1995

A Positive Program for Successful Capitalism

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Introduction

1995 marked the fiftieth anniversary of the end of World War II. As these great victories were celebrated a moment should have been set aside to celebrated a something that has not happened since World War II: a non event which strongly affects our discourse on economic and social policy. This non event is a depression, which by not happening made Post World War 2 capitalism a success.

Capitalism, an economic order based upon private ownership and direction of the means of production, comes in many forms, ranging from the American slave society, Hitler's Germany, the fundamentally laizzez faire capitalism of the late 19th century, Latin American oligarchic societies to the post World War 2 Scandinavian welfare states. Capitalism is compatable with democracy, but, as Germany demonstrated in the 1930's, it is also compatable with brutal totalitarianism.

It was the specific post World War II capitalism, and not some abstract market economy, that has been successful. By its success, this specific form of capitalism secured the victory in the cold war and "buried communism". Today we smile in a superior way at Krushev using his shoe to pound

1. This title consciously echoes Henry Simons *A Positive Program for Laissez Faire.*

the podium at the United Nations as he promised to "bury capitalism". We smile because we collectively forget that by some measures the Soviet Union was doing better at that time in economic growth and recovery from the Great War than the capitalist countries. Furthermore Marxist doctrine held that depressions were inevitable under capitalism and Krushev assumed that one would occur soon. A depression on the scale of the great depression would make the Communist model seem even better relative to the Capitalist world. Krushev was wrong because:

1. The Soviet Union's rapid growth was mainly due to its rebuilding of war damages and was not sustained after the first reconstruction was completed and
2. the depression, so confidently assumed by Krushev as being just around the corner, did not take place.

The successful capitalism of the era that began in 1945 was a far different creature than the capitalism that was such a dismal failure in the winter of 1932-33 and which never recovered sufficiently to achieve anything resembling a close approximation to full employment until after 1939, at which time wars and preparation for war led to a vast expansion of government demand for labor and goods. The crushed economy of 1932-33 was the result of an interactive process among income, employment, asset prices, and property values over the some three and a half years which began in October of 1929 and finally came to a halt in March or April of 1933. Irving Fisher called such an interactive process a debt deflation.

Half hearted attempts by the Hoover Administration, the Leaders of Finance and Business, and the Federal Reserve to halt and reverse the debt deflation process failed: the prevailing view was that the contraction would have to work its way through the economy. Today there is talk about a safety net - in the three and a half years of the great collapse of the American Economy there was no safety net. A wide fall in standard of livings took place.

The United States was not alone and arguably it was not the worst performer over the 1929-1933 period. The Great World Wide Collapse of Capitalism hit Germany and Japan very hard. It led to Hitler becoming the Chancellor of the Reich and Japan to undertake to create a Greater East Asia Co-prosperity Sphere. The Co-prosperity sphere required that the United States and other "colonial" powers be expelled from the East Asia.

The United States "lucked out". Ineffectual Herbert Hoover and the Republicans were replaced by Roosevelt and his coalition of Democrats, Progressive Republicans, liberals, and even former Socialists.

There is no evidence that Roosevelt had any deep understanding of what caused the Great Contraction or about any inherent flaws in Capitalism. The systematic exposition, by John Maynard Keynes in *The General Theory of Employment Interest and Money* of the ways in which

Capitalism was flawed and how apt interventions can contain effects of the flaws, was not available until the end of 1935.

If there was any consistent intellectual source of the approach to the depression and to the reconstruction of capitalism by the Roosevelt administration it was to be found in the American institutionalist tradition in economics (Veblen, Commons, Mitchell and Ayres) and legal scholars who had wrestled with the concept of ownership in a corporate world. Much of what became characteristic of the New Deal were amalgams of "moral" positions, such as no one will starve in America and a "dole"[2] is anathema, and structural reforms, designed to root out imperfections in the banking and financial system that were revealed in the great contraction.

The American capitalism that emerged from World War II, and which was the institutional base of the successful no depression capitalism of the past fifty years, did not conform to the *laissez faire* model, which is inscribed in textbooks and serves as the core of the, "training" that professional economists acquire.

Capitalism was successful not just because deep depressions were avoided but also because a closer approximation to full employment than had hitherto been

2. This dole is not the long time Senator from Kansas but rather the British system of cash payments to unemployed adult males. The "made work" programs of the New Deal, the W.P.A., N.Y.A. and C.C.C. were the logical result of these two prejudices of Franklin Roosevelt.

achieved was realized and becuase as President Kennedy phrased it "A rising tide lifts all bottoms.", i.e. there was a braod distribution of the gains in total income due to the substantial economic growth that was achieved. In 1930 Upton Sinclair ran for governor under a banner of EPIC, "end poverty in California". In the 1960's Lyndon Johnson waged war on two fronts, in Vietnam and on poverty. In truth poverty in America was decreased substantially between the end of World War II and roughly 1970. In the years since 1970 poverty in the United States has increased. This increase in poverty and also in insecurity has made the American capitalism of the years since 1970 less successful than the the capitalism of the first 25 years after World War II.

In spite of the deterioration of the performance of the economy during the second 25 years of the Post World War II era as compared with the perform~~Nm~~ance in the first 25 years, the overall performance over the fifty years has been successful. However the relative decline of the performance during the second 25 years as compared to the first twenty five years is an illustration of the general rules that nothing lasts forever; in particular if economic rules or interventions effectively constrain the self seeking behavior of agents in the economy in time ways to avoid or evade the constraints will appear and become prominent characteristics of the economy.

The particular capitalism that was successful in the World War II era was and remains a big government interventionist capitalism. It has a big government at its center 20% or more of GDP and, for the earliest and most successful part of the era, a central bank (in the United States) that ~~was~~ is not encumbered by a need to be concerned about the status or value of its currency in international markets. The United States' reconstructed capitalism falls into the general classification of a welfare state, inasmuch as old age pensions, aid to families with dependent children, and unemployment insurance were part of the post war structure but elements such as universal children's allowances, universal medical care and a large expansion of education support, which were usually part of the European Welfare State, were not part of the post war structure welfare state structure. The expansive human education of the post-war veteran's programs did not become a permanent part of the social structure in the United States.

Sustained prosperity in the United States, combined with the dominant international financial position of the dollar, allowed, through transfers such as the Marshall Plan and an open door to imports, for American prosperity to spill over to both Western Europe and Japan. The war in KOREA was an essential step in Japan's taking to a "modern" industrial state The United States' international position was so dominant in the beginning of this era that even after Europe and Japan achieved a prosperity that was commensurate with that of the United States, the United States was able to continue to run deficits in trade, which powered the economic expansion of a second tier of countries: Hong Kong, Korea, Singapore and Taiwan.[3] {Minsky Wallenberg Papers}

One result of *no depression* for half a century is that the collective memory of the United States has but a dim awareness of the fragility of good times and the prevalence of hard times in the essentially laissez faire and small government capitalism that ruled prior to the Great Depression. The main strain of economic teaching and thinking about economic policy these days takes "*no depression capitalism* " as the normal outcome in a market economy.

The Impact of Institutions
Upon the Performance of the Economy:
The Government - Economy Interface.

One characteristic of the "no depression" capitalism of the Post Wold War II era has been an abscence of any sharp decline of of aggregate profits. Another characteristic has been that no collapse of asset values has occurred.[4]

3. The United States ran a trade deficit even as it ran a surplus on correct account until about 1980. The politically and economically disastrous deficits in trade and the balance of payments did not occur until the Reagan administration which began in 1981.
4. It is worth noting at this time that the general assertion about portfolios and repositories for private wealth, to the effect that any well structured portfolio should include equities, assumes, without making the assumption explicit, that there will be no drop in equity values such as occurred over 1929-1933 when the Dow Jones

Both of these characteristics are due to the new demensions of the governmetn econoy interface in the post war period.

The institutional reforms of the 1930's achieved these objectives perhaps unwittingly. In a market economy the amount of aggregate profits is determined by the composition of demands and how the various demands are financed. Demands are financed in one of three ways:

1. by current income flows: (including retained earnings)
2. by activating idle ~~bal~~ cash balances
3. by debt + equity issues

Economic Theory Underpinnings

of our Positive Program.

These days the invisible hand assertion of Adam Smith,

<u>cite</u>

is virtually a postulate for thinking about economic policy, even though Smith's assertion has been shown to be true only if several very heroic and essentially unacceptable assumptions are made.

It is widely believed by the policy oriented professional economist of the United States that mathematical general equilibrium theory shows that a decentralized market economy leads to an outcome that can be labeled an optimum, i.e. a best. However this best rests

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fell to some 15% of its high. Between 1929 and 1933 ~~cash,~~ govmt bonds + currency ~~was a~~ were much better assets to hold than any portfolio of common shares and private bonds. Not enough Govt. Bonds in 29 upon two very tough assumptions:

1. That the existing distribution of wealth (and power) is sacrosanct.

and

2. That all agents in the economy have perfect foresight.

In a capitalist economy the existing distribution of wealth is a result of the behavior of the economy in the past. It reflects the differential impact of past government policies upon the creation of capital and the current policy on interventions to prevent or contain deep and prolonged depressions. Even though many large fortunes are the result of the functioning in the economy of the present owners of these fortunes, many are due to inheritance. - they can be said to have earned them - ~~the~~ That main argument against emphasized by H. Simons great disparities of wealth and incomes is that such disparities seem to be incompatible with the continued existence of constitutional democracy. As a minimum the bottoms to incomes need ~~s~~ to be compatible with sustaining self esteem and the tops need to be such that a few cannot undermine democracy by using the power their wealth brings them to subvert the political process.

One peculiarity of the proofs that market economies have the properties that conform to Adam Smith's dictum is that the agents in the economy have "perfect foresight": they can transform observation on the past and their knowledge about the way the economy works - i.e. a correct economic theory - to predict the future well enough for purposes of decisions making about investment, financing of asset ownership, and ~~household~~ composition of portfolios portfolios. The world of economic theory is knowable and known and agents in that economy know enough of how the economy functions through time to make valid decisions. Paraphrasing a remark due to Peter Albin "*The agents in the economy have a model of the "model" and this model is sufficiently true so that the agents for all practical purposes operate as if they have perfect foresight*". In other words agents in the economists view of the world have no doubts about their vision of the economy.

The physicist Richard Feyneman described the mental state of the scientist as "*The scientist has a lot of experience with ignorance and doubt and uncertainty, we take it for granted that it is perfectly consistent to be unsure.*"[5]

If economic agents are not like decision makers in the rational expectations assumptions but rather are like Feyneman's scientist, in that they not only have imperfect foresight but they know they have imperfect foresight, This means then that the equilibrium, to which the invisible hand is supposed to guide the economy, does not exist. In particular if those economic agents who as managers of firms finance positions in capital assets and investment outputs and those who as bankers and managers of portfolio's acquire equity and debt instruments conform to Feynman's scientist then under

5. Richard Feynman as cited in The New Yorker magazine of May 15, 1995 p46.

coherent or simple a tranquil behavior

various circumstances small deviations from an "equilibrium" will lead to large scale changes in the movement of economic variables: the economy becomes far removed from the former tranquil state ~~equilibrium~~ and by means of the internal reactions that determine the overall behavior of the economy, ~~may lead~~ to behavior of the economy that is best described as incoherent emerges. If such tendencies exist then the observed tendency towards coherence become dependent upon the current system of interventions and constraints in the economy, which have the effect, in analytical terms, of establishing new initial conditions for the interaction dynamic processes that generate the observed variables in the economy.

In an economic world in which equilibrium does not exist economics of necessity must deal with processes that generate the path through time of the economy. The economic world of a theory which does not lead to equilibrium results is one in which periods of tranquil behavior (pseudo equilibrium) give way, because of the internal structure of the processes that determine the interdependent system's path through calender time, to potentially explosive, implosive or hysteretic interaction behavior.

Incoherent behavior by an economy can be observed only for short intervals. In all but a few instances systems of constraints and controls, which contain the incoherent behavior and set the economy into a new regime of transitory tranquility, become operative. During these episodes of transitory tranquility the economy seems to achieve a semblance of the smooth behavior that could be passed off as an equilibrium, but it is a *pseudo equilibrium* because it is mainly the results of effective constraints and interventions. Note that such *pseudo equilibria* are conducive to risk taking and investing. As will be argued later 'effective' interventions, which sustain a close approximation of full employment, are more certain guarantors of future gross profits than the invisible hand postulated by economic theorists.

Propaganda, for the benefit of those who do well under controlled capitalism, by economists, who do well by catering to those who can pay for such views, has led the public as well as our policy makers to accept the superiority of the laissez faire model of capitalism to the interventionist model. The fact that a economic structure and policy regime that was a close approximation of laissez faire did not do well in the early part of the twentieth century and well nigh completely broke down over 1929-33 whereas the very imperfect interventionist regime, whose contours were largely set in place during 1933-1937, enjoyed unprecedented success over the first 25 years after World War II and middling success in the second 25 years, has been made ~~was made~~ obscure by a chorus orchestrated by those who, in spite of doing well, were disaffected by the level of taxation required by a successful big government capitalism if it was to maintain the validity in the market of its debts. Inasmuch as the structure of the successful capitalism of the Post World War II era depended upon the unquestioned

integrity of the government's debt contract big government capitalism requires a revenue system that can raise the required sums to support not only a big government but also
to service
a sizeable government debt.

Thus the current dominant view as to policy making as we approach the end of the 20th century rests on false analytical premises, such as the proposition that agents have perfect foresight, and a poor reading of history, an unwillingness to recognize that the capitalism that ruled after World War II was different from and superior to the capitalisms of earlier times.

For the United States this *no depression capitalism* that ruled over the *fifty years* since World War II is especially striking when compared with the behavior of the American economy over the 75 years that elapsed from the end of the Civil War to the start of World War II. The Great Depression, which began in 1929, hit bottom in 1933 and still ruled until the massive fiscal impact of World War II brought prosperity, was just the biggest of the regular progression of hard times, rainy days and depressions that characterized the path of the American economy as it industrialized.

Even as 1995 is the 50th anniversary of the end of World War II so 1996 is the 100th anniversary of William Jennings Bryan's Cross of Gold speech to the Democratic Party convention. In that speech Bryan articulated the frustration of the American workers and farmers over the run of crunching depressions that had taken place over the 30 years since the end of the Civil War. The depressions against which Bryan railed were followed by depressions in 1907-8, 1921-22, the big one of 1929-33 and a final pre World War II depression of 1937-38. No depression of a depth or an intensity comparable to those of the first forty years of the 20th century has occurred since 1940.

Something that was right in the post World War II American capitalism was missing in the earlier American Capitalism: this something was the ability of the Federal Government and its agencies to contain and offset the tendency of our capitalism to deteriorate into serious depressions. There are two candidates for what is better between 1945 and 1995 which was not there between 1865 and 1940. One is the immensely larger share of the federal government in the economy. This larger government sustains profits through its deficits, which occur when private investment falters and when as a consequence, income falls away from a high and growing level.

The second is the way in which the stability of the banking and financial system has been enhanced by a combination of

1. central banking that is not constrained by gold standard rules,

2. the contractual requirement for deposit insurance, and the Federal government as the guarantor of deposit insurance, to infuse implicit or explicit equity into

negative net worth depository institutions, and

3. the sustaining of the prices of financial assets by a combination of the Central bank intervention into financial markets and the aforementioned manner in which government deficits sustain aggregate profits when private market determinants of aggregate profits would lead to a fall in aggregate profits.

Both the increase size of the government and the greater ability to stabilize financial markets are improvements in the control mechanisms for the economy, which contain the downside potential of the economy, over the control mechanisms of the earlier forms of capitalism in the United States. Government tax and spending policies, which turn from surpluses towards deficits whenever the economy contracts and from deficits to smaller deficits or surpluses whenever price inflation rears its head, has the power to contain both depressing and inflationary potentials of our economy.

The impact of the increased share of government in preventing depressions follows from the way government deficits sustain and even increase business profits whenever private investment, the dominant source of profits in a small government economy, turns down. Financed investment spending sets in motion activities that force savings and profits out of a small government capitalist economy, If the Federal Government had been significantly smaller in relation to the economy than it is now, say we had a Federal

Government that was 3% of Gross product, as it was in 1929, rather than a government that was about 25% of Gross product, as it was during 1988-1992, then the mild recession at the end of the Bush administration would have been a major depression. It was big government + the refinancing of banks + S+L's by G that saved President George Bush from going down in history as a second President Herbert Hoover.

In the absence of the government which runs large deficits, a decline in investment and profits, in the context of a fragile financial structure such as we had in the late 1980's, would trigger a recursive debt deflation process by which an intensely financial market economy collapses into a deep depression. Government interventions stabilize the economy by stabilizing profits. With profits sustained a collapse of income, employment, output prices, investment and asset values does not occur.

It is not necessary for Government to be as big as it is now to be effective in containing depressions: a government that is 20% of Gross product would do, especially if tax and spending programs were such that a small fall in income and employment would lead quickly to a deficit large enough to sustain profits. For this to happen government revenues would need to decrease markedly and government spending would need to increase sharply when income falls. This implies that the tax system would need to be very progressive.

A government that is somewhat smaller than our present government, one that is say 20% of gross product, needs to have a tax system that collects a bit more than 20% of gross product during good years even as it runs deficits in poor years. But a tax system that collects some 20% of gross product in taxes bites into the incomes and the purchasing power of the public. Such biting taxes mean that there is a constant danger of a tax revolt, especially if the public is unaware of the relation between the size of government and the well being of the economy.

Government debt is unlike private debt only in that government has a longer expected survival time any private debtor. In history government debt has often fallen into bad repute: the phrase "Not worth a Continental" refers to the worth of the debt of the Continental Congress in the interval between the Washington's victory at Yorktown and the birth of the Constitutional Republic. The worth of government debt, like the worth of any debt, depends upon the cash receipts of the debtor. The credit card debts of most people, and the debts of the credit card issuers on the markets largely depend for their value upon the mainly wage and salary incomes of the card holders. The value of bonds and stocks of businesses depend upon the gross profits that enterprises earn. The value of government debts depend upon the ability of the government to collect taxes.

The implication I draw from on the one hand the necessity of government to be big and on the other hand that the tax system this government needs, in order to maintain the acceptability of its debt in bad times, has to yield so much in revenue that there is always a threat of a "taxpayer's revolt". It behooves those who recognize the fragility of capitalist success and its dependence upon government being big to propose tax systems which are adjudged to be fair and spending programs which yield benefits that are wide spread and deemed to be worthy. Those who are aware of the importance of big government to successful capitalism need to forever be questioning the wisdom and the aptness of the taxing and spending policies in place.

Every tax system has a structure. Every spending program has a structure. A tax system put in place over the past fifty years can now have different impacts than it had when it started. A great deal of the tax and the spending programs in place have their origins in the measures undertaken to overcome the great depression of the 1930's. Such measures initially put in place in the effort to recover from the great depression have been adjusted and revised through the years. In their present form and in the light of a capitalism which has not had a serious depression for half a century they may not be appropriate.

No institutional structure will be efficient forever in a world where the restrictions of the institutional structure constrain self interest driven behavior. There is a propensity to evade and avoid restrictions just as there are propensities to evade and avoid taxes. The Jefferson idea of a need for a revolution every 20 years has merit. However the revolution need not be a dumbing down of the society which is the characteristic of the Republican Conservative "Pseudo Revolution". We must not forget that a core of the neo-conservatives consists of former Trotskyists and their Red diaper babies: Once a Leninist always a Leninist.

THE EMPLOYMENT SYSTEM
AND
THE MEANING OF FULL EMPLOYMENT

Labor market conditions are one indicator of the success or failure of an economy. One standard which is used to measure the success or failure of an economy is the ability of the economy to provide a close approximation to full employment over an extended period of time. In this view lapses from aggregate full employment should be of short duration.

The substantive meaning of full employment is not invariant over time. In an economy denominated by peasant propriator agriculture or the American "family farm" periods of not working at agriculturre alternate with periods of intensive work. Furthermore a peasant propriator may well work for wages. Most of the discussion of emplyment policy in the post World war II period assumed that on the whole most workers had employment relations with one firm or agency over a substantial set of years. Such relationships characterized employment in the large firms and held not only for manual labor but alos for managerial cadres. Such a system led to tying the well being of a worker to the well being of a particular business.

An alternative emloyment system is one in which an employee is of a particular skill and emplyers hire from a rostrum of available workers on some rotation basis: this is a union hiring hall or some shape up system. Every worker may appear to be a casual day worker but ove a span of time the worker may well get the full year number of days worked. A modern alternative is the system of temporary workers hired through a placement firm which has a rostrum of available workers. This temporary system is used to give flexibility in permanent staffing.

In recent years it has become increasingly apparent that a cadre of management, the middle layers, is becoming a source of job movement and job displacement.

Two pronged tax reform Consumption based tax and value added tax.

Pro progressive consumption based "income tax" Tax what one takes out rather than what one puts in.

Defining what one takes out: fair rental value of owner occupied homes.
This is the biggest loophole in all of our tax laws

The deductability of all payments on mortgages, not just the interest.

Capital gains tax as selective: pension funds capital gains are not taxed - the incomes of the pension receivers are taxed and there is no distinction between what part of the income is due to interest and dividends and what part is due. Essentially treats self managed assets as equivalent to fund managed assets.

Value added tax: We now have a partial value added tax.
VA = VA labor + VA by capital

Employers contribution to social security = %(value added by labor) + 0(value added by capital)
whereas
VAT = (VA Labor + value added capital)%
split VA payments into SS%(VALabor) and (1-ss%)(VALabor)
and add %VA(Capital)

Dominici - Nunn: The emergence of a Serious Alternative to the our current Income Tax.

The current griping about the poor performance of the economy reflects the fact that the first period after World War II, 1945-1970 was markedly better than the second post war period, 1970-1994. This deterioration while serious, is minor compared to the mass poverization that took place say between 1929 and 1933.

Large government combined with the need for fiscal responsibility, which requires that government debt does not increase as a ratio to national income over a run of years means that the tax system must
The proposal by Senators Domenici and Nunn to shift to a combination of progressive personal consumption tax and a value added tax from our current combination of a progressive personal income tax and a corporate income tax elevates the seriousness of the discussion of tax reform.

positive3

Tom Stoppard "Arcadia"

Septimus, Thomasina's tutor

"When we have found all the meanings and lost the mysteries, we will be alone on an empty shore"

Beautiful, but Thomasina caps him, very simply:

"Then we will dance"

The tragedy of our times can be captured by why havent we danced when GDP is seven thousand billions and in potential GNP the total is much greater.

The reason for affluence is that we can do the mundane things necessary so that we can feed our faces: this means we can talk about morality and do poetry and dance. It is fear and fear alone that makes us retreat from enjoying what is and keep up a quest for more and more.

In nominal terms GNP is some 140 times what it was during the bottom of the depression and yet at that time a charismatic and happy warrier who was President of the United States could call us to battle to free from want the 1/3 of our country that was ill fed and ill housed. Could rally America to free the world to battle for the four freedoms: from want, from fear, and of religion and of speech. We need to recapture our can do spirit and eliminate from the seats of power those of little faith and of little vision.

The road to true affluence is by censoring wants - for a family and for a nation. Who needs multi million dollar incomes.

globalized finance

modern 100% money TRANSACTION BALANCES +
currency offset by public debts.

Purchased deposits capital absorption ratios by assets, not liabilities and HPM. No need for HPM.

globalized finance and national sovereignty over income creation

Social Security, private "induced provisions"

Housing in a modern world

Labor mobility

Full employment

Fiscal Policy: not just the aggregate but also the shape

Composition of government spending,
structure of the tax system

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Introduction

Analysis of economic policy in the United States is dominated by a conservative mantra that gives one answer to fit all situations: "Let the *MARKET* do it." or "The *MARKET* solution is best". This dominence of the *MARKET* in the discourse is surprising for the best experience of the American economy sisnce the founding of the Republic is the post New Deal period that began after the second World War ended.

Economic theory like other theories is the blinders puton a horse, it which limits the field of vision. The dominent economic theory is deeply flawed for it was designed to mimic physics in the days when phsics set up problems so as to reach an equilibrium. Thus the elementary construction of supply and demand curves with a nice intersection which defines ther equilibrium. This Economics A construct is perhaps a good way to start thinking about elementary problems but it tells us little about how a complex system of interrelated supply and demand curves which are dated so that some relate to the past, others to the present and still other to the future.