Classical Economic Fashion Redux: Growth Economics to the Forefront

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We have in recent years been witnessing a resurgence of the mode of thought and framework of the “founding fathers” of Economics. This has happened not by chance in a sort of curiosity, but because the message they delivered in 1930, we are to say, very apropos, very responsive to the questions posed by modern day economic events.

We can identify two such events. One is the demise of colonial empires that has spawned a crop of less developed states enmeshed in their “vicious circles of poverty,” and seeking the mechanism that would deliver the “breakthrough” and have them overcome the obstacles to economic development. Yet it is ironic that when we look back to the decades of the 1950s and 1960s when Planning for Development was in vogue, how little effort was given to promote the study of the history of the more highly developed countries to ask how they were able to do it. What was the basic driving force behind their progress. One might suppose that the leaders of the underdeveloped states would have more to learn from the history of states that have been able to make the changes than from those that have not. In any event, one does recall studying classical economic models as perhaps ancient economic exercises without any awareness of any application to underdeveloped systems. It is as if these models were somehow good in their own time but had nothing to say to us today.

A second event deals with the stagnating real economic growth that was characteristic of advanced economies in the decades of the 1960s and 70s, particularly in the United States. This was a time of growing and high levels of government spending and taxation as proportions of the G.N.P., high inflation rates and little growth. Some serious questions were being thrown at the efficacy of “demand management” or “fine-tuning” regarding inflation control and to balance the economy upon some desirable growth path.

It might do well for us to recall some of the conditions prevalent in the U.S. at the outset of the 1980s. The economic expression from 1975 had not seen marked increases in capacity and enhancement of productivity. The evidence suggested that the system had settled into a long-run productivity outlook of less than 2% per annum. Productivity in the non-farm sector fell from an average yearly growth of 2.7% during the period of 1948 to 1955, to a rate of 2.5% from 1955 to 1965, to a rate of around 2% from 1965 to 1973 and slipping to less than 1% from 1973 to 1978. Indeed this gloomy picture becomes gloomier by seeing an output per person of 4% in 1978 which was the smallest rise since the recession year of 1974. Of course, this “no growth” environment related directly to the slow rate of business fixed investment. The real investment growth rate in terms of an average of five years ending in 1980 was 8.0%, coding in 1973 it was 3.1% and in 1977 it was 1.7%.

Now on top of this relatively shrinking base we maintained a high government drain on resources and high levels of transfer payments. Again some numbers will be helpful. At the outset of the 1000's total government expenditures as a share of the G.N.P. stood at around 27%; it then took a rather severe upward turn to 38% in 1970 and remained at high levels through the decade of the 70's. By 1980 expenditures at all levels of government rose to about 33% in 1980. Yet if we look at matters solely at the Federal level we find this expansion of the public sector being generally the result of increasing involvement in redistributing income. Income transfers as a share of the federal budget rose from approximately 15% in 1980 to a high of over 37% in 1980, and as a percentage of G.N.P. stood at around 12% compared to 8.3% in 1970 and 5.7% in 1960.

We may want a quick look at government revenues (at all levels) as a percent of G.N.P. We see it at about 27.5% in 1980, at 30% in 1970 and at about 31% in 1980. Historically though from 1945 to 1960 revenues averaged about 25%.

It is fair to say that the thrust of economic policy, that the center of economic reasoning, if you will, at least at the layer of policy—was that of demand management and income redistribution. The criteria for success seemed not to be the growth of capacity nor that of productivity, but some altered division of the “economic pie.” Attention to supply seems to have been almost entirely submerged.

One can generally read what one will into most numbers, but I submit that the “zeitgeist” had changed with the onset of the 80s based on a consensus of an unhappy reading of economic performance. At the policy level, questions were being asked concerning the nations most basic problem; that of the lack of growth. For many years the American economy had not been growing fast enough to provide a rising standard of living, to maintain an adequate growth in jobs and in the same time to provide for a strong national defense. Economic growth had indeed returned to the forefront of macroeconomic thinking.

Now these events met up with an ongoing rethinking (at the upper level of theoretical reasoning—think of one might think of it as the lower level) and I hasten to add a growing discomfort among neoclassical and Keynesian models that had become orthodox thinking and an ingrained habit of analysis. Suspicion concerning some of the micro-mechanisms of neoclassical surfaced early on with Staggs's critique of Marshall in his 1926 paper, but it was not widely understood, and in any event it was quickly overshadowed by conditions which brought on Keynesian economics that thrust economic analysis into the highest macro plan.

This Keynesian direction had certainly provided macroanalyses with an integrity of its own; that is, it emerged as more than just an extrapolation of observed microlevel behavior. However, when one turned to steady-state growth models with the necessary abandonment of states and notions of equilibrium, then it was necessary to pick up those micro underpinnings of distribution of income and the mechanisms of price setting that support the growth path. And this, in turn, required an explicit recognition of—if we may employ Marxian terminology—the social relations of production and to unerringly admit that these relations have a definite class character with particular (and perhaps antagonistic) roles to play.

In general we can point to these ongoing events that advanced economics began to emphasize policies with economic growth as the fundamental aim, that the matter of development being primary and continuous for the LDC's, and on the theoretical plane the emerging upheaval concerning practically all of the neoclassical assumptions. All of this resulting in "Classical Economic Fashion Redux.”

The structure of classical economics does provide a general theory of development (within particular institutional arrangements), its purpose was to identify these elements in a society that promote economic growth through an understanding of the process of capital accumulation. In this regard what has been rehabilitated can perhaps be best described as the “Classical—Marxian Approach.”

II

Let us turn then to a brief look at the essence of the classical structure. Capital was at the heart of matters; it was not only the dominant construct of the model, but also the key variable in achieving the major objective of classical economics, namely economic growth. Simply put, to account for economic growth we need to explain the determinants of capital accumulation. It is important to keep in mind that classical economics did not talk in terms of a separate theory of growth, but considered it as an outcome of accumulation which itself emerges from the interconnectedness of the entire system involving the
neshing of production, exchange and distribution. They would have looked anachronistic at our modern-day habit of compartmentalizing the system into those micro and macro boxes.

The basic classical model viewed the economy in terms of a period format consisting of production and exchange. Production necessitates the use of capital (or the capital stock) and the output or profit is measured as the surplus over and above the cost of production. The cost of production includes the wages of labor, the interest on capital, and the rent paid for land. The surplus is distributed between the owners of the means of production and the workers who use them. The division of income into wages, profits, and rent is a fundamental concept in classical economics.

In the classical model, the level of output is determined by the amount of capital and labor available. The capital stock is accumulated through saving and investment, and the labor force is determined by the demand for goods and services. The economy is in equilibrium when the quantity of goods produced equals the quantity demanded.

The price of a commodity is determined by the interplay of supply and demand. The demand for a commodity is determined by the social utility of the commodity, while the supply is determined by the cost of production. The equilibrium price is the price at which the quantity demanded equals the quantity supplied.

The exchange process determines the relative prices of goods and services. The exchange process is mediated by money, which serves as a medium of exchange, a store of value, and a unit of account. The introduction of money simplifies the exchange process by reducing the need for barter and facilitating transactions.

In summary, the classical model provides a framework for understanding the forces that shape the economy, including the production, distribution, and exchange of goods and services. The model emphasizes the role of supply and demand in determining prices and the importance of competition in ensuring efficient allocation of resources.

The classical model also highlights the role of capital accumulation in driving economic growth. The accumulation of capital is necessary for the expansion of production and the growth of the economy. The classical model also recognizes the importance of technological progress in increasing productivity and reducing the cost of production.

The classical model has been influential in shaping economic thought and policy. However, the model also has limitations, such as its assumption of full employment and the absence of government intervention. Despite these limitations, the classical model remains a valuable framework for understanding the economy and its underlying dynamics.
Now this way of looking at the economy highlights the activity of economic agents as consumers. At a point in time they are allocating their given resources with relative prices being the rationing mechanism. This mechanism being the solution to the scarcity problem. The theory of value, from this viewpoint, rationalizes the role of prices in the setting of demands.2

The significance of this approach can be mirrored in terms of two crucial conclusions. First, that individuals and their wants are to be treated as the ultimate and independent data of the economic problem. These are the atoms of the exchange process and of market behavior beyond which the analysis did not go. What is revealing are the equations inherent in the market process. They explain value. One does not penetrate to any "deeper" explanation based upon real factors. Second, that one derives a theory of distribution as incidental to the pricing process, in that distribution is determined by the conditions of exchange. This leads to the view that there is no need for any special analysis of the value of each factor of production. One need not relate, or better yet justify, the reward to each factor as stemming from its particular role in the production process. Since all factor incomes flow from the same explanatory principle, it is then a short step to seeing the relationship between the capitalist, landlord and worker as an essentially harmonious one; each makes its distinct contribution to production and receives its appropriate reward. In so far as there is any "antagonism" between them it arises merely from the competition as to which of the factors shall get more of the value they have jointly created.

Thus the neoclassical conception of society is one of a class-less society consisting of atomic households with particular preferences and ownership of resources. The hallmark here is that of the principles of maximization and marginalization centered around individual behavior. After all, when we think of marginal utility theory its focus is one of subjectivity or introspection at a bias for forming hypotheses about economic behavior—but an introspection that is common to all economic units in the same way. We conceive of society as a property owning democracy based on exchange of products in accordance to independently given preferences of class-less individuals. There is, we have said, no basic confrontation here, since all are governed by the same natural—mathematical laws. So, in an overall way, neoclassical economics focuses upon the allocation of given resources between competing ends subject to the constraints imposed by technical possibilities. No use is made of the idea of economic surplus; growth is not central to the analysis. And the relevance of the distribution of income between labor and property is generally explicitly denied.

It is exchange rather than production that is uppermost, and market transactions instead of underlying social relations dominate the analysis. Now there have been suggestions to try and account for this change in view point, for the onset of the "Marginalist Revolution"—

It has been suggested:

1. That the consumer and not the capitalist become the dominant force.
2. That the employer of labor was not directly identifiable with the investor of capital; indeed that the manager, the entrepreneur, and the investor of capital had become separate individuals.

That personal savings and non business savings become the source of investment funds. In general that institutions had changed from the time of the writings of Smith, Ricardo and Mill, and that one can indeed make a connection between changes in the economic structure of society and the emergence of subjective value theory.

One should also mention that marginal utility theory was considered as the bourgeois answer to Marxism. It was an approach that was considered as ideologically neutral and compatible with any political and social framework. In this way the study of economics was taken out of the "political-economy" context and put into a "scientific" one where explicit mathematical reasoning together with terminology borrowed from Physics and Mathematics formed the tools of economic analysis. Suppos-

edly this gave respectability, but whether the emerging neo-classical mathematical models really helped us to understand the "essential" matters of exchange and distribution has recently come under much doubt.

In general, let us reiterate that problems of growth and the evolution of the capitalist economy were alien to a tradition where chief focus of analysis is that of a stationary state and optimal allocation.

IV

I would say that the mechanics of the re-emergence of the classical, let us say of the "surplus tradition," is what Neo-Ricardian (some prefer the term Neo-Keynesian) economics is all about. As we tried to make clear in the first part of this paper, on a political level this was prompted by the pressing need to refocus attention on growth matters; but as well, on the theoretical underpinning level, shortcomings in the neoclassical model had now sharply come into focus, and in coming to grips with them much of the neoclassical approach had lost its legitimacy which then paved the way for a return to classical thinking. Now all we can do here is try to identify in a brief fashion some mainstreams of this "new-old" paradigm.

Let us proceed along the lines of some obvious main topics beginning with production theory. Neo-Ricardians reject the notion of the existence of a set of smooth production functions for each good produced representing all the combinations of capital and labor which can be used to produce those goods. There is a rejection of the neoclassical vision of the "remit" substitution of resource inputs, specifically between capital and labor as their relative prices change. There are two related points bearing on this. First that the idea of a capital input as a homogeneous item that somehow be put into a production function has to be abandoned. What we are dealing with is not a particular thing called "capital," but rather capital goods which is a heterogeneous concept. Capital consists of specific plants together with specific equipment that produce a specific output. This means that one cannot get hold of the capital input in the absence of value which itself includes the being of a rate of profit; this has some profound implications for neoclassical distribution theory. Secondly, these capital goods must often be used in fixed combination with labor and raw materials—so the usual circumstance that there is no room for factor substitution in response to factor price changes other than be switching from one fixed proportion technique to another.

Now what we must consider is the usual existence of heterogeneous capital and fixed factor proportionality has at times been shown to result in what was thought at first to be "pervasive" behavior in technical changes. For example, a relative fall in the price of capital could be associated with the choosing of a production technique that is of a lower capital intensity, that a lower rate of profit is associated with techniques that employ less "capital," but while the earlier work by Joan Robinson obey these lines was seen as a narrow technical problem in capital theory and treated as a "curiosity," it took Sraffa's work in 1960 to nail down the idea that what was exceptional is indeed not the "odd" switching possibility, but the neoclassical model itself.

By revisiting we mean that the choice of the most profitable technique would be one that would occur at more than one level of a relative factor prices, with other techniques being desirable at intermediate levels of factor prices. For example, were we to begin at rate of profit (r) with the rate rising—the switch would be to a system that evidences is lower net product per worker and a lower value of capital per man. Thus the rate of profit increases the switch to the least cost technique yields inconsistent results regarding the value of capital and productivity per man; but furthermore there is the observation that in the higher range of the rate of profit producers do switch back to a system of production which had already been in use at lower levels of the rate of profit.

Both of these results are in contract with neoclassical theory which in an overall way tells us that any change in the rate of profit, however small, brings about a change in productive systems; and that one system is in use at each possible level of the rate of profit. What was put into question by all this is the fundamental neoclassical relation between capital intensity and the factor price ratio. This uncoupling of the inverse ordering between the rate of profit and the degree of capital intensity throws
serious doubt on the neoclassical answer to the question of what determines the rate of profit and upon its basic approach to explain prices in general. Questions concerning production lead to questions concerning distribution.

But there is another aspect of production that we want to briefly look at. According to marginal theory the equilibrium price is given by the intersection of the supply and demand curves. The industry equilibrium position which is established at that price assumes that each firm in the industry is at equilibrium where it is producing under conditions of increasing costs. Therefore for the industry as a whole an increase in costs resulting from an increase in production is to be found in the being of some constant factor and in the diminished productiveness associated with the more intense use of it. Yet this means that the industry supply curve will be upward sloping unless at least some of the firms have negatively sloped supply curves; and this is not possible since a condition for firm short-run competitive equilibrium is that its MC curve be rising so that the quantity supplied by the firm at that price is a profit maximizing one.

However, the industry supply curve can be downward sloping if we are talking about a state of increasing returns which must be due to "external economies" which implies interdependence of conditions of production among industries. Here we are considering advantages derived by individual firms from the growth not of their own output but of the industry in the aggregate. There cannot be any internal economies of scale that allow the individual firm to cut costs as the size of the industry increases; the external nature of the economies coming to each firm can only result from a variation in the number of firms.

Now the classicists used the laws of return to convey relationships between output in the aggregate and overall development in the economy, and also to consider the long-run tendency concerning production and distribution. They were not used to construct an apparatus that determines particular industry equilibrium prices. Increasing returns was regarded by classical economists as an important aspect of the division of labor, and thereby related to progress in the wider economic environment, and not the result of an increase in the scale of production on the part of a particular piece of the system. But this means that the equilibrium output in any particular industry is related to production conditions in other industries.

One cannot speak of an industry supply curve in a "coerced paribus" way. That is, independence of conditions of production of the commodity concerned from those of all other industries. But this was exactly the assumption that neoclassical maintained in studying the equilibrium conditions of single commodities; i.e. in presenting the partial equilibrium analysis. We reiterate that the crossing of the demand and supply curves is subject to two conditions: (1) perfect competition, (2) "coerced paribus." But indeed, if the amount produced of a commodity is changed which leads not only to a change in its price, but of the prices and hence production of other commodities, then the supply schedule based on coerced paribus is simply not valid.

The upshot of all this is that the route for an understanding of prices must encompass the recognition of the general interrelations among the costs of production of various industries and the analysis of this by a system of general equilibrium and as well to abandon completely the assumption of perfect competition. For neo-Ricardians the way to go is that of price determination without an assumption on returns. There is no question of an analysis of the variation in costs associated with variation in the quantity of output produced. Indeed no hypothesis at all concerning returns is necessary in the determination of what the classicists considered as "prices of production." Prices are determined independently of any possible marginal variations.

Thus, neo-Ricardian theory of production is then based on an open集中 model consisting of a production system composed of n industries, each producing a different good. In this structure the input coefficients representing the given technology exist independently of any particular set of prices. Indeed it is the technology that determines the set of relative prices and not, as in the neoclassical model, the reverse. Relative prices are to be viewed as the ratios to which a regular repetition of the production process was linked, and not as indicators of relative scarcities of the goods produced. Now regarding distribution, as we may now anticipate, neo-Ricardians eschew the notion of a set of marginal physical product curves for all inputs used in the production process, and more critically for the "capital" inputs.

The neoclassical explanation of the distribution of income is based on the idea of supply and demand operating in competitive markets; with the demand for the resource being derived ultimately from its contribution to output at the margin, i.e. its marginal productivity. The supply of the factor being determined by the disutility associated with its use. Now Sraffa was able to show that a system of equilibrium prices could be derived independently of any notion of marginal change and without any direct relation to the role played by the demand for factor services. There was simply no need to rely on the ideas of marginal disharmony or marginal productivity to determine equilibrium prices. We should mention that Keynes, early on, denied that demand for labor services depends on its marginal productivity; he rejected the notion that labor income or, indeed, the amount of employment could be determined by marginalists principles at the micro level in the labor market.

Yet there is a more telling point specifically regarding the capital input. Once we accept the reality of the heterogeneous commodity that constitutes capital (we get away from the notions exogenous lump of late representations), then, as we mentioned, there is no way to measure the quantity of capital except by calculating these quantities in value terms. This brings us to the obvious problem that the marginal product of the value of the physical capital as a determinant of the rate of profit is itself not possible in the absence of knowing what the rate of profit is. The values on the stock of capital depends on prices, and the prices in turn will depend on the distribution of income (on the rate of profit). There is a circularity of reasoning to talk in terms of placing quantities of "capital" into an aggregate production function, and then to take its marginal productivity to determine the rate of profit. The valuation placed on the input capital is not independent of the distribution of income which the "quantity" of capital is meant to explain—and there is no way to get hold of an aggregate measure called capital independent of the rate of profit that it is supposed to determine.

This is not the place to go into great details suffice to say that this denies the very logical foundations of a demand curve based on marginal productivity principles, and the whole neoclassical explanation of matters. There is something more "deeply" involved here then considering a theory of distribution as incidental to the pricing process. And it is this kind of thinking that has led neo-Ricardians to relate the distribution of income between wages and profits to investment and the growth of output. The direction here is that the distribution of income is explained by a set of macroeconomic conditions rather than by micro-market factors of neoclassical theory. Classical economists would feel very much at home with the approach that there is an inter-relationship between the accumulation of capital which makes for economic growth and the associated phenomena of distribution and pricing. The working out of this inter-relationship is greatly what neo-Ricardian economics is about.

NOTES