POLICY, POWER and ORDER

The persistence of Economic Problems in Capitalist States

Kerry Schott

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Contents

1 Introduction

> The winds must come from somewhere when they blow,
> There must be a reason why the leaves decay;
> Time will say nothing but I told you so.
>
> Auden, 'If I Could Tell You'

Background

My particular concern with economic policy and economic theories of the state first came from my experience as an economist working within government. In the latter half of 1975 I was fortunate enough to be employed by the Australian government as an economic advisor in the now defunct Priorities Review Staff. This small group was originally set up by the government to examine longer-term policy issues and priorities. This role was envisaged as a supplement to the shorter term policy concerns of existing government departments, which in their day-to-day running tended to give longer-term issues less attention than it was felt they deserved.

In reality what happened within the Priorities Review Staff was that longer-term policy was examined but shorter-term demands were also placed upon it from time to time by the Prime Minister's Department. This seemed to occur particularly when conflict over policy was evident. This conflict was either between different government departments or between the Cabinet and government departments. Either different arms of the public service had different views on policy recommendations, or government politicians had different views from the civil service. There were also occasions when both kinds of conflicts occurred simultaneously.

These differences over policy are of course part of the normal functioning of government, but my training as a macroeconomist had not prepared me to pay heed to the way in which policy was eventually formulated within government. This political input into economic policy outcomes did not only come from the ideological concerns of the governing party via its cabinet but also from the interactions between government departments and indeed from political influences originating outside these state institutions. Through this daily experience of the interactions between politics and economics it became obvious to me that economists needed to pay more attention to these interactions than they typically do in their textbook models. My explorations in this field led naturally to the literature on economic theories of the state. These theories, which were new to me at that time, are attempts to explain the actual economic behaviour of a state. Unlike a typical economic policy model these theories are not asking what a state ought to do; they are simply trying to understand what a state actually does.

In thinking about these economic theories of the state I concurrently read some history and in doing so I was struck by the fact that the one overriding concern of any state was its desire to maintain social and economic stability or order. Indeed it makes no sense to speak of a state once order has broken down and governance has ceased. Hence whatever the actual actions of a state it seemed to me that these must, at a very fundamental level, be concerned with maintaining order.

Now this state quest for social and economic order appeared to be curiously neglected in the economic theories of the state I examined. Typically order is either implicitly assumed and hence entirely ignored; or alternatively order is explicitly taken as given and its persistence is explained by state behaviour. In the latter approach, common among Marxist economists, the ongoing stability of capitalist society is due to state intervention, but this order is usually assumed to be reached without too much difficulty on the part of the state.

But is stability really so easy for a state in democratic developed countries to maintain? What are the characteristics of the economic and social system within which we live and work and are these conducive to social and economic stability or not? In considering these questions it became clear that the economic systems of the developed countries have changed gradually but dramatically over this century. In particular, in all developed countries we now have a very large public sector and money wages and price movements are sticky in a downward direction. Both these changes are especially apparent since World War II and both are relatively new developments.

These changes appear to be related to an increase in the power of the working class. As unionization increased this century so too did the influence and control of workers over their money wages. In turn, increasingly concentrated industries and firms were capable of passing these increased money wage costs on to consumers in the form of price increases. The downward stickiness of prices and wages, common in all developed countries, appears to be at least partly related to the increase in unionization of the workforce.

The labour force has also increased its strength and influence in the political arena. The introduction of universal suffrage this century is associated with a not surprising increase in the vote for broadly left-of-centre political parties in all countries except the United States. Where these parties have governed for prolonged periods and had a substantial presence in the Cabinet it is clear that public expenditure has been higher out of GDP than in other comparable nations.

We thus now appear to be living in an economic society where the power resources of the working class have increased. These power resources cover developments such as increased unionization and the rise of political parties that attempt to represent working-class interests. It is through resources of this type that power can be exercised. These social and political developments are associated with the observed economic changes already noted. Wage and price movements are sticky downwards and the public sector has grown dramatically. Furthermore this conjuncture of events is now coincident, and perhaps causally connected, with difficulties in economic management. In the 1970s and early 1980s the developed economies have performed significantly worse than in the two decades following World War II. Economic growth has been slower, inflation has been a serious problem, and unemployment has reached levels that were unthinkable in the 1950s and 1960s. And these economic problems, as I write in 1983, appear to be extraordinarily persistent. Different economic policies to remedy the situation have been tried in different countries, and at different times in the same countries, but the ongoing frustration with economic policy, and with the theories behind it, continues in the minds of all but the most dogmatic.

For the first time in developed countries an economic crisis is associated with a social and political situation where the working class has more power resources at its command than at any previous time. During the 1950s and 1960s this working-class strength was coincident with a successful economy; and in periods of economic crisis in previous history the workforce were not so strong. Hence this conjuncture of economic crisis and a strong workforce is quite unprecedented.

This is not to argue that the workforce is necessarily the strongest group in society. It is simply to suggest that it is now stronger than in previous historic periods. And this increased relative strength on the part of the workers has important implications for state economic behaviour. In maintaining both social and economic stability the state is now in a new and interesting position, and this may be one reason why current economic problems are so persistent. Economic policies to remedy the dismal economic situation may be ineffectual if they are applied because of social changes in our societies; or economic policies may be judged simply as non-operational because of the social conflict they would engender if they were applied. The state, in developed democratic countries, may be groping for a solution to its economic problems, but to find this solution is difficult or even impossible. Stability and order must be upheld and any economic policy that conflicts with this goal is either severely constrained or not on the agenda.

This type of interaction between the polity and the economy is the subject of this study. On one level this book is a plea to economists to begin seriously the task of integrating social and political arrangements and practice into the body of economic theory. This is not a job to be left to sociologists and political theorists; they have done some excellent work in this field but economists have a contribution to offer which only they are equipped to make. For too long this sort of work has been classified as 'not economics' and avoided like the plague by many of my colleagues. But economic policy analysis is only useful when it can be applied, and this means we must understand the sort of society in which we are operating. Indeed if we do not seek this understanding we are in danger of working on policies that will never be applied or of applying theories in inappropriate situations. It is well to keep in mind the salutary experience of Emperor Franz Joseph of Austria who worked diligently on his papers every day from four in the morning until noon while his empire disintegrated about him.

Outline of the Book

As a necessary step in resolving the economic difficulties facing the developed countries we must first understand the problem. The economic explanations of the dismal economic performance of the 1970s are briefly examined in the next chapter. There I focus on neo-Keynesian and neoclassical theory and argue that both approaches lead to policy prescriptions that can in practice be quite ineffectual. The ability to solve domestic macroeconomic problems depends on both the application of policy and the responsiveness of the economy. The appropriate policy must be chosen, but if society is not responsive to this policy for some elusive reason, the policy will not be effective.

For neoclassical policy to be effective in the present climate it is clear that a reduction in the money supply and in government expenditure must be accompanied by a fall in prices and the real wage. If real wages and prices do not fall in response to this deflationary policy the end result will simply be reduced output and employment.

With a neo-Keynesian policy the recommended way to deal with an economic slowdown is to have an expansionary policy. But with an expansionary fiscal and monetary policy there is a real danger that runaway inflation in prices and money wages could result. To deal with this contingency the Keynesians usually link their expansion to an incomes policy, and should this be successful the expansion will not generate inflation. However experience suggests that if an incomes policy cannot be implemented than an expansion will generate inflation.

Hence the policy effectiveness of both the Keynesians and the neoclassicals depends critically on the response of the economy. For the Keynesians an incomes policy is vital in order to restrain inflation; for the neoclassicals both prices and real wages must fall. These considerations immediately lead to two questions. First, which is the appropriate policy strategy to pursue? Second, will the economy respond appropriately?

Now in choosing the appropriate policy strategy we must decide which theory is the most applicable to the society we are examining. We know that in microeconomics it makes no sense to apply a perfect competition model to a monopolistic market. In macroeconomics one hopes we would similarly choose to reject a theory of policy if it was not appropriate to the given situation. In this sense a theory is rejected not because it is wrong but because it is inappropriate. In Chapter 3 it is argued that neoclassical theory is inappropriate in the light of the changes indicated above. The workforce now has sufficient strength to stop real wages falling, and should this policy be applied it will be ineffective. This increasing strength on the part of the working class also has implications for Keynesian policy strategies and specifically for whether or not a successful incomes policy can be implemented.

It is suggested, on the basis of public choice theories, that where social groups have evolved that are encompassing there is every reason to expect that an incomes policy will work. An encompassing group is one that includes virtually all individuals or interested parties. It is not fragmented into smaller groups with diverse goals. The aim of any group is to achieve benefits for all its members and where this group encompasses all society the outcome is more likely to be in the broad social interest. Where, on the other hand, groups are fragmented, the benefit to a group is more narrowly defined and less in line with the wider social interest. Thus in a country like Britain where the union movement is strong but fragmented there is little reason, on public choice grounds, to expect an incomes policy to hold. On the other hand in a country like Sweden or Austria where the union movement is strong and approximates an encompassing group we might expect an incomes policy to work effectively and in the wider social interests of all workers.

This argument is investigated in some detail in Chapter 4 where the domestic economic performance of eighteen OECD countries is examined. There are quite clear links between political arrangements and economic outcomes which tend to support the previous argument. Low inflation and low unemployment tend to be associated with liberal corporatism. Under modern corporatist arrangements encompassing groups, typically labour and business leaders, meet together and decide economic policy with the state in a mediating role. As an interest mediator the role of the state is crucial, and its aim of avoiding conflict and achieving economic stability is quite overt.

This interaction between politics and economics is completely missing in the most familiar economic analysis of policy. The framework within which most economic policy is discussed is considered in Chapter 5. Here it is argued that this basic policy model is logically inconsistent and naive. The assumption that agents within the state sector act in the public interest conflicts with the assumption that agents in the private sector behave in their own self-interest. Since a public sector worker is also a private sector consumer this set of behavioural assumptions involves an assumed schizophrenia on the part of some individuals. While they are at home they are self-interested; but once they are at work in the public service they rather oddly act in the public interest.

Also this model assumes an omnipotent state which operates in a socially stable private and public sector. There is no possibility of a breakdown in governance in this model, and the maintenance of order is quite simply assumed.

Now since this model is used to give advice to governments it addresses what the state ought to be doing and not what the state is doing. However even within its own terms this framework for analyzing economic policy suffers from severe shortcomings. The next two chapters, Chapters 6 and 7, turn to economic theories that seek to explain actual state economic behaviour.

Within these economic theories of the state there are two quite distinct approaches. The first assumes that individual agents in the public sector, be they politicians or bureaucrats, act to pursue their own self-interest, and conduct economic policy in line with this self-seeking code of conduct. There could be constraints on this behaviour but nevertheless the outcome of it is most unlikely to be in the public interest.

The second approach to understanding state economic behaviour is derived from Marxist economics. The prolonged stability of capitalism was something of an enigma to Marxist theorists who, on the basis of their theory of capitalist production, might have expected a crisis in capitalism accompanied by social conflict. In the event of a continuing capitalist order these theorists sought to explain this stability by examining the role of the state. They suggested that capitalist order prevailed because the state evolved institutional forms and functions that maintained this social system. The state, in capitalist society, acted to preserve the system and it was essentially these state actions, including its economic policy, that enabled capitalism to prevail. This line of theory also of course implies that economic policy is not directed at public interest objectives. It is determined by the requirements of capitalist production, including the maintenance of social relations which serve capitalism.

But both the Marxist and more mainstream economic theories of the state tend to overlook the difficulties a state may face in achieving stability and order. The first type of state theory, based on the pursuit of individual self-interest, assumes stability and order within both the private and public sectors. No attention at all is paid to the maintenance of this order in society. Order is simply and implicitly taken for granted. In Marxist theories of the state on the other hand, the focus is on explaining why there is an existing and rather long-lived order. But the problem here is that because the observed order is being explained in these theories, little attention was placed on the difficulties that might appear in the actual maintenance of this order. Because Marxist theories were trying to explain order, they tended to take its existence for granted. These Marxist theorists observed stability, and thus somewhat curiously assumed that it had been achieved by the state without too much trouble.

On the basis of this criticism of both the Marxist and mainstream economic theories of the state this study then goes on to consider the problem of order. Chapter 8 begins with a discussion of the existing economic literature on this topic. This treatment is essentially an economic analysis of the Hobbesian problem: how can order be obtained given a crude state of prevailing anarchy? The main argument in this chapter is that present-day society does not spring from a starting point of anarchy. If it did the economic analysis in this chapter would be of more interest. But looking at the evolution of democracy from feudalism suggests that the power distribution within society changes over time and that we can best understand this by examining the relative power of different groups in society.

This discussion relates back to the work on power in Chapter 3 where the power resources of the workers are examined in some detail. On this basis Chapters 9 and 10 then attempt to analyze how order may be established when power is distributed across groups, specifically workers and capitalists. The first approach in Chapter 9 is static but it does show that if workers become more powerful then this change in power must be accommodated if order is to prevail. Various economic implications of this are discussed and the strategies that a state might be expected to pursue are explored.

However for insight into the different growth and investment performances of the developed countries, we must look to dynamic analysis. In Chapter 10, a simply dynamic model of capitalism is developed to investigate these matters. Both the power of the labour force and the particular economic situation affect whether or not consensus around economic policy is likely and attainable. In view of this model the social and economic quiescence of the 1950s and 1960s can be explained and the difficulties now confronting present-day economic management can be at least partly understood. The final chapter summarizes this argument and concludes that our current economic problems could persist for a very long time. The reasons for this are not only economic; nor are they simply caused by a crisis in economic theory. The problem is both economic and political. Only when these two issues are considered together can we hope to understand the modern economy. While no grand new theory is offered here it is hoped that the start made will be sufficient to persuade other economists to join in the development of a new political economy.

2 A Shortcoming of Domestic Macroeconomic Analysis

The generally accepted view teaches
That there was no excuse,
Though in the light of recent researches
Many would find the cause

In a not uncommon form of terror;
Others still more astute,
Point to the possibilities of error
At the very start.

Auden, 'Let History Be My Judge'

Introduction

In this chapter I argue that both neo-Keynesian and neoclassical analyses of the macroeconomy suffer from a common shortcoming. I begin by discussing the bare elements of both these theories and point out that in practice both can lead to policies that can be quite ineffectual in coping with the problems that are now facing the developed economies. The effectiveness of economic policy depends on the responsiveness of the economy in which this policy is applied, and if the economy, for some elusive reason, remains unresponsive to policy actions then the policy fails. I then proceed to suggest that macroeconomic theory must be adapted to take account of changes that have occurred in the society to which it is applied. This part of the chapter is methodological and it sets the stage for an examination of some changes in the developed economies that are examined in some detail in Chapter 3. The focus of our attention in macroeconomic theory must be switched to pay heed to these changes and unless this occurs our understanding of the present macroeconomic situation is severely limited.