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## Chapter V of "Financial Instability and the Current Economic Policy" -- Perspectives on Economic Theory

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Chapter V.

Perspective On Economic Theory

I. Introduction

Merely asking the question "why is our economy so unstable?"

leads to a perspective ~~on the economy~~ that is different from

that which now <sup>guides</sup> ~~rules in Congress, the Administration, and the~~

various public bodies where economic policy, <sup>Policy making</sup> ~~is made.~~ ~~The per-~~

~~spective on how our economy works that dominates in the making of~~

~~policy~~ is rooted in the economic theory of the <sup>who have the ear of</sup> ~~advisors to~~ policy

makers. This ~~economic theory is~~ <sup>Today's</sup> standard economic theory,

~~what~~ is commonly called the neo-classical synthesis ~~but which~~

(Joan Robinson has pithily labeled <sup>it</sup> as "Bastard Keynesianism") ~~this~~

~~theory~~ is flawed because it cannot explain instability.

Because their <sup>established</sup> ~~theory~~ cannot explain instability, <sup>policy is based</sup> ~~the policy~~

<sup>now being used both by the experienced</sup> ~~advising economists hold that the observed~~ instability is either

due to a "devil" or "human error" <sup>or it has been approached in each episode</sup> ~~Instead of the various instances~~

of instability <sup>and not</sup> ~~being seen~~ as different manifestations of a common

tendency, ~~each instance~~ is treated as a special case. Because ~~each~~

<sup>experience</sup> ~~instability~~ is viewed as ~~being, in each instance, due to special cases.~~

~~circumstances, the~~ <sup>is</sup> ~~policy advising economists~~ are unable to

<sup>develop</sup> ~~prescribe~~ measures to eliminate or attenuate instability.

~~In all disciplines~~ <sup>The</sup> theory serves as both a lens and a set of blinders. Like a lens theory focuses thought upon those problems

that are well defined within the theory even as it blurs the rest of the possible areas of study. Once thought is focused on a well delineated area, meaningful relations and descriptions of behavior within the isolated part of the system are derived. As a result theory enables conditional predictions to be made about a limited set of phenomena.

Like a set of blinders each theory narrows the field of vision. Questions that seem meaningful to one not trained in a particular theory are nonsense questions to one wearing the blinders of the theory. If the "nonsense" questions will not go away, if something out there in the world keeps on posing embarrassing questions to the practioners of the discipline, then the theory becomes negotiable -- it is subject to change. A change in theory involves shifting the lens and adjusting the blinders, it requires the development of new mechanisms and relations as the instrument of thought. Changing theory is a difficult intellectual process.

From the point of view of standard economic theory the question "Why is our economy so unstable?" is either a false, trivial, or nonsense question. It is false in the sense that given the censoring of observations by the blinders of standard theory only stability is observed. It is a trivial question because to a practitioner of standard economics, observed instability, if it exists, is due to external shocks. <sup>It is a honest question</sup> ~~Each acknowledged case of financial or~~

~~economic instability is explained by the special circumstances of the market or unit that exhibits instability. To a practitioner of neo-classical theory the insistence that an explanation of widespread phenomena by appeal to the particular circumstances of the affected unit will not do, that there must be something about the normal behavior of units of the economy that breeds instability, is a nonsense question.~~ Standard economic theory not only doesn't lead to an explanation of instability as a systemic attribute, it ~~really~~ doesn't recognize that instability is a problem that a satisfactory theory must explain.

The current, and past, crop of policy advising economists are neither fools nor knaves. In spite of the evidence of the years 1965-66 our political leadership is not exclusively nor even largely the province of fools and knaves. Nevertheless these professional economists and their political patrons live and work within a theory that cannot explain instability. ~~The reason that~~ They are able to do so is because the theory within which they live and work provides answers to deep and serious questions and has had some success as the basis for policy. Before we abandon the neo-classical theory we have to understand its strengths. ~~Presumably~~ <sup>do have</sup> we would like a theory that explains instability even as it explains the important phenomena that standard theory handles in good fashion. Our first step is to develop an understanding of what it is that

neo-classical theory does explain in a good fashion.

Instability is a fact. If standard theory doesn't explain instability and nevertheless standard theory remains the basis of policy, then it might be true that the practitioners of the economic policy do not observe instability. History, the drama of 1974/75, and the events of 1966 and 1970 that were detailed in the previous chapters, are interpreted in a different way. One question that must be examined is the nature of observations in economics. Knowledge of the world seems of little importance in academic economics.

Ideological differences lead to differences in perception. Economics cannot be exclusively positive if it is to be a policy science. Each policy decision has a for whom and what kind implications. However above and beyond the inescapable for whom and what kind questions the ideology of Laissez-Faire acts to constrain perceptions. Unfortunately most believers in Laissez-Faire do not understand the limitations upon the power of market processes to achieve socially acceptable results.

In this chapter a number of general and preliminary - perhaps even philosophical - matters are taken up. We need to discuss the questions that standard economics does address, the problem of ideology as an input to economic analysis, and the nature of observations. However this chapter is about theory - it is not yet the

time to do theory. Hopefully by first arguing around the subject of economic theory, the issues of theory will become clear.

In the next chapters we will do theory. First a brief statement of the essential characteristics of standard theory will be essayed. This will be followed by \_\_\_\_\_ chapters in which an economic theory that can explain instability as an endogenous phenomenon in a capitalist economy, even as it does not ignore the questions addressed by standard theory, is put forth. Once we know the problem and have a theory we can proceed to criticize the existing strategy of economic policy and develop an alternative.

## II. The Importance of Theory

An understanding of the strengths and weaknesses of standard economic theory and of alternative theories is particularly important these days because active economic policy is the norm rather than the exception. It is now generally accepted that government and the authorities will intervene by means of monetary or fiscal measures to try to steer the economy in a particular direction. It is also accepted that each year the Congresses and Parliaments of this world pass measures which affect the institutional structure of the economy. Government no longer consists of just legislative, administrative, and judicial branches, government now includes a large number of boards and administrations which exist in order to affect the behavior of the economy.

In a society in which active economic policy is the normal order of the day the vision or view of how the economy functions, i.e., the economic theory, that is held by the political office holders, their technical advisors and aides, and the professional economists who instruct and inform the public is of importance in determining what happens in the economy. Keynes' famous dictum, that ". . . the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else."<sup>1</sup>

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<sup>1</sup>J.M. Keynes, The General Theory of Employment, Interest and Money, Volume VII of the Collected Writings of John Maynard Keynes, MacMillan for the Royal Economic Society, London, 1973, p. 383.



is more relevant now than when Keynes wrote. The content of the generally accepted, as well as of alternative, economic theories, and the significance if any of the differences in theory for policy is of special interest in a world of active policy.

The importance of economic theory in the making of policy was underlined by James Tobin, who was a member of the President's Council of Economic Advisors during Kennedy's first two years, when he wrote "The terms in which a problem is stated and in which the relevant information is organized can have a great influence on the solution" (James Tobin: The Intellectual Revolution In U.S. Policy Making, Noel Buxton Lectures, 1966, University of Essex, England, p. 14). But the way in which "a problem" is stated and the determination of what is "relevant information" reflects the theory as to how the economy behaves that the advisor maintains. That is the technical economic advisors to Presidents, Prime Ministers, and Legislators "rig the game" of policy making. It is "theory" that determines the questions that will be asked and theory will determine the options that will be presented to the political leadership.

Keynes' dictum that was quoted earlier is especially relevant in today's highly organized advising process. However where Keynes referred to "some academic scribbler of a few years back", the present formalized advising process tends to make the views of the

current select scribblers who advise the political leadership important determinants of the course of the realm.

Much is made in the public press and in the professional literature about the distinction between monetarists and Keynesians; between the economics and the economic policy advice of Nobel Laureates Milton Friedman and Paul Samuelson; between a chairman of the Council of Economic Advisors like Alan Greenspan and one like Walter Heller. In truth there is no significant difference in the economic theory used by these economists: Monetarists and "Keynesians" use the same economic theory.

Today's standard economic theory which is the theory that underlies the models of both the monetarists and the "Keynesians" is usually called the "neo-classical synthesis". This economic theory is largely a creature of the years since World War II. The neo-classical synthesis was born after the appearance of Keynes' classic work on Employment, Interest, and Money, and integrates some aspects of Keynes' thought with the older classical analysis that Keynes believed he was replacing. It is the neo-classical synthesis that cannot explain instability.

It is ironical that an economic theory which purports to be based upon the work of Keynes fails because it cannot explain instability. Keynes' major work is a complex study that explores

many facets of a capitalist economy. The essential aspect of Keynes' theory is a deep analysis of how financial forces -- which we can characterize as Wall Street -- interact with production and consumption forces to determine output, employment, and prices. One, but not the most important, result of Keynes' theory is the demonstration that under capitalist institutional arrangements the economy at times will be characterized by persistent unemployment. The neo-classical synthesis seizes upon this result of Keynes' theory. However, the most important result of Keynes' theory is ignored in the neo-classical theory. This most important result is that a capital-using capitalist economy with sophisticated financial practices (i.e., the type of economy we live in) is inherently unstable. It is this second result, and the analysis of the economy by Keynes that led to this result, that provides us the foundation for an alternative to the neo-classical synthesis, an alternative that takes the question of instability seriously.

The neo-classical synthesis is derived by integrating a simple model derived from Keynes that explains the way in which an economy may generate persistent unemployment with the labor and commodity market model that was developed in the classical economics. The neo-classical synthesis shows that (1) fiscal and monetary policy measures can eliminate persistent unemployment and (2) there are

self-correcting forces within decentralized markets that would in time lead to the absorption of unemployment. Thus the neo-classical synthesis speaks with a forked tongue. On the one hand, it holds that activist, interventionist policy can eliminate persistent unemployment or chronic inflation; and on the other, it holds that if nothing is done the economy will in time and of its own workings settle in a stable price, full-employment regime. The same theory can rationalize the noninterventionist views of Alan Greenspan and the interventionist views of Walter Heller.

It is evident that this neo-classical synthesis will not do for our economy in our time. It is designed to deal with equilibrium and equilibrating tendencies, whereas our economy has been increasingly unstable. The three progressively more serious financial trauma, recessions, and inflations since 1966 indicate that it is doubtful if our economy is at all an equilibrium seeking system.

However unless we understand what it is about our economy that leads to the observed instability we cannot prescribe -- make policy -- to modify or eliminate the instability. Identifying a phenomenon is not enough, we need to understand what it is about our economy that brings it to pass. This means that a theory is needed which makes instability a normal result in our economy.

### III. The Three Questions of Economic Theory

#### A. Introduction

To understand what economic theory is about one should begin at the beginning. In economics this means with Adam Smith. In The Wealth of Nations Smith identified two questions that economics must address. The first Smith question is "Why does a decentralized market mechanism not result in chaos; i.e., why does it lead to a coherent result?". Put another way, the question is "If no one is ordering production and distribution why is the world not chaotic? The second Smithian question is "Why is one economy richer or poorer than another?" This second question can be transformed into "How does an economy become richer or poorer over time?"

We now know that a third question or problem has to be added to the two that Smith posed. We have shown that from time to time -- in 1966, 1970, and 1974/75 in recent years -- strong destabilizing forces dominate in determining the behavior of our type of economy. Instability -- which was absent for some twenty years after World War II -- once again became a fact of life in the mid 1960's. Our economy seems to generate financial instability and financial instability carries threats and realizations of deep depressions. The history of American capitalism can be written in terms of periods of stability, i.e. coherence, interrupted by episodes of instability, i.e. incoherence. The behavior of our economy forces us to consider

why our type of economy has episodes of incoherence, why is it so unstable?

The question of the "coherence" of a market economy has two facets. On the one hand a decentralized market economy will not lead to chaotic behavior in the determination of the detail of economic life. On the other hand financial markets and the markets that closely interact with financial market exhibit incoherence -- not always but rather from time to time.

In order to understand the issues of theory posed by the from time to time incoherence of our economy, we will first examine the way the standard economic theory handled Smith's two questions. We will then examine how the observation that the normal functioning of our economy leads to episodes of instability forces us to extend the conditions that must be satisfied for transitory coherence to exist. These extended conditions for coherence are such that they cannot always be fulfilled. Failure to satisfy the extended conditions for coherence leads to the observed instability.

#### B. Coherence

The coherence problem was identified by Adam Smith when he argued that if "the propensity to truck, barter, and exchange one thing for another" is allowed a relatively free reign, the result will be coherent rather than chaotic. It can be observed that in a market economy a seemingly proper amount of each of the multitude

of goods and services that make up the outputs of an economy are produced and used. Furthermore the relative terms on which alternatives are available tend to be approximately the same over periods of time. Regularity and order, both over time and in response to changes, can be observed in a decentralized market. Wherever coherence can be shown to exist -- whether for the economy as a whole or for subsets of the economy -- intervention is not necessary to achieve order. The market mechanism serves as an adequate control device to produce order. On the other hand wherever tendencies toward incoherence exist, control cannot be left to the market: policy, in the form of stabilizers and regulators, is required.

The "fact" that for at least some types of transactions and markets decentralized markets lead to a coherent result is used by the apostles of market Socialism, Oscar Lange and Abba Lerner, to argue that the same market processes that are used in capitalism can be used in socialism. That the market is an effective signalling and control device, once the problems of income distribution and investment determination are solved, is the underlying principle guiding these market Socialisms of economic theory. It turns out that income distribution is the prime equity problem that besets capitalism and that instability is closely tied in with the way a capitalist economy determines the amount of investment and finances investment and ownership of capital assets. Thus Lange and Lerner

were fundamentally correct in saying two things -- that Socialist economies can use markets and that there is nothing much wrong with a market capitalism if inequity and instability are eliminated. A proposition that emerges out of the way instability under capitalism is explained is that measures to eliminate instability will tend to decrease inequality.

The observation that unguided and unplanned market mechanisms lead to coherent, i.e. not chaotic, results led to the question "how come". What is the explanation of order and the apparent rationality of the changes that are observed? What in other words is the mechanism that leads to coherence? Are there deep and fundamental characteristics of the various commodities that explain why they seem to exchange one for the other in apparently stable or orderly changing ratios?

The search for reasons why commodities are desired led to various forms of "value" theory. In particular Smith and many of his followers -- Ricardo, Marx -- looked to the labor or pain cost of production as an explanation of exchange values. This was followed by Benthamite explanations of exchange value in terms of utility and later as economists discovered the calculus, marginal utility. Ultimately the "costs" and "utility" (benefits) were combined into a "supply and demand" theory of exchange value; costs being embodied in the supply conditions and benefits to the



individual unit being embodied in demand curves.

It has often been said that an economist is a parrot which has been trained to say supply and demand. The economists of about a century ago -- Marshall, Walras, Casells -- evolved an explanation of the observed coherence in terms of an interrelated set of supply and demand curves and the notion that the dynamics of the various markets would tend to generate those relative prices at which for each commodity supply equals demand. In later years the 'preference systems of individuals' and the production functions for commodities were used to describe how the sum of individual consumption and production decisions generates the observable market variables and how the terms on which exchanges take place in markets effectively controls and constrains the behavior of individual producing and consuming units.

The preference systems of individuals -- unexplained and taken for given -- and the production possibilities of firms -- given by technology and perhaps changeable in response to economic conditions -- are in the ruling economic theory combined into a system that explains the observed coherence. Furthermore the theoretical system is such that it can predict how observed results will change when taxes, subsidies, quantities available, etc. change because of developments outside the economy, including policy decisions. Thus the model not only explains coherence but it also

explains some changes and the effect of specified policy actions.

This theory, which explains price formation and how prices, when taken as signals, leads to a coherent market result is powerful. The result that individual decision units behaving under no guiding principal but constrained self interest will lead to an orderly world is not obvious; the proposition that the system of prices that rules is a controlling and coordinating mechanism is both an important guide to policy and a powerful insight to how social mechanisms operate. The knowledge that decentralized markets work at least in the sense that they can yield a coherent result is the powerful insight that distinguishes those who understand economics from those who do not. Because standard theory yields these powerful insights, because it leads to an understanding of how a situation that on the surface is conducive to chaos is in fact characterized by order, economists will not cavalierly abandon standard theory. Rather than abandon standard theory economists will try to force an explanation of all the diverse phenomena they need explain out of the production function-preference system or the supply and demand apparatus of standard theory. The loyalty to standard theory is well deserved. Any economic theory that explains the emergence of instability from time to time will also need to explain the possibility of coherence and why the price system in fact does at times work if it is to make a serious dent in the allegiance of economists.

It is necessary to note and emphasize that what can be proven is the existence of coherence. Coherence is presumably an observable phenomenon. The theory leads to a demonstration that that which is, can be. The theory is powerful because it shows how that which is can be affected by various policy or external impact.

We should note that the theory demonstrates coherence as a result of market processes. Scientific theory cannot assert that market processes yield a "best" result, for "the best" implies a value judgment on what is observed, whereas chaos or coherence can be directly observed. Nevertheless the invisible hand proposition of Adam Smith that an individual "By pursuing his own industry he frequently promotes that of society more effectually than when he really intends to promote it" [p. 423, Modern Library Edition], i.e. he is "led by an invisible hand to promote an end which was no part of his attention" [p. 423] has been blown up by generations of economists to prove that the coherent solution that can be observed is in some sense a best result.

One argument that is used to advance the proposition that a trading system yields a "best" result is that if the transactions that take place are voluntary, so each participant is free to transact or not to transact, then each party to the transaction is in "his" own mind made better off by this transaction. Therefore

transactions will take place only if they are mutually beneficial, i.e. both parties gain. But the most that follows from this trading set up is that every participating party is better off, not that a best has been achieved.

In any bargaining situation, the apportionment of potential benefits among the transactors depends upon the anxiety to trade of the transactors. One who is anxious to trade, is forced to transact because of some particular circumstances is likely to do poorly in trading. For each transaction to be mutually beneficial and for the gains to be apportioned in a presumably best way, it is necessary for the pre-trade position of each transactor to be compatible with the sustaining of life. If one party must trade to survive and the other is free not to trade, then the apportionment of the gains that trade makes possible is likely to be biased. One who has only his labor to sell and who cannot survive without selling his labor is unlikely to gain his fair share from trading. Transactions do make both parties better off, but it is also possible that power is so distributed among the traders that "exploitation" can take place -- exploitation in the sense that some participants in the transactions realize but a small portion of the gains from trade that could have accrued to him.

The market mechanism therefore works in the sense that it leads to a coherent result, but this coherent result need not be

the best 'possible' result and the coherent result is compatible with the existence of exploitation. President Kennedy is supposed to have remarked that the "world is not fair". The claims that are often made for the price system is that it yields a result that is fair. This claim is only possible if it is assumed that all transactors are faced with a myriad of possible trading partners, and each of this myriad is equally powerful both in wealth and the perfection of his foresight and information. These assumptions are so heroic, so contrary to fact, that the claim to fairness evaporates. The decentralized price mechanism yields a coherent, not necessarily a fair, result.

The market mechanism works through a system of relative prices. The deep insight derived from the theory of prices is that if relative prices are allowed to adjust, then the quantities of the various economic goods and services supplied and demanded will vary in such ways so that the quantity supplied will equal quantity demanded. That is there is at least one, but perhaps more, set of relative prices at which all of the various markets will clear, i.e. at which quantities supplied equals quantities demanded. This result depends upon two conditions: relative prices are free to vary and quantities taken and quantities sold will adjust to changes in relative price. The adjustment to changes in relative prices takes the form of substituting against the relatively more expensive commodity or service.

The adjustments of quantities to changes in relative prices take the form of substituting against those goods and services whose relative price has increased, substituting in favor of those goods and services whose relative price has decreased. If the dollar price of coffee explodes as the result of a shortfall in supply due to weather, then the amount of coffee bought will tend to decrease. The quantity of tea that is taken at a constant dollar price of tea will tend to increase. The dollar price of tea will tend to rise -- but by a smaller ratio than the rise in coffee prices. The total amount spent on tea and coffee may increase, decrease or remain constant and the combined effect of the rise in the dollar price of tea and coffee and the change in the total dollars spent on tea and coffee will affect other markets and other commodities. A wave of repercussions will spread from the initial disturbance but this wave of repercussions will dampen out. Even if a new situation of relatively unchanging relative prices is not achieved until after the elapse of some time, the progression is orderly and what is observed follows the precepts of the model. Coherence exists not only in the existence of market clearing relative prices but in the adjustment process to imposed changes.

### C. Relative Riches

Why is one country poor and another opulent and how is it that the opulence of a country varies over time? A country may become richer or poorer as time elapses, and these changes may

occur quickly or over longer periods of time. This question concerned Smith and it concerns us today in a number of ways. Efforts to aid and abet the enrichment of the currently poor countries is the problem of economic development. Efforts to achieve a steady accretion of opulence in the richer countries is the problem of economic growth. The from time to time impoverishment of a country because resources are unused during a depression or recession is the problem of the business cycle.

The answer that Smith gave to explain the relative richness of one country as compared to another was complex. Social structure and political stability were important determinants of relative richness. However after all Smith's historical and political analysis the final determinant of relative riches of countries was the comparative stock of capital assets per worker. The worker in the rich country had more and better capital assets to work with than was true for the worker in the poor country.

However capital assets are not original endowments due to nature, they are the result of the past of the economy. The process of acquiring capital assets is called accumulation or investment. One country is richer or poorer than another exactly as it has accumulated more capital assets per worker. But in order to accumulate an excess of output over consumption must exist. The workers who produce consumer goods must produce more than they themselves

get so that those who produce investment goods can consume.

Thus in the economists' sketch of the historical process the initial prerequisite for economic progress is the development of an agriculture which yields more foodstuffs than the farmers use. This excess of foodstuffs can support a non-agricultural population, i.e. a city or a state apparatus. Thus an agricultural surplus is necessary for the initial step to accumulation, and by extension, a surplus of output over consumption is necessary if accumulation is to take place in our type of sophisticated economy.

Thus economists tend to inpute the differences in wealth that can be observed among countries to differences in past accumulation per head. In one country the differences in well being from one date to another is due to the accumulation of capital assets over the interval. The comparative riches of different countries and the progress of a country are explicable in terms of the accumulation process.

The question of observed differences in riches is now pushed back to how does an economy generate and allocate a surplus? Is the surplus something that just naturally flows out of the economy's functioning or is a surplus something that has to be forced or extracted? A theory of the way in which a sophisticated complex capitalist society generates its surpluses is required if we are to explain the course of progress in our time.

The supply and demand apparatus is successful in explaining



behavior in commodity markets. Once a discipline has a successful bit of apparatus it is quite natural to apply that apparatus to additional problems that have to be solved. Thus the neo-classical economist approaches the problem of the surplus; its generation and its allocation just like he approaches any problem: He breaks it down into supply and demand factors, and a price that tends to equate the quantities supplied and demanded. The surplus becomes the savings of the economy and savings are the supply of resources that are available to produce capital-assets. The incentive to save is the gain that can be made in the future, which can be identified with an interest rate.

The demand for the surplus output or savings that is considered in the simple model is investment. Investment is motivated by the flow of profits that are expected to accrue in the future. Thus a savings and investment determination of the pace of accumulation emerges out of the attempt to explain accumulation by using the supply and demand apparatus.

This view of the savings-investment process -- that it is just another supply and demand problem -- is what Keynes attacked in his General Theory. One flaw in the application of simple supply and demand and analysis to the problem of accumulation is that the demand for investment output is a function of future expected profits and is not a "timeless" phenomenon as is the consumers demand on

commodity markets. Investment demand is not an allocation of income by the investor, it is determined by the expected future profits and available finance in a capitalist milieu. Thus in drawing a supply and demand curve for savings and investment a question of compatibility arises: The savings schedule is due to current and past behavior of the economy and the investment schedule depends upon a flow of future income.

The neo-classical theory is largely based upon the view that the savings function is generated by consumer preference just like any demand function and the quantity of investment adjust to conform to the savings forthcoming. All of this presumably takes place within constant income. Keynes' theory is that investment is financed and that a surplus is forced which equals the investment. Furthermore the size of the surplus is varied by varying income, a larger investment that is financed increases income which yields more savings is the path towards the market clearing of savings and investment in the Keynes' view.

A major issue in theory is whether the generation of the surplus and its allocation can be treated as just another problem in pricing or whether the surplus and its generation and allocation requires an analytical framework that is different from the savings/investment framework borrowed from the supply and demand apparatus. If one

attacks the generation of the surplus directly the question becomes how does the economic mechanism operate so that workers cannot buy back all of what is produced. A portion of what is produced -- the investment or accumulation goods -- becomes either the property of the "capitalists or rentiers" in a capitalist economy or the property of the state in a socialist society. Nevertheless workers income is generated in the production of both investment and consumption goods and the consumer goods need be priced so that they absorb all of wage income. Profits or tax revenues therefore emerge out of the way it is brought about that all of wage income buys only a part of workers' output. Thus the surplus is forced out of the way commodities are priced and there is a strong correlation between the pace of investment and the profits earned by capital assets.

Thus we can see that there are two possible analytical frameworks for economics. One framework -- the supply and demand analysis -- emerges out of the effort to explain the observed coherence of the economy. The other framework emerges out of the effort to explain differential riches and it begins by an analysis of money and income flows. Whereas the supply and demand framework has trouble assimilating time and financial interrelations, the attempt to explain the emergence and extraction of the surplus in a capitalist economy quite naturally begins with the way in which the banking system affects system behavior.

D. Instability; Incoherence

Smith's Wealth of Nations was published in 1776, the same year as the American Declaration of Independence. In England capitalism was young, and the banking system was really just getting started. The problems of instability that were to plague the capitalist economies in the two centuries that have elapsed since the appearance of "The Wealth of Nations" were barely perceptible. It is no criticism of Smith that he did not ask the third question "Why is our economy so given to fluctuations"; the observation of instability was really not there for him to see. It is a serious criticism of today's current standard theory that it has not moved on to this third question; instability is an evident trait of our economy.

We will in what follows try to develop a theory of why our economy fluctuates. It turns out that the fluctuations of a capitalist economy -- in particular those fluctuations that are associated with financial difficulties -- are associated with the techniques by which the surplus is forced in our type of economy. The surplus is forced as investment is undertaken, and investment will not be undertaken unless a source of financing over the time the investment output is being produced is assured -- or at least reasonably certain.

In order to build a railroad in the United States in the late 19th century it was only necessary to get the "go ahead" signal with respect to the availability of finance from J. P. Morgan or one of the other great nahobs of Wall Street. In the current situation

where corporations dominate the scene, investment plans are based upon the expected availability of finance both from internal and external (banking, bond issues, etc.) sources. Finance, not in the sense of cash on hand but in the sense of funds that will be available from one source or another, is the critical element in forcing the surplus in a capitalist economy -- and it is worth noting that the state owned banking apparatus of the socialist economies play a similar function.

The instability and incoherence that capitalist economies exhibit from time to time is related to the development of fragile financial structures out of the normal course of the business in which control over capital-assets and investment are financed. There are essentially speculative elements in the processes of capitalist finance because of the way in which financial (debt) contracts link today and a succession of tomorrows and how investment activity which is based upon the expectation of future profits determines profits at the time the investment is taking place.

Extracting a surplus, allocating it effectively, and then using capital assets so that the payment commitments in the debt structure are fulfilled are the links in the chain which connects the problem of explaining comparative riches and the problem of explaining coherence and instability.

IV. Economic Observations and the "Social" Characteristics of  
Economics

In the sketch of recent economic history of chapters II through IV, financial instability and therefore incoherence was emphasized, not as a theoretical construct but as a fact; financial instability is a characteristic of our economy. Furthermore, because financial instability is linked with the deep depressions of history and because the deep depressions of history imposed huge costs upon society, control and prevention of financial instability is a vital policy objective. In order to have a policy that can prevent or control financial instability and deep depressions it is necessary to develop a theory that explains financial instability: Without understanding why a phenomenon occurs one cannot develop policies to control or prevent the event.

Nevertheless, the dominant economic theory has no place for financial instability. How is it that an observation that seems so important is ignored? To understand why economics as a discipline does not see this evil it is necessary to understand some of the "social" characteristics of economics.

In spite of its practical importance in policy advising and even to business organizations, economics is mainly an academic discipline. Each academic discipline has an internal system of rewards and an internal pecking order. Prestige in the discipline

follows from the importance attached to different types of research and professional activity. Although income is important to practitioners of academic disciplines, the main goal of an academic is discipline prestige. Therefore an academic will do that which leads to discipline prestige.

Academic disciplines differ in the prestige that is attached to making real world or experimental observations and the prestige that is attached to pure theory and the analysis of the discipline's literature. In the development of post World War II economics the greatest prestige and the major research fundings were attached to work that was far removed from observations upon the economy. Working in pure theory and on problems derived from the literature carried greater rewards than work on the structure, behavior, and evolution of economic institutions. The tradition of acute and sharp analysis of what goes on in our economy, identified with great American economists such as John R. Commons of Wisconsin, Thorstein Veblen of many places, and Wesley C. Mitchell, of Columbia, was replaced by an effort to "mathematize" the formal structure of theory and to obtain truth by manipulating numbers, i.e. by econometrics.

The knowledge of institutions and their evolution is too often considered as an enemy of theoretical analysis. Nothing can be

farther from the truth. Institutional and historical analysis forces economic theory to be conditional and relevant. Knowledge of historical and institutional detail is an enemy of the type of theorizing that builds world systems; it is not an enemy of a high level of insightful abstraction about the essential nature of an in fact economy. In truth meaningful propositions about the behavior of an economy with institutional and historical detail can be made only if insightful abstractions are made.

Whereas economic theory is essential to an understanding of how our economy functions and vital for the development of meaningful policies, the highly mathematical very general theorizing that has dominated academic literature in recent years is largely irrelevant. Theorizing about our economy that is conditioned by existing institutions does not require elaborate mathematical formulations because the points that have to be made are quite gross. Elaborate mathematical and econometric analyses are necessary only if fine points are at issue.

Given that the reward system of economics emphasizes work within the literature it is not surprising that a major shift in the way the economy works went virtually unnoticed by leading model builders and users. The data spewed forth by the age of relative tranquility in the financial markets and in the economy was largely



consistent with the theories that explain the overall behavior of the economy by extending the supply and demand formulations that were developed to explain why decentralized markets lead to coherent results. Simple minded but complex models that summarized a great deal of statistical detail into "econometrically" fitted functions were developed which summarized the behavior of the economy in the early post war period. The development and manipulation of these models became a major focus of research. Instead of looking at what was going on in the world, an entire generation of economists was developed which looked at runs and policy simulations within these models. When a radical change in the normal mode of behavior of the economy occurred -- as happened in the mid-60's -- the leading policy advising economists were watching the print outs of their model simulations rather than the economy.

In fact leading policy advising economists have continued to look at their models and their print outs as the 70's progressed. Throughout much of the Nixon - Ford years a gaggle of policy advising economists of the Kennedy - Johnson years were in "exile" at the Brookings Institution. These economists regularly published volumes of policy proposals that were "alternative" to that which the incumbent administration proposed in volumes that were titled "Setting National Priorities". In 1976 perhaps because they were "tired"

after a run of annual models or perhaps in the expectation of a victory by a friendly Democrat, Brookings published a volume of essays titled "Setting National Priorities: The Next Ten Years". This volume was edited by Henry Owen and Charles L. Schultze (Schultze became the Chairman of the Council of Economic Advisers when Mr. Carter became President).

This volume contained an essay by George L. Perry entitled "Stabilization Policy and Inflation" which purported to deal with the problem of unemployment and inflation. The business cycles and policies of the 1960's and 1970's are reviewed and policies for the future are examined. Nowhere in this essay are the credit crunch of 1966, the liquidity squeeze of 1970, or the Franklin National/REIT affair of 1973/74 mentioned. If policy is guided by analysis such as Perry's, then any future financial instability will "surprize" the officials. If the advisers are those who take the Perry type analysis seriously, then the advisers will 'set up' the problems for the political leadership's decisions in such a way that the instability inducing or attenuating effects of the policy is ignored. When instability becomes a problem that cannot be ignored -- when a crisis seems or is imminent -- then the potential or actual crisis will be treated as an isolated event.

Thus even as the behavior of the economy and the problems that policy must confront change, the economists who advised on policy

remain largely oblivious to the need to adjust their theory. Their discipline success had been based upon their power in formal analysis and in building and manipulating a particular type of model, not on observation and certainly not in creating new and novel theory. They wear the blinders of the inherited theory as they advise policy makers.

#### V. The Status of Laissez-Faire

Laissez-faire, in the simplistic sense of non-intervention by government in economic affairs or in the sense of a minimal government involvement in the economy, is dead. In fact it may never have really lived. True, in Britain in the late 18th and early 19th century an inherited system of economic institutions, which tended to constrain and restrict the role of the market in the economy, was dismantled. But what was left was far from an unconstrained market economy. Furthermore instability and inequity became evident as the constraints were relaxed so that new interventions were quickly introduced. As a result of instability most countries had some sort of central banking institution by early in the 20th century.

Nevertheless as recently as the Hoover Administration the from time to time occurrence of a deep depression was taken for granted. Government was viewed as being quite powerless to either prevent or ameliorate such economic disasters. Today as a minimum it is

accepted that it is the responsibility of government to prevent or abort great depressions.

Occasionally a Secretary of the Treasury may pay lip service to "Adam Smith" and "Laissez-Faire", but the content of the remarks will favor measures that are but a slight modification of the existing set of institutions and policy interventions.

There are many possible systems of government control and intervention into economic life and many different possible ways to organize product, labor, and financial markets. Whatever exists is by its nature a special case. This "special case" is the result of a combination of institutional evolution in response to market forces and legislated intervention. The legislated interventions, that determine institutions and policy systems, reflect the power relations and the views as to how the economy functions that were prevalent at the time the interventions took place. The subject matter of economic theory is how the economy works. Thus the legislated institutions and policy interventions reflect the theory as to how the economy works that was dominant at the time the legislated changes occurred. As the dominant economic theory changes, the views that affect legislation and policy decisions change.

Inasmuch as legislation is usually incremental, in that new measures are added onto an existing body of legislation, the economic theory underlying one portion of the legislated institutional

structure is likely to be inconsistent with that underlying another part. It is possible that what institution or policy "A" does is undone by institution or policy "B". In principle policy and institutions should reflect a consistent view of the economy; in fact the inherited policy structure is replete with inconsistencies because it reflects different views or theories about how the economy functions.

A great American proponent of liberal economic ideas, Henry C. Simon of the University of Chicago, titled his most passionate and persuasive tract "A Positive Program for Laissez-Faire".<sup>1</sup> The message of his tract is that active government intervention is needed to first organize and then sustain the conditions under which decentralized markets can function to achieve an apt set of outputs and an adequately equitable income distribution. Even as Simon argued that free and decentralized markets can do the job of organizing the details of economic life, he realized -- largely because he was writing in 1934 in the midst of the Great Depression -- that active government policy was needed to sustain appropriate overall conditions in the economy so that decentralized markets can do their job. Simon implicitly recognized that the problems and the instruments of policy change as the economy forces new dimensions

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<sup>1</sup>H.C. Simon, "A Positive Program for Laissez-Faire" in H.C. Simon, Economic Policy for a Free Society, The University of Chicago Press, Chicago, IL, 1948, pp. ix - 353.

of behavior to the fore and as economic theory develops new understandings of the reasons why the economy performs as it does, even as he explicitly recognized that the need for policy does not change.

In a society in which active economic policy is the normal order of the day the vision or view of how the economy functions, i.e. the economic theory that is held by the political office holders, their technical advisors and aides, and the professional economists who instruct and inform, is of importance in determining what happens in the economy. Thus Keynes' dictum, that ". . . the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else."<sup>1</sup> is more relevant now than when Keynes wrote. The content of the generally accepted, as well as of alternative, economic theories, and the significance if any of the differences in theory for policy are of special interest in a world of active policy.

Economic theory is not now and has never been a large set of propositions relevant to our economy which are universally accepted as valid by all certified professional practitioners. The propositions that are universally accepted are true within abstract theoretical constructs designed to facilitate dealing with parti-

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<sup>1</sup> J.M. Keynes, The General Theory of Employment, Interest and Money, Volume VII of the Collected Writings of John Maynard Keynes, MacMillan for the Royal Economic Society, London, 1973, p. 383.

cular "questions". Controversy attaches to almost all propositions asserted as being valid for our particular capitalist economy.

In part this controversy reflects the inescapably normative content of economics. No matter how technical or abstract economic theory becomes, in the application of theory to practical matters questions as to "for whom" and "what kind" cannot be wholly avoided. Every policy decision has an implicit 'for whom and what kind' implication, even though an explicit discussion of these issues is often avoided.

In addition to controversies centering around normative 'for whom and what kind' issues controversies among economists reflect differences in the questions that various economists hold economic theory is to address. The "questions" that economic theory is to address are presumably derived from observations in the world. There are some "gross" phenomena that require explanation and these gross phenomena lead to questions theory seeks to answer.

Once a gross question is asked, the observations on the economy that are relevant to answering the question are defined and the way in which observations are to be arranged is determined. Furthermore the gross questions that are asked largely determine the technical apparatus used in examining the economy.

A problem that traditional economic theory has addressed is

whether a decentralized market mechanism yields a coherent result: This question is the central question of standard theory. It is obvious that chaos is not the rule in economies without central planning. Thus an economic theory has to be developed that shows how the observation, the absence of chaos, is brought about.

However the absence of chaos is not the same as a social best or optimum, to use a word much loved by economists. The theory which demonstrates coherence (non-chaos) does not demonstrate that an optimum results from decentralized markets. Furthermore even though the proposition that a decentralized market mechanism is coherent is robust, in that it is true under a fairly broad set of conditions, it has not been shown that coherence holds for an economy in which capital-assets, money or finance, and thus time exist. Even the existence of a social optimum, with decentralized markets, has not been shown for an economy with the characteristics of our economy.

The proposition that a decentralized market mechanism yields a social best is used as a foundation for the advocacy of Laissez-Faire. However the proposition about the social optimum is valid only in a very limited sense. The existing distribution of the sources of claims to income must be taken as given and correct before it is possible to claim that the market can yield an optimum. Furthermore it is evident that our type of economy exhibits



incoherence from time to time and has exhibited such intermittent incoherence over long stretches of time and a wide variety of institutions. Thus by observation that intermittent incoherence exists, by the flaw in the logic of extrapolating from an abstract economy to our economy, and by the limited definition of the social optimum that is used in economics it is evident that Laissez-Faire is not a valid universal policy prescription.

One of the major sources of controversy and confusion in economic policy is the continued belief by publicists, politicians and some economists who are in the public eye that economics has demonstrated that Laissez-Faire, in the sense of virtual anarchy, leads to a social best. Even if policy tries to let the decentralized market mechanism do much of the job of determining the allocation of scarce resources among alternative employments, intervention will be needed to prevent the emergence of incoherence. The fact of instability implies that laissez-faire won't do as a policy strategy.

#### VI. Conclusion

When Keynes summarized the import of his new theory, he stated that "this then is why our economy is so given to fluctuations" (QJE 1937). However fluctuations of the type that concerned Keynes are foreign to the behavior of the economy that is described in

standard economic theory. In particular now that business cycles that involve threats of financial crises are once again a readily apparent attribute of the United States economy one question that requires an answer is how are threats of "incoherent behavior" -- for that is what a financial crisis is -- generated. In the light of the strong cyclical behavior of the economy in the years since the middle 1960's any economic analysis that is relevant needs to address three questions:

(1) How does the ruling market mechanism achieve coherence in particular outputs and prices,

(2) How is the time path of incomes, outputs and prices determined, and

(3) Why is it that from time to time coherence breaks down, i.e. why is the economy susceptible to threats of serious business cycles if not the actuality of deep depressions.

All of these questions need to be answered in the context of the institutions and usages which prevail, the relevance of answers in the context of an abstract economy are questionable.

Inasmuch as the standard economic theory which demonstrates coherence and explains growth abstracts from institutional and in particular the financial detail of our economy, and furthermore as this standard theory is not really capable of explaining the business cycles of current experience as the result of the internal operations of the economy, a particular question we have to

address is whether the institutions and in particular the financial institutions of an advanced capitalist economy tend to lead to the observed tendency of the economy not only to fluctuate, but to be seriously disrupted? Where do strong destabilizing forces at work in the economy which vitiate the findings of standard economic theory that a decentralized market mechanism defines an equilibrium and the dominant processes seek out this equilibrium originate?

Given that an economy with the institutional detail of our economy behaves in ways that are foreign to the economic theory that argues that a decentralized market mechanism will yield a coherent and perhaps even an optimal result, a fundamental question that economic policy analysis must confront is whether and to what extent and over what domain market processes can be relied upon to achieve a satisfactory economic performance where satisfactory performance includes at least an attenuated cycle.

In the political arena, the issue of whether and to what extent market processes can be relied upon is one upon which political partisans take strong stands; often in the form of strongly asserting positions that are more propagandist than scientific in their content. Appeals to the wisdom of the market, as to the abstract virtues of something called the American Free Enterprise System have

to be disciplined by the awareness of market flaws, failures, and imperfections.

The general view that is sustained by our analysis is that the market mechanism is a sufficient device for making social decision about unimportant matters such as the mix of colors in the production of frocks, the length of skirts, or the various flavors of ice cream to be produced. The unconstrained market however cannot -- and in fact is not -- relied upon for important "big" matters -- such as the final distribution of income, the maintenance of economic stability, and the education and training of the young. Thus any serious policy oriented study needs to explore and define the areas in which the market can be allowed a free scope of how, if at all, the market can be used or guided to achieve desired social goals.

The market has some advantage over direction and control by government. Presumably it requires less oversight by a bureaucracy. By making each decision small and if it has ways of censoring, or penalizing, error it minimizes the social impacts of individual mistakes. The ability of error to lead to mischievous results is perhaps best minimized by properly decentralized markets -- which is a major virtue of properly organized markets.

Thus we start, with a bias in favor of using the market

mechanism to the fullest extent possible to achieve social goals, but with a recognition not only that regime of completely free markets is seemingly intrinsically unstable, but also that it quite apparently leads to distasteful distributions of wealth and power.