The Predatory State
by James Kenneth Galbraith

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Review by DW MacKenzie, PhD
The Coast Guard Academy

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The Predatory State is an ambitious book. Its author aims at replacing the current global economic system "based on military power, financed through the dollar system" with "a system of collective international security, domestic full employment, infrastructure renewal, and technological leadership" (p206). Professor Galbraith wants to replace "a world ruled by fear with a world ruled by hope". The troubles of the actual world supposedly lie with failed privatization and deregulation policies enacted by the Reagan and Thatcher Administrations. Privatization and deregulation have allegedly failed to the extent where even Republicans have abandoned free market theories and policies. Free market economics supposedly serves as intellectual cover for the new predator state.

The predator state is "a system where entire sectors have been built up to feast upon public systems built originally for public purposes" (p146). To make his case Professor Galbraith examines a variety of domestic issues; tax reform, deregulation of industry and finance, public spending. There are also numerous theoretical issues addressed in this book, as well as references to foreign experiences with privatization. Galbraith identifies Milton Friedman as the most important culprit in advancing privatization and deregulation.

The specific claims made by Professor Galbraith are not easily substantiated. Galbraith's first major claim is that markets cannot and do not think ahead. Planning must be done by the state, directed by the democratic process. Galbraith claims (p166) that since "people not yet born send no market signals … futures markets have nothing to do with preparing for, protecting, or representing the needs of the future". Galbraith is correct in his assertion regarding markets and future generations, but he fails to recognize that people not yet born also send no political signals through voting or lobbying. One can thus also claim that democracies cannot and do not think *generations* ahead. Galbraith prefers to attack Neoclassical models that assume immortal agents with perfect foresight. While Neoclassical

models are clearly unrealistic, Galbraith's focus on such models serves only as a diversion from relevant debate over public choice issues. Could his predator state be at least partially the result of regulatory capture and special interest bias? The answer this book provides would seem to be no. On page 24 Galbraith asserts that economic freedom "is terribly limited, compared to political freedom and democracy". This is, however, and empty and unsupported assertion. The faith that Galbraith exhibits in democratic processes is hardly enough to prove his case for the relative superiority of government planning.

Professor Galbraith claims that China has benefited from "the relative absence of a developed market for capital assets … capital markets have limited scope, limited liquidity, and do not exercise discipline" (p83). The Chinese system works because it allows firms to operate while incurring *losses*. Supervision in China comes from banks, but these banks are state owned, policy oriented, and normally bankrupt (p84). Rather than shutting down firms that incur losses, China allows them to continue operating. China is therefore *production driven* rather than *profit driven*. By focusing on production rather than profits "China reproduces the theoretical dynamics and public welfare implications of the perfectly competitive market … precisely because it lacks the essential feature of fully developed capital markets" (p85-86). Here we have the basis for the comparison Professor Galbraith wants to make. He feels justified in holding Western Capitalism to the standard of perfectly competitive equilibrium because China has replicated these results through planning. So when Professor Galbraith claims (p160) that "the existence of externalities and asymmetric information proves that the decisions of thousands of businesses and millions of individuals is not the same as the best achievable result" we can take this statement literally. Professor Galbraith would have us believe that we can achieve the results of an ideal market system of zero transaction costs and perfect information through state planning and hobbled capital markets.

Professor Galbraith seems to have joined the long list of scholars who have grossly overestimated Chinese economic performance. While China has posted officials statistics indicating remarkable economic growth in the past thirty years, these numbers have been disproven. Chinese GDP had been thought to have exceeded ten trillion dollars, but a 2007 report by the World Bank indicates that Chinese GDP has only exceeded six trillion dollars. According to Professor Galbraith China has managed to achieve economic perfection, while still having only ⅛ the per capita GDP of the supposedly crippled and inefficient American system of laissez faire financial capitalism.

Galbraith's second major claim that wage determination is a social and not a market decision. The relative distribution of income between labor and capital are not determined by technology or productivity, but society. And society can improve living standards through policies that promote greater income equality. There is, in Galbraith's view no trade-off between equity and efficiency. We can achieve greater equity and efficiency through the use of the familiar concept of 'countervailing power'- the "ability of labor, through their union, to raise wages by drawing on the position of the firm" (p119). Professor Galbraith does not consider the possibility that unions could themselves carry out a form of predation. Oddly, professor Galbraith (p38) blames cost push inflation for stagflation. Rising oil prices and union wage demands drove up the cost of living. Is it unreasonable to characterize such transfers as predatory? Is inflation not a tax upon the general consuming population? If union wage demands drove increases in inflation taxes on the general consuming public, then unions are as predatory as any corporation that "feasts upon" the public. The arguments that Professor Galbraith advances for cost push inflation depend upon his weak and highly implausible criticism of Monetarist explanation of Stagflation. Monetarism supposedly failed when tested as "a precise numerical relationship" (p38). Did Friedman

really claim that there existed a precise numerical relationship between the monetary base and income or inflation? Laidler (1981 p25) regard Monetarism as validated because the money demand function is *more* stable over time than early opponents of Monetarism suggested, and because shifts in money demand are not large enough to undermine *long run* relationships between money and nominal income. In fact, experience with Keynesian economic policy has validated the proposition that monetary expansion translates into inflation, *after short run adjustments in expectations*. Since inflation is a monetary phenomena rather than cost-push driven, labor unions do not appear all that predatory. However, Professor Galbraith's own arguments run counter to his pro-Union convictions.

Galbraith's claim that equity and efficiency can coexist derives from his view of the effects of capital investment on wages. According to Galbraith the case for improving living standards through private investment is self-contradictory. His argument is simple: efficient private investment requires the full internalization of the returns on investment. Yet if capitalist investors gain the full returns of investment, workers gain nothing. Hence efforts to improve the general well being of society through increased private investment actually benefit only a few economic elites. Were workers to gain something from private investment by capitalists, this would prove the existence of externalities, and externalities indicate market failure. Proponents of free markets would therefore seem to face a dilemma: capitalism either benefits only a few capitalists or it fails to deliver economic efficiency.

The argument from the preceding paragraph uses improbable assumptions and faulty reasoning to pose a false dilemma. It is first worth noting that the existence of externalities does not imply that markets are inefficient. Private investment could generate positive infra-marginal externalities to workers, and infra marginal externalities do not affect allocation. A second and more important objection to Galbraith's argument is that even externalities that

affect the margin of production do not imply the relative inefficiency of private markets. It has long been recognized that private and public institutions are imperfect alternatives, so that imperfections in one do not imply the *relative* efficiency of the other[1]. As previously noted, Professor Galbraith believes that the results of perfect competition can be realized through government planning, thought this is obviously impossible.

Perhaps the most egregious error in Galbraith's analysis of investment is in the implicit assumption Galbraith makes regarding labor supply. Capitalist acquire all the gains from trade that derive from capital accumulation if labor supply is *infinitely* elastic. With elastic labor supply any increases in labor demand that derive from capital accumulation leave wages unaffected, and employers acquire 100% of gains from trade. Galbraith's implicit assumption regarding labor supply is reminiscent of Marx's claims regarding the reserve army of the unemployed. Capital accumulation will fail to increase wages in the imaginary situation where labor is seemingly abundant. In reality, the marginal opportunity cost of labor rises with increased labor demand. Under real world economic conditions capital accumulation increases labor demand and wages according to marginal productivity, and workers also gain producer surplus of the margin[2]. Professor Galbraith's proposition that workers gain nothing from capital accumulation is so contrary to historical experience that one must wonder how it is that he can advance such a claim. As Olson (2000 p49) put it "everyone knows the countries with high per capita incomes have incomparably higher capital intensity". Yet this obvious fact seems to have eluded Professor Galbraith.

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[1] See Demsetz (1969), Coase (1960), and Mises (1949 p)

[2] We of course assume that labor and capital are gross complements. Also note that under Galbraith's assumptions accumulation tends to generate greater employment, albeit at fixed real wages. Workers do therefore gain something, even under his imaginary conditions. However, the least implausible scenario for perfect elasticity of labor supply is the aforementioned Marxist scenario, in which case workers gain additional work only at a subsistence wage.

Galbraith claims that tax cuts for the wealthy have not stimulated private savings (p34). For this reason Galbraith characterizes the supply side Reagan tax cuts as a failed policy. Professor Galbraith contradicts himself (p50) on the Reagan Tax Cuts when he admits that "Reagan's tax cuts were undone in the 1982, 1984, 1986 tax reform acts". How could he say that tax cuts failed during a time period when they were, in his own words, not in effect?

There are also obvious reasons why American savings rates have been low in recent decades. Foreign financial capital has flooded into the US in recent decades. The availability of foreign finance has lowered long term interest rates (Warnock and Warnock 2006). With interest rates low, Americans have little financial incentive to increase savings. There is also evidence indicating that American saving has reached diminishing returns. Scholz, Seshardi, and Surachi () find compelling evidence that eighty percent of Americans who are approaching retirement age have saved 'optimally'. Smith, McNair, and Love () find that eighty eight percent of Americans over the age of fifty one save at least enough to avoid poverty in retirement. While Galbraith claims that we save according to 'habits', the fact of the matter is nearly all of us save according to retirement targets. Since Americans have high incomes and typically experience lower living costs during retirement, low savings rates can be explained by rational choice in the face low interest rates.

The Reagan tax cuts "failed to increase savings" because they were undone, and there is little reason for most Americans to increase their current rate of saving anyway. Foreign savings finance much of our private investment and public debt, and nearly all Americans can save enough to avoid poverty even with a low rate of savings. Americans enjoy this advantageous financial position because we have high labor productivity and have the good sense to maintain a relatively secure environment for investment. To put it simply: we are

wealthy and secure, and these are good things[3]. However, Professor Galbraith is not content with this happy situation. He believes that America ought not to be such a safe place for investment. Rather we should substitute public planning for private investment. Lee and Gordon (2004) find a significant negative correlation between corporate taxation and economic performance. In fact, their data indicates that a ten percent cut in corporate tax rates would increase economic growth by one or two percent.

Further evidence in favor of developed capital markets exists in the form of data on capital markets in developing nations. Levine and King (1993) find a strong association between the level of financial development and real per capita GDP growth in eighty countries from 1960 to 1989. Developed financial markets correlate with improvements in the efficiency with which economies employ physical capital, and between the predetermined component of financial development and several factors: future rates of economic growth, physical capital accumulation, and economic efficiency improvements. Levine and Servos (1998) find strong correlation between stock market liquidity/bank development and future rates of growth. Borsch-Supan and Romer (1998) find that competitive financial markets reinforce product market competition by cutting off funds to unproductive companies, provided there are competitive threats. Henry (2003) finds that deregulating stock exchanges increases investment and per-worker productivity. Liberalized stock exchanges can also facilitate the adoption of new technologies in developing nations. Henry (2006) finds that liberalized stock exchanges caused a short run increase in economic growth. Argarwal (2001) finds that that stock exchange development has increased economic growth in nine African nations. Argarwal (2007) finds that stock exchange development increases private investment

[3] The recent problems in the housing market are an obvious example of current financial insecurity and distress for many. However, we should remember that Fannie Mae was a creation of FDR in 1938. Given the nature of Fannie Mae and Freddie Mac, we can hardly blame the current crisis on free markets, but is instead a product of the general rule that government guarantees lead to moral hazard.

and economic growth in twenty-one developing nations. It would seem then that capital markets do direct capital investment with some degree of efficiency, as recognized by Mises (1922) and Hayek (1935) when they critiqued state planning.

The failure of Galbraith's arguments against free capital markets is critical because this failure undermines his case for income redistribution and economic planning. Galbraith claims that since capital accumulation benefits only a few capitalists, tax cuts that supposedly stimulate private investment do not benefit the general working population. It might also have crossed Professor Galbraith's mind that in his imagined world of elastic labor supply heavy tax *increases* on capital do not *harm* the general working population. Professor Galbraith views income distribution as a social matter, by which he means a political matter. He concedes that taxes on capital might infringe upon natural rights of ownership, but why should the right of property stand over the rights of labor to retain earnings (Galbraith p33)? If the decision to tax labor or capital does not affect economic efficiency, then it is a political matter, a matter of power relations between labor and capital.

This brings us to the critical issue in Professor Galbraith's system of arguments: "Economic power naturally translates into political power" (p102). The problem with the predatory society is supposedly that powerful private interests feast upon what are meant to be public resources. Professor Galbraith also claims that wealth concentration leads to the concentration of political power. This is perhaps why he thinks that economic freedom is "terribly limited compared to political freedom". Markets are, however, pernicious "even if they are perfectly competitive because they entail inequality, and the poor do not matter to the market" (p166). Professor Galbraith's reasoning is internally consistent up to this point. However, we must remember that he blames our current predicament on the *ideas* of Milton Friedman (and also on FA Hayek). If wealth inevitably leads to power and power is used for

wealth, then it would seem that ideas have little effect on the course of the economic aspects of history. Professor Galbraith switches back and forth between the economic determinism of Marx and proposition that ideas matter as it suites him. If Schumpeter, Keynes, and Hayek are right about the influence of ideas, then *The Predatory State* has some chance of altering the course of future events, but this proposition undermines a key argument of this book. If ideas matter over material interests, then capitalism is not as dangerous as Professor Galbraith believes. If, on the other hand, material interests matter over ideas, Professor Galbraith's wasted his time in writing this book. His ideas will change nothing. Also, if material interests matter over ideas, then he is wrong about the causes of the rise of the Predatory state. If economic power leads to political power *naturally*, then the supposed intellectual cover provided by Milton Friedman for predatory interests was convenient for these purposes, but also unnecessary. It might be possible for Professor Galbraith to argue that there is some kind of interplay or tradeoff between interests and ideas, but this book contains no such concepts. It contains only glaring contradictions.

Professor Galbraith gets into further trouble with his rejection of the principle of comparative advantage. He argues that there is a strong case for industrial policy because the original argument for trade according to comparative advantage assumed static conditions (i.e. factor immobility). Of course, this argument makes sense if we accept Galbraith's *assumption* that markets cannot and do not plan. It is important to realize that this is an unsupported assumption. Furthermore when we examine the overall record of government planning of industry and compare it to the overall achievements of capitalism, it becomes quite clear that markets can and do plan quite well. We should therefore not only trade according to comparative advantage, we should let capital markets plan out how we develop specific comparative advantages in the pursuit of private profit.

Galbraith makes a fair point when he notes that both workers and capitalists have the right to retain honestly acquired incomes. However, his argument that accumulation benefits capitalists only fails in a way that indicates that incomes are determined in a social-economic manner, rather than through a purely social-political process. Improved quality and quantity of capital does increase real wages in line with the discounted marginal productivity of labor. The capitalist system is, contrary to Galbraith's assertions, a system that determines incomes socially, through exchange and price/wage formation that is *relatively* efficient. Furthermore, the capitalist system has a proven record of increased real wages and living standards of workers and capitalists alike through capital accumulation.

Serious problems exist with Professor Galbraith's assertion that deregulation has failed. Gwartney et al (2006) find that the impact of private investment on GDP is 74% higher in countries with a high degree of economic freedom. Furthermore, the impact of private investment on development is greater than the impact of public investment. Dawson (2007) finds a negative correlation between most regulation and economic performance. Positive correlations between regulation and economic performance mostly concern types of governmental intervention that make property rights more secure. Borsch-Supan and Romer find that state regulation and ownership are important causes of low capital productivity, both directly and indirectly through limitations of competition. For example, the trade protection of the German and US auto industries and Deutsche Telekom enabled these companies to reap high profits, despite low productivity. Professor Galbraith claims that principled proponents of laissez faire were naïve, and "have been abandoned by history". Yet actual historical data indicates otherwise. The key problem with *The Predatory State* at this point is not merely the existence of the aforementioned counterevidence, but the lack of evidence from Professor Galbraith in support of his own position.

The Predatory State is meant for a general audience, but it should not mislead this audience. Professor Galbraith is correct in one observation. There are private interests which feed upon ostensibly public institutions. However, proponents of free markets have long opposed large activist governments in part because of the tendency of special interests to capture the benefits of public programs, while leaving the associated costs public. Special interests do posses the advantages in lobbying legislators and capturing regulators. The voting public is by in large rationally ignorant of the dealings between special interests and public officials. The predatory state is not a new phenomenon that emerged as an unintended consequence of Milton Friedman's pursuit of economic freedom. It is a Public Choice problem.

Generally speaking, *The Predatory State* is a call for state planning not unlike other recent books on Globalization. Professor Galbraith denies the great progress of modern capitalism and proclaims the superiority of governmental planning. He calls for limited governmental planning and with it a dramatic reduction of the importance of markets and competition in society. Professor Galbraith ultimately wants to take steps towards a new international order of global democratic governance. There is nothing really new in his states goals. What is different about this book is that its individual supporting arguments are less well reasoned than even those of Joseph Stiglitz and Jeffery Sachs.

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