

The Macroeconomic Theory of Vera C. Lutz

1. Introduction

Vera Lutz was an economist with wide-ranging interests. Her principal fields of research were credit theory, the theory of the firm, economic development theory and labour market analysis. In Italy Vera Lutz's name is primarily linked with the theory of wage dualism. The part of her theoretical work dealing with the more general themes of macroeconomics and the equilibrium between aggregate supply and demand are much less well known.

There are nonetheless several good reasons why special attention should be paid, in a re-examination of Vera Lutz's work, to the way she treats the problem of macroeconomic equilibrium. In particular, the following points need to be remembered:

a) the way in which she tackles and solves the problem of macroeconomic equilibrium reflects the theoretical assumptions of her thinking which permits all her work, i.e. both that of a socio-political nature and that of an analytical nature, to be set within an overall framework;

b) as will be shown in greater detail, her macroeconomic theory provides a key to a better understanding of her much discussed theory of wage dualism, which, if it is not set within the broader framework of economic equilibrium, remains like an insulated fragment with no adequate justification;

c) finally, it should not be forgotten that the period in which Vera Lutz conducted her research coincided with the foundation and spread of Keynesian macroeconomics. She completed her studies at the London School of Economics in 1935, one year before the publication of the *General Theory*, and published her most important works on development theory between 1955 and 1962, when Keynesian income

support policies were at their height. Vera Lutz intervened directly in the Keynesian debate only twice, in 1952 and 1955. Her essays show that though she came from a totally different and conflicting school she had nonetheless become well-versed in Keynesian theory.¹ Hence, if she decided to adopt a different approach in her theoretical research, this cannot be attributed to lack of knowledge of Keynesian macroeconomics, but must be interpreted as a deliberate theoretical choice. Thus, from this point of view, too, Vera Lutz's macroeconomics deserves special attention.

Notwithstanding all these valid reasons for examining and discussing her ideas in the field of macroeconomic equilibrium, it remains true that there has been very little debate on these aspects of her thinking. In fact, there was only a short-lived debate in 1962, when Ackley and Spaventa wrote an article criticizing her ideas on the development of Southern Italy.² Their intervention, which in any case dealt more with facts than with the theoretical framework, led her to reply, but did not stimulate any other comment. The debate on her thinking remained restricted then, as now, to her theory of structural dualism.

2. Market and Social Justice

It need hardly be recalled that Vera Lutz was convinced of the fundamental efficiency of the market economy. Although she always remained faithful to the basic ideas she had absorbed at the school of Robbins and Hayek, she did not fail as the years passed to modify her abstract ideal schema and to enhance it with far-reaching changes based on the observation of facts. Indeed, in some cases she brought a detachment to bear in her observation of the mechanism of the market economy that enabled her to point out its obvious negative elements and failures.

In her interpretation of market mechanisms, Vera Lutz faithfully follows the marginalist approach; from the theoretical point of view, her investigations can, in fact, be considered as applications of marginalist

theory to particular cases.³ For a marginalist thinker, the most difficult problem is to reconcile the marginalist doctrine of income distribution with the requirements of social justice. The doctrine whereby each resource (hence, including labour) is remunerated according to its marginal productivity is essentially no more than a consequence of the general principle of the maximization of profits applied by the individual firm under conditions of perfect competition. The theory therefore guarantees that the spontaneous forces of the market (precisely because they are guided by the profit principle) will distribute the income produced in accordance with the productive contribution of each factor. However, they do not, nor can they, guarantee that this distribution of income will satisfy any of the requirements of justice.

It is true that the more superficial theorists of marginalism have not hesitated to make the jump from an equilibrium condition to a situation in which justice is achieved. It is also true, however, that the more discerning writers have rigorously distinguished between the two levels of reasoning.⁴ Vera Lutz undoubtedly belongs to the more conscious followers of marginalist doctrine, and is not trapped into the naive belief that the competitive market in itself possesses the requisites of justice. These are to be sought elsewhere, beyond what the market is able to achieve.

A critical analysis of the marginalist doctrine immediately leads to the question as to which factors in a market economy determine the productivity of the various types of labour. Here it is easy to fall into one or other of the traps laid by the more orthodox formulations and to furnish one of two replies: either labour productivity depends on the inherited talent at the disposal of the worker, thus referring any further discussion on the distribution of income to natural and non-modifiable factors; or labour productivity depends on the capital endowment at the worker's disposal, thus attributing any increase in productivity to the efforts of the investor, who has made it possible to produce the capital goods which the worker uses, and who should therefore enjoy the fruits thereof. Vera Lutz refuses to accept either approach and maintains on

¹ V. LUTZ, "Real and Monetary Factors in the Determination of Employment Levels" *Quarterly Journal of Economics*, 1952; and "Multiplier and Velocity Analysis: a Marriage", *Economica*, 1955.

² V. LUTZ, "Some Structural-Aspects of the Southern Problem: The Complementarity of Emigration and Industrialization", in this *Review*, December 1961; and "Reply" to the article by G. ACKLEY and L. SPAVENTA, *Ibid.*, June 1962.

³ A text that gives an overall idea of the economic theory and political doctrine of marginalism is that by F.A. HAYEK, *The Constitution of Liberty*, London, Routledge and Kegan Paul, 1960; this text is also significant because Vera Lutz was a student of Hayek's at the London School of Economics. See also S. ZAMAGNI, "Sui fondamenti metodologici dell'economia austriaca", *Note economiche*, 1982.

⁴ J.B. CLARK, *The Distribution of Wealth*, New York 1899, is the most orthodox version of marginalism; J.A. SCHUMPETER, *Das Wesen und der Hauptinhalt der Theoretischen Nationalökonomie*, Ducker and Humblot, Berlin 1908, especially the third part.

the contrary that labour productivity depends on *the worker's skill and hence on the degree of education received*. A further step along this line of reasoning leads her to recognize that, in its turn, the education received by the worker depends on his starting position, and hence on the initial income distribution. Income distribution is thus no longer linked to factors of a naturalistic type, but becomes a phenomenon connected with the social structure. This brings Vera Lutz to a position fairly close to the ideas of Einaudi at his best. She was, in fact, a warm admirer of that thinker.⁵

Though apparently heterodox and packed with reformist implications, this finding was used by Vera Lutz in a manner that was entirely consistent with her liberal beliefs. If, on the one hand, the needs of efficiency require that each resource should be remunerated according to its productivity, and if, on the other, productivity depends on the education and training received, any intervention designed to correct inequalities without diminishing the efficiency of the market must seek to create greater equality in the starting points of individuals. It would be a serious mistake to correct the inequalities in wealth by changing the incomes but not the productivity of individual workers. It would be folly to seek to make the market work in a manner contrary to its inner logic. For this reason, she was bound to take a negative view of trade union militancy and especially of the Italian trade unions' wage claim policy, which she saw as an attempt to obtain a redistribution of income without taking action as regards the structural conditions that the market inexorably respects.⁶ The Italian trade union movement, she notes with the conviction that stems from her democratic liberalism, still suffers from the illusion that capitalism is based on class struggle, and hence directs its action to increasing wages at the expense of profits. A more mature trade union movement would realize that other factors, rooted in the social structure constitute insuperable constraints, the removal of which is an indispensable prerequisite for an improvement in the conditions of the working class. Well-being, according to Vera Lutz, is not arrived at through trade union militancy aiming at the immediate objective of extracting higher wages, but through joint efforts to increase productive capacity. A dispute over a limited amount

of wealth, such as that which she saw in the Italian case, was bound, she believed, to give rise to corporative pressures, which enrich some at the expense of others without any overall progress being made.

This is the root of the theory of dualism which is the best known aspect of her interpretation of the Italian economy. It is precisely the idea which, according to her, is erroneous, that it is the trade union's duty to fight exclusively for wage rises which led the Italian trade unions to concentrate their action on sectors where they could more easily extract wage concessions, i.e. in big firms, while, vice versa, neglecting the small firms. Trade union action in Italy seems to have been successful. But, as Vera Lutz tried to show by her theory of dualism, the effects of this action should on the contrary be judged as highly detrimental in the wider perspective of the country's economy as a whole.

In short, her theory can be summarized in a few propositions. Wage increases concentrated in the large-firm sector have, she contends, created a situation of wage dualism. The large-firm sector has reacted by reducing the number of people employed in it and by having recourse to advanced technologies. The result has been that the bulk of the unemployed flowed into the small-firm sector and found jobs with low wages and also in technologically backward situations with reduced levels of productivity. This dualistic schema of the use of capital and labour clearly represents a case of bad utilization of resources, and, in Vera Lutz's opinion, was bound to result in the incomes produced and in the country's rate of growth being lower than they would have been had there been a unified labour market.

The real social struggles, in her view, are those designed, not just to ensure privileges for limited groups of contenders, but also to guarantee *equality as regards starting points*. In turn, the equalization of the starting points can only be achieved by far-reaching reforms. A basic requisite which conditions the whole operation of the labour market is that education and vocational training should be open to all on the same conditions. Equally rigorous rules should be imposed as regards relations between firms: the battle against monopolistic formations and the strict application of tax regulations follow therefrom as recommendations for action.

It can be said that, during her whole life, Vera Lutz remained constantly faithful to the ideal model of an egalitarian society, which served as the basis of her interpretations and for her economic policy recommendations. Her theoretical faith was gradually tempered by a realism that became increasingly incisive as the years passed. She

⁵ F.A. HAYEK, *The Constitution of Liberty*, op. cit., chapter 23, "Education and Research"; see also, along the same lines, L. EINAUDI, *Lezioni di politica sociale*, Torino 1946, and E. ROSSI, *Abolire la miseria*, Laterza, Bari 1977.

⁶ V. LUTZ, "Das freie Unternehmertum in Italien", *Schweizerische Monatshefte*, 1963.

always recognized that theoretical models and reality were two distinct, and often unrelated, categories. Nonetheless, while she was inclined to see the real mechanism as having a tendency to converge with the theoretical solution in her early works, her later works reveal a considerably more sceptical view about the market's self-regulating capacity and an increasing propensity to consider disequilibria not as temporary upsets, but as a stable state due to the preponderance in the market of privileged groups. From this point of view, the essay on the emigration of Italian workers to Switzerland, which will be discussed below, is a model of theoretical analysis applied to a market dominated by privilege and discrimination.

3. Vera Lutz's Analytical Schema

Vera Lutz never set out her macroeconomic theory in general terms; her interest was always focussed on particular concrete problems. In the analysis of the case of Italy, it was the problem of the Mezzogiorno that sent her go back to the principles of the equilibrium between aggregate supply and demand, and led her, albeit implicitly, to formulate a macroeconomic theory.

This theory rests on two sets of factors — one, of an abstract nature, that she inherited from the general principles of her academic training, and the other of a historical and empirical nature, that she derived from the specific case of the Southern Italian economy in the fifties.

a) *The Theoretical Basis*

The specific problem of the Southern Italian economy was how to create an adequate productive capacity. Any orthodox Keynesian economist would have seen this problem in terms of a lack of demand and would have claimed that only by supporting aggregate demand would there be a large enough flow of productive investment to create an adequate industrial structure. Vera Lutz, without explicitly expressing an opinion about Keynesian economics or polemizing with its supporters, tackled the macroeconomic problem using a different model.

Keynesian theory approaches the determination of national income through the analysis of aggregate demand. The hypothesis that permits this theoretical approach is that supply can move in line with demand. At the root of the Keynesian theory of the determination of income there is therefore the assumption of a general nature that the supply of goods will be sufficiently elastic.

Vera Lutz's position differs in several respects from the Keynesian formulation. She does not accept the idea that investment demand can be regarded as an autonomous aggregate based on a not very clearly defined entrepreneurial spirit among investors. In her view, the decision to invest is a part of rational behaviour, and is based on the principle of profit maximization. Profits in turn are measured, she believes, by the marginal productivity of investment (i.e. by the increase in product obtained by postponing consumption). She therefore completely adheres to Fisher's theory of investment.

Since she deals with problems of development and structural transformation, the key aspect for her is not the overall level of investment (as it is with the Keynesian approach), but *the sectoral structure of investment and production*. The problem tackled by her is that of the modernization of the economy, and hence of the shift from an agricultural economy to a more diversified one. If investment decisions depend on current profits and if the main problem is that of directing increasing shares of investment towards the industrial sector, the key aspect to analyze is *the structure of profit rates*: a process of progressive industrialization therefore requires that the profit rate in industry should always be high enough (compared with that in agriculture) to attract a sufficient amount of investment.

The structure of profit rates depends, in turn, on the system of relative prices of the products of each sector, and these relative prices depend on the respective strengths of sectoral supply and demand. To obtain a structure of profits that encourages investment in industry, it is also necessary that relative prices (i.e. the terms of trade between agricultural and industrial products) should not change to the disadvantage of industrial products. For this not to happen (i.e. for agricultural prices not to rise compared with industrial prices), agricultural supply must not be too rigid and the demand for industrial products must be sufficiently income elastic. Accurate empirical knowledge of the elasticity of supply and demand in each sector is thus essential if the real scope for achieving industrial development in a given region is to be assessed and if the interventions capable of overcoming any difficulties encountered are to be determined.

b) *The Empirical Basis*

The factual elements underlying Vera Lutz's macroeconomic theory are drawn from her concrete knowledge of the Southern Italian economy, but could all be applied with an acceptable degree of approximation to any other region that, like Southern Italy, has the characteristic features of an open economy undergoing development. There are basically four structural characteristics of Southern Italy that are important for the theoretical analysis:⁷

(i) *Elasticity of demand.* She expressed the view that not only is there a very high propensity to consume in developing countries, but there are also very high values for the elasticity of the demand for food products and correspondingly lower values for the elasticity of the demand for non-food products. Such a structural characteristic does not call for particular explanation since it is one of the best known features of backward economies. It is, however, extremely important in Vera Lutz's model because, as will be shown below, it determines basic aspects of development policy.

(ii) *Consequences for potential savings.* She applies her assumption about the high elasticity of the demand for food products extremely rigorously. An especially important consequence of this assumption is to be found in the way she analyzes the problem of hidden unemployment in agriculture. A view widely held in the past considered hidden unemployment in agriculture as *potential wealth* that developing countries should try to use as widely as possible.⁸ Vera Lutz, on the other hand, considers this productive potential to be theoretical rather than real. In fact, if the surplus workers are taken out of the agricultural sector, those that remain benefit on an average from a greater supply of agricultural products. Vera Lutz considers that this supply is entirely devoted to a greater consumption of food products. At this point the workers taken out of agriculture can no longer be sustained by the agricultural sector (since this continues to consume the whole of its product) and will have to be sustained with resources taken from other sources. They are thus no longer a cost-free potential resource, but a productive resource costing the same as all the others. Hence, she

⁷ V. LUTZ, *Italy. A Study in Economic Development*, Oxford University Press, 1962, chapter 7, and also "Some Structural Aspects...", *op. cit.*

⁸ R. NURKSE, *Problems of Capital Formation in Underdeveloped Countries*, Oxford, Blackwell, 1955.

concludes, even in backward countries with a large amount of hidden unemployment, it is not possible to speak of a surplus of potential resources (or of a surplus of potential supply), nor to take this alleged surplus as the basis for a development policy. *The potential surplus of resources simply does not exist.*

Vera Lutz's theorem regarding the non-existence of a potential surplus of production can also be used to explain why it is that, even in countries with an evident surplus of labour, highly mechanized (and therefore labour-saving) technologies are in use. If it is accepted that surplus labour in agriculture, once it is transferred to other employment, has to be considered as a resource that has a cost,⁹ the whole question of technologies needs to be re-examined. The existence of surplus labour in agriculture does not in itself automatically make the most labour intensive technologies the most advantageous. The optimal technology has to be determined *exclusively on the basis of the wage level in the industrial sector*; the level of productivity in agriculture becomes of no importance in the calculation of the relative scarcity of resources.

(iii) *Direct elasticity of supply.* The third empirical assumption on which Vera Lutz bases her reasoning is that the agricultural sector of a developing country has a *low elasticity of supply* in relation to market stimuli (an increase in demand or in relative prices). As will be shown, Vera Lutz stresses that the crucial element in the construction of the model is not the absolute value of the elasticity of agricultural supply but the fact that *it is less than the elasticity of the demand for agricultural products*. Since, as mentioned, the elasticity of demand tends to be high, even an advanced agricultural sector could find it difficult to meet the market's requirements. The situation in developing countries is, however, aggravated by the fact that the agricultural sector is backward and badly placed to react to the stimuli of demand or to compete with the supply coming from other countries. In her theoretical framework this, as will be shown below, is one of the key elements in the determination of a suitable intervention strategy.

(iv) *Indirect elasticity of agricultural supply.* Still at the empirical level she assumes that there are real limits to the scope for expanding the availability of agricultural products by purchasing them in international markets and supplying manufactures in exchange. This opera-

⁹ A.K. SEN, *Choice of Techniques*, Blackwell, Oxford 1962, chapter 5; M. DOBB, *An Essay on Economic Growth and Planning*, Routledge & Kegan Paul, London 1960, chapters 3 and 4.

tion would imply a development strategy based on manufacturing industry and exports of manufactures. The increase in the latter would have to be large enough to cover the imports of agricultural products needed to satisfy the increase in demand. In purely theoretical terms, this development strategy is consistent, but she considers it unrealistic. She claims that the new industry in Southern Italy cannot reasonably be expected to compete with the industry of the Northern regions since greater transport costs would prevent it from being competitive in its natural markets in the rest of Europe.

At the economic policy level, this assumption was the most burning issue at the time. Acceptance of it meant that any policy for the development of Southern Italy based on industrialization was wrong. An all the more thankless conclusion in that it came at the very moment when, in the name of greater efficiency, public intervention in Southern Italy had switched from a policy of agricultural support and infrastructure construction to one of industrial development. Since the supporters of an industrial future for Southern Italy had always been considered more avantgarde and progressive, while the supporters of an agricultural economy for the Southern regions were reckoned to be more moderate and conservative, Vera Lutz found herself not only in conflict with the prevailing strategy for intervention but was also lumped with the less enlightened members of the cultural spectrum of her time.

c) *Agricultural/Industrial Relative Prices*

On the basis of the four empirical premises regarding respectively the elasticities of the supply of and demand for agricultural and food products, Vera Lutz analyzes the consequences of an increase in income in developing region. (As always she deals explicitly with the case of Southern Italy, but the analysis is of a more general nature.) In her analysis, she does not concern herself with the source of the increase in income since its consequences, which are what she wishes to highlight, are the same whether it is an increase in internal production or in demand financed by external subsidies. The point which she sets out to analyze is not the mechanism whereby the increase in income is generated, but the conditions that are necessary if the increase, once it has been achieved, is to be lasting — conditions that concern the equilibrium between supply and demand in the individual markets.

Let us take the case of a closed economy. On the basis of the assumptions made and supposing that the division between the demand for food products and that for non-food products is stable, an increase in income produces a proportional increase in the demand for food products. To meet this demand, the supply of agricultural and food products would have to increase at the same rate as income. But if, as was assumed, the income elasticity of the supply of agricultural products is low, it is likely that agricultural production in real terms will only succeed in expanding at a lower rate. This in itself provokes an increase in agricultural prices relative to those of non-agricultural products, and hence a deterioration in industry's terms of trade. If the increase in income is generated by an increase in industrial production, the phenomenon will be all the more pronounced. In this case, the increase in income is accompanied by an increase in the supply of the industrial sector, but, on the basis of the assumptions made, only a small proportion of the increase in income is used to augment the demand for industrial products. Consequently, for an equilibrium to be established between supply and demand, it is likely that agricultural output will have to rise at an even faster rate than in the case of an increase in income generated, for example, by an external intervention, and that the deterioration in industry's terms of trade will be even greater.

Vera Lutz thus arrives at the conclusion that any development policy that fails to improve the agricultural sector's productive capacity is bound to worsen the prospects of the industrial sector. Moreover, this worsening is more pronounced when the external intervention consists of the development of industrial production than it would be if the intervention consisted of a policy of transfers or of public works. An industrialization policy that attempts to "force" the development of manufacturing production by directly installing plants only worsens the prospects for the further development of the industrial sector.

d) *Obstacles to Industrialization*

The deterioration in industry's terms of trade vis-à-vis agriculture is inevitably reflected in the two sectors' relative profits. A fall in industrial prices compared with agricultural prices causes a fall in industry's profits compared with those of agriculture, since it reduces the marginal productivity, measured in value, of all the resources used in the industrial sector and hence forces a reduction in the amount of resources used in order to conform with the equalization of profits rule.

From the point of view of the industrial sector, the fall in prices appears in the form of an inadequate growth in demand: the expansion of industrial production is matched by the inability of the market to absorb the growing output, and the level of prices falls. Industrial development is thus blocked by the lack of a domestic market able to absorb an increasing supply.

Underlying this lack of demand there lies, as previously mentioned, the low propensity to consume industrial products, which, in turn, stems from the high propensity to consume agricultural and food products that is typical of developing economies. This mechanism deserves to be considered in its entirety, since focussing on just the final stage, i.e. on the fact that industrial development comes to a halt for lack of an adequate market, might encourage the belief that Vera Lutz's macroeconomic model implies non-acceptance of the law of outlets. This would be a wrong interpretation. At no point does she explicitly tackle the problem of Say's law, and, on the contrary, everything suggests that she accepts the traditional conclusions on this point. It can be assumed, therefore, that aggregate demand is always equal to aggregate supply as a result of the fact that all saving is reinvested. The equality of supply and demand that is guaranteed in this way does not, however, represent a sufficient condition for equilibrium. In fact, in the case dealt with by Vera Lutz, the equilibrium of supply and demand is accompanied by a constant disequilibrium at the sectoral level. The fall in profits progressively reduces industrial investment, and takes the economy in the opposite direction to that desired by the supporters of industrialization.

This obviously does not mean that industrial development cannot be achieved. But it does mean, however paradoxical this may appear, that investment must first be increased, not in the industrial sector, but in the agricultural sector so as to increase the elasticity of agricultural supply and to prevent relative prices from moving in a direction that would reduce industrial profits.

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To assess in full the originality of this position compared with the doctrines then prevailing, especially in Italy, with regard to the industrialization of Southern Italy, it must be remembered that, throughout the debate on industrial policy and the structure of incentives, attention

was focussed on costs, and little or no attention was paid to the problem of the development of a market for industrial products. Vera Lutz set the problem of the demand for industrial products at the centre of her analysis, while her contemporaries virtually ignored the problem. The essence of the disagreement is to be sought in the different assessment of the underlying situation. For most people at the time, the idea that the new industry in Southern Italy could run into difficulty on the demand side appeared irrelevant. Since Italy was integrated in the international market, it seemed obvious that Southern industry, provided it was enabled to produce at competitive costs, would have had no difficulty in penetrating the European market, where the last barriers were soon to be removed. On the contrary, Vera Lutz believed that, even when the difficulties of establishing an industrial sector in an unindustrialized region had been overcome, there would remain the disadvantage of the distance separating Southern Italy from the richer markets of Northern Europe, and the consequently higher costs for the transportation of finished products. This explains why the whole debate brought her and the prevailing trend to a point at which they could no longer communicate and lost interest in each other.

The main problem according to the prevailing view was that of costs. The infant industry in Southern Italy appeared burdened with inevitably higher costs because of the environment in which it was being located, the lack of an industrial tradition, the difficulty of finding skilled workers, or even workers trained for factory work, and the lack of supporting services. The immediate aim of legislation in aid of Southern Italy needed, therefore, to be, in the words of Pasquale Saraceno, "to equalize the conditions" of Southern and Northern Industry. This was considered an objective that even a state based on economic liberalism could and should set itself. However, once industry's starting positions had been equalized in the two regions, Southern industry was to stand on its own feet in domestic and foreign markets. It was not expected that this would be a problem, since Southern industry would start with the advantage of more advanced technology. On these theoretical grounds, the whole effort to industrialize the South was directed towards creating a system of incentives designed to reduce the kind of costs that were likely to be higher for Southern industry. No incentive was foreseen, at least in the initial phases of the intervention, for the employment of labour since its cost was considered to be lower in the South than in the North. The measures were concentrated instead on supporting capital investment. For the same reason no steps were

taken, at least initially, to ensure a market for the emerging Southern industry. The idea that incentives should also promote the creation of a domestic market for Southern industrial products was subsequently translated into the requirement that public sector firms and the state-controlled corporations should purchase 30% of their supplies from firms in Southern Italy — a measure that was implemented only after some considerable delay and even then only partially.

e) *Indications for Economic Policy*

Vera Lutz's analysis implicitly indicates the measures best suited to implement a policy of industrialization.

Her analysis shows that the barrier to industrial development is the difficulty of keeping the profit level high in industry when demand can only be expanded with difficulty and in any case is biased towards food and agricultural products. Measures to promote industrial development must therefore have as their immediate objective to prevent the fall in the industrial profit rate compared with that in agriculture.

Four general guidelines for intervention can be laid down that conform to this approach.

(i) *Increase in productivity in the agricultural sector.* Measures designed to raise labour productivity in agriculture would enable the sector to react to increases in demand, no longer simply by increases in prices, but also by increases in supply. This would prevent the continual increase in agricultural prices compared with industrial prices and bring to a halt the deterioration in industry's profit rate.¹⁰ According to Vera Lutz, therefore, any policy of industrial development must start from a policy to strengthen agriculture; not because the agricultural sector should provide a market for industrial products, but because it must be able to satisfy the increase in demand for its products rapidly. The priority given to the agricultural sector is not, therefore, a consequence of a basic scepticism with regard to the scope for industrialization in developing countries. From this point of view, it would be a serious mistake to consider Vera Lutz as an advocate of an international division of labour making a sharp distinction between agricultural and industrial countries. On the contrary, her idea is that the development

¹⁰ V. LUTZ, *Italy, op. cit.*, pp. 139 and 145.

of domestic production should definitely not be based on specialization, but conform to the structure of demand. Hence, while the strengthening of agriculture appears to be given priority, this must be seen merely as a necessary step to tackle the initial phase of development, during which the demand for products is directed mainly towards the expansion of food consumption. This point will be taken up again below.

(ii) *Limits on the increase in industrial wages.* An indirect way of supporting industrial profits is to curbe the increase in wages. This is obviously an indirect measure that does not tackle the problem at its roots, but attempts to restore equilibrium, through interventions on the cost side, to a situation made difficult by the structure of demand. To the extent that it is not possible to direct demand towards industrial products or achieve a greater elasticity of agricultural supply, the fall in industrial prices can be offset by a corresponding change in relative wages that will provide the industrial sector with an acceptable profit rate, even when relative prices change to its disadvantage.

(iii) *Curbing the demand for agricultural products.* Another measure to support industrial profits is to attempt to reduce the domestic demand for food and agricultural products. To do this, according to Vera Lutz, it is necessary to *develop a policy of emigration abroad*. As will be shown shortly, this is the proposal which, among the various proposals put forward by Vera Lutz, gave rise to the greatest controversy.

(iv) *Support of manufacturing exports.* A last line of action consists of supporting exports of manufactures with a view to increasing what has been called the indirect elasticity of agricultural supply. In fact, higher manufacturing exports permit larger imports of agricultural products, and thus provide another way of overcoming the bottleneck caused by the structural backwardness of agriculture.

4. The Problem of Emigration

In low-income countries with a backward agricultural sector, surplus labour in agriculture is always a hindrance to development. By definition, such labour has a marginal productivity equal to zero, and tends, moreover, to absorb every increase in income in the form of

consumption; if it is left in the agricultural sector, it will consume every increase in agricultural output directly, and, if it is transferred to the industrial sector, it will equally use the income received to purchase food and agricultural products. Thus, a surplus of labour, far from being a resource available for the development of production, is, if anything, an obstacle to the transition from agriculture to industry.

Vera Lutz's position on the question of emigration met, as already mentioned, with violent opposition. To many it appeared that she had been caught up in the abstract logic of her model to the point where she recommended emigration as the solution to the problems of Southern Italy without taking any account of the social costs that the transfer of workers involves. It is, in fact, undeniable that her position on this point was initially based on a view of the problem that was in part schematic. It is equally undeniable that her position as regards this problem underwent the greatest changes as time passed. When she studied the economic problem of Southern Italy in the 1950s, she considered migration simply as a reduction in the demographic load and in the pressure on consumption, and considered exclusively the positive effects of this on the industrialization process. When, during the 1960s, she had an opportunity to study the mechanism of the Swiss labour market, her view became much more carefully considered and cautious. From this point of view, her essay on foreign labour in Switzerland is probably the most mature and complete of her career.¹¹

Thanks to her knowledge of Swiss economic reality, Vera Lutz recognizes that, for migration to start, it is necessary not only that the country of origin should stand to gain from giving up labour, but also that the recipient country should have an interest in obtaining it. To understand the phenomenon of migration in full, it is therefore necessary to study the reasons that induce some advanced countries to import labour. When she tackles this problem, Vera Lutz shows herself to be capable of extremely acute and penetrating analysis. Faced with the large scale of the migratory phenomena that have been a feature of the industrial development of so many countries, not a few scholars have been satisfied with producing generic explanations. The most widespread is that which has recourse to a mechanical application of elementary production theory to claim that the abundance of capital and the scarcity of labour in advanced economies result in a high marginal productivity of labour and push up the level of real wages, thus

¹¹ V. LUTZ, "Foreign Workers and Domestic Wage Levels with an Illustration from the Swiss Case", in this *Review*, March 1963.

stimulating migratory flows. Vera Lutz, without taking a stand vis-à-vis these simplistic explanations, follows a different, and analytically much subtler line. She recognizes that a migratory flow must satisfy specific interests in the labour-importing country and sees this interest in the advantages that the latter gains from the possibility — guaranteed precisely by the presence of immigrant workers — *to divide the labour market into two non-communicating sectors*, each of which covers different activities, consists of different groups of workers and pays different levels of wages.

Her reasoning deserves to be re-examined since, although it was developed on the basis of the Swiss labour market, it could also be applied to the Italian one. The Northern Italian regions have also acted as importers of labour from Southern Italy. Hence one is also justified in asking what mechanisms reconciled the interest of Northern Italy in importing labour and the tendency of the Southern population to emigrate.

Vera Lutz's analysis can be summarized in the following terms. Increases in income in a country at an advanced stage of development produce a tendency for the working population to become concentrated in the activities with the best pay and working conditions. The distinction between preferred and abandoned sectors is not a random one; in general, it can be said that the border line between the two groups of sectors does not exist in principle, but is, in turn, the result of market conditions. During the process of development some sectors are more exposed to international competition and, consequently, must maintain high levels of efficiency and productivity; other sectors producing non-tradable goods and services are protected from foreign competition and can accept lower levels of efficiency. The more efficient sectors recruit the more highly skilled workers and pay them more. The same sectors are technologically more advanced and able to provide better working conditions. The less efficient sectors hire unskilled workers, pay lower wages, utilize relatively backward technologies and offer worse working conditions. The distinction between more and less efficient sectors does not correspond to that between the production of goods and services; among the sectors that are exposed to external competition (and hence efficient) are sectors producing services (such as banking and finance in the case of Switzerland), while, in the group of inefficient producers protected from competition there are sectors producing goods (such as construction). Since the efficient sectors offer better working conditions in every respect, there is a tendency for

workers to abandon the less efficient sectors for the more efficient ones. Furthermore, since the condition to be hired in the more efficient sectors is to possess adequate qualifications, a tendency develops for workers to acquire increasingly high levels of professional qualifications. As development proceeds, workers therefore tend to become increasingly highly qualified, to abandon manual and unskilled work, and to converge on the more skilled and highly paid jobs.

Countries that find themselves undergoing a similar gradual shift of labour and which are faced with unfilled vacancies in the less sought after sectors have the following options: *a)* to reduce the overall growth rate, thereby reducing the rate at which the advanced sectors absorb labour and leaving a sufficient proportion of the labour force in the stagnant sectors; *b)* to modify the structure of wages by reducing the relative wage of the advanced sectors and increasing the relative wage of the stagnant sectors; *c)* to let the sectoral migration of workers run its course and to fill the vacancies in the stagnant sectors with labour from abroad.

The first solution might appear the easiest to put into practice. But to renounce a high growth rate means renouncing one of the most sought after objectives in contemporary society's scale of values.

The second solution, that of opposing the tendency for workers to abandon certain sectors by increasing wages, would require explicit intervention by the economic authorities since, if anything, market forces would be operating in the opposite direction. More specifically, the sectors that attract labour are, as mentioned, the more efficient ones and in these sectors it is easier for workers to obtain wage increases proportional to improvements in productivity. It is therefore more likely that market forces will produce improvements in the relative wage of the sectors absorbing labour than in that of the sectors losing labour, which is exactly the opposite of what would be needed to curb the shift of workers from one group of sectors to the other.

There thus remains the third solution, that of *opening the doors to immigration*, which is the one that spontaneous market forces have produced and are producing in a large number of advanced countries. The importation of workers from other countries is nonetheless a phenomenon that is subject to strict rules which, designed as they are to provide effective protection of the position of national workers, result in the labour market having a rigidly segmented structure.

The traditional theory of emigration, Vera Lutz notes, teaches that the effect of migratory movements is to equalize the level of real wages in the labour-importing and exporting countries. This supposes, how-

ever, that the labour market in the labour-importing country is a unified one, in the sense that national and immigrant workers have the same opportunities. If this were the case, the importation of foreign labour, while it would permit the importing country to maintain a high rate of growth, would nonetheless damage national workers, since it would slow down the increase in real wages. By contrast, Vera Lutz points out, experience shows that the importation of foreign labour is always regulated in such a way as to prevent, at least initially, its damaging national workers. *The segmentation of the labour market* is precisely the way of making it possible to reconcile the two, apparently conflicting, requirements of importing labour on the one hand and of protecting national workers on the other.

Segmentation of the labour market means that *the jobs to which nationals and foreigners have access are rigidly separated*. It goes without saying that national workers reserve for themselves the jobs that were already more desirable and better paid, leaving to foreign workers the jobs they had started to abandon. The way in which this separation is actually implemented can vary: the better jobs may be restricted to national workers because they require a level of education that immigrant workers do not have, or simply because they call for a knowledge of the national language that immigrant workers do not possess, or even by means of administrative procedures for the granting of residence and work permits. What matters is that there be a separation and that it be respected.

If foreign workers are imported within the framework of these rules, their importation will have two effects on the level of wages:

a) a first, general, effect is in conformity with traditional teaching and consists of *a reduction in the general level of wages*, merely as a consequence of the larger supply of labour;

b) a second, specific, effect typical of a segmented labour market is the concentration of the reduction in wages among the jobs open to immigrants, which automatically implies *an increase in the relative wage* of the jobs reserved for national workers.

By means of this mechanism national workers transform the consequences of immigration from being damaging to being beneficial; they succeed in making the decline in wages fall almost exclusively on the group of sectors reserved for immigrants, thus gaining an advantage for themselves in the form of a relative improvement in their position.

However, according to Vera Lutz, this selective mechanism cannot be maintained for any length of time. It is, in fact, practically impossible

to preserve the barrier preventing immigrant workers from having access to the better jobs indefinitely. If the barrier consists of professional qualifications, sooner or later immigrants will acquire the training needed to obtain the better jobs; if it is of a linguistic nature, it may prove effective for a whole generation, but not for the following one. This means that sooner or later the barrier is destined to fall and the labour market to pass from a segmented to a unified state. When segmentation collapses, so do the privileges of national workers. At this point, it is to be expected that the initially favourable attitude towards immigrant workers will give way to explicit hostility and that concrete proposals will be made tending to curb the inflow of new immigrants.

Vera Lutz's analysis, briefly outlined above, deserves careful consideration from several points of view.

A first comment concerns the problem of emigration in relation to the macroeconomic theory examined previously. Vera Lutz considers that it is necessary for developing countries to let a part of their agricultural workers emigrate. Her subsequent analysis of the labour market, conducted from the point of view of labour-importing countries, shows that emigrant workers succeed in finding employment only because they take up a subordinate position in the framework of the structure they enter. When she studied the case of Southern Italy, she claimed that a part of the Southern workers would have to emigrate to make the industrialization of the South possible; when she analyzed the case of Switzerland, she recognized that this migratory flow, which occurred on a very large scale, *served to provide the advanced countries with a labour force to be exploited* and on the basis of which the privileged positions of national workers were erected. The only attenuation of this state of affairs is that, as the years and generations go by, the revenge of the emigrants (or of their descendants) begins as they themselves succeed in penetrating the higher echelons of the labour force.

A second consideration is more directly related to the analysis of the labour market within developing countries. The theory of dualism put forward by Vera Lutz is based to a large extent on the different degree of unionization in the various sectors. Vera Lutz claims that, in the highly unionized sectors (mainly those with large firms), the wage level is higher, which would reduce employment; while, in the less highly unionized sectors (mainly those with small firms), the wage level would be lower, which would make it possible to create more jobs. Vera Lutz's analysis of the Swiss labour market considers dualism from a different point of view. It does not appear that in a market of this type,

dualism can be created exclusively by trade union action. On the contrary, the underlying factors giving rise to dualism are attributable to technological considerations (the different need for skilled labour) or even to aspects of a market nature (the different degree of external competition to which the various sectors are exposed). The vein of anti-unionism in Vera Lutz's thinking that led her to see the mistakes of the unions as one of the ills of the Italian economy appears considerably attenuated when she analyzes the Swiss labour market, which, *even though it cannot be considered as dominated by extremist unions, is nonetheless found to be marked by a pronounced dualism*.

5. Vera Lutz and the Prevailing Theories of Her Time

Vera Lutz's macroeconomic theory differs in various respects from the prevailing theories of the period in which she wrote. Although it is always difficult to compare different theoretical positions, it is perhaps worth recalling some of the most widely held views regarding economic development and contrasting them with Vera Lutz's.

In her view, the key to the problem of development is to be found neither in the struggle between classes, as Marxist theories assert, nor between social groups nor between dominant and dominated countries, as modern theories of dependence have it. Economic development, in her opinion, is a spontaneous product of the market, provided that the market is left to act according to its natural rules without hindrance or interference.¹² She therefore does not accept any of the theories that find the key to underdevelopment in some specific form of inferiority:

a) She does not consider it right to talk of *technological inferiority*. As is well known, there has been no lack of those arguing that, since developing countries do not have the ability to develop their own technologies and consequently have to adopt technologies developed in advanced countries, they find themselves having to operate in technological fields that are not suited to the available resources. The works of R.S. Eckaus and of G. Fuà are along these lines.¹³ Vera Lutz does not

¹² V. LUTZ, "Das freie ...", *op. cit.*, and "Italy's Problem: Unemployment", *Swiss Review of World Affairs*, 1953.

¹³ R.S. ECKAUS, "The Factor Proportions Problem in Underdeveloped Areas", *American Economic Review*, 1955; G. FUÀ, *Lo sviluppo economico in Italia*, vol. 1, F. Angeli, Milano 1981.

attribute particular importance to the problem of the rigidities of technologies or of the fact that they are imported. In her opinion, the technologies available are not such as to put obstacles in the way of the full employment of productive resources, provided the market mechanism is not blocked by the presence of monopolies.

b) It is equally wrong, in her view, to attribute fundamental importance to the presence of *external diseconomies*, which, in developing countries, are supposed to preclude the spontaneous emergence of private entrepreneurs capable of competing in the market. At the time Vera Lutz was writing, Saraceno had elaborated his theory of the greater costs borne by firms located in developing regions and of the need for the state to intervene with a policy of incentives to equalize the starting positions of firms located in different regions.¹⁴ Saraceno's approach was one of those that, while respecting the market economy, assigned a specific role to public intervention and thus ended up by considering a form of mixed economy to be desirable. Vera Lutz never attributed decisive importance to similar approaches. She never denied that developing regions such as Southern Italy may suffer from organizational shortcomings that reduce the productivity of resources and raise the level of costs. But the conclusion to be drawn from situations of this kind is that, if labour productivity is lower in Southern Italy than in the other regions, then the level of wages must also be lower. Once the level of wages called for by the market system is re-established, the external inefficiencies and the lower yield of investment will appear for what they are, i.e. an artificial problem created by a wage level that is justified on social grounds but incompatible with the actual structure of the economy.

c) Similar considerations can be made with regard to the *indivisibilities theory*, introduced into Italy at the time by Rosenstein Rodan. This theory is applicable in part in the public works sector and in part in relation to directly productive private investment. As for the question of public works and the, widely recognized, need for the most demanding works to be carried out with the support of, or even by the state, there are no grounds for believing that Vera Lutz was opposed to this view, more especially as it is a principle that is applied everywhere and not just in developing countries. Conflict arises, on the other hand, in connection with the indivisibilities of a third type, those on the

¹⁴ P. SARACENO, *Il meridionalismo dopo la ricostruzione*, Giuffrè, Milano 1974.

demand side, which, in a developing country, are supposed to represent an obstacle to private enterprise and to make necessary a certain amount of planning in the directly productive investment sector as well.

Difficulties of this kind cannot arise with Vera Lutz's approach, since the problem of the indivisibility on the demand side arises as a concrete problem above all when it is a question of a closed economy. If, as Vera Lutz assumes, a developing economy takes on the form of an open economy, and if, as she considers indispensable, the logic of the market is respected with regard to the retribution of productive resources, no problem can arise on the demand side. Competitive firms will make good the shortfall in domestic demand abroad, and if a part of the income generated by productive investment gives rise to an increase in imports, the equilibrium of the external accounts will be ensured by changes in the exchange rate. If, furthermore, as Vera Lutz believes is the specific case of Southern Italy, the developing economy is excluded from foreign markets because of excessively high transport costs, the new industry is not bound by efficiency constraints since it is intended to supply the domestic market and hence is not bound by size constraints either, and the problem of indivisibility does not even arise.

d) Vera Lutz adopts an equally negative position towards those who justify the presence of public enterprise in developing countries by claiming a *structural inadequacy of entrepreneurial ability*. This was, in her time, the position taken up by Arthur Lewis and (in Italy) by P. Saraceno. In none of her works is a similar idea to be found, nor is there any element justifying the deduction that she considered developing countries to lack entrepreneurial ability.

e) If she does not accept any of the positions that, directly or indirectly, end up by justifying public intervention in developing countries, this does not mean that she blindly embraces the numerous abstract theoretical models of development based on the action of the market. In this direction the leading example is obviously Arthur Lewis' model, which was further elaborated by Fei and Ranis.¹⁵ The model sets out to interpret the process of accumulation in an underdeveloped economy where the investment process is regulated by the supply of saving and productive activity is entirely in the hands of private enterprise. According to the model, underdeveloped economies are

¹⁵ A. LEWIS, *The Theory of Economic Growth*, London, Allen & Unwin, 1955; J.C. FEI and G. RANIS, *Development of the Surplus Labour Economy*, Irwin, Homewood 1964.

marked by *an unlimited supply of labour*, where unlimited supply means the willingness of workers to offer their labour at a constant wage related to the subsistence level in agriculture. As has already been pointed out, Vera Lutz does not accept this assumption. Her knowledge of developing economies, and of Southern Italy in particular, leads her to believe that the subsistence level in agriculture is a magnitude that is totally irrelevant in determining the wage level. For Lewis' wage theory to be correct requires that, as labour passes from agriculture to industry, those who remain in agriculture will be satisfied with the same level of consumption as was available before, and that this level will serve as the norm for setting the wage in industry. Experience shows, on the contrary, that the reduction in demographic pressure on the land leads to an increase in per capita consumption, and that the wage paid in the industrial sector consequently has to rise progressively. Vera Lutz's refusal to accept the wage theory based on subsistence implicitly involves her refusal of the whole of Lewis' model.

6. Vera Lutz's Intellectual Isolation

Vera Lutz's analysis of the Italian case led her to conclusions that were in profound conflict with the dominant economic policy strategies of the day. The constant anti-union thread running through her work was in conflict with the emergence of the unions as an unquestioned social force towards the end of the sixties; her steadfast liberalism came up against the interventionist ideology, which at the end of the fifties, even before the Centre-Left became a government formula, already envisaged an economic policy based on the accelerated industrialization of Southern Italy and the nationalization of a number of key sectors of the economy; her egalitarian creed of equal starting positions (cf. her insistence on public education policy) made her dubious about the attempts to implement egalitarian policies *ex post* simply by levelling money wages (abolition of geographical wage inequalities, income supplements and various subsidies). In her view, a wage and wealth levelling policy needed to be pursued by tackling the problem at its roots, i.e. by levelling education, vocational training and, in the final analysis, the productivity of the various forms of labour. By contrast, she saw Italian economic policy as having an increasingly superficial

orientation, designed to achieve apparent levelling by manipulating money incomes and forced to offset the deviations from the logic of the market through more and more extensive public intervention.

In her writings for the Italian public Vera Lutz restricted herself to presenting her views in analytical terms. Without sparing criticism, she refrained from entering into arguments of a political or ideological nature. In an essay for the German public, on the other hand, she described the political and intellectual climate of the Italy of that period in words that clearly revealed her profound disagreement.

The essay containing this "confession" was published in 1963 (see note 6) the year of the shift to a "Centre-Left" Government in Italy. She informed her readers of the climate favourable to public intervention that she thought now prevailed in Italy, and sought to explain the factors that had made this possible. The ideology of the Left, she argued, was based on a series of errors. The unions were in error: by continuing to pursue an outdated Marxism they stubbornly continued to regard labour conflicts as a class struggle. The parties of the Left were in error and especially the Communist party, which Vera Lutz considered to have retained a basically extremist and revolutionary attitude, an attitude which, she claimed, damaged the country's political activity by causing workers and employers to adopt rigid hostile positions as extreme as they were useless. The intellectuals were in error since, for the most part, they were Left-wing sympathizers who had become open supporters of an interventionist policy without any logical justification. And, finally, the professional economists were in error: corrupted as they were by Anglo-Saxon Keynesianism, they had abandoned the sound theoretical foundation of the liberal school and attributed effects, as miraculous as they were fanciful, to public expenditure. In painting this picture, Vera Lutz appears to have been fully aware of the isolation in which she would find herself. Although well known and widely discussed, her works did not seriously influence the debate on the economic policy of the day. The theory of dualism was soon pigeon-holed, and her suggestions regarding economic policy were quickly forgotten.

Napoli

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