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OVERCOMING THE OBSTACLES TO SUCCESSFUL
PERFORMANCE OF THE WESTERN ECONOMIES

by

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Interrelations

Overcoming The Obstacles To Successful Performance Of The Western Economies*

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I T IS, I THINK, convenient to discuss the obstacles to a more successful performance of the Western economies in the context of some asserted prerequisites for such performance. I have chosen to distinguish between eight such prerequisites — all of them being more or less threatened today. As we shall see, most of these eight prerequisites refer to conditions on the supply side i.e. the production side, rather than the demand side, which has been so much emphasized in postwar economic policies.

1. The first prerequisite to be discussed is that production and investment are reasonably profitable. In particular the experiences in many European countries during the last decade, with historically low profit levels, illustrate vividly the consequences of a low general level of profits: sluggish production and investment and rising unemployment. A more profound effect of a generally low profitability level is that governments in such a situation often feel compelled to step in with protectionist measures (subsidies and equity capital) to avoid both lay-offs of labor and bankruptcies. In other words, increased protectionism and mercantilism by national governments — with an increased risk of international economic conflicts — is a predictable outcome in a world with a low general level of profitability.

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What is then a rational policy response to this situation? For an individual country, a devaluation of the currency will sometimes help. However, the situation is of course a different one for the world as a whole: If the reason for low profitability is a cyclical one — low capacity utilization — appropriate expansion of aggregate demand in the world economy could in principle solve the problem. If the reason instead is aggressive labor unions, who have “bargained away” profits, what is required is, in principle, lower real wage rates and hence higher tolerance of profitability among labor union leaders. However, if the reason for the low profitability in the developed countries of the West is stiffer international competition, the rational response would probably be a slower rate of capital accumulation in these countries, possibly combined with increased capital exports to the LDCs, where profitability may have increased. In the last case, the low profitability of investment should be regarded as a “normal outcome” of the operations of a highly competitive system.

2. The second prerequisite for a more successful economic performance to be discussed here is that the apparent inflationary bias of the Western economies be mitigated. There are many reasons why this is important, though I will mention only one here. High and rising inflation often forces governments to fight inflation by cutting back aggregate demand, which means that the inflationary bias of our societies indirectly becomes an important factor — perhaps the most important one — behind capacity slack, and hence recessions, in our economies.

How to mitigate these inflationary tendencies is, of course, one of the unsolved policy issues of our time. Contemporary policies of demand-accommodation of various types of cost increases have in principle created an economic system without “a fixed point” that can “anchor” the general price level. In the case of individual countries, experi-

ments have, of course, been made to create such a "fixed point" either by way of a fixed target for the path of monetary aggregates, as suggested by the "monetarists", or a fixed path of the average wage rate, as suggested by the advocates of "incomes policy." For small open economies, a fixed point relative to prices in the outside world may alternatively be established by way of a permanently fixed exchange rate.

However, what all suggestions of a "fixed point" really boil down to is, in my judgement, that labor unions are given a greater responsibility for the employment level. Perhaps that could be facilitated if governments would declare in advance of new bargaining that wage and price increases above certain limits will not be accommodated by demand management policies. A policy of this type is most promising in highly open economies with rather centralized bargaining. However, it is of course open to severe doubt if governments in the real world really dare to make, and stick to, such announcements of non-accommodation.

3. An efficiently functioning market system requires well functioning markets in the sense that physical bottlenecks are avoided, entrepreneurship is vital, and relative prices and the allocation of resources respond in a flexible way to changes in taste, technology and competitive situations on world markets. This brings me to the third prerequisite for a successful performance of the Western economies.

It is generally, and I think correctly believed, that the functioning of markets in several Western countries has seriously deteriorated in the last decade. If we believe that there are serious problems in the product markets, it would, I think, be natural to recommend tougher anticartel policies, further trade liberalizations, and the break-up into smaller units of larger corporations with strong market powers. Moreover, the shift to more "political prices" is probably bound to reduce the flexibility of relative

prices and hence to deteriorate the efficiency of the allocation of resources. The most striking recent example is perhaps the resistance by governments in oil-importing countries to price increases for energy which, together with environmental problems of most types of energy, and public opinion resistance to nuclear energy, is possibly the most severe threat to affluence and full employment in our countries.

My conclusion is that a retreat from the politization of prices in our economies is probably a necessary condition for more flexible product prices, and hence better functioning product markets. Economists have, I believe, also the rather unpopular duty to point out that part of the unemployment problems in the contemporary society depend on distorted relative prices of labor — in the sense that not only lower real wage rates but also lower relative wage rates in areas with unemployment as compared to the wage rates in areas with vacancies, would reduce unemployment in our societies.

Moreover, a result of recent tendencies, in particular in Europe, that wages become fixed costs for firms is an increased reluctance, and a reduced ability, of firms to make new hirings in business upswings. It would seem to me that these costs of economic security mainly have to be carried by society, as a whole, rather than by individual firms, for instance by way of some insurance system.

4. The question of the functioning of markets is, of course, closely connected with the problem of economic incentives, which is the fourth issue to be discussed here. What I would like to stress in this context is the large wedges that have recently been inserted between social and private rates of return on work effort, in particular for efforts "on the margin." The main manifestation of this is, the marginal tax rates in income taxation which, in some of the most elaborate welfare states in North-West Europe, now amount to more than fifty percent for ordinary workers.

In such a world, the choice of activity of households is distorted, in the sense that ordinary market activities are discouraged. Citizens are likely also to find that political and judicial actions are more efficient ways of increasing their incomes than are individual action or markets. In other words, there would be a tendency for citizens to turn to the transfers of resources from others — “zero-sum games” — both in individual and political actions, rather than concentrating on the “positive-sum games” of productive activities.

It is not easy to see speedy ways out of these problems. Theoretically, some possibilities would be (1) a reduction of the ambitions to redistribute incomes among people above the levels of low-income brackets; (2) a reduction of the share of public spending relative to GNP; and (3) increased reliance on fees for public services. However, all these methods are in practice difficult to implement, mainly because of factual or perceived consequences for the distribution of welfare in society. I will return to this issue.

5. Another prerequisite for a successful performance of the Western economies is that the technical and administrative competence is kept up and improved, which is largely an issue about investment in human capital. It is my judgement that some countries are facing serious future problems in this area. Of course, higher return on investment in human capital would be one way of trying to avoid serious problems in this field in the future, which brings us back to the issue of incentives and taxation. Another well-known proposal is increased government support of basic and applied research and development. However, it is likely that the crucial factor for the development of technical and administrative competence, including innovations of various types, is to establish a general environment that is favorable for decentralized initiatives, i.e. a reasonably high general profitability level, appropriate incentives for individuals, well func-

tioning markets and a school system that combines mass education and "the pursuit of excellence."

6. So far I have discussed conditions in the market-oriented part of the economy. However, it is quite obvious, that with the present size of the public sector, conditions in that sector are quite important for the performance of our economies. Theoretically there are some possibilities of introducing competitive market mechanisms for the purpose of stimulating efficiency in the public sector — for instance, by fees for some public services, by an increased use of private subcontractors in public production (for instance building activity) and by accepting competing private institutions and enterprises in areas where public institutions are close to monopolies (schools, hospitals, and child and old age care centers). However, due to the desire in our societies to achieve a more egalitarian distribution of such services than of income in general, social security systems or "voucher systems" with egalitarian ambitions, would then most likely be necessary, in order to respect widespread political preferences regarding "fairness" of distribution in our societies.

7. A factor of great importance for economic development, often neglected by economists and politicians, is that laws and rules have to be reasonably stable. Otherwise it becomes extremely difficult for individual agents and organizations to judge the consequences of planned actions. In other words, there must be a certain stability of the relation between actions and outcomes, i.e. of the "pay-off" functions. If laws and regulations change violently all the time, the returns accruing from correct speculation about the next moves of the authorities often become higher than the returns from careful investment in skills, product development, choice of production technique, and marketing. The sluggish behavior of investment activity of most Western economies during recent years depends perhaps not only on low short-term profits, but also on increased

uncertainty about future government policies and the future rules of the games.

Moreover, in a system where rules and regulations change continuously, there will be great temptations, particularly for large firms, to bargain with politicians over the rules, including bargaining about selective subsidies and various "deals" with the authorities. There is, therefore, an obvious risk that not only households but also firms will increasingly enter into "zero-sum games" rather than "positive-sum games": they will concentrate on redistributions in their favor via bargaining with governments rather than trying to create new resources by way of production. The day firms start chasing subsidies instead of efficiency, our economy is on its way down the drain.

8. It is, of course, important to consider the likely distribution effects of reforms of the economic system along the lines discussed here. The avoidance of severe distributional conflicts is therefore the eighth, and last, prerequisite to be discussed for successful economic performance. One obvious distributional problem is implicit in the suggestions for a profitability level that is high enough for dynamic performance of a private enterprise system. However, it is conceivable that an increased tolerance of profits would be facilitated if a broader "anchoring" of the direct interest in the return on capital among individual employees could be brought about (by a broadening of the individual ownership of capital by employees, and a broader recruitment of managers of, and board members for, major capital funds). Personally, I regard such developments crucial to the possibility of achieving a successful long-term performance of the Western economies.

Also recommendations of greater flexibility of relative wage rates are usually resisted with the argument that the consequences for the distribution of income would be unfavorable. There is, of course, considerable substance in this opinion too. It is often necessary to make a trade-off between effi-

ciency and distributional aspects on relative wage rates, though efficiency considerations often would in fact require relative wage increases for types of jobs which are connected with specific disutilities, such as uncomfortable working hours, dirty, heavy and psychologically demanding work — such as for mine workers, workers in heavy industry, hospital nurses and often, policemen in large cities — i.e. for groups that should perhaps not be regarded as belonging to a privileged “upper class” in our society.

An even more obvious conflict occurs when demands are raised for reduced (explicit and implicit) marginal tax rates for the purpose of increasing the possibility for individuals to raise their income levels by their own effort. It is usually impossible to increase the return on efforts by individuals without at the same time, increasing income differentials between individuals.

However, that is only part of the issue. Increased taxes and transfers may not only mean that some inequalities of income are reduced. New inequalities of income often emerge as the result of the interventions. The most obvious example is the increased economic reward for exploiting information about tax loopholes, illegal tax avoidance and criminal activities in general. Perhaps some people would say that this is not so serious from the point of view of the distribution of income in the long run, as in a long-term equilibrium situation increased entry into these fields will guarantee that the return on effort and capital in such fields adjusts to what is the “normal” reward for risk-taking. However, that is a limited comfort for all of us who believe that it is a serious social problem to have a society where a not insignificant fraction of the population is engaged in dishonest or asocial activities of various types. For these reasons, there is probably a limit to the argument that redistribution via the tax and transfer system contributes to social consensus.

CONCLUSION

My diagnosis of the problem of the Western economies may be summarized as a rather advanced form of arteriosclerosis, or more specifically a deterioration of the system of economic incentives for firms and households, reduced flexibility of organizations and markets, and the emergence of a political system that is more conducive to short-term vote buying by way of public spending and "rule changes", than to stimulating competence and flexibility of the allocation of resources. The previous discussion might give the impression that politicians, labor union leaders, and the general public believe that our countries are now so rich that we can start to "consume" the very foundations of our affluence — such as economic differentials and the ability to reallocate capital and labor. In fact, our problems are deeply embedded in our competitive political system, which has a tendency both to put markets out of operation, and to expand public expenditures more rapidly than the growth of total resources.

In conclusion, no single reform is by itself likely to result in a fundamental improvement of the performance of the Western economies. It is also important to realize that different types of reforms have their main effect in quite different perspectives. Thus, the most promising strategy when trying to overcome the obstacles to successful performance of the Western economies is to rely on a battery of reforms, each one with its major effects in a quite different time perspective from many of the others.

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