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KEYNES, KALDOR AND DEVELOPMENT ECONOMICS

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Abstract

Development economics grew up as a stream fed by several different tributaries. The writings of nationalist policy-makers in colonial countries and the Soviet plan models are two of those tributaries. John Maynard Keynes and Nicholas Kaldor are often treated as economists who have nothing to teach about the problems bedevilling the contemporary global economy. However, their work not only illuminated the issues of turbulence of the capitalist economy but that work also left a conceptual framework for formulating policies for stabilization and growth both at the global and at the national level. In particular, their work shed a lurid light on the normal malfunctioning of unregulated stock markets and can be used to show the falsity of the claim that deregulating financial markets could increase the prosperity of nations. Their writings also demonstrated the importance of stabilizing the commodity markets and the incomes of primary producers for allowing the global economy to grow on a sustained basis. The deliberate amnesia imposed on new generations of economists by policy-makers of the neo-liberal persuasion can be enormously harmful for their training.

The three lives of Keynes, development economics and macroeconomics

As an economist, Keynes led at least three different lives in three phases of his career.

The first phase lasted from his entry into the India Office until the time he was defending his **Economic Consequences of the Peace,** that is, say, up to the end of 1921. His view of the world remained centred on the place of the British empire in the world and the place of Europe as the fountainhead of world civilization and the anchor of global prosperity, and a world that could be re-created if only European prosperity could be restored by restraining the madmen who had crafted the Versailles treaty and the bankers who hankered after the prewar (gold) parities of the major currencies and especially sterling (Keynes, 1919). Elsewhere I have argued that up to the outbreak of World War I, he not only viewed the world through the lenses of an instinctive defender of the Empire, but in many ways, including his monetary theory and his view of the evolution of terms of trade between industrial and primary products, he remained rooted in the tradition handed down from Ricardo (Bagchi, 1991; see also Moggridge, 1992, chapter 8; Toye, 1997).

The second life of Keynes began from his editing of the **Manchester Guardian Supplements** on Europe and stretched to the writing and defence of the **General Theory.** This was the phase in which he alerted the world and the British public about the dangers of deflationary policies, competitive devaluation, free mobility of capital and lack of co-ordination among central bankers regarding the acceptable levels and necessary changes in exchange rates.

In the third phase of his life, Keynes began drawing up and ceaselessly defending his plans for an International Clearing Union and his plans for stabilisation of prices of primary products. Along with Harry White, he can be seen as the intellectual parent of the Bretton Woods institutions.

In none of these phases did Keynes cease to be a defender of the Empire; nor did he display much sensitivity about the needs of the poor countries, the vast majority of whom lived in colonial or semi-colonial dependencies. On at least two occasions, for example, the policies advocated by Keynes would have done further harm to Indian interests. The first was when he defended a totally unrealistic exchange rate of anywhere from 1s. 8d. to 2s. for the rupee at the end of World War I (Keynes, 1971, chapter 5). His aim was both to deflate the Indian economy by forcing it to import more goods from abroad and to prevent India from absorbing any substantial part of the gold reserves of the world. (It has to be said to his credit that in 1919-20, he put his money on the soundness of his advice, betted on the Indian currency along with dollars and lost all his money: Skidelsky, 1992, pp.41-43). During World War II, Keynes wanted to indefinitely block the balances accumulated by the members of the Sterling Area, including India and Egypt, in the postwar period. (India and Egypt, in that order, were by far the largest creditors of Britain within the sterling area). However, the Bank of England and Keynes's colleagues in the British Treasury objected to this, because they wanted to preserve the postwar convertibility of the British pound, at least within the sterling area (Keynes, 1940-44/1980, pp. 305-7; Moggridge, 1992, chapter 29). At the Bretton Woods Conference, Keynes's speech on 10 July 1944 scuttled the proposal of the Indian delegation that a part of the sterling balances could be used for multilateral settlements (Keynes, 1941-46, pp. 85-87). This kept India firmly tied to the apron strings of the sterling area years after her independence.

Despite all this relative indifference to the welfare of the world outside England, Europe, and by extension, the North Atlantic seaboard, Keynes made seminal contributions to the evolution of development economics in at least three directions: First, he forged the tools of macroeconomics and they began to be applied to issues of development from the 1950s. Secondly, his signposting of the dangers of unlimited capital mobility has acquired special significance since the onset of financial liberalization from the late 1970s. Thirdly, the extended analysis of the necessity for paying attention to all aspects of growth and stabilization in the world economy, — including the curing of unemployment, the stabilization of primary product prices and regulation of financial markets, including stock markets —remains

as contemporary as ever. He also played a major role in the designing of the two Bretton Woods institutions, namely, the International Monetary Fund and the International Bank for Reconstruction and Development, aka, the World Bank. It has been argued that Harry Dexter White, who led the US team at Bretton Woods, rather than Keynes, had the final say in the shaping of the two institutions and there were some important differences in their perspective on postwar economic policy (Baughton, 2002). White's dominance is explained to a large extent by the emergence of the USA as the hegemonic capitalist economy of the world. The subsequent evolution of the two institutions and the pursuit by both of them of goals that were antithetical to those of either Keynes or White is largely to be attributed to the starting of the Cold War soon after the end of World War II and the assault mounted against the working class and the developing economies from the 1970s.

Development economics and its enemies

Development economics arose long before Keynesian macroeconomics was applied to problems of growth and development. The impulse came from the Russian five-year plans and the lessons learned from Prussian policies that stimulated industrial growth in Germany. M. Visvesvaraya, an Indian engineer turned statesman, published a book in 1920, advocating policies for quickening economic growth in India. In 1934, he published a book, explicitly advocating planning for stimulating Indian economic growth. By 1938, the Indian National Congress had established a national planning committee for India. In the meanwhile, the Russians had carried out two five-year plans; the Turkish government had drawn up plans for accelerating industrialization, and had received Soviet aid for those plans. During World War II, the British Indian government had initiated moves to draw up plans for economic reconstruction after the war. Side by side, of course, the Central and Eastern European economists seeking refuge in England put forward the plans that John Toye has sketched. In 1952, Bhabatosh Datta published his book, *The Economics of Industrialization* (Datta, 1952). Unlike in Britain and the Crown Colonies of that country, where the national accounting framework was hammered out by Keynes and his junior colleagues at the British Treasury, the statistical foundations of national income accounting and planning in India were laid mainly under the leadership of and Simon Kuznets and P. C. Mahalanobis, a physicist turned statistician and planner. The theoretical framework for the Indian Second Five-Year Plan, drawn up by Mahalanobis, was inspired by Soviet models, rather than Keynesian macroeconomics. In fact, writings appeared that explicitly criticised the application of Keynesian economics to underdeveloped countries. However, almost simultaneously, other economists stressed the necessity of stimulating demand by expanding public expenditure when there was excess capacity and of restraining it when there was a supply-side crunch as revealed by external deficits or inflationary pressures.

Already, in the 1950s, conservative economists such as Peter Bauer and Milton Friedman were arguing against the drawing up of deliberate development plans for poor countries or the use of fiscal instruments to control expenditure. Dependence on the working of free enterprise rather than deliberate government action or social engineering was their preferred route to economic development. Under successive attacks by Friedman and Robert Lucas, Keynesian economics in its different formulations (Old Keynesian, structuralist or Kaleckian, IS-LM synthesis or post-Keynesian) lost its academic hegemony. The search for the microfoundations of microeconomics led to the questioning of the very rationale for a separate branch of macroeconomics.

In the meanwhile, the Polak-Friedman monetarist doctrines were applied to draw up structural adjustment programmes and cause utter mayhem in developing countries. While paying lip service to the necessity of putting microeconomic specificities above the generalizations of development economics and Keynesian economics, the SAPs were designed to work on the principle of 'one size fits all'. The latest PRSPs are designed to

ensure not only that all aid is directed towards the goals favoured by the Washington twins but also that any residual autonomy enjoyed by governments of poor countries is completely eroded.

But in the current crisis of global political economy, Keynes's emphasis on preserving the policy autonomy of national governments, even while crafting institutions for international policy co-ordination has become a matter, literally, of life and death for hundreds of millions of people all over the world. In assessing the roles of the different incarnations of development economics and Keynesian economics, it is essential to link them to strategies of hegemonic or imperialist powers from World War I to Iraq War II.

Kaldor as the pre-eminent successor to Keynes, and a pioneer of development economics

Nicholas Kaldor started out as a theorist of capitalism, rather than as a theorist of development of underdeveloped countries as such. But already in his paper on the theory of capital (Kaldor, 1937), he had come up with the model of a slave economy, in which the rate of growth of the slave population was also the rate of interest obtained on the capital stock of slaves[1] . Moreover, from the 1950s, he engaged intensively in the analysis of general problems of economic growth and the fiscal problems of developing countries.

I agree with Luigi Pasinetti (1986) and Tony Thirlwall (1987) that the mantle of Keynes fell on Kaldor rather than on any of the other Keynesians of the Cambridge group in more senses than one, even though Kaldor was not a member of the group which participated in the forging of Keynes's *General Theory* (Keynes, 1936). Kaldor, like Keynes, regarded economics as an essentially fact-based discipline, rather than one in which theories are spun only for their beauty.

[1] Thirlwall (1987, p. 73, n.11) regards this as an anticipation of the von Neumann result on the Golden Rule of growth, but von Neuman had presented his model at a mathematical seminar in Princeton in 1932, although it was published for the first time in German in 1938 (Von Neumann, 1945-46, p.1n.).

Like Keynes again, Kaldor believed that capitalism as a system was highly unstable, but was amenable to control and regulation in the interest of furtherance of human welfare. There are other similarities in their approach to the subject, such as their treatment of risk and uncertainty, their view of money and the capital market. Even the distinctly Kaldorian theory of income distribution harks back to Keynes' famous analogy with the 'widow's cruse' in Vol.1 of his *Treatise of Money* (1930)[2]. Like Keynes, Kaldor was also engaged in policy discussions practically all his life, and believed that it was necessary for the state to intervene in economic affairs, although both of them regarded capitalism as the only system worthy of their intellectual and moral support.

One of the foundations of a capitalist economy is a class of people who control the means of production and engage in various future-oriented activities, many of which involve the shouldering of risk. Hence, risk-taking and dealing with uncertainty have come to be accepted as major hallmarks of a capitalist economy. Risk-taking behaviour fascinated both Keynes and Kaldor. Keynes' first theoretical work was his *Theory of Probability* (1921), in which he put forward his essentially subjective theory, drawing on the heritage of Thomas Bayes. He regarded insurable risk to be rather uninteresting and theorized about the way people formulated their behaviour in the presence of events that do not repeat themselves in exactly the same fashion. It may be argued that the Marx-Schumpeter

[2] Keynes used his so-called 'fundamental equations for the value of money' to argue that there is a peculiarity of profits as against other forms of income that if entrepreneurs indulge in riotous living, the total profit income from the sale of luxury goods would go up by exactly the amount of profit income thus spent: 'Thus profits as a source of capital increment for entrepreneurs, are a widow's cruse which remains undepleted however much they may be devoted to riotous living. When, on the other hand, entrepreneurs are making losses, and seek to recoup these by curtailing their normal expenditure on consumption, i. e., by saving more, the cruse becomes a Danaid jar which can never be filled up; for the effect of this reduced expenditure is to inflict on producers of consumption goods a loss of an equal amount' (Keynes, 1930/1971, p. 125).

theory of innovations characterizing capitalism would require precisely this kind of probabilistic judgement on the part of the entrepreneur.

Kaldor's view of the central role of speculation in a market economy is clearly spelled out in his paper, 'Speculation and economic stability' (Kaldor, 1939/1960a). In this paper, Kaldor classifies commodities and their uses into basically two groups, those with positive carrying costs, mainly commodities that are used as working capital and those with negative carrying costs, mainly fixed capital. He derives a formula connecting current price and expected price:

$$EP\text{-}CP = i + c - q + r$$

where EP and CP are expected and current prices respectively, i is the rate of interest, c the marginal carrying cost, and r the risk premium. It can be easily shown that the futures price (with the same time period) FP is FP =EP-r. 'The possibility of arbitrage, i.e. buying spot and selling futures simultaneously and holding the stock until the date of delivery' prevents the futures price from rising above EP-r, while speculation…prevents it from falling below the amount' (Kaldor, 1939/1960a: 24-26). 'Thus, in addition to the factors mentioned above, the determination of the futures price will also depend, in the real world, on *divergence of opinion*'[3] (Kaldor, 1939/1960a: 29; italics in the original).

This insistence by Kaldor and Richard Kahn on divergence of opinion as a condition for the operation of futures markets, including markets in bonds and equities, distinguishes them from those who think of modelling them on the basis of some universally agreed expected price. Kahn was much more consistent in his views in this respect because he disputed the possibility of anchoring the relationship between the short-term and long-term rates of interest in expected values of those rates

[3] The futures price is the current price of a commodity or an instrument such a share or an option on a share that is to be delivered at a future date specified in the contract.

or changes in those rates, as Kaldor (1939) tried to do (Kahn, 1954/1972).

For many economists, Tobin's paper of 1958 is supposed to provide the formal underpinning for the liquidity preference theory of interest (Tobin, 1958). But as Buiter (2003: F587) has pointed out, the mean-variance approach to behaviour under conditions of risk in asset prices and their returns, pioneered by Markowitz, Tobin, Sharpe and others, has gone from strength to strength, but 'it is a remarkable example of a theory that emphatically fails empirically yet is generally considered to yield important insights'. In fact, this genre of theories shares this characteristic with another major neoclassical formulation, namely, general equilibrium theory. Both of these serve an ideological purpose, namely, demonstrating that the unregulated price mechanism leads to efficient choices, while ignoring the fact that the conditions required for this result to be validated are never to be found in the real world.

The whole branch of finance that works on the hypothesis that deregulated financial markets are efficient has a more sinister effect as well. The deregulation and manipulation of markets world-wide have been major instruments for greatly increased concentration of all assets in a few hands, as so-called technical analysts and investment advisers have herded unwary small investors into the turbulent stock markets to be slaughtered by the well-heeled asset-holders. As in India, in most other countries, governments — acting as the agents of the wealthy — have collaborated in this far-from-innocent game of make-believe.

In his 1939 paper, Kaldor also examined the ways the prices of bonds and shares behave (Kaldor, 1939/1960a: section II). He summed up his analysis of price behaviour of long-term bonds in the following manner: 'In the market for long-term bonds, the elasticity of expectations is normally small, and the elasticity of speculative stocks is large, both absolutely and relatively to the elasticity of non-speculative demand and supply (i.e. the elasticity of the supply of savings, and the elasticity of the producers'

demand for funds, as a function of the rate of interest). Hence the price in the short period is largely determined by speculative influences' (Kaldor, 1939/1960a: 42). Kaldor then goes on to account for the contrast between the stability in the gilt-edged market and the instability of the share market: 'shares are also subject to the same influences as bond prices; changes in the expectations regarding future interest rates should affect the one as much as the other. But in addition they are also subject to changes in the expectations concerning the expected level of profits. And here experience suggests that the elasticity of expectations concerning the future level of profits is fairly high; share prices correlate fairly well with fluctuations in current earnings' (Kaldor, 1939/1960a: 43).

Although Kaldor provided some of the micro-economic nuts and bolts (to use a phrase from Hahn, 1989) for the speculative motive to work, his analysis of the stock market did not really advance even as far as Keynes (1936) had taken it in chapter 12 of the *General Theory* on 'long-term expectations'. It is still salutary to read Keynes's warnings about the competence or capacity of the 'professional investors' which is supposed to guarantee the equilibration of the stock market through competition resulting in 'efficiency'. As he pointed out, the professional investors

> are concerned, not with what an investment is really worth to a man who buys it for 'keeps' but with what the market will value it at, under the influence of mass psychology, three months or a year hence…it is not sensible to pay 25 for an investment of which you believe the prospective yield to justify a value of 30, if you also believe that that the market will value it at 20 three months hence.
>
> Thus the professional investor is forced to concern himself with the anticipation of impending changes, in the news or in the atmosphere, of the kind which experience shows that the mass psychology of the

market is most influenced. This is the inevitable result of investment markets organised with a view to so-called 'liquidity'. Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity, the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon the holding of 'liquid' securities. It forgets that there is no such thing as liquidity of investment for the community as a whole. The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future. The actual, private object of the most skilled investment to-day is "to beat the gun", as the Americans so well express it, to outwit the crowd, and to pass the bad, or depreciating half-crown to the other fellow (Keynes, 1936: 154-155).

It is thus obvious that Keynes regarded the so-called competitive stock markets as a predominant case of market failure, and he used the behaviour of American stock markets as a telling illustration. This criticism of the working of the stock market was not confined to its inefficiency as a signalling device. Keynes also regarded the stock market as a poor conduit for the financing of aggregate investment. The reasons are again best given in Keynes' acerbic prose:

> Speculators may do no harm as bubbles on a steady stream of enterprise. When the capital development of a country becomes the by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of *laissez-faire* capitalism — which is not surprising, if I am right in thinking that the best brains of Wall Street have in

> fact been directed towards a different object (Keynes, 1936: 159).

Both Keynes and Kaldor recognized the fundamental instability of a capitalist economy and the role the shifts in the preferences of wealth-holders — as between different assets — played in that instability. But both of them, in their different ways, believed in the existence of a 'normal rate of interest' — underwritten by government bonds — that anchored the long-term expectation of asset-holders. But this anchoring would have to be sustained by appropriate government policies. Neither Keynes nor Kaldor believed in the ability of commercial banks, by themselves, to sustain such a policy. Nor did they trust central bankers to do the job. They also recognized that leaving everything to the gyrations of the stock market would produce sheer chaos. Thus, interestingly enough, although they remained distrustful of banks as the major controllers of the national economy, the system of financing they wanted was bank-centred, rather than equity-centred — to use a dichotomy that has become current coin in the wake of the Asian financial crisis.

Moreover, they both recognized the ideological roots of the right-wing desire to use monetary policy to control inflation or to cure other economic ills. In 1926, polemicising against Britain's decision to return to the gold standard at the pre-war parity, Keynes had written that the underlying monetary policy was 'simply a campaign against the standard of life of the working classes' operating through the 'deliberate intensification of unemployment…by using the weapon of economic necessity against individuals and against particular industries — a policy which the country would never permit if it knew what was being done' (Keynes, 1925, as quoted by Thirlwall, 1987: 299). Half a century later, in 1977, in a speech at the House of Lords, Kaldor predicted that monetarism was doomed to failure 'because it could succeed, if it succeeded at all, only by ruining industry, long before it succeeded in making labour more submissive' (Thirlwall, 1987: 301).

Both Keynes and Kaldor supported capitalism for the freedom of enterprise and the growth it promised. But they were both convinced that without intelligent public intervention, it functions badly, especially as far as the employment and standard of living of the workers were concerned. For the last thirty years, the dominant trend of economic policy, centring on anti-inflationary monetary and fiscal policies, has run in a completely different direction. Both Kaldor and Keynes believed in a kind of dualism of employment and price stabilisation and thought, with David Hume, that moderate inflation was good for growth. In recent years, the emphasis of monetary and fiscal policy has been almost entirely on the control of inflation, no matter what happens to employment or growth.

It is important to note that although monetarism began its triumphant march over the bodies of dismissed and homeless workers from the 1970s, it had been embedded in the stabilisation enforced by the IMF on hapless underdeveloped countries from the late 1950s. The basic doctrine was propounded by Jacques Polak, Director of Research at the IMF, in a paper published in 1957 and has remained the battering ram of the devastation caused by its wars ever since (see Fine 2005).

Issues of stability and sector proportions

Many of the issues that have cropped up as problems of structural misalignment in the context of programmes of full employment in developed economies and raising rates of economic growth were foreshadowed in Book V of Keynes' *General Theory*, in Kalecki's work dating from before the publication of the *General Theory* and in Kaldor's paper, 'Stability and full employment', published in 1938. I shall primarily concentrate on Kaldor's work in this area. Kaldor starts from a situation in which full employment has somehow been achieved. At that point there is a certain distribution of income between wages and profits. Associated with that distribution, there is also a distribution of GDP between capital goods and consumer goods. It would be entirely a fluke if the distribution of expenditure between

consumption and saving matched the outputs of consumer goods and capital goods. If in this situation, ex ante investment exceeds saving, or conversely, falls short of saving, forces will be set up to dislodge the economy from the full employment situation. The situation in which saving exceeds investment is familiar to everybody: the reaction is very quick, as goods pile up, output is slashed and workers lose their jobs. In the opposite case, prices rise, income is redistributed in favour of capitalists and eventually result in excess savings. In this paper, Kaldor also brought in the specificity of equipment as further constraints on the achievement of a balance between the sectoral outputs of goods, the division of expenditure between consumer goods and capital goods and the ex ante rates of saving and investment. Kaldor wanted to remedy the maladjustment by regulating the propensity to save, through wage subsidies or taxes on wages.

I stumbled upon similar problems in discussing the difficulties of implementing an ambitious growth plan in an economy in which the private sector plays a major role (Bagchi, 1970). In an open underdeveloped economy, you can have the co-existence of several apparently contradictory features: an excess demand for luxury-and import-intensive goods, a balance of payments deficit, a deficiency of demand for mass consumer goods and a deficiency of demand for capital goods. The high propensity to consume on the part of the capitalist class, belying some of the assumptions of the Cambridge School, and Marxists like Kalecki was recognized by Kaldor as a serious obstacle against the development of underdeveloped economies with capitalist institutions when he was asked to advise on the right fiscal policy for India and Chile (Toye, 1987; Palma and Marcel, 1987).

Kaldor made strategic use of the idea of sectoral imbalances impeding the achievement of full employment, stability and growth when he analysed the problems of the world economy. The sectoral relations he examined were between the primary and the manufacturing sectors of a modern economy. There are at least three kinds of difference or asymmetry between the primary and the manufacturing sectors:

(a) the former is characterized by diminishing returns whereas the latter displays both static and dynamic economies of scale;

(b) in the former prices are demand-determined whereas the prices in the latter sector are supply-based (this distinction goes back to Kalecki);

(c) the income elasticity of demand for the output of the primary sector is typically less than one whereas the income elasticities of demand for manufactures (and especially for those that are newly innovated) is generally more than one.

Kaldor had analysed the problems of stabilising commodity product prices in 1952 when he acted as a consultant by the FAO to examine the economics of the International Wheat Agreement in 1952 (Thirlwall, 1987: 279). This agreement was a multilateral scheme that had been ratified in 1949. Under this scheme certain agreements would be purchased by the organization implementing it at a minimum price, whereas any excess would be traded at market prices. The scheme, while not entirely free from moral hazard problems, had the virtue of preserving incentives. Kaldor preferred this kind of scheme to buffer stock arrangements because it preserved incentives while stabilising prices. Later, he became concerned about the general tendency of primary product prices to be not only unstable, but to demonstrate a declining trend in relation to prices of manufactures and wrote a paper on it in the March 1964 issue of the *Economic Bulletin for Latin America*.

For individual countries, he opted for what have been called 'positive adjustment policies', preparing for a soft landing or transition of primary producers to industrial employment while the country passes from being an agrarian economy to a situation in which industry dominates the generation of income and employment. After the oil crisis of 1973, he became concerned about the destabilizing effects of sudden changes in the terms of trade of primary vs. secondary sectors and wrote a widely quoted paper on this theme (Kaldor, 1976). There, he pointed out that

because of the way in which the mark-up or other cost-linked prices of the secondary sector are likely to be affected by sudden increases in prices of primary products, an inflationary spiral may start in industrial economies with adverse effects on income and employment as well.

> The rise in the price of raw materials and fuels is, according to Kaldor's analysis, passed through the various stages of production into the final price with an exaggerated effect.... This initially causes a rise in the profit share (in the value added in manufacturing), which — in countries with strong trade unions — is a strong factor in causing pressure for causing wage increases. Added to this is the price-induced rise in wages caused by the reluctance of workers to accept a cut in standards of living. Through these different mechanisms, the industrial sector resists any compression of its real income by countering the rise in commodity prices through a cost-induced inflation of industrial prices. Furthermore, this inflation will have a *deflationary* effect on real demand for industrial goods, for two reasons. One of them is that the rise in producers' profits is not matched by a rise in their spending; the other is that the governments of industrial countries will tend to react to increased domestic inflation by deflationary fiscal and monetary measures, that reduce consumer and investment demand (Griffith-Jones, 1989: 227).

Because of the asymmetries in pricing situations and income elasticities between the primary and secondary sectors, it is not obvious that a reduction in primary product prices would stimulate the world economy. However, their prices could and did enter the prices of industrial products via the consumption basket of wage earners and the cost of transport and intermediate goods. Policies or circumstances that caused dramatic changes in primary product prices would affect the price situation in advanced capitalist countries as well, even if changes in unemployment failed to affect prices. Deflation in the primary-producing countries and the reversal of their industrialization process would affect the employment situation in advanced capitalist countries via another route. The capitalists in those countries would threaten to relocate their production in the poorer countries unless the workers are prepared to accept lower wages and worse working conditions. The mere threat would often suffice to browbeat trade unions and governments of those countries (Burke and Epstein, 2003). These manoeuvres would transmit further deflationary impulses to the world economy.

From the end of the 1970s in Britain and from the beginning of the 1980s in the USA, neo-liberal policies such as increasing interest rates on loans and especially on loans to developing countries and concerted attacks on trade unions and workers' rights in general had the effect of both causing an external debt crisis in major developing counties and thereby reducing their bargaining power in foreign markets and increasing unemployment rates in OECD countries and putting their workers on the defensive. Inflation rates in OECD countries came down significantly compared with the 1970s. Beckerman and Jenkinson (1986) carried out an exercise to determine the relative roles of changes in primary product prices and increases in unemployment rates in moderating inflation in the 1980s. They argued that

> most of the deceleration of inflation in the OECD countries in general (including Britain) that took place between 1980 and 1982 not to the direct impact of higher unemployment on the labour market but to the fall in 'commodity' (i.e. primary product prices from 1980 to 1982, following their very sharp rise (accompanying the second 'oil shock') between 1978 and 1980 (Beckerman and Jenkinson 1986: 39).

In many ways, this is an old story (except for the rise in unemployment in OECD counties). In 1979, I had argued that the drastic decline in the terms of trade of primary producers in the late nineteenth century had played a major role in lowering the cost of living of the working class and industrial costs in general and thereby promoted the growth of the North Atlantic seaboard during the period of the so-called Great Depression. I would hazard the guess that in view of the rise in the standard of living of the workers of the European countries in the next eighty years and hence a decline in the proportion of expenditure on food and other agriculture based commodities, the effect of such a decline on the living standards of the workers of Europe and North America is likely to be far more muted today. But that is not the full story. Oil has become the most important source of energy world-wide and hence the control of oil has become such a priority for the rulers of the USA and their allies that they are prepared to go to any lengths, including the murder of millions of hapless people in order to attain that end, as was cinematically demonstrated by their naked aggression against Afghanistan and Iraq. While Kaldor paid far more attention to the inequitable nature of international economic and political relations, both of them almost blind to the working of imperialism and its effect in shaping the contours of the world economy.

Disciplining the capitalist class

Both Kaldor and Keynes believed that the function, nay, the duty of a capitalist class was to save and invest. Kaldor often quoted Keynes' statement in the *Economic Consequences of the Peace* to the effect that the Victorian capitalists were allowed the ownership of the principal part of the national cake on condition that they should consume very little of it. In 1956, Kaldor found in Chile and India that the wealthy hogged a far larger part of the national income and wealth but squandered most of it in wasteful consumption, he set about suggesting fiscal measures to try and garner a part of the waste for productive investment by the state and introduce incentives under which the capitalists would be both induced and forced to save a larger part of their income. For this purpose, he recommended the introduction of a capital gains tax, an expenditure tax, and in the Indian case bringing down the marginal rate of personal income tax to a maximum of 45 per cent (Kaldor, 1956; Toye, 1989).

In the Chilean case, he was only to write a paper for the *ECLA Bulletin*, whereas in India, he was brought in as an adviser to the government. His recommended tax reform measures for India, including a comprehensive, self-checking system of reporting covering all accruals of income and transfers of income and wealth. As it happened, the rightwing was so outraged in Chile that his paper could not be published in a UN journal, namely, the *ECLA Bulletin* (Palma and Marcel, 1989).

The outcome of his recommendations for India was not much more propitious. The Finance Minister was changed after he had introduced a diluted version of the Kaldor proposals, though the ostensible reason was different, and most of the proposals were buried. The remnants were summarily killed under the new tax reforms of the Rajiv Gandhi era.

Kaldor's tax reform proposals had three basic aims. One was to encourage investment and discourage wasteful expenditure. The second was to inject a greater degree of equity into the system by taxing people according to their ability to pay. The third was to make it much easier for the tax authorities to check evasion, while not subjecting the taxpayer to the arbitrary authority of the tax collector by leaving a large grey area of interpretation. These goals were probably most clearly expressed in his proposals for Indian tax reform (Kaldor, 1956).

In order to encourage risk-taking and entrepreneurship, Kaldor proposed that the highest rate of marginal tax on income should be brought down to 45 per cent from rates of 60 per cent and above. But in order to ensure that the increased income accruing to the rich is not squandered in luxury consumption, he proposed a tax on personal expenditure, the detailed theoretical arguments for which he had already worked out (Kaldor, 1955). The second reason he recommended the imposition of an expenditure tax was that although he considered the Haig-Simons definition of income as the aggregate of all accruals to the purchasing power of a person to be the only acceptable definition of taxable income, he knew that such a definition required estimation of many components that involved a considerable degree of judgement by the tax authorities. In contrast to that, actual expenditure is easily verifiable, if taxpayers were asked to keep accounts of their spending.

But Kaldor also wanted the capital of individuals to be brought under the tax net, for the possession of tangible, non-human capital conferred additional borrowing and spending powers on a person. A budding scientist cannot, at least under modern conditions, offer himself as collateral for a loan[4], but he can pledge an inherited house to obtain credit from a bank. Kaldor therefore wanted an inheritance tax (called estate duty in India) to tap the wealth of those whose only claim to property was that they were wellborn. He also wanted a capital gains tax to garner some of the accretion to property values for the benefit of the public.

Finally, Kaldor proposed the taxation of gifts because many wealthy persons wanted to rid themselves of tax liability on their accruals to income and wealth, while endowing their progeny or other near and dear ones with unearned income or property by giving away part of their income or property to the latter. Kaldor did not think that the capital gains tax or the gift tax would damage the incentive to earn, since much of the capital gains made by the rich (such as increases in real estate values caused by population growth and urbanization) had nothing to do with their own efforts. Moreover, he was proposing a drastic reduction of their marginal income tax rates. The clutch of taxes

[4] But under the current neo-liberal regime, when government subsidies for education are being drastically slashed, many aspiring scientists and other professionals are entering the labour market as heavily indebted debt-slaves of banks and other financial organizations.

proposed by Kaldor had a self-checking property, for a person could either spend, give away or invest his income, and any of these would show up in an inconsistency, if he was wittingly or unwittingly trying to evade taxes on one head or another.

There were many reasons why Indian property-owners would not have accepted the Kaldor proposals in 1956 or after. The allurement of getting the marginal income tax rates reduced was not great enough for most of them since there were many loopholes through which they avoided much of their tax liability. First, under the personal property and inheritance laws that governed most Hindus, and especially the dominant Hindu business communities, the property was jointly held by several generations, so that, for example, part of the income generated by it could be shown as belonging to a one-year old grandson of the male head of the family. Secondly, under company law, a large part of the expenses of the family controlling the firm and their trusted executives could be passed off as business expenses. Thirdly, there was no tax on agricultural land, so that descendants of landlord and princely families some of the richest families of India paid very little personal tax anyway. On top of all this, there was an enormous amount of tax evasion, especially by those who derived their income from trade and industry, rather than from salaries in the organized sector of the economy.

From the 1970s, the climate of opinion in ruling circles in developed capitalist countries had also changed to favour capitalists as much as possible ostensibly because redistributive measures and the enhanced power of trade unions had damaged the propensity to save and invest on the part of the rich. Kaldor ruefully commented on the climate of opinion in the UK after the election of Margaret Thatcher's government to power in that country: 'given the hostile attitude of the present Conservative Government to any form of taxation of capital or of the benefits derived from the ownership of property—aided by the argument that during an inflation capital gains are illusory and the tax is a haphazard levy on capital', the long-term capital gains tax, along

with the expenditure tax, was in danger of being abolished (Kaldor, 1980: xi-xii). The message that indulging the rich further was good for economic growth — communicated through the propaganda blitz and structural adjustment measures imposed on the developing countries by the IMF and the World Bank — was heartily welcomed by the ruling classes of these countries, since they had never believed in paying any price for their countries' goods anyway. He concluded the introduction to the first volume collecting his writings on taxation with the following statement:

> I have become far more sceptical of the possibilities of improving the distribution of income and wealth through taxation or of introducing effective reforms when these are perceived, in anticipation, as affecting adversely the interests of the property-owning classes (Kaldor, 1980: xxiii).[5]

Increasing Returns, Capital Gains And Increasing Inequality

All his life, Kaldor was uncomfortable with the notion of equilibrium in economic theory and its application to economic policy. This is shown by the very first papers he published in

[5] With the benefit of hindsight and with the specific examples of India, Chile and Turkey in mind, it can be argued that apart from the general opposition of property-owning classes to measures of taxation that might harm their interests, there is a further problem in underdeveloped countries in which landlords still effectively rule the countryside. In such countries, the landlords *are* the state, and no public policy measures can ameliorate the condition of the ordinary people if they are perceived as reducing landlord power. Essentially, confiscatory land reforms are the only means by which the private non-market power of the landlords can be abolished. It is not an accident that virtually the only developing countries which have succeeded in disciplining the capitalist class and growing fast are those that have abolished landlordism and compelled everybody, including landlords families, to obey the law of the land (Bagchi, 2000). Under pressure from reformers and critics, the World Bank has conceded that pro-peasant land reforms are necessary to give peasants the incentives and resources to act as free economic agents. But the officials following the advice of the Bank are trying to effect this via the market route. That route

this area, namely, 'The determinateness of equilibrium' (Kaldor, 1934/1960a) and 'The equilibrium of the firm' (Kaldor, 1934a/ 1960a). In these papers, he sought to give far more definiteness to the notion of equilibrium in economic theory than was to be found in the existing literature of the time. In his critical examination of Chamberlin's theory of monopolistic competition, he had already come across problems posed by increasing returns to scale in reaching an equilibrium configuration of outputs and prices (Wood, 1987). But he still thought of increasing returns to scale in static terms, and his view of the determination of prices and quantities in microeconomic settings was basically neoclassical in orientation, as modified by E. H. Chamberlin and Joan Robinson. However, after his adherence to Keynesian macroeconomics, he became convinced that the neoclassical framework was totally misleading for figuring out aggregate levels of employment and income distribution.

By the beginning of the 1950s, Kaldor realized that marginal productivity theory could not explain the major facts of income distribution obtaining in the real world (Kaldor, 1955-56/1960a). His theories of economic growth were based on the assumption that firms continually exploit increasing returns to scale and innovate as they expand (Kaldor, 1957/1960a, 1958/1960a; Kaldor and Mirrlees, 1962/1978). His critique of the marginal productivity theory erupted into a ringing denunciation of the whole notion of general equilibrium underlying mainstream economic theory in its neoclassical incarnation (Kaldor, 1972/ 1978, 1975/1978). Even before this denunciation, he had implicitly turned to classical modes of analysing adjustments to

has proved to be a blind alley as far as the empowerment of peasants is concerned, in the Philippines of Corazon Aquino or the Egypt of Hosni Mubarak, as it did in the Prussia of the nineteenth century (for a selection of articles critiquing the market route to land reforms, see Ramachandran and Swaminathan, 2002). In Chile and other Latin American countries, the failure to discipline the bourgeoisie has costly results, even for the bourgeoisie. The price paid in India was less dramatic and spread over a much larger number of years and over a vastly larger mass of humanity.

external disturbances or endogenous changes in basic economic parameters in his paper on the 'Neo-Pasinetti Theorem' (Kaldor 1966/1978).

In neoclassical analysis, the production functions of firms and the demand curves facing them are taken as given or, in the case of oligopolies or polypolistic markets[6], 'conjectural variations' are allowed in the demand schedules. But classical economists recognized that adjustment to any significant change involves investment in fixed or working capital. Adam Smith basically worked with the assumption that most accumulation processes take the form of changes in working capital, although he provided such a path-breaking analysis of the division of labour in a pin factory that necessarily required the employment of fixed capital:

> It is not sufficiently recognised that Adam Smith's concept of competition was intended for a world of merchant capital rather than a world of industrial or fixed capital. In the former context the conditions of capital mobility are established directly through exchange. Commodities whose rates of return are expected to be high are purchased by the merchant. Whether or not his expectations are later borne out at the time of the sale, his capital is restored to liquidity. Since no portion of his capital remains tied up in commodities, it is entirely free to pursue another purchase in whatever area the highest returns are expected. Through the influx and outflow of merchant capital to areas of higher returns from those of lower returns, there is established a uniform rate of profit.
>
> The situation is quite different, however, in a world of industrial or fixed capital. Where finance is

[6] 'Polypoly refers to a market in which there are many sellers but they may not behave as price-takers because they face a downward sloping demand curve.

> committed to production activity it is at once immobilised. Only that portion of fixed capital used up within the period of production becomes restored to liquidity through the sale of produced commodities (Clifton, 1977: 146).

In the presence of increasing returns and marginal cost curves, which slope downward even at the point of maximum profit, strategic behaviour plays a major role in establishing the distribution of market shares among different firms.

In his path-breaking paper, 'Speculation and economic stability', Kaldor showed that merchants' stocks can play a stabilizing role under certain conditions, but he did not discuss the role of investment in fixed capital in adjustment to disturbances. He briefly analysed this function in his reply to the critique of Pasinetti (1962/1971) by Samuelson and Modigliani (1966). Kaldor (1966/1978: 85) clearly formulated the compulsions imposed on individual firms by capitalist competition:

> I have always regarded the high propensity to save out of profits as something which attaches to the nature of business income, and not to the wealth (or other peculiarities) of the individuals who own property. It is the enterprise, not the particular body of individuals owning it at any one time, which finds it necessary in a dynamic world of increasing returns, to plough back a proportion of the profits earned as a kind of "prior charge" on earnings in order to ensure the survival of the enterprise in the long run. This is because: (i) continued expansion cannot be ensured in an uncertain world, and in the long run, unless *some proportion* of the finance required for expansion comes from internal sources; (ii) the competitive strength of any one enterprise, in a world of increasing returns, varies with the enterprise's

> share of the market—it declines with any decrease in that share, and improves with an increasing share; hence (iii) in a world of expanding markets, continued expansion (by the individual firm) is necessary merely to maintain the competitive strength of the enterprise. Hence the high savings propensity attaches to profits as such, not to capitalists as such.

Kaldor's analytical route to the neo-Pasinetti theorem can provide the core of a theory of the increasing income inequality associated with financial liberalization. Kaldor puts forward the following equation characterizing the 'equilibrium' in the securities market:

$$s_w W = cG + igK,$$

where s_w is the propensity to save out of wage income, c is the proportion of capital gains consumed by stockholders, G is the value of capital gains, g is the growth rate of capital, K is the value of capital and I is the proportion of new investment financed by the issue of new securities. In an economy in which savings are embodied solely in stocks, the left hand side gives the total demand for securities by the non-corporate sector. This demand is satisfied by the sale of old securities in the secondary market represented by cG (saving out of dividends distributed to shareholders is included in s_w) and by the issue of new securities in the primary market. Then, a crucial variable has to be introduced, namely, 'the valuation ratio', defined as 'the relation of the market value of shares to the capital employed by the corporations (or the book value of assets)'. After taking into account the change in the value of stocks, as the difference between the valuation ratio multiplied by the growth of capital stock and value of the proportion of investment financed by the issue of new securities, and manipulating the equations, Kaldor arrives at the following two equations that embody his neo-Pasinetti theorem:

$$v = 1/c[(s_w /g)Y/K- (s_w /s_c)(1-i)-i(1-c)] \ldots\ldots (1)$$

and $$\rho = [g(1-i) /s_c] \ldots\ldots (2)$$

If v is given, these two equations determine the relation between the rate of growth and the rate of profit, and the distribution of income between wages and profits in a steady state. But suppose v were to be raised exogenously or s_c were to decline, how would the rate of profit and the distribution of income be affected?

Answering these questions would require us to first establish the processes through which the values of v or of s_c were to be changed. One set of conditions raising the value of v would be the financial equivalent of what, in military parlance, is called the power of massed reserves. This would work through the processes resulting in economies of scale in production and marketing, processes that Kaldor stressed in his later analyses of economic growth and the resulting movement from dis-equilibrium to dis-equilibrium, movements that give rise to cumulative causation[7].

But equally important would be the economies of massed finance, that have become the major propelling source of changes in v of big firms since the wave of financial liberalization that has swept over the world since the late 1970s. This acceleration in the use of massed finance and the development of a fast-moving market for corporate control has not led to the increase in v, especially relative to the returns to be obtained from investments in bonds and debt instruments. It has also completely upset the stability in the ratio of profits to wages which Kaldor had tried to explain through his innovative growth models.

[7] Although Adam Smith is credited with discovering economies of scale through his analysis of the workings of a pin factory, he did not really extend his insight to the economy as a whole. Josiah Tucker has a much better claim to be regarded as the pioneer analyst of economies of scale and cumulative causation in the macroeconomic context. Moreover, like Kaldor and Myrdal (1957), in his *Tract* of 1774, Tucker applied his analysis to the explanation of differentials between rich and poor countries. Tucker (1774) catalogued a better endowment of capital and infrastructure, a better command of knowledge and information, a superior ability to learn, a higher propensity to invest, a higher level of wages and, hence, a higher level of domestic demand, a higher degree of social division of labour leading to high rates of productivity growth, a greater degree of competitiveness among tradesmen and craftsmen and a higher endowment of investible capital, resulting in a lower rate of interest as factors allowing a rich country to continue to be more prosperous than a poor country (Tucker, 1774; Bagchi, 1994: 84-87). He ended up with what can be characterized as the Hume-Tucker law:

> *operose* or complicated manufactures are cheapest in rich countries, and *raw materials* in poor ones. And, therefore, in proportion as any commodity approaches to one, or the other of these extremes, in that proportion will it be found to be cheaper, or dearer, in a rich or a poor country (Tucker, 1774: 36).

The stability of the distribution of income between profits and wages was in fact the outcome of the institutional setting of capitalism in the two decades following World WarII and was not a historical constant as Paul Baran, a more radical critique of capitalism had pointed out in his reply to Baran's argument that the growth of monopoly capital threatened growth under capitalism (Baran, 1959/1969: 187-188). Contrary to the predictions of some Marxists, the capitalist system has not collapsedunder the weight of its contradictions. But it has become an ever more oppressive system for the majority of mankind and has generated a degree of inequality of economic power unprecedented in recorded history. The contravention of some policies that Keynes and Kaldor tried to put in place, and increasing reliance on a necessarily casino-like stock market, which they had implicitly or explicitly decried, have contributed mightily to this outcome.

The reality of deregulated stock markets and increasing inequality

Contrary to the claims of Milton Friedman (1953) and his followers, that the stock market is not a place which easily corrects mis-pricing of stocks if they depart from their so-called fundamental values (Shiller, 1999; Barberis and Thaler, 2003). What applies to stock markets also applies *mutatis mutandis* to currency markets. In Friedman-type accounts, the 'arbitrageurs' are supposed to take advantage of any mis-pricing of a stock by buying it when it is under-priced and selling it when it is overpriced. But in fact, herd behaviour, or rumours or the incentives and operations of ill-informed 'noise traders', such mis-pricing continues. Such situations, however, provide corporations or individuals with very deep pockets to clean up after arbitrageurs, noise traders and small investors listening to the advice of their brokers and investment consultants have bitten the dust, to buy up whole companies or controlling shares in companies.

One major piece of evidence supporting the proposition that the stock market does not allocate resources efficiently is the so-called 'equity premium puzzle' (Mehra and Prescott 1985). Their puzzle is that practically throughout the twentieth century, a representative selection of US stocks has earned significantly higher rates of return, after reasonable adjustments for risk, than bonds issued by public authorities. If the stock market was really an efficient allocator of funds, this premium for stocks should have vanished. One simple explanation is that while small investors have to decide which particular portfolio of private corporation shares to hold in order to get a reasonable return, they consider it much safer to invest their savings in government bonds, because the government is not likely to default. The persistence of this propensity and the consequently higher returns earned by more canny and well-heeled investors are also part of the explanation for the enormously increased concentration of economic power in most economies.

The issues of US hegemony or imperialism rarely enter into mainstream analyses of why a highly indebted US economy run by a highly indebted government continues to attract hundreds of billion of dollars to fund the burgeoning US balance of payments deficit and US government deficit. The main reason is that the investors in Japan, Germany or, for that matter, China know that so long as the dollar remains the dominant currency of exchange, and so long as the US government is able and

ready to use both its political and military muscle to literally fight off any challenges to dollar supremacy, US Treasury bills will be honoured, however low the return on these bills may be. The recent US government anger with Iran and Iraq was sparked not only by their refusal to become vassals of the US government, but also their plans to shift to the euro as their main currency for trading oil. Ultimately, oil has become the commodity effectively backing the dominant international currency. The US government wants to ensure its monopoly of control over that commodity, even at the cost of violating all international laws governing the declaration of war against other countries.

Keynes had conceived the International Monetary Fund (IMF) as an agency for stabilising international currency exchanges, thereby facilitating the growth of the world economy. In Kaldor's case, the cause of industrialization of underdeveloped economies was even more explicit in his agenda for international monetary reform (Griffith-Jones, 1989). However, the IMF has become an instrument for impoverishing underdeveloped economies, and has helped make the international economic order even more unequal than it was in the 1970s. Once a poor country gets into a debt trap, the IMF works out a stabilisation package. Two conditions are invariably included in that package. First, the government is made to assume the burden of all external debts incurred by the public sector and all citizens of the country, however illegitimately those debts might have been incurred. In a classic moral hazard situation, the sins of loan-pushing transnational banks and other financial institutions and of the not-so innocent borrowers in that country are visited on the hapless common people of that country. The second condition that forms a standard part of the IMF stabilisation package is a programme imposing severe deflation on the country seeking assistance. This leads to widespread bankruptcy; assets built up over decades, are grabbed by foreign 'vulture' capitalists, often transnational corporations that can easily buy them out. Thus the wrecking of the international monetary system Keynes and

Kaldor had pleaded for in some of their seminal writings led to an escalation of inequality in an international order already characterized by a high degree of international inequality (Milanovic, 2002).

In writing about the pioneers of thinking about economic development, we should pay attention to what they wrote and preached. But we have also to reckon with the undoing of their work during the last quarter of the twentieth century. An attempt to resurrect of their perspective will need to confront the enemies of that work, in ideology and policy-making. My contribution is a small step in that direction.

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