

Howard Vane & Terry Caslin

Current Controversies in Economics



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Edited by
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To our parents

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Preface

This book aims to provide a critical and concise, yet rigorous discussion of selected current controversies in economics for students taking introductory courses in economics. The book is primarily intended as a supplementary text for specialist economics students taking first-year undergraduate courses in universities and polytechnics. However, a number of chapters should also be very useful to the more able 'A'-level students and non-specialist students taking first- and second-year undergraduate economics courses on such degrees as accountancy, business studies and social studies where economics plays an important role.

In determining the content of the book we have deliberately chosen current controversies which for the most part are inadequately covered (if at all) in many established textbooks. Where such controversies are covered in standard texts they tend either to be discussed in passing or relegated to appendices, rather than being fully integrated into the main body of the text. Further, the presentation of many of the topics in the main economic journals is, more often than not, far too technically demanding for students first approaching the subject. Constraints of time and space have forced us to restrict the number of controversies covered. For example, we do not overtly discuss such controversial issues as environmental policy, regional policy or trade union policy. Having said this, restricting the number of issues has allowed us to give greater depth of treatment to the controversies selected than that given in (the limited number of) journals aimed specifically at this market. At the same time unlike journal articles the reader will find numerous cross-references linking, and showing the connection between, issues covered in individual chapters. While the book is written in such a way as to allow students to read individual chapters in isolation, according to their interests and needs, the book does follow a structured direction. Part A (chapters 1 and 2) provides an introduction

and identifies an underlying theme throughout subsequent chapters of the book, namely that of the importance of government policy and state intervention. Part B (chapters 3 and 4) reviews some recent developments in economics and their policy implications. Part C (chapters 5–8) deals with some current areas of general policy concern. Finally Part D (chapters 9–13) examines particular UK policy issues under debate. A book of this kind involves a fair amount of statistical evidence both on the past and recent performance of the UK economy. Given the time lags between: (1) the collection and publication of official data and (2) the writing and publication of this book, some of the data cited in the text will necessarily be somewhat out of date. Wherever possible the reader is strongly recommended to turn to the various sources quoted to update the data provided in the various tables and graphs.

We would like to express our gratitude to Sue Corbett and Paul Dutton at Basil Blackwell, and Basil Blackwell's referees for their constructive criticisms at various stages in the development of the book, in particular Professor Mark Casson of the University of Reading who read all draft chapters and made many helpful suggestions and comments en route. Our final thanks go to Joyce Johnson for her patience and co-operation in typing a substantial part of the final typescript. Any remaining errors are our responsibility.

Howard Vane and Terry Caslin

PART A

Introduction

1

Introductory Economics: an Overview

TERRY CASLIN & HOWARD VANE

1.1 Introduction

Our aim in this chapter is to provide a brief overview of the economic analysis relevant to the controversies addressed in subsequent chapters of the book. Because it is assumed that students will be following one of the standard introductory 'principles of economics' texts the overview is primarily intended as a revision exercise to bring to the students' mind what he has already met (or is currently meeting) – to provide, that is, a comprehensible but essentially concise summary. Some additional complications and limitations of the analysis are discussed later in the context of the controversy at hand.

In this chapter we will follow the common expedient of distinguishing between microeconomics and macroeconomics but one of the features the reader will recognize in subsequent chapters is the interdependencies between micro- and macro-issues.

1.2 Microeconomics

Microeconomics is concerned with the processes of exchange between individuals and organizations in society, and the basic problem is the determination of the allocation of resources. The basic theory is that of the determination of relative prices through demand and supply. The main areas of study include consumer choice, supply by firms and income distribution. In what follows we will focus our review on the over-riding concept of the 'efficient' allocation of resources, but first a brief

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note on the historical antecedents of modern microeconomics.

In 1776 Adam Smith published *An Inquiry Into the Nature and the Causes of the Wealth of Nations*. The book marked the consolidation of political economy into a social science.¹ It marked the beginnings of the *classical* school of political economy which was to hold dominance in the Anglo-Saxon world for the better part of a century. It was contemporary with the industrial revolution and was the expression of that revolution in the realm of economic ideas. From around 1870 the nature of economics altered substantially and the term 'marginal revolution' is often used to describe the considerable change in the emphasis, nature and techniques of economics that occurred in the last quarter of the nineteenth century.² Many would argue that it was at this time that 'economics' as distinct from 'political economy' came into existence, and that the emergence of the subject as a science can be dated from this period.

Classical political economy had concentrated its attention on broad questions of what we now call macroeconomics. Its central concern was with the long-run considerations of economic growth and the conditions for and implications of the process of steady expansion.³ The extent of disaggregation in classical thought was minimal, emphasis being upon the behaviour of broad social classes.

The economics which developed as a consequence of the marginal revolution, and which came to be known as *neo-classical economics*, gave rise to the area which is now referred to as microeconomics. Here the concern is very much with disaggregated questions and the analysis is conducted at the level of the individual decision-making unit, be it the consumer or the producing organization.⁴

Neo-classical economics is essentially about the problem of *resource allocation*. It takes as its brief the analysis of the relationship between the multifarious objectives of individuals and of society, and the limited resources that are available for their achievement. Thus, in one of the most quoted of economic passages: 'Economics is the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses'⁵ (Lionel Robbins, 1932).

In this section we review the issue of whether microeconomic analysis can give any *general* guidance on how best to determine the allocation of resources in an economy, and of what problems emerge in such an approach. It is worth emphasizing at the start that although economists' attempts to analyse the general issues associated with resource allocation are often couched in terms of relatively abstract theories and models, the central questions of resource allocation – of how the scarce resources of any society *are, could be or should be* allocated amongst the multiplicity of competing activities – are at the centre of many areas of political controversy and public concern.

We will discuss two central problems:

- 1 In what sense, if any, can a particular allocation of resources be said to be superior, inferior or equivalent to some other allocation?
- 2 How is the actual allocation of resources in an economy determined, and can any particular method of determination be said to lead to an 'optimal' allocation?

Readers will recognize that problem (1) is associated with the distinction between 'positive' and 'normative' economics and will necessarily lead us into the domain of the latter with its associated difficulties of making 'value judgements' about alternative situations. In what follows we consider the so-called Pareto criterion for making comparisons of alternative resource allocations.

Problem (2) has always been central to economics. The actual allocation of resources in an economy can be determined by a wide variety of methods ranging from centralized commands at one end of a spectrum right through to the unfettered free trade of individuals in markets at the other. In practice economic systems contain elements of more than one method. Thus though Western economies are basically market economies governments do wield a great deal of power, while Eastern Europe largely follows the basic pattern of a command economy but allows firms some limited decision-making. Here we concentrate on the free market method, partly because this book is chiefly concerned with the UK and partly because in almost all societies at least some part of the actual allocation of resources is determined by the operation of markets in which relative prices play the central role. That the price system can co-ordinate the innumerable individual decision-makers in an economy in an ordered manner and produce an 'optimal' allocation of resources has been central to economic and political thought ever since Adam Smith. In section 1.2.2 we examine the way in which free-market competition *could* satisfy these claims to optimality as a foundation for a discussion of the strengths and weaknesses of free competition as an allocative mechanism.

1.2.1 The Efficient Allocation of Resources

The difficulty with trying to establish criteria for comparing alternative allocations of resources is the great diversity of opinion and preferences evident in most societies. Economists traditionally assume that the individual is the best judge of his own welfare, and have accordingly been unwilling to make interpersonal comparisons. This has led to the widespread adoption of the so-called *Pareto criterion*.⁶

Pareto's concept is based on the contention that distributional judgements

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are best avoided altogether since it is difficult to obtain consensus about them, they do not lend themselves easily to incorporation in an analytical framework, and particular assumptions would limit the applicability of conclusions based upon them. Instead he defined an improvement in social (or community) welfare only if it involved an increase in the utility of at least one individual and a decrease in the utility of none. Such a change is seen as an increase in efficiency and Pareto defined a position of maximum efficiency (optimality) as one in which no input and no output can be transferred to some alternative use without making at least one person worse off, even if the welfare of others is improved.⁷

The development of Pareto's principles into conditions which define a position of maximum efficiency will be familiar to most students of economics,⁸ and is based on the proposition that in such an optimum situation it is impossible to redistribute resources so that one individual (or production process) can obtain greater satisfaction (output) except at the expense of another unit of the economy. When an economy is at a Pareto optimum it is characterized by the equality of certain pairs of marginal quantities; indeed these equalities are necessary conditions which must be satisfied if the economy is to have an economically efficient allocation. It is required that:

- 1 the marginal valuation of every good in terms of some common numeraire (say money), must be the same for all persons;
- 2 this marginal valuation must be equal to the marginal cost (measured in the same units) of producing that good;
- 3 the marginal cost of supplying a factor service must be the same for all persons, and also equal to the marginal product which the employer obtains from hiring it.

These conditions can be summed up by requiring that the marginal social cost (i.e. marginal private costs plus any marginal external costs; see section 1.2.3) of producing any commodity or supplying any factor or service must be equal to the associated marginal social benefit. If the former is less than the latter, too little is being produced or supplied, and vice-versa.

The conditions of Pareto efficiency discussed above constitute a framework, albeit very limited, in which some questions relating to the relative merits of alternative allocations of resources can be considered. Two important points must be stressed. First, the Pareto criterion and the efficiency conditions do not isolate a *uniquely* 'best' allocation of resources. An 'optimal' resource allocation will exist for each conceivable income distribution in the economy. Different income distributions will imply different patterns of consumer demand and thus the best resource allocation will be different since the criterion for optimality is nothing more than

a measure of how well this allocation accords with the pattern of demand. On the basis of the Pareto criterion it will be impossible to say which income distribution is the best since a redistribution of income will involve making some members of society better off only at the expense of putting others in a less favourable position (see chapter 8).

Second, the Pareto welfare criterion is an extremely weak one and of very limited significance in practical decision-making.⁹ Most social projects are politically contentious for the very reason that they do involve making some groups better off only at the expense of making others worse off. However the ideas discussed above are primarily intended to provide an analytical rather than a practical framework for assessment. In reality governments have a variety of different objectives, some of which conflict with each other. Pareto efficiency is never an explicitly stated government aim. Nevertheless the ideas of efficiency we have discussed are useful for interpreting the claims made by the proponents of free-market competition and do in fact underlie many practical proposals of microeconomic policy, (see especially chapters 2, 7, 9–13).

1.2.2 The Price System and Resource Allocation

In the previous section we identified the conditions necessary if society was to achieve a Pareto-efficient allocation of resources. In this section we examine how the outcome of free competition between economic agents in markets *could* be Pareto-efficient, before proceeding in section 1.2.3 to discuss the problems associated with real-world market behaviour. We will first summarize how a single market operates (readers should be well familiar with this process).¹⁰ Second we examine the simultaneous working of the price system for all goods and services (the general equilibrium), and third we analyse the relationship between free market competition and efficiency.

The operation of a single market. In an economy characterized by decentralized decision-making, the function of co-ordinating decisions is undertaken within a market by the operation of price. Individual economic agents, be they buyers or sellers, determine their behaviour patterns within the constraints imposed by the structure of relative prices, and by their combined actions determine what the price structure will be. In a situation where these individual actions lead to a contradictory result, the consequent changes in price will induce changes in individual behaviour which will bring them into harmony or equilibrium. The price system is thus the co-ordinating mechanism.

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General equilibrium. The concept of general equilibrium requires not only that each particular market be in equilibrium in terms of the equality of supply and demand, but that the relationship between markets be such that there is no tendency for the system to change, and that resources are allocated according to the structure of demand in the economy. It requires that all individual markets have adjusted to their respective equilibria and that these are simultaneously consistent with each other. It will involve a set of prices at which the resources of the economy are allocated in such a way as to supply a set of outputs which, given the pattern of demand, is consistent with these prices. The price system as a whole will be acting as the co-ordinator of the multiplicity of individual decisions by acting as an indicator of relative scarcity and as an incentive to action.

In a situation of perfect competition in which there are constant or diminishing returns such a mutually consistent equilibrium can be attained. It is possible for a set of prices to be established which produces particular equilibria in all the product markets and all the factor markets simultaneously. If the economy is subject to change from outside then it will, given the exclusion of the possibility of increasing returns, converge on a new equilibrium. If, for example, the demand for a product changes or if a change in technique occurs each market will tend towards a new equilibrium and the mutual interactions will cause markets to move in a way which is consistent, one with the other.

The reader should be aware that the general equilibrium of perfect competition is an abstract concept. No real economy has ever, or ever will be, in a situation of perfectly competitive general equilibrium. Rather the concept demonstrates what might happen in a situation of 'ideal' (no ethical connotations intended here) competition. It shows how the competitive mechanism might bring about consistent and, as we will see, efficient behaviour, in a situation of potential disharmony.¹¹ An understanding of the implications of general equilibrium serves to illuminate the effects of anything less than the full equilibrium of perfect competition.

We now turn to investigate the efficiency proportions of general equilibrium.

*Competitive general equilibrium and Pareto efficiency.*¹² In the situation of perfect competition not only will a general equilibrium be attained but it can be shown that the resource allocation that results from it will be Pareto optimal. This optimality is indicated by reference to the long-run equilibrium condition for the perfectly competitive producer. Because of the special nature (horizontal) of the demand curve facing the perfectly competitive firm, in determining the position of profit maximization equality

will also be established between price and marginal cost, and it is the latter which is the indicator of optimality.

The price is an indication of consumers' evaluation of the product. If a consumer is prepared to pay a price, P , for a good it means that the marginal unit of the good is just worth P to him. The price, P , is in effect the opportunity cost of the product since it is a measure of the alternatives forgone by deciding to purchase this particular product. It is, of course, a subjective evaluation by the consumer, but all consumers will reach the same subjective evaluation as they all face the same market price.

Marginal cost is an objective evaluation of the cost of producing the marginal (or last) unit. It is a measure of the value of factors which must be utilized in its production. This value in turn is the opportunity cost of the factors, i.e. what they would be worth in alternative production uses – seeing that our firm will have to pay the 'going rate' for factors. Marginal cost thus indicates the objective value of the alternatives forgone in order to produce the marginal unit of the product.

Where price and marginal cost are equal it means that consumers' subjective evaluation of the marginal unit of the product (the marginal benefit) is exactly equal to what they must objectively forgo in order to obtain that marginal unit (the marginal cost). The allocation of resources and composition of output is thus at an optimum. Output in each area is expanded to the point where the last unit produced is just worth while producing, given consumers' preferences.

We have now demonstrated that the equilibrium of the perfectly competitive market would imply Pareto efficiency. The result provides a precise statement of the sense in which 'free competition' can be said to be optimal, given the definition used and the limited applicability of the Pareto criterion. In the next section we will examine some qualifications which imply that real-world competition will fail to generate such efficiency results, and consider some further limitations on the use of the Pareto criterion itself.

1.2.3 Market Failure

In the real world markets often fail to perform in the idealized fashion required for allocative efficiency. Here we list the principal factors that prevent markets from working in the manner described above.¹³

Imperfect competition. The widespread existence in the real world of monopoly and other forms of market structure, which allow firms power over price setting, will lead to prices exceeding marginal costs (as such firms equate marginal cost with marginal revenue which is less than price). The result will be Pareto-inefficient. This resource allocation argument