Economic Philosophy fails Australian Agriculture

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"The financial crisis represents the ultimate failure of this education system and of the academic discipline as a whole. Economics education is dominated by neoclassical economics"

Zach Ward-Perkins and Joel Earle

Economics students need to be taught more than neoclassical theory

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This article discusses why neoclassical economic philosophy and market theories have failed rural Australia

1 Institutionalization of Neoclassical economics in Australia

Following the 1972 election , the Whitlam Administration sought to widen the powers of the Tariff Board. Sir John Crawford was invited to advise on establishment of a new institution to provide informed and professional policy advise to the Government. The subsequent Crawford Report[i] (1973) recommended a new institution that should provide coordinated policy promoting efficient resource allocation. Implied in this recommendation is neoclassical economics of markets.

In December 1973, the Industries Assistance Commission Act was passed. The Legislation carried only minor variations to the recommendations of the Crawford Report[ii]. Guidelines for the Commission stressed resource allocation, adjustment to change, and integration of assistance measures with overall government policy. Policy approach by the IAC is conservative economics favouring free market efficiency and minimum government intervention[iii]. Since its inception IAC has been restructured and today is the Productivity Commission.

Over 1970-72 , Evans developed the first general equilibrium model of the Australian economy[iv]. His work became the forerunner of the IMPCT model. In 1975, the IMPACT Project was initiated to provide analytical advice on implications of social and economic change as well as policies. The project was initiated by the IAC; but, included a number of other departments[v]: Departments of Industry Commerce, Employment and Industrial relations, Environment Housing and Community Development, and Australian Bureau of Statistics. The Project structure comprised two models for analysis of both medium and future time horizons. The medium term module MACRO consisted of an annual general equilibrium model ORANI; and, a longer- term demographic model BACHEROO. The MACRO medium term model was structured to link sequences of annual projections. The purpose of the long term model, SNAPSHOT, was to provide analytical information on the economy at some arbitrary future point in time.

Provision of the IAC and other government departments with neoclassical general equilibrium models institutionalised market theory as the analytical basis of Australian policy analysis and development. A market clearing assumption within the models reinstates Say's Law of Markets as supply and demand theory. Under Say' Law, supply creates demand. This assumes away deficiency of demand under flexible markets. Competition, efficiency and productivity become industry policy objectives.

2 Economics Post 1983 supply side economics

The Hawke/ Keating Administration brought supply side economics[vi] to Australia. Supply side economics is viewed as "*a renaissance of the classical economics of Adam Smith and Jean Baptiste Say"* [vii]*.* David Ricardo's Comparative Advantage Theory also features in supply side economics. Supply side economics was a policy direction not in itself an economic philosophy. Consequently, the institutionalization of neoclassical models across Australian public service institutions was not incompatible with supply side economics as both have a common heritage in Say, Smith and Ricardo

The architects of supply side economics was a group of politically powerful vested interest players led by Wall Street Journal editor Robert L Bartley; and, editorial writer Jude Wanniski[viii] . Supply-siders drew on thinking of Nobel Prize economists: Robert Mundell, Milton Friedman, James Buchanan, and Friedrich Hayek[ix]. Mundell and Friedman are recognised Chicago School monetarists. Hayek is from the Austrian School of thought whilst Buchanan is regarded as being sympathetic to Austrian economics. Another non Nobel Prize former Chicago School lecturer deeply involved in the development of supply side economics was Arthur Laffer

Wanniski was a formidable financial journalist. It was Wanniski in his work "*The Way the World Works"* that the modern fear campaign about the use of protectionism has its roots. Wanniski argued that the Smoot-Hawley tariff triggered an ensuing trade war[x]. Bartley modifies this claim by saying that Wanniski was probably right; but, the stock market had begun to slide months before the Smoot-Hawley legislation was enacted. Drawing on Robert Lucas' theory of "rational expectations"[xi](Chicago School, 1995 Nobel Prize winner), Bartley argues that investor expectations of the legislative effects might have triggered the "pricking of the share (market) bubble". Despite this tenuous link, the argument that protectionism caused the Great Depression has become a strong defensive instrument against interventionism

3 Applied Policy Failure: Rural Australia

Hawke/Keating removed industry protection to reform Australian agricultural through exposure to foreign competition. International competition would force Australian agriculture to increase efficiency and raise productivity. Table 1 shows empirically how applied policy produced perverse outcomes of falling profits and rising debt as the number of farm units decline.

Table 1

Farm Debt and GVFP per Farm Unit

Year	Farm Units		$ GVFP/debt	Debt/ GVFP%
	No. Units	$Debt		
1969	195700	$9 980	$2	49.5%
1979	177218	$18 627	$3	32.4%
1983	178025	$30 878	$2.13	50%
1993	151966	$85624	$1.74	57.3%
2003	132983	$236511	$1	94.7%
2009	135996	$466639	$0.97	102.8%
2010	134184	$461582	$0.64	156.2%
2011	135447	$472989	$0.74	134.2%
2012	N/A	N/A	$0.74	135.4%

Note: (a) calculated from ABARES GVFP and RBA Rural Debt Table

(b) GVFP = Gross Value Farm Production

(c) Calculations are average debt per farm unit. Distribution is unavailable.

Because of available data, Table 1 is average calculations. The distribution of debt per farmer is the significant figure and that is not available in public published data. The seriousness of the debt crisis cannot be overstated. The populist urban "armchair" commentator's view of inefficient small scale farmers in trouble is nonsense. From our Rural Debt Round Table activities, this time it is large scale efficient mechanised farmers that are in serious financial difficulties. These are the farmers who "bought" the political spin of economies of scale as the pathway to profitability. As 20% of farmers produce 80% of national agricultural production, should these large farmers default on debt, then there is a national food production problem

The evidence is indisputable. As the level of debt rises, the value of output per dollar borrowed declines. The Table shows that in 1983, debt equalled 50% GVFP and each dollar borrowed supported $2.13 of output. By 2003 debt equalled 94.7% of GVFP, each dollar borrowed supported one dollar of output. From 2004, the value of output from a dollar borrowed falls to 74[c] in 2012. Table 1 shows the dismal failure of applied policy that sought to build an internationally competitive and prosperous rural sector through deregulation, economies of scale, increased efficiency and rising productivity.

Why did banks continue to advance monies to farmers that were producing declining volumes of output relative to monies borrowed? There is no secret to that answer: debt to equity finance. As asset prices in the wider community rose, rural land prices increased also. Banks chasing market share ignored a long standing financial fundamental: capacity to repay debt form income.

When the GFC hit over 2008-09, rural finance changed. Capital market securities backed rural mortgage pools were no longer attractive to investors. Investors realized that underlying rural mortgage pools were overvalued. Capital markets effectively devalued rural mortgage pools by their reluctance to buy the securities based upon those pools.

The toxic nature of rural mortgage pools meant that debt to equity lending ceased. Farmers were asked to meet debt commitments from income. As loans were never designed to be repaid from income, heavily indebted farmers were seriously exposed the will of creditors. As finance dried up, forced sales created an oversupply of rural properties. Oversupply of properties for sale generated further downward pressure on rural land prices. Falling land values eroded formerly sound debt to equity positions. Consequently, the rate of insolvencies began to rise as banks sought to protect portfolios. Inevitably, rural suicides began to escalate as some farmers saw no other way out.

Pre GFC existing government farm finance programs were never designed to address consequences of a GFC type event. Widespread drought simultaneously compounds the financial positions of farmers whilst increasing pressure on State rural assistance programs. Rural Australia is a mess and the responsibility comes back to long term policy failure by successive governments besotted with elegant neoclassical mathematical models providing unquestioned advice to government.

4 Why did Rural Policy fail?

"Our criticism of the accepted classical theory of economics has consisted not so much in finding logical flaws in its analysis as in pointing out that its tacit assumptions are seldom or never satisfied, with the result that it cannot solve the economic problems of the actual world"

J.M.keynes

General Theory--.p. 378

This excerpt from Keynes' General theory provides a clue to why neoclassical rural policy has failed to deliver a profitable farm sector for over three decades. Underlying assumptions of neoclassical theory do not reflect the real world of agricultural production

*Firstl*y, the economies of scale solution implicitly assumed constant returns to scale. Table 1 demonstrates empirically that agriculture operates under declining returns to scale - not constant returns to scale. Consequently at some point, further expansion of a farm enterprise produces an unprofitable farm. Underlying assumptions implicit in the economies of scale policy not reflect the real world of agricultural production.

*Secondl*y, assumptions underlying supply and demand theory are also deficient when compared to the real world of agricultural production.

"*The downward trend in real commodity prices need not of itself produce a loss of national income nor a decline in the profitability of commodity producers if the decline in the real commodity or manufactures price is the result of higher productivity*"

NFF , Beating the commodity price cycle, 1995

This excerpt from the National Farmers Federations "*Beating the commodity price cycle*" is a modern restatement of Say's Law of Markets in terms of commodities.

Keynes' General Theory (p.18) carries these comments about Say's Law of Markets"

- *From Say and Ricardo , classical economists have taught that supply creates its own demand*

And quotes J.S Mill

- *Could we suddenly double the productive powers of the country, we should double supply of commodities in every market--- by the same stroke we should double the purchasing power—everybody would buy twice as much as everyone would have twice as much to offer in exchange*

J.S Mill

Principles of Political Economy

Implicitly underlying Mills interpretation of Say's Law is the assumption that costs of production must be covered always by the sale value of output. This assumption becomes the classical theory's axiom of parallels embracing (G.T, p. 21):

- *Social advantages of private and national thrift*
- *Traditional theory of the rate of interest*
- *Classical theory of unemployment*
- *Quantity theory of money*
- *Unqualified advantages of free trade*

If you think about Say's Law as explained by J.S. Mills, productivity becomes the policy of growth. Mill's interpretation explains why modern orthodox economics confuse productivity with profitability. They are one and the same in the eyes of Say's Law.

In the real world, productivity and profitability are very different concepts. Profit is revenue less costs whilst productivity is the percentage change in output from a change in an input or inputs. The change in output can be just as easily cash negative as it can be cash positive. So policy emphasis on research and development to boost productivity need not solve the low farm income problem

(2) Engel's Law

Engel's Law states that as incomes rise in a mature economy the percentage spent on food declines proportionally. Applied economic policy based upon Say's Law of Markets assumes that rising supply will always find a market and return a normal profit. These two important laws describe behaviour from different sides of the market with opposite conclusions. Both cannot be true in the real world.

Confirmation of Engles' Law in Australia have been provided in previous writings which can be found at http://www.benrees.com.au/

Conclusions:

This discussion has shown that assumptions underwriting contemporary orthodox economics are defective relative to the real world. The current low farm income and debt crisis becomes long term perverse policy outcomes of an agricultural policy reliant upon assumptions that do not reflect the real world of agriculture. Consequently, the philosophical underpinning of agricultural policy pursued since the 1970's lies at the centre of this rural crisis of low farm income, low profitability and unmanageable debt levels.

In the new Federal Parliament, a Minister for Agriculture has been appointed who has a farm upbringing combined with professional training in banking and accountancy. it is hoped that this new Minister will not blindly accept policy advice from elegant mathematical models of a failed economic philosophy. The new Minister could begin the hard task of returning agriculture to profitability by asking the public service and industry leaders and advisors to defend their long term support for failed policy in terms of economic philosophy and underlying assumptions.

[i] Watson, A.S. , Agricultural Policy, from, *Surveys of Australian Economics,* Gruen F.H. ed., Allen & Unwin 1978, p. 195

[ii] Lloyd, P.J. Protection Policy, from Chap. 5; *Surveys of Australian Economics*, Gruen, F. H. ed. , Allen & Unwin, 1978, p.257.

[iii] Penguin Macquarie Dictionary of Australian Politics, Penguin Books, 1988, p.181

[iv] Lloyd P.J, Surveys of Australian Economics., ed. F.H. Gruen, George Allen Unwin,1978, Ch. 5 ,p.271-72

[v] Watson, A.S. op. cit. p. 274

[vi] Omerod Paul, The death of Economics, faber and faber,1994,p.68

[vii] Cleaver H. ; Supply Side Economics: The New Phase of Capitalist Strategy in the Crisis; Babylon Metropoli, El Gallo Illustrado, 1981, p. 1;webspace.utexas.edu/hcleaver, 12/07/2012,

[viii] Bartley Robert L; *How Reaganomics Made the World Work: We're all supply siders now*, The Arsenal, April 1989,p.1

[ix]Bartlett Bruce; *How Supply-Side Economics Trickled Down*, Economists

[x]Bartley Robert L; *How Reaganomics Made the World Work*: *We're all supply siders now*, The Arsenal, April 1989,p.8

[xi] Yergin, Daniel, and Stanislaw, Joseph, *Commanding Heights*, Simon & Schuster 1998, p. 148