Changing Institutions and the Roots of Modern ES

I. The Classical View – Smith, Ricardo, Mill, Malthus

- Change is a gradual process
- Growth is primarily a function of capital accumulation
- Malthusian model: population growth, the iron law of wages, diminishing returns
- Ricardian model: economy will eventually stagnate. Rising food costs, rising land rents, rising nominal wages, falling profits, falling investment rates (worsened by proportional depreciation)
- Tendency toward equilibrium
- Pessimistic view of econ development - econ growth would be limited by diminishing returns; stagnation was the likely result

II. The Neoclassical View

- The neoclassical view is much more optimistic
- Focus is more on improvements in human capital rather than on additions to physical capital and diminishing returns
- Same view of gradual, equilibrating change, but growth can be perpetual.
- Growth is a gradual result of:
  --Investment in physical capital
  --Technological progress resulting from the incentive to invest in research and development
--Improvements in human capital resulting from individual incentives to invest in skills and education

--Improvements in efficiency resulting from efforts to increase profits.

• **International trade and finance** has a potential role in neoclassical view:
  --Governments of countries will engage in global competition
  --Firms are encouraged to produce more efficiently, and economic growth occurs from specialization and exchange.
  --The flow of goods, services, and capital between countries favors higher returns and lower costs.
  --As a result the forces of supply and demand tend to lead towards an equalization of prices, wages, interest rates, and policies across nations, and thus tends to lead towards increasing economic convergence.

• **Convergence**—that different ESs will become more similar over time b/c of the fundamental imperatives of econ growth & development.
III. Marxist Theories of Economic Change

1) Karl Marx (1818-1883)

- Born in Prussia of Jewish family converted to Christianity
- Influenced by the philosopher Hegel
- Much of his work in London in collaboration with Friedrich Engels
  - concept of dialectical materialism
  - The Communist Manifesto
2) Marx’s view on econ change:

- Economic change is evolutionary even revolutionary process, and one which determines social and political structures.
- Dialectical materialism:
  - Social and economic change through conflict
  - Emerging classes associated with economic innovations come into conflict with the old
  - Replacement of an old economic order with a superior one
  - Capitalism is a qualitative leap over feudalism
  - Socialism is a qualitative leap over capitalism
  - Societies advance according to a predetermined pattern—primitive production, feudalism, capitalism, socialism, and communism

3) Marx’s view on capitalism

- Inefficient feudalism replaced by far more efficient capitalism
- As capitalism emerges, there is an accumulation of capital (wealth) by the bourgeoisie (the capitalists) and the creation of a free labor force, the proletariat; Capitalism is a system of exploitation of one class of people by another.
- Extreme dichotomy between capital and labor
- Sets up two classes which must eventually conflict
The Model

- History is driven by class conflict
- Marx proposes a "labor theory of value"

Value \( V \) is determined by three things:

- amount of labor used to produce the good, or direct labor cost (variable capital) \( v \)
- indirect labor through capital and intermediate inputs (fixed capital) \( c \)
- the capitalist’s surplus (surplus value or profit \( s \))

\[
V = c + v + s
\]

Where does this surplus value come from?

- Workers are paid a subsistence wage
- Employers compel workers to produce a value above that needed to generate subsistence wage
- The workers get the subsistence wage, the capitalist gets the surplus
  - the “Reserve Army of the Unemployed” keeps wages at subsistence level
  - exploitation of labor
Marx identified three laws that made the collapse of capitalism inevitable:

1) The law of disproportionality—Tendency toward overproduction
   - workers too poor to buy much
   - capitalists too busy saving (accumulating capital)
   - economic depressions become more and more severe

2) The law of concentration of capital
   - Each firm in cut-throat competition for each other’s business
   - Driven to gain temporary competitive advantage over others
   - The way to do this is to introduce labor saving innovations (that is, replace labor with capital)
   - But innovation diffuses quickly through economy, dissipating innovator’s advantage
   - Thus, throughout the economy, capitalists are driven to accumulate capital in order to replace labor with capital
   - More and more firms fall behind and fail
     - bankrupt capitalists lose their capital and join the swelling ranks of the proletariat

3) The law of a falling rate of profit
Competition and increasing productivity would lead to decreasing returns on investment, making it harder to make a profit, so Capitalists would not invest in new production. Companies don’t hire new workers, so employment and profits both fall. Capitalists try to keep up rate of profit by exploiting labor more and more.

Revolution

- The stage is set for revolution
  - proletariat swelling and becoming increasingly exploited
  - bourgeoisie shrinking and becoming increasingly cut-throat
  - the proletariat rises up in revolt, replacing the bourgeoisie as the dominant class and creating the new socialist order

What happens after the revolution?

- Dictatorship of the Proletariat
- Socialism: government acts in the interest of the proletariat to eliminate capitalism. Markets replaced by more rational planning. State ownership replaces private ownership. Workers become more productive, and scarcity is eliminated.
- Socialism would follow the rule, “From each according to his ability, to each according to his labor.”
- Communism would follow, “From each according to his ability, to each according to his need.”
• Emergence of Advanced Communism: self–organizing and socially–interested. Markets, planning, money, classes, and government all no longer necessary.

Weaknesses (contradictions) of Marxism:
1. Capital accumulation does not lead to falling profit rates.
2. The revolution did not come first to the most advanced capitalist economies.
3. Value cannot simply come from labor, or management, capital, entrepreneurship, luck, et cetera would not matter. Instead, it comes from scarcity–what people are willing to give up on the margin to have it.
4. Not foreseeing the flexibility and adjustability of capitalism (increased government role, labor unions, etc.).
IV. Lenin’s Contributions

Vladimir Lenin (1870-1924)

– born of educators/government bureaucrats
  • a member of the bourgeoisie
  • a well educated intellectual
  • deeply committed to welfare of the common man
A Problem with Marx’s Theory

- Theory implies that revolution will occur where capitalism the most advanced
- No sign of revolution in most advanced capitalist economies by the 1910s
  - in fact, there is greater and greater prosperity
    - Great Britain
    - Germany
    - United States
- Instead, revolution occurs in Russia

Lenin’s “Monopoly Capitalism”

- As capitalism advances more and more firms fail and are taken over
- Markets become increasingly monopolized
- Most advanced economies need to find new sources of raw material and labor
  - they start to colonize under-developed countries
    - imperialist expansion
    - less advanced capitalist states like Russia cannot compete
- Advanced states bribe the domestic proletariat with share of surplus
  - buying domestic stability
- Labor exploited fully in the colonies
– colonial labor powerless to overthrow a foreign power

• Russia is a weak link
  – advanced enough not to be colonized itself but not enough to be a colonizer
  – cannot export labor exploitation like the more advanced, imperialist powers

• Thus the Marxian scenario can be played out only in a weak link like Russia

• Even without bribe, proletariat not revolutionary by nature
  – must be led by bourgeois intelligentsia like Lenin!
  – combination of a weak-link economy and a Lenin-led intelligentsia and the result is the Russian Revolution of 1917

Characteristics of Capitalism in Marxist-Leninist Thought

• Extreme inequality of income
• Vulnerability to macroeconomic instability
• Imperialistic tendencies
• Marxist-Leninist Theory conditions socialist philosophy
  – importance of equality in distribution of income
  – importance of economic stability
  – prominence of imperialism in socialist attacks on capitalism
V. Creative Destruction

1.) Joseph Schumpeter.
• The driving force of evolution in the capitalist economy is innovation (the development and implementation of new products, new ideas and new ways of doing things)
• Fundamental condition of financial development, the role of the Entrepreneur, and the process of Creative Destruction in producing technological progress and economic growth. (process of new ideas replaced the old)
• The decline in entrepreneurial activity would be a fundamental reason for eventual decline of capitalism

VI. The New Institutional Economics

The New Institutional Economics focuses on how institutions evolve and on the effect of this evolution on econ performance.

1) The New Institutional Economics was inspired by:
a) Friedrich A. Hayek—argued that economic organizations arise according to a spontaneous order in which new organizations, laws, regulations, and customs are tested by daily econ life.
b) Coase: organizations (e.g. business enterprises) are created when transactions costs of market transactions are too high.

2) New Institutional Economics (Douglas North, Mancur Olsen, etc.) explain institutional change by examining property rights; transaction costs, and rent seeking.
a) Douglass North—the idea is that societies choose among available alternatives that work best to solve their particular problems. Over time, more efficient economic systems evolve due to this selection process.

b) Economic evolution is not just an idea that economic and social change occurs over time; it is a theory about how and why those changes occur.

c) The New Institutional Economics views institutional change as being dictated by econ variables, whose course of change cannot be predicted in advance. The path depends on the starting point (initial conditions) and on the course of transaction costs, property rights, and other factors.

VII. Change in Capitalist Economies

Change is more gradual and less visible than change in socialist econ, which comes from above.

1. Property Rights

a) Privatization—property that have been state-owned is transferred to private owners

b) Nationalization—when privately owned property becomes publicly owned
2. Competition
a) Relaxation of trade barriers to international trade
b) Deregulation
c) Antitrust policy
d) Growing international competition and deregulation should increase the degree in competition in capitalist economies.

3. Income Redistribution by the State
a) Tax system
   • Progressive tax
   • Regressive tax
b) Distribution of transfer payments to low-income recipients (social security, welfare programs)

4. Worker Participation
a) Fixed wage contract
b) Profit-sharing contract

5. Government Intervention
a) Fiscal and monetary policies
b) Indicative planning- the market is the principal instrument for resource allocation, but a plan is prepared to guide decision-making

c) Industrial policy-general strategy of development worked out by government agencies

VIII. Change in Socialist Economies

1. Socialist Reform Models

a) Improving the planning mechanism

b) Organizational reform

c) Decentralization

IX. Transition

1. Strategies:

a) Shock therapy-the transition must occur on all fronts as quickly as possible.

b) Gradualism-the transition must occur gradually and not on all fronts simultaneously