

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 possibilites 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.¹

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

¹I 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 neo-classical 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".²

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".³

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.

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

³*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".⁴

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?*²

— 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?*²

— 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?*²

— 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?*²

— 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

⁴*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.⁵ That is a step forward!

All this constitutes one of the major issues discussed in my latest book.⁶ 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

⁵Deputy Executive Secretary of CEPAL.

⁶*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 heterogeneity 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

