Agenda, Volume 8, Number 3, 2001, pages 266-272

Economic Rationalists and Irrationalists

*William Coleman and Alf Hagger, **Exasperating Calculators: The Rage Over Economic Rationalism and the Campaign Against Australian Economists**, Macleay Press, Paddington NSW, 2001*

Reviewed by ***James Cox***

The authors of this book argue that the debate over economic rationalism has damaged Australia. A campaign was launched in 1991 against economic rationalism, an economic policy that was adopted by Australian governments during the 1980s and 1990s. But increasingly the campaign came to be fought against economists. This is because, in the minds of the critics, it is economists who give rise to economic rationalism. Coleman and Hagger use the term 'economic irrationalists' to refer to the critics of economic rationalism and it is convenient for me to do the same in this review.

The campaign against economic rationalism, the economic policy, has in the authors' view been largely unsuccessful (p. 297). This is because policies such as tariff reductions and privatisation continued to be implemented during the 1990s despite the efforts of the campaigners. Nevertheless, there is less support for these policies in the general community now than during the 1980s and politicians have adjusted to the changed climate of opinion. The authors argue that, by contrast, the campaign against economists has been much more successful. The results of this success can be seen in declining enrolments in economics courses in secondary and tertiary education, less attention given by the media and academic colleagues to the views of economists on problems such as unemployment and, above all, increased unpopularity of economists which leads to embarrassment in social settings such as dinner parties and games of golf. 'Overall', the authors (p. 300) argue,:

> the end result of Economic Irrationalism has been to reduce the authority of economists, to reduce the respect for research and specialism in the public mind, and to lodge in their place a horrid incubus, to alarm and, of course, to be blamed. Conversely, another part of the legacy has been to confer honours on those prominent in the Irrationalism campaign …. We wonder if the campaign against economics has encumbered the problem-solving ability of Australia in general and given room to tirade and propaganda in general.

The authors are, they say, motivated by a 'sense of shock at the exaltation of the state that we thought had been extinguished by the events of the 20th century – a disgust at the disrespect by the public culture for intellectual standards, and indignation at the swinish calumny heaped upon decent and useful people.'

Exasperating Calculators is, like Economic Rationalism in Canberra (the famous book by Michael Pusey that launched the debate) organised in a number of

levels. The first level provides Coleman's and Hagger's assessment of the worth of the contributions made by the economic irrationalists. The authors argue that these contributions are without value. The second level provides an assessment of the contributions that Australia's economists have made to the economic rationalism debate.

Coleman and Hagger conclude that, on the whole, economists have not been effective in the debate. Few economists took part in the debate and those who did were unnecessarily tentative. By contrast, Coleman and Hagger argue that economists should have pointed out the weaknesses in the arguments of the economic irrationalists and drawn the public's attention to those things concerning the role of government in the economy that economists agree on rather than those things that economists do not agree on.

The third level of Coleman's and Hagger's argument places the debate over economic rationalism into the broader context of anti-economics. They point to the long history of anti-economics in Australia and elsewhere and to the enthusiasm with which economic irrationalist views were taken up by certain sections of the media. They argue that episodes similar to the debate about economic rationalism are likely to occur in future and that economists need to be better prepared for them.

I now turn to the more detailed comments on Coleman's and Hagger's contribution at each of the levels. The assessment of books and articles of economic irrationalist intellectuals is the foundation on which the Coleman's and Hagger's book rests. Coleman and Hagger (p. 290) have defined the criterion for success for this part of their work as follows:

> We hope that, in opening these pages [our readers] held Economic Irrationalism to have some value: that it landed some palpable hits on Economic Rationalism and economists (even if it exaggerated those hits), or that it was a worthwhile corrective to Economic Rationalism (even if it was biased). It is to purchase the assent of such readers to our claim of worthlessness that we have written this book.

The relevant chapters of Coleman's and Hagger's book satisfy this demanding requirement to varying extents. Chapter Three examines the book that started the debate – Michael Pusey's famous 'Economic Rationalism in Canberra'. In this chapter Coleman and Hagger establish convincingly that Michael Pusey's conclusions that 'a disproportionate number of bureaucrats come from privileged social backgrounds' and 'our top public servants are far more conservative than they say or believe' are not well supported by his survey of Senior Executive Service Officers in Canberra. Rather, these conclusions were arrived at by reading into the survey results supplementary information that may have been available to Pusey but certainly was not available to his readers, and by rhetorical devices that appear to make something out of nothing. In honour of its subject, the notoriously

unfactual Michael Pusey, this section includes some factual errors — see, for example, pages 52 and 55[1].

So far, so good. However, an open-minded reader who is moderately sympathetic to economic irrationalism might note that Coleman and Hagger discuss only two of Pusey's six chapters. Although they raise some interesting issues, I agree with Coleman and Hagger that the missing few chapters are not any great value. However, their readers will have to take Coleman's and Hagger's word for this.

Chapters Five and Six deal, respectively, with the contributions of the economic irrationalists of the left and the right. These contributions are dealt with fairly briefly. A summary of the author's argument is presented, followed by an assessment by Coleman and Hagger. These assessments emphasise (in particular) the factual errors made by the economic irrationalists, but also their ignorance of economics and history, logical errors, weakness of argument and (sometimes) unpleasant social values. Chapter 11 (on 'Third Ways and Half Measures' includes similar material, especially in assessing contributions by the prophets of antiglobalisation, Saul and Gray. Coleman and Hagger think that open-minded readers will be impressed by the sheer number of factual errors that they find in the work of the economic irrationalists.

These errors, in the author's view, go beyond carelessness and indicate an absence of concern for reality. Or perhaps Coleman and Hagger think that calling the economic irrationalists to account for their misdeeds will discourage similar productions in future. I am not sure that they are right about this. Despite the factual errors, an open-minded reader might conclude that there is something in what the economic irrationalists were trying to say but they had not managed to say it very well. In particular, Coleman and Hagger do not attempt to guide the reader to a more satisfactory analysis of the issues raised by the economic irrationalists. It is interesting to compare Coleman and Hagger's discussion of Robert Manne's views on the desirability of protecting Australian industry (pages 78-90 of Exasperating Calculators) with their account of John Stone's response to Manne (pages 168-171). Coleman and Hagger point to the factual errors made by Manne and the view that he 'insinuates' (p. 85) that 'it is beneficial if economists are ignored in the formulation of economic policy'. By contrast, Stone gets to grips with Manne's arguments and explains why they do not support Manne's conclusions.

The second level of Coleman's and Hagger's analysis examines the contributions of economists to the economic rationalism debate. The authors think that economists have been far too charitable to their adversaries. This is not an error that Coleman and Hagger wish to perpetrate. No one emerges unscathed

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[1] The errors are as follows: at page 52. Coleman and Hagger write: 'We start with questions 20 and 21, the first two questions in Part Two. They are dealt with in Chapter 4 of the Pusey book' — in fact, they are dealt with in Chapter 1 of that book. At page 55 they write: 'One gathers from the wording of the seventeen page commentary which Pusey presents, following the two tables in question (Pusey 1991:37-44) …' — as the page reference suggests, seven pages is correct.

from their examination – not even John Stone, although he does better than most. Chapter Six examines the contributions of those who attempted to order the debate by providing a definition of economic rationalism. This, ultimately, has proved to be a fruitless task because the debate has been about many things, not one thing. Chapter Seven examines the writing of economists who were in favour of economic rationalism. Some of these economists attempted to destroy the arguments of the economic irrationalists. Coleman and Hagger approve of this activity but they think that economists (with the notable exception of John Stone) have not been very good at it. Other economists attempted to provide arguments in favour of economic rationalism. According to Coleman and Hagger, these arguments have not been very effective; I should add that I am one of those criticised here.

Chapter Eight examines 'the sociologically interesting phenomenon of economists spurning Economic Rationalism and, indeed, economics' (p. 206). This chapter makes the useful point that economic rationalism is not the same thing as neoclassical economic theory. Chapter Nine examines why economists were so ineffective in the debate and draws attention to some truly embarrassing attempts by some economists to appease their adversaries.

The most interesting chapter in this second level of analysis is Chapter 10 which presents the authors' views about what economists should say to the wider community about the economic role of government. The authors believe that economists should talk to the wider community about the things they agree on rather than the things they do not agree on. They then present their own views about what economists agree on.

The result is strongly reminiscent of our old friend, the analysis of market failure. To my mind at least government failure, while recognised, is under-emphasised. As has been noted recently (see, for example, Stiglitz, 1998) there are systemic reasons why governments often find it hard to achieve the objectives they set for themselves. A more important point is that the account of things that economists agree on presented by Coleman and Hagger is entirely theoretical. As such, it provides no useful guidance on what should be done in a practical situation. Empirical knowledge, which economists certainly possess, is needed for this. As is well known, arguments for industry protection that are perfectly consistent with neoclassical economic analysis are invented (or rediscovered) from time to time. The desirability of low rates of protection is something that most (but not all) economists agree on because they doubt the empirical applicability of the arguments for protection. The things that (most) economists agree on should, in my view, therefore be extended to include some empirical knowledge.

The third level of analysis in Coleman's and Hagger's book looks for the reasons for the popularity of the campaign against economic rationalism. Chapter One points to the surprising success of Michael Pusey's unreadable book. Chapter Two discusses some contributions to the debate by members of the public who were not professional intellectuals. Finally, Chapter 12 offers some reflections on why the debate on economic rationalism occurred. The campaign took off, the authors argue, because some sections of the media agreed with the views of the

economic irrationalists. The role of Pusy's book was to provide academic legitimacy for views the media already held. As Coleman and Hagger (p. 306) put it:

> In 1991 University Tests Proved that Economic Rationalism was bad for you, and the media fell for the shaggiest line in the ad man's book.

Coleman and Hagger discuss 'the campaign against Australian economists' largely in terms of the writings of economic irrationalists and their opponents. Although what is written is important, there is surely much more to the campaign than this. Moreover, although Coleman and Hagger emphasise the extent to which economic irrationalism is offensive to commonly held social values in Australia, it is equally clear that the climate of opinion has become increasingly hostile to the market economy in recent years throughout the developed world as well as in Australia. I suspect that many members of the general public as well as the media would have agreed with much of the criticism of economic rationalism. Most people who have not been trained economics (and even professional economists in their less guarded moments) hold what David Henderson (2001) calls pre-economic ideas that tend to be protectionist, hostile to the market economy and supportive of government intervention. Henderson refers (p. 86) to:

> the strongly held intuitive notion that market economies, which are taken to be anarchic and amoral, are heavily populated with non beneficiaries and victims — the deprived, condemned, excluded or marginalised – whose well-being depends on collective action by (society) or 'the international community' to bring deliverance from above.

On page 87, he notes the emergence of new millennial collectivism,

> in which mistrust and misunderstanding of markets goes with global salvationist ideas and a strong intuitive bias towards interventionism. In effect, there is today an informal but wide-ranging alliance of those who share this view of the world and broadly agree on what needs to be done. Besides many businesses and some business organisations, it comprises trade unions, the moderate NGOs, commentators and public figures including parliamentarians, political leaders and civil servants in a good many government departments, a range of interventionist quangos, and most U.N. agencies.

Coleman and Hagger point (eg, pp 83-90) to the real, although not very precise, knowledge of economic processes that economists possess. Economists, in their view, can provide the best guide to the likely economic consequences of government policies. In practice, economists are valued by policy makers more for their technical skills than for the general ideas they hold about good economic and social policy. On these broader issues policymakers, who may well have studied economics in their youth, and who consider their experience of life to be at

least equal to that of the average economic adviser, are more likely to be guided by pre-economic ideas.

What conclusions can be drawn from this discussion about the success of the campaigns about economic rationalism and economics? Coleman and Hagger are right to note that economic rationalist policies were, at least in some policy areas, followed during the 1990s. Despite the rhetoric, governments (for reasons of their own) continue to follow some economic rationalist policies, including privatisation. However, the impetus towards further microeconomic reform has eased in recent years and the regulation of business for 'social' rather than economic reasons has tended to increase.

Perhaps Coleman and Hagger do not emphasise sufficiently how exceptional the 1980s were in Australian history. Economic rationalist policies were embraced, not because they were especially liked but because they were thought necessary to address poor economic performance. The impetus to make further reforms receded as economic performance improved during the 1990s; the community chose to give greater weight to objectives other than economic objectives. However, as noted earlier in this review, the growth in influence of ideas that are hostile to the market economy is worrying. It is notable that Treasuries and Departments of Finance have not been effective in countering these views either in Australia or overseas countries. Indeed, less effort is now being made to explain the advantages of economic reform to the general community than during the 1970s and 1980s. A renewed campaign to explain the advantages of low protection and economic reform more generally may be needed during the next few years.

What about the success of the campaign against the economists? Here I think that Coleman and Hagger are guilty of exaggerating both the extent to which economists have lost ground in recent years and the extent to which the debate over economic rationalism has been responsible for economists losing ground. Economist have not, contrary to Michael Pusey's wishes, been expelled from the institutions. Nor are they likely to be. Their quantitative skills are far too valuable to policy makers even if their values are suspect. Good economics graduates readily find employment, enrolments have been maintained at the honours level (as Coleman and Hagger note) and professional economists continue to be appointed to influential positions. It is true that enrolments have fallen at secondary and pass degree levels, but the growth of business education as an alternative (and easier) route to a vocationally relevant education is an alternative explanation that is likely to appeal to many economists. Even here, economists may be successful in persuading students that courses in economics are an important part of a vocationally relevant education (see, for example, Ward et al, 2001; Keneley and Hellier, 2001).

Coleman and Hagger argue (p. 298) that New Zealand has had a lesser decline in final year high school enrolments in economics than Australia. This, in their view, illustrates the success of the campaign against economists. Two points should be made here. First, New Zealand like Australia has seen a retreat from the politics of economic reform in recent years. There has been much in common

between the two countries in terms of the movement in public opinion. Secondly, the authors of the article from which Coleman's and Hagger's data is taken (Alvey and Smith, 1999) attribute the decline (in both countries) to competition from business studies programs, which may have taken a more virulent form in Australia (pp 94-95). The reader of Coleman's and Hagger's book is not told this.

The final word here should be about the issue of popularity. As noted, Coleman and Hagger are concerned about the decline in the social standing of economists. It is not easy to be someone who advances unpopular views. A desire by Australian economists to avoid unpopularity may well have been an important reason why they went to such great lengths to accommodate their adversaries in the debate over economic rationalism. However, during his Australian visit in 1976 F. A. Hayek presented an alternative view about the unpopularity of economists. Like Coleman and Hagger, Hayek quotes Sir Keith Hancock: 'Australians have always disliked scientific economics and (still more) scientific economists.' Hayek (1979:1) added:

> This seems to show that Australian economists have done their duty and performed the greatest service economists can render to the public. This is to question public beliefs which to them seem to be delusions, warning against measures and procedures which they have reason to think will fall short of what they are meant to achieve, and may often produce opposite results.

Hayek thought that economists should not only tell the public about the things they agree on but should draw the public's attention to the predictable (although perhaps unintended) consequences of government policy. Such a course of action is unlikely to achieve popularity. It is a tough job which may not raise the social standing of economists, but someone has to do it.

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James Cox is a Member of the NSW Pricing Tribunal. He notes for the record: 'Some articles by Michael James and myself are among the many contributions assessed by Coleman and Hagger. I do not wish to reply to them at length but not to do so at all would only confirm the authors in their poor opinion of Australia economists. In both our cases, I think that Coleman and Hagger present a very selective summary of what we wrote and then criticise it. Readers who are sufficiently interested may wish to compare the articles by James and Cox listed below with pages 162 and 165 of Exasperating Calculators.'

Capital Controls in Developing Nations

George Fane, ***Capital Mobility, Exchange Rates and Economic Crises***
Edward Elgar, Cheltenham, UK, 2000

Reviewed by ***Geoffrey Kingston***

Two decades ago the case for liberalising international capital movements was revived in Australia. The trailblazer was Michael Porter. He had recently graduated from Stanford University, where his teachers included E S Shaw and R I McKinnon, who were pioneering the case for freeing up capital markets in developing countries. Also at Stanford, William Sharpe was pioneering the development of the capital asset pricing model, which was rapidly becoming the workhorse of financial risk management.

Porter made liberal use of the two-period Fisher diagram in order to show that the argument for freeing up the capital and financial account of the balance of payments parallels the argument for freeing up the current account. This was at a time when some economists, including Treasury ones, were simultaneously supporting current account liberalisation and opposing capital account liberalisation.

Porter also used the basic Sharpe diagram, with expected portfolio returns on one axis and the volatility of returns on the other, to show that restricting domestic access to foreign equity markets could have the unintended consequence of *reducing* the domestic demand for domestic equities – Kim Beazley and Alan Jones (who are among the public figures claiming that Australian superannuation funds have invested too much offshore in the sense that risky yet superior domestic opportunities have been passed up) please take note.

Porter fine-tuned his ideas at the Australian National University (before serving briefly at Monash University.) Indeed, the ANU had previously acted as a sounding board for Max Corden's ideas on the inefficiency of current account controls, and was shortly to do the same for Ted Sieper and George Fane, who wrote a detailed critique of Australia's capital account controls at the behest of the Campbell Committee. A decade later, Tony Makin, now at the University of Queensland, was reviving the Fisher diagram at the ANU, in order to demonstrate that current account deficits are not necessarily harmful.

The book under review is a new landmark in this ANU tradition of powerful critiques of controls on the balance of payments. Having gone a considerable distance towards liberalisation during the 1980s – and in the aftermath of a handy rise to ninth position on the OECD League Table by 1999 — Australia has become progressively less in need of ANU strictures on the need for economic openness. Accordingly, the book under review reverts to Shaw and McKinnon's topic, namely, capital controls in developing nations. Particular attention is paid to countries in our part of the world, including Indonesia, Malaysia, Thailand,

Korea, Taiwan and Chile. Policy instruments first analysed by Porter, such as regulating offshore borrowings by means of a Variable Deposit Ratio, are treated in depth. As with Sieper and Fane's analysis of the Australian case two decades ago, Fane's solo work here is distinguished by patient efforts to unravel and explain the complexities of particular institutional arrangements; the book displays a real knack for this. On the other hand, elegant geometry built on solid microeconomic foundations is nowhere to be found. I admit to being ambivalent about this particular departure from ANU tradition.

Chapter One provides an outline of the book. There is also a handy thumbnail history of major speculative attacks during the 1990s: the crisis of Europe's Exchange Rate Mechanism in 1992-93; the 'Tequila' crisis of 1994-95; and the Asian/emerging markets crisis of 1997-98.

Chapter Two lays out a portfolio balance model of the exchange rate, the share price index, and the short-term interest rate in a small open economy. While this exercise is carried out professionally, it may be a little terse for students. Also, my personal preference would have been for more emphasis on arguments involving currency substitution. Although currency substitution models may have failed to live up to their initial promise, I know of no better way of modelling the contagion issues raised by exchange rate crises.

Chapter Three presents case studies of capital controls in Taiwan, Malaysia, Korea and Chile. It concludes by casting doubt on the proposition that controls were effective in ameliorating currency crises.

Chapter Four is a careful discussion of first-best and second-best arguments for capital controls. Chapter Five is mostly devoted to a review of the theory of speculative crises. The sources range from Friedman to Krugman. There is also a brief review of empirical evidence.

Chapter Six is on the interplay between banks, moral hazard and prudential regulation in developing countries, drawing on commentators spanning Bagehot to Kane, Merton and Bodie. This chapter sensibly recommends either much higher capital adequacy ratios for banks in developing countries or, alternatively, much higher risk weights on loans to borrowers in developing countries regardless of where the lending banks are domiciled.

Chapters Seven and Eight are on monetary and exchange rate policies. Their central concern is the familiar one of monetary authorities that are unwilling either to allow a clean float, or to accept that if fixing is in fact the preferred exchange rate policy then little or no scope remains for an independent national monetary policy. Problems created by attempting to sterilise the monetary impacts of capital inflows are explained. Currency boards are discussed. 'The case for a currency board is particularly strong when a country's reputation for monetary discipline is poor' (p. 171).

The final chapter is on 'reforming the international financial architecture'. The topics include expansion of the authority of the International Monetary Fund, the possibility of an Asian monetary fund, the desirability of official guarantees for loans to developing countries (a proposal championed by George Soros), and the desirability of taxes on spot transactions in foreign exchange (a proposal

championed by James Tobin). The author displays intelligent scepticism towards all these proposals. This reviewer was persuaded by the author's scepticism, and was reminded of the old adage for dealing with acquaintances who are financially down on their luck: either refuse outright to help, or give generously, so long as you don't acquiesce in half-baked schemes involving concessional loans.

Overall, this is a skilful blend of sound economic reasoning and institutional knowledge. The writing is clear and concise. The policy conclusions are valuable antidotes to various manifestations of economic snake-oil. Teachers of development economics and international money should find the book useful. Investors in emerging markets could also read it with profit. Above all, present and prospective policymakers in developing nations need to read this book.

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