IN SEARCH of NATIONAL ECONOMIC SUCCESS

Balancing Competition and Cooperation

LANE KENWORTHY

SAGE Publications
International Educational and Professional Publisher
Thousand Oaks London New Delhi

Contents

Introduction

One of the most valuable pieces of information social scientists could potentially provide to citizens and policymakers is an explanation of why some countries achieve better economic performance results than others. Yet despite numerous efforts, we lack a convincing theory of comparative economic success.[1] This book attempts to help remedy that failure.

For most of the past two centuries the prevailing view among economists, policy intellectuals, and government authorities has been that economic success is a product of free markets and competition. This *market liberal* view holds that the performance of an economy is impeded by, among other things, nonmarket constraints on freedom of choice, income equality, government intervention, and labor organizations. The book is organized around an assessment of these claims from a comparative perspective. I find them to be largely, although by no means entirely, lacking in empirical support.

In the course of examining market liberalism, we shall encounter a number of criticisms directed at it; a range of theses regarding the effects of free choice, equality, state intervention, and labor organizations on performance outcomes; and various alternative theories of economic success. Although there is much of value in these arguments and the studies on which they are based, I will endeavor to show why some of them are wrong, and why the others are, if not quite wrong, at least not entirely right.

Finally, and most important, I offer my own explanation for why some national economies do better than others. In my view the key factor is the degree to which countries combine competition with various forms of economic cooperation.

Chapter 1 outlines the basic tenets of market liberalism and traces its influence on economic thinking and policy making, with a focus on the United States. Although it has never been uncontested, the market liberal view dominated scholarly and popular thought about capitalist economies during most of the 19th and the early part of the 20th centuries. The Great Depression and World War II ushered in an era in which state intervention and nonmarket institutions such as labor unions were viewed by many as legitimate, even productive, elements of a well-functioning economy. Although it continued to influence policy making throughout much of the industrialized world, market liberalism no longer enjoyed hegemony. In an age of what appeared to be ever-increasing affluence, the notion that there is an inherent trade-off between economic efficiency and social justice and that market impediments severely constrain economic advance seemed mistaken.

Then, with the onset of stagflation after 1973, the tables turned again. Excessively high tax rates, overly generous welfare states, government regulatory meddling, union rigidities, and other inhibitors of the market's invisible hand were effectively portrayed as the chief culprits behind the downturn in economic performance suffered by all of the world's industrialized nations beginning in the mid 1970s. Although its impact on policy has been uneven across countries, market liberalism has once again become the single most influential theory of economic success among scholars and policymakers. And although the 1990s have witnessed a lessening of market liberalism's political influence in the United States and Britain—formerly the homes of its most outspoken proponents in Ronald Reagan and Margaret Thatcher—in a number of other nations its political fortune has been, if anything, on the rise.

Given our limited ability to conduct controlled experiments, social scientists must frequently rely on historical data for empirical evidence.[2] The best uses of historical data are comparative. Comparison helps us to isolate factors that might be relevant causes of whatever phenomenon we seek to understand, by holding other factors constant. Curiously, interest in explaining cross-national variation in economic performance among industrialized capitalist nations was minimal prior to the mid 1970s. In the pre-depression years, this owed to limited data availability and the existence of widespread agreement about the key to economic success. During the post-World War II boom period, the lack of concern stemmed primarily from the similarity of performance results among these countries. All developed economies were relatively healthy and improving rapidly, and it was widely expected that this pattern would continue.

It was the downturn following 1973, coupled with increasing divergence in performance outcomes, that stimulated interest in why some countries achieve better economic results than others. The past two decades have witnessed an outpouring of theorization and research on this question. The most clearly articulated and intellectually and politically influential of the views set forth to explain cross-national performance variation has been that of market liberalism. Any attempt to come to terms with the issue must therefore begin with this theory. Chapters 2 through 5 of the book endeavor to do just that.

Chapter 2 focuses on constraints. Freedom of choice is commonly thought to be capitalism's fundamental attribute and supreme virtue. According to neoclassical economic theory, under conditions of market competition and free choice, actors' attempts to pursue their own selfish interests serve to promote the general interest as well. I argue that the conventional emphasis on freedom of choice is misplaced. The key determinant of efficient economic behavior, even in neoclassical theory, is the constraints economic agents face. But in a number of important instances, nonmarket or extramarket constraints are superior to market incentives at generating such efficient behavior. In a market environment, rational actors with extensive freedom of choice will in some instances be led to make reasonable choices that produce notably suboptimal outcomes. To achieve superior performance, economic actors must sometimes be constrained by non- or extramarket institutions to do what is in their own, and society's, best interest. In elaborating this argument I draw upon the experiences of Germany, Japan, and the United States in the areas of finance, worker training, and purchaser-supplier relations.

Chapters 3, 4, and 5 inquire into the performance consequences of equality, government intervention, and labor organizations, respectively, drawing on a mix of qualitative and quantitative evidence.

The quantitative analysis examines the 17 richest industrialized democracies—Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, New Zealand, Norway, Sweden, Switzerland, the United Kingdom, and the United States—over the period 1960 to 1990. Reliable data on economic performance are available for these nations beginning in 1960. The year 1990 provides a useful cutoff point, because (like 1967, 1973, and 1979) it marked a business cycle peak. Developments since 1990 are discussed in Chapter 6.

Economic performance indicators are of two principal types: those, such as growth and inflation, which aim to measure economic efficiency, and those, such as equality or access to health care, which relate more specifically to social welfare. I use only the former here. This is partly to keep the analysis manageable, but in part also because one of the key issues for consideration will be whether social welfare is compatible with efficiency. Instead of focusing on only one or two components of economic efficiency, as is common in comparative analyses, I use a variety of indicators—including productivity growth, output growth, productivity levels, investment, trade balances, inflation, and unemployment.

Readers unfamiliar with statistical methods may panic upon arriving at the first bit of quantitative analysis in Chapter 3. Please don't! I have tried to keep the analysis simple and to render it comprehensible to readers with little or no statistical training. The results can be understood, in any case, simply by following the discussion in the text.

Economic equality is commonly believed to have two nefarious effects: It reduces investment by shifting resources away from those with the strongest proclivity to save and invest, and it dampens work effort. The asserted trade-off between equality and efficiency is perhaps the most widely accepted of the market liberal claims. But is it supported by the comparative record? A heterodox view contends that equality may have beneficial efficiency effects—by augmenting consumer demand, encouraging workers to cooperate in upgrading competitiveness, and enabling society to take full advantage of its human resources. Chapter 3 examines the effects of income equality and equality of opportunity on performance outcomes. Contrary to the market liberal claim, the comparative evidence suggests that greater levels of equality than presently exist in most, if not all, developed countries are compatible with an efficient, successful economy. Indeed, there is strong indication that increasing equality would enhance performance in many nations.

No economic institution has come under more severe attack over the past two decades than government. Government intrusion has been widely blamed for the economic malaise that has stricken much of the industrialized world since the early 1970s. State intervention is accused of producing a variety of adverse consequences. Because governments seldom face a hard budget constraint (that is, they do not face bankruptcy if they act inefficiently) and because politicians can maximize reelection chances by catering to the wishes of rent-seeking special interest groups, state activism is said to be highly susceptible to inefficiency. It is also said to reduce investment and work effort and to fuel inflation. Against this reasoning, proponents of an affirmative state point to an array of potential positive effects. Government spending on transfer programs may help stabilize and increase consumer demand, heighten motivation and workplace cooperation by promoting fairness, and encourage wage moderation. Labor market policies can help increase the skill level of the workforce and reduce friction in the job matching process. Industrial policies can help remedy market failures in the allocation of capital, the supply of research and development, the diffusion of technology, and the frequency of cooperation among firms.

Chapter 4 examines the market liberal view with respect to five types of government intervention: fiscal policy, redistributive policy, labor market policy, industrial policy, and regulation. The only support I find for the free market perspective is a possible, though questionable, deleterious effect of high levels of taxation and government spending on investment and growth. Otherwise, the comparative record tends to support the contrary view. Labor market and industrial policies, in particular, appear to enhance national economic health.

Critics of government also frequently claim that state intervention tends to fail in its direct objective. Redistributive programs fail to reduce the incidence of poverty; policies aimed at reducing unemployment and upgrading labor force skills have no such effect; and so on. I find these charges to be similarly unfounded.

Chapter 5 investigates the market liberal claim that labor organizations adversely affect economic performance by blocking technological innovation, interfering with the market for labor, and raising wages above marginal productivity levels. Here again the comparative record suggests little support for the market liberal view. Unions, works councils, and codetermination arrangements do not generally impede technological change, and they may contribute to better performance by lowering quit rates and facilitating improved communication between workers and managers. Unions also appear to reduce labor-management conflict.

It is in the area of wages that unions are expected to have their most damaging effect. Yet, ironically, it is here that labor size and strength is most clearly beneficial. Encompassing labor movements have proved more willing and able than low-density, fragmented unions to restrain wage demands, and in doing so have contributed to superior macroeconomic performance in the form of lower misery index (inflation plus unemployment) levels. A number of political scientists and economists have advanced this sort of argument over the past decade, but I show that the three currently prevalent versions of this institutional perspective on unions and wages are flawed. I offer an alternative model that, in my view, is more compelling theoretically and more consistent with the comparative evidence.

The final chapter, Chapter 6, is the linchpin of the book. There I attempt to answer the question: If the market liberal view is wrong, what *does* explain cross-national variation in performance outcomes? I argue that the key to national economic success lies in combining competition with cooperation.

Competition has indeed proved an effective spur for economic progress, and markets are certainly the best mechanism with which to coordinate most economic activity. But in a number of critical areas of economic life, the structure of incentives in a market-based economy is such that actions which are optimal for individual actors—workers, managers, firms, unions, government officials, and so on—are suboptimal for the economy as a whole. Locally optimal actions yield globally suboptimal outcomes.

Such perverse incentive structures plague virtually all of the key relationships among economic actors in a market-based economy. Specifically, such problems occur at three levels. At the macro level, they occur in the relations among firms in different industries, among unions, and between government and interest groups. At the meso, or sectoral, level they obtain in the relationships between purchaser and supplier firms, between firms and their investors, and among competing firms. Structural inefficiencies also exist at the micro level—that is, within the firm—in the relationships between labor and management, among workers, and among functional divisions within firms.

In such circumstances economic success requires cooperative behavior, and cooperation in turn depends upon nonmarket or extramarket institutions such as long-term, guaranteed relationships and formal organization. Countries in which such institutions are more prevalent should therefore achieve superior performance results.

The comparative evidence strongly supports a focus on cooperation-inducing institutions. The nations with the best performance records over the past three decades—Japan, Austria, Germany, the small northern European countries, and (northern) Italy—have been those most committed to combining competition with cooperation. Those faring worst—the United States, Britain, Canada, Australia, and New Zealand—rely predominantly on atomistic, individualistic competition. The theory fares well against rival explanations of economic performance outcomes. It provides a more compelling account than perspectives focusing on macro-, meso-, or micro-level institutions alone. And its predictive utility is superior to those theories that can be tested across the full set of developed capitalist nations, including the market liberal thesis.