed? Today, for example, we have had Stella Creasy promoting her campaign against legal loan sharking. The Government is reluctant to act against companies profiteering outrageously from people's misfortune and misery. Does "slowly training a plant to grow in a different direction" demand a fundamental reorientation of our understanding of the role of finance? Not just structures and regulations, but rethinking of purposes and values. A retreat from the rentier society, as it were.

Do we have a clear vision of the role that the financial system should play in British society? Equally importantly, do we have a clear route map for realising that vision? And can economic stability and genuine – not debt-fuelled – prosperity be recovered without questioning the wisdom of free capital markets?

On flash crashes and their prevention

4th January 2012

How often do you encounter something important and find yourself thinking "how is it that I didn't know about this already?". It happened to me last week when reading an FT piece by Gillian Tett on the flash crash experienced by the US equities market in May 2010.[17] On the afternoon of 6th May the market lost nearly a $1tr in value in half an hour, only to recover most of that value by the close of the day's trading. An enquiry followed, but no one has yet established precisely what happened.

Tett's article draws on a Foresight report by Dave Cliff and Linda Northrop for the Government Office for Science that looks at the global financial markets from a perspective rooted in ICT and systems engineering.[18] Cliff and Northrop argue that the world economy had a lucky escape in May 2010. Had the flash crash happened a couple of hours later the market would not have recovered before closing. As a consequence East Asian markets would have plummeted and worldwide financial meltdown could have been triggered.

Given that all this was news to me, and is clearly highly significant, I spent some of my New Year's Day reading the report.

The authors take an "ultra large scale systems perspective". They argue that the global financial system – indeed, each national financial system – is a System of Systems (SoS) that has grown up organically, with individual components developed separately but then expected to communicate effectively with each other. What could possibly go wrong? Not only that but financial markets are large scale socio-technical systems: a key part of the markets' aggregate behaviour is shaped by the way in which humans and technology interact. The rise of phenomena like automated high frequency trading over the last decade has fundamentally altered the character of the markets. They have long since ceased to operate at a human pace.

My familiarity with the engineering end of things is pretty much non-existent, but as I understand it the core of Cliff and Northrop's argument is that flash crashes are likely to be an inherent property of a SoS. So we should expect them to happen again. In the same way as in physical systems such as bridges or aeroplanes there may be a combination of circumstances which results in system failure, the financial system can find itself in a state which triggers a flash crash. It doesn't mean someone necessarily made a mistake and therefore can be blamed. In physical systems the key issue is whether the probability of such system failure is so low that it can be treated as negligible for practical purposes. If so, then the system can be considered 'safe'.

Cliff and Northrop's point is that at the moment our knowledge of how financial markets – when thought of as ultra large scale systems – operate is not sufficiently advanced to say how probable or otherwise such flash crashes are likely to be. Sometimes the term 'black swan' is invoked here, to indicate an unlikely event that did, in fact, come to pass. However, given that, as Cliff and Northrop note, there is a suspicion that there was another smaller flash crash in September 2010, it isn't clear that we are talking about events that are particularly improbable. I am reminded of Mandlebrot's argument from a while ago that much of the modelling used in financial markets is based upon flawed foundations.[19] It assumes risks can be modelled using normal distributions when in fact the distributions describing market movements are fat-tailed. The result is that markets are far more volatile in practice than the theory says they should be.

The core of Cliff and Northrop's proposal is that building large scale simulation models, drawing on techniques for modelling the coevolution of complex adaptive systems and the like, offers the possibility of enhancing our understanding of the global financial system – its properties and propensities. With increased understanding of the concatenations of circumstance that are likely to trigger a crash, regulators will be better able to formulate smart rules to prevent the system finding itself in those states, thereby averting financial Armageddon.

While the authors are, I infer, convinced of the value of this approach, they note that it would be appropriate to put the proposal through a thorough cost-benefit assessment. To construct such models would most probably require an international collaboration that would not come cheap. So it is as well to be sure it is a sensible use of time and money. We'd expect nothing less in our vfm policy world.

Two points particularly struck me from reading this report.

First, the premise of the report is to work with the grain of the way in which the financial markets have evolved and continue to evolve. The central question is how regulators can reduce the accompanying chronic risk of financial collapse.

Yet, this discussion is taking place at a time when the very purpose and value of much of the activity of the financial markets is being questioned. What does it add to the sum of human welfare (as opposed to the bank balances of those involved)? Andrew Haldane's argument that much of the value created by financial markets in recent years is largely a mirage produced by taking on more and more unacknowledged risk seems germane. A number of high profile economists have questioned whether the financial sector has become bloated and largely self-serving (including the recent post by Brad Delong at Project Syndicate). Some governments are questioning whether high frequency trading, for example, needs to be curbed.

An alternative mechanism for seeking to minimise the risk of flash crashes bringing the entire global economy to its knees would be to apply a form of the precautionary principle and unwind or step back entirely from certain technologies or combinations of technologies.

That is clearly still a question of regulatory intervention. Yet it is a question not of inserting circuit breakers to stop the system reaching particularly dangerous states, but rather of ruling certain types of circuit as being too dangerous. They need to be deactivated.

The argument is about costs and benefits, but we would be weighing the downside risk more heavily, because the costs have to be socialised when things go wrong. In the absence of compelling evidence that certain types of risky activity are socially useful the onus is upon those who think they should be allowed to demonstrate why. The counterargument that it would be possible to design appropriate insurance products to hedge against such risks would, I submit, completely fail to learn the lessons of the recent past.

The second point I was left wondering about was how we theorise about the operation of financial markets. Post-Keynesian approaches, inspired in particular by Hyman Minsky, have gained popularity – outside the academy at least. But such theories are fundamentally more humanistic than much conventional economic theory. They are about risk, uncertainty, optimism, animal spirits, bulls and bears – there is a strong streak of emotion in explaining what drives markets. As a general account of markets populated by people such theories are, in my view, an improvement upon standard economic theories of clear-eyed rational calculation and efficient markets. But what about markets in which a large proportion of traders are automated and, at best, boundedly rational in following pre-specified rules? There should no doubt be more focus on the rules being embedded in the technology. It may be that those rules embody certain types of irrationality. But they will be executed without emotion.

I'm not sure quite what to make of that. It could have profound implications for theorising financial markets, and indeed markets more generally. It is very likely that there are well-developed strands of the finance literature, with which I am not familiar, that have already wrestling with these issues. More research – for me at least – is necessary. As is always the case.

This is a fascinating topic. And one which speaks directly to some of the biggest questions of our time. Clearly there is an important technical dimension to the debate. But it raises broader questions of social ordering that justify scrutiny at a much more profound level. It feels to me to be one of those topics that is too important to be left within a particular policy community.

The developing case for capital controls

9th January 2012

The desirability of free capital movement is an article of faith for the international organisations that seek to govern the global economy. The perspective is shared by the governments of most developed countries. Liberalisation of capital markets is typically part of the medicine prescribed to ailing countries. A weakened country might consider imposing capital controls in a bid to gain some relief from a battering in the global financial markets, but international treaties can stand in its way. This is part of the challenge currently facing Hungary, as discussed by Frances Coppola here.

A month ago I blogged *On the wisdom of free capital markets*, in which I drew on James K Galbraith and Keynes to argue that an overwhelming emphasis upon retaining the free movement of capital is mistaken. This becomes even clearer when one looks at the issue from a development perspective. Successful development has not been founded upon free capital markets. Free capital markets have led, historically, in a different direction.

Given this starting point, my eye was drawn to an article by Heather Stewart in yesterday's Observer entitled Financial crisis could turn the tide against unrestricted capital flows.

The piece draws on a recent report by the Bretton Woods Project which argues that it is time for a new consensus on the regulation of capital flows for the benefit of society. The starting point is that while cross-border capital flows can be beneficial, the countries with the most deregulated regimes suffered worst in the recent financial crisis. Not only that, looking back to the Asian financial crisis of the 1990s it was the countries that controlled their capital account – even in the face of opposition from International Organisations (IOs) – that managed to minimise the damage to their economies most effectively. Conversely, the countries that have recently witnessed considerable growth and development – notably China and India – have retained controls on capital movements, again in the face of pressure from International Organisations to liberalise.

Capital flows into a country in the form of long-term investment that can promote positive development, whereas purely speculative flows can be destabilising. The report argues (p.ii) that:

> There is considerable consensus in the economic literature that capital flow surges and stops contribute to financial and banking crises. And these crises are more than just headline grabbing events, but have wide-ranging negative social impacts. The way in which financial flows are managed impacts on wealth distribution, poverty, children's well-being, women's economic advancement and unemployment. These impacts are not generated only by a crisis, as boom periods can also bring problems of inequality and de-industrialisation. Having a fully liberalised capital account also facilitates tax avoidance and tax evasion.

More specifically it draws on the work of Ilene Grabel, writing in 2000, to identify five types of risk associated with unregulated global capital flows (p10):

- **Currency risk** under open capital accounts has two dimensions … it refers to a country's exposure to currency speculation and the risk of currency collapse following investors' decisions to sell their holdings.
- **Flight risk** refers to sudden capital outflows from an economy because of panic and investor herding, causing sudden drops in asset values.

Episodes of capital flight can become self-fulfilling prophecies in the case of sudden drops in confidence.

- **Fragility risk** refers to borrowers' and an economy's vulnerability to external debt obligations. Often fragility risk is heightened by short-term foreign borrowing being used to finance long term investment. Changes in conditions may make it difficult for the borrowers to continue repayment or for an economy to roll-over debt obligations coming due.
- **Contagion risk** refers to being effected by financial crises that have their origins in other countries through financial integration. Often this may be cross-border versions of investor herding or panic, as was seen in the Asian financial crisis.
- **Sovereignty risk** describes the risks that a government will be constrained in its ability to pursue independent social and economic policies as a consequence of capital account liberalisation.

The report goes on to argue that there needs to be greater recognition of the value of capital controls to reduce countries' exposure to these risks and to render fiscal and monetary policy more effective. Recently it appears that IOs are increasingly willing to recognise that capital controls could help in emergencies. But the Bretton Woods Project is arguing for something more routine.

Some control can be gained over capital flows without violating international treaties, but the report argues that recognising the strong pragmatic case for capital controls means going further. This leads to the argument that when treaties are renegotiated – as, for example, it is likely the Lisbon treaty will be – renegotiation ought to encompass a more benign view of measures to enhance or incentivize long-term investment rather than speculation.

These arguments run up against all sorts of objections from the perspective of conventional understandings of the macroeconomy. From the conventional perspective it has been demonstrated in theory that liberalisation will, pretty much by definition, improve resource allocation. Barriers to free movement are consequently an impediment to efficiency and development. My feeling is that this is one of those situations where the only sensible response can be "it works in practice, but it's impossible in theory – it must be the theory that's wrong". That is hardly an outlandish position to adopt. As Lord Adair Turner observed back in 2009, the financial crisis meant that we faced "a fairly complete train wreck of a predominant theory of economics and finance".

The challenge is building a consensus around an alternative position were "Finance must serve the ends of society, not society the ends of finance" (p1). If that means less 'hot' money sloshing about and financial speculators having less scope to scour the world for opportunities to turn a quick buck then so be it.

The policy that dare not speak its name

17th February 2012

Buses. Buses and markets. Markets for buses. It's not a topic I have spent much time thinking about. But it's been on my mind. And it's my own fault.

Last week I ran a session with some students discussing the economic critique of government and its consequences, mostly privatisation. One point we explore is that an understanding of why an activity is in the public sector in the first place can be helpful in anticipating what will happen when it is transferred to the private sector. If we're talking lame duck industry nationalised to stop it going under then we'd expect one sort of outcome from privatisation. If we are privatising the production of a good subject to one of the classic technical market failures – public goods, externalities, information failures, failures of competition – then if we're not careful with regulation it is likely that the problems of inadequate coverage, undersupply, or whatever will reassert themselves pretty quickly. There is a need to descend from abstract pronouncements about the benefits of private markets to thinking about the characteristics of specific markets and industries. It's not rocket science, in the context.

This year we had a look at the recent Competition Commission investigation into local bus services outside London, published just before Christmas, as an example of economics 'in action' in a policy context. The local bus market has too complex and varied a history to summarise it as a straightforward example of privatisation. It was in some areas, but not necessarily everywhere. But it is certainly an example of Thatcher-era deregulation in pursuit of competition. And most local bus services are now in private ownership, although significant sums of public money find their way to the market through concessionary fares, supported services, Bus Service Operators Grant and through more specific local and infrastructure initiatives. The market was referred to the Competition Commission by the Office of Fair Trading in 2010 under the Enterprise Act 2002.

This sounds like pretty dry stuff. But in fact the report is fascinating. It offers a huge amount of material to reflect upon the strengths and weaknesses, the potential and limitations, of markets.

The Competition Commission's headline conclusion is fairly stark. Competition in local bus markets is very limited. Many local markets are highly concentrated. Significant consumer detriment results.

I know competition in my local area is pretty limited and buses are expensive. But it is clear that this situation is duplicated right across the country.

Three potential sources of competition are identified: head-to-head on route; market entry by an existing company operating in another local area; market entry by a new start up. Head-to-head competition was found to be rare. The investigation estimated that only 3 per cent of routes, or 1 per cent of weekly services, were likely to be subject to effective head-to-head competition. Such competition tends to be sporadic. Periods of intense head-to-head competition can result in benefits to consumers in driving down prices, but often lead to one operator being driven out of the market. If head-to-head competition is rare then market entry is even rarer. Anticipation of predatory pricing by incumbents in order to drive new entrants out of the market means new entry lacks appeal.

Overall there were significant barriers to entry, including sunk costs that are variable and uncertainty but can be substantial. The market is therefore in effect neither competitive nor contestable.

The Competition Commission also found examples of tacit, or explicit, collusion. Bus operators in neighbouring areas can come to an understanding that they will divide up a region and not infringe on each other's territory. You can't help but hear echoes of Adam Smith's famous quote:

> People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.

Some of the Competition Commission's findings felt like they came from the Wild West not twenty-first century Britain:

> We found that there were some aspects of competitive conduct which were undertaken to diminish a rival's ability to offer its service but which delivered no benefit to customers. We term this category of conduct 'cheap' exclusion. Examples of 'cheap' exclusion include obstruction of a rival's services, for example through deliberately blocking or delaying their services on the road, preventing them from using bus stops and stands, intimidating drivers, causing damage to a rival's vehicles, depots or other facilities, removing rival operators' publicity and timetables, providing misinformation about a rival's services to passengers, imitating a rival (such as copying its livery), or guiding passengers at a bus stop away from boarding a rival's services. Cheap exclusion restricts head-to-head competition and the constraints from potential competition and new entry. We found that, despite it being to some extent subject to the powers of the Traffic Commissioners and other legal constraints, incidents of cheap exclusion are still observed.

Some bus passengers plan their journey in advance and compare suppliers. Many just turn up at the bus stop. Once they get there consumers are relatively insensitive to price. They simply want to catch the next bus to their destination. So this doesn't exert any discipline on suppliers' pricing behaviour.

The only effective long term competition to buses appears to come in areas with mass transit systems such as trams. Buses are not really competing with private cars.

As simple economic theory would predict, the Competition Commission found that bus operators who accounted for a large part of a market with significant barriers to entry could be highly profitable. They were able to earn "profits that were persistently above the cost of capital".

After laying out this range of problems the Competition Commission proposed remedies under three headings: market-opening measures for commercial bus services; measures to promote competition in supported services; and recommendations about the policy and regulatory environment (summarised on pp11-13 of the final report). These measures struck me as extremely modest relative to the scale of the problem. Change to ticketing arrangements and increasing access to bus stations is fair enough. The idea that it might be nice to have a code of conduct and ask operators to abide by it is laudable, but strikes me as rather touchingly naïve. And so on.

And here's the problem. The Competition Commission's role is, of course, restricted to analysing the state of the market and making recommendations about changes that can enhance competitiveness. Yet, reading through the document and thinking about the nature of this market, you get the strong sense that this is rather barking up the wrong tree. Or paddling against a strong tide in a small dinghy. Looked at more expansively the obvious conclusion is that, for a range of reasons, the local bus market is more akin to a natural monopoly. Some local authorities are currently looking to abandon the tendering approach to supported services and move to franchising. While the Competition Commission doesn't support this approach, it would appear to indicate that some have concluded that seeking competition in the market has failed and the best you can aim for is competition for the market.

A thorough-going franchising approach may well be the best solution if one is obliged to hold to the current policy framework. But it is equally plausible to argue that the framework is wrong. The nature of local bus provision is such that the only way to avoid the sort of widespread profiteering and consumer detriment identified by the Competition Commission would be to return to a world of municipal bus companies run for the people rather than profit. Nationalisation? The policy that dare not speak its name.

Unless we're talking about banks, of course.

Economists? That'll be your problem right there

10th June 2012

Last Wednesday Suzanne Moore posted a Guardian comment piece entitled [Why do we take economists so seriously?]() which takes a rather scatter-gun approach to some familiar themes. The argument, in outline, is that the economy is in a mess and this is primarily because we have been hoodwinked by orthodox economists. These economists produce inadequate theories unsuited to understanding society. But we nonetheless invest them with too much power over it, and us. The range of opinions on how to resolve the current crisis is too narrow and largely reflects the interests of those who support the current social order. New voices are needed. As Moore argues:

> we are indeed in reduced circumstances when debate is reduced to bankers arguing with economists. This clash of ideologies is not really left versus right. It is more akin to fundamentalists talking to agnostics …
>
> This is what you get from this dictatorship of economists, and it should be overthrown. It is wrong and keeps being wrong. The choices to be made now are moral, not economic ones. Only an idiot or an economist would think otherwise.

For a piece in which the author professes to be largely ignorant of the matters about which she is writing, this is quite a brave stance. Predictably it has generated a response.

In a post that garnered considerable support from tweeting economists, the estimable Chris Dillow highlights Moore's failure to grasp the way economic thinking is evolving and the richness of current economic research. Moore argues that:

> Economics is not a science; it's not even a social science. It is an antisocial theory. It assumes behaviour is rational. It cannot calculate for contradiction, culture, altruism, fear, greed, love or humanity at all.

Regardless of whether this qualifies as an accurate characterisation of economics at some point in its history, Dillow points out that these are issues about which current economic research is very much aware.

Over at The Lay Scientist Michael Story notes that the sort of criticism Moore offers is not uncommon:

> I get the general idea … economists are either foaming free-market fundamentalists or mindless automatons, sitting uncaring in their lairs, crunching numbers and models that have increasingly little relevance to the real world.

Story's post tries to balance a recognition of the valid points in Moore's piece (the problems associated with complex synthetic financial products and regulatory weaknesses) with the broader point that such anti-economics sentiment, though widespread, is misplaced. Here again Story argues that economics is a richer body of thought than Moore credits and is already tackling – in its own way – the purported inadequacies that Moore identifies.

I find myself somewhere between these positions. Moore's argument is a monumental, and rather confused, generalisation. Yet, it is hardly news that economics finds itself in the dock over the 2007-08 financial crisis and its fallout. And so it should be. Perhaps the most high profile examination so far was the film *Inside Job*, which raised important questions about the ethics of economics and (some) economists. Prominent members of the discipline have been forthright in their condemnation of the failings of contemporary macro (as I've discussed in earlier posts). There is no credibility in the argument that economists are not –

even partially – culpable for the problems we now face. And I would not be entirely optimistic about the discipline's capacity to deal successfully with its own deficiencies.

But which "economics"?

One of the problems with this discussion is the term "economics". It is used almost indiscriminately. Often several significantly different meanings can be in play at the same time.

"Economics" can refer to what is actually happening out there. That is, in the portion of the social world we label "the economy". Where business is conducted. Trade occurs. Needs are met or go unfulfilled. Fortunes are gained and lost.

Or it can refer to the sort of economic arguments and understandings that circulate in public discourse – in the papers and the pubs – which was discussed a decade or so ago under the heading "ersatz economics".[20] This bears no necessary relationship to "proper" economics.

Or it can refer to the "proper" economics associated with the academic discipline that carries the name. Even here we can differentiate between the economics encountered in the textbooks – the sort that those who have studied economics are familiar with – and the state of the art in economic research, much of which is utterly impenetrable to outsiders.

Then, finally, it could be the economics that is influential in policy circles. This is often a radical simplification of economic thought, in part because that is what is digestible to non-economists. There is, for example, a strand of free market zealotry, often peddled by the libertarian component of the Think Tank industry, which could no doubt win prizes for sticking faithfully to the simple nostrums preached by Chicago price theory in its pomp. But it bears almost no relation to the more qualified appreciation of what markets can deliver that characterises much subsequent and contemporary "proper" economic thought. Many economists recognise the limits to what markets can achieve or the contingencies underpinning market success. But they aren't the ones relentlessly pushing free market ideas into the policy process. Or bending the Minister's ear about the indisputable benefits of marketising everything that is as yet untouched by the market's cold embrace.

As for the economic ideas propounded by politicians with no formal training or appreciation of the field, radical simplifications would be the best that could be said for them.

Of course, it isn't just Think Tanks who act as policy entrepreneurs for marketization. *Inside Job* illustrated the role that some economists have played in moving out of the academy and into the policy arena. A more detailed discussion of these moves has been provided by Donald Mackenzie in his work on the way in which economists such as Friedman, Black and Scholes played a role in acting on the world to transform it to better accord with their vision of how it should be ordered.[21]

The disaster of Long Term Capital Management should perhaps have alerted us to the risks of these types of intervention. But clearly the financial markets, financial theorists, and financial regulators weren't paying close attention. So when Andrew Haldane argued this week that new models of financial markets are necessary he is right. But the point should have been obvious for quite a while.

When we argue that economists are to blame for the mess we're in, what exactly are we referring to? Which flavour of "economics" are we objecting to?

When "proper" economists move into the policy world and start to advocate for putting their theories into practice, what status does that activity have? Standard economics lays great emphasis upon the positive/normative distinction. The "science" of economics is the positive analysis of the world as it is. It has an aversion to normative claims. So when economists start lobbying policy makers for change because this or that theory says the world would be a better place if it were remoulded to conform more closely to the theory, is that even "economics"? Or is it something else entirely?

Economics: somewhat less benighted

If we restrict ourselves for a moment to "proper" economics the picture is, as Dillow and Story point out, more complex than Moore appreciates.

Economics is a global discipline which covers a range of perspectives. So to talk of "economics" as a unified body of thought is wrong-headed. But, at the same time, it is a discipline in which there is a strong orthodoxy, a reasonably clear global hierarchy, and a heterodox periphery. It is a more unified body of thought than any other science of society.

The received wisdom is that heterodox economists struggle to be heard and largely participate in conversations parallel to the mainstream. These are not the people who shape the economic canon. Yet, there are signs that this may be changing slowly. The World Economics Association – which was launched last year by those unhappy with the perceived hegemony of orthodox approaches – is now the second biggest membership organisation in the field. Among heterodox economists a range of ontologies are deployed, many of them explicitly reject then sort of asocial models of the individual that Moore rails against.

But it wouldn't be right to look entirely to the dissidents to remake the discipline in a new image. Indeed, some heterodox economists operate with a somewhat caricatured – or, perhaps more accurately, outdated – understanding of what the mainstream is up to. For example, while rational choice approaches undoubtedly continue to dominate microeconomics, there is plenty going on under the heading of behavioural economics that moves the discipline away from simplistic models of narrowly defined and clear-eyed preference satisfaction. Some of the most interesting papers being produced at the moment are trying to wrestle with precisely the sort of qualitative, emotional or "non-rational" factors shaping behaviour that Moore identifies. The idea of bounded rationality is now commonplace, although frequently not used in the way that Herbert Simon intended. Equally, there is an explosion of interest in breaking away from atomistic conceptions of decision making to recognise a range of interaction effects – reference levels and relativities, peer groups, neighbourhood effects, herding and the like. This opens up possibilities for multiple equilibria, path dependency and all sorts of sub-optimal outcomes. Many of these developments therefore have the potential to transform our understanding of the welfare implications of market allocation mechanisms. Once you place "individual failure" alongside market failure and government failure the world starts to look rather different.

Whether such moves ultimately lead to the transformation of the discipline remains an open question. In part this is because the implications of these ideas have yet to be worked through fully. But they also pose a threat. Some of these developments in economics are deeply uncongenial to those who hold to a conservative, free market ideology. You only have to look at the critical – at some times rather rabid – response to Sunstein and Thaler's libertarian paternalism or Robert Frank's arguments about income relativities and status effects to appreciate this.

Yet, while mainstream economics now tolerates ideas that would have been ruled out of court a few years ago, there remain significant blind spots. For example, macroeconomics seems in thrall to market-clearing models that are not fit for purpose. The challenge is to change the path that theory has been pursuing for the last couple of decades. You would have thought that the spectacular failures to anticipate the global financial crisis would lead to a major rethink. While some prominent economists have called for this, it is by no means certain it will follow. It could be argued that the discipline has become locked into a sub-optimal developmental path by its incentive structure, but that is an argument for a different day.

Standing back

We are going through a period of exploration and innovation in economics, but significant ontological issues remain largely unexamined. Ontological issues are at the heart of much that separates the social science disciplines and schools of thought within a discipline. But economists don't tend to do philosophy. At a push they might venture into methodology. But rarely do you encounter explicit ontological or epistemological reflection.

This is unfortunate because it can act as a brake on change and progress.

We can contrast this with previous eras in which such philosophical reflection was a legitimate part of economic discourse. I was reminded of this last week during a Twitter discussion in which someone mentioned the Cambridge Capital Controversies.[22] There was a time when puzzling over what precisely "aggregate capital" might refer to, and the dangers of the fallacy of composition, was a pressing issue at the centre of economic debate. It wasn't banished to some darkened corner where economic methodologists gather. Hard to imagine today.

One of the most obvious contemporary illustrations of this is the way in which economics treats uncertainty. We might think that recent events have rendered rational expectations approaches even more questionable than they were previously. But where next? Mainstream approaches tend to transform uncertainty into risk, albeit with a growing acceptance that risks in some markets may be fat-tailed rather than normally distributed (as discussed in the Haldane paper on financial markets cited above). Post-Keynesians, on the other hand, argue that genuine uncertainty cannot meaningfully be "tamed" by translating it into risk. Action in the face of radical uncertainty has to be the starting point of analysis, it cannot be abstracted away, even as a first step. Recent debates have disinterred the

Keynesian concept of "animal spirits" in a bid to understand what is happening on the capital markets. But few have fully taken on board the implications of embracing caprice among market actors. Deep Keynesians like Shackle would argue that radical uncertainty transforms the methodology of economics and renders much of the formalism of orthodox economics beside the point, a position shared by many Austrian economists.

And that is the reason why such ideas do not gain much traction. Logical consistency, parsimony and tractability are valued. Highly-prized formal methods are privileged over a plausible ontology.

Constructive critique

I welcome Suzanne Moore's post. Not for the force of its argument but because, by inviting a response, it helps to sharpen the counter-arguments. It hints at some genuinely important questions not just about economic analysis but about the role that economic ideas play in the policy process. But it is not a very effective critique of those ideas. If anyone is interested in examining the current state of economic knowledge in a rather more informed and balanced way then I'd suggest starting with Roger Backhouse's excellent short book from a couple of years ago.[23]

The maths question in economics

24th October 2012

Over at Noahpinion last week a post on [the role of maths in economics] generated plenty of comment. This followed the award of the "Nobel Prize" in Economics to Shapley and Roth for work that is, in almost anyone's book, highly mathematical. Noah Smith identified a number of reasons for using maths in economic analysis, each of which could be a good or a bad reason, depending on circumstance. His broad conclusion is that:

> Math is not always the most appropriate tool in economics. But the more real successes economics achieves, the more *good* math it will use.

He argued that there are times when it would be appropriate to make less use of maths in economics. The argument here is summarised as:

> The only time not to use math in econ is when we haven't found the right math yet.
>
> And in practice, I find that a few of the people calling for less math in economics … don't seem to have any such goal in mind. There are a few people out there who would rather econ stay imprecise forever – so that nobody will ever be proved wrong or right, and we can let a million flowers

bloom, and everyone's scholarly opinion about the economy will be equally valid.

This is a debate that I spent some time thinking about a while ago. I have written a little about it in relation to the specific applied field of housing economics. It was interesting to revisit the topic for the first time in a while.

It strikes me, though, that this brief flurry of interest in the maths question is framing the discussion a bit too narrowly and missing some of the significant points.

One problem with which economic analysis can be afflicted is that, without care, methodology drives ontology. If the only tool you've got in your toolbox is a hammer then everything looks like a nail. When econometricians were restricted to working primarily with linear functions then all curves were linear, by assumption and as an approximation. As the techniques of nonlinear dynamics became better understood and more widely used suddenly we were happy to accept all sorts of behaviours and possibilities – such as multiple equilibria or complex dynamics – that previous generations of economists couldn't easily accommodate or actively sought to prove to be impossible.

That is just a variation on Smith's point that 'we haven't found the right math yet'. Seeking to contort the economy on the procrustean bed of an inappropriate mathematical technique can disguise more than it reveals.

But there is a more fundamental sense in which methodology – particularly mathematical formalism – can drive ontology.

Perhaps the most famous example is the case of Hicks' 1937 interpretation of Keynes' General Theory.[24] Hicks seemed to have managed to tame Keynes' approach into an economic framework that was intelligible to conventional economists of the time. However, in doing so he emptied Keynes' approach of some of its most novel components – particularly the role of genuine uncertainty – because they cannot easily be incorporated into the mathematical frameworks used at the time. In his later years Hicks recanted. He felt he'd sent the debate off in an unhelpful direction. The risk/uncertainty problem is still with us. You can't travel too far down the road of an economic discussion of uncertainty before it is operationalised as probabilistic risk, which is a completely different phenomenon.

That is why I would depart from Smith in his characterisation of the "less maths" brigade. I wouldn't dispute that there are some with the motivation to insulate their theorising from any form of testing. But there have been some heterodox economists who eschew the use of much mathematics because they conceive of the economy as something that cannot be tamed and parameterised. They have an ontological stance which leads to a different methodological palette. If you conceive of the economy primarily as a discovery process involving agents operating in open systems making genuine choices under radical uncertainty, who use conventional decision rules and are subject to the double hermeneutic, then there is little to be gained from overly elaborate algebraic specification or heavy duty estimation. Structural stability is a chimera. The economy is an embodiment of Heraclitus' famous aphorism: you cannot step into the same river twice.

Equally importantly, the maths question is about the allocation of scarce resources. Maths undoubtedly has a part in economic analysis, but does it justify the pre-eminence it currently has? That depends on your view of what economics is trying to achieve. Given disciplinary incentives it makes absolute sense for individuals to focus on signalling advanced mathematical ability, because they know that's what gets published in prestigious journals and plays well at hiring time. It delivers clever models and analysis honoured as being "deep".

But if the aim of economics is to advance our understanding of the economy then perhaps the allocation of effort to theory is less obviously justified. Twenty years ago Thomas Mayer argued that we can think of economic explanation as a chain.[25] The economics profession seems intent on strengthening the links in the chain that are already the strongest – the models – to the detriment of improving the links in the chain that are weakest – the plausibility of assumptions, the behavioural foundations of the models, the operationalisation of concepts, the quality of the data used to test the models. And if a chain is only as strong as its weakest link then that isn't a wise strategy.

Finally, there is the link between the mathematical models and the way in which they map on to the economy. One of the commenters on Noah Smith's post cited Alfred Marshall's famous quote:

> (1) Use mathematics as a shorthand language, rather than as an engine of inquiry.
>
> (2) Keep to them till you have done.
>
> (3) Translate into English.
>
> (4) Then illustrate by examples that are important in real life.
>
> (5) Burn the mathematics.
>
> (6) If you can't succeed in (4), burn (3).

Smith is avowedly not a great fan of *argumentum ad verecundiam*, but this quote seems to me to have something useful to say. It can be interpreted in different ways. I tend to focus on point (4) and think of it as an anchor. It is a prescription for stopping economics drifting off into its own world of abstraction. It demands that the discipline is not engaged in mathematical pyrotechnics simply for the fun of it. The analysis has to be illustrated with examples from real life. And not by trivial examples or stylised facts but by examples that are of real world importance.

Some economists who prefer to work with serious mathematics never lose sight of what the discipline is ultimately trying to achieve. They are willing to anchor discussion in "examples that are important in real life". But it is hard to dispute that some have drifted off into the ether, perceiving no great need or obligation to root what they are doing in advancing our understanding of the economy.

So students who come to economics to see if they can understand the world, address the pressing questions of the day, and maybe make the world a better place, end up having their heads stuffed full of maths which appears to have limited relevance to anything of significance. Master the technique; never mind the intuition, let alone the application. They may be mistaken in forming that impression, but it is understandable that they do. And that's your problem right there.

Economists in reflective mood

17th November 2012

Next weekend Bristol will host the Festival of Economics, organised under the auspices of the Festival of Ideas. The programme for the Festival of Economics has been assembled by Diane Coyle of Enlightenment Economics. It brings together economic journalists, applied academic economists, and economists in the think tank world who seek to talk directly to policy makers. Some are relatively mainstream in their orientation. Some are decidedly more heterodox.

The arrival of the festival coincides with my finally getting the chance to finish Diane's recent edited collection *What's the use of economics? Teaching the dismal science after the crisis* (WTUOE).[26] The book arises out of a seminar held back at the beginning of the year, which I would dearly have loved to have attended. Unfortunately it clashed with teaching my economics of public policy unit. The book comprises 22 brief chapters giving a range of perspectives on how economists should respond to the deficiencies exposed by the 2007-2008 financial crisis.

At least some parts of the economics community are in reflective mood.

One of the key questions contributors to WTUOE address is how the curriculum at undergraduate and postgraduate level should be changed to equip students with the knowledge they need to put economics to work in the real world. Much economics education, particularly at postgraduate level, is geared towards producing academic economists specialising in producing clever models addressing relatively esoteric concerns. But the vast majority of students with training in economics won't go on to have academic careers in economics. Particularly relevant here are a couple of thought-provoking contributions on the role and activities of economists in government.

Equally profoundly, how does economics need to change as a body of knowledge in response to the explanatory failures of existing approaches?

The discussion of how economics students can be better equipped encompasses both macro and micro, while the discussions of the theoretical adequacy or otherwise of contemporary approaches is mostly macro oriented. Given that the starting point of the discussion is the financial crisis that is understandable.

The contributors to WTUOE differ significantly in their views on how much established economic approaches need to be modified. The minority view among contributors is that mainstream approaches need a bit of tweaking. With more sensitivity to characteristics of real world economies which don't typically feature in conventional RBC models of whatever flavour – institutional structures, the banking system, finance and debt – perhaps business can continue pretty much as usual. However, the view that a more profound shift is necessary is just as frequently encountered as you go through the chapters. Contributors argue that models that rely on representative agents and rational expectations, for example, are inappropriate tools for analysing networked societies of heterogenous agents interacting on the basis of bounded rationality. Alan Kirman provides a typically thoughtful contribution. The argument is not the sort of anti-formalist argument that some heterodox economists advance. Rather the argument is that economists have got stuck using the wrong sort of mathematics. They need to embrace a vision of the economy as an evolving complex system. And that implies fundamentally different modelling strategies.

The contributors similarly differ in respect of the teaching of economics students. A minority view is that there isn't a great deal that needs changing. But the more common argument is that economics education has become too specialist and too narrow. There is little space in the curriculum for the history of economic thought or economic history and the study of the evolution of economic institutions. Where student do applied work it often involves the secondary analysis of other people's data. Rarely do students explore the problems associated with collecting primary data – either administrative data or through surveys. The judgements involved in transforming the messiness of the world into the neatness of the rectangular data matrix – problems of coding and classification – go unexamined. These are topics that other social scientists find squarely at the centre of their research methods training. But economists tend to be rather incurious about the processes by which the data arrive in the archive. Never mind "garbage in, garbage out", it tends to be full speed ahead to apply the most complex statistical technique they know. I caricature. But only slightly.

A number of contributions, particular those looking at the work of economists in government, highlight the emphasis of the economist's education on deductive reasoning rather than also exploring processes of induction. The strand of macroeconomic thinking that views the core of macroeconomics as primarily being about models that can be run on computers, without the urgent need to bring those models into close dialogue with real world economies, is deprecated.

Far from living a life of pure deductive reason, applied economists in the real world are often required to start by piecing together data before trying to make sense of it by applying some theory, while recognising the importance of institutional constraints and incentives in a way that much theory does not explicitly capture. The "science" requires a dose of the art of judgement in order to become useful.

Indeed, there is a suggestion that economists could do with being, at the very least, sensitised to the sort of concerns that sociologists, political scientists and psychologists bring to the analysis of society in order to enhance their ability to interpret the world effectively with the aid of economic theory.

A word that crops up several times in the contributions to WTUOE is "humility". There is the suggestion that there has been an unwarranted arrogance about mainstream macroeconomics. Several contributors feel that, having had its deficiencies exposed and its certainties undermined, this attitude needs to change.

Few of the contributors to the book framed their chapters explicitly in philosophical terms. Yet, much of the material was underpinned by some profound questions of ontology – what does "the economy" comprise? – and epistemology – how can we best represent and analyse "the economy"? In emphasizing the importance of the history of economic thought contributors raise important questions about how economic knowledge evolves. Indeed, whether it in any meaningful sense can be said to accumulate. In the absence of experiments or crucial empirical tests it is possible that knowledge evolves through fads, fashion or as a result of social factors. That opens up the possibility that good ideas were dropped for bad reasons. Or knowledge may move on as a result of real world events that demonstrate existing paradigms are inadequate. In this respect Wendy Carlin's chapter on reforming the macroeconomic curriculum was particular interesting. She suggests that it is possible to weave together the content of economic theory, the history of economic thought and economic history to give an account of how economic crises generate paradigmatic shifts in thinking, which feed into policy, which in turn generate new crises. Students would not only come to understand the content of different theoretical approaches to macroeconomics but do so in a socially embedded way. This in itself should, if done effectively, deliver an appropriate degree of humility about whatever is considered to be the current state of the art.

You'll not be surprised to discover that I am in agreement with many of the contributors to WTUOE who argue for this more pluralist approach to economics education. I have no doubt it is beneficial. Certainly it is the way I try to structure my own approach.

It is great to see some of these debates moving beyond the realm of the economic methodologists and edging closer to the mainstream. But I feel that there is still a way to go before it penetrates the heart of the citadel.

The reopening of the economic mind?

26th November 2012

Where is the revolutionary thinking in economics? That was one of the first questions posed by a speaker at the Festival of Economics held last weekend in a very damp Bristol. It is also one of the most pressing and the most intriguing.

I was among the hardy souls who bought a season ticket for the event and got a feel for the range of material covered. But rather than review the whole event I want to consider the issue of revolutionary thinking – posed as part of the session on *The future of capitalism* – in the light of the discussion in the last session on *Economics in crisis*.

The question about revolutionary thinking was part of a discussion reflecting upon the way in which paradigm shifts in economic thinking are associated with previous economic crises. Most notably, the rise of Keynesianism occurred in the aftermath of the Great Crash of the 1920s and the adoption of monetarism – and neoliberalism more broadly – took place after the apparent breakdown of Keynesianism and the appearance of stagflation in the 1970s. Where is the new thinking – the reconceptualisation of the macroeconomy and the role of the state – to go alongside the current crisis?

If we think a bit harder about the two previous crises it is clear that the relationship between economic crisis and economic theory is rather less straightforward. While Keynes had been piecing together the fragments of his theory over a period of years its articulation largely followed the crisis. Yet, the ascent of neoliberalism – as Daniel Stedman Jones highlighted in his presentation – was rather more deliberate and took decades. The ground had been well prepared. Policy entrepreneurs were ready to introduce monetarism when the 1970s crisis opened a window for policy change.

But that doesn't detract from the basic point. The ecology of economics has in the past been more diverse. It was possible for distinctive schools of thought to coexist in a way that appears no longer to be the case.

While one approach to economics was in the ascendant following the interventions of Samuelson, Arrow and Debreu it took a while to become embedded as the mainstream. In macro, real business cycle models continue to frame the debate. New Keynesian models may throw some grit into the frictionless world created by Kydland and Prescott but they are pressed from the same mould. And models that don't show at least a family resemblance run the risk of being disdained as irredeemably *ad hoc*. There is limited tolerance of heterodoxy.

This situation can be contrasted with the way microeconomics is developing. As Diane Coyle pointed out during the *Economics in crisis* session, microeconomics appears relatively open to new ideas and learning from outside economics – particularly in respect of the rapid movement of behavioural economics from the margins to the mainstream.

This is perhaps all the more extraordinary once you start enumerating the key characteristics of the macro models – continuous market clearing, rational expectations, representative agents, the absence of an explicitly modelled financial sector. It is hardly surprising that such models are unable to capture the characteristics of the current crisis. Yet, as Coyle noted, some macroeconomists have a problem even recognising that there is a problem.

Personally I wouldn't want to overstate the extent to which microeconomics is cognitively open, but the contrast is illuminating.

A point I have made repeatedly, from my rather semi-detached position, is that economics tends to prioritize methodology over ontology. Students spend a lot of time being drilled in the latest mathematical technique and solving problems. They spend less – or no – time thinking about what sort of an entity the economy is and how it should be modelled.

The rational expectations assumption is one of the best examples. Sure it maintains mathematical tractability. But really? Even on average? When professional macroeconomists don't have a particularly good grip on what the economy is going to do next?

I studied macroeconomics just as RE models were coming to full prominence. I'll be honest, I found them utterly implausible from the start, even as an approximation. They just felt misconceived at a foundational level. I guess that was part of the reason I fell out of love with much of the substance of economics and became more interested in the practices of economics.

Of course, since those days things have got a whole lot worse. At Saturday's session one student commented from the floor that he felt that he wasn't really studying an MSc in economics but an MSc in maths. He finished his remarks by rather plaintively wondered whether there might be potential to study something a bit more clearly related to the real world economy.

The presentations from the panel in the *Economics in crisis* session were fairly unified in their call for the economics curriculum to incorporate more consideration of the history of economic thought, economic history and the nature of economic institutions. These are all topics which have been progressively excised from the curriculum in many of the leading economics programmes. I would add to the mix the revival of the philosophy and methodology of economics; something which has also been sidelined to make space in the timetable for ever more ferociously complex mathematical and quantitative techniques. If there could be consideration of philosophy I would expand that to include ethics. Aditya Chakrabortty rightly referred to examples – such as those showcased in the film *Inside Job* – of economists facing substantial and self-evident conflicts of interest and nonetheless proceeding without reflection. This would be considered unethical practice in most other disciplines, but quite a few economists are nonplussed that the issue is even raised. I blogged about this in *Economists, implicated* back when the film was originally released.

Another student in the audience asked when they might see some of these topics featuring in the curriculum of a degree programme. While work is underway to progress this agenda, it is not a transformation that will be effected rapidly.

The panel also offered a general endorsement of the value of inter-disciplinary collaboration. Chakrabortty noted that some of the most interesting work on the economy is being done in places like Manchester's Centre for Research in Socio-Cultural Change or the new Sheffield Political Economy Research Institute. These research centres may involve economists working with scholars from other disciplines, and they are surely doing interesting and important work, but it would be interesting to see whether any of that work would have the honorific "economics" bestowed upon it by a prominent member of the economics professional.

That raises an issue that troubled me about the session. None of the speakers was a true defender of the faith. All were, at the very least, open to recognising the weaknesses of the economic approach and the possibility of learning from and collaborating with other scholars. But in this respect they were atypical of most of the economists of my acquaintance. The disciplinary incentives are massively stacked against this type of approach.

Young academics know that research is all that counts in recruitment. Departments want recruits – or 'hires' as economists are wont to call them – who are doing work that is "clever" or "deep" and addresses a theoretical or empirical puzzle that is preoccupying some part of the discipline. Applicants know that being able to offer a job market paper targetted at a journal that is considered core to the discipline, with plenty of ABS stars, is what counts. An R&R or acceptance in such a journal is even better. Applied work in field journals plays less well. Cross-disciplinary work can be frowned upon and considered rather third-rate: "not economics".

Academics with an interest in things like economic methodology or history of economic thought have a choice. Either they suppress that interest and do something deemed to be more important or they reconcile themselves to life in the academic slow lane. One can imagine that in the UK they might even end up in teaching-only positions so that their research doesn't have to weaken the power, or sully the purity, of the department's REF submission.

If one wants to change this situation the challenge is formidable. The discipline has followed a path-dependant process to an equilibrium that is now self-reinforcing. Conventionally we might say that an exogenous shock would be required to change the trajectory of the system. But the exogenous shock would need to be bigger than the Global Financial Crisis. Because that hasn't managed to trigger change and shift thinking at the core significantly.

I wonder what it would take?

I am reminded of a comment Paul Krugman made a while ago when he said he couldn't see a way forward: he suggested that what was needed to work out how to change the discipline was a sociologist not an economist. Someone who understands the way in which strong group cultures are formed, sustained and can be changed.

Now there's an admission.

Morality, tax and tax morale

5th December 2012

Many have been outraged that large companies appear to be paying next to no tax, often over periods of many years. Amazon, Google and Starbucks have felt the heat of consumer anger and the media spotlight. There are repeated calls for a clampdown on tax evasion – if there is any – and tax avoidance, whether aggressive or otherwise.

At one level it is odd that this has come to light now, because we are talking about tax-minimising practices that have been around for a long time. Scholars who have studied globalisation have noted the scope for these sorts of practices. Governments often respond to international competition by cutting tax rates, which has led to longstanding concerns about a so-called "race to the bottom". Evidence that this is a problem in general – if not the lurid individual case studies – has been around for a while.

But given the parlous state of the government's current fiscal position and an austerity agenda that is doing real damage to people's lives it is perhaps not so surprising.

Starbucks has been back in the news because it is negotiating with HMRC over its tax liabilities. The suggestion is that this is because they have bowed to moral pressure. Martha Gill in the New Statesman argued that this is precisely the wrong thing to do. The taxation system should be grounded in a strong legal framework. Tax liabilities should not be determined or amended by the degree to which people are outraged.

I have to say that I largely agree with this position. Companies have a fiduciary duty to their owners which would include minimising tax liabilities using all available legal means. If we don't like the level of tax at comes out the end of that process then the primary problem is the politicians who set the rules rather than the individual companies that take full advantage of them. Of course, politicians may well set the rules under pressure from perceived external competitive threats, corporate lobbying or international obligations – so the susceptibility of politics to the corporate sector may be at the root of the problem, but that is a broader issue.

It may be that many feel that they have given up hope of the political system responding to their concerns. Tough political rhetoric about curbing tax avoidance, closing loopholes and cracking down on evasion is not perceived to be followed by similarly tough actions. Truly effective action on tax avoidance and evasion needs to be taken at supra-national level. Given the difficulties in concluding agreements in such international negotiations lack of progress is as understandable as it is dispiriting.

So the alternative is to apply pressure directly to the corporations. Unlike politicians, they have reputations to protect. So they may buckle. That might be understandable, but I'm not sure it'll turn out to be the best course of action.

I suppose my underlying concern is that the debate over these high profile corporate tax avoiders fails to recognise that corporations don't really pay tax. Or rather they (may possibly, in some cases) hand over the money to HMRC but they don't actually pay it. Ultimately the tax burden falls either on consumers, workers or the owners.

That isn't necessarily an argument against corporation tax, but an argument that the consequences of pressing for higher corporation tax need to be better understood.

Crudely speaking, a company's profit is the excess of its income over its costs. Levying a tax on profit reduces the profit available for distribution to the company's owners. So shareholders will receive a lower income. If the shareholders are shadowy hedge funds or fat cat managers who are maximising the company surplus in order to line their own pockets we might say 'good'. But if the shareholders are pension funds who then have problems covering their commitments to sustain the incomes of older people we might say 'not so good'.

But, of course, each of the three components of this equation – profit, income and costs – is a variable that can be manipulated, both in reality and in accounting terms. And multinational corporations have more scope for creativity than domestic firms because they can shop around tax jurisdictions.

If profits are taxed more heavily but a firm feels it has to continue delivering the expected income to shareholders – otherwise it'll be punished through its share price – then it could bump up the price of its goods, if the market isn't too competitive. So it is consumers who ultimately pay the increased tax burden.

On the other hand, if the market won't stand an increased price then the company will look at reducing its costs to restore profitability. Costs, crudely, comprise land, labour and capital. For a firm like Starbucks there is limited flexibility on land. There is little point closing your branch on High Holborn and opening one on an industrial estate on the edge of town simply to save money on land. It would appear from recent accounts that the company is already minimising the costs of non-labour inputs through a range of aggressive transfer pricing mechanisms such as apparently buying coffee beans from countries that don't produce coffee.

That only leaves reducing the costs of labour. So it is no great surprise that the Guardian reported on Monday that Starbucks is in the process of adversely changing the terms and conditions of their employees in order to reduce labour costs. Some have suggested that this is in response to the pressure to pay more corporation tax, although Starbucks deny it and say that this process of changing terms and conditions has been under way for months. I'm not sure that it matters which version is correct. If the company's strategy has already minimising its other costs, reducing labour costs was the logical next step if it is looking to boost profitability further.

But if it is a move in response to the pressure to pay more corporation tax then that just demonstrates the point that it isn't the company but the workers who ultimately paid for the increased tax burden in this case.

This may all sound like an apology for corporate cupidity. Some economists would use these arguments as the basis for seeing corporation tax as fundamentally ill-advised. Some might argue that rather than tax corporate profits it is better for those profits to be distributed and to tax wealth holdings, because that reduces the latitude for profit expectations feeding back into increased costs for consumers or increased exploitation of workers. But as a practical matter we tend to find advocacy of low corporation tax coexisting with advocacy of low levels of all other varieties of taxation.

My intention is not to be an apologist. Rather my intention is to point out that once you start thinking about tax incidence the issue becomes more complicated. People may be outraged and want to "punish" firms they see as being involved in tax scams. But it may not be the firms that are ultimately punished.

If we wanted to create real change in this field then we'd have to go back to a broader debate about tax morale. Only if there is a broader debate about the purpose and benefits of taxation, and a broader acceptance that taxation is necessary and appropriate, coupled with concerted efforts to restructure tax law in a way that reduces the scope for abuse, are we going to make any progress. And for that we need some leadership from politicians.

I find it hard to be outraged by the actions of Amazon, Google, Starbucks et al. It's more a weary sense of expectations fulfilled. Clearly they have taken the pursuit of tax minimisation to the limit. And in the process they have an unfair competitive advantage over firms that cannot exploit the flexibilities of multination operation. But they are only doing what comes naturally to firms in a capitalist system. I find it peculiar that there is broad-based popular support for the system of social organisation that is globally dominant, and yet distaste at its logical consequences.

Capitalism is great, apart from the capitalists.

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