Search for a theory of the business cycle

DESPITE their poor track record, economists continue to claim that the harrowing depression of the '30s could not be repeated in the 1980s.

This belief is based on the assumption – explicitly stated in many cases – that we can now track the health of the economy.

Statistical information now enables us to monitor market trends, and to respond quickly as the need arises.

> **The flaw in this complacency is that the economists who defend this view – and there are Nobel laureates among them – assume that the theoretical basis of their social science is a match for the challenges that confront the global economy.**

Yet this is precisely where economics, as practised today, is found wanting: there is no satisfactory body of theory to guide effective policy-making, and until we firmly recognise this fact, the prospects of developing alternative hypotheses will remain small.

BUT WHAT comes first: statistics or theory?

As it happens, the question is irrelevant – because *neither* is a satisfactory starting point for a thoroughgoing overhaul of the discipline of economics.

Let's look at the data first, and pick a problem that ought not to provide room for much doubt: the unemployment figures.

How many people are unemployed? This might not seem too tough a question, because it suggests a simple arithmetic solution: count the people who do not go to work for a living.

In fact, there is considerable doubt about the official figures.

In Britain, the official figure last November was 3,094,000.

- Left-wing critics, however, argued that this disguised the true level of unemployment: they wanted to add a further 1.3m, whose plight was disguised by the official exclusion of certain categories of unemployed people, the effect of special employment measures, and so on.
- Right-wing critics, however, maintained that the official figure ought to be reduced by 1.4m, which includes 490,000 people who were allegedly not really looking for jobs.
- The truth is to be found somewhere between the two extremes. Certainly the government's revision of the basis on which it calculated unemployment levels enabled it to argue that there had been an improvement.

But who can have faith in a flexible truth?

In the U.S., the improvement in unemployment figures last year worked wonders for President Reagan's re-election prospects.

The drop from a peak 10.8 per cent to September's 9.3 per cent came as a surprise. Was it a reflection of reality?

Well, that depends on which of the two official surveys you believe.

- The Federal government was happy to go along with the household survey, because it showed a sharp fall in the number of people out of work.
- But the payroll survey data implied a September unemployment rate of 10.2 per cent, not the 9.3 per cent that was officially reported to the nation.

As Robert Samuelson noted at the time: "What appears shaky to statisticians, though, is presented to the public as solid. The apparent drop in joblessness has quietened the economic policy debate."[1]

Thus, the forecasts about the direction and pace of growth undertaken by the universities and private institutions is grounded on data that is subject to a rich array of manipulative devices.

This is not calculated to encourage the politicians to change their policies, simply because they cannot have faith in the original diagnosis of the problem.

Mrs. Thatcher's government, for example, fought the general election last June in the belief that the economy was growing at a 3 per cent rate. By November, however, the Whitehall statisticians had re-examined their data, and the figure was reduced from 3.2 per cent to 2.8 per cent.

Half-a-per cent may not appear much, but it buries a lot of hopes and jobs.

Key to recovery

DR. WILL LISSNER, editor-in-chief of *The American Journal of Economics and Sociology,* assesses the efforts by economists to construct a theory of the business cycle.

NO SATISFACTORY THEORY of the expansions and contractions of business activity known as the business cycle has yet been empirically validated.

The National Bureau of Economic Research spent millions of dollars in an effort to develop one, and as a result made contributions worth billions of dollars to statistical economics. But the primary goal of the work proved elusive.

Other programs at other centres made equally important contributions to economic science, but a theory of the cycle was not one of them.

Now, a British economic journalist, Fred Harrison, trained at Oxford and at the University of London, editor of *Land and Liberty,* the international journal of land reform, and author of several outstanding monographs, presents case studies of the current global recession as it affected the United Kingdom, the United States, Japan and Australia.

His report of his investigation, *The Power in the Land,*[1] maintains that land monopoly "has been the unrecognised cause of the periodic booms and slumps which have regularly afflicted the industrial economies of the West over the past 200 years."

He does not indict the price gouging of the Organisation of Petroleum Exporting Countries, the Arab oil cartel, as one of the primary causes; in his view OPEC's activities were only a secondary cause. The primary cause, he believes, is the institution of absolute private property in land and natural resources which gives

Are we better off if we turn to theoretical constructs for enlightenment?

Alas, no, as some economists are now beginning to confess.

Herbert Stein, who was chairman of the Council of Economic Advisers under President Nixon, has noted: "We must confess that we don't know what is the optimum path of the economy for price stability and real growth; we don't know how to achieve that path if we could identify it . . . and we don't know what caused the slowdown in economic growth or how to correct it."

QUOTE by Dr. Francis Cripps of the Department of Applied Economics, Cambridge University: "Nobody really understands how the modern economy works. Neither the IMF nor GATT have a model of the world economy that really works. Nobody really knows why we had so much growth in the post-war period, what was the role of the Marshall Plan, how the various mechanisms slotted together." *The Guardian* (London), Sept. 26, 1983.

The soul-searching is trans-Atlantic. Wynne Godley, the Professor of Applied Economics at Cambridge University, exposed himself to some searching questions from his undergraduates when he declared:

"Macro-economics is in a state of deep confusion. The profession is deeply divided. So far from there being any body of knowledge which is generally accepted, almost every proposition is extremely contentious. Public discussion of economic policy has no coherent rationale and governments, notwithstanding their emphatic rhetoric, cannot give a credible explanation of how their policies will not achieve the results they seek, nor have they any basis for negotiation with one another."[2]

Economic theory – as practised – is no better equipped to head off a re-run of the 1930s than the statistical "evidence" that is bandied about by politicians and the Press.

That is why a three-year study by the International Federation of Institutes for Advanced Study ought to be fruitful.

Scholars from 15 countries met in Pocantico Hills, New York, last June – and decided to undertake a complete re-examination of their science. The $1m study is being under-written by the Nobel Foundation in Sweden and by the Rockefeller Foundation in the U.S.

According to Dr. Victor Urquidi, of Mexico, whose report on the global economy served as the starting point for the debate among the economists:

"We are living in a disjointed planet which is based on economic concepts which have nothing to do with present-day reality."[3]

REFERENCES

1. Robert J. Samuelson, '1 million jobs: missing or mirage?' *The Washington Post*, 25 Oct., 1983.
2. Wynne Godley, 'Cambridge Keynesianism fights back', *The Financial Times*, 11 May, 1983.
3. Kathleen Teltsch, 'Economic Theories Face Test', *The New York Times*, 21 June, 1983.

To be continued

● QUOTE by Prime Minister Margaret Thatcher in November 1983: "You may remember in 1981 when Sir Geoffrey Howe took his courageous steps to cut government borrowing, 364 economists united in condemning his action – 364 economists, one for almost every day of the year. What an alarming thought. And all of them actually in agreement! They said the Chancellor was wrong. They said he would deepen the recession. It was they who were wrong, for Britain's recovery dates from that time."

● TWO OXFORD DONS, in a paper published by the Bank of England, have attacked the empirical basis of Milton Friedman's monetarist theory.

Prof. David Hendry and Mr. Neil Ericsson undertook a critique of the econometric methods on which Milton Friedman and Anna Schwartz based their book *Monetary Trends in the U.S. and U.K.: their relation to Income, Prices and Interest Rates, 1867-1975.*

Their paper is scathing about the failure of Friedman and Schwartz to provide test evidence of their assertions, thus leaving them "devoid of credibility".

Rigorous evaluation of empirical claims seems a necessary first step "towards taking the con out of economics," state the two dons, implying that the basis for the theories of Friedman are false.

● Read Vic Blundell: p.37

● NEW YORK TIMES columnist Leonard Silk, reviewing the state of economic theory is the U.S. today, concluded:

"Proponents of the Reagan Administration's economics would maintain that its underlying laws remain valid and that, whatever the pains of adjustment after the blunders of past administrations, the classical laws are working marvelously, and there is indeed evidence that the economy has moved toward price stability and higher employment.

"But its opponents say the Reaganites are slaves of assorted dead economists, and that in the end all will go badly. Either it will go badly or it will not."

rise to perennial speculative booms that cause economies to go bust.

IN HIS BOOK Fred Harrison marshals all the evidence he can find that might throw light on the truth or error in his position and he presents a fascinating case for it.

● Dr. Will Lissner

The publisher describes the book as "lively" and "readable" but that is an understatement. Mr. Harrison's book is a formidable challenge to the apologists for the status quo which raises, and goes a long way toward answering, the questions that gnaw at the intellects and consciences of all thinking men and women.

● John Maynard (Lord) Keynes was a land reformer until he encountered what he believed was "a silent change in the facts."

● Paul Samuelson wrote specifically about the change: "Pure land rent has become a declining fraction of Gross National Product and Net National Product." No one had the courage to demand that he prove it in the absence of data on land prices.

● Raymond W. Goldsmith attempted to prove it but had to confess that his estimates were so fraught with error they could not be relied upon. (This has not kept proponents and opponents of the view stated by Professor Samuelson from citing Professor Goldsmith's estimates in support of their position!) Mr. Harrison points out why such estimates, at present, must be incomplete. He also presents such evidence as is available.

Since conclusive evidence is not yet at hand, these questions must be judged by the weight of the evidence; and it is certainly on Mr. Harrison's side of the argument.

In one of the final chapters he considers policies for recovery in the 1980s and asserts: "A reappraisal of why profits have slumped must be at the very centre of any attempt at fresh policy formation." He explains: "The rational strategy is to reduce rents and the buying price of land in locations where firms might start up or expand; and reduce taxes on wages and interest, to stimulate new capital formation and higher productivity."

A switch in tax policy from employment and investment, which now carry the burden of government levies, to land value taxation, he holds, is the only practical way to implement this policy.

REFERENCE

1. Fred Harrison, *The Power in the Land*, Universe Books (New York) and Shepheard-Walwyn (London), 1983.

● This article is reprinted from *The American Journal Of Economics and Sociology*, Oct. 1983.