Lance Taylor

The flavors of economics & the public interest

Two hundred years ago, the ancestor of today's economics was called political economy: it was political in that it had a strong connection with political philosophy and a focus on public policy. Nowadays, political economy is called classical economics. It was succeeded late in the nineteenth century by a neoclassical revision that itself diverged into contending schools, but still controls the policy debate, especially in the United States.

This genealogy is useful because the different flavors of economics incorporate distinct attitudes about the public interest. How the state interacts with collective actors is central to the distinction. On the surface, mainstream economics does not consider collective actors at all. Rather, like the chorus in a Greek play, it incessantly chants that the economic system is populated by highly competitive 'agents' with good information, who strive to maximize their own well-being (profits for firms and consumption 'utility' for households) within an observed price system. These choices lead to a welfare level as high as it possibly can be for each participant. Shorthand labels for this level are Walrasian equilibrium, named after a late-nineteenth-century French economist, Leon Walras, and Pareto optimum, after Vilfredo Pareto a bit thereafter. When the equilibrium is perturbed, prices rapidly adjust to signal how resources should be reallocated to ensure that they are fully employed – with the proviso that the only way that one actor could gain additional income would be for another to lose.

However, policy practitioners may group agents into wage-earners, profit recipients, the government, etc. So to speak, collective actors enter via the back door. Moreover, even the agents in the play may have a hard time behaving as the chorus thinks they should – an insight often credited to Alfred Marshall, another nineteenth-century founding economist – because economic

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information is, in practice, not fully reflected in prices: 'Distortions' such as taxes and tariffs (almost always blamed on government intervention) lead decisions astray. Monopoly positions exist that, further supported by increasing returns to scale (or decreasing costs per unit of production), can deform the price system. All these forces push the economy away from a Pareto optimum.

Mainstream economists and pundits thus vacillate between the view of the chorus and the travails that the agents confront. Most – notably those in a position to influence policy – continue to take the perspective of the chorus while seeking to expunge whatever distortions may exist. Advocates of liberalizing international trade belong to this group. Others construct mathematical models about the manifold optimization problems that economic actors in daily life are supposed to resolve. A main theme of their work is how asymmetric information between agents can force the system away from a Pareto position. State intervention may at times improve the situation. More recent empirical work on topics like minimum wages and poverty has drifted away from mathematized behavioral models, but remains informed by the narrow neoclassical worldview. To paraphrase Clifford Geertz, 'thin description' is the order of the day.

In contrast to the mainstream picture of the economy is the classical (or more generally, 'structuralist') perspective, which has roots in politics and sociology. The economists Adam Smith, David Ricardo, Thomas Malthus, and Karl Marx adopted this view. Rather than focusing on either the price-mediated functions of the whole system or the behavior of individual agents, they highlighted the dealings of collective actors – organized groups or classes such as capitalists, landlords, and peasants. In the twentieth century, John Maynard Keynes took this approach, directing his wrath against bear speculators and high-saving rentiers, who could slow economic growth by seizing up the financial system.

In this alternative account, relationships among collective actors help determine relative prices and income distribution, and influence technical progress and supply. Smith and his successors were clearly aware of the importance of technological advance – routinely measured by increases in the average productivity of labor – often stemming from decreasing costs, as in the famous pin factory. Such scale economies are much more easily realized in some sectors of production – notably but not exclusively industry – than in others. Classical economists saw economic development as the expansion of sectors with increasing returns (web search is the most striking recent example) while sectors with more mature technologies gave way.

On the other side of markets are factors that determine the level of effective demand. For Keynes, among these were the "animal spirits" of investing firms, but they also include the upswings and downswings of household spending. These factors also influence the pace of growth in productivity. The economy's position depends on these interacting supply and demand systems.

Prior to Marx with his reserve armies (and in line with the present-day mainstream), the classical economists assumed that forces on the supply side would determine overall output and employment, in part as an empirical generalization from the fact that in a poor economy lacking a differentiated structure of production an employable worker will not long survive without holding some kind of job. This postulate of full

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employment was named Say's Law after Jean-Baptiste Say, a French contemporary of Ricardo's. The law is enforced in a general way over long periods of time – unemployment does not rise indefinitely. But over decades it certainly can: witness Western Europe over many years stretching into the twenty-first century.

Contemporary structuralists also emphasize how accounting balances among economic actors – essentially, what is bought must be sold and what is borrowed must be lent – play a crucial role in determining how supply and demand forces interact. Keynes's basic insight that often (though not always) the level of effective demand determines aggregate supply emerges from such macroeconomic accounting restrictions. His rejection of Say's Law hinged on the observation that in an economy with a complex financial system there can be a long and variable period between the sale of one commodity and the use of the proceeds to buy another. Supply need not create its own demand, but rather adjusts to the demand that is out there.

Finally, underlying both demand and supply are shifting financial decisions by collective actors such as bull real-estate and stock-market speculators and bear hedge funds. The Asian crisis of 1997 was a replay of many prior episodes in which financial turbulence derailed the productive side of the economy.

So how do the different schools try to enhance the public interest through economic policy? The differences in their attitudes toward the public interest are apparent in the contexts of foreign aid as well as recent patterns of growth and income distribution in the United States. Let us turn first to the arena of foreign aid, and development policy more generally, for examples that are certainly at the forefront of international debate.

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An adage from Lao Tzu sums up the contradictory aspects of aid: "Give a man a fish and you feed him for a day. Teach him how to fish and you feed him for a lifetime." The true purpose of aid is presumably to help a man (or a national economy) sustain himself (or itself). For successful 'fishing,' the economy should maintain 2 percent annual per-capita output growth, and employment creation should keep pace with population growth. This combination can make a big dent in poverty by increasing average income by 22 percent over ten years and by 49 percent over twenty.

Foreign aid has certainly helped launch 2 percent or faster per-capita growth in diverse policy environments. In many cases, limited availability of hard currency is the crucial bottleneck in a developing economy, holding down both supply and demand. If effective demand can increase because foreign exchange is available to pay for the associated imports, it can stimulate private-sector investment and innovation. At the same time, the imports can bring in essential goods and technologies to raise productive capacity.

The first, most successful aid efforts were the post–World War II Marshall Plan in Europe and the parallel reconstruction program in Japan. They emphasized breaking foreign-exchange bottlenecks via coordinated public and private interventions, as opposed to market liberalization. It is worth recalling that the Americans who helped implement reconstruction were New Dealers at ease with an interventionist state.

In the 1960s and 1970s illiberal and bureaucratically planned South Korea utilized capital inflows and American-guaranteed market access to create a formidable industrial base, beginning with textiles. It then built the world's biggest

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integrated steel plant, eventually moving on to chip manufacture, automobiles, and broadband Internet coverage for over 90 percent of the country. South Korea's international economic situation was a consequence of cold-war politics, but its planners took full advantage of the opportunities they had.

In the 1980s, Chile sidestepped the rest of Latin America's 'lost decade' because it received ample foreign assistance from international aid agencies favoring its neoliberal policy stance. Increasingly sophisticated raw-material exports supported its economic expansion. Several economies in sub-Saharan Africa also now have respectable growth rates, because of Nordic and other donors who have provided steady aid over decades for their own geopolitical reasons.

Two-percent overall growth has several implications. First, it requires even higher growth rates in labor productivity in the leading sector(s), which in many poor economies is agriculture. Despite its adverse effects on income distribution, the aid-fueled Green Revolution successfully increased both land and labor productivity. In time, though, with real income growth, agriculture's shares in GDP and employment inevitably decline.

At higher income levels, the lead sector(s) must offer increasing returns and opportunities for robust output growth in response to demand. A clear pattern of structural change emerges from the data for economies – today mostly in East and South Asia – that sustain rapid growth. As in South Korea, industry almost always serves as the engine for productivity growth, though not job creation. For a sector or the entire economy to generate employment, its per-capita growth rate of demand has to exceed its productivity growth. Net job creation usually takes place in services.

In this situation, more foreign resources can help raise industry productivity, so real incomes can rise, and ease the demand constraint economy-wide, and people can be employed. Ultimately, exports and private capital can provide hard currency, as in Asia now, but aid can help get the growth process started.

In all these countries, a combination of technocratic top-down policy and spontaneous innovation from the bottom up created landmark shifts in economic structure. Even in neoliberal Chile, the government consistently supported expansion of mineral and agricultural exports. Unfortunately, neoclassical arguments to the contrary are highly influential today, even though they were completely ignored at the time of the Marshall Plan or South Korea's growth spurt. A widely held idea in economics now – first clearly stated by the founding neoclassical Austrian school from Vienna in the 1870s – asserts that rapid growth can only emerge from private entrepreneurship with clear property-rights protections. (William Easterly is a recent epigone).

History belies the proposition. Besides the cases of the now-industrialized economies and twentieth-century success cases that we have already seen, in which the state proactively intervened in development, consider the United States in the nineteenth century. Agricultural exports prevented a foreign-exchange bottleneck. Enormous public subsidies (with enormous corruption) supported investment in infrastructure, and the highest tariffs in the world protected industry. Entrepreneurs – from Rockefeller to the robber barons – abounded, but paid scant heed to conventional property rights.

In less strident versions, the Austrian argument dominates much current discussion of aid and development policy,

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especially among major donors. The famous 'Washington consensus,' now seemingly entering remission, strongly emphasized private-sector initiatives and strict limits on state guidance of the economy. In an argument dating back to Ricardo and built solidly into neoclassical theory, elimination of barriers to trade was supposed to generate big gains in economic efficiency. Thanks to Say's Law, workers and enterprises displaced by the removal of protection would be reemployed in other activities without significant hitches.

But over the past two or three decades, many aid packages and economic 're-form' programs informed by the consensus did not generate linkages among demand growth, productivity, and employment. Per-capita income levels did not rise, and workers displaced by trade liberalization vanished into informal and subsistence activities. Foreign aid became at best a dole, and at worst a cesspool for corruption.

Certainly, doles can have positive impacts at the micro level if one can avoid problems ranging from an established, exploitative class structure to Marshallian distortions and information asymmetries. A handout from abroad may cure smallpox or alleviate childhood malnutrition – but it is a handout notwithstanding. In recent decades many poor countries have seen marked improvements in primary education and health care, but their economies have not been able to grow. Even if they succeed on their own terms, people-oriented technical fixes at the household level – advocated by individuals such as Bill Gates and Jeffrey Sachs – do not directly stimulate economy-wide expansion and enduring poverty alleviation.

Foreign assistance is bound to be available in limited quantities. Cost estimates for the Millennium Development Goals (MDG), a humanitarian aid program emphasizing technological tricks to bring quick results, range upward from $150 billion per year. Current aid flows, including debt relief, are on the order of $100 billion in principle. In practice, the transfer is far less. The International Monetary Fund (IMF) is not allowing governments to channel forgiven debt toward increased spending on poverty reduction because of its phobic fear (not supported by any evidence) that a modest increase in fiscal outlays will kick off uncontrollable inflation.

Even if aid mounted, the IMF relented, and humanitarian goals were realized, the MDG effort can only be successful if it puts economies on paths of sustained growth. In the past aid has sometimes set off growth, but more often it has not. There are many challenges to overcome: At the micro level, augmenting human capital by itself will not support steady growth unless highly productive enterprises get started. Entrepreneurship is essential to this end, and should be rewarded. But that will not happen spontaneously in a liberalized market environment. The state has to play a strong supportive role.

Unfortunately, Washington consensus packages currently bind the hands of governments in developing countries. To direct their limited resources toward productive ends, these governments must have the available 'policy space' to use instruments like sensible tariffs and trade quotas, targeted credit, and production subsidies. Scale economies are potentially available in many lines of endeavor – the task is to identify and support them. Linking fetters on development policies to disbursements of aid – standard practice for the World Bank and IMF – is completely counterproductive.

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In the United States, productivity growth and distributive conflict have come to the fore. Although growth since the recession of the early 1980s has been relatively stable, the rates are unimpressive compared to the post–World War II golden age of market capitalism. More ominously, inequality has widened. Even with generous corrections for fringe benefits, index-number biases, and the business cycle, real-wage growth has not kept up with labor productivity. Across cycles, the wage share of output (equal to the real wage divided by productivity) has declined and the profit share has risen. The wage gap between skilled and unskilled workers has grown, and a chasm has opened between median, mean, and even 99th percentile wages and payments to top executives, entertainment and sports stars, and financiers (who are in a higher income bracket than even the top executives).

The standard neoclassical explanation for these trends is that they are inevitable: the economy is at a Pareto optimum, which because of factors such as globalization, increased use of information technology, and financial innovation has shifted in favor of the affluent. But from a broader perspective, we must ask why such income concentration has been permitted to occur. Surely something in the nature of the social contract must have changed.

Take, for example, the CEO of Norway's Norsk Hydro, a company dealing in oil and aluminum. There was public outcry over his pay package this summer. Because the center-left government owns 44 percent of the company, the Minister of Trade and Industry intervened. The CEO ended up with a 10 percent raise on a salary of roughly $1 million per year, but his accrued stock options were trimmed to around $4 million with no more to be granted in the future.

The Hydro chief is presumably as competent as his counterparts at smaller American competitors, but they make at least ten times what he does. His relative penury is in part a consequence of the Nordic socioeconomic model, which has rested for decades on income equalization. People in egalitarian societies are jealous of excess affluence and do not tolerate its existence for long. Americans have never been anywhere near as egalitarian as the Nordics, but it is striking how their tolerance of opulence has grown over the past two or three decades – with a substantial political push from the people at the top.

Macroeconomic forces also underlie shifts in distribution and growth. One way to think about them is a 'demand-led' growth model proposed by the Cambridge structuralist Nicholas Kaldor in the 1960s. He observed that productivity growth appears to be stimulated by output growth – an idea also raised by Arthur Okun on this side of the Atlantic at about the same time. Going back to Marx and Ricardo – notably the latter's discussion of England's Luddite machine-smashers early in the nineteenth century – rising real wages may also induce firms to seek technologies to save on labor and production costs.

Unit labor costs are reflected in the wage share, which is reduced by higher productivity. Lower costs in turn can stimulate aggregate demand by making capital formation cheaper and national exports more competitive in the world market. Because the nonwage, or profit, share increases when productivity rises relative to real wages, we can say that demand (and output) growth is 'profit-led' under such circumstances. If demand is 'wage-led' on the other hand, higher productivity can displace workers and lead to jobless growth as the Luddites feared. The United States and

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countries with similar economies (e.g., the United Kingdom and Japan) appear to be profit-led; wage-led may be the rule on the Continent.

If Kaldor's (or more generally, Keynes's) model applies, there is ample room for demand-side policies to stimulate economic growth. Sensible expansionary monetary and fiscal actions can support demand and thereby stimulate productivity growth through Kaldor-Okun effects. Fiscal deficits may be a consequence, but they need not lead to unacceptably high real rates of interest and inflation. Productivity gains themselves can help keep inflation in check.

If demand is sufficiently profit-led, employment can rise as well. Labor-market interventions such as minimum- and living-wage programs can help maintain the labor share, providing a stabilizing influence against 'excessive' demand stimulation. Enhanced public investment may well 'crowd in' private-capital formation, and help provide vital infrastructure (contrast the United States' broadband coverage at 50-plus percent with South Korea's at 90-plus percent).

Demand-driven models explain other aspects of the macroeconomy – for example, a cycle between demand and distribution as proposed forty years ago by Richard Goodwin, an American economist-artist who found the universities of Cambridge and Siena more congenial than the ones in the United States. At the trough of an output cycle, productivity rises rapidly as the economy emerges from recession, boosting the profit share and demand. Real wages rise (accompanied by inflation) with output as the labor market tightens; cut into profits; and reduce demand at the peak. But any complex system changes its behavior over time. As of summer 2007, we are in a cyclical upswing, and it remains to be seen whether wage increases will impose their familiar brake on demand expansion. Labor's bargaining power has visibly eroded over recent decades.

A final question is how wage- and profit-led demands fit into the broader economic system. Along classical lines, the Dutch economists Ro Naastepad and Servaas Storm point to a strong institutional complementarity among 'Anglo-American' uncoordinated industrial relations ("flexible labor markets"), a stock market–based financial system placing emphasis on short-term profitability, and a profit-led demand regime. Similarly, a 'Continental' regulated labor market, bank-based financial system, and wage-led demand appear to be complementary.

Both institutional structures have their advantages and disadvantages. In the period since Thatcher and Reagan, political discourse and financial reportage especially have emphasized the adaptability of Anglo-American systems. Slow, jobless growth is allegedly a Continental malaise. While such growth is certainly a possibility in wage-led systems, well-designed policy can sidestep it, as in the Nordic countries with their relatively low unemployment and high growth rates of GDP, productivity, and real wages.

Beyond the cyclical short run, jobless growth is not even contemplated in the model both liberal and conservative policy economists utilize to analyze the United States. Variant versions formulated eighty years ago by the Cambridge polymath Frank Ramsey and thirty years later by MIT's Robert Solow – elegant renditions of the neoclassical Greek chorus – incorporate Say's Law, along with the corollary that the supply of savings exclusively determines investment or capital formation (simply ignoring Keynes's "animal spirits"). Savings in

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turn follow from the level of output, set by fully employed labor and capital along with a rate of productivity growth coming from "technological factors" outside the macroeconomic system. Forces of "productivity and thrift" thereby determine macro outcomes.

This model has strong ramifications, two of which served as rationales for the tight fiscal policy pursued by the Clinton administration. First, the theory contends that by absorbing part of the available savings flow, a fiscal deficit will curtail investment and reduce growth. While such an argument might make sense for an externally constrained developing economy, it is irrelevant for the United States, where investment has exceeded saving since the early 1980s and the shortfall offset by borrowing from abroad.

A low deficit also supposedly puts less pressure on financial markets, so that interest rates decline. Keynes debunked this idea decades ago when he observed that returns to assets in thick markets, like the ones for Treasury bonds, are much more likely to be determined by transactions involving the total volume of obligations outstanding rather than by the relatively modest new issues resulting from the current fiscal deficit. In fact, real bond interest rates were at historically high levels leading into and during the fiscally austere Clinton period, and dropped off to very low levels after 2000 when fiscal policy became highly expansionary under Bush. Though driven in part by the Federal Reserve's actions, these changes were also responses to shifting perceptions of risk and inflation (possibly reversing as of mid-2007) in the bond market. Real saving and investment flows were of secondary importance in this context.

Third, the belief is that because available savings constrains total investment, public-sector investment will crowd out private capital formation. And if, as is commonly assumed, private economic decisions are 'more efficient,' Say's Law leaves scant room for public-capital formation – even for creating social goods such as human capital.

In a Walrasian world, available supplies of labor and capital, along with the behavioral responses ('marginal conditions') generated when firms maximize profits and households maximize utility, set the real wage and the wage share. As I noted earlier, labor-market interventions can have strong effects in demand-led growth models. But under neoclassical growth assumptions, about all they can do is contribute to cost-side inflation and dilute the efficiency of resource allocation by distorting the price system. (In fact, it is not clear that the assumptions really apply. Some recent empirical work suggests that concerns about distortions induced by minimum wages, for example, are likely to be unjustified.)

The inflation angle follows directly from Say's Law. Full employment of labor is now called a NAIRU (non-accelerating inflation rate of unemployment), an acronym only an economist could love. There is a mainstream obsession with policy aimed at the price (or nominal) as opposed to the quantity (or real) side of the economy. Rather than creating jobs or building infrastructure, policy is now directed toward 'inflation targeting,' which often implies high interest rates and a strong exchange rate to hold employment below the NAIRU level and reduce the cost of imports as well as support international financial transactions. This combination of 'macro prices' is kind to the wealthy and well-connected, but it does little to support processes of production.

Whether the interest of the public at large is served by this policy orientation

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with its denigration of government initiatives is an open question. Structuralist, demand-based theories point toward different policy goals within a broader socioeconomic framework. In both poor and rich countries, orthodox policy has not been notably successful for the majority of the world's populations since it came into its heyday during the Thatcher-Reagan period. It is high time to give that old grey mare a chance to rest.

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