

# CEPAL Review

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## Dialogue on Friedman and Hayek

From the standpoint of  
the periphery

*Raúl Prebisch\**

In all his recent writings, the author has maintained that neoclassical thinking is not only incapable of explaining the structure and operation of capitalism in the periphery, but has a misleading influence on economic policy decisions. In the present article he reverts to these ideas, formulating them as if they came up in the course of a dialogue carried out with followers of the two leading contemporary mentors of the thinking in question; thus he is able to present his points of view with the fluid simplicity in which strictly academic essays are often lacking.

In his opinion, the root cause of the incapacity of neoclassical thinking to interpret peripheral capitalism lies above all in its failure to take into consideration the economic surplus, which is the hub of this system's basic characteristics. It disregards the structural heterogeneity which possibilitates the existence of the surplus; it bypasses the structure and dynamics of power which explain how the surplus is appropriated and shared out; it shuts its eyes to the monetary mechanism of production which allows the surplus to be retained by the upper strata; and it underestimates the waste involved in the ways in which the surplus is currently used.

This shortsighted interpretation of the economic process predisposes neoclassical thinking to propose policy measures which do not succeed in promoting the development of the periphery, which increase and consolidate social inequality and which necessitate the establishment of authoritarian régimes, diametrically at variance with the ideas of democratic liberalism. The necessary transformation of peripheral capitalism, which the author propounds, must preserve the values and institutions of democracy and at the same time ensure vigorous economic development and equitable distribution of its fruits.

\*Director of the CEPAL Review.

## I

### The ideas of Milton Friedman

#### 1. *Their broad outlines*

The swing of the ideological pendulum has now brought neoclassicism freshly to the fore, and to Milton Friedman belongs the merit of being its supreme disseminator. For some time past I had been reading his various studies, without, however, finding his arguments and propositions at all convincing, until the appearance of his book *Free to Choose*, written in collaboration with Mrs. Friedman. I felt drawn to read it, since it presumably constituted a complete presentation of the eminent economist's ideas. I carefully perused its pages, prepared to revise my original opinions, but I must confess that what I read still failed to convince me; rather did it strengthen my frankly critical position.

I recognize, however, that the book is admirable for its limpid clarity and persuasive force: and also for its frequent recourse to concrete illustration and example. I fully understand its power of penetration. Milton Friedman indeed offers us straightforward and simple solutions to the disquieting problems of the economic world: let the forces of the economy have free play, get rid of the restrictions with which enterprises and workers distort their operation, do away with tariff protection and the other hindrances to the international division of labour, and we shall see prosperity and distributive justice springing up on every side. No brakes on economic activity, but the growth of the State does need curbing: a constitutional limit to it must be established. And ceilings must also be set to the monetary expansion which has led to chronic and disruptive inflation.

How can one fail to be captivated by the doctrine of an economist who, over and above the merit referred to, has seen his academic distinction crowned with the award of the Nobel Prize, which has likewise been received by Dr. von Hayek, of whom we shall also be speaking?

The Chicago professor has innumerable

adherents: I have met with many of them in our countries and, above all, among the younger generations who are leaving the United States universities, especially the one in which Milton Friedman lectures. And I have often had a chance to talk with some of them, although not all—they are too numerous for that. Moreover, there are some among them who, deeply convinced of an incontrovertible truth, do not deign even to enter into discussion with any who profess different ideas. But there are others, and no small number to be sure, who do find discussion acceptable, prompted perhaps by certain insidious doubts that arise out of their other readings.

With these latter, too, I frequently have the opportunity of maintaining a dialogue; rather ought I to say the privilege, for dialogue with those who have something to say or to ask I always find stimulating, so much so that I felt it should be reflected in these pages. To reproduce it meticulously would be tedious, since the same arguments crop up again and again; I have therefore tried to extract their essential points and expound them with a measure of orderliness which is not always practicable in the animated course of several conversations. In doing so I have thought it fitting not to confine myself to a strictly academic critique, but to adopt the same diffusive tone that characterizes the above-mentioned book by Milton Friedman.

In presenting the main outlines of the dialogue, I hope to reach the many who are anxious to clarify their own thinking in face of the serious world crisis through which we are passing.

Before embarking upon the discussions, I thought I ought to check the correctness of my interpretation of the content of Milton Friedman's essential thinking, which in my opinion could be summarized as follows:

— The free play of market forces, unimpeded by any interference whatsoever in a fully competitive system, leads to the optimum allocation of the factors of production and to the remuneration of these factors in accordance with their contribution to the production process;  
— For this to happen, an indispensable requisite is to prevent restrictions on free competition. Restrictions which take the form both of

combinations on the part of enterprises to raise prices and combinations on the part of the labour force to increase wages;

— The State must adopt an absolutely *laissez-faire* policy, although it is recognized that something must be done to alleviate the unhappy lot of those who in the play of competition are left at the bottom of the system. Hence the negative tax (to avoid the term subsidy) proposed by Milton Friedman;

— Lastly, inflation must be curbed by regulating the creation of money and preventing the fiscal deficit from which it stems. Hence too the inescapable necessity of limiting the growth of public expenditure.

I must warn readers that I have confined myself to considering the foregoing points without going into other issues with which scientific criticism usually deals, such as the nature and behaviour of the economic agents and certain assumptions relating to the operation of the market.

Without depreciating Milton Friedman's proselytizing effort, I contend that there is no question of new ideas, but of intelligent diffusion of the neoclassical thinking formulated during the second half of the nineteenth century. As far as I myself am concerned, I confess that I too drew sustenance from that doctrine, and taught it as a young university professor in the 1920s. In those days I even translated a little book in Italian by a brilliant disciple of Vilfredo Pareto, which contained a lucid exposition of the theory of general equilibrium.<sup>1</sup>

Well, everything is to be found in those neoclassical texts, including the idea of a subsidy for the poor, and also the proposal to limit the creation of money in circulation which derives from the old and much-debated quantitative theory of money.

In reality, one cannot but be surprised at the dogmatic persistence of certain ideas, such as these in defence of capitalism, as well as others of an opposite tendency which also emerged in the second half of the last century. This intellectual stagnation, at least as regards

<sup>1</sup>I refer to Enrico Barone and his book *Principios de economía*.

development, seems very odd indeed in comparison with the impressive evolution of the other scientific disciplines. What has happened?

I have not the slightest doubt that what lies behind this ideological pertinacity is the sometimes formidable pressure of certain interests. I do not mean that the original ideas underlying the major theories of neoclassicism stemmed from such interests, nor that this accounts for the dogmatic stubbornness of some of their adherents today. In their time the neoclassical theories signified a great stride forward in the scientific area, above all by virtue of their precision and their mathematical elegance; but their perpetuation is largely due to the interplay of interests.

Thus, the theory of the international division of labour, which CEPAL began to criticize in its earliest publications thirty years ago, was entirely responsive to the interests of the great centres and of the upper strata in the Latin American periphery. It seems astonishing that the aim now should be to return to it and, as regards development, put back the clock. Similarly, the play of interests explains the fervour with which certain social groups in our countries cling to Milton Friedman's doctrine, inasmuch as it repudiates the disturbing action of trade-union movements. What is more, in the name of the freedom of the market the doors are opened to the transnational corporations, which are not exactly the most genuine expression of free competition.

This is why the propagation of neoclassicism has at the present moment the impressive backing of the United States television, which, with great skill in driving home its message, broadcasts far and wide over Latin America certain ideologies whose dissemination is not usually inspired by an authentically scientific purpose.

After these initial remarks, we will now embark upon the dialogue. I shall refer to the lack of congruity between the neoclassical theories and the realities of the periphery. As regards their significance in the centres, devastating criticisms exist, and this is not the place to dwell on them. We will first discuss Milton Friedman and then Dr. von Hayek. They could have been taken together, since

there is so much that is coincident in their writings, but I prefer to devote special attention to the latter towards the end of the present article, where I examine in particular his conception of the State and liberty.

## 2. Market laws

First and foremost I want to refer to a passage which condenses Milton Friedman's ideas on the virtues of the market. It draws its inspiration from the work of Adam Smith, the well-spring of neoclassical thinking. Our authors say:

"Adam Smith's flash of genius was his recognition that the prices that emerged from voluntary transactions between buyers and sellers—for short, in a free market—could co-ordinate the activity of millions of people, each seeking his own interest, in such a way as to make everyone better off. It was a startling idea then, and it remains one today, that economic order can emerge as the unintended consequence of the actions of many people, each seeking his own interest.

"The price system works so well, so efficiently, that we are not aware of it most of the time. We never realize how well it functions until it is prevented from functioning, and even then we seldom recognize the source of the trouble".<sup>2</sup>

Later they add:

"Prices perform three functions in organizing economic activity: first, they transmit information; second, they provide an incentive to adopt those methods of production that are least costly and thereby use available resources for the most highly valued purposes; third, they determine who gets how much of the product—the distribution of income. These three functions are closely interrelated".<sup>3</sup>

And on income distribution they make the following comment:

"There has been an attempt to separate this function of the price system—distributing income—from its other functions—transmitting information and providing incentives.

<sup>2</sup>Milton and Rose Friedman, *Free to Choose. A Personal Statement*, Harcourt Brace Jovanovich, New York and London, 1980, pp. 13-14.

<sup>3</sup>*Ibid.*, p. 14.

Much government activity during recent decades in the United States and other countries that rely predominantly on the market has been directed at altering the distribution of income generated by the market in order to produce a different and more equal distribution of income. There is a strong current of opinion pressing for still further steps in this direction".<sup>4</sup>

The perusal of these pages is the starting-point of our dialogue. And in the give-and-take of this dialogue a question that almost always arises is the following:

— *Why do you object to these ideas which Milton Friedman presents so clearly?*

— Before putting forward my objections, let me ask you a question so as to be sure of understanding your interpretation. What do you think is the *modus operandi* of Adam Smith's 'invisible hand', whereby the economic interest of individuals leads the way to solutions which benefit the entire community?

— *To us it is obvious. The individual entrepreneur, impelled by the profit incentive, introduces technical innovations which step up productivity and reduce costs. This has two consequences: in the first place, it induces him to increase production so as to make larger profits; and secondly, in a régime of free competition, other entrepreneurs take pains to do the same. In this way production expands, with the concomitant fall in prices. In other words, to adopt the terms you use in your studies, the fruits of technical progress are transferred to the consumers. And the tendency is to reach a position of equilibrium in which profits disappear, and all that remains is the entrepreneurs' remuneration for the work they do and the risk they have run. In our opinion, this argument is incontrovertible. Don't you think so?*

— Undoubtedly it is from the standpoint of individual enterprises. But let us look at the matter from the angle of the dynamics of overall growth. Would you be prepared to do so?

— *Of course. The whole is the sum of the parts, and if this is so, why should not the tendency to equilibrium be evinced likewise?*

— I think we have come to a very important

point. According to you this tendency is manifested in an increase in supply which brings down prices until they are equal to costs. But the increase in supply is not instantaneous. The production process takes a certain time, from the stage of producing raw material up to the appearance of the finished good on the market. During this process, the purpose of which is to produce future goods, enterprises pay out to the labour force higher incomes than those paid out before, and these constitute the cost of the supply of today's goods. Is that so?

— *Agreed, although that is a highly simplified argument.*

— Very well. I could make it more complicated, if you wish, albeit I do not think it necessary. I will go on. From these incomes that the entrepreneurs pay out in the course of the production process stems consumer demand. In the case of a single enterprise, this demand is spread out thinly over the whole breadth of the market; and it has only a negligible bearing on the final goods produced by the enterprise under consideration. Accordingly, there is no reason why it should affect the tendency towards equilibrium which you postulate. But when, on the other hand, account is taken of the overall growth which characterizes development, it is a different matter.

— *Why should it be different if we are dealing with the sum of the parts, that is, the whole body of enterprises?*

— For a very simple reason. When the whole body of enterprises is concerned, the rise in the incomes that stem from the expanding production in process increases the global demand which extends to all goods, although in widely varying degrees. But obviously the goods in question are not those still in the making, i.e., tomorrow's goods which in due course will result from the production in process, but those which form today's supply. The demand of which we are speaking derives from incomes which, as I have just said, are higher than those contained in the cost of the goods in which the present supply consists.

It is this greater demand that allows the fruits of the productivity increment to be absorbed without a fall in prices.

Bear it in mind that this increased demand finds expression through the creation of money

<sup>4</sup>*Ibid.*, p. 23.

by the bank system, and when the supply of final goods comes on to the market, the enterprises recover not only the money they paid out previously to obtain that supply, but also the additional money with which they pay out the incomes corresponding to the current expansion of the production in process. Accordingly, this additional money reverts to the enterprises in the form of profits, and thus they can appropriate the fruits of increasing productivity.

I would ask you to reflect that we are considering a dynamic phenomenon, a phenomenon of expanding production, which would not occur in a static situation.

— *If we have understood you aright, in this dynamic phenomenon great importance attaches to the expansion of income and demand, with the consequent monetary expansion.*

— Yes, indeed, otherwise price levels could not be maintained. You wouldn't find such an explanation in neoclassical theories. In these theories the phenomenon in question is attributed to market imperfections. Therefore, if prices do not fall in spite of the increase in productivity, the reason is that they are prevented from doing so by monopolistic or oligopolistic combinations on the part of enterprises.

Neoclassical theory does not take into consideration the monetary expansion which accompanies the growth of the production in process. If there were no such expansion, prices would fall as productivity improved. And if they were prevented from falling by the enterprises' combinations, there would be less demand for other goods, and the price decline would exceed the productivity increment; in other words, prices would drop below the cost of production, which would be an untenable position. Believe me, there can be no explanation of this phenomenon if the expansion of income and money in a dynamic situation is disregarded.

However, this neoclassical reasoning, notwithstanding the flaw I have mentioned, has had the merit of making some adherents of neoclassicism in the periphery acknowledge the existence of great disparities in income distribution. Until not long ago they expected that

these disparities would gradually be corrected. Now they recognize that this has not happened, and agree that they do exist, as was pointed out to me by Norberto González.<sup>5</sup> That is a step forward!

All this constitutes one of the major issues discussed in my latest book.<sup>6</sup> I hope that the present very succinct explanation of the phenomenon concerned may have enabled you to appreciate its significance.

— *We find your explanations interesting, and should like to think them over thoroughly. You maintain that the growth of demand in the course of the production in process makes it possible to absorb the supply of final goods without a fall in prices by virtue of the productivity increment. And that enterprises are thus enabled to garner the fruits of productivity in the shape of profits. But this does not preclude the system's tending towards equilibrium, with the consequent elimination of profits in accordance with neoclassical reasoning. Equilibrium might be reached in another way that you have not considered.*

— I am still very far from having considered all the variables. But what would be this other way of reaching equilibrium in the system?

— *You have referred to prices but not to the wages of the labour force. Let us suppose that prices do not fall. But the incentive of larger profits induces enterprises to expand production, for which purpose they need to increase employment. Enterprises thus compete with one another to recruit this additional manpower. And this competition has the virtue of raising wages at the expense of profits. Hence there is a tendency towards equilibrium. Consequently, if it may correctly be asserted that profits do not disappear because prices decline, they will be wiped out in the end by virtue of the increase in remunerations, including the remuneration of entrepreneurs.*

— The argument you put before me is not without its logic. But in real-life conditions in the periphery this is not how things happen. The neoclassical theories take no note of the

<sup>5</sup>Deputy Executive Secretary of CEPAL.

<sup>6</sup>*Capitalismo periférico. Crisis y transformación*, Mexico, Fondo de Cultura Económica, 1981.

social structure of the periphery and the continual changes it undergoes. It is a heterogeneous social structure in which great disparities in productivity are found; while, on the one hand, part of the labour force is employed in jobs using high-productivity techniques, on the other hand there are masses of human beings working at very low levels of productivity. And between the two extremes stretches a wide range of varying techniques and productivities. This structural heterogeneity is of considerable importance, since the labour force which in the dynamics of development is gradually absorbed at high levels of productivity, thanks to capital accumulation, does not improve its income correlatively with that productivity in the free play of market forces. It is prevented from doing so by competition on the part of the broad masses of workers from the lower social strata who are left behind in the lower-productivity layers of technology. A regressive competition takes place which makes it impossible to improve remunerations commensurately with the system's rising productivity. Do you understand this structural phenomenon?

— *We think we understand it, but it does not altogether convince us, for it seems to us that this maladjustment between productivity and wages is a temporary phenomenon which will also tend to disappear. In other words, the system's tendency towards equilibrium will take longer to operate, but will end by gaining the day.*

— Well, I realize that your faith in the neoclassical theory of equilibrium is unassailable. Possibly you trust that a steady increase in capital accumulation will mean that more and more workers are absorbed, at higher and higher rates of pay, owing to the productivity increment, and that all this will come about at the expense of the enterprises' profits. In this way the system will approach its position of equilibrium. It would then be a matter of time...

— *Exactly. Such, in our opinion, is the tendency of the system if it is undisturbed by any form of interference, that is, if the economic system functions unhampered, if market forces operate freely. Therein lies the great significance of neoclassical reasoning. Can you deny it?*

— That would be the case if the dynamics of

the system worked out as you think. But unfortunately this is not what happens. Unfortunately, I say, because if it were to happen, the major problems with which we are faced could be spontaneously resolved. And I should become a Friedmanite!

— *We will continue to follow what you say with close attention, so as to understand so downright a statement.*

### 3. *The dynamics of the economic surplus*

— Well, at this stage in our dialogue I shall introduce the concept of the economic surplus. As a first approximation, which will suffice for the time being, we may assume that the surplus is identifiable with the profits of enterprises. I refer you to my book if you are interested in this point, and will concentrate for now on the economic surplus, which is of profound dynamic significance.

Keep the concept well in mind. The surplus represents that part of successive productivity increments which is not transferred to the labour force because of the heterogeneity of the social structure and because of the regressive competition mentioned above. The owners of the enterprises' means of production appropriate the surplus and retain it thanks to the continuous expansion of demand. The surplus represents a combination of a structural phenomenon and a dynamic phenomenon.

— *I am afraid you are deflecting us from our line of argument. Giving profits a change of name and talking of the surplus does not mean that this latter will not tend to decrease until it disappears as the result of active competition among enterprises.*

— Please have patience with me. Given the nature of the system, the economic surplus must continually increase. That is a dynamic requirement of the system; and it is so because the surplus—and everything pertaining to it—is the source of a major proportion of the enterprises' reproductive capital accumulation. If the system is to develop and employment and productivity are to increase, ceaseless growth of the surplus is indispensable.

The surplus serves, however, not only for accumulation but also for consumption. The fact is that much of it is increasingly allocated to



the privileged consumption of the upper strata of the social structure in whose hands most of the means of production are concentrated. And this is detrimental to the intensity of accumulation. The same thing happens in the case of the excessive siphoning-off of peripheral income by the centres. And this insufficient accumulation has a weakening effect on the absorption of the lower strata; that is, it brings in its train the exclusive tendency of the system.

— *But what you have just said does not necessarily occur. Suppose the surplus were used intensively for accumulation purposes, as well as the income siphoned-off by the centres. In that case, the period of transition towards equilibrium would be much shorter, but equilibrium would be reached in any event.*

— Don't think I am just being obstinate, but this is now how things turn out. To prove it, let me revert to the surplus.

I was speaking earlier of the dynamic necessity of continually increasing the surplus. It increases thanks to constant productivity increments. Now, as the labour force acquires more and more spontaneous ability to share in the fruits of productivity, the growth rate of the surplus and therefore of reproductive capital accumulation is adversely affected.

Thus, let us assume that a time comes when improvements in wages absorb the whole of the productivity increment. But the global surplus would then have attained its highest level. And in accordance with the line of reasoning you have been following, competition among enterprises in order to obtain more and more labour to expand production would compel them to raise wages progressively until in the end the surplus disappeared. The substantiation of neoclassical reasoning would in this way lead to a sort of euthanasia of the surplus.

— *Which shows that the neoclassical postulate of equilibrium is correct, as we were saying.*

— It would be correct if this was indeed the way in which things worked out. But matters follow a very different course. Remember that the surplus is the wellspring of capital accumulation. And if it is gradually reduced by the growing competition among enterprises to obtain additional labour, capital accumulation

will increasingly suffer. The consequences would be very serious, since employment and production would decline, and an economic contraction would supervene.

— *Be it so. But therein might lie the solution of the problem. Contraction and unemployment would bring down wages, which had increased inordinately, to the detriment of accumulation. And this adjustment, however distressful for the time being, has the merit of reducing wages until the surplus is re-established, its dynamics is restored and, therefore, the growth of accumulation and employment is renewed.*

— Well and good. But think what you are arguing. If a contraction is necessary in order to allow the surplus to start growing again, that means that the tendency towards equilibrium which you assume does not in fact operate. It does not operate, because the surplus increases again thanks to the fall in wages. To reach equilibrium it would be essential for the surplus to be wiped out.

— *Allow us a moment's reflection. The fact that the surplus decreases does not necessarily mean that accumulation stops growing. Other patterns are possible; for example, as accumulation on the part of those who appropriated the surplus weakens, it may be the labour force itself that accumulates capital as wages rise. So the dynamics of the system would function without interruption.*

— Agreed. But there is nothing in the spontaneous play of the system which leads the labour force to accumulate instead of the upper strata. In reality it would have to accumulate more in order to correct the exclusive tendency of the system. But this is not how the system works. Do you suppose that enterprises would look on unmoved at the spectacle of their returns falling while wages rose? And assuming that they did so, what would happen if the labour force increased its own consumption instead of accumulating?

— *Obviously the dynamics of the system could not continue to operate. But in that case, the responsibility would have to be laid not on the privileged consumption of the upper strata, but on the consumption of the labour force.*

— That is not the point at issue. It is not a

question of responsibilities, but of the way in which the system functions. The system does not bring about its own transformation. It is what it is...

— *We find so sweeping an assertion disconcerting; we should like you to explain your ideas to us more fully.*

— Once again I assert that the system can function regularly only while the heretogeneity of the social structure, the great disparities in productivity, permit the ceaseless growth of the surplus. If capital accumulation were highly intensive and great dynamism characterized the absorption of the labour force, a time would come when the surplus began to decrease because of competition among enterprises. And then the aforesaid fundamental dynamic requirement would not be fulfilled and contraction would supervene. Which means that the dynamics of the system is founded on social inequality and that this cannot be remedied beyond a certain point.

— *Yet this crisis of the system would appear to occur when reproductive capital accumulation is very vigorous. If it were not, the absorption of labour would necessarily be less intensive, and then the crisis would be warded off.*

— Undoubtedly, the crisis would be warded off if another very important factor did not intervene. But if this were the case, you had better forget about the tendency of the system to reach a position of equilibrium in which the incomes of the factors correspond to their contribution to the production process. Do you acknowledge this?

— *We should like to give thorough consideration to what you have said before expressing an opinion. In the meantime, to what other factor are you referring?*

#### 4. Trade-union power and the crisis of the system

— I am about to explain it. The labour force does not wait until, in the course of time, perhaps a very long time, its redistributive power with respect to the surplus is spontaneously strengthened. The changes in the social structure which occur in the course of development are accompanied by the growth of the

trade-union and political power of the labour force. It is a power that increasingly counterpoises the power of the owners of the means of production to appropriate the surplus. Thus, while it is true that wages do not spontaneously improve correlatively with the productivity increment, owing to the insufficiency of capital accumulation, the improvement in question is secured thanks to the trade-union and political power of the labour force, in so far as the democratization process develops unhampered in the course of the aforesaid structural changes.

— *But in that case it would be the evolution of trade-union and political power which would end, in our opinion, by driving the system to its crisis. Milton Friedman would then be perfectly right in impugning trade-union power. Could you read us the relevant paragraphs?*

— Here they are. This is what they say:

“Unions of highly skilled workers have unquestionably been able to raise the wages of their members; however, people who would in any event be highly paid are in a favourable position to form strong unions. Moreover, the ability of unions to raise the wages of some workers does not mean that universal unionism could raise the wages of all workers. On the contrary, and this is a fundamental source of misunderstanding, *the gains that strong unions win for their members are primarily at the expense of other workers.* (Italicized in the original text.)

“The key to understanding the situation is the most elementary principle of economics: the law of demand—the higher the price of anything, the less of it people will be willing to buy...

“A successful union reduces the number of jobs available of the kind it controls. As a result, some people who would like to get such jobs at the union wage cannot do so. They are forced to look elsewhere. A greater supply of workers for other jobs drives down the wages paid for those jobs. Universal unionization would not alter the situation. It could mean higher wages for the persons who get jobs, along with more unemployment for others. More likely, it would mean strong unions and weak unions, with members of the strong unions getting higher

wages, as they do now, at the expense of members of weak unions."<sup>7</sup>

— As you see, Milton Friedman, like other neoclassicists, abominates trade-union power. He considers it to be an arbitrary power. He takes no account whatever of the arbitrariness of the appropriation of the surplus. In view of this power of appropriation, the labour force resorts to its own redistributive power to secure an ever-larger share in the fruits of the system's increasing productivity. First those that are best organized, as Milton Friedman says, and afterwards the less well organized, availing themselves of their political power.

Milton Friedman condemns trade-union power because, in his opinion, it implies a violation of market laws. He would be right if these laws, in a régime of free competition, were to spread the fruits of increasing productivity. But I have explained that this does not happen: the fruits in question are retained in the guise of the surplus and, in order to share in them, the labour force resorts to its trade-union and political power. What is involved, therefore, is a conflict of powers.

— *This conflict of powers, however, according to your own writings, leads to the social inflation which has increasingly disturbing effects on the system.*

— That is so. I have tried to demonstrate in my theoretical arguments that this happens even if unrestricted competition reigns, and even if State expenditure is marked by the moderation that Milton Friedman recommends.

— *But moderation is hardly a characteristic of the State, and Milton Friedman maintains that this is a primary factor of inflation. I believe you yourself recognize it.*

— I have recognized it for a long time past. The State's responsibility for inflation is heavy, not only when it incurs a chronic deficit, but when it covers all its expenditure with taxation. When expenditure is excessive, as generally happens, taxes tend to become inflationary. This does not occur in those phases of development in which the labour force is still lacking in trade-union and political power. But once it acquires this power, it tries to recoup itself for

the taxes and other burdens that fall on its shoulders. And it does so by pushing up its wages and at the expense of the growth of the economic surplus. So two elements are combined in the system's march towards crisis: the genuine endeavour of the labour force to improve its situation, and its efforts to recoup itself for the taxes and charges that erode its income. You should take it into consideration that there are also taxes and charges which bear directly upon the surplus and whose effects intensify the process I have just explained.

— *We think we are beginning to understand you. According to what you are saying, a twofold pressure is exerted on the surplus: that of the labour force and that of the State through the labour force. And this twofold pressure tends to make for a crisis through its adverse effects on capital accumulation, employment and the global product.*

— I am glad to hear you say this... The pressure is not twofold, however, but threefold. Don't forget the internal pressure on the surplus: the pressure of privileged consumption. If those who appropriate the surplus practised austerity and used their accumulation potential to the utmost, we might talk of twofold pressure. But peripheral capitalism is not characterized by austerity. And the crisis is reached precisely when this threefold pressure prevents the continued growth of accumulation.

— *There is an aspect of the question which is still not clear to us, and which we would ask you to explain. Why does inflation necessarily occur?*

— Simply because when the surplus decreases not only is the profitability of enterprises weakened, but at the same time capital accumulation suffers, the rate of absorption of the labour force slows down and unemployment and a contraction in economic activity supervene. You will realize that so precarious a situation cannot last very long. And the only way out for the enterprises is to raise prices so as to re-establish the dynamics of the surplus, with the consequent capital accumulation, and when the labour force has sufficient trade-union and political power, the rise in prices is followed by a further wage increase. And so in succession. Thus a continuous and ever-widening inflationary spiral is triggered off.

<sup>7</sup>Milton and Rose Friedman, *op. cit.*, pp. 233 and 234.

— *You describe the spiral as ever-widening. Surely if that is true it is due to the tolerance of the monetary authority. That is why we attach great importance to Milton Friedman's recommendation that a strict limit be fixed to the creation of money.*

— Take care! You are treading on very thin ice. In face of the phenomena we are discussing, which are different from those of the past, monetary policy proves not only incapable of containing the inflationary spiral, but also counterproductive. Let me explain why I make so categorical an assertion.

Remember what I said on the expansion of the production in process and of the need to create money in order to pay out the steadily increasing incomes which it entails. Now, if the monetary authority refuses to enlarge the flow of money needed by the enterprises to pay these higher wages, what will the enterprises do in face of trade-union pressure? They cannot help but use part of that flow of money to meet wage increases. And in proceeding thus they must necessarily reduce the amount of money that they ought to have earmarked for the expansion of production. So the rate of production in process slackens or contracts —according to the degree of intensity of the monetary restriction. This is a phenomenon that used not occur before: namely, higher wages and prices on the one hand, and on the other hand a contraction of production and employment. Do you follow me?

— *Your reasoning is clear; but we must take a look at what happens afterwards. Don't you think that in the end unemployment will undermine trade-union and political power, bring down wages and ultimately contain the rise in prices, thus doing away with the spiral?*

— Unless trade-union and political power is repressed by the State I do not think that what you say will happen. But let us assume for a moment that it does; let us suppose the power in question has been dissolved by virtue of the use of force by the State. The monetary authority will then be able to pursue an expansionist policy in order to encourage the recovery of the economy. Unemployment will be remedied and the labour force will renew the struggle to regain former wage levels and later improve upon them. Thus the distribution struggle will

enter upon a new cycle, unless trade-union and political repression continues.

Can the devotees of Milton Friedman go on talking, then, of political liberty and the regulatory efficiency of the market through economic liberty?

— *Are you impugning the market as well?*

— Not at all. A sharp distinction needs to be drawn between the market and the regulatory virtue attributed to it. A close look must be taken at the social structure that lies behind the market, the changes that occur in it, and the play of power relations which is the outcome of all this. The market in itself is an efficacious mechanism, and has great political significance. But we must not expect of the market what it simply cannot give.

As I have already explained, the heterogeneity of the social structure enables the upper strata, chiefly, to appropriate the economic surplus as the production technology of the centres penetrates into the periphery. And since they do not use it as fully as possible for reproductive capital accumulation, in view of their privileged consumption, insufficient accumulation makes it impossible for the lower strata that are relegated to the bottom of the social structure to be absorbed at rising levels of productivity, a state of affairs which is aggravated by the population explosion. In the same connexion I have mentioned the siphoning-off of income by the centres. None of these deficiencies can be spontaneously corrected by the market.

—*You also frequently allude to the hypertrophy of the State that militates against accumulation, a point on which there would seem to be some coincidence of views with Milton Friedman.*

— With a great difference, however. For this hypertrophy is largely due to the dynamic flaws in the system, to its insufficient labour-absorbent capacity and to the arbitrary appropriation of the fruits of technical progress. The State performs a labour-absorbent function, especially in the middle strata. But it performs it badly, because what is involved is partly a spurious absorption of manpower which is really not needed. Moreover, the various social services provided by the State are justified largely by the system's great distribu-

tive disparities. But this is not all. The State is also a reflection of changing power relations, not excluding, of course, the influence of military power on its expenditure. And, furthermore, it is very far from efficient in its operation. Rather than State hypertrophy, we ought to speak of State obesity, which prevents it from fulfilling its functions with briskness and efficiency.

##### 5. *The allocation of resources*

— *Your were saying that the market is in itself an efficacious mechanism. Do you recognize this efficacy with respect to the allocation of productive resources?*

— I would recognize it if the problem of accumulation and that of the great structural disparities in income distribution, which must be distinguished from functional disparities, were resolved outside the market —I stress the words 'outside the market'. The allocation of resources would then be correct, but even so it must be borne in mind that the market inherently lacks not only a social horizon, but also an extensive time horizon, and it must be guided with foresight. This lack of foresight implicit in the play of market laws we are witnessing now in certain dramatic manifestations of the ambivalence of technology. I am referring to the irresponsible exploitation of non-renewable natural resources and to environmental deterioration. Do you think that in this case market laws have led to rational allocation of the factors of production?

— *Of course not; that would be to ignore the evidence of facts itself. But there can be no doubt that the market makes it possible to correct these flaws through the price system, as Milton Friedman has also pointed out.*

— I acknowledge that the price system offers a good solution, always provided that certain essential measures are deliberately adopted. Unquestionably, the rise in petroleum prices will help to restrict consumption and encourage production. But did the market mechanism by any chance make prices rise spontaneously? For several decades the real price of petroleum followed a steady downward trend, although this was a resource approaching exhaustion. How do you account for this serious defect in

the allocation of resources through the play of market laws?

— *The explanation seems very straightforward. Market laws have not operated freely, since competition has been very seriously restricted. A few companies have dominated the market and have fixed unduly low prices.*

— What you say of the serious restrictions on competition is very true. But do you think that if there had been many fully competitive enterprises —as Adam Smith assumed—, that would have caused prices to rise? The oil companies' own interests would have led them to expand production in order to increase their profits; subsequently, competition among them would have caused a price decline at the expense of their profit margins. So that consumption would have increased even more intensively, to the detriment of different sources of energy and with other highly regrettable consequences. Moreover, the producer countries had no power to protect the petroleum that was being squandered.

— *But you do recognize that the rise in prices will have the merit of reducing the rate of consumption, on the one hand, and, on the other hand, encouraging the development of other forms of energy.*

— I recognize it fully. But take it into account that we are not speaking of prices spontaneously established by the operation of the market, but of deliberately determined prices which the producer countries have found themselves compelled to adopt as a countermeasure to the serious situation that had been reached.

Nor did the market show foresight with respect to the deterioration of the environment. The State has had to do what the play of market laws could not. It has had to impose restrictive measures which imply price increases, either because of the larger amount of capital required to prevent pollution, or owing to taxes of which the burden falls on prices. The problem now lies in the need for the social cost of all this to be equitably distributed.

— *The material discussed will give us much food for thought before we can form a definitive opinion. In any case, we should like to maintain this same dialogue with respect to*

*the leaders of neoclassical theory. But you have spoken to us only of Milton Friedman, bypassing so eminent and forceful a neoclassicist as Friedrich von Hayek.*

## II

### The ideas of Friedrich von Hayek

#### 1. *Their broad outlines*

— I was keeping in reserve the consideration of some of his ideas. I think the time has now come to discuss them, although later I shall invite you to revert to Professor Friedman.

I have always followed with interest the prolific writings of Friedrich von Hayek, but on this occasion I shall refer only to a recent article entitled "The democratic ideal and the containment of power",<sup>8</sup> since it represents a good summary of his political ideas, especially his defence of the liberal State in the original sense of the term, and of the principle of personal liberty which is inherent in it.

As in the case of Milton Friedman's thinking, before embarking upon a dialogue, I should like us to reach an understanding as to the essential ideas of Von Hayek.

First and foremost, it seems to me that underlying these ideas, as in the preceding instance, is the fundamental concept of neoclassical theory. Remember that, according to this concept, when a régime of free competition is in full force, the incomes of individuals tend to be equated with their respective contributions to the production process. Such is the ethic underlying neoclassical reasoning. An ethic which is certainly very far from being put into practice in real life.

Given this concept, any restriction of free competition is arbitrary, because it violates the principle of distributive justice, if I may be allowed to use my own terminology. Arbitrary,

too, any State intervention that transfers income from some social groups to others, likewise violating market laws. Nothing whatever must be allowed to interfere with the market's role as supreme regulator of the economy.

As we are apparently in agreement, I will continue with my interpretation, if you have no objections. From what I have just said very important conclusions may be deduced. It is necessary for the Constitution to set limits to the power of the legislative assemblies and also to the power of majorities, in order to avoid the violations aforesaid.

An essentially democratic constitution—in the true meaning of this concept—lays down essential human rights as sacrosanct, and if a legislative majority does not respect them, it lapses into arbitrariness, into the most flagrant violation of the Constitution.

Von Hayek defines arbitrariness as follows: "Arbitrary means... action determined by a particular will unrestrained by a general rule—irrespective of whether this will is the will of one or a majority. It is, therefore, not the agreement of a majority on a particular action, nor even its conformity with a constitution, but only the willingness of a representative body to commit itself to the universal application of a rule which requires the particular action, that can be regarded as evidence that its members regard as just what they decide".<sup>9</sup>

The same thing happens when a majority interferes with market laws. It would be a form of arbitrary action inconsistent with the principles hallowed by the Constitution.

— *Since you have von Hayek's article by you, will you please read us the relevant para-*

<sup>8</sup>"El ideal democrático y la contención del poder", in *Libertad y Leviatán, Estudios Públicos*, No. 1, Santiago, Chile, Centro de Estudios Públicos, December 1980. This article is based on Friedrich von Hayek, *Law, Legislation and Liberty*, Vol. 3, *The Political Order of a Free People*, University of Chicago Press, 1979. Page numbers for quotations therefore refer to the original English text.

<sup>9</sup>Friedrich von Hayek, *op. cit.*, p. 8.

*graphs? What is the source of the Constitution? Who approves it?*

— The Constitution is the expression of a collective consensus, or, in the words of von Hayek, it is on “the consent of the people on which all power and the coherence of the State rest. If that consent approves only of the laying down and enforcement of general rules of just conduct, and nobody is given power to coerce except for the enforcement of these rules (or temporarily during a violent disruption of order by some cataclysm), even the highest constituted power may be limited. Indeed, the claim of Parliament to sovereignty at first meant only that it recognized no other will above it; it only gradually came to mean that it could do whatever it liked—which does not necessarily follow from the first, because the consent on which the unity of the State and therefore the power of any of its organs are founded may only restrain power but not confer positive power to act.

“It is allegiance which creates power and the power thus created extends only so far as it has been extended by the consent of the people. It was because this was forgotten that the sovereignty of law became the same thing as the sovereignty of Parliament. And while the conception of the rule (reign, sovereignty or supremacy) of law presupposes a concept of law defined by the attributes of the rules, not by their source, *today legislatures are no longer so called because they make the laws, but laws are so called because they emanate from legislatures, whatever the form or content of their resolutions.*”<sup>10</sup>

Thus it is not a higher ‘will’ that limits power—von Hayek insists—but rather the consent of the people.

That consent, on which the Constitution is based, has to limit the power of the legislative assemblies *vis-à-vis* the laws of the market. Thus, “all pressure on government to make it use its coercive powers to benefit particular groups is harmful to the generality”.

Let us see what these pressures consist of, especially, the pressure that can be exerted by large firms or corporations.

This pressure, however, is not comparable to the pressure of organized labour groups “which in most countries have been authorized by law or jurisdiction to use coercion to gain support for their policies. By conferring, for supposedly ‘social reasons’, on the trade unions unique privileges, which hardly government itself enjoys, organizations of workers have been enabled to exploit other workers by altogether depriving them of the opportunity of good employment. Though this fact is conventionally still ignored, the chief power of the trade unions rests today entirely on their being allowed to use power to prevent other workers from doing work they would wish to do”.<sup>11</sup>

But it is not only a question of restrictions on competition authorized by the legislative assemblies. There is also direct government interference with the distribution of income. On this subject, the distinguished professor says the following:

“So long as it is legitimate for government to use force to effect a redistribution of material benefits—and this is the heart of socialism—there can be no curb on the rapacious instincts of all groups who want more for themselves. Once politics becomes a tug-of-war for shares in the income pie, decent government is impossible. This requires that all use of coercion to assure a certain income to particular groups (beyond a flat minimum for all who cannot earn more in the market) be outlawed as immoral and strictly anti-social”.<sup>12</sup>

And further on he adds: “...once we give licence to the politicians to interfere in the spontaneous order of the market for the benefit of particular groups, they cannot deny such concessions to any group on which their support depends”, which leads to “an ever-growing domination over the economic process by politics”.<sup>13</sup>

And, again: “[giving] general licence to politicians to grant special benefits to those whose support they need still must destroy that self-forming order of the market which serves the general good, and replace it by a forcibly

<sup>10</sup>*Ibid.*, pp. 3-4. (Italics in the original text.)

<sup>11</sup>*Ibid.*, p. 144.

<sup>12</sup>*Ibid.*, p. 150.

<sup>13</sup>*Ibid.*, p. 151.

imposed order determined by some arbitrary human will".<sup>14</sup>

From all this we may draw a definitive and emphatic conclusion: "In its present unlimited form, democracy has today largely lost the capacity of serving as a protection against arbitrary power. It has ceased to be a safeguard of personal liberty, a restraint on the abuse of governmental power which it was hoped it would prove to be when it was naively believed that, when all power was made subject to democratic control, all the other restraints on governmental power could be dispensed with. It has, on the contrary, become the main cause of a progressive and accelerating increase of the power and weight of the administrative machine".<sup>15</sup>

All this leads to the progressive disintegration of the system and to "resort in despair to some type of dictatorial régime".<sup>16</sup>

## 2. *The arbitrariness of the surplus and the arbitrariness of redistribution*

— I will stop at this point to ask you: What do you think of all this?

— *We think Friedrich von Hayek's ideas are very logical, provided one starts from the premise you mentioned at the beginning, namely, the supreme regulatory role of the laws of the market. As we have just seen, if those laws are violated, the inevitable result is government by force. It is interesting to note that although you do not accept that premise concerning the laws of the market in your critique of peripheral capitalism, you arrive at a similar political conclusion. Are we right?*

— We will comment on the last point later. With regard to your first remark, your interpretation is correct. If we admit the validity of that premise, everything else falls into place. The problem is that that premise has absolutely no validity, however, as I will try to show when I refer to Friedman's thinking.

It is worthwhile stressing this, as it is very important. Both authors hold that it is arbitrary to interfere with the laws of the market. But

they refuse to recognize the existence of the economic surplus and the fact of its appropriation, particularly by those who have concentrated in their hands most of the means of production. In the light of neoclassical reasoning, both this appropriation and the fact that the surplus does not tend to be eliminated by the play of competition would be arbitrary.

According to this interpretation of mine, the arbitrariness does not lie in the departures from the system, in the violation of the laws of the market, but rather is intrinsic in the system itself, in a system whose dynamics depend fundamentally on the need for the surplus to grow constantly instead of on that euthanasia which would occur if neoclassical reasoning were carried to its conclusion.

— *How do you explain the fact that this phenomenon is not taken into account?*

— In my long life I have seen brilliant men hold stubbornly to certain dogmas. I would say that the more brilliant they are, the more stubbornly they hold to their dogmas, and the more extreme their dialectic becomes as they seek to assert the absolute truth they believe they possess. Please do not forget, also, that the so-called science of economics is very new by comparison with other scientific disciplines. But let us get back to the main thread of our discussion.

— *We think that is a very good idea. We said a moment ago that, despite your fundamental differences with Friedrich von Hayek, you reach a similar conclusion when you hold that, if we have understood you correctly, in the advanced stage of the structural changes in the system, there is a tendency towards the dictatorial use of force.*

— That is indeed the case. But please wait a moment before we come to this extremely significant point. I would like to stress a great difference between the reasoning of our neoclassical author and my own, as I stopped being a neoclassicist a long time ago.

According to von Hayek, the disturbances in the system, as regards the distribution of income, are due to the fact that there are social groups that interfere with the play of the laws of the market in order to appropriate for themselves what other groups have obtained in line with their contribution to the productive

<sup>14</sup>*Ibid.*, p. 151.

<sup>15</sup>*Ibid.*, p. 138.

<sup>16</sup>*Ibid.*, p. 152.



process. For me, however, the problem begins earlier, that is to say, when certain social groups appropriate for themselves the fruits of the technical progress that should have been distributed among all according to their productive contribution.

— *If we have understood you correctly, you hold that there are privileged social groups that appropriate for themselves the fruits of the productivity of the system and prevent those fruits from being distributed according to the rationale of the laws of the market that the neoclassical economists assume to exist.*

— Your interpretation could not be more correct. And at the risk of repeating myself, I might say that the arbitrariness of that primary appropriation is followed by the arbitrariness of redistribution in the play of power relations. And since there is no regulating principle whatsoever in this struggle for distribution the system thus moves towards its crisis.

— *We would like you to explain us, however, why this trend towards crisis has not occurred before in the development of peripheral capitalism.*

— I will try to do so. The tendency to move towards crisis is a consequence of the structural changes that occur in the system as the technology of the centres is adopted. There are structural phases in which the redistributive power of the labour force is either non-existent or very weak because the process of democratization—I am talking about genuine, not apparent or manipulated democratization—is only incipient. Well, as this process continues, the labour force acquires the power to share the successive increments of productivity and to compensate itself for taxes and other burdens imposed by a State that is running to fat, for the reasons I have explained. And when this increasingly antagonistic struggle makes it impossible to continue meeting the dynamic requirement that the surplus must grow constantly, this gives rise to the crisis and the inflationary spiral that upsets the system.

### 3. Apparent analogies and great differences

— *That is exactly what we were saying: you reach a conclusion similar to von Hayek's.*

— Similar, yes, but for a very different reason.

Because for von Hayek the crisis is due in the final analysis to the fact that abuse by the democratic majority has violated the laws of the market. Whereas I hold that the crisis is due to a system that is vitiated from the beginning because it does not allow the laws of the market to play the redistributive role attributed to them.

— *Now we understand. But what would be the consequences of two concepts that, despite their being so different, and so divergent in their significance, would seem to lead inevitably to the same outcome?*

— I will try to answer that very important question. For von Hayek and Friedman, there must be a constitutional limitation to prevent restrictions on competition, whether from combinations of enterprises or from trade unions, and at the same time to prevent arbitrary transfers of income between the social groups. In contrast, I propose a transformation in the system of accumulation and distribution.

— *Before you expand on that, please allow me a slight digression. You have not commented on a statement made by von Hayek (and also by Friedman) to the effect that the trade unions, by arbitrarily setting wages, prevent the employment of other workers.*

— This idea is being widely disseminated nowadays in certain articles written by neoclassicists. According to them, unemployment is to be explained by the artificial increase in wages achieved by the trade unions. These wages should really be as low as is necessary in order to achieve a balance between the supply and demand of labour. Let us suppose that is so. Nevertheless, this reasoning leaves out a very important matter. If wages go down, according to the laws of the market prices would have to go down as well. But I believe I have shown you that prices do not go down, but rather that the surplus goes up. These phenomena cannot be explained without taking into account the social structure.

— *You were referring to certain constitutional limitations which, according to von Hayek, should ensure the free play of the laws of the market. What would those limitations be?*

— First of all, limitations to prevent combinations of enterprises and workers. Then, limita-

tions to prevent State expenditures from going above a certain proportion of the global product, in order to check the arbitrary transfer of income decided upon by the parliamentary majorities. And, finally, a negative tax or subsidy to alleviate the fate of those who have very low incomes, either because of their small contribution to the productive process or for some other morally acceptable reason.

— *These proposals are perfectly understandable in the light of neoclassical principles. But since we are beginning to follow your train of thought, we assume you have objections to them.*

— I most certainly do. We are still leaving out the structural surplus. Please recall what I said before. The fact that prices do not go down as productivity goes up is not due to combinations of enterprises, but rather to the mechanism of appropriation of the surplus that prevents the fruits of productivity obtained through competition from being spread throughout the society. Combinations change the internal distribution of the surplus, but do not affect the amount of surplus there is.

The dissolution of trade-union power, however, would bring about an increase in the rate of growth of the surplus. If this phenomenon were accompanied by a spontaneous process of reduction in prices as long as remunerations were not increased, we would have no objection. But we know very well that the system does not work that way, at all.

It is true that accumulation could increase if the surplus increased this way as a result of the elimination of trade-union power or the limitation of State expenditure. And that could have a positive effect in certain phases of development. But if, on the contrary, the surplus increased in this way was devoted to consumption, what would happen then?

— *That is just what we wanted to say. In order for the limitations advocated by our neoclassical authors to have positive dynamic effects, it would also be necessary to limit privileged consumption. What are your views on this point?*

#### 4. The social use of the surplus

— Now I see that you are on the right track. It is

necessary to limit privileged consumption in order to increase accumulation and stimulate the absorption capacity of the system: this would be the best way to achieve a dynamic distribution of income. But clearly, there would also have to be a certain direct redistribution of income, particularly at the expense of privileged consumption: to use Dr. Friedman's term, a negative tax.

All this, however, cannot be conceived as a series of piecemeal and disconnected measures. They have to be part of a rational concept of the social use of the surplus.

— *We must interrupt you in order to ask a very important question. Will it be necessary to transfer to the State the ownership and management of the means of production in order to achieve the purpose you have just stated?*

— No, absolutely not. This view has quite wrongly been attributed to me. It is the very enterprises from which the surplus comes which should distribute it, through accumulation, redistributive improvements and State expenditure, by compressing that part of the surplus that is devoted to excessive consumption or excessive transfers abroad.

— *Are you proposing that the enterprises should perform this very important role at their own discretion?*

— Not at all. The enterprises would merely be responsible for implementing the social use of the surplus. The decision must come from a broad consensus, a consensus enshrined in the Constitution in order to prevent the enterprises from disposing arbitrarily of the surplus. As you see, my view on the constitutional consensus is based on Friedrich von Hayek's idea: a consensus establishing the general principles that will guide the social use of the surplus. The legislative majorities would have to follow these guidelines in their specific decisions, but they would not be able to change them. Any change would have to be made through a constitutional amendment. I have tried to explain all this in my book, so please do not ask me to go into it in depth now.

— *Very well, but let us mention one point that has great political significance. You speak of a consensus enshrined in the Constitution and say that you are inspired by von Hayek in this.*

### 5. *Changes in the structure of power*

— There is, of course, a coincidence of views as to the procedure, but not as to the objective. My objective is fundamentally different from that proposed by von Hayek. In order to achieve what this economist wants, it would be necessary to make a regressive change in the structure of power that would clearly be detrimental to the labour force. To provide for the social use of the surplus, on the other hand, it is necessary to make a progressive change in the structure of power that is detrimental to those who appropriate and retain a considerable proportion of the surplus.

— *You speak of a regressive change in the structure of power that is detrimental to workers in the broadest sense. How is this related with your views about the use of force to deal with the crisis of the system?*

— Actually, it amounts to two different ways of saying the same thing. I said before that when the workers have acquired great trade-union and political power, the crisis cannot be solved with a restrictive monetary policy. A rise in prices cannot be avoided, only mitigated at best, and there is a contraction of the economy and unemployment. The force is used to overcome the trade-union and political power of the workers. I call this a regressive change in the structure of power.

— *This would seem to lead to a very serious political outcome. Is there not some alternative to the use of force in order to induce workers to accept the unrestricted rule of the laws of the market?*

— Well, I must say quite frankly that I have reached the conclusion that there is no such alternative. Would you be willing to advise the workers not to use their redistributive power in order to ensure the continued growth of the economic surplus in the hands of the upper strata?

— *Well, we might feel able to give this advice if at the same time a limit was placed on privileged consumption, in order to increase accumulation and improve distribution. What would you say to that?*

— You must bear in mind that this limitation of consumption, in order to be effective, would require the progressive change in the structure

of power which I mentioned before. What happens, however, is that when force is used to solve the crisis of the system, trade-union and political power is suppressed without any measures being taken to limit privileged consumption. On the contrary, trade-union and political power is suppressed in order to restore the dynamics of the surplus. And this gives new impetus to privileged consumption.

— *Is it not conceivable that the upper strata would spontaneously, under the protection of a régime of force, limit their consumption and increase their coefficient of accumulation without any coercion at all?*

— Yes, it is conceivable, as you say. If that were the case, the dynamic capacity of the system would improve, although at the great social and political cost implicit in a régime of force. Please take a look at the facts, at the specific cases, and see what happens in such instances.

— *So you do not deny the possibility that the restoration of the dynamic capacity of the surplus might allow for the achievement of a satisfactory rate of development and the elimination of inflation under a régime of force?*

— I do not deny it. For that to happen, there would have to be a coherent and systematic policy, and the conclusive proof that such a policy was being followed would be the growth of the rate of accumulation at the expense of privileged consumption in order to achieve a progressive improvement of employment and distribution. I also believe that it would be possible to contain social inflation.

— *But could those and other dynamic objectives really be achieved? We would like your frank opinion.*

— I believe they could, if that were really the objective. Looking at the facts, however, I am convinced that once the dynamics of the surplus is restored to the benefit of the upper strata and to the detriment of the labour force, inflation becomes tolerable once again to the dominant social groups, regardless of whether it comes from internal or external factors. And if to that we add the fact that there is no decisive stimulus to the economy and in some cases there is an increase in unemployment, doesn't it seem to you that the use of force will inevit-

ably bring about tremendous frustration? A tremendous feeling of frustration among all those who have sincerely believed in the effectiveness of the laws of the market, but not among those who have increased their economic power extraordinarily: they praise the freedom they have enjoyed to do so, which is incompatible with the freedom of others.

This is what neither Friedman nor von Hayek recognize. They do not want to acknowledge that neoclassical principles can only be applied under a régime of force. Do you accept the idea that economic freedom can be imposed by suppressing political freedom? Will there be a constitutional consensus for that?

### III

## Back to Dr. Friedman

#### 1. *Protection and subsidy*

— In order to keep the sequence of our dialogue, I had suggested we comment on von Hayek's ideas and then pick up the thread again. Now is the time to do that.

We at CEPAL have always been concerned about a certain latent tendency on the periphery towards external imbalance. It is true that Dr. Friedman does not particularly consider the imbalance at the periphery, but rather that which occasionally occurs in the centres. He feels, however, that this is no reason to resort to measures involving intervention.

He holds that the commercial imbalance brought about by external factors is corrected spontaneously by the play of the rates of exchange. I have his book here, and to avoid confusion, let me read the relevant paragraphs. He says the following:

"Suppose that, to begin with, 360 yen equal a dollar. At this exchange rate, the actual rate of exchange for many years, suppose that the Japanese can produce and sell everything for fewer dollars than we can in the United States: TV sets, automobiles, steel, and even soybeans, wheat, milk and ice-cream. If we had free international trade, we would try to buy all our goods from Japan. This would seem to be the extreme horror story of the kind depicted by defenders of tariffs —we would be flooded with Japanese goods and could sell them nothing.

"Before throwing up your hands in horror, carry the analysis one step further. How would

we pay the Japanese? We would offer them dollar bills. What would they do with the dollar bills? We have assumed that at 360 yen to the dollar everything is cheaper in Japan, so there is nothing in the United States market that they would want to buy. If the Japanese exporters were willing to burn or bury the dollar bills, that would be wonderful for us. We would get all kinds of goods for green pieces of paper that we can produce in great abundance and very cheaply. We would have the most marvelous export industry conceivable.

"Of course, the Japanese would not in fact sell us useful goods in order to get useless pieces of paper to bury or burn. Like us, they want to get something real in return for their work. If all goods were cheaper in Japan than in the United States at 360 yen to the dollar, the exporters would try to get rid of their dollars, would try to sell them for 360 yen to the dollar in order to buy the cheaper Japanese goods. But who would be willing to buy the dollars? What is true for the Japanese exporter is true for everyone in Japan. No one will be willing to give 360 yen in exchange for one dollar if 360 yen will buy more of everything in Japan than one dollar will buy in the United States. The exporters, on discovering that no one will buy their dollars at 360 yen, will offer to take fewer yen for a dollar. The price of the dollar in terms of yen will go down —to 300 yen for a dollar, or 250 yen, or 200 yen. Put the other way around, it will take more and more dollars to buy a given number of Japanese yen. Japanese goods are priced in yen, so their price in dollars will go

up. Conversely, United States goods are priced in dollars, so the more dollars the Japanese get for a given number of yen, the cheaper United States goods become to the Japanese in terms of yen.

"The price of the dollar in terms of yen would fall until, on the average, the dollar value of goods that the Japanese buy from the United States roughly equaled the dollar value of goods that the United States buys from Japan. At that price everybody who wanted to buy yen for dollars would find someone who was willing to sell him yen for dollars."<sup>17</sup>

— *Here again, we have a reasoning that is very attractive because of its simplicity. The market solves the imbalance by itself without there being any need for State intervention. Now we would like to know what you think about it.*

— In looking at this question, let us take as our point of departure several indisputable facts; all connected with the periphery. First, economic development brings with it a heavy growth of demand, particularly for industrial goods. Second, primary exports from the periphery are inadequate to cover the cost of meeting this demand, save in exceptional cases: that is why industrialization is an inevitable requirement of development. And, third, industrialization is also essential to absorb the great mass of the labour force that cannot be employed in primary production, either for domestic consumption or for export. And the more technology penetrates into primary production, the greater the need for industrialization will be.

If you do not object to our using this point of departure, let us continue our argument.

To satisfy this demand, there are only two possibilities and a combination of the two: one of them consists of developing domestic production of industrial goods with technologies that are already available to us and exporting part of these goods in order to import other industrial goods that we cannot manufacture because of the sophisticated technology involved or because we do not have the natural resources necessary to do so. This would be industrialization with extensive opening up to the outside.

The other possibility would be to stress production for the domestic market through import substitution rather than industrial exports. Which would you prefer?

— *We think the first possibility would be better, because it would allow us to gain the well-recognized advantages of trade.*

— So do I: I agree with you and we will come back to that later. For the moment, I would like to mention the differences between the industrial costs of the centre and those of the periphery that result from the technical and economic superiority of the centre, on which I will also expand in a while.

This is also an indisputable fact. The higher costs of industrialization in the periphery represent a considerable obstacle, whether it is a question of exporting industrial goods in competition with goods from the centres, or of producing them domestically also in competition with goods from the centres. Do you agree?

— *Of course. These facts exist independently of any theoretical consideration. Please continue.*

— Very well, for Dr. Friedman the solution is right at hand. If, as the result of higher costs, exports are lower and imports are higher than they should be and there is an imbalance, this will correct itself because it will bring about monetary devaluation, which will lower the cost of exports and raise the cost of imports without any need for State intervention.

— *That would undoubtedly be a logical consequence of Friedman's theory.*

— If we think it over, we can see that the immediate effects of devaluation would be similar to the effects of protection or subsidy, so why should we object to protection in order to make possible domestic production by defending it from excessive imports? And why object to a subsidy that would be equivalent to protection in order to promote exports? Frankly, I prefer the latter and I am going to explain why. I suspect, however, that you are inclined to agree with Dr. Friedman.

— *We will reserve judgement until we hear your argument.*

— Here are my objections. Devaluation not only cheapens exports of industrial goods that are not competitive, it also cheapens primary

<sup>17</sup>Milton and Rose Friedman, *op. cit.*, pp. 41-43.

exports that *are* competitive. This means a loss of income for the country concerned, particularly in the case of very sensitive products, where the increased supply would be accompanied by a drop in prices that would wholly or partially wipe out the increased value of exports, or even exceed it.

— *Let us interrupt for a moment. The proponents of devaluation suggest a tax on exports of competitive goods in order to avoid this adverse effect. Non-competitive goods, however, would be favoured by devaluation.*

— You must consider, however, that the tax would not be a spontaneous result of the play of the market, but rather a deliberate State action. It would be reverse protection, so to speak. I will continue stating my objections.

Devaluation means changing the entire internal system of costs and prices; protection, on the other hand, would have much more limited effects internally, and the lower the coefficient of foreign trade with respect to the global product of the economy, the more limited these effects would be.

Finally, this disturbance of costs and prices is translated into an overall increase in prices, bringing with it the need for a series of readjustments, which will eventually bring about another devaluation because the short-term effects I mentioned will have been lost.

— *Then you are against devaluation.*

— Let me explain. I am against this type of devaluation and I do not hesitate to say that I prefer protection or an equivalent subsidy, provided it is moderate and not abusive, as often happens.

But I am not against devaluation; on the contrary, I consider it absolutely necessary when it is a question of adjusting the external value of the currency to an inflationary rise in domestic prices in excess of international prices. It is well known that over-valuation causes serious imbalances, as it holds back exports and excessively encourages imports, to the detriment of domestic production and employment.

— *You already expressed your preference for industrialization oriented more towards exports than towards import substitution. We also prefer this course, as we have already said.*

— That is indeed so. But whether or not we are

able to pursue this preference depends not only on the decision taken by our countries, but also to a large extent, on the decisions of the advanced countries. Those countries have neither promoted the industrialization of the periphery in the past nor have they subsequently favoured this area's industrial exports.

## 2. *The centripetal nature of advanced capitalism*

— *Are you saying that this attitude has been intentional?*

— I do not attribute an evil intent to those countries, but rather I believe this situation is the consequence of the centripetal nature of advanced capitalism. This is a very significant fact which must be stressed. Industrialization has developed in those countries over a very long period, and their constant technological innovations have brought about an enormous increase in productivity. But the fruit of this productivity has remained in the centres themselves and has not been disseminated through the periphery by means of a drop in prices. And regardless of how this fruit has been distributed socially, it has remained in the centres themselves, it is there that demand has increased, and this increasing demand has stimulated innovation and industrial development.

During the course of this centripetal process, industry could not have reached the periphery spontaneously. It was not until the crises in the centres—the First World War, the Great Depression, the Second World War—that industrialization became essential in order to provide substitutes for what could not be imported. Consequently, substitution was not the outcome of a doctrinal preference, but was imposed by adverse external circumstances. And since the centres had progressed considerably in their technology and their capital accumulation, the periphery began its industrialization with an obvious handicap. Hence the greater costs, which make necessary protection and subsidy. And although this handicap is being overcome with regard to certain goods, it is still there with regard to others because of the constant technological innovations being developed in the centres.

— *But later this whole panorama changed and it became possible to export.*

— That is quite true, particularly during the long years of prosperity of the centres, which went on to the mid-1970s. Some Latin American countries took advantage of these favourable conditions and achieved fantastic results. They followed a policy of subsidies and different forms of export promotion. They violated the laws of the market! Even today, even with the centres in the midst of their crises these policies are still producing positive results.

— *Do you believe countries should go to extreme lengths to promote exports and abandon the policy of import substitution?*

— We are talking about two aspects of the same problem. It is necessary to stimulate exports while at the same time continuing to develop the domestic market through substitution. In my opinion, it is inconceivable that the centres should open their doors without restriction to everything we might need to export in order to meet the growing needs for imports required by development.

Moreover, this amazing increase and diversification of exports of manufactured goods has been achieved thanks to the industries created previously as part of the process of import substitution.

— *You suggest a combination of both measures, then. But in what proportions should they be combined? Which should be emphasized more: exports or substitution?*

— That is a good question. I believe the answer depends to a large extent on the attitude of the advanced countries. You know quite well that there are in these countries strong protectionist trends which are encouraged by unemployment, as well as by their centripetal tendencies. The centres are not following Dr. Friedman's advice at all, and have no intention of tearing down all the trade restrictions that hold back exports from the periphery. It is not merely a question of new restrictions, but rather of other very significant ones that started long ago, such as the establishment of sliding scales of customs duties: very low duties or no duty at all for imports of raw materials, with duties on processed materials that go up according to the degree of processing in the periphery.

— *We cannot help being surprised by what you have just said, as we thought that a policy of ample liberalization of imports had been agreed during the Kennedy Round and the Tokyo Round.*

— That is indeed true. But this policy is concerned primarily with the trade of the centres. It is to a large extent concerned with goods where the constant technological innovations of the centres are very evident—goods that are increasingly sophisticated and capital-intensive. This is a clear manifestation of the centripetal nature of advanced capitalism. Once more, the periphery is to a large extent left out, as it had been before with regard to industrialization.

In contrast, liberalization has not extended to the less sophisticated manufactured goods that the periphery has learned or is learning to export. If that liberalization occurred, it would be extremely advantageous for our development as well as for the centres, as we would import more from them, with the advantages resulting from a rational division of labour.

And here you have the answer to your previous question. The rational combination of measures to encourage exports and substitute imports depends fundamentally on the degree of liberalization to be found in the centres. These are not good years, because of the crisis the centres are undergoing, but it would be a serious mistake to weaken our export efforts and to falter in the struggle to get the centres to change their restrictive policies.

— *If we have understood you correctly, the more restrictive the centres are, the more the periphery will have to stress substitution?*

— Correct. Not substitution in watertight compartments, however, but rather in broader markets through reciprocal trade. Otherwise, it would be too costly because of the type of goods that have to be substituted.

— *Aren't you concerned about this cost? Isn't there some way of eliminating it?*

— Of course I am concerned, just as much as you are. Export subsidies involve a cost, as do taxes on imports. We must try to ensure that the cost is as low as possible.

Think about the fact, however, that this is the cost we must pay in the present stage of development in order to achieve more inten-

sive growth. There is a net gain, since the increase in the global product of the economy is much greater than this cost.

— *You have just referred to the present stage of development, which makes us think you consider this factor to be transitory. Is that so?*

— You have interpreted my words correctly. At present, our countries would not be able to swim in the strong current of the industrial trade of the centres. But as they acquire technological capabilities and accumulate more capital, they will gradually be able to do so. We must go through certain stages in our industrialization. Development policies must be aimed at accelerating the process. And, above all, we must not fall into dogmatic positions.

— *What do you mean by that?*

— I mean the Friedmanist dogma that opposes subsidies and protection. Under that dogma, some solid industries are being torn down and a longstanding industrialization effort is being destroyed.

I will end this dialogue here, for the time being, because I believe we must continue it and we must counteract the penetration of ideologies which have serious implications for Latin American development. We have an inescapable responsibility to do so. In this case we are not talking about just one of the many episodes of intellectual dissemination from the centres. This is clearly a phenomenon of deliberate propagation. Visits, interviews and conferences, ardently supported by a free-spending and well-organized campaign in the mass media. There is more, much more, behind this that pure apostolic zeal. This is a systematic

effort to turn back the clock, and it represents a tremendous step backwards intellectually, just at a time when we had managed to move forward, with great difficulty, in interpreting Latin American development.

Over thirty years ago, we demonstrated the falseness of that long-past scheme of international division of labour, to which neoclassical theoreticians would now have us return. And in the name of economic freedom they would justify sacrificing political freedom.

Let Milton Friedman understand! Let Friedrich von Hayek also understand! A genuine process of democratization was moving forward in our Latin America, with great difficulty and frequent delays. But its incompatibility with the system of accumulation and distribution of income is leading towards crisis. And crisis brings about an interruption in the process and the suppression of political freedom: just the right conditions for promoting the unrestricted play of the laws of the market. What a paradox you involve! You praise political freedom and individual rights. But don't you realize that in these lands of the periphery, your preaching can only bear fruit through the suppression of that freedom and the violation of those rights? A tremendous paradox and a tremendous historical responsibility. Because, not only do the ideologies you preach perpetuate and aggravate social inequalities, they also conspire flagrantly against the effort that must be made to reach new forms of understanding and articulation between North and South. The damage you are doing with your dogma is immeasurable!