Review
Reviewed Work(s): Capitalists, Workers and Fiscal Policy: A Classical Model of Growth and Distribution by Thomas R. Michl
Review by: John McCombie
Source: *Eastern Economic Journal*, Vol. 38, No. 3 (Summer 2012), pp. 417-420
Published by: Palgrave Macmillan Journals
Stable URL: http://www.jstor.org/stable/23271216
Accessed: 28-02-2018 20:37 UTC

Book Review

Capitalists, Workers and Fiscal Policy: A Classical Model of Growth and Distribution.
By Thomas R. Michl. Harvard University Press, Cambridge, MA, 2009. 296pp.,
$55.00. ISBN: 0674031679.

John McCombie
University of Cambridge

Two pressing concerns for economic public policy are the degree of public debt
resulting from budget deficits and the way public pensions are funded. In this book,
which is a veritable *tour de force*, Thomas Michl brings together the results of a
10-year research project to provide a comprehensive theoretical analysis of how
these issues affect the distribution of income and growth. Although some of the
work has previously been published, the book integrates all the arguments in an
encompassing fashion and comes up with some important conclusions.

   Michl's approach lies within the post-Keynesian tradition, taking its methodology
from the Classical economists through to the works of Joan Robinson, Michal
Kalecki, and particularly Nicholas Kaldor and Luigi Pasinetti. This approach
will be familiar to readers of this journal, although some of the conclusions may
not be. But the book ought to have greater impact. The models are at the same level
of abstraction as the Solow-Swan and Diamond models, and are constructed with
an optimizing framework. As such, they can easily be contrasted directly with
neoclassical models, as is Michl's explicit intention.

   The key to this approach is that issues involving public debt and public pension
provision can be best understood though a methodology that focuses on the class
structure; namely, the division of society into capitalists and workers. It is this
which places it firmly in the Classical/post-Keynesian camp. The core is the Kaldor–
Pasinetti model of distribution and growth, which Michl extends, and for which he
provides some necessary microfoundations. The Kaldor model arose from the need
to provide a mechanism to reconcile the actual and natural rates of growth in
the Harrod-Domar model. The well-known neoclassical solution of Solow and
Swan was to postulate a well-behaved aggregate production function where capital-
labor substitution allowed the capital-output ratio, and hence the actual growth
rate, to vary.

   Kaldor, however, proposed a radically different adjustment mechanism while
maintaining the assumption of a fixed-coefficients production function. Assuming
that the capitalists' propensity to save is greater than that of the workers, changes
in the distribution of income will alter the average savings propensity and can bring the
actual and natural growth rates into equality. The Pasinetti or the Cambridge
theorem, which forms the bedrock of much of Michl's analysis, demonstrates that
the rate of profit equals the growth of the capital stock (or output) divided by the
savings propensity of *only* the capitalists. It is independent of the workers' and the
government's savings rate and independent of technology.

   The Kaldor-Pasinetti models generated a great deal of interest in the 1960s
and merited discussion in textbooks on growth written in the early 1970s. But the
names of the post-Keynesian economists mentioned above, and their models, have
disappeared from the mainstream literature, "like images of Trotsky from a Stalinist
photograph" to use Michl's memorable phase [p. 4]. (This is not to say that
some post-Keynesians have not continued to produce valuable work with this

framework.) One reason for this is that the Kaldor-Pasinetti results could also be generated using an aggregate neoclassical production function complete with the marginal product of distribution. Second, the methodological reductionism of neoclassical economics raises the question — what is so special about the categories of capitalists and workers?

However, Michl makes a compelling case in the Introduction (and also in some insightful comments buried away on pp. 84–86) that the use of a two-class model brings out important insights into the functioning of the capitalist economy that the methodological individualism of neoclassical economics cannot. Yet, his approach has some similarities to the neoclassical approach and thus is able to provide a direct challenge to this framework, as noted above. He extends the Kaldor-Pasinetti model using a one-sector (corn), fixed-coefficients production model. The representative agent model, used separately for both the capitalists and workers, as opposed to the household in neoclassical analysis, provides the microfoundations. Some post-Keynesians will find this approach controversial. Thus, the various models are within a constrained optimization framework where dynamics, temporary equilibria, etc., are carefully examined. Technical change is treated as exogenous and is abstracted from for understandable reasons of tractability, except in the last section of the book that discusses the production function.

Two types of model are initially constructed with different closures. These form the foundation for the subsequent analysis. In the first model, the distribution of income is given exogenously and this determines the growth rate, which is free to vary and can be brought into line with the natural growth rate. The supply of labor is assumed to be perfectly elastic. This is a *capital-constrained growth* model, as long-run growth depends on capitalists' savings. In the short run, firms take the capital stock as given and adjust capacity utilization, depending on the level and growth of effective demand. In the long run, the firms adjust capacity, and monetary policy (with shades of inflation targeting) ensures that it is fully utilized. This is also termed an *endogenous growth* model.

The second class of model postulates that the growth is determined by the *exogenous growth* of the labor force. The distribution of income is now free to adapt so that it is compatible with the natural growth rate. This is the *labor-constrained growth* model. Again, for simplicity, full employment is assumed, although this assumption is not essential. In both models, full-capacity utilization is assumed in equilibrium and when excess capacity occurs, Keynesian adjustment mechanisms come into play, but unlike some post-Keynesian models, growth is not demand constrained in the long run.

In each of the models, two assumptions are made about the capitalists. In the first, the capitalist "agent" is assumed to optimize consumption over time, but cares about his/her offspring. This is tantamount to assuming the capitalists have an infinitely-lived dynasty. The alternative assumption is that the agent lives for one period and optimizes consumption and the value of the legacy. The worker "agent," on the other hand, is assumed to optimize consumption without regard for future generations. Having set out the basic models, Michl then proceeds carefully to analyze the outcome when there is public debt. There is not the space in this review to discuss all the nuances of the models, but some clear general conclusions can be drawn from both the endogenous and exogenous growth models.

In both models, and so regardless of whether growth is capital or labor constrained, public debt arising from budget deficits is at the expense of the workers,

and increases the degree of polarization in wealth. In the capital-constrained model, with Ricardian equivalence, the Cambridge theorem ensures that the growth rate is independent of government saving/dissaving. Where the capitalists optimize over a finite period, they consume more. But even if the capitalists pay all the taxes and their share of capital wealth is reduced, the Cambridge theorem shows that the workers will still be worse off as the rate of growth of output and employment will be reduced. In the labor-constrained model, where the growth rate is exogenously given, the workers are again worse off.

Nevertheless, the results need to be put in context. "[T]he back-of-the-envelope calibrations of the effect of increasing the debt-GDP ratio performed here do not suggest that the effects of the distribution on wealth are very dramatic" [p. 270]. This is an important result because of the importance of the use of fiscal deficits in the short-run stabilization of the economy. From the workers' perspective the conflict between the use of fiscal policy to raise output in the short run and the long-run disadvantages of increased public debt for the workers may not be overly severe.

Michl next uses both the endogenous and exogenous growth models to study the effect of prefunding a public pension system from either a payroll tax or a capital levy. In the endogenous model with a payroll tax, there is an intergenerational effect with the present generation being made worse off compared with future generations. This is unattractive to the extent that the latter are also likely to benefit from higher wages due to technical change. The capital levy has the result that the main costs are born by the capitalists and there are no costs on workers of any generation, as with the payroll tax. The attractions of a capital tax are no longer as clear-cut under the exogenous growth model, but both methods unambiguously raise the welfare of future generations of workers. Michl then goes on to discuss the optimal policy implications.

The last part of the book discusses the production function, but almost as an (important) addendum. Michl assumes that in a putty-putty capital model, the values of the latest vintage of the technical coefficients (namely, labor productivity, capital productivity, and the capital-labor ratio) are determined by the rate of biased technical change from some base-year values. He then shows that although the underlying production function is a fixed-coefficients "fossil" production function, the relationship between labor productivity and the capital-labor ratio can take a form remarkably similar to the Cobb-Douglas production function. A significant difference, however, is that the exponent that is the output elasticity of capital in the orthodox Cobb-Douglas is now a function solely of the rates of biased technical progress.

This result is reminiscent of one of the earliest criticisms of the Cobb-Douglas production function by Horst Mendershausen [1938, p. 153], who showed that the results of estimating a Cobb-Douglas without detrending the data gives an exponent that is simply a function of the trend rates of growth of the various variables. In these circumstances, and more generally, empirically estimating the Cobb-Douglas tells us nothing about the form, or indeed existence, of the production function. Michl [p. 274] argues that his analysis shows that "an alternative parable can be constructed and empirically implemented." It may be better regarded as another nail in the coffin of the aggregate neoclassical production function, along with those provided by the aggregation problems (including the Cambridge capital theory controversies) and the insoluble problem posed by the accounting identity when value data are used.

To conclude: this is an important work of scholarship and will repay careful study by heterodox and mainstream economists alike. It provides an excellent example of the continuing importance of Classical political economy and its policy relevance.

Reference

Mendershausen, Horst. 1938. On the Significance of Professor Douglas' Production Function. *Econometrica*, 6: 143–153.