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Working Paper No 110

Comment on Paul A. Samuelson's Paper:
The World Economy at Century's End

by
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Institut für Weltwirtschaft an der Universität Kiel

Comment on Professor Samuelson's Paper

"The World Economy at Century's End"

1. Professor Samuelson deserves the applause he received for his lecture about Keynes, Schumpeter, and "The World Economy at Century's End". However, my role is not to praise him, but to criticize. Let me try to discharge my duty

- (1) by searching for a bias and for faults in Samuelson's picture, and
- (2) by indicating where the picture does not fill the frame given by its title and the more general context of this Congress' theme "Human Resources, Employment, and Development".

2. There are two main characters in the picture - Keynes and Schumpeter - and one favorite subject matter - the mixed economy.

Samuelson is in sympathy with Keynes who half a century ago predicted the high standard of living - and the boredom - people will enjoy at century's end in a Swedish type society. The material foundation of this society is the mixed economy. Keynes himself seems to have given birth to it; at least he nursed it. For without the Keynesian Revolution there would not have been protection against deflation and persisting slump (p. 16), and the world would not have experienced the miracle decades of the 1950's and the 1960's (p. 16). As the mixed economy has human equalities (p. 35) we are left with the impression that Keynes' real historical role was to be something like the alma mater (in its original sense) of the good society.

3. The second main character is Schumpeter who happened to be Samuelson's teacher. He does not look like a good mother, but like an unsympathetic dominating father. Samuelson calls him cynical

(p. 2, p. 17), schizophrenic (p. 5) and half a mountebank (p. 11). Methodologically, he must have been fairly authoritarian: with a wave of his hand he airily dismissed post-Keynesian apprehensions instead of invoking theoretical arguments (p. 9); his thought was confused (p. 22); and he broadened definitions when it suited him, e. g. the definition of a socialist to include Samuelson and others who are objective about capitalism (p. 21).

As a forecaster Schumpeter earns a C in Samuelson's eyes (p. 4) because he substantially underestimated the post-war performance of Germany and Japan, Sweden and Switzerland and of the whole world economy (p. 16). He even believed in Hitler's victory (p. 6). Politically, he was a conservative (p. 24) and - if you read between Samuelson's lines - an advocate of the fascist solution (p. 32). Taken together this comes close to an overkill, masterly hidden in a marvellous exposition devoted to the future of the world economy. Final judgement must be left to future historians, if not psychologists, of economic thought who have lower opportunity costs than we at this congress.

4. To turn to the subject matter, we note that Samuelson's main concern is the mixed economy, set in sharp contrast to Schumpeter's unfettered capitalism. For lack of definition we have to gather that this type excludes both classical socialism and all countries where the market operates under the umbrella of a one-party dictatorship. It is unclear where he puts Mexico, but as to the OECD countries, they all seem to be included with the possible exception of Yugoslavia. Samuelson's favorite example of a successful mixed economy is Sweden which is infinitely more often mentioned than Keynes' own country. What is so exciting about the mixed economy, apart from its vitality which seems to contradict Schumpeter's horoscope or Hayek's horror scope of an inevitable march into socialism? Is it an ongoing election campaign in the U.S. or a hazardous Thatcher experiment in Britain? In my opinion the real issue of the mixed economy is - apart from stagflation - the unhappy choice between equity and

efficiency, so aptly described by the late Arthur Okun.

5. If the characteristic feature of the mixed economy is the mix between market efficiency and a determined government policy in pursuit of equity and social security, I fail to see its relation to Keynes. Its roots can be traced further back to Bismarck's social security legislation of almost a hundred years ago and to those German economists who called their professional society founded in 1872 "Verein für Socialpolitik" or association for social policy. I also see a close link to the West German post-war concept of a "social market economy".

6. However, Samuelson is preoccupied with effective demand and with fiscal policy propelling the multiplier-accelerator mechanism. Thus private autonomous investment is left out of the picture, and the Schumpeterian entrepreneur, hardly alluded to by Samuelson, has no role to play as a driving force of economic development. I admit that the dynamic entrepreneur is now a rare animal, after more and more businessmen in mixed economies have become Keynesians waiting for the government to provide them with effective demand for induced investments; but the post-war economic miracle, at least of West Germany, mentioned by Salmuelson, had a different engine. This development is not at all miraculous when seen through Schumpeterian rather than Keynesian glasses. If you want an explanation even more closely related to human resources than Schumpeter's you better try to extract it from David MacClelland's pioneering book on the "Achieving Society".

7. As regards West Germany in the 1970's Samuelson maintains that her performance was worse than that of the U.S. When at an earlier occasion he supported the point with statistics of industrial production I explained why this was not admissible in a period of accelerated decline in the share of the industrial sector. Now the reference is to GDP. Here the growth rate in the 1970's is indeed

higher for the U.S. (3.2 per cent) than for West Germany (2.8 per cent). However, West Germany clearly outperformed the U.S. in terms of GDP per capita, GDP per employee and GDP per hour worked, not to mention the fantastic productivity growth in West Germany's relatively shrinking industrial sector. Sweden, which receives so much praise for not slowing down the rate of growth of its social pie (p.17) exceeded West Germany's post-war performance (p.18) in no decade in terms of GDP, or GDP per capita or GDP per person employed.

Sweden which Samuelson believes to have shown annual productivity improvement of eight per cent is, in actual fact, not advancing at a record pace. Trusting Denison's figures, we see Swedish productivity growth from 1950 to 1973 below that of many other countries, though above that of North America and the U.K. From 1973 to 1978 productivity growth in manufacturing was lower than before, but particularly in Sweden; Sweden even fell behind Canada and the U.S. Only Britain was a worse performer than Sweden among the countries selected by Denison (Denison, 1979, p.146).

8. One of the central points in the present mixed economy debate is the question whether government expenditure as a per cent of trend GDP will continue to rise, as it did until recently in all major OECD countries, led by the Netherlands, the Scandinavian countries, and the U.K. (OECD, June 1977, p.211). The answer may well be yes, in accordance with Adolph Wagner's law formulated in 1861. This law is plausible to those who see Parkinson's law operating in "bureaucracies without bankruptcy" and who observe how politicians compete for special groups of voters by making promises at taxpayers' expense.

9. But history has seen reverse swings, like the "retreat from mercantilism into laissez-faire in the 19th century" (Cairncross, 1976, p.113), heralded by philosopher-economists of Scottish and English origin. These intellectuals in Schumpeter's sense had a

workable alternative to government regulation - i. e. the market. This is why they were more successful in their drive towards a withering away of the state than Karl Marx and those who followed him in this respect. Intellectuals of the same spirit were at work in Prague in 1968. Economists seem to contribute to such swings with the fashions of the profession. When the market has a wide scope to operate we concentrate our efforts on supposed market failures, assuming a perfect government which ideally could do better. And when we accumulate experience under real world governments - mercantilist, fascist, and socialist - we rediscover and preach the virtues of the market like those German economists around Walter Eucken who had opposed and yet survived Hitler. What Schumpeter possibly failed to see is that intellectuals tend to be dissidents in either polar system. Economists are intellectuals in the "state versus market" controversy and are bound to overshoot as long as the profession is incapable of defining rules for the optimum division of labor between governments and markets which are sufficiently operational and can be applied in different socio-political circumstances.

10. As long as we have not done serious work in this field we have to rely on personal impressions. For the sake of further discussion let me draw on 40 years experience in German civil service and state the following presumptions:

- Civil servants are relatively efficient and usually do their best. Yet serious coordination inefficiencies do arise from over-centralization, loss of relevant information in the bureaucratic communication system, institutional rigidity, and a systematic incapability of using and expanding the learning potential of the human resources employed.
- Most serious is the lack of rewards for economizing, risk taking and innovating. As a director of a government financed and bureaucratically controlled research institute I have to spend

most of my efforts on maintaining and defending natural human motivations against external pressures to substitute control for confidence and regulation for incentives.

- Decentralization of responsibility helps in many respects, but it cannot be tolerated in wide limits if the output is not subject to external evaluation and competition. Internal competition is merely a substitute; and it can mislead people who receive freedom for decision making to merely becoming budget maximizers.

Fortunately for GNP growth, the government sector can rely upon the Central Statistical Office to estimate its output as equal to its input and to impute to its servants an annual productivity increase of 2 per cent or whatever the top secret guesstimate just may be. So much about X-efficiency in the public sector in countries like West Germany.

11. Outside the public sector, detailed regulations and controls have similar depressing effects on motivations and productivity improvements in the market. However, we in Germany observe many foreigners becoming petty entrepreneurs. The question how they can cope with all the regulations formulated in an involved German that they can hardly read, let alone understand, has a plausible answer: they have the privilege to ignore these regulations and to return to southern Europe once they get into difficulties due to this ever growing literature. Another striking observation is that the international sector of the West German economy which is exposed to the storms of Schumpeterian competition shows a much higher productivity growth than the over-regulated and cartel ridden domestic sector. Thus the open economy comes to the rescue of the mixed economy.

12. An alternative way of getting around the high state content of the mixed economy is disloyalty: tax avoidance through shortening of the work week and retreat into tax free activities during leisure time. Together with a subsidization of search unemployment by relatively high

unemployment benefits and the pensioning off of the unemployed close to retirement age, this gives plausibility to presumptions that the modern mixed economy suffers from the emergence of a substantial underground economy. Those who want to learn more about this phenomenon are advised to study what is becoming known as Italy's "new economic miracle".

13. For Samuelson the real problem of the mixed economy is stagflation. My explanation for this disease is that politicians have been made to believe in the existence of a stable non-vertical Phillips curve. When unemployment is low they discover inflation, and when inflation is low they consider unemployment as public enemy No. 1. The outcome is a politically determined go and stop business cycle. Its go part (in terms of output) requires the existence of money illusion (supported if possible by exchange rate illusion) or adaptive expectations which bring about a time lag in the upward adjustment of wages and prices. An illusion which is thus exploited disappears. It then needs to be restored. This happens in recessions. The less effective this restoration, the greater must be the subsequent inflation if it is to produce the expected output effect. Thus, by walking up and down the Phillips curve politicians shift it - and worsen the tradeoff. The problem in my view requires a deep reform. The two conflicting targets of low unemployment and price level stability need a separate institution or instrument for each, and a division of labor between them that matches the norms of comparative advantage. This is not the place to describe the ideal solution; but some consensus societies (in the context of an open economy) seem to be on the right way when they gradually learn that there is more classical unemployment in this world than Keynesians believe and that such unemployment must be tackled on the wage front rather than by monetary acceleration.

14. Let me now talk about the world economy rather than Samuelson's paper. The main topic left out of his picture for the road to 1999 is the lack of productive jobs compared with the hundreds of millions of people in LDCs who need and deserve them. How can the advanced economies in the First World most effectively contribute to a mutually advantageous solution of this serious problem?

15. My answer, apart from development aid, is: make the mixed, advanced economy as open as possible for those LDCs that wish to take advantage of export led growth and an international transfer of capital and knowledge. Resistance against liberal imports from countries with an abundant supply of labor is likely to be strong in countries where labor is well organized and politically influential. This proposition is based on the Stolper-Samuelson theorem, on the existence of adjustment costs, and on the fact that governments usually have little maneuvering room for paying adjustment assistance as a temporary device. The proposition is borne out by abundant experience. This seems to indicate that the real class conflict of our age is between labor in less developed countries and labor in advanced countries. The mixed economy may have humane qualities, as Samuelson emphasizes, but its organization in a nation state limits humanitarian activities essentially to compatriots, and perhaps even only to those who belong to pressure groups.

16. Unfortunately, the rich mixed economy solves some of its domestic problems at the expense of poorer countries in the Third World. Here is a short list of examples:

- A premature reduction of wage differentials - interindustrial, interregional and between unskilled and skilled workers - attempted in the name of equity, aggravates adjustment problems in structurally weak industries and regions, and contributes to heavy unemployment among youths, females, and elderly persons. To mitigate this effect on the poor at home, a system of import protection and subsidies is built up which largely discriminates against the poor abroad.
- Domestic labor unions, notably under co-determination, protest against direct investment in LDCs unless the investment is complementary to domestic labor and can be justified as securing domestic employment at higher real wages. This limits direct investment in LDCs to projects which are sales oriented or ensure cheap raw material supplies.
- High real wages for unskilled workers are a strong inducement to labor augmenting innovations which raise the capital intensity built into the capital stock, including the capital intensity built into investment goods which are delivered to LDCs under development assistance programs. The growing unemployment in the world economy has thus little to do with effective demand, but very much with technology and capital shortage.
- Artificially low energy prices, notably in the U.S., maintained under populist pressures worsen the position of oil importing LDCs.
- Government deficits in advanced countries, often recommended for preventing domestic unemployment, have a crowding-out effect not only on domestic firms but also on foreign firms and governments, including governments of LDCs.

17. In search of a common cause for such malfunctions, I dare to submit a hypothesis that could help us to understand, if not predict or prevent, some likely developments in the world economy during the next two decades:

- The tendency to overvalue present goods relative to future goods (observed by Böhm-Bawerk) leads to an increased shortage of capital unless the real rate of interest is allowed to be positive and high enough.
- Under the impact of policies devised to fight classical unemployment by Keynesian methods, the mixed economy shows a tendency to depress the real rate of interest, sometimes below zero.
- Mankind tends to overvalue human resources not only in relation to physical capital but also in relation to natural resources, including exhaustible raw material deposits and in relation to human capital.
- Once the shortage of natural resources and of capital exceeds threshold levels, human resources will accept, although reluctantly, a devaluation. This will be felt as a crisis. It will probably last until mankind has adjusted to a sufficiently high real rate of interest on both capital and exhaustible resources.
- The mixed economy in advanced countries is abused to prevent market forces from enforcing quick adjustments to changes in the world economy. The main reason is that the objective of social justice is vague and that, in the absence of generally accepted norms, traditional relative prices and traditional income differentials are often taken as the best possible approximation. This social conservatism is likely to lead to increasing protection against LDCs. The Stolper-Samuelson theorem demonstrates how the relative value of human resources can be maintained in advanced countries, however at the expense of LDCs and world welfare.

- In advanced countries, such protectionism reduces economic growth by slowing down structural change; and in LDCs it strengthens political pressures in favor of de-linking and import substitution policies. Defensive investments in advanced countries defeat LDC attempts at earning the foreign exchange needed for job creating investments. Taken together this is likely to exacerbate the capital shortage and unemployment in the world economy in this century.

18. Let me conclude with an optimistic note. Like Samuelson, I have a dream. It is about the open rather than the mixed economy. To be specific, I shall formulate several wishes addressed to the European Community of which my country of citizenship is a member.

First: Replace the Common Agricultural Policy by a system of income subsidies so as to end the vicious circle of producing, protecting, storing or dumping that arises from excessive "target prices", "intervention prices" and "threshold prices" (Cairncross, Giersch, Lamfalussy, Petrilli, Uri, 1974, pp. 91-115). The waste which the mixed economy produces in this area, while large parts of the world suffer from starvation, is a bad precedent and a human tragedy.

Second: Enlarge the Community, but make sure that the new entrants will support commercial openness as if they were still excluded.

Third: Make a unilateral and irreversible pledge that all imports will be fully liberalized from duties and controls in a series of steps before the end of this century.

Fourth: Member countries should be induced to cut all permanent subsidies in a parallel series of steps in order to obtain financial means for granting adjustment assistance on a temporary basis; capital losses, however, need to be compensated for only if and to the extent that windfall profits have been subject to taxes and provide the financial means.

Fifth: Capital outflows will follow free commodity imports once domestic entrepreneurs have learned that it is both possible and cheaper to serve the domestic market for standardized products by producing in countries where labor is abundant. LDCs wishing to participate in this resource transfer should be invited to form investment agreements which clearly define the frontiers between government and enterprises and which give assurances against whatever political risks are seen as an impediment.

Sixth: Technology follows investment and trade, but rich EC countries can do much to encourage the export of investment goods which incorporate technologies appropriate for LDCs. Fears about unemployment in rich countries can be easily dispelled by demonstrating the vast demand for investment goods that is bound to develop once LDCs can earn more foreign exchange and become viable capital importers. There is no Keynesian liquidity trap in the Third World.

Seventh: Rich EC countries which import more and more standardized Heckscher-Ohlin goods and will also have to pay relatively more for resource based Ricardo goods can maintain their position on the world income scale by concentrating resources on the research and the development of new and better products which, in honor of Samuelson's teacher, I like to call Schumpeter goods.

Eighth: The developing advanced rich economy must be open vis-a-vis the future as well as vis-a-vis less advanced countries. Openness vis-a-vis the future requires a free market in ideas as well as in goods. This practically excludes fascism and other forms of dictatorship. Hence there is no fascist solution that could be imagined for a Schumpeterian economy, whatever Schumpeter may have thought a couple of decades ago.

Ninth: Perhaps the most important good for the world economy is good money, money with a fairly stable value in terms of goods and services. The dollar, after having been used to produce the environment for the miracle decade of the 1960's, no longer qualifies for that role.

Those central banks in Europe which produce close competitors to the dollar should quickly learn how to become the supplier of the nth currency and how to earn the compensating seignorage gain.

Tenth: Europe will remain one of the three centers of the world economy outside Comecon. Having largely caught up with the U.S. in the last three decades, the strong countries in the European Community should feel responsible for a Community policy that would help other countries to catch up with them. It is in this way that international income differentials can be reduced in a worldwide positive-sum game.

Although these wishes are addressed to policy makers I am not without hope. This hope is based on the belief that people in a society which is open vis-a-vis the rest of the world and open vis-a-vis the future cannot but learn from failures and success.

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