World Politics, Volume 31, Issue 01, October 1978, pp 108 - 128
DOI: 10.2307/2009969

Review Articles

ECONOMICS, INFLATION, AND THE ROLE OF THE STATE: Political Implications of the McCracken Report

By ROBERT O. KEOHANE*

Towards Full Employment and Price Stability, by Paul McCracken, Guido Carli, Herbert Giersch, Attila Karaosmanoglu, Ryutaro Komiya, Assar Lindbeck, Robert Marjolin, and Robin Matthews. Paris: Organization for Economic Cooperation and Development, 1977, 341 pp., $16.00.

THE 1970's have been difficult years for the world economy, and embarrassing ones for many policy-oriented economists. The combination of inflation and serious recession has troubled governments and angered their citizens. Assertions by economic advisors in the 1960's that the economies of industrialized countries could be "fine-tuned," with steady growth virtually assured, now seem to have been naively optimistic, if not ridiculous. It has become platitudinous to portray the world economy as "in disarray."

What went wrong? To this question there is a bewildering variety of answers, from economists of various persuasions as well as from journalists, politicians, and assorted miscellaneous observers. One set of answers merits particular attention, however, because of its source. In 1975, the Organization of Economic Cooperation and Development (OECD) appointed eight eminent economists, most of whom have held high governmental positions, to prepare a report on "the main policy issues involved in the pursuit, by member countries, of non-inflationary economic growth and high employment levels in the light of the structural changes which have taken place in the recent past" (p. 3). The result, after 18 months' work by members of the group and the OECD Secretariat, is *Towards Full Employment and Price Stability.* This report attempts to explain, and to suggest remedies for, "the recent serious deterioration of economic performance" in the advanced capi-

* I am grateful for comments on earlier drafts of this paper to more than a dozen friends and colleagues. The suggestions of Benjamin J. Cohen, Van Doorn Ooms, and Edward R. Tufte were particularly extensive and valuable. For inspiration and insight, I am most indebted to the late Fred Hirsch. Part of my work on this paper was supported by the Center for Advanced Study in the Behavioral Sciences under National Science Foundation grant BNS-76-22943.

talist countries. It contains a wide-ranging examination of some problems of modern capitalism, and it suggests policy directions in response to those dilemmas.

The report requires evaluation first as explanatory theory. I will argue that its attempt to understand inflation and unemployment in advanced capitalist states is inadequate. This inadequacy is not entirely the result of faults that may exist in its purely economic analysis (which I will leave to economists to criticize), but of a failure seriously to investigate political, social, and psychological influences on macroeconomic outcomes.

The report's authors aspire to prudent policy recommendation as well as to coherent explanation. Thus they have tried to serve the principal function of policy science (prescribing policies to be followed on issues to which technical expertise is relevant) as well as to attain the chief goal of normal science (explaining phenomena in light of a generally accepted theory). In this essay I will question how successfully the report combines these tasks. To what extent are the policy recommendations of these OECD economists derived from the findings of economics *per se*—and to what extent do they stem, instead, from unexamined political or ideological assumptions? Are the analytical accomplishments of economics used to generate sound prescriptions, or do they merely serve (with the reputations of the report's authors) to legitimize an essentially political argument?

Finally, the report raises some larger questions about economics and politics in the capitalist democracies of the OECD. Its recommendations for economic policy suggest the necessity for political change, although the feasibility and consequences of such change are not explored. Indeed, the report goes so far as to imply that, for the sake of economic prosperity, modern democratic states will need to play different political-economic roles in their societies than they have during the last thirty years. They should, according to the report, exert more discipline on their economies while resisting the temptation to confer short-term benefits on their citizens through large-scale public spending. Since the report fails to assess the political feasibility of these recommendations, however, it leaves us with an unresolved analytical question rather than with valid policy answers. Can the conflicts between the conditions for economic growth (as identified by the report) and the practices of modern governments be reconciled without fundamentally altering either democracy or capitalism?

The authors of the McCracken Report may not realize that they have posed this fundamental and perennial question. Indeed, they seem to assume that democracy and capitalism are, and can remain, fully compatible with one another. In view of the fact, however, that Marx and Schumpeter thought otherwise, social scientists would be wise to reexamine this issue under late-20th-century conditions. In this review essay, I make no attempt to suggest an answer. Nor do I ask here about the compatibility of socialism with democracy. Critical analysis of capitalism by no means implies a preference for a specific alternative system—whether socialism, feudalism, or syndicalism. My purpose is to indicate, first, that the evolving relationship between capitalism and democracy remains a source of puzzles that have no satisfactory answers in the present state of our knowledge; and second, that further political and sociological inquiry, as well as economic analysis, will be required if we are to make progress on these questions. Sustained attention to problems of political economy seems essential if some of the most important forces affecting our lives are to be understood.

Explaining Inflation

The report classifies the factors contributing to deteriorating economic performance in the industrialized economies under three headings: shocks; errors of policy; and "changes in basic relationships endogenous to the economic system" (p. 101). The "shocks" include the food and oil price explosions and the collapse of the fixed exchange-rate regime that governed the world's financial relations during the 1960's. According to the report, governments made major errors of policy in 1970-72. Overly expansionary policies, particularly monetary policies, led to the boom of 1972-73 and the acceleration of inflation. These "shocks" and errors are held accountable for most of the deterioration in economic performance:

> A key conclusion we draw from this assessment of the factors underlying recent experience, is that the most important feature was an unusual bunching of unfortunate events unlikely to be repeated on the same scale, the impact of which was compounded by some avoidable errors in economic policy. In other words, the first half of this decade saw an upheaval in the economic affairs of the western industrialized nations that is unlikely to be repeated. . . . To understand recent economic events one need not appeal to theories about the breakdown of traditional economic institutions, the demise of basically market-oriented economic systems, or the crumbling of world order (p. 103).

The authors argue that part of the worsening of performance must be accounted for by more fundamental factors that are of long-term significance. They maintain that the inflation of the mid-1970's was caused to some extent by a rise in popular aspirations, which was a result of a long period of prosperity. As people's expectations adjust to successful economic growth, their demands increase—both their direct demands for goods and services and the demands they make on the political system (p. 156). Confidence in the ability of governments to maintain growth and full employment leads to more aggressive bargaining for wages (p. 104). Organized labor presses for higher wages even at the cost of higher unemployment, since the burden of unemployment is rarely felt by union members (p. 159); and there may be a tendency for real wages "to increase too rapidly," or "to increase relative to output prices," leading to a decline in the profitability of investment and increased unemployment (pp. 159, 161, 170-71). Business firms, in an environment of inflation, raise prices, contributing to a wage-price spiral; commodity prices rise as a consequence of higher current levels of economic activity as well as of hedging and speculation.

Although the report holds that the most fundamental sources of inflation are domestic (p. 237), it considers international factors to be of increasing importance. The collapse of the pegged-rate system led to rapid increases in international official liquidity: from $78.4 billion in 1969 to $183.7 billion in 1973, and $227.4 billion in 1975 (Table A.3, Annex, p. 269). Eighty-five percent of the increase between 1970 and 1973 was accounted for by increases in foreign exchange reserves. The creation of reserves on this scale "contributed to the synchronized boom of 1972-73 and was therefore inflationary" (p. 56).

Because of close financial ties among industrial economies, domestic inflation in one country reinforced inflation in others: "When a large number of countries are simultaneously pursuing expansionary policies, the combined multiplier effect for the system as a whole is stronger than an individual country would expect to be applicable to its own economy if it had acted alone: the OECD area is much less of an open economy than each of its components" (p. 65).

These internal and international factors were not sufficient by themselves, however, to produce the inflation of 1973-74. Governments had compounded the problems by failing to exercise domestic discipline over their money supplies in 1971-72: "It was because the domestic authorities decided not to sterilize—or were unable to sterilize—the large foreign-exchange inflows at the time of the breakdown of the system of pegged exchange rates" that monetary supplies grew so rapidly (pp. 109-10). The report classifies these monetary policies as "avoidable policy errors," but behind those mistakes the authors perceive the more fundamental problem of governmental weakness. Pervading the report is the view that contemporary democratic governments are unwilling to exercise sufficient domestic discipline, particularly monetary discipline (cf. pp. 128, 237). They tend to err on the side of laxity. Massive increases in foreign exchange reserves in 1970-73 therefore constituted a temptation for easy monetary policies that governments were unable to resist.

An examination of these explanations of inflation immediately reveals their political and sociological nature. None of them is essentially endogenous to the *economic* system. Increases in food prices during 1972-73 were partly due to bad weather and poor harvests in much of the world. Policy decisions, made largely for political reasons, contributed to the rise of food prices. These decisions included earlier changes in U.S. and Canadian policies concerning food reserves, and Soviet decisions, in the wake of disappointing harvests, to import feedgrains rather than to reduce livestock herds.[1] The rise in the price of oil in 1973-74 was less a product of market forces than of governmental decisions that were taken for both economic and political reasons. The collapse of the "Bretton Woods Regime" in 1971 may have been inevitable (as the report argues) in light of changing economic conditions; but these conditions themselves in part reflected political and even military actions (such as the Vietnam War). The "avoidable policy errors" of 1970-72 were not principally caused by incompetent economic advice or even inadequate data (although both may have been involved); they were the consequence of political decisions that imparted an inflationary bias to policy.[2] The long-term internal factors on which the report relies—increases in popular aspirations, the development of inflationary expectations, and increased union militance—are hardly "economic" factors. Finally, the interdependent international economic system, which in the view of the authors compounded inflationary problems, is to a great extent the result not only of conscious govern-

[1] See *The Global Political Economy of Food*, special issue of *International Organization*, XXXII (Summer 1978), edited by Raymond Hopkins and Donald J. Puchala.

[2] These political decisions were due not merely to pressures for prosperity from the public, but also to active attempts by leaders to manipulate their economies in such a way as to assure their own reelection. See Edward R. Tufte, *Political Control of the Economy* (Princeton: Princeton University Press 1978). Economists have also explored this question. Prominent examples include William D. Nordhaus, "The Political Business Cycle," *Review of Economics Studies* XLII (April 1975), 169-90; Robert J. Gordon, "The Demand for and Supply of Inflation," *Journal of Law and Economics* (December 1975); Assar Lindbeck, "Business Cycles, Politics and International Economic Dependence," *Skandinaviska Enskilda Banken Quarterly*, II (1975); and Lindbeck, "Stabilization Policy in Open Economies with Endogenous Politicians," *American Economic Review*, Vol. 66 (May 1976).

mental policies, but of the United States' political and economic dominance in the postwar world.

We are thus confronted with the paradox of an "economic" report, written exclusively by economists, that accounts for major macroeconomic phenomena in political and sociological terms. Yet despite its reliance on impressions about sociological, psychological, and political phenomena, the McCracken Report makes no attempt to specify the importance of those phenomena, or even carefully to verify their existence.

Thus the report affirms its authors' belief "that there is much qualitative and impressionistic evidence that the rapid rise in aspirations has been a cause of problems"; but no such evidence is adduced, and no studies of public aspirations and attitudes are cited (p. 156). The report asserts that "increasingly, present-day wage bargaining reflects a determination not only to maintain a certain money wage level but to maintain a certain real wage level and even a certain rate of growth of real wages" (p. 158); but no data are presented to show that unions have become more militant. The report also argues that "rising public emphasis on objectives relating to income distribution, and to the welfare of the populations of developing nations, have altered economic goals and led to pressures for increased state intervention and administrative control in economic affairs" (pp. 102-3). Evidence is not offered for this sweeping assertion; and alternative hypotheses (for instance, to the effect that in pluralist societies, organized groups press for increased state intervention to serve their own interests) are not even mentioned.

Thus the report treats casually the factors that—on its own analysis—are most important in explaining inflation. The authors can trace in detail the processes by which inflation is transmitted from one country to another, or from one sector to another; when they are engaged in this exercise, as in their discussion of the effects of increased liquidity on inflation, they present large amounts of data with great care. Yet in discussing the "causes" of inflation (as identified in their own report), they are quite content to select important variables in a casual, *ad hoc* fashion and to evaluate their significance impressionistically, without benefit of either information or research.

Explaining Recession and Stagnation

The report views the recession of 1974-75 as the result of belated governmental decisions to control inflation.

> There seems little doubt that a substantial recession was intended—and, most of us would argue, necessary to limit the risks of wage explosions

and an accelerating price level—but also little doubt that it turned out to be steeper and deeper than initially expected. There was underestimation of the simultaneous lagged effects of restrictive policies and the external shock of the oil price increase, both acting concurrently in nearly all countries, interacting with—and reinforcing—progressive loss of confidence on the part of both business and consumers (pp. 70-71).

The authors have a more complex explanation for the slowness of the recovery. At the domestic level, they attribute great importance to the development of inflationary expectations as a result of recent experiences. "The expectations of high rates of inflation and pessimism about future growth generated by recent experience have undermined normal, self-correcting forces present in market economies" (pp. 191-92). Indeed, the key reason for the report's recommendation that governments not pursue highly expansionary fiscal and monetary policies is *not* a fear that shortages of labor or capacity would soon appear, but that "despite the existing large margins of spare capacity an overly rapid *rate of increase* in demand would lead to a resurgence of the kind of anticipatory inflationary behavior in commodity and product markets—feeding back on labour markets—which characterized the 1972-73 boom" (p. 183).

The report identifies lack of confidence among businessmen as another major barrier to recovery (p. 163). Businessmen lack confidence, according to the report, because of continuing high rates of unused capacity as well as uncertainties caused by high rates of inflation and currency upheavals. The industrialized countries are in a "catch-22" situation: increasing the pace of economic activity will stimulate inflationary expectations, but failing to do so will keep confidence low, thus perpetuating stagnation. The authors of the report optimistically envisage a "narrow path to growth" that avoids both inflation and stagnation:

There may be at the moment only rather a narrow path around the target recovery track which those responsible for managing demand should be aiming at in order to minimize unemployment and maximize output over the recovery period. The lower limit is set by the need for a rate of expansion sufficient to encourage a recovery in investment, both through spreading overhead costs and improving profit margins, and through creating expectations of the need for additional capacity in the reasonably near future. The upper limit is set by the point at which a rapid increase in aggregate demand would reverse the trend towards a gradual winding-down of inflationary expectations (pp. 189-90).

The two major factors in this analysis—"inflationary expectations" and "lack of confidence"—have their sources as much in social psychology as in economics. The key concept forming the basis for the recommendations of the report—the idea of a "narrow path to growth"—can only be valid if there is a range of activity that will improve confidence more than it will reinforce inflationary expectations. In economic terms, the "activity-elasticity" of confidence must be greater, across some range of activity, than the "activity-elasticity" of inflationary expectations. Otherwise, moderate stimulative policies will worsen inflation more than they will increase investment. Yet despite the vital role of confidence and inflationary expectations in its recommendations, the report makes no attempt to present data on these factors, much less to estimate how they would react to different rates of economic growth.

It is hard to avoid the conclusion that the McCracken Report fails to present a convincing and well-specified explanation of inflation and recession. The fundamental causes cited in the report, which are political, sociological, and psychological, are neither described precisely nor explained. The report does not develop an interdisciplinary analysis; indeed, the authors do not even manifest an awareness that one is needed.

The consequence of this narrowness is to relegate economics to an important but limited role in the explanation of macro-level political-economic events such as inflation. Economics can account for certain inflationary processes: for instance, given the large increases in the world's money supply in 1970-72, macroeconomists are able to explain much of the inflation of 1973-74. But economics alone cannot explain the governmental decisions that led to relaxed monetary policies; nor can it account for the sharp policy reaction to double-digit inflation, or for the variability of that reaction from one country to another. Similarly, an economic analysis can account for the effects of wage increases on prices and profits; but it can hardly explain the wage increases themselves in a heavily unionized economy not suffering from excess demand.[3] Like science generally, economics is at its best in formulating and testing conditional propositions: for instance, if the money

[3] George L. Perry found that economic variables in his models did not successfully predict "wage explosions" in France and Japan in 1968, or in Belgium, Germany, Italy, Sweden, and the United Kingdom in 1970. Neither monetarist nor cost-push theories of inflation yielded strong results. He concluded that "conflict over income shares has been a source of wage inflation," and that "institutions are important and can lead to a wage behavior that would be unpredictable from equations one could normally fit." Perry, "Determinants of Wage Inflation Around the World," *Brookings Papers on Economic Activity* (Washington, D.C. 1975), 403-35. Douglas A. Hibbs, Jr. attributes wage inflation in Britain, France, Italy, and the United States to a considerable extent to trade-union militancy; see Hibbs, "Trade Union Power, Labor Militancy and Wage Inflation: A Comparative Analysis," Center for International Studies, Massachusetts Institute of Technology (April 1977).

supply increases at rate x in period t prices will rise at about rate y in period $t + 1$. The problem is that the key determinants of macroeconomic phenomena such as inflation seem to lie in the non-economic conditions that must be known, or specified, before the economic analysis can take place. Economics is a necessary part of an explanation. But since it relies on a prior specification of social and political conditions—and since policy responses to economic events are also conditioned by social and political, as well as psychological, factors—it can occupy only an intermediary position in any general explanation of inflation, recession, or successful growth in modern economies. A more profound understanding of macroeconomic events will only be achieved by combining economic argument with the analysis of conflicts of interest, and the exercise of power, as they take place within different national societies and in the international political economy.[4]

The McCracken Report as "Policy Science"

Why has the disappointing Western economic performance of this decade not discredited conventional economics as a policy science? After all, economists such as those who produced the McCracken Report were in positions of influence during the early 1970's, when governments made serious policy errors. Many central banks collaborated with governments in following the easy-money policies that have contributed to our present ills.[5] Even the president of the American Economic Association has recently expressed dissatisfaction with the ability of the profession to understand and interpret events.[6] Nevertheless, major governments continue to rely heavily on the advice of professional economists: although past economic policies may have been discredited, economics retains its prestige.

Ironically, the persistence of economics as a policy science depends in large part on the political weakness of economists, and the consequent failure of politicians to follow their advice. Since the ultimate causes of macroeconomic events lie outside the strictly economic sphere,

[4] Recent sociological and historical analyses of the origins of capitalism are suggestive, although their ambitions are only exceeded by the difficulty of carrying out similar undertakings for the contemporary world. See Perry Anderson, *Lineages of the Absolutist State* (London: New Left Books 1974), and Immanuel Wallerstein, *The Modern World-System: Capitalist Agriculture and the Origins of the European World-Economy in the Sixteenth Century* (New York: Academic Press 1974). For a brilliant critique of the latter, see Theda Skocpol, "Wallerstein's World Capitalist System: A Theoretical and Historical Critique," *American Journal of Sociology*, Vol. 82 (March 1977), 1083 ff.

[5] For a discussion of the behavior of the U.S. Federal Reserve Board during 1971-72, see Tufte (fn. 2).

[6] Robert Aaron Gordon, "Rigor and Relevance in a Changing Institutional Setting," *American Economic Review*, Vol. 66 (March 1976).

economic theory cannot be blamed for the most serious malfunctions of the economy. Economists in the OECD countries cannot control the "exogenous shocks" emanating from planned economies and OPEC; nor can they always persuade "endogenous politicians" to follow policies that might be economically optimal in the long run, but politically costly during their own tenure. For the typical political leader, Keynes's aphorism, suitably modified, remains cogent: "In the long run, we will all be out of office." The political weakness of economics means that the theories of its leading practitioners are never exposed to a "pure test," and therefore never risk clear disconfirmation. Paul McCracken and his collaborators can offer their advice without worrying that it might be fully implemented—and found inadequate.

The authors of *Towards Full Employment and Price Stability* seem well aware of their political weakness, and seek to remedy it, in part, by trying to persuade political leaders that they *must* pay more attention to economic constraints. They emphasize the inherent limitations on governmental action in a capitalist economy. It is an illusion, they argue, that governments can create full employment and price stability regardless of how private actors behave: "Governments cannot deliver on an unqualified guarantee of full employment regardless of what is happening to wages and prices" (p. 186). The actions and expectations of individuals, unions, and firms can make governmental power ineffective. The powers of government are limited externally by the effects of other governments' actions as well as by the decisions of private financial markets. Governmental policies that are inconsistent with the expectations and behavior of the public, or with the requirements of international solvency, are likely to fail. Only those policies that pursue the "narrow path to growth," involving considerable unemployment over a period of time, have much prospect of success. Contemporary capitalism implies considerable unemployment in the short run.

This argument is clearly less congenial to mild social democrats or liberals (in the American sense) than it is either to conservatives or radicals. For conservatives, such an analysis is used to reinforce the case for deflationary policies, accepting unemployment in the short term (and perhaps indefinitely) in order to contain inflation and to increase the confidence of businessmen. For radicals, on the other hand, recognition of an unemployment-inflation dilemma suggests that if capitalism cannot solve this problem, it should be scrapped. The contemporary welfare state was viewed by its advocates as a refutation of Marxist theories about the crisis of capitalism. If the managers of the economy were to renounce their commitment to full employment with price stability, one of the key justifications for capitalism (from the viewpoint of the working class) would be undermined. Could one then blame workers for reconsidering their endorsement of political and economic arrangements that had failed to fulfill their expectations?[7]

The economic analysis in the McCracken Report helps us to understand political polarization in Western Europe. The report implies that the social democratic "middle way" is running into a dead end: ambitious welfare states cannot achieve their goals. If people believe this (whether it is true or not), they will feel a greater necessity to choose between Right and Left.[8]

Professor McCracken and his colleagues are not content merely to point out the dilemmas that capitalism poses for democracy. On the contrary, they vigorously argue for pro-capitalist policies, using unexamined conservative assumptions and values to make their point. Although they do not undertake a sophisticated analysis of political and social institutions and processes, they are willing to make policy recommendations that rest on political ideology as well as on economic argument. Thus the report displays a consistent bias against increasing governmental involvement in the economy, particularly through greater public ownership or wage and price controls. It warns against "disproportionate growth of the public sector" (p. 112), and asserts that "excessive reliance on monetary policy for restrictive purposes can introduce a bias against private as distinct from public expenditure" (p. 124). No analysis is offered of the "proper" extent of the public sector. In a critical discussion of price and wage controls, however, the report does invoke what appears to be a form of natural law theory to support its conclusions: "The benefits (of price and incomes policies) obtained in terms of any improvement in the trade-off between inflation and high levels of employment are outweighed by the costs in terms of the distortions introduced into the economy and the diversion of existing social and political institutions *from their natural functions*" (p. 218; emphasis added).

Political theorists with a sense of humor will appreciate this passage, but will regret that the authors did not further elaborate their theory of the "natural functions" of contemporary political and social institutions.

The McCracken Report emphasizes the necessity for governmental

[7] The report recognizes this possibility: "The continuation of excessively high rates of unemployment could call into question the market-oriented economic system" (p. 183).

[8] The authors of *Towards Full Employment and Price Stability* do not seem to recognize this implication of their analysis, which remains largely unexplored in their report.

discipline so that the momentum of capitalism can be restored. National policies should be designed to increase profits, and hence investment. Thus the report suggests that governments might "try to reach a consensus on the need for higher profits and investment among the government, labour, and management in the framework of some form of price and incomes policies" (p. 208). Such a policy implies, as a corollary, that "in a number of countries public expenditure will need to grow less rapidly than it has in recent years" (p. 176). The report expresses the hope that governmental self-restraint will also help to stabilize the international monetary system, despite the pressures to which it has been subjected: "We can only hope that it is the stronger disciplinary element under the present regime that will prevail; that faced with the greater pressure to adjust, countries will find the strength of purpose needed to overcome the greater difficulties involved" (p. 128).

Conservative external policies are considered particularly important since "exchange markets have long memories." Confidence in governmental policies on the part of the international financial community will therefore be essential to a successful domestic economy: "Gaining enough confidence by firm policies—and keeping it—will inevitably require determined and sustained domestic discipline" (p. 237).

The policy science of economics, as manifested in the McCracken Report, assumes that modern democratic governments must act in ways that promote capitalist development. If successful capitalism requires increased profits and private investments, democratic governments should endeavor to increase corporate profits. If international financial markets are important, governments should try hard to gain the confidence of international financiers. The unstated premise in these transitions from positive statements to normative imperatives is the contention that democratic politics must adjust to capitalist economics, rather than vice versa. Capitalism has its own imperatives, according to the report; these cannot be fundamentally altered by political decree. Furthermore, the report assumes that capitalism must be retained. Given the assertion and the assumption, it is a short step to the conclusion that democracy must conform to capitalism—particularly if one has not undertaken an analysis of the political constraints under which modern democratic governments labor. When this conclusion takes on the status of doctrine, and its proponents preach to governments about the "narrow path" to the Heaven of full employment with price stability, policy-oriented economics—whether Keynesian or monetarist—comes to resemble traditional theology. It becomes "neo-orthodox."

Neo-orthodox Economics and the Role of the State

To those used to thinking in terms of Left versus Right, it is surprising how much agreement on contemporary capitalism exists between conservatives and Marxists. Both contend that the capitalist system has an internal dynamic, centered on the accumulation of capital. Crises and drastic political-economic change will result if, over a substantial period of time, the political system fails to create the conditions for capital accumulation.[9] American liberals and their mildly social democratic European counterparts, by contrast, have de-emphasized the dynamics of capitalism, even to the point of being reluctant in some cases to describe contemporary economic systems as "capitalist." Here the conservatives and the Marxists surely have the better part of the argument. Admittedly, the economic role of the state has increased; but private control of the means of production and resources for investment remains predominant in the OECD area. The major economic sources of power rest in private hands. Pressure from business on governments for more favorable policies is continuous, and capital's ability to punish governments for non-cooperation (by failing to invest domestically) is considerable.[10] On the other hand, even Marxists no longer adhere uniformly to the view that OECD governments are merely puppets of coherent ruling classes: they also recognize some degree of governmental autonomy and bargaining power. What conservatives and Marxists have in common, however, is a perception of the limits placed on governmental power by the inner logic of the capitalist system. Policies that threaten capital accumulation cannot be pursued indefinitely without threatening the momentum of capitalism itself.

The internationalization of capital, as reflected in the rapid growth of international financial markets over the past decade, has reinforced the political power of financial interests in modern capitalism. The McCracken Report points out that governments have increasingly relied for financing on private financial markets: borrowing arrangements from other official sources have become "of only moderate importance." As a result,

> Governments are formally unconstrained in their demand for credit to

[9] For two Marxist statements of this thesis, see James O'Connor, *The Fiscal Crisis of the State* (New York: St. Martin's Press 1973), and Claus Offe, "The Theory of the Capitalist State and the Problem of Policy Formation," in Leon N. Lindberg and others, eds., *Stress and Contradiction in Modern Capitalism: Public Policy and the Theory of the State* (Lexington, Mass.: Lexington Books 1975).

[10] For a recent exposition of a similar argument from another disillusioned liberal, see Charles E. Lindblom, *Politics and Markets: The World's Political-Economic Systems* (New York: Basic Books 1977).

finance payments imbalances or to influence exchange-rate movements, as long as they are willing to pay the market rate of interest. So long as the private markets are prepared (and able) to increase their deposits in domestic banking systems in order to satisfy higher loan demand, governments will be able to continue borrowing and official reserves will continue to be created. Consequently, the limits of reserve-creation have become ill-defined and fluid, being set now by the private market's judgment of the credit-worthiness of individual countries rather than by official multilateral evaluation of the needs of the system as a whole. *In this sense, the private market has taken over functions and responsibilities that used to be thought more appropriate to national and international authorities, and the international monetary system has taken on some of the characteristics of a domestic credit system without a central bank.* Today, it is often private institutions which effectively make the crucial decisions regarding access to liquidity and the financing of payments imbalances. The terms attached to this liquidity tend to be those associated with standard banking practices (p. 130; emphasis added).

Dependence of governments on private financial markets—which is to a great extent the result of increases in oil prices—creates additional pressures for conservative economic policies that are deferential to the interests of capital. It becomes more difficult to follow egalitarian polices of income distribution. The report explains that in formulating polices affecting the distribution of income,

> . . . some governments may have underrated the consequence(s) of international interdependence and overrated their scope for independent action. With the improvement in international communications there are increasing signs of an international "demonstration effect" which, coupled with the greater mobility of skilled labour, may lead to a capital flight and a brain drain from countries pursuing equality strenuously with an inadequate growth rate, while in others failure to do enough about inequality creates political unrest (pp. 136-37).

The McCracken Report urges governments to restore the vitality of capitalism by pursuing steady policies promoting relatively slow growth (thus perpetuating high unemployment through the short-to-medium term), and by encouraging increases in rates of profit while restraining rises in real wages. The role of the state is to keep the collective behavior of individuals and firms in the private economy consistent with the dynamics of capitalism—in particular its need for investment, exports, and efficient allocation of resources. There are serious international as well as domestic constraints on the state's ability to redistribute income or promote full employment in the short term. Within a limited sphere, defined largely by the dynamics of capitalism, the state must be active; but it must not transgress its "natural" limits. And within those limits, much of its activity should be directed toward restraining people's impulses: despite public desires for short-term gratification, the state must pursue a steady, long-range plan, imposing in the short run the sacrifices necessary for long-run success.

This conception of the state is quite different from either *laissez-faire* theory or the "pluralist Keynesianism" of the 1950's and 1960's. The OECD economists favor a much more active role for the state than *laissez-faire* theory would have allowed. They do not assume that the economic system is self-equilibrating: the state must play the role of disciplinarian, restraining individuals and firms for their own long-term good. This "disciplinary state" is also quite different from that envisaged by the optimistic Keynesians of the postwar quarter-century. During that period, many officials and policy-oriented economists believed that sustained growth and relatively full employment could be maintained under conditions of only moderate inflation. Indeed, resources remained for increases in social welfare benefits and subsidies to a myriad of organized groups active in pluralistic societies. Politically influential segments of the public regarded the state as a benefactor; elected leaders justified their policies by pointing to the general prosperity. Capitalism did not take care of itself; but government measures required to promote capitalism—such as budget deficits—brought short-term rewards, rather than costs, to members of the public.

The authors of the McCracken Report derive the need for a disciplinary state from their analysis of contemporary capitalism. Since they believe in representative government, they hope for the appearance of *democratic* disciplinary states that will be able to persuade their citizens to accept greater economic restraint, and fewer benefits, than they have enjoyed in the past. These governments would presumably have to be relatively unified and to enjoy substantial legitimacy within their societies. They would also have to obtain the cooperation of business and labor. In the view of the report, governments should regularly discuss target price and wage levels with business and labor organizations; and they should attempt to harness these groups' market power "to promote the public interest in price and growth stability" (p. 216).

Such democratic governments play the role of *deus ex machina* in the McCracken Report. Their existence is posited, not because it has been shown to be plausible on the basis of sophisticated political analysis, but because such governments *must* be possible in order to reconcile capitalism with democracy. Fundamental contradictions between modern capitalism and political democracy have been excluded by assumption.

In Germany, Japan, and perhaps the United States, disciplinary democracies such as those favored by the McCracken Report may be feasible. The wealth, economic vigor, and political stability of these societies may allow them to take their economic medicine without suffering allergic political reactions. But in the weaker economies of the OECD, such as Britain, France, Italy, and several smaller countries, fragile and internally divided governments are in power, and economic difficulties are often severe. Calling for more sacrifices by ordinary people in order to increase profits and thus preserve capitalism hardly constitutes a brilliant rallying cry for a new majority. It is difficult to imagine French socialists, Italian communists, or British trade unionists joining readily in a "consensus on the need for higher profits." The prescriptions offered by the economic doctors of the McCracken Report could bring political death for weak coalition governments before they succeeded in restoring vigor to their economies.

The authors of *Towards Full Employment and Price Stability* are thus better at suggesting dilemmas than in demonstrating that democratic governments can overcome them. Their optimism about the ability of governments to pursue disciplined internal policies is questionable. If they are correct, disciplinary states are necessary for the prosperity of capitalism, but such states are unlikely to be established democratically throughout the OECD area. In some countries, democratic institutions and modern capitalism may be compatible; but there is no guarantee that this will be the case everywhere. In the short run, one can expect a continuation of current patterns of uneven development: strong economies (such as those of Germany, Japan, and the United States) will become stronger relative to the weaker ones (such as those of Britain, France, Italy, and several smaller OECD countries). In the longer run, political upheaval and crisis may occur in several countries.

In its conclusion, the report turns to "the international dimension," and in particular to the role of international coordination of policy in the world economy. Rather than providing a basis for greater optimism, international considerations cloud the picture even further. Close links among financial markets in various countries make the coordination of demand management essential:

> Central banks have little choice today but to act as components of a sort of global Federal Reserve System if they wish to continue to have any

> effective control over macro-economic developments in the world economy. The essential instruments of monetary sovereignty, of course, remain national. But in using them, monetary authorities must act increasingly in terms of the broader interests of the world community as a whole (p. 242).

What basis does the politically informed observer have for believing that the "broader interests of the world community as a whole" can be defined or acted upon by separate national agencies? The "public interest" is difficult enough to agree on domestically. Where there is a hegemonial power in the world economy, it may be able to define the "global interest" unilaterally and impose it, at least to some degree, on other actors. But historical experience does not lead to much confidence that governments can agree on strong international economic regimes where power is dispersed.[11] The attempts of the Carter Administration during 1977 to persuade Germany and Japan to reflate their economies were not conspicuously successful. Under some conditions, effective coordination of international economic policy may be feasible on certain issues; but no studies have yet been published that specify those conditions or that systematically analyze constraints on such coordination. The alleged necessity for international coordination thus raises further questions about the prospects of world capitalism. The OECD economists aver that good economic policy is made at home; but they imply that good policies followed by only a few countries could be thwarted by the foolishness or lack of public spirit of others. Interdependence is more a complication than a remedy for the problems facing world capitalism.

Conclusions

This essay has assessed the McCracken Report on three dimensions: (1) as explanatory theory, accounting for macroeconomic (or political-economic) phenomena such as inflation; (2) as policy science; and (3) as a set of largely implicit recommendations for political arrangements compatible with modern capitalism. As explanatory theory, the report is deficient. It does not carefully explore non-economic sources of inflation and therefore cannot explain its fundamental causes. Worse yet, it resorts to sloppy, impressionistic discussion when treating social, political, and psychological issues. As policy science, it contains a large dose

[11] For discussions, see Charles Kindleberger, *The World in Depression, 1929–1939* (Berkeley: University of California Press 1974), 305-7; and Robert O. Keohane and Joseph S. Nye, *Power and Interdependence: World Politics in Transition* (Boston: Little, Brown 1977), 229-34.

of ideology, which is neither explicitly defended nor critically examined. This pervasive ideology facilitates the many transitions in the report from empirical to normative propositions. Finally, the political recommendations fail to resolve an apparent contradiction between the role of the state required by capitalism and the political conditions in many OECD countries at the present time. There is little reason to believe that the policies recommended are politically feasible in many of the weaker OECD countries. On the contrary, it is more plausible to expect continued unevenness of development within the OECD area; political upheavals in several countries are by no means impossible.

The deficiencies of the McCracken Report as policy science and prescription result more from its authors' political biases than from their disciplinary affiliations. Strictly economic arguments would not have carried them into the thicket of natural law theory or the swamp of conservative ideology. They were taken in those unpromising directions not by economics, but by their unquestioning acceptance of conventional elite assumptions about capitalism and democracy, as well as by their own biases. In this respect, the report illustrates a recurring problem of policy science. To gain the attention and respect of policy makers, analysts must accept their assumptions; but where those assumptions are faulty or problematical, such acceptance eviscerates the analysis. It prevents a systematic exploration of fundamental issues.[12]

The inadequacies of the McCracken Report as explanatory theory derive more directly from the traditions of economics as a field of study. Economics has achieved precision at the cost of narrowing its scope and becoming a somewhat "thin science," lacking contextual richness and depth in dealing with complicated problems.[13] The most sophisticated economists have recognized this problem, and have taken it carefully into account in defining the conditions under which their findings apply.[14] Others, however, have overreached themselves by

[12] This criticism applies as strongly to the attempts of many political scientists to carry out policy analysis as it does to those of economists. For an interesting discussion of related issues, see Lawrence Tribe, "Policy Science: Analysis or Ideology?" *Philosophy and Public Affairs*, II (Fall 1972).

[13] The idea of economics as a "thin science" is meant to contrast with Clifford Geertz's notion of good anthropology as "thick description." See Geertz's essay of that title in his book of essays, *The Interpretation of Cultures* (New York: Basic Books 1973).

[14] Joseph Schumpeter, for instance, comments as follows: "When we succeed in finding a definite causal relation between two phenomena, our problem is solved if the one which plays the 'causal' role is non-economic. We have then accomplished what we, as economists, are capable of in the case in question, and we must give place to other disciplines." Schumpeter, *The Theory of Economic Development: An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle*, trans. by Redvers Opie, 1934; (4th print-

claiming wider relevance for their knowledge than is justified. As I have tried to show, the authors of the McCracken Report have committed this error.

Failure to understand the political economy of contemporary capitalism, however, cannot be laid entirely at the economists' door. Political scientists and sociologists have been equally guilty, by failing to bring their analytical approaches or research methodologies to bear on problems such as inflation and unemployment. Even a conscientious economist, careful to recognize the limits of his or her discipline, will find that political science and sociology have relatively little of value to say about macroeconomic issues.

Signs of change are appearing in this bleak landscape. Tufte's important work has already been cited. Both in Britain and the United States, major projects on the "political economy of inflation" are under way.[15] Both seek to explain inflation by reference to political and sociological, as well as economic, factors. One possible approach, as John Goldthorpe argues, would be to develop a sociological account of inflation "which is not tied, so far as its validity is concerned, to any one particular economic theory." According to Goldthorpe, sociologists must assume that "the economic problem is to an important degree epiphenomenal." Social divisions and antagonisms" will be found "at the root of what are experienced as economic problems."[16]

Fred Hirsch has responded to this "neat counter-thrust in sociological imperialism" by proposing that the social relationships contributing to inflation can themselves be analyzed with the aid of economic principles—particularly the theory of public goods. In Hirsch's view, it is the "constriction of the economic approach to a model of rationality appropriate only to private economic goods" that has narrowed the vision of most economists, thus leaving the most fundamental determinants of inflation rarely discussed and poorly explained. Hirsch therefore favors an integrated theory of inflation that does not accord superior status, *a priori*, to any single explanatory approach.[17]

---

ing, Cambridge: Harvard University Press 1951), 4-5. By contrast, the McCracken Report does not acknowledge the necessity to "give place to other disciplines," which in this context would require serious professional treatment of political, sociological, and historical issues.

[15] Fred Hirsch and John Goldthorpe have edited a volume, *The Political Economy of Inflation* (London: Martin Robertson 1978; Cambridge: Harvard University Press 1978), based on a conference held at Warwick, U.K., in May 1977. Charles Maier and Leon Lindberg are leading a Brookings project on "The Politics and Sociology of Global Inflation," which is to yield a book that may appear in 1979.

[16] Goldthorpe, "The Current Inflation: Towards a Sociological Account," in Hirsch and Goldthorpe (fn. 15), 210-12.

[17] Hirsch, "The Ideological Underlay of Inflation," in Hirsch and Goldthorpe (fn. 15).

Work such as that of Goldthorpe, Hirsch, and Tufte suggests numerous complementary paths of research for historians, political scientists, and sociologists. Changes in the roles of governmental institutions, such as political parties and central banks, should be explored on a comparative historical basis.[18] The behavior of trade unions needs greater attention. We need to understand more fully the calculations of union leaders in pressing for higher wages even when higher prices will result: under what conditions, or in what countries, are they merely trying to keep up with anticipated rates of inflation or with other unions, and when and where do they attempt to change income shares fundamentally? The causes and effects of union militancy should be further investigated.[19] The effects of "corporatist" as opposed to "pluralist" forms of politics may shed light on the effectiveness of macroeconomic policy as well as on questions of "ungovernability."[20] Even more broadly, an investigation of class inequalities and the changing legitimacy of status differentiations in advanced industrial societies could contribute to our understanding of changing power relations that affect inflation and unemployment.[21]

Little systematic work has been done thus far on the *international* political sources of inflation. At one level, international processes can be seen as "transmitting" domestically generated inflation.[22] It would be valuable to have a political analysis of this process of transmission. Under what circumstances are governments more or less inclined to accept "imported inflation"? To what extent is inflation permitted, or limited, by the nature of the international monetary regime—itself largely the product of politics? If the influence of the international regime is "essentially accommodative," what are the reasons?[23]

See also Hirsch's brilliant book, *Social Limits to Growth* (Cambridge: Harvard University Press 1976).

[18] See Charles S. Maier, *Recasting Bourgeois Europe: Stabilization in France, Germany, and Italy in the Decade after World War I* (Princeton: Princeton University Press 1975), and Maier's comments in Lawrence B. Krause and Walter S. Salant, eds., *Worldwide Inflation: Theory and Recent Experience* (Washington, D.C.: The Brookings Institution 1977), 668.

[19] For an interesting effort in this direction, see Hibbs (fn. 3).

[20] See in particular the work of Philippe Schmitter, esp. "Still the Century of Corporatism?" in Frederick B. Pike and Thomas Stritch, eds., *The New Corporatism* (Notre Dame, Ind., and London: University of Notre Dame Press 1974), 85-131, and "Interest Intermediation and Regime Governability in Contemporary Western Europe," paper prepared for the American Political Science Association convention, Washington, September 1977.

[21] For an imaginative exploratory effort, see Goldthorpe (fn. 16).

[22] A recent systematic analysis of international transmission of inflation from an economic viewpoint can be found in Walter S. Salant, "International Transmission of Inflation," in Krause and Salant (fn. 18), 167-227.

[23] Hirsch, "The Ideological Underlay of Inflation" (fn. 17), attributes this accom-

More fundamentally, we should consider the impact of changing international power relations on inflation. The oil "price revolution" of 1973-74 contributed to inflation as well as to unemployment in the advanced industrial countries. The sharp increase in oil prices reflected a decline in the influence of the United States, its allies, and their international oil companies on the structure of oil pricing and the governments of the OPEC countries. Oil is certainly distinctive, if not unique; yet it is quite important enough, in itself, to suggest a strong link between shifts in international power relations on the one hand, and inflation and unemployment on the other. Insofar as economic stagnation is accounted for by increases in the price of oil, we will need to incorporate international political explanations for those increases into our analyses of macroeconomic failure.

Analytical success will not necessarily contribute to more effective governmental policies. Certain problems or contradictions may be fundamental, and thus immune to the remedies of policy science. Critical analysis may even compound the difficulties of elites if it leads to greater public skepticism about the ability of governments to harmonize democracy with capitalism. I am not proposing that political scientists simply replace or join with economists as the new policy wizards.

Combining politics and sociology with economics is likely to contribute to better understanding of macroeconomic behavior. Economic analysis alone is unlikely to yield an adequate explanation of the economic troubles of advanced states. Economists will need more help from their fellow social scientists than they have sought, or been offered, in the past.

---

modative stance to the high priority given by major capitalist governments and the International Monetary Fund to a liberal international economy. Inflation is thus seen, in part, as the price paid for liberalism.