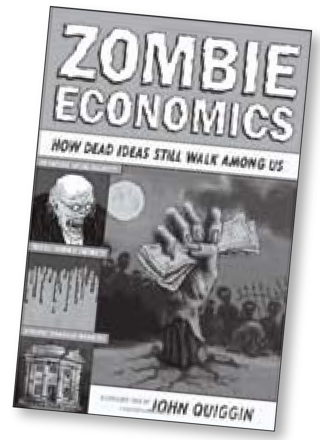
TILTING AT ZOMBIES

John Quiggin nails some weak arguments for market liberalism but he doesn't tackle all the strong arguments, write **James Savage** and **Robert Wiblin**



Zombie Economics: How Dead Ideas Still Walk among Us

By John Quiggin
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In a recent, noisy debate between Princeton economist Paul Krugman and Harvard historian Niall Ferguson, Krugman scolded Ferguson as belonging to a 'Dark Age' of pre-Keynesian economics. In justifying his thoughtful reply, Ferguson retorted cheekily: 'A cat may look at a king, and sometimes a historian can challenge an economist.'[1] Around the time of that well-publicised tiff in mid-2009, a dike was breached: at least since then, an ongoing squabble has occurred about the value of economists' analysis in society, given the degree to which the global financial crisis was unanticipated by the profession. Into this debate, John Quiggin—certainly a king within the Australian economics profession—released his book *Zombie Economics*.

Quiggin is one of the most influential economic theorists in Australia. His most well-known contribution to the field, in expected utility theory, launched him in the early 1980s to international fame (or at least as much fame as could be gained in the sub-discipline of expected utility theory); since then, he has written several popular books on industrial relations, microeconomic reform, and taxation as well as a large number of papers on a diverse range of issues, including risk pricing and environmental economics. Since 2002, he has been a figurehead in the Australian blogging community, and with *Zombie Economics*, he pioneered a new editing strategy, publishing chapters on his blog to solicit criticism from readers. Since 1996, he has been a regular columnist for the *Australian Financial Review*, and he is a federation fellow at the University of Queensland.

Quiggin is a self-described social democrat who does not shy from public debate, welcoming opportunities to engage those he disagrees with. Quiggin's writing, at least from the late 1980s, has been consistently critical of faith in 'economic rationalism.' Most recently, he has been a fierce public critic of the Queensland Rail privatisation. *Zombie Economics* is his latest salvo at the perceived oversteps of *laissez-faire* economists. The book takes aim

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at five big ideas that he believes should have been finally discredited by the global financial crisis: the so called *great moderation* in the business cycle since the mid-1980s; the *efficient markets hypothesis* that financial market prices incorporate all of the information we have about the future; the belief that *dynamic stochastic general equilibrium* models can describe the macroeconomy and wisely inform fiscal and monetary policy; the *trickle-down* theory that the poor can be effectively helped by policies that directly benefit the rich; and finally the belief that the public interest is best served through the *privatisation* of public enterprises.

Quiggin builds his case against these ideas around the zombie motif, the zombies being the theories he believes should have been buried by experience but somehow dig out of their graves and shuffle onwards in the public debate. Quiggin clearly relishes the zombie metaphor and opens each chapter with zombie images to help break up the challenging combination of history, empirical evidence, and rhetorical flourish that make up the rest of the book.

The great moderation

From the mid-1980s, many Western countries saw a marked decrease in most measures of economic instability. These included falls in the volatility of GDP growth, unemployment, prices, and other economy-wide variables. This decrease in volatility, which was noted across G7 countries by leading econometricians Mark Watson and James Stock in a 2002 paper, was termed 'The Great Moderation.' Interestingly, Stock and Watson concluded in the same paper that the Moderation was mainly due to a long string of good luck, especially the lack of commodity price shocks.

> [B]ecause most of the reduction seems to be due to good luck in the form of smaller economic disturbances, we are left with the unsettling conclusion that the quiescence of the past fifteen years could well be a hiatus before a return to more turbulent economic times.[2]

The idea itself should really have finished where it started; neither Stock nor Watson, the empiricists they are, was comfortable attributing any deep causes to the Moderation. But as in any field where there is sugar there are ants, and there was no lack of ideologically inclined experts declaring their pet policies responsible. Decreases in price volatility were due to improvements in monetary policy; decreases in consumption volatility owed to new credit facilities such as credit cards; decreased unemployment volatility happened because of labour market liberalisation; and so on.

Though Quiggin flirts with the possibility that no moderation occurred, he does not fundamentally dispute that the 1990s and 2000s had lower volatility in some economic variables. Instead, he argues against the belief, held by some, that the market-oriented reforms of the 1980s and 1990s had 'solved' the boom-bust business cycle. His most convincing argument is his first: that the reduction in economic volatility during the Great Moderation cannot be conclusively pinned to market-oriented reform. There was a long, equivalently tranquil post World War II boom in which market liberalism did not inform policy to the extent it does today. And, he points out, the Asian countries that today drive global economic growth hardly adhere to the 'Washington Consensus' policies, claimed by some as responsible for stability in the West. Quite simply, in light of the global financial crisis, market liberal triumphalism is misplaced in claiming the Great Moderation.

But Quiggin's hatred of the idea of the Great Moderation extends beyond misplaced claims over its cause. His real anger is with the decisions, made both by companies and governments, that were justified by a faith in the Moderation. This second argument is that even if there was a reduction in economic volatility, it was accompanied by a general transfer in economic risk from governments and corporations to individuals. Labour market and health insurance reforms, made more acceptable in an environment of apparent calm, allowed large-scale retrenchment, all while executives wrote their own options contracts. While some of Quiggin's stylised narrative is unfortunately true—and there is no reason to think these sorts of episodes are intrinsically good—the argument seems to be the perennial leftist complaint, made far more eloquently by John Kenneth Galbraith in the 1950s and 1960s. In this section though, Quiggin doesn't spend time pinning down what risks were shifted to whom (do households actually bear more risk now?); instead, he rants about how bad it all was.

His third argument—a zombie in regular economic circles—lurches further still from orthodoxy. In this view, the Great Moderation was not a result of good luck but something far more sinister: a boom in stock and asset prices driven entirely by the neoliberal reforms that others suspected were causing the moderation! While the section has clear explanations of Keynesian, Post-Keynesian, and Austrian thinking on the causes of crisis, it offers little explanation why a boom in asset prices should result in a decrease in volatility, as is hinted at by Quiggin.

Efficient Markets Hypothesis

Quiggin's next 'zombie idea' is the Efficient Markets Hypothesis (EMH). The EMH, associated with work done by economists Paul Samuelson and Eugene Fama, claims that financial markets are 'informationally efficient.' This simply means that financial market traders make the best use of information available to them in deciding how much a financial asset is worth. The implication of the EMH is that because any trader could improve their estimate of how much a company is worth simply by collecting more information, all information available to the market is incorporated into the price of any given financial asset.

The conventional wisdom that emerges from the EMH is that the market is difficult or impossible to beat. If one can find a way of making money using available information—from the algorithmic trading of many hedge funds to the hugely laborious task of poring over disclosure statements in search of anomalies—then the money made is equivalent to the wage of the very difficult job of doing so. Because financial markets are impossible to beat in this technical sense, it must follow that because something is worth only what people are willing to pay for it, the market price in the presence of full information is *right*. It is with this final conclusion—which serves as the starting place for much policy and many decisions—that Quiggin has a problem.

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Quiggin essentially believes that many public policy decisions, which in retrospect have appeared to be poor ones (or at least from Quiggin's view, mainly ineffective prudential regulation and poorly considered privatisations), were justified on lazy beliefs about the power of financial markets in deciding the value of assets. These justifications, Quiggin says, traded due-diligence, caution and temperance in decisions made by governments, banks and ratings agencies for a belief that the market prices of various assets contained all the information needed to make an informed decision.

For example, the EMH would suggest that all the publicly available information regarding the likelihood of default on mortgage-backed-securities before the crisis was incorporated into their price. Given these prices, banks could deduce what sort of 'safe' loans they were allowed to hold. However, if the prices of these securities did not reflect the likelihood of default, given the information available, then banks could be left holding bad debt—as ended up happening. The key here is the public policy message coming from the EMH: to ensure the price is *right*, simply ensure more information is available. However, if markets don't digest this information, as is suggested by Michael Lewis's excellent *The Big Short*, then the EMH leads to potentially ineffectual regulation.[3] This criticism is laid most bare when Quiggin discusses the incorporation of for-profit ratings agencies into the BASEL II capital adequacy framework:

> Thanks to the EMH, crucial public policy decisions, were, in effect, outsourced to for-profit firms that had strong incentives to get the answers wrong.

Of course, Quiggin has a strong point here; it is obvious that in many countries in the run-up to the global financial crisis, caution was thrown into the wind. But in trying to frame the EMH as the idea responsible for this recent, sad episode, Quiggin's paints the hypothesis as trying to explain far more than is valid. Take, for example, Quiggin's logic about why 'the Efficient Markets Hypothesis implies that there can be no such thing as a bubble in the prices of assets such as stocks or houses':

> The argument begins with the claim that if a bubble in stock prices were indeed observable speculators would sell the asset in question. If that did not end the bubble, short-sellers would enter the market ... [and] ensure that the price returned rapidly to the true market value.

Of course, having presented such a simplistic version of EMH-esque logic (how easy is it to short a house?), Quiggin has no trouble in tearing this argument apart. But by presenting this Finance 101 version of EMH, Quiggin does himself a disservice. There is no shortage of economic theory showing how rational investors trading on full information can engage in a rational bubble. In a classic paper, IMF Chief Economist Olivier Blanchard and Princeton professor Mark Watson show rational, EMH-consistent bubbles to be entirely possible. Likewise, crashes in asset prices can be similarly consistent with EMH. Yale professor John Geanakoplos's recent work has shown that perfectly rational investors, being buffeted by new sources of news, may form wildly different expectations of the future from one another; the effects of this, he says, range from excessive volatility in asset prices relative to their underlying fundamentals, through to crashes and panics. And all without departing from the core finding of the EMH: that markets incorporate public information into prices.

Dynamic stochastic general equilibrium

Quiggin's next zombie isn't so much an idea as an entire branch of economics, a school of macroeconomic modelling known as Dynamic Stochastic General Equilibrium (DSGE). His critique of DSGE starts with an exemplary review of the history of macroeconomic thought, from the classical economists of the nineteenth century through to Keynes, and the explosion of macroeconomics after World War II. This section will inevitably be prescribed reading for undergraduate History of Economic Thought classes in the future; it is first rate. However, when he arrives at the end-point—DSGE—Quiggin seems to miss the basic point of why and how macroeconomists build models.

Before a small revolution in macroeconomics in the mid-1970s, central banks and finance ministries built models of their economies composed of hundreds of statistical relationships, tying economic variables to each other based on their past correlations. For example, if prices would rise whenever unemployment would get very low, then that relationship would be programmed into the model. Governments and central banks could then 'simulate' the effects of policy by changing one variable (government spending, perhaps) and form a view about what was likely to occur in the whole economy based on their policy.

After the oil-shocks of the 1970s and early 1980s, however, these models started giving very strange results. The models broke down because they were built to reflect past relationships, while in the 'actual economy' people had changed their expectations about how the economy worked—especially regarding inflation. This begot the joke, 'Macroeconomic modelling is like driving while looking out the rear-vision mirror.'

The sensible solution for macroeconomics, then, was to try to build models that incorporated people's expectations of the future. It was this research program, combined with great leaps in the amount of computing power available to economists, that eventually led to DSGE modelling. The fundamental idea of DSGE modelling is that each 'sector' of the economy ('sector' in the broadest sense: households, firms, a central bank, a foreign trade partner) may be represented by a few equations that describe:

a) what the 'actor' is trying to achieve (for example, households generally try to maximise consumption and leisure); and

b) what constraints each actor faces (a household can't accumulate debt forever).

The model then finds an 'equilibrium,' which is when all 'actors' are simultaneously 'optimising,' and the modeller can then 'shock' something—a tax or an interest rate. Often some of the 'core' parameters of these models are statistically deduced, using methods indistinguishable from magic to anyone but the advanced econometrician, and other parameters are 'calibrated,' which means they are made up.

As Quiggin points out, DSGE models did not predict the global financial crisis, nor do they usually predict bubbles or large deviations from General Equilibrium. In light of the knowledge that bubbles and crises do occur (whether large deviations from General Equilibrium occur is more a philosophical argument), should we abandon DSGE? The answer is a qualified 'no.'

The failure of DSGE models to predict the crisis is little reflection on their capacity to do useful economic modelling. Their failure to predict the crisis is because the factors that caused it were simply not included in these models. If 99 times in 100, an econometrician can establish strong relationships between the number of machines, number of workers, the interest rate, the exchange rate, the unemployment rate, and GDP, then a good reason exists to build a model relating them. However, if the other one time in 100, mortgage defaults explain the change in those variables, that does not mean it is worth including in the model every time. This core principle in economic modelling is what Quiggin appears to miss, and it makes his strange argument against this technical discipline somewhat misplaced. DSGE did not cause the global financial crisis. The fact that one kind of model cannot predict everything we want to know does not mean it predicts nothing we want to know.

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Trickle-down economics

Next in Quiggin's firing line is trickle-down economics, the claim that the poor will benefit from tax cuts for the rich. The most notable part of 'trickle down theory', insofar as anyone believed it, is the 'Laffer curve,' which describes the relation between tax rates and total revenue raised by government. According to the curve, at some point tax rates can get so high that people avoid the taxed activity so much that total revenue in fact goes down. The idea that tax cuts could increase tax revenues was used, at least in political rhetoric, to build support for tax cuts passed under Presidents Ronald Reagan and George W. Bush. While the logic of the Laffer curve is sound, Quiggin rightly observes that there was never any chance that tax cuts would generate enough additional economic activity as to increase tax revenues.

Quiggin takes slightly more seriously the idea of 'dynamic efficiency,' in which lower taxes increase investment or innovation, and in the long run, boost growth enough to raise government revenue to its original level. However, Quiggin finds that the effect is not sufficient, in one 'optimistic' assessment offsetting only 17% of the cost of income tax cuts, and 50% of the cost of capital tax cuts. If the government borrows to fund tax cuts, as occurred under Reagan and Bush, Jr., the benefits disappear altogether.

Quiggin then moves on to growing inequality, in particular, wage and income stagnation for the bottom 50% of households in the United States. He points to data suggesting real household incomes for the bottom 20% have barely shifted in the last 40 years, while the 50th percentile has grown at a fraction the rate of the 80th, let alone the 95th. Perhaps remarkably, the proportion of the US population under an absolute poverty line appears to have grown slightly between 1974 and 2008. Quiggin notes that inequality might have a positive effect on growth rates, but estimates the effect is far too small to compensate the losers. He also points to lower social mobility in the US system compared to other countries as a result of growing inequality. In the United States, 41% of men with fathers in the bottom 20% of incomes will remain in the same group, compared with 25% in Denmark, or 30% in the United Kingdom.

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Quiggin's observations are an important reminder that while all taxes generate some inefficiency by discouraging trade and encouraging avoidance, those inefficiencies vary widely. Thanks to the influence of economists, it was only in rare cases that tax rates remained over the peak of the Laffer curve even in the 1980s. Where that remains the case today will usually be the result of unconsidered combinations of taxes or interactions with welfare reductions. It is quite correct that while the poor may benefit in some indirect ways from tax cuts for the wealthy, there is no reason to assume those benefits will be enough to compensate them for reduced government services. If our goal is to help low-income earners, tax cuts for low-income earners or other interventions like Earned Income Tax Credits will provide more bang per buck.

However Quiggin's analysis has a number of weaknesses, in particular, a singular focus on the United States. It is always hard to demonstrate causation in the economy, but without comparing regions Quiggin cannot convincingly show that the tax changes he opposes are the primary cause of the problems he identifies in the US. A comparison between US states or with Europe might help us rule out other causes that have been proposed. These include technological changes that can disproportionately enhance the productivity of the most intelligent and an education system that fails to effectively educate a significant proportion of the population.[6]

Other economists have questioned the underlying claim that most wages are stagnant, attributing it to misleading data. In their assessment, the income measures fail to adequately reflect rising social security benefits, misreporting of income to minimise tax, non-wage incomes, the true rate of inflation experienced by low incomes earners, and changing family structures.[7] Thomas Sowell has also suggested that the wage distribution can be stagnant while most people see their incomes going up up over time, the difference being explained by large numbers of immigrants entering the country on low incomes. Some of these issues are mentioned but only in passing.

Privatisation

Quiggin next turns his pen to the pandemic of privatisation in the OECD since the 1980s. Quiggin believes that large portions of the economy are best managed by the private sector but that crucial infrastructure, especially those prone to oligopoly or other market failures, are often best managed by government. For Quiggin, this would include rail, telecommunications, water, electricity, health and education, among others. While market liberals are broadly correct that 'because of the incentives associated with private ownership, private enterprises are always more efficient than comparable public firms,' this is dependent on profit being a good guide to efficiency, 'which in turn depends largely on the absence of significant market failures.' Quiggin's treatment of privatisation is in many ways a traditional neoclassical analysis, dominated by concerns around managerial efficiency, competition, and market failure. The dispute with mainstream market liberals is simply an empirical one over how significant these benefits and costs are in practice.

Quiggin notes that 'the majority of economists, including market liberals, favored breaking up public enterprises and stripping them of monopoly privileges before privatisation,' but adds that 'such measures inevitably reduced sale prices, and the opportunity for incumbent managers to enrich themselves' and so were often rejected. Quiggin's explanation of real-world privatisation is full of public choice theory, an approach that is otherwise rarely taken in the book. Quiggin makes some important observations, in particular, that the same governments that most mismanage public enterprises are also those most likely to mess up the details of privatisation, enriching financiers unnecessarily, and failing to separate firms in ways that restrict excessive market power. Quiggin even suggests that politicians engage in privatisation explicitly to please the financial sector and secure cushy jobs after retirement. How else to explain their frequent but nonsensical claims that privatisation, which trades a flow of revenue for a roughly equivalent lump sum today, raises the total amount of money the government can spend? Unfortunately, the problems caused by having these same ruthless politicians captured by special interest groups directly managing essential services are not discussed.

Here Quiggin makes one of his most thought-provoking claims, that the so-called equity premium typically makes privatisation a loss for the government. The equity premium is the higher interest required to induce investors to lend money to private firms rather than the government. The fact that the more risky private investment is more expensive is not in itself mysterious, but the huge difference in the United States over the twentieth century, 2% for the government and 6% for private, is far beyond than justified by mere risk aversion. As a result of the gap, a business that in government hands can service $3 billion in public debt is only worth enough to the private sector to service $1 billion of that debt, assuming that privatisation will not increase profitability. Expressed another way, the government has a low cost of capital, which can make public enterprises very profitable.

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One obvious response is that while this may justify public ownership, it does not justify public management. A privately managed firm with the government as a major shareholder would serve just as well for servicing government debt, as would any tax revenues. While the argument is a complex one the review cannot examine in detail,we suspect that an accounting trick must be at work somewhere as far as social welfare is concerned. Presumably, total social welfare would not be enhanced by having the government become a shareholder in all large firms if this lead to no improvements in business practices. With the same wealth being created, any benefits generated by more cheaply serviced government debt must be come at the expense of others in the economy, if only because the government crowds out private investment by borrowing at artificially low rates.

Conclusion

As market liberals, we should engage with the smartest from the other side—and so our review of Quiggin's book. Unfortunately, Quiggin does not always afford the same luxury to those who hold market liberal views; rather than arguing with the truly great contemporary market liberal macroeconomists, who in our experience hold nuanced and considered views, he too often takes easy shots at those who blame the global financial crisis on Obama's future election or believed that privatisation generated revenue out of nowhere. This makes *Zombie Economics* a more entertaining if less substantive read. Nonetheless, *Zombie Economics* contains excellent accounts of the development of economic thought over the twentieth century. On the many occasions that Quiggin drives a nail into the head of illogical or discredited justifications for *laissez-faire*, he is doing everyone a favour.

Endnotes

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2. James H. Stock and Mark W. Watson, 'Has the Business Cycle Changed and Why?,' *NBER Macroeconomics Annual* 17 (National Bureau of Economic Research Inc, 2002), 159–230.
3. Michael Lewis, *The Big Short: Inside the Doomsday Machine* (WW Norton & Co, 2010).
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5. John Geanakoplos, *The Leverage Cycle*, Cowles Foundation Discussion Paper No. 1715R (Yale University, July 2009, revised January 2010).
6. Tyler Cowen, *The Great Stagnation: How America Ate All The Low-Hanging Fruit of Modern History, Got Sick, and Will (Eventually) Feel Better* (ebook: Penguin, 25 January 2011).
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