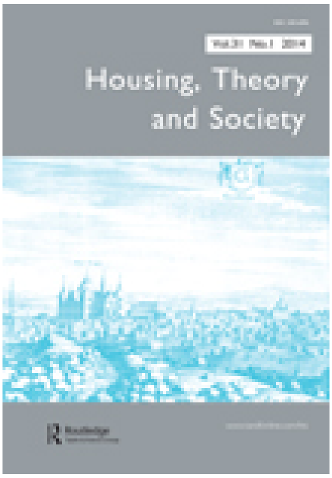

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COMMENT

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A Starting Point

I always find it difficult to read – let alone review – polemics, because my response is to try to find alternative arguments to each element of the story being put forward. This is both tiring and ultimately unproductive, as it avoids engaging at the more fundamental level of why the writer is so angry. In this context, both Mike Berry and I can be called traditional generalist economists, and we are both probably angry about the same things: that the solid foundations of economics are sometimes being misrepresented by particular groups to the point where the sensible lessons that can be drawn from a careful understanding of economic principles and their application to policy are lost.

The picture of neo-liberalism and market fundamentalism put forward in this paper is one held by only a tiny minority of economists most of whom fully understand (or understood, as most are dead) the limitations of the models they were working with, but take a normative view that markets have, generally, been less subject to catastrophic failure than alternative regimes (see Whitehead 2012, for an analysis of the legacy of neo-liberalism to housing and urban research). In some notorious instances, this has been linked to strong political beliefs around a particular understanding of individual freedoms and choice. These are indeed a form of fundamentalism but as with other areas of belief, not all economists – even those who believe strongly in the market – should be blamed for a few extremists.

The problem here arguably stems from the inherent and intended naivety of economic modelling, which attempts – as all logicians do – to use assumptions as parsimoniously as possible in order to enable specific predictions. It is others who argue that the model is wrong because the assumptions are unrealistic rather than because it predicts incorrectly. In other words, it is not enough to say "people don't

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profit maximize, so the model is wrong" – what matters is whether the outcomes in terms of output, prices and indeed profitability can be better predicted by models which assume profit maximizing than by other approaches – and here the evidence is pretty strong that it is a good starting point.

This distinction is implicitly recognized in the introduction of Berry's paper where it is argued that the predictions in the early 2000s – not those of neo-liberalists, but of macro economists in general and financial market analysts in particular – were simply wrong. This is a view with which I have considerable sympathy, especially in the context of portfolio risk evaluation. But it is also possible to argue that governmental and regulatory responses were just as wrong as the market, and that it was the politically based interaction between the two – rather than the rhetoric of market fundamentalism – which deepened the crisis in ways that we no longer know how to address effectively. This type of analysis depends on a much deeper understanding of these relationships than can be achieved while the situation is still unwinding, and at the same time being modified by administrative and policy responses as well as by market pressures themselves directly impacted by the power of particular groups. Everyone has a right to hold a view here – but that view cannot be based as yet on thorough empirical analysis.

What I find more difficult to follow thereafter, however, is the paper's emphasis on economic neo-liberalism as the cause of the problem as opposed to the misinterpretation – purposive or otherwise – of the fundamentals of economics, by politicians, power brokers and administrators alike. This could itself be viewed as a failure of political economy – although I tend to see it more as an outcome of the incentives each group faces than perhaps fits the polemical model.

Understanding the Role of Simple Economic Models

In the first year – and sometimes the first week – of any traditional undergraduate economics course, the lecturer will explain the role of prices as a means of allocating scarce resources in a market system, and of the equivalent decisions with respect to quantities in an administrative system. In time, the necessary marginal conditions for the pricing system to optimize the allocation of these scarce resources (given individual utility maximization) will be set out and compared to the equivalent necessary conditions for an administrative system to maximize a well-defined social welfare function (Bator 1957; Hicks 1975). It will be pointed out that the necessary conditions are fundamentally the same, but to achieve them requires different assumptions, particularly, about competition on the one hand and team decision-making and the transfer of information on the other. It will also be pointed out that while the necessary conditions can be specified in simple comparative static models, they are not realistic in either context.

In the context of administrative decisions, the generally held view is that the predictions of the simple model failed to the point where, post the collapse of communism and almost without discussion, market-based systems are generally seen to lead to better efficiency outcomes (Stiglitz 2000).

None of this means that markets work perfectly – or even that they work well; rather that in many circumstances, they work better than other options and, for the optimists among us, they are seen as having a better chance of improvement through appropriate government intervention. Here, again equivalence theorems play a role in that, under highly restrictive conditions, regulation, taxation and subsidy, and direct provision can all be used equally as means of generating more desirable outcomes (Whitehead 1983).

This puts us straight into the issue of the second best (or really the *n*-th best) world, which is the one we live in (Lipsey and Lancaster 1956–1957). General equilibrium theory in its most extreme form applies only if all conditions are met – which they clearly are not. The general theory of second best generated two distinct results (i) that if there are market imperfections, the separation theorem, by which government could make political decisions about the distribution of income and wealth – e.g. by enabling equal distribution of the ownership of available resources – and then allow the market to deliver the efficient outcome for that distribution, does not hold; and (ii) that if there is more than one market imperfection (think of the long list of assumptions and realize that will always be the case), you cannot adjust the market in a way which appears to increase efficiency, and be sure that the outcome will be a Pareto improvement. So for instance, if you reduce monopoly power in one industry the result may be over-production in that industry as compared to all the other industries where monopoly power continues to exist. This could be a worse outcome than leaving well alone. As a result, each intervention has in principle to be directly assessed to determine both efficiency and distributional outcomes. There are no inherent certainties, but we can learn from our understanding of the outcomes of past decisions to improve future outcomes.

This is the world in which my generation grew up – one concentrated on welfare economics and the imperfections of markets; one based on using social cost-benefit analysis and related tools to improve decisions; and one based on a clear understanding that outcomes should be assessed, so that we learn what are the most important drivers of change and the most likely impacts both intended and perverse. It is a world where neo-liberalism had been trounced and a world of normative decision-making (by well-meaning economists and politicians who recognized they might be wrong) dominated. It is, I think, this world to which Berry wants to return.

Relevance to Urban Economics and Cities

By the time students get to analysing urban systems, they tend to have completed their undergraduate degree and to have worked through the general equilibrium model. The starting point for understanding urban economics is, therefore, the limitations of market economics in the context of space. Once we allow for location, there is no such thing as perfect competition – at the best there is monopolistic competition with trade-offs having to be made about scale on the one hand and desirable diversification on the other. But more generally, there are spatial limits to markets arising from the locational patterns of economic activity and residence. These, together with large economies of scale and distributional networks especially with respect to urban transport and utilities, ensure that there will be inherent issues of market power, and at the limit natural monopoly, with respect to many urban services. Equally, markets are almost certainly going to fail to produce local public goods effectively and, more generally, will lead to underinvestment in urban, and inter-urban, infrastructure. Finally, many of the benefits of urban systems involve spatial externalities – both limiting negative impacts and encouraging positive relationships.

All of these are elements of gross market failure, where very few economists – would argue that the market should be left to resolve. Perhaps the most extreme argument in favour of markets was spelled out by Coase in his seminal 1960 article in the context of externalities, setting out the conditions for ensuring efficient levels of externalities, and leaving the distribution of benefits to that specified by the legal framework which enables the contractual arrangements (Coase 1960). This is another exercise in showing that markets can do the job, where there is perfect information and costless monitoring and enforcement. But, as these conditions clearly do not hold, we are back in a second best world where efficiency and distribution are linked, and government intervention is required to bring about many of the benefits of urbanization.

Then, the argument becomes one about the relative likelihood of successful intervention vs. letting the market rip. It has to be said that the evidence in favour of regulation in particular has often been weak. Administrators have their own objectives and relative access to imperfect information, so they should be in a position to improve on market outcomes. Governments also, through taxation, have the power to make decisions based on social discount rates – lower than the market both because governments can in principle manage risks, particularly of large-scale specific investments (such as tunnels and airports), better than the market and because societies care more about the longer term future and sustainability than individuals making market decisions. Thus, the case for government involvement in investment and network decisions is particularly strong, and countries that make less use of these powers – such as the USA – tend to find it difficult to provide and maintain these types of infrastructure. But to call this neo-liberalism except in the political rhetoric is to my mind going too far.

What, unhappily, needs to be stressed just as much is that administrative decisions are not necessarily any better than market ones – either with respect to efficiency or the distribution of benefits. In the UK for instance, in the 1970s, some 90% plus of government-sponsored investment (including nationalized industries making up over half of the economy) was not subject to any formal assessment of likely returns or value for money, but rather was justified on the basis that it was necessary – without any concept of opportunity cost. In Australia, vast tracts of land were serviced never to be used around the capital on the same basis. The introduction of formal, market-oriented, evaluation techniques employed within a (relatively) transparent political system has undoubtedly vastly improved the general quality of investment decisions – even if it has not ruled out large-scale vanity projects.

It is in this context that the importance of modern information networks and their impact on the speed of decision should be stressed – as indeed Berry does. His position appears to be that these networks are inherently dangerous from the point of view of markets implicitly because much of the information may be wrong. Again, there is a fundamental distinction between those who see competition in the provision of accurate information as the best option and those who argue that much information is fundamentally a public good and must, therefore, be government provided or at the least regulated. It is clear that the quantity of information available and the speed at which it has to be absorbed has massively increased the stakes of failure both in market and in regulatory.

Where we stand on the mix between market and administrative decisions depends not just on our own normative views and our governments' political agenda, but increasingly on evidence of success and failure with respect to outcomes. In

China for instance, the emphasis remains on centralized administrative decisions with respect to large investments – partly for political power reasons, but also because it has been seen to work relatively well given the current stage of development. But, there are growing indications not just of the increasingly uneven distribution of benefits but also of massive wastage of resources, almost certainly negatively impacting on future growth. In the USA on the other hand, pressures are increasing to find more effective ways of providing the infrastructure and technological base to maintain their world role and support higher growth rates. In both cases, the final decisions are political, although they have immense economic implications.

The Economist's Role

The biggest problem in the interface between economists and politicians lies in the fact that politicians like simple messages, while economists want to spell out the complexities. As a result, most of the messages that politicians argue they take from economics are wrong. Here, I just give two examples from housing and taxation policy in the UK. The first example: policy-makers tend to argue that on economic grounds, demand-side subsidies are more effective than subsidising supply. This is true only under the most restrictive partial comparative static model, but has been central to the housing policy debate on income related vs. rent subsidies over the last 30 years. The second was the economic basis for reform of local government taxation, in the 1970s. Then, the politicians were happy to take on board from economics literature the idea that poll taxes are non-distortionary even though the form of tax they wished to introduce bore little relationship to the basic model of non-distortionary taxes. These, and the many similar examples that can readily be found in almost any other industrialized country, make it clear that economists need to be far more sophisticated in how they present advice. Otherwise not only are they misrepresented, they are also blamed for over-simplification. This is the position with respect to neo-liberalism which is fundamentally a political not an economic concept.

In conclusion: what lessons should we draw? First, the fundamental of economics lies in looking carefully at alternatives. The world is not perfect and cannot be perfect. Choices have to be made between different imperfect approaches to improving the use and distribution of resources – and there is always an opportunity cost to each decision. Second, urban economies involve, particularly difficult areas of market failure – but these are also areas, where administrative systems are often just as likely to fail. Any effective urban policy must involve a careful mix between the two. Third, the only way we will improve decisions is better to understand the drivers of past failures and successes. And finally, while we have a reasonably strong basis for micro-economic decision-making, arguably we need to go back to the drawing board when it comes to understanding macro-economic systems in a global economy. Blaming neo-liberalism is far too easy a way out.

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