GAREGNANI´S SVIMEZ REPORT, DEVELOPMENT ECONOMICS AND THE ROLE OF GOVERNMENT SPENDING IN LONG RUN GROWTH [*]

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I.Introduction

Today I want to make a few remarks on the significance of the recently published more constructive theoretical part of Garegnani´s 1962 SVIMEZ report. I will first try to put his contribution in perspective relation to development economics as practiced at the time the report was written. I then turn to discuss some interesting implications that arise when we follow the theoretical framework proposed in that report, concerning the question of the role of government spending in long run demand led growth.

II.Garegnani and Development Economics

II.1 Development economics and the unlimited supply of labor

Postwar development economics did not get to point of arguing that there was something undamentally wrong with the neoclassical view of the operation of the competitive market mechanism. The point was that poor region and underdeveloped countries had some peculiar features that justified, and in fact required, specific policies which often implied a very strong degree of state intervention in the economy. One basic idea was that, in spite of the unquestioned validity of the principle of factor substitution, poor economies had so little capital and such backward techniques that the level to which the real wage would have to fall to reach full employment would have to be zero, or at the very least below the minimum subsistence real wage (Lewis (1954)). This set a rigid floor to the real wage that had to be paid in the modern capitalist sector,

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and the effect of this exogenous wage on the choice of technique made capital and labor ultimately complementary, with capital being the factor in short supply.

II.2 Capacity saving determines investment

No such analytical clarity , however , could be found in development economics concerning the relation between potential saving and investment and the tendency towards the full utilization of the (small) existing capital stock in the underdeveloped countries or regions.

Most authors simply took for granted that potential saving , that now due to structural unemployment could not anymore be called "full employment" but had to be called "full capacity saving", determined investment. Say´s law hold, like in Ricardo.

Therefore , for most authors in the tradition of development economics, in order to encourage investment it was both necessary and sufficient to discourage consumption. There was no discussion , for instance, about whether the adjustment mechanism of investment to potential saving through changes in the long run rate of interest could still work in developing economies with exogenous real wages.

Nor there was any discussion coif the mechanism by which the monetary rate of interest would move towards the long run equilibrium rate of interest through the effect of changes in money wages and prices on the level of the real money supply, the socalled "Keynes effect", could possibly work in an economy with structural unemployment without money wages and prices falling towards zero.[1]

Thus, investment was simply assumed to be determined by capacity saving. Among those who made this assumption we could include Lewis, Singer, Nurkse, Furtado, Prebisch and even Marxists as Paul Baran. But this list is far from complete. Most of these authors were obviously keenly aware of the Keynesian/Kaleckian principle of effective demand but somehow thought that it was not relevant for discussing the problems of the developing economies and regions in the long run.

As Garegnani argued in 1962 the little justification for such strong and arbitrary assumption that could be found usually was based on a non sequitur. From the true fact that generic aggregate demand stimulus by itself could not solve the problem of

[1] Though Kalecki had noticed just such incompatibility in a remarkable and little known article published in polish in 193? With the title "three systems"

structural unemployment for a given level of the capital stock it was incorrectly deduced that effective demand was irrelevant.

This deduction is incorrect for two main reasons. The first is that in a monetary capitalist economy there is no reason why the existing capital stock would tend to be always fully utilized, that the level of aggregate effective demand will adjust to it . and this is totally independent from the question about this capital stock being large enough to employ the whole of the labor force.

Moreover, there is no good reason to assume that the level and evolution over time of effective demand and the actual degree of capacity utilization will have no effect on investment and thus on the long run growth of the capital stock.

In other words, the fact that there is too little capital relative to the size of the labor force does not at all imply that there is too little capital also relative to the size of effective demand.

II.3 Investment determines capacity saving through changes in distribution

This misconception was so prevalent in the tradition of development economics that even the few authors that clearly understood that even in a developing economy a fall in consumption by itself can have no positive effect on investment usually still made the assumption that aggregate demand adapted itself to productive capacity in the long run. The mechanism was different. It was assumed that for some reason capacity was always too small relative to effective demand in the long run and that generated chronic demand inflation that shifted distribution away from low saving wages to high saving profits , as money wage increases lagged behind that of prices. In this conception of "forced savings" it was too much investment that reduced consumption , not too much consumption that reduced investment, using what became known as the Cambridge theory of distribution.

Note that it is not easy to understand why "too much" investment would fail in the longer run to increase the capital stock and productive capacity undoing the very need for "forced saving". But unsound as this view was, it was also widely held in development economics circles. Even Kalecki, who vehemently opposed this argument when applied to developed capitalist economies, considered that this reasoning was applicable to the developing economies that he called "mixed economies". He was no doubt influenced by the reality of socialist centrally planned economies that did operate a bit like this. But this was certainly not a reasonable representation of capitalist developing economies.

So, between those who thought that capacity savings determined investment and those who argued that investment determined capacity savings through changes in distribution postwar "development economics" analyses considered that the growth of consumption expenditures was either a direct hindrance to or would be anyway sacrificed in (usually together with distributive equity) the process of generating fast growth of investment required for economic development.

II.5 Garegnani´s SVIMEZ report

In very sharp contrast to the then prevailing views in the SVIMEZ 1962 report Garegnani argued that investment may be encouraged (instead of discouraged) by a faster growth of consumption. Garegnani first used the critical results of Sraffa(1960) and his own Ph.D. dissertation to show that there was no sound theoretical basis for the factor substitution mechanisms upon neoclassical theory relies to argue for a tendency towards full employment.

He then shows that, in the absence of the neoclassical mechanism, full capacity saving does determines investment, neither in the short nor in the long run.

Or to put in other, perhaps more intuitive words. Actual levels of investment, even in the long run are not determined by the size of the productive capacity of the capital goods sector (capacity saving).

In fact in a longer run it is the opposite tendency that should be expected. The productive capacity of all sectors will tend to adjust to their demands, as the pace of investment will be chiefly regulated by the growth of demand. That means that it is the size of the productive capacity of the capital goods sector or capacity saving that will adjust to demand , in this case investment. He thus explicitly rejects both Say´s Law and the Cambridge forced savings doctrine discussed above.

Garegnani argues that the long run, the main determinant of investment is the expansion of the part of aggregate demand that does not create capacity for the private sector of that particular economy which he calls “final demand”, such as consumption, government spending and exports.

Moreover , in what regards exports, Garegnani draws attention to its two distinct roles. One of them as a component of final demand . The other as a source of foreign currency for financing the balance of payments.

III. The role of government spending in demand led growth

III.1 Exports and government spending

In the Svimez report Garegnani was focused on the specific question of the effect of real wages on consumption and that of consumption on investment. For this reason he only mentions government spending in a footnote. But in personal conversation he mentioned to me many times that one should look at the role of exports and government spending in long run demand led growth. We at the Grupo de Pesquisa em Economia Politica at the Federal University of Rio have followed his advice and have been studying these questions for a while, based on the theoretical framework presented by Garegnani in the Svimez report. I would now like to bring up for discussion a few ideas that sprung from our applied and theoretical research.

III.2 "False positives": Apparent cases of export led growth

In what concerns the role of the growth of exports as a component of autonomous demand, as opposed to its financial role in alleviating the external financial constraints, we have recently began to notice that in many countries this role has been to a certain extent somewhat overestimated.

I am not talking only, or even mainly, of countries like Mexico that have in the last decades combined very fast growth of exports with relatively low growth rates of gdp. In this particular case, the high import content of exports in the well know Mexican "maquilladora" export sector , combined with low growth of public expenditures may easily explains the basics of the overall situation. And indeed this serves as an useful warning to other countries that may think of pursuing an export led growth strategy based on at all costs trying to get integrated on the now fashionable international "global" (or regional) " value chains". Such strategy , as the Mexican experience has shown, may in reality bring quite slow growth of overall output and especially formal employment.

What I have in mind is something a bit more subtle which happens in countries and periods in which there is a stronger correlation between the rate of growth of exports and the rate of growth of gdp.

In some of these cases the implied effect of exports on induced consumption and induced investment seems to us suspiciously large. Let us take for instance the examples of the Russian Federation and Argentina in the 2000s. There a very strong connection between the growth of Russian energy exports and the rate of growth of gdp. The same can be said of the correlation between the growth of agricultural commodities in Argentina and the growth of the economy. In both cases one gets the impression that the domestic value added by the export sector (and its share of total employment) is not that big relative to the overall size of the economy or even, it seems relative to total autonomous demand.

But in spite of this the growth of the economy seems to follow quite closely the growth of exports.

In part one could explain this away in terms of the growth of exports alleviating the external constraint and the government very quickly taking advantage of it to increase the overall growth of aggregate demand. That is in fact what is implied in the well known Kaldor-Thirwall model of balance of payments constrained growth.

But that strikes us as a rather mechanical explanation, and one that tends to ignore that balance of payments constraints, as the name says are just constraints not determinants, and so are by nature very asymmetrical. Indeed, while it is easy to see that there is some sort of upper limit of how much a country can lose foreign exchange reserves without running into serious problems , the opposite is not true. A country can (and many do) accumulate large amounts of foreign exchange reserves without such serious consequences (Brazil in the 2000s has been an obvious example).

There seems then to be some other factors at work. We believe we found a couple of these factors that may explain at least in part this strong correlation between exports and growth in economies where the internal market cannot be considered to be small.

One of them has to do with the fiscal regime and institutions. In some countries the taxation of exports has always been a major source of fiscal revenue. This combined with a traditional aversion to large fiscal deficits , either for political reasons or more strucutrually because historically the threat of balance of payments crises did not encourage anti cyclical policies, tend to make government expenditures and social transfers to move in line with fiscal revenue and thus with the export performance.

This will give the clear impression that growth is directly led by exports , when in fact is being pulled also by government spending and transfers.

Thus the relatively fast growth of Argentina in the 2000s appear to us as being possible "false positive" instances of apparent export led though this certainly deserves more careful study. In both of these countries the literature seems to vastly exaggerate the direct expansionary effects of exports and underestimate the very important role of the fast growth of public expenditures. I am sure there may be or have been many other instances of such "false positives" perhaps even in postwar Europe and that this is a promising line further enquiry.

III.3 The role of government spending and transfer is underestimated

In fact we believe that in general the important role of the public sector in demand led growth has tended to be underestimated both in general and relative to exports in the literature for a number of reasons, apart from the one already mentioned.

One of these we think is a quantitative underestimation of the size of the impact of government social transfers (and the public sector wage bill) on "private" or "household" consumption expenditures. Many studies measure the contribution of the public sector to aggregate demand merely by adding government consumption and government investment , leaving aside investment from public owned enterprises that are included as private investment. And , more importantly, considering the whole of the growth of household consumption as part of the contribution of the private sector to aggregate demand. This seems to us to underestimate the role of the public sector in aggregate demand in any country that has a large Welfare State or a large public enterprise sector. Note that although retirement pensions or other social transfers naturally increase private disposable income and consumption is usually thought as induced by disposable income. There is nothing wrong with that but in our view it is more useful to separate the properly endogenous amount of consumption that is induced by the contractual incomes associated to the decisions of production (basically, the wage bill) from the exogenous, autonomous or "political" source of extra purchasing power to consumers associated with the system of social transfers and the public sector wage bill. In some circumstances, like that of the Brazilian expansion in the 2000s this has certainly led many analysts to underestimate the overall contribution of the public sector to the growth of aggregate demand.

III.4 Extending Haavelmo´s balanced budget theorems

Another source of general underestimation of the role of the public sector in ensuring the growth of final demand had already been pointed out by both Steindl and Kalecki´s analysis of postwar economic growth in advanced capitalist countries as a whole and in the American economy.

This has to do with the generalized tendency to think that only government deficits have positive impacts on aggregate demand.

Indeed, the fact that in general large and persistent fiscal deficits have only appeared in advanced capitalist countries after the end of the so called Golden Age of postwar economic growth (basically as a result of high interest rates and a drastic decrease in progressiveness of taxation) only reinforced the impression that the contribution of the public sector to demand led growth was somewhat limited.

III.5 The government´s "effective" marginal propensity to spend must be greater than that of those who are taxed

But as both Kalecki and Steindl pointed out using a special case of Haavelmo´s balanced budget theorem the parallel fast and large increases in tax revenues and government spending certainly added to the growth of final demand.

For these two authors this due to the increase of taxes that fell on the recipients of the surplus as they assumed workers did not save at all and thus taxes on wages were not expansionary.

But using Haveelmo´s more general analysis it is clear that a simultaneous increase in tax revenues and government spending will be expansionary whenever those that are taxed have a lower propensity to spend than the government and/or the recipients of government transfers. Thus,as the rich tend to have higher marginal propensities to save, the more progressive the system of taxation also the system of social transfers are , the bigger is the net positive contribution of the public sector to final demand.

To this we may add that in an open economy that this positive effect on demand will be reinforced if government expenditures and/or recipients of social transfers have higher propensity to spend on domestically produced goods (and lower to spend in imports) than those who are taxed.

Therefore we believe that Kalecki and Steindl were right to point out the postwar construction of welfare states and advanced capitalist countries and of the welfare plus warfare state in the USA have played a major important role in the growth of final demand and of the internal markets and ultimately of private investment in these countries during the Golden Age, a role much bigger than the impression given by the relatively small (especially if properly adjusted for inflation) public deficits as a share of gdp that occurred in that period.

Of course government deficit spending is obviously more expansionary than balanced budget expansion as it renders unnecessary to increase tax and thus reduced disposable income of those who are taxed and possibly their consumption.

But it is useful to reexamine and to extend Haavelmo´s framework to deal with cases in which for some reason or another government deficit spending is not possible for purely political or institutional reasons.

Assume that in a particular country or region the current fiscal rule requires for some reason the government to run a primary surplus as a share of gdp of a%. Does that mean then than fiscal policy cannot be expansionary in this context?

Not necessarily. Note that what really matters for fiscal policy to be expansionary is that the effective marginal propensity to spend of the government or of the recipients of government transfer on locally produced goods and services must be greater than that of those who are taxed. If there is a primary surplus target this clearly reduces the effective marginal propensity to spend of the government as this is income that is taxed and not spent at all. Any expansionary effect of fiscal policy will be obviously smaller the higher is the target primary surplus as a share of gdp a. But let us look at what may happen. Imagine that the government taxes only to spend in goods and services and to obtain the primary surplus , assuming now for simplicity the case of a closed economy. The effective marginal propensity to spend of the public sector will be given by t-a , i.e., the tax as share of output (t) minus the primary surplus target (a). If the marginal propensity to consume of those who are taxed is equal to c , then taxing t % of income will reduced consumption by -c.t , the product of the tax rate and the marginal propensity to consume. We thus have that while it is clear that fiscal policy will be less expansionary than if there was no primary surplus target , it will still have expansionary effects if the extra demand from the government is still higher than the reduction of consumption of those who have been taxed:

$(t-a) - c.t > 0$

this implies that :

$t(1-c) > a$

Which shows that , if the marginal propensity to save of those who are taxed is high than the target primary surplus share is not too large, the contribution of the public sector to effective demand is still positive. That contribution can be increased either by increasing the tax rate or decreasing the target primary surplus share a.

III.6 Fiscal policy without monetary sovereignty

This type of analysis may be of some relevance to subnational regions of a country that issues a sovereign country (as the italain mezzogiorno in the past) or to a country that belongs to a monetary union (as the Euro countries nowadays).

For our purposes we may call these two types of political entities "regions".

From what we have discussed it seems that, contrary to what is commonly thought , the governments of such regions are not completely powerless to stimulate the effective demand for the goods and services of the region even if they have to balance their budgets or to run a small primary surplus.

Fiscal policy can be expansionary if government spending and recipient of social transfers have a larger effective marginal propensity to spend in the local economy than those who are taxed. The necessary condition for this type of policy is that the government of the region is really willing to increase taxes on profits and the rich in general which have a high marginal propensity to save. And the regional government should try to spend as much as possible in local goods and services.

III.7 The adjustment of capacity to demand and the tax burden

But in Haavelmo´s short run Keynesian framework, in which investment is taken as given, each increase in the level of output brought about by higher taxes and spending imply an increase in the level of tax burden (tax as a share of gdp).

So we are led to the conclusion that , while such type of fiscal policy could increase the level of regional effective demand , it would be less attractive politically as a means to generate a particular rate of growth of effective demand

But here we come back to Garegnani´s contribution in the Svimez report. Garegnani argues quite persuasively that there is a tendency of capacity to adjust to the trend of effective demand, through the effects of the growth of final demand on induced investment.

When we take this into account we see that a sustained increase in tax revenues and government spending at a certain rate will tend , after a while to stimulate private investment to grow , as the degree of utilization of existing capacity increases. These new investments by their turn will cause through their own usual multiplier effects further increases in induced consumption and income. These increases in induced investment and consumption will no doubt increase tax revenues further and counteract the tendency of the aggregate tax burden T/Y to increase. If we provisionally assume that government spending is the only autonomous component of aggregate demand, it is easy to see that induced investment will tend to grow at least as fast as government spending in order to keep the actual degree of utilization from increasing without limit. If that happens induced consumption will grow at the same rate and thus the whole economy will tend to grow at the same rate as government spending and therefore the ratio between government spending and output and tax revenues as share of gdp will stabilize.That is indeed what happens implicitly in the simple demand led growth model presented by Fabio Petri (200x).

But that will not be all. In fact , as capacity can only adjust to demand and the degree of capacity utilization go back to its normal value if investment grows for a while **faster** than the growth of aggregate demand , over a longer period of time there will be a tendency for the share of investment to gdp to increase. But that will make aggregate demand and output to grow for a while more than government spending. But this means that the share of government expenditure and, paradoxically, the associated balanced budget tax burden will tend in fact to decrease because of the accelerator effect of the higher rate of growth of aggregate demand on induced investment. This result is also implicit in Olivier Allain´s (2015) demand led growth model.

If we remove the strong assumption of government spending being the only autonomous component of demand, things will not be so simple. The trend growth of the economy would tend to a weighted average between the rate of growth of government spending and that of other autonomous expenditures. And the tax burden would tend to increase for longer before starting to fall.

But my point of mentioning these simple analytical exercises is to show that even a continuous expansion of government expenditures financed by taxation could be engineered by a region that was willing to raise taxes progressively and that this, if investment is induced by the growth of final demand as Garegnani argued in 1962 report, does not imply at all an ever rising tax burden.

III.8 Financial balance of payment considerations should not be a problem for regions

But in general would expansionary balanced budget fiscal policies into balance of payments difficulities ? In terms of the extra demand leaking out as imports from outside the region , there would be no problem as the policy as we have seen above has already taken these leakages into account when deciding who to tax and how to spend.

On the other hand, in terms of the financing of balance of payments position with other countries this in principle of course could be a problem for any country that has monetary sovereignity and has to manage its own exchange rates and foreign currency payments.

But for regions, that is either subnational regions or countries as a whole that belong to a monetary union, this, in principle should not be a problem.

In terms of payments of truly foreign currencies originated in this region , it is the central bank that would really in charge of the currency in use that would have to deal with the exchange rates and the payments in foreign currencies of the whole monetary union, no matter where or how they have originated within it.

In terms of payments to other regions belonging to the same monetary union, again it is the central bank of the monetary union that should ensure the stability of the interbank interest rates of all regions of the union and ultimately act as a lender of last resort in its own currency for the private banking system of each and every region.

Therefore a region that does not have a sovereign currency appears to have disadvantages compared to countries that issue their own currency in terms of fiscal policy, as the central bank does not act as lender of last resort to the regional governments.

But on the other hand, the regional government does not seem to have to worry directly about the overall financial balance of payments implications of its expansionary fiscal policies.

IV Final Remarks

That being said I come now to my brief and provisional, but for now necessarily final, remarks**.** From our discussion above it seems that regional governments can in principle always do something to stimulate effective demand in the region, provided that there is a real willingness to tax the rich, unlike what seems to have happened in France quite recently. Financial balance of payment difficulties with other regions or with the rest of the world will only be a problem if the central bank that controls the currency openly sabotages the region, by ceasing to be the lender of last resort for the region´s private banking system. But if and when that happens, as it may have recently occurred in Greece, it will be a clear sign that membership in the monetary union brings only disadvantages and it is time to exit.