

Capitalist Development in the Twentieth Century

An Evolutionary-Keynesian Analysis

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1 Economic development and economic performance

1 Introduction

Looking back over the twentieth century at what are now the advanced capitalist economies, one of the more outstanding characteristics of macroeconomic development has been the radical transformation of their economic structures, i.e. the tastes, technologies and institutions that shape economic activity. The fourfold increase in real per capita income since the early years of the twentieth century is not the result of balanced growth, with output expanding at the same rate in every sector. Instead, growth has been accompanied by large shifts in the composition of output and in the sectoral distribution of capital and labour, transformations that have led economic historians and economists to distinguish among epochs of capitalism, such as the ‘industrial’ and ‘post-industrial’ phases. But this observation barely scratches the surface. These transformations are themselves made possible by technological change, as within each sector industries grow and decay, product and process innovation are commonplace and resources continuously reallocated. And with technological change there have been changes in the lifestyle of individuals that go far beyond those implied by mere increases in income, however large, and, beyond even this, changes in society itself. A well-known example is the advent of the ‘age of steam’, which introduced the factory system and urbanization. In the case of such sweeping change to the type of work and its organization, and to how and where people lived, it is relatively easy to recognize that new rules and norms would become established to govern behaviour under these new conditions. The point to be made here is that capitalism transforms itself continuously, and that change is both pervasive and radical. There are no ‘givens’ in the long run, or even in the intermediate run. Technologies, tastes and institutions change, and a change in one can trigger events or trends that lead to changes in the others.

2 Development or performance?

Our main concern is to explain macroeconomic performance in the advanced capitalist economies over a period covering roughly the twentieth century. Nevertheless, we have chosen to use ‘development’ in the title, rather than ‘performance’, because of the structural changes that have taken place over this period. These are incorporated into our analytical framework, which is designed to explain not only key indicators of macroeconomic performance, for example GDP and unemployment, but also the interaction of performance with the evolving economic structure that accompanies industrialization and transformation.

This cannot be done within the mainstream framework. The neoclassical model simply responds to exogenous forces; given a change in economic structure, the model’s sole response is to restore equilibrium. The cause of all long-run economic change is to be found outside the economy. Observation of the historical course of capitalism demonstrates the falsity of this view. History shows that performance and structural change are inseparable in real economies. And, although some structural change may be traced to exogenous causes, much of it is endogenous. For example, products and processes are the result of innovation, the search for different and improved goods and methods of production. Even when the underlying scientific knowledge is properly classified as exogenous, its adaptation to commercial use is a central activity of the capitalist economy, the task of entrepreneurs. The alternative framework we use is therefore evolutionary, that is, it gives a central place to endogenous structural change as the process by which capitalist economies transform themselves.

This approach demonstrates some sharp differences from neoclassical theory. First, we treat institutions – the rules, laws and customs that define acceptable social behaviour – as well as tastes and technology as part of the structure of the economy. Moreover, as part of the structure they undergo change. Therefore we also investigate the process by which economic variables and outcomes induce institutional change, as well as change in the other structural variables. Second, power is introduced into the analysis both as an important influence on economic performance through the power of organized interest groups to affect institutions, for example the impact of unionization on welfare legislation, and as a force affected by the economy, for example the effect of full employment on union density. This focus on organized interest groups affects the way in which we treat tastes. Our concern is with collective preferences, so that where consumer theory considers income as the means of optimizing individual preferences, we consider power (whether economic or political) as the means of achiev-

ing group preferences. Before an interest group can affect institutions, it must acquire and exercise sufficient power.

3 Institutions and institutional change

The decision to incorporate institutions in our analysis stems in part from the belief that capitalist development cannot be modelled adequately if they are omitted. They are an integral part of the structural framework. Institutions act as cognitive devices (Hodgson, 1993); by encapsulating information about the probable actions of others, they reduce uncertainty, giving stability to social and economic relations. However, in doing so they simultaneously regulate behaviour, which must conform to the established norms, which reduces conflict. More generally, because they guide behaviour, institutions such as tastes and technology affect the manner in which the economy performs, for example whether growth proceeds rapidly or slowly, whether it is accompanied by serious inflation, whether the rising affluence is denied to large segments of the population through unemployment. As a result, any explanation of economic performance, and of why it differs among countries or from one period of time to another, requires study of the way in which institutions affect economic processes.

The impact of institutions on performance is only part of the story. Change is central to capitalism, both economic and institutional change. For many early economists, change was capitalism's overwhelming characteristic, making its development incomprehensible except as a historical process. As Heilbroner (1986, p. 143) notes, all the great political economists describe 'dramas of social as well as material evolution' brought about by capitalism. Following this tradition, we maintain that long-run macroeconomic performance is one of the most powerful causes of institutional change. And because institutional change alters behaviour, future economic performance is also affected. A similar view is appropriate with respect to the more familiar structural features treated as exogenous in neo-classical analysis. To emphasize this last point further, our approach to modelling macroeconomic performance differs from the neoclassical approach not simply by including institutions as additional structural features affecting performance, but more fundamentally because it considers the impact of performance on tastes, technologies and, especially, institutions. Long-run performance is modelled as the outcome of an interaction between economic performance and the structure of the economy. Economic performance in the short run is always constrained by some initial set of structures, but in the long run economic performance induces changes in the structural framework, creating a causal sequence of events. In more familiar terms, economic performance and structural change over

time can be envisaged as an interaction between the demand side of the economy and the ‘supply side’, where the latter is to be viewed in terms of an expanded list of structural characteristics.

4 Some benefits

Clearly this cannot be the whole picture as disturbances and trends independent of the performance of the economy can have a significant impact on economic performance and structures. But we maintain that highlighting the interaction between performance and economic structure is the key to understanding the basic processes of macroeconomic development. It also has other benefits. First, by incorporating the induced effects of economic performance on the economic structure and the effect of changed structure on economic performance in subsequent periods, an endogenous evolutionary chain of causation is established. Economic performance in a more recent period is explained in terms of economic events at an earlier period, and the future is similarly related to the present. This is to be contrasted with the lack of explanatory power of neoclassical growth dynamics in which long-run movements in the economic variables are merely traced to elements of an unexplained exogenous structure.

Second, this inclusion not only permits a more satisfactory explanation of events, but provides more information on which to base remedial policies in the event of economic malfunction. Thus, if poor economic performance can be attributed to structural change, which is in turn related to economic performance at an earlier point in time, both poor and superior performance can be explained endogenously within a common framework, a possibility ruled out in neoclassical analysis. Further, our approach gives policy makers some indication of what might be done to improve performance by identifying ‘ports of entry’ for policy intervention, clues and opportunities overlooked when the source of difficulty can be assigned only to some exogenous force. We intend to support these views in part II of the book in our explanation of some of the more important macroeconomic developments in the advanced capitalist economies during the twentieth century.

5 What drives the system?

In a study of macroeconomic performance and evolving economic structure, a decision must be made about which performance variables and economic structures to study. In this section we argue that the choice of performance variables is dictated by which forces drive the economy. For example, if economic development is a process in which aggregate demand

(AD) adjusts passively to supply forces, as in neoclassical growth theory, supply-side variables such as rates of growth of the labour force and technological progress are of chief interest. On the other hand, if growth is a process in which AD induces adjustments on the supply side, the focus is on Keynesian variables, for example rates of growth of investment, fiscal and monetary policies and unemployment. As suggested in the introduction to part I and to be treated in detail in chapter 4, our emphasis is on AD and its rate of growth, both because of its direct impact on output and unemployment, the stuff of traditional Keynesian economics, and because of its indirect impact on the structure of the economy.

Consider the following observations. In a world devoid of invisible hands, full employment even in some long run is not guaranteed; the output and unemployment record will depend upon AD and its growth. As well as the usual Keynesian variables, the level and growth of AD directly influence the behaviour of other economic variables such as the growth of productivity and per capita incomes. This is especially likely when AD growth causes or is caused by investment growth. The negative intertemporal correlation shown in table 2.1 between unemployment rates and per capita income growth rates illustrates this connection, as do the econometric results of chapter 10. Less obvious, but no less important, is the effect of rising levels of per capita incomes and affluence that growing AD and output generate. They alter the distribution of sectoral output and employment, the result of differences in sectoral income elasticities of demand and sectoral levels and rates of growth of productivity. These distributional effects induce structural changes on the supply side. For example, AD and its growth influence the choice of production techniques, the growth of investment and the growth of the labour force through induced effects on participation rates and immigration. Finally, growing incomes and rising affluence induce institutional changes, for example by shifting the distribution of power from capital to labour and by raising the aspirations of ordinary workers. Directly and indirectly, AD has a crucial role to play in economic development. In contrast, slow-growing or stagnant AD leads to high unemployment and low output growth, bringing these and related aspects of transformation to a halt.

An emphasis on AD as a prime driving force behind economic growth and development might appear unusual, as there exists a large literature emphasizing entrepreneurial innovation, in particular the adoption of new product and process embodied investment, as the engine of growth. The works of Schumpeter immediately come to mind. But Schumpeter's assumption of full employment whatever the position of the economy should also remind us of the general neglect of the demand side in the development literature. At the very least our approach can be seen as filling this

gap in development theory. Further, there is no conflict between our emphasizing the importance of AD and others choosing to stress entrepreneurial innovation and technology in the study of economic development. Rather they are complementary and partially overlapping approaches. It is enough to note that the degree to which entrepreneurs are willing to undertake innovation activities and bear the risks of implementing new ideas will greatly depend upon the rewards to such activities; this is heavily dependent upon the state of AD. The level and growth of AD provide the key to explaining both the lower turning points of a growth cycle (something which is missing in Schumpeter's work) and differences in the supply of entrepreneurial skills along alternative long-run growth paths (Baumol, 1968). To quote Goodwin (1991, p. 32),

But because the level and growth rate of demand plays so great a role in productive decisions, especially in the case of new and risky projects, various innovations are launched and/or rapidly expanded in a rising market: then the requisite investment required further accelerates the already buoyant market. . . . Thus the Kahn–Keynes multiplication of expansive and contractive demand furnishes a crucial missing link for Schumpeter's innovative theory of technological evolution.

Treating AD as the driving force in economic growth and development in this study dictates the choice of performance variables to study. We have singled out the unemployment rate for special attention, judging it to be the best measure of the state of AD. There are three additional reasons for choosing the unemployment record. First, the ability of an economic system to provide employment for anyone wanting to work is a widely accepted indicator of national economic well-being.¹ Second, other dimensions of macroeconomic performance are related to the overall state of the labour market and these also have welfare implications, some of which we wish to study; for example, the growth of productivity and incomes, the incidence of poverty and crime, the degree of inequality in the distribution of incomes. Third, other important aspects of macroeconomic performance are negatively related to unemployment performance, and this raises the issue of trade-offs between macro goals. Thus periods of high involuntary unemployment are attributed in the first instance to a deficiency of AD. When these deficiencies occur they are traced to the adverse effects of higher levels of AD and lower unemployment on other economic and political goals, for example price stability, external balance, capital's control of the workplace. Conversely, when periods of full employment levels of AD occur, this reflects an absence of adverse side-effects of full employment on potentially competing macroeconomic goals. Thus, in explaining

¹ Keynes saw full employment as essential for reconciling capitalism and democracy.

unemployment, the analysis is automatically extended to include and explain additional dimensions of macroeconomic performance.

6 Selecting components of the economic structure

The criterion we adopt in choosing which components of the economic structure to study is largely dictated by our emphasis on explaining unemployment trends. As we will argue, periods of high and low unemployment, and of poor or superior performance in general, depend ultimately upon prevailing institutions because of their impact on AD. An obvious example is a law forbidding government deficits; even when private demand is weak it will prevent the use of stimulative fiscal policies, making higher unemployment inevitable. The Maastricht criteria are relevant examples of such constraints on AD. Of equal interest are those cases in which trade-offs between macroeconomic goals are involved. As will be discussed at some length in chapter 5, institutions affecting the labour market can lead to a poorly placed Phillips curve and a politically unacceptable rate of inflation under full employment conditions. The post-war record shows that in such cases restrictive AD policies are used to combat potential inflationary tendencies. To relieve the economy of restrictions on AD and to improve unemployment *and* inflation performance, policy-induced changes in institutions must precede the use of stimulative AD policies. On the other hand, at a different time or in another economy, the menu of unemployment–inflation choices open to the authorities may contain a number of politically acceptable options. In this case, it is shown that elements of the institutional framework allow low unemployment and low inflation to be achieved simultaneously. One of our aims is to determine which institutions permit low rates of unemployment because their presence allows the economy to avoid the adverse side-effects of high levels of AD.

7 Evidence

Given the central role of structural change in economic development, it becomes clear that recurrent crises resemble each other only with respect to their most prominent manifestation, such as lengthy periods of high unemployment. In every other dimension they can be expected to differ, because the economic structure differs. Thus history does not repeat itself, but rather traces out a sequence of episodes, each with its distinct structural characteristics. For example, a given exogenous shock may have no effect, or it may trigger a sequence of events that culminate in a crisis, depending on the economic structure. Let us suppose that the second result obtains; again, depending on the economic structure, the process of transmitting the

shock will differ, as will the set of performance variables affected and the extent to which each changes. Therefore, not only is the same exogenous shock applied to the same economy at different phases of its development expected to yield different results, but these results are expected to take effect via different processes.

This clearly presents a problem for the analyst, for, no matter how accurate the data, the structure of the economy is changing in the long run. For an individual economy, the available statistical evidence is inadequate to test an explanation of economic performance; any results would be highly speculative. This, however, is only part of the broader picture presented here. We stress the importance of endogenous change, in particular the way in which economic performance induces structural change that in turn alters the economic processes. In view of this, poor performance and even crisis may be the product of the cumulative effects of endogenous change. This presents an even greater dilemma: given the evolutionary nature of economic development, how is it possible to determine whether a poor performance in some country is to be attributed, for example, to a set of unfortunate institutions rather than to exogenous disturbances?

While the data do not permit us to test our proposals for an individual economy, we make use of multi-country analysis. Although the development of an economy involves a continuous evolution of its economic structure, we believe that the advanced capitalist economies have experienced broadly similar evolutionary paths over the past century, particularly since World War II, and that they will continue to do so. Much of the explanation of the similarities is implicit in section 5, which discussed the direct and indirect impacts of AD on the economy. Not only have all these economies responded to AD pressures in the manner described in that section, but historically there has been substantial similarity in average AD pressures across countries. Stagnant AD conditions were a common feature during the 1930s, as were strong and growing AD during the 'golden age' of capitalism and the reversion to stagnant conditions since the mid-1970s.

There were also supranational changes, largely external to any individual economy but affecting all of them, that led to similarities in development patterns. These include the increasing international linkages brought about by the rapid expansion of trade, and the changed international monetary regime following the breakdown of the Bretton Woods Agreement. The impact of deregulated international capital flows, especially since the 1980s, on AD policies within each economy is a case in point. To these can be added long-run forces. These, while not entirely exogenous, must because of our ignorance be treated as such. They affect

the structural framework and performance of all economies in a similar way (for example, the spread of free education and the extension of the franchise).

8 Similar development patterns, different performances

In the previous sections we have noted that there are parallels in the development patterns of the advanced capitalist economies. However, we do not take the position, made popular by social scientists in the early part of the post-World War II period, that there is an inherent tendency for industrialized economies to undergo convergence of their economic structures (Kerr, 1960). In fact, case studies of the industrial relations systems and other institutions of the developed capitalist economies show examples of both divergence and convergence in the course of their development. Institutional divergence has resulted in different economic performance because of the effect of institutions on economic processes. Underlying these events, however, is the long-run development pattern shared among them as they move through the stages of industrialization and modernization and on toward post-industrialism; it is against this background of broadly similar experience that these differences in economic performance and structure stand out so clearly. And it is these differences that provide the evidence essential to an investigation of the impact of economic structure on economic performance.

In summary, the approach to be used in this study is to explain similarities in the development patterns of a group of economies in terms of similar interactions of economic performance variables and economic structures, and then to account for differences in economic performance between these economies in terms of differences in the evolving structural framework, especially their institutions. This task can be divided into three parts, with institutional differences used as an example. First, it is necessary to determine the process that enables institutional differences to generate performance differences among economies. For example, cross-country analysis of the golden age in chapter 5 shows a wide variation in unemployment rates and almost no variation in rates of inflation. Although other influences were at work, this can be largely attributed to differences in institutions of the labour market, in particular to how effectively they can contain rates of inflation at low rates of unemployment. Similar cross-country analysis can be used to examine other periods. The second task is to determine when certain institutions have changed sufficiently that new constraints on AD are in operation or old constraints have been removed, and to identify how and how strongly they affect economic performance. Radical alterations in macroeconomic performance are clues to such

changes. Once it is established that significant institutional change has occurred, the investigation proceeds to determine whether it is endogenous (that is, can be attributed to the cumulative impact of past macroeconomic performance) or whether and to what extent exogenous forces were involved. The final task is to combine these results in the form of a causal chain illustrating the interaction of performance and structures.

9 Historical laws and predictions

Our analysis of macroeconomic performance employs a framework in which key aspects of an evolving structure are explained. This may appear to some as a quest for historical laws of macroeconomic development with all the ambitious predictive connotations this usually carries. It is not our intention to engage in what we believe would be so fruitless a task. Instead, the task we have set ourselves reduces to answering two quite straightforward questions. First, what part do economic structures, especially institutions, play in the determination of differences in economic performance? And, second, how does economic performance itself influence these structures?

Our efforts to answer these questions necessarily depend on the past experience of a limited number of economies. Can our findings be applied to economies beyond this sample, and can they be used for prediction? In assessing their general applicability, we are faced with the complications arising from the centrality of institutions to the analysis, and the fact that institutions tend to be country specific. We maintain that there have been and will continue to be important similarities between the development patterns of the advanced capitalist economies. For this reason, an understanding of the role of institutions and the causes and results of institutional change in these economies will provide valuable information for policy makers. Furthermore, in the absence of catastrophes, there is every reason to believe that the newly industrialized countries (NICs) will experience similar patterns of development. It also seems reasonable to expect that the rate at which the NICs will transform themselves will be as rapid as, perhaps more rapid than, the rate experienced by the present industrial leaders when they were at a comparable level of development. Given these similarities, the experience of the advanced capitalist economies is relevant, and with some modification our analysis would be applicable.

Because the NICs appear to be following the paths of the advanced capitalist economies, there is the possibility that our results might be used for medium- or longer-term forecasting. However, such forecasts would be very speculative, subject to error stemming from unforeseen shocks, from structural changes unrelated to their past economic performance, and from

the unique features of a country's historical development. Predictions become even more perilous when considering the likely evolving performance of the already industrialized economies. For example, the 1950s and 1960s were a period of rapid and sustained growth and low unemployment in the advanced capitalist economies. Viewing the future from the vantage point of, say, the late 1960s to early 1970s, a forecast of continued superior macroeconomic performance would have appeared reasonable and was the view held by the overwhelming majority of macroeconomists at the time. In retrospect, the late 1960s to early 1970s marked the beginning of the end of the great post-war boom. Beginning in the mid-1970s and extending until the late 1990s, macroeconomic performance in the OECD economies was characterized by high and rising unemployment rates, greatly reduced growth in productivity and incomes and the spread of poverty.

In our view, the failure of the economics profession to foresee the events about to unfold in the mid-1970s was due to an inability to comprehend some important underlying institutional changes that were taking place; these were to have a strong negative effect on economic performance. This failure can be traced to two causes. First, the trend in macroeconomic theory had for some time been in the direction of greater formalization in modelling dynamic processes, a formalization increasingly devoid of attention to economic structures, especially institutions. Second, these economies had never before experienced prolonged full employment during a period of rising union strength. The impact of these events on institutions, eventually leading to strong inflationary pressures under full employment conditions, could not have been foreseen even had trends in macroeconomic theory followed a different path.

In view of this, the question arises whether the inability to predict future structural changes casts doubt on the value of our approach. We think not. For one thing, we believe that our framework provides a deeper explanation of past macroeconomic performance of the developed capitalist economies; it examines the historical record, viewing both exogenous and endogenous forces as potential determinants of economic performance. We also believe that, by pinpointing the structural features that lead to poor or superior performance, we are better able to make sound short- and intermediate-run forecasts than alternative approaches would allow. All forecasts are conditional but ours explicitly emphasize their conditionality on unchanged structures, and these are relatively stable features of most economies. Further, our approach involves examining economies for evidence of structural change, so that observed systematic trends can be used for forecast purposes; when change has no discernible pattern, it will be clear that no forecast will be reliable.

Its inclusion of structural change enables our approach to offer deeper

understanding of the current difficulties of persistent high unemployment, and this opens new options for improving performance through policy. It emphasizes the need to look for structural changes as sources of the current difficulties. More ambitiously, by determining the structural causes of malfunction, we are able to indicate the kind of policy-induced structural changes that will foster recovery. This is not a claim that policies can always be found, or that they will achieve results quickly and accurately. There are still too many unknowns. But, rather than attempting short-run ‘fine tuning’ of the economy, we are suggesting that establishing which institutions stand in the way of recovery and seeking policies that will induce the needed changes offer hope for a longer-term solution to malfunction in economies that are clearly not self-regulating.

10 What can we learn from studying the long run?

The purpose of this study is to explain long-run macroeconomic development. Given current economic conditions, this raises the question of relevance. We live in an age of high unemployment now well in to its third decade; there is little indication of noticeable improvement in the near future. Accordingly it can be argued that the proper role of a macroeconomic model builder should be to tackle the unemployment problem. Certainly explaining macroeconomic performance over nearly a century is our stated aim, but it is done with the objective of shedding light on current problems and has been motivated in large part by a desire to find remedies for this malfunction. However, in order to provide a convincing explanation of today’s problems we think it necessary to demonstrate that our framework has some claim to generality by offering an explanation of other historical periods. We wish to convince the reader that in earlier periods as well as today, whether performance can be termed superior or poor, the outcome has been the result of structural changes themselves induced by endogenous economic forces, and not simply caused by avoidable human error or other exogenous disturbances interrupting the otherwise seamless progress of a self-regulating system.

11 Looking ahead

The remaining chapters in part I develop the points summarized in this chapter. Here we have introduced the idea of the evolution of the economy’s structural framework as a fundamental process of development. Chapter 2 concentrates on the economic variables, particularly trends in output and unemployment and the likely causes of these trends. This requires some evaluation of mainstream growth theories and of the adequacy of conven-

tional unemployment measures. Alternative measures of unemployment are also discussed. We pay particular attention to the recent American experience because, as usually measured, its unemployment performance has been relatively good. The institutional features of the 'American model' are alleged to be responsible for this result and are widely cited as the proper goal of institutional reform. Chapter 3 is a critique of supply-determined equilibrium analysis in general and the neoclassical theory of unemployment in particular. Chapter 4 introduces an extended Keynesian model of demand-determined growth in which outcomes are attributed to the state of AD and not to forces on the supply side, not only when there are unemployed resources but also under full employment conditions. Chapter 5 discusses institutions and their functions, and considers both institutions and the distribution of power as determinants of economic performance. These ideas are illustrated by several well-known empirical studies, to which we add our own econometric investigation. Chapter 6 considers the long run, when institutions and the distribution of power vary. This completes our framework for modelling economic development. Chapter 7 compares our approach with other attempts to model long-term economic development.