COTE2009 - The Macro Economic Framework: "Valid Theory and Policy Choice", by Eric St Cyr

Introduction: Today I wish to make one point. If economic theory is to be of assistance in guiding policy it must be both valid and relevant to the context. We know from elementary logic that valid argument will never lead from true premises to false conclusions. We know further that valid theory must be scientific; its premises must be empirically tested. Only then can its predictions of the unknown be trusted. With these methodological building blocks in place I give two examples illustrative of the consequences of the use of invalid theory and proceed to make the case for our continuing search for a usable theory of Caribbean Economy.

Example One: A classic example of economic theory leading to social disruption because it did not apply was the cut in wages in Britain in 1926. It led to the General Strike. Neo-classical macro-economics held that the forces of supply and demand in the labour market determined both the real wage and level of employment. Through the operation of an aggregate production function this level of employment determined the level of aggregate output. Assuming with Say's Law that 'supply creates its own demand' the goods market would also clear at full employment as what output was not used in current consumption would be invested, interest rates adjusting to bring savings and investment into equality. Money was assumed to be neutral; variation in its supply simply determined the nominal price level, that is, its purchasing power.

When following on World War I, and its many disruptions to economic life, there began to emerge open unemployment in Britain, the economic wisdom of the day diagnosed the cause as the downward inflexibility of the real wage and the solution the reduction of the money wage. This led to widespread social disruption and to re-evaluation of the theory. Out of this came the Keynesian revolution, *inter alia* shifting focus to the determinants of aggregate demand and to financial markets.

Enough has been said here to make the following points: economic theory is valid in its context; societies evolve and contexts change; social institutions are key elements in historical contexts.

Example Two: The very distinguished West Indian Nobel Laureate in Economics, Sir Arthur Lewis, proposed in his 1950 paper "The Industrialisation of the British West Indies" a strategy which has been dubbed 'industrialisation by invitation'. As implemented, this strategy has not produced the anticipated results because the analysis on which it was based did not explicitly distinguish between an *offshore sector* of Caribbean economy, where foreign enterprise and capital have always had sway, and an *onshore sector* where the residentiary population operates. Lewis' theory needed to be more precisely located in Caribbean empirical reality.

The problem Lewis addressed was the low level of income which the Caribbean economy of 1950 afforded its members. To Lewis, low incomes resulted from low productivity in its principal industry, namely agriculture. In order to raise factor productivity, agriculture needed to be mechanized to raise the land/man ratio since output per acre already compared favourably internationally but output per man was low. There was however a severe constraint on land space in these small island territories of mountainous terrain. Labour therefore had to be removed from the land to make room for mechanization. In the European experience, with which he was familiar, this was achieved by shifting

labour from agriculture to manufacturing, from the land to the factory. The Lewis' strategy thus required that manufacturing industry be established as necessary to raising productivity in agriculture. There were however the problems of capitalizing manufacturing and finding markets for its output. This is the context in which foreign investors were to be invited to establish and capitalize their enterprises and produce for overseas markets initially. The record shows that Caribbean governments gave generous incentives to foreign capital through the various Pioneer Industries Ordinances, and that there was much foreign capital invested throughout the Caribbean. The vast bulk of the investments however went into resource based industries in the offshore sector - petroleum in Trinidad, bauxite in Guyana and Jamaica, tourism in Barbados, Bahamas and the OECS, sugar in Trinidad, Guyana and Belize, citrus in Belize and bananas in the OECS. Few investments were made onshore complementing the surplus labour in that sector. It needs to be said that Lewis was not unaware of the existence of what he called a 'West Indian peasantry' onshore; nor of the downside of foreign investment. He in fact stated that foreign capital would be less dangerous in manufacturing than in resource based industries.

The point of this example is that Lewis' strategy which proved to be successful in South-east Asia rather missed the mark in the Caribbean by the theory on which it was based not having taken account of historical and institutional factors unique to the Caribbean.

Caribbean Economic Theory: The nineteenth century English economist John Stuart Mill denied the existence of a Caribbean economy, regarding these parts as the place where Britain produced her tropical staples. Sir Arthur Lewis was clear that received economic theory did not apply wholesale everywhere; which led him to articulate in his "Economic Development with Unlimited Supplies of Labour" (*Manchester School*, 1954), a model tailor made for Egypt, India or Jamaica. However it was the English economist/statistician Dudley Seers who made the methodological point most clearly in his "The Limitations of the Special Case" (*Bulletin of the Oxford Institute of Economics and Statistics*, 1962). The writer has surveyed the literature in "The Theory of Caribbean Economy: Its Origins and Current Status", (Institute of International Relations Occasional Papers #4, 1983) and gone on to state some basics in his "Some Fundamental Propositions in the Theory of Caribbean Economy" (*Social and Economic Studies*, Vol 40 No 2, 1991). However it is to the pioneering work of Lloyd Best - "Outlines of a Model of Pure Plantation Economy" (*Social and Economic Studies*, Vol 17, 1968), the summary statement of George Beckford's (ed.) *Caribbean Economy* (ISER,1972) and to the forthcoming book by Lloyd Best and Kari Levitt, *Plantation Economy*, that the perspective here given owes lineage.

Caribbean-type economy, of which Trinidad and Tobago is today the classic case, is externally propelled. It is neither export led, like resource scarce Japan or resource rich New Zealand, nor is it internally propelled by technical innovation and investment like the USA or the European Common Market. It is only over the last 500 years of modern world history that the Caribbean as we know it has come into existence, its institutions and culture shaped by the main actors of this era. With less than 50 years of independence, opportunity for self knowledge and self determination remains rudimentary.

There seems to be compelling grounds for treating the economy, not as a monolithic whole, but as comprising two quite distinct parts, namely an *onshore* and an *offshore* sector. This dichotomy, it seems to us, makes for more meaningful analysis than such other classifications as Lewis' "modern versus

traditional" or Ricardo's "agricultural versus industrial". Moreover because of the way that our populations have arisen and our nations have come to independence a central role must be ascribed to the state both as an axis of economic power and in the determination of policy direction. We thus have as the structure of the economy an offshore and an onshore sector mediated by a state sector.

The legacy of history has been that domestic resources have been harnessed for use by overseas enterprise and capital for the production of staples for export markets, the driving force being the maximization of returns to foreign capital realizable in foreign exchange. At some time the very population/labour force comprised chattel capital to be optimally utilized towards the objective of the enterprise. In other words, resource use was not aimed at maximizing the welfare of the human resource in these hinterlands of exploitation. The consequence of this historical legacy is that the society is still, not only externally propelled, but highly externally oriented, dependent as it still is on overseas supplies for provisioning, with the implication that the earning of foreign exchange remains critical to survival and welfare.

The bare bones of the operation of the economy might now be modeled. International enterprises operating through their agents, trans-national corporations (TNCs), identify a natural resource of interest; a concession is obtained from the authorities and investment made to exploit the resource; in the process some local factors (mainly labour) are employed and paid, and royalties and taxes are paid to the state based on production and prices; in turn the state monetizes its receipts from offshore revenues and from taxes on local factor incomes and corporations and injects resources onshore in the process of providing governmental services; purchases from all these incomes are made from businesses onshore from which further incomes and taxes accrue; and so on. Thus the economy is driven externally, its fortunes ebbing and flowing with activity worldwide, and in the offshore sector which constitutes the virtual engine. This pattern has resulted historically in wide swings in the availability of foreign exchange, incomes, employment and tax revenue, and taking good years with bad low long-run average welfare.

The stated goal of economic policy, vociferously and aggressively pursued since independence, has been to raise the trajectory of long-run average income and reduce its volatility. At the collective level this entails building up the stock of social capital and increasing the supply and distribution of public goods, while at the individual level maintenance of full employment at a living wage with stable prices. It is not difficult to agree on these goals. What's debatable is how best to achieve them.

We have already adverted to the lack of success achieved by the Lewis' strategy if "industrialization by invitation" which replaced the Moyne inspired *laissez faire* policy of the Colonial Development and Welfare programmes. Also essayed was regional/insular "import substitution industrialization", a strategy soon abandoned when it became evident that this was only feasible were the necessary foreign exchange to be supplied by other earning sectors. With the oil boom of 1973-82 the state in Trinidad and Tobago embarked on what we have termed the Point Lisas Strategy, namely using surplus revenues from the boom to secure the inflow of foreign exchange from direct state owned investments in offshore production. With the gas boom (1999-2008) this strategy has been resumed. The success of

this strategy enables the state to maintain injections into the onshore economy thereby maintaining high levels of employment and income.

While this strategy would reduce the dependence of the economy on foreign enterprise, that is its being externally propelled, it does not meet the drawback of its being prone to volatility or vulnerable to external shocks. The question we have raised is whether the alternative of transforming the onshore sector of the economy from being a net foreign exchange user into a foreign exchange earner is not a more desirable long run strategy. Such a strategy of Onshore Transformation would require surpluses now being earned offshore to be invested onshore to raise the productivity of the labour force and call forth productive enterprises onshore which are internationally competitive. Might not this be what "developed nation status" really means and what a 20/20 Vision should entail?

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