THE POLITICAL ECONOMY OF GROWTH

—David Simpson—

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The Political Economy of Growth

Classical Political Economy and the Modern World

Basil Blackwell · Oxford

First published 1983
Basil Blackwell Publisher Limited
108 Cowley Road, Oxford OX4 1JF, England

British Library Cataloguing in Publication Data

Simpson, David
The political economy of growth.
1. Economic history – 1945–
2. World politics – 1975–1985
I. Title
330.9'048 AC59

ISBN 0-631-10871-8

Typeset by Cambrian Typesetters,
Farnborough, Hants.
Printed and bound in Great Britain
at The Pitman Press, Bath

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To Barbara, Jackie, Donald and Fergus

Preface

It has been suggested that the annual revisions to the official National Accounts prepared by the Central Statistical Offices of each country cease, not because an acceptable degree of accuracy in the estimates has been achieved, but because the services of the statisticians thus employed are required for other, more pressing, tasks. In much the same way, this book, which has been through innumerable drafts and has been some ten years in the making, has finally been published.

Although the book has many remaining defects, I am aware that I owe a particular apology to students of classical political economy for my cavalier treatment of their subject. The justification for allowing the contents of the following chapters to be published is that I believe that the theme of the book is an important one, however inadequately it is expressed.

This theme is that, if we wish to understand the operation of a modern advanced economy, we must escape from many of the 'habitual modes of thought and expression' associated with contemporary neo-classical and neo-Keynesian economic theory, and adopt the long-run perspective of classical political economy, concerning in particular such phenomena as the nature of competition and growth in a market economy, and the evolution of institutions and attitudes. In the recent past, a small but growing number of books has been written in this tradition (I should like to believe that it is not an accident that a disproportionate number of these have come from the Scottish universities), but very few departments have offered courses in political economy. It is therefore encouraging to discover, at the time of writing, that such courses are slowly beginning to return to the curriculum, albeit at the post-graduate level.

I am grateful for comments and criticisms of various sections of earlier drafts to Paul Hare, Frank Harrigan, Jim McGilvray and Iain McNicoll. I am profoundly indebted to Professor Peter Bauer, whose advice and criticism encouraged me to complete the manuscript. My colleagues at the Fraser of Allander Institute have borne additional burdens of work while this book was being written, and the secretaries at the Institute, Mrs Sheelagh Blackhall, Mrs Isobel Sheppard and Miss Patricia Cassells have, with great patience, typed and re-typed the various drafts. The index has been compiled by my wife, Barbara Simpson.

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Economic analysis, serving for two centuries to win an understanding of the Nature and Causes of the Wealth of Nations has been fobbed off with another bride, a Theory of Value . . . Faced with the choice . . . economists of the last hundred years have sacrificed dynamic theory in order to discuss relative prices. This has been unfortunate, first because an assumption of static overall conditions is such a drastic departure from reality as to make it impossible to submit anything evolved within it to the test of verification and, secondly, because it ruled out the discussion of most of the problems that are actually interesting and condemned economics to the arid formalism satirised by J. H. Clapham in 'Of Empty Economic Boxes'.

Joan Robinson, *The Accumulation of Capital,*
London, 1966, p.v

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Part I THE FAILURE OF CONTEMPORARY ANALYSIS

1

Introduction

This book is concerned with the scope and method of contemporary economic analysis. Its starting-points are the major problems of economic policy common to the advanced industrialized countries of the Western world. Many of these problems are shared by the developing countries and by the countries of Eastern Europe, but it is on the experience of those countries which for practical purposes can be identified as member countries of the Organization for Economic Co-operation and Development (OECD) that I wish to draw for empirical evidence.

The book tries to demonstrate that the major problems currently besetting these advanced economies can best be understood within the framework of a theory of economic growth. This is so because the advanced economies of the modern world are characterized primarily by continuous change. Unfortunately, contemporary economic analysis, whether neo-classical or neo-Keynesian, does not provide a satisfactory theory of economic growth, and therefore we must turn to the classical tradition, with its much richer and broader scope, for the necessary ingredients. Nothing as ambitious as a comprehensive theory of growth will be offered; like Schumpeter, I do not aspire to do more than to identify tendencies. But I do believe that an approach to a theory of economic growth in the classical tradition can contribute more to an understanding of the way advanced economies actually behave than can be found in the 'arid formalism' of steady-state growth theories.

It is curious that, although Adam Smith made institutions the key instrument variables (as we should now say) of his famous theory of growth, and although experiments in institutional reform as an aid to growth are a feature of the contemporary scene in Eastern Europe and in some developing countries, the role of institutional change has for long been disregarded in economic theorizing in the Western world. This may be because we have come to believe that institutional arrangements in the advanced countries have reached a state of ultimate perfection (as both Smith and, later, Marx believed their own schemes represented). It is more likely that institutions and other 'non-economic' variables have been forgotten because the theory of economic growth has gradually been replaced by the theory of value as the principal subject of interest to economists in the advanced countries. Closely related to this phenomenon is the terminological dichotomy whereby there is supposed to be a separate and distinct theory of growth for developing countries, called the 'theory of economic development', as if the growth process in developing and advanced countries was somehow different.[1]

Because of its connotation of having a broader range of variables within its scope, this book might appropriately have contained the words 'economic development' within its title. However, this phrase has become so closely associated with the underdeveloped countries that it was considered preferable to avoid it. The term 'political economy', too, has been so abused by contemporary writers that it is only with the greatest reluctance that it is used here.[2] The use of that term in this book is intended to convey its original sense, that is, the study of economics in the classical tradition, which has three principal characteristics that distinguish it from contemporary analysis. First, it takes the long-term growth and development of the economic system as its principal object of study; secondly, it recognizes that social, psychological and other non-economic variables must therefore explicitly be taken into account; and thirdly, it has a much wider range of methods of analysis which are admissible than is the practice in contemporary analysis.

The main chapters of the book can conveniently be grouped into three parts. The first three chapters discuss the failure of contemporary economic analysis to deal satisfactorily with the issues of economic policy in the advanced countries. This factor is attributed primarily to the lack of an adequate theory of economic growth. Chapters 4 and 5 set out the classical tradition in the analysis of economic growth, and identify those elements which may be helpful in contributing to a contemporary theory. The purpose of chapter 4 is to establish similarities between the contributions of different writers in the classical tradition, and thereby provide a framework for the analysis of economic growth which may be helpful in understanding contemporary problems. This chapter concentrates on the general features of the major writers and, in particular, on the role which they assigned to institutions and attitudes as variables in the process of growth. The word 'attitudes' is used loosely to include all psychological variables, such as motives and expectations. Chapter 5 discusses two central themes of the classical theory of growth – the nature of competition and the progressive extension of the division of labour.

Chapter 6 discusses some important changes in the advanced economies which have taken place in the recent past, within the perspective developed in chapters 4 and 5. Chapter 7 analyses the origins of some contemporary problems in the economies of the advanced countries. Chapter 8 outlines some probable future developments: what is most likely to happen. The concluding chapter, chapter 10, considers, on the other hand, what might be done on the part of governments to influence the outcome of events. Between these two chapters comes chapter 9, which proposes some changes of emphasis in the methods of contemporary economic analysis.

Much economic theorizing in the period following the Second World War, especially on the subject of economic growth, has taken the form of the presentation of essentially simple ideas in extremely sophisticated or difficult terms. This would appear to be a continued pursuit of the 'arid formalism' criticized by Clapham after the First World War.

One purpose of this book is to return to the classical tradition of presenting somewhat more sophisticated ideas in relatively simple terms. Although nothing is easier than making fun of the shortcomings of contemporary economics, the intention is to put forward a positive alternative.

Another theme of the book is the desirability of reintegrating economics with the other social sciences. Although I agree with Marshall that one single theory of social science is probably impossible, it is suggested here that what is essential is the recognition that 'economic' events seldom have an exclusively economic character, but more often than not are multidimensional. In this connection it is appropriate to quote from John Stuart Mill:

> Except on matters of detail there are perhaps no practical questions, even among those which approach nearest to the character of purely economic questions, which admit to being decided on economic premises alone. And it is because Adam Smith never loses sight of this truth, because in his applications of political economy he perpetually appeals to other and often far larger considerations than pure political economy affords, he gives that well-grounded feeling of command over the principles of the subject for purposes of practice, owing to which the Wealth of Nations, alone among treatises of political economy, has not only been popular with general readers, but has impressed itself strongly on the minds of men of the world and of legislators.[3]

2

Objectives of Economic Policy in the Advanced Countries

For present purposes the advanced countries may be taken as being congruent with the member countries of OECD.[1] Despite their differences, these countries share a number of common problems. Indeed, it is probably true to say that, as time goes by, the commonness of their problems increases, so that, although there may or may not be convergence between 'capitalist' and 'socialist' countries, there is certainly convergence among the advanced countries themselves.

I shall begin by identifying six problems which represent contemporary policy preoccupations in these countries. It is not suggested that all of the advanced countries manifest all of these problems, but that most of the seven major industrialized countries (the United States, Japan, West Germany, France, the United Kingdom, Italy and Canada), which account for by far the greater part of economic activity in the advanced countries as a whole, do exhibit most of them. These problems are:

1 inflation;
2 unemployment;
3 slow rates of growth of total output and productivity;
4 the environmental consequences of the growth of output;
5 the psychological consequences of the growth of output;
6 the nature and limits of government control of economic activity.

This list may be regarded as incomplete. I have left out the underdeveloped countries as a problem, since I do not believe that, as a group, these countries have a decisive influence on events in the advanced countries. This is not to say that particular underdeveloped countries at particular periods of time do not have such an influence.

Although I will discuss in later chapters the inequality of incomes within countries, I have not identified income distribution as one of the stylized problems, principally because it does not appear to be a major preoccupation of policy in North America or Japan, and its importance as an issue varies throughout Western Europe.

The balance of payments has been omitted on the grounds that, where it is a problem for a particular advanced country, it is usually not a separate problem but simply another symptom of one of the first three problems listed above. Of course, these three may not be regarded as independent problems, but rather as separate symptoms of a common underlying problem. This is the view which is taken in this book. These symptoms have been related to each other by the popular press and given the phrase 'the English disease', first observed some two decades ago and more recently observed to have spread to the USA, Sweden and even to West Germany. The symptoms of the disease are a poor performance in all three areas, sustained over a period of more than five years.

It must be said right away that the concept of a 'poor' performance is not necessarily to be judged by comparison with the past performance of the country concerned. Nor is the relevant comparison with the performance of other advanced countries, though both types of comparison are made, and are often influential. Rather, performance is judged by reference to the expectations of the country's inhabitants. Thus a 'problem' arises from a discrepancy between an expected or assumed norm and reality. It may be the case that the cause of the problem is the selection of an inappropriate norm.

Unlike the first three items, the fourth and fifth problems are associated with the consequences rather than with the causes of growth of output, and with faster growth rather than slower growth. Economists who have recently drawn attention to the adverse psychological consequences of sustained growth of output include Hirsch and Scitovsky; those associated with concern for the environment include Forrester, Meadows and Schumacher; while Mishan and Heilbroner are concerned with both. The distinction drawn between the physical and psychological consequences of growth may be blurred. It is not clear, for example, whether tourist 'pollution' should be regarded as a physical or a psychological problem.

The final item may not appear to be so much an object of policy as an instrument of policy. Nevertheless, it is easy to see that the discontents generated by contemporary industrialized life do give rise to political demands, or perhaps give added strength to existing political demands. Although this item may not appear to affect directly the performance of the economy, the appropriate nature and limits of government control in the advanced economy does concern the choice of instruments by which performance is influenced. It also concerns the political institutions of the country. I have included this as a 'problem' because it does seem to be both a matter of continuing debate and of continuing change in practice in the advanced countries. It is clearly related to all of the other items.

It is my contention that the origins and nature of these six problems can best be understood within one framework of analysis, which it is the principal object of this book to present. I do not claim that the proposed framework of analysis will resolve these problems. I deprecate the rush into policy recommendations on the basis of an inadequate understanding of the economic process which is the hallmark of so much of contemporary economics. I do, however, think that policies which are developed in the light of this framework may have a greater chance of success than those which are not. First, however, I shall say a little more about each of the problems identified.

Inflation

In contrast to the period between the two world wars when prices were either stable (1920s) or fell (1930s), there has been a continuous and accelerating rise in prices in the advanced countries since the Second World War. The rate of increase of prices averaged 3 per cent in the 1950s, 4 per cent in the 1960s and 8 per cent in the 1970s. However, the upward drift has not been a steady one. An examination of the inflation rates for the seven major industrialized economies, and for OECD as a whole, shows that until the year 1967 the average annual price increases shown by both series never reached 4 per cent. But from 1968, the average increase never fell below 4 per cent, and from 1973 never below 7 per cent. The other major discontinuity displayed by these two series is the acceleration into double figures in the years 1974 and 1975 following the first round of oil price increases.[2] The same two series returned to double figures in 1980 and 1981, following the second round of major oil price increases.

An increase in the rate of inflation has not been the only response of the advanced economies to the oil price increases. As we shall see below, the reactions within the advanced economies to these exogenous 'shocks' provide case studies in the individual adaptability of each economy to change. However, inflation is important for a number of reasons, not least that it has widely been held to be subversive of existing institutions and attitudes. In Schumpeter's words, it 'quickens the pace of social change'. Perhaps for this reason, inflation appears to be regarded as a greater evil than unemployment by inhabitants of the advanced countries. This is suggested by the fact that the second round of oil price increases evoked a uniform response from the governments of the major industrialized countries. All adopted and have maintained tight monetary and fiscal policies. The absence of strong popular opposition to these policies hitherto suggests that the preference of the governments may be shared by the populace as a whole.[3]