Democracy and Development for Mexico

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Introduction

In the last two decades Mexico has lived through two fundamental transformations of its social and economic life. First, it adopted as its central strategy for economic growth a program of economic liberalization, and opened its markets to global international trade. Second, its decades-long transformation toward democracy finally overcame seventy years of uninterrupted rule by the PRI (Institutional Revolutionary Party). Each of these sets of deep changes had promised to bring with it long-sought solutions to the problems of poverty, inequality and a deficient state of rights and rule of law. Instead, the country has experienced low rates of economic growth, continued poverty and unemployment, twelve years of dead lock in Congress, and now faces a painful costly war on drugs.

The need to reevaluate the economic and political thought that orients Mexico’s development arises naturally. The wide spectrum of social classes in Mexico gives rise to conflicting views and aims on development that are enough to block dialogue. Mexico’s problems are not isolated. The global economic crisis also brings up the need for a paradigmatic shift in thinking. How should developed and underdeveloped countries define ‘local’ policies in a global context?

Inevitably, in developing an economic and political synthesis of ideas contributing to a common-good consensus for economic and political development in Mexico, we at the same time address some of the fundamental dilemmas faced by the US and globalization, trying to contribute to a basis for cross-country dialogue.

Economic thinking is still based on paradigms representing beliefs and convictions rather than facts. There are still schools in economics: Neoclassical, Keynesian, Marxist, and the Modern Theory of Economic Growth are almost disjoint discourses. Difference sectors of the population, from policy makers to the common voter hold to different mixes of these seminal ideas. We conduct an objective discussion of these various paradigms and propose a synthesis to construct a single body of ethical economic thought that can serve to formulate policy.

A Single Body of Economic Thought

Neoclassical economics

In Neoclassical Economics, the mathematical jewel is the theory of General Equilibrium. This theory shows how free market exchange between small agents can lead to Pareto efficiency: no economic improvement exists making anyone better off without make someone else worse off.

This result has an ethical level. Given an initial distribution of assets, market exchange produces the best possible result for cooperating through exchange of goods and services. In that sense, participation is free and voluntary. It is unnecessary for a government to intervene for this result to be obtained. This result is very attractive, because if a society is characterized by a broadly equal distribution of wealth, then the market mechanism is a means to coordinate the economic actions and desires of a multitude of people, without the need for government. However, market exchange as such will leave inequality and poverty untouched.

Government itself, when it fails and is characterized by the abuse of power, does not have the ethical level of markets. Thus, for the purpose of clarity, we define four ethical levels,

E0. No ethical level – abuse-of power

E1. Individual rights, Pareto efficiency

E2. Individual rights and pursuit of equality

E3. E2 plus extensive human rights and community values

At ethical level E0, the rich and powerful can force a transfer from the poor. At level E1, individuals live according to their assets and wealth, billionaires and homeless side by side. At level E2 while there are property rights, there are also economic obligations from the rich towards the poor, and society continually restores equality. At this point, ethical level E2 could be external to many people. Ethical level E3 represents a wider, non-economicist, integrated conception of equality, humanity and community.

The fact that people value transferring wealth from the wealthy to the poor can be evidenced in various ways; for example, the existence of progressive taxation, and the existence of millions of nonprofit organizations in the US.

The perfect markets result only holds under stringent conditions that include a) production has diminishing returns, consumption diminishing marginal utility, b) all agents are perfectly informed about the relevant present and future actions of all other agents and c) all agents are too small to engage in strategic economic behavior affecting any market. Without these conditions, the ethical level of market exchange decreases from E1 towards E0.

Is the theory of general perfect market equilibrium an approximate representation of actual market exchange?

There is no text-book answer to this question. One might think there would be an academic consensus as to how closely the main economic theory, as currently taught in the US, matches up to reality – there isn't. Instead there are strong convictions, and these have a strong impact on policy.

However, the facts show most markets are concentrated. In the US, from 1935 to 1992, on average the four largest firms in 459 industries produced 38.4% of all shipments. Similarly, from 1992 to 2002, the 200 largest manufacturing companies accounted for 40% of manufacturing value added. In 2007, the 50 largest US firms by value added produced about 25% of US value added, with only about a 17% and decreasing participation of payroll and employees, reflecting both technology and market power levels. Historically, economic concentration began in the last decade of the 19th Century.

In fact, under the recent wave of globalization a great amount of concentration took place. In 2007 89.3% of global FDI inflows consisted of mergers and acquisitions. By 2008, the world's top 100 non-financial transnational corporations produced 14.1% of global output, rising but still below US levels of concentration.

Since the theory of technological change is based on market power, and automated production involves fixed costs and is therefore subject to increasing returns, perhaps the consensus would be that much of market equilibrium approximates monopolistic competition.

To what extent is overall market structure stable to the dynamics of competition?

This question is again practically absent from economic literature. Nevertheless, the same data we sighted before points to the stability of market concentration. Between 1947 and 1987 the average proportion of shipments of the four largest firms across industrial manufacturing codes only fluctuated between 36.6% and 38.9%.

To what extent are financial markets compatible with competition?

The history of merger waves in the United States shows that financial institutions play major roles in market concentration. Mayer-Foulkes (2011)[1] shows that a well developed financial system can convert a wide class of markets from competitive to monopolistic. The essential mechanism is a change in the ownership structure of production, brought about by the financial system by borrowing from small agents to finance large agents.

The compatibility of the financial system with a competitive market is never even questioned, though the financial system can change the ownership structure of production as just noted. Nevertheless the conviction, powered by strong economic interests, that markets should be left alone to do their work led to the deregulation of financial markets in the US. The result is that financial markets are now an oligopoly with a few main players that can profit from global volatility, and that Americans have entrusted their savings to the largest Casino ever. To whom are free markets, lower taxes, and therefore lower government spending, most attractive than those with market power?

In the two historical episodes of extreme liberalization that the US experienced in the 1920's and from 1982 to the present, income concentration rose and the financial system finally became unstable, leading to the stock market crashes of 1929 and 2008. From 1982 to the present the income share of the top US decile rose from 35%, the approximate level since 1942, to 50%, a figure unparalleled since 1929.

[1] "Vulnerable Markets," available at http://ssrn.com/abstract=1878683.

To what extent is the ethical level E1 associated with market efficiency compatible with the ethical level E2 that values equality?

First, market power is well known not to be Pareto efficient. It in addition introduces a tendency for income to concentrate, therefore producing more and more unequal endowments as time proceeds. Hence market concentration tends to reduce ethical levels from E1 toward E0.

Second, the result of market allocations reproduces the initial distribution of wealth and therefore does not lead to E2 improvements.

Summarizing, while competitive markets are E1- ethical, they are E2- unethical. Concentrated markets tend to be E1-unethical as well.

Is the process of achieving general equilibrium stable in itself?

This takes us – for political reasons – to another school of thought.

Keynes

Keynes proposed that the uncertainty involved investment (which forms about 16% of demand) led to instability in the formation of aggregate equilibrium.

Keynes proposed that government spending could mitigate the business cycle. One of the failings of Keynesian policies was government over-spending through growth and boom periods, an ethical failure. These policies ceased to be successful during the stagflation of the 70’s, and led to the neoclassical counter revolution. A series of papers showed that if agents had rational expectations, there would be no disequilibrium, only unexpected government spending would have an impact. While with regard to government spending and inflation, there may be enough informed agents, particularly large financial agents for this to be true, the necessary hypotheses to rule out disequilibrium – perfect foresight – are again too strong to be realistic. It thus follows that the study of macroeconomic disequilibrium and the role of aggregate demand is a necessary part of economics and economic management.

There are other sources to macroeconomic instability, such as the financial system, its role in creating money, and changing creditworthiness criteria across the business cycle (the Minsky Financial Instability Hypothesis).

Other sources of macroeconomic instability include the negotiation of real wages, which originates with ideas in Marx, to whom we turn next.

Marx

In neoclassical economics and even Keynes, capital and labor are simply factors of production. But for Marx the heart of the matter is people, and how their role as labor or capital transforms them. What seems just the normal state of affairs – a factory worker and a factory owner – for Marx represents the categories of labor and capital taking over people’s lives in alienation. The laborer cannot create his work and is alienated from his own product. The owner so easily becomes unethical.

Marx’s central motivation is to achieve an egalitarian society characterized by aggregate, ethical rationality, humanity and wellbeing. Today´s monopolistic competition, represented by global financial and non-financial transnationals, is not too far away from Marx’s characterization of capital. Unfettered self-interest threatens global sustainability and even human survival. Capital calculates its returns without any other consideration; shapes technology to reduce the participation of labor; influences politics to reduce worker’s rights, regulations, taxes, and so on; shaping competition to gain market power. There is conflict between labor and capital for participation in the benefits of production, that is not fully resolved by competition.

Note that without the inadvertent assumption that perfect competition are stable, the contradictions between the Classics and Marx are less than they would have at first appeared.

Assume that some combination between negotiation and demand and supply determines equilibrium wages, so there need not be full employment, and that wages rise with employment. When wages rise, investment may diminish, causing a reduction in wages and then again a rise in investment. This gives rise to cyclical economic growth in what is known as Goodwin’s cycle model, which can be combined with Solow’s growth model and is conspicuously absent from textbooks. Surely differences between workers and capital are relevant.

The American and French Revolutions inspired a wave of democratic and nationalist revolutions in Europe in 1848. This is known in some countries as the Spring of Nations or Springtime of the Peoples (Merriman, 1996). A parallel can be drawn with the modern day Arab Spring, highlighting the violence with which tyrants defend their status quo. At that time Marx and Engels wrote the Communist Manifesto, underscoring the issues of capitalist injustice and proposing a further, economic dimension to democratic revolution.

Marx's ideals inspired social movements in many countries through the 20th Century and the emergence of socialist regimes. These did not achieve the level of egalitarianism and wellbeing that had been hoped for. The main reasons were that democracy was rejected and that the main proposed tool for solving the problems of capitalism was government, whose ethical level was therefore E0.

While capitalism can produce excesses of greed, this is a human failing that occurs in other circumstances as well. For a government to perform at a higher ethical level it is necessary for the many to be able to put limits on the powerful, an essentially democratic function.

Democratic revolution eventually consolidated in Western Europe, the US, Canada and other neo-European countries, with an ethical level between E0 and E1. These institutional arrangements constitute a steady state in which concentrated economic and political power cannot join forces to produce an autocracy but instead the majorities can put a limit to the abuse of power. The majorities can organize their collective action by means of the rule of law, a series of grassroots organizations, property rights, and enough economic power. Such a democratic balance of power moving beyond an ethical level E0 remains to be achieved in most countries of the world.

Capitalism itself is consistent with and can strengthen both autocracy and democracy. Moreover, democracy in itself is not a guarantee of equity, and can therefore remain at an ethical level E1 or worse. Even so, once democracy is present, the road is open to an increased ethical level of governance.

In fact, democratic transformation is essential to economic growth and development.

Modern Economic Growth

After the Industrial Revolution some countries became developed, while most did not. Development theory, studying this panorama of unequal development, proposed the existence of virtuous and vicious circles capable of retarding economic development in the long-term. The neoclassical counter-revolution simply threw these theories out. The argument was that they were not valid in the globalized world of trade and foreign direct investment being created in the 1980's. The brand new research predicted that liberalization would bring economic growth to all. In fact, divergence continued through the second half of the 20th Century, and through the wave of globalization starting in the 1980's.

As the new theory of economic growth continued to develop, the concepts of human capital and technology were introduced. Econometric estimates concluded that technological differences are the main explanatory fact for income differences. The demographic transition was also highlighted as a fundamental fact and motor of human development (Galor and Weil, 2000), itself driven by the returns to human capital. Urbanization is also a fundamental aspect of modernization, as are institutional arrangements. Even now, few theories explain the possible coexistence of development, underdevelopment and miracle growth under globalization, representing different equilibria that can subsist under and be strengthened by trade and foreign direct investment. Globalization policy is conducted under a competitive understanding of trade and investment, even though we have seen that production is concentrated. In fact, most of FDI has represented a process of market concentration. It is little understood how innovations itself is oligopolized in advanced countries (e.g. Microsoft-Apple), market power being obtained *for* innovation in mature industries rather than *from* innovation. This process might itself be at the heart of underdevelopment, which faces the obstacle of overcoming this level of market power so as to carry out high levels of innovation.

So how does the theory of modern economic growth stand in relation to neoclassical theory, Keynes and Marx? The fundamental processes of development, technological change, human development, urbanization, demographic transition, and institutional change, can be understood by means of the neoclassical paradigm. In effect research on long term development has found the neoclassical paradigm to be an insufficient basis for long-term policy. Moreover, economists concerned with obstacles to development and qualitative transformation considers multiple equilibria that describing these fundamental processes. This again implies that, on their own, market policies do not necessarily lead to development.

As far as economic instability is concerned, globalization faces the huge challenge of how to deal with global business cycles, which first synchronized in when the information technology bubble burst in 2000.

Because capital now stands at a global level and white and blue collar workers compete across nations, it is now essential to make economic and human development pro-poor.

Synthesis

The different strands of economic thought we have examined can be viewed as a single body of knowledge from the following perspective.

Competition in the market economy reaches a balance at a considerable level of concentration of production, which increases as regulation decreases. While mainstream economics provides a methodological point of departure, perfect competition does not provide an adequate paradigm for policy, including trade and development policy. Financial markets in particular can function as instrument of economic concentration. The neoclassical understanding of markets is invalid because it is inconsistent with the full reality of imperfect competition. The recent extremes in economic liberalization have weakened democracy by increasing the power of the elites and by weakening the social and community cohesion that lends strength to majorities and protects minorities. Policies continually improving income distribution are essential for maintaining equity and stable democracies.

With regard to Keynesian economics, instability is an essential concern for economic policy that cannot be assumed away, particularly in a context of global, international synchronization of the business cycle.

With regard to Marxist economics, the determinants of: worker and human capital participation in income, including conflicts of interest, cannot either be assumed away. It is also necessary to understand and fully consider determinants in political economy; community; family; and the quality of life, in order to truly put economic and social arrangements at the service of humanity.

Even at their theoretical best, the ethical level of markets is insufficient for achieving an egalitarian society. This implies that it is indispensable to develop a sufficiently ethical level of governance, at the local, national and global levels, so as to adequately regulate economic activity and distribute its benefits. This is particularly important in the presence of poverty and development traps, and of the global sustainability challenge.

An objective and ethical economics is essential.

Conclusion: A Democratic, Ethical, and Egalitarian Commitment

What does this perspective for a single body of economic thought say for Mexico?

First, economic liberalization is not enough to promote economic growth and development. It needs to be complemented with government policies making technological change, human capital accumulation, urbanization, and economic equality available for all.

Second, democracy is essential for effective economic policy, but difficult to achieve. This is especially so when emerging from an authoritarian status quo. The basic lines of power that have run from top to bottom need to run from the bottom to the top.

Ethical governance, based on a strengthened, participative democracy, is essential for an egalitarian Mexico, and essential for its economic development.