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Chapter XIII of "Financial Instability and the Strategy of Economic Policy" -- Introduction to Policy

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Chapter XIII

Introduction To Policy

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Introduction to Policy

> If to do were as easy to know as what were good to do, chapels had been churches, and poor men's cottages princes' palaces.
> William Shakespeare, The Merchant of Venice (I, ii)

Portia's observation pinpoints the dilemma of economic policy--i.e., that it is relatively easy to agree on abstract objectives but much more difficult to establish institutions and start processes that will achieve objectives. Few will argue that full employment, stable prices, and the elimination of poverty are desirable. The difficulty lies in attaining these and other equally admirable goals such as equity in the distribution of income, public safety, equality before the law, good schools and a non-corrosive environment. Promises without effective programs will no longer do: We must go beyond "what" to "how".

Political leaders and their advising economist are to blame for promising more than they or the economy can deliver. The promises about fine tuning and delivering the good and beautiful life for all reflect the advisers views that these are attainable goals. Neither the political leadership nor the public are made aware about the limitations imposed on policy by the economic process and the ability to administer. Economists in advisory positions have failed to convince the legislators and the administration that though it is they who propose, it is the economy that disposes. The economic leadership is not aware that the normal functioning of our economy leads to unemployment, financial crises, inflation, currency depreciation, and poverty in the midst of what should be affluence. The public and the political leadership try to achieve unattainable results.

The economic advisers, whether liberal or conservative, believe in the fundamental "soundness" of the economy. Finding fault with one thing or another, they advocate reforms such as changing Federal Reserve operating techniques, tax details, national health insurance, and wars on poverty but all in all, they exhibit complacent satisfaction that the basic institutions are apt. The policy advising economist still contend that all that is necessary to correct observed malfunctioning is some tinkering with details. In this respect all of the advising establishment are conservatives. Not only do American economists lack a socialist tradition, but the critical spirit about the institutions of capitalism that illuminated the work of "conservative" economists of the thirties such as Henry C. Simons and that marked the efforts of the "liberal" Temporary National Economic Committee is missing from the current discussion. According to today's gospel the fault lies in details, not in fundamentals.

It is in the details that economists of the policy advising establishment differ: Walter Heller proposes to fine-tune the economy by fiscal tinkering: Milton Friedman wants to achieve a noninflationary natural rate of employment through steady monetary growth. Neither sees anything basically wrong with the capitalism we have. The credit crunch of 1966, the liquidity squeeze of 1970, the banking crises of 1974-75 and the inflation of 79/80 are in their view minor aberrations. And since nothing is basically wrong they also hold that incisive corrective measures need not be taken. Furthermore, because the economic theory of the policy advising community fails to recognize the importance of institutions, the economic importance of the proliferation of special financial institutions such as REITs or the growth of complex financial empires such as banks that control other financial institutions goes unrecognized.

The truth of the matter is that something is fundamentally wrong with our economy. A capitalist economy is inherently flawed because its investment and financing processes introduce endogenous destabilizing forces. The markets of a capitalist economy cannot readily adjust to highly sophisticated, long-lived, expensive capital assets. The economic theory of the policy establishment does not allow for capital assets and financial relations such as in fact exist. Wall Street and the input of bankers in financing activity do not figure in their theory.

President Ford's excursion into "show biz" economic policy-making and the fitful economic policies of the Carter administration underscore the futility of standard economic analysis. In the fall of 1974, as inflation raged and the economy was heading toward the deepest and longest recession since the thirties, Mr. Ford presided over meetings of the economist architects of the crisis. They searched for cures for an illness they could not diagnose. Fords futile policy summit did bring home two points: (1) the economists' perception of the problems trivialized their seriousness, and (2), each of the participants continued to ride the same old hobbyhorse. Each participant's prescription was simply an elaborations on the nostrum they had advocated in earlier, more tranquile times.

Even as Gerald Ford was convening his experts the Federal Reserve Bank of New York was refinancing Franklin National Bank to the tune of nearly $1 billion, and the REITs to were being forced to use their bank lines of credit. But since the neo-classical synthesis does not recognize financial crises, the advice issuing forth from the summit was not only banal but its perceptions of how the economy actually worked bore little resemblance to reality.

Upon taking office Mr. Carter installed a new set of advisers, composed mainly of veterans of the Kennedy-Johnson era. The basic tenet of this new-old group is that there was nothing really wrong with the policies of the early sixties, that errors in details and timing may have been made but that on the whole the thrust of policy of the 1961-65 years were correct. None was ready to entertain the idea that the 1961-65 period marked a transition from a robust to a fragile financial structure and that since 1966 the economy has been characterized by strongly cyclical behavior and recurrent financial crises. As they took office the Carter administration economists maintained that a four-year approach to comparatively full employment, a balanced budget, and a winding down of inflation was feasible. When double-digit inflation hit the country, in the second year of this program these advisers, the Congress, and the President were caught by surprise. The Carter Administration's approach to economic policy is as flawed as that of the Nixon-Ford and Kennedy-Johnson Administrations. Conservatives and liberals alike believe our economic system is capable of achieving and maintaining stable prices and full employment. They believe that policy measures which do not change institutions can assure this result.

Economic policy discussions have centered on how much more (or less) of the one--fiscal policy--and how much less (or more) of the other--monetary policy is necessary. If we are to do better in the future we must launch a serious debate that looks beyond the level and techniques of fiscal and monetary policy and examines the instability of our economy and inquires whether this instability is inherent in an economy with capitalist finance such as we have.

As a first step an agenda for public discussion must be prepared. The agenda is important for the alternatives that are discussed and the way they are presented are likely to influence decisions. James Tobin, a member of the Kennedy Council of Economic Advisers in an address at the University of Essex in 1966, aptly described the role of the adviser as censoring evidence and phrasing loaded questions for his Prince's attention when he noted that "the terms in which a problem is stated and in which the relevant information is organized can have a great influence on the solution".* Thus President Carter mouths simple-minded phrases about a trade-off between unemployment and inflation rates, not knowing that the trade-off of which he speaks only existed for a brief period after World War II and that there is little if any evidence to support the idea that this trade-off now exists. Yet becuase this trade-off is built into the economic theory and econometric models of the policy-advising establishment, the problems of policy are phrased in its terms. These models do not ask the serious question that whether trade-off reflects the output produced by the increase in employment. No distinction is drawn in this trade-off between lowering unemployment through the production of more consumer goods--which is deflationary--or through a government deficit or the production of more investment goods--which is inflationary.

The most important concern in court politics is access to the Prince. And if economics is too important to be left to the economists, it is certainly too important to be left to economist-courtiers. Economic issues must become a public matter and the subject of public debate if new directions are to be embarked on. Meaningful reforms cannot be put over by an advisory and administrative elite, that is itself the architect of the existing situation, for unless the public understands the reason for change they will not accept the costs of change.

The Importance of Agenda

Tobin's definition of the role of the house intellectual may be described as controlling the agenda. Princes and public alike depend on intellectuals to

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*James Tobin, "The Intellectual Revolution in United States Policy-Making," Noel Burton Lecture, The University of Essex, 1966, p. 14.

formulate issues and define alternatives. In a democracy the definition of the issues and even the order in which they are presented for consideration affects the outcome. The thrust of the reforms of the budget process by Congress in the 1970's is an attempt to make the final budget the result of an overview of individual decisions rather than a ratification of an accidental sequence. Existing legislation--ranging from the agricultural programs through the various transfer-payment schemes to import quotas--is not the result of a design that reflects a consistent view of the economy but rather it is a hodgepodge, reflecting, responses of the Congress, various administrations, and the public to problems as they were identified. The existing structure is the result of sequential decisions that did not consider the interactions among the programs and institution.

The discussion of the energy problem that began in 1973 demonstrates the part the phrasing of a problem can take in determining its disposition. Starting the debate by showing that a correlation exists between energy and per capita gross national product and asserting that if the economy fails to grow depressions and mass unemployment are inevitable ties the solution to a heroic effort to achieve a given targeted growth in energy supplies with all the inefficiencies that such an effort implies. If, on the other hand, historic growth in per capita energy consumption is related to a decline in the relative cost and price of energy, and if it is shown that economies in which the relative price of energy is higher than here use much less energy per unit of useful output, then the relation between energy and well-being is broken. The issue then centers on how to adjust to the higher relative price of energy. In other words, the phrasing of the problem and the economic theory underlying the views of those who pose the questions on behalf of the political leadership tend to rig policy decisions.

The agenda is important not only because of what it includes or omits or how it phrases issues, but also because of how it ranks them. On aspect of public-choice theory and the process by which collective decisions are made concerns the possibility or even likelihood that collective preferences come in cycles. The following scheme illustrate the problem of cyclical preferences. Let us assume that three voters--A, B, C--are presented with three choices--X, Y, Z--and let each voter rank the choices thus:

A prefers X to Y, Y to Z, and X to Z

B prefers Y to Z, Z to X, and Y to X

C prefers Z to X, X to Y, and Z to Y

If the choice is between X and Y, then A and C vote for X, and only B votes for Y, hence X wins.

If the choice is between Y and Z, then A and B vote for Y, and C votes for Z; and hence Y wins.

If the choice is between X and Z, then A votes for X, and B and C votes for Z, hence Z wins.

If we assume that voting is sequential, the choice is always between two items, and the order in which the alternatives are put to the voter is fixed by the agenda, then control of the agenda determines the outcome; the agenda determines social choices. In the above example if those who draw up the agenda are familiar with the preferences of the decision makers they can control the outcome.

An agenda has three attributes: the issues raised, the ordering of the discussion and decisions, and the permitted interrelation among options. The issues put on the agenda reflect perceptions of reality and connections as well as values. But the perception of economic reality and of economic connections--and thus of what can be done--is a question of economic theory.

Economic Theory and the Agenda

Theory has the properties of both a lens, which improves the ability to perceive, and blinders, which restricts perception. Without a theory we cannot know what is significant and what is possible. On other hand, by restricting what is thought to be relevant each theory rules out some questions and makes others irrelevant. In putting some issues beyond the pale of discussion a theory may rule out of order some questions that need answering. Gregory Grossman of the University of Berkeley commenting on the student rebellions of the late sixties, remarked that "the left had the questions even though it did not have the answers". Yet having the questions is a prerequisite for finding answers. In order to know whether a problem can be solved it is first necessary to have a theory in which the problem can occur.

Within the body of neoclassical theory it is not meaningful to ask how financial instability is endogenously generated and whether a rise in transfer payments or in the ratio of investment to consumption leads to inflation. It is meaningless to doubt that a rise in the proportion of income going to investment will lead to a rise in the growth rate of output and in real per capita wages. Furthermore within neoclassical theory, it is not permissible to doubt that productivity, in the sense of marginal productivity, determines the share of labor and capital in total income. The proposition that capital income is a share of output that reflects how a capitalist economy is behaving makes no sense within neoclassical theory.

The neoclassical synthesis has set the agenda for economic policy discussion over the entire post-World War II era. The extraordinarily robust financial

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[1] Arrow, K.

situation inherited from World War II and the Great Depression, combined with a reluctance to speculate--a legacy of the Depression--made the first twenty post-war years a time in which economic policy in fact did not matter very much in determining employment and price levels. The cold and hot wars institutionalized large government which, whenever income fell from a set target, automatically generated a deficit and, whenever income rose above that target, generated a surplus. These built in deficits and surpluses were taken as evidence of the effectiveness of fiscal policy. Furthermore, as the Federal Reserve and the banking system accommodated government deficit financing, the money supply reacted positively to the government's debt financing. The data supported the contention that changes in money an led changes in income--once the lead was allowed to be variable. Milton Friedman and the St. Louis Federal Reserve Bank were able to prove to the satisfaction of monetarist economist, gullible publicists, and conservative politicians that changes in the money supply determined the course of nominal income. The first twenty postwar years were so lacking in serious cyclical movements that explanations of economic behavior that postulated an inherent stability were validated. This period did not lend itself to important observations on the stability properties of our economy.

The neoclassical synthesis leads to some highly peculiar propositions about economic behavior. Establishment-Keynesian policy holds that changes in the government's fiscal posture (deficit, balanced or surplus) constitute an effective determinant of income, regardless of the details of the changes in spending and taxes. Monetarist economists hold that changes in the nominal money supply determine changes in nominal income, regardless of allows the changes in financial markets and practices.

Clearly today's economic crisis is as profound though not as overtly critical as that of the thirties. The instability, inflation, and chronically high unemployment of the years since 1965 are not satisfactory and that the policy prescriptions that may have served well enough in the earlier postwar years, can no longer achieve the desired results. Moreover, there is no consensus on what we ought to do. Conservatives call for the freeing of markets even as their corporate clients lobby for legislation that would institutionalize and legitimize their market power, business and bankers recoil in horror at the prospect of easing entry into their various domains. Corporate America pays lip-service to free enterprise and extols the tenets of Adam Smith while striving to sustain and legitimize the very thing that Smith abhorred--state-mandated market-power.

Liberals, instead of pioneering innovative experimentation and change, are wedded to the past. They support minimum-wage increases without questioning whether these laws have ever served any real purpose since the Great Depression, when reflation was the object. They are unwilling to face up to the shortcomings of policies inherited from the past. They are timid about setting forth in new directions.

Instead of analysis and new ideas, we get slogans: free markets, economic growth, national planning imprecise phrases that question neither the what nor the how of these objectives. The various demands for changes in policy are based on misconceptions of both the strengths and weaknesses of market processes. One of the reasons for the intellectual poverty of policy proposals is that they continue to be based upon ideas drawn from the neoclassical theory. Economic theory is relevant to policy, for without an understanding of how our economy works we cannot find cures. But for an economic theory to be relevant, that which happens in the "world" must be a possible event in the theory. On that score alone standard economic theory has failed the test.

Today's economic policy is a patchwork, where every change designed to correct some shortcoming has side effects that adversely affect some other aspect of economic and social life. If we wish to improve upon what we now have we must embark upon a new age of institutional and structural reforms that will check the tendencies toward instability and inflation. Standard theory offers us no guidance on that score. A new era of reform cannot be simply a series of piecemeal changes. A thorough, integrated approach to our economic problems, must be developed, policy must range over the entire economic landscape and fit the pieces together in a consistent, workable way. Piecemeal approaches and patchwork changes will only make a bad situation worse.

Poverty in the midst of plent and joyless affluence are but symptous of a profound disorder. Persistent financial and economic instability and unemployment coupled with inflation are normal results in our capitalist economy. The commitment to private investment as the road to prosperity and salvation through "growth" combined with expanding government transfer payments amplifies financial instability and chronic inflation. Our problems are in good part the result of how we have chosen, even if inadvertently and in ignorance of the consequences, to run the economy. An alternative policy strategy is needed. We have to go back to Square 1--1933--and build a new policy strategy that is based upon a modern understanding of how our type of economy generates financial fragility, unemployment, and inflation.

The Approach To Be Adopted

The three policy slogans--the conservatives' call for free markets, the 'liberals' commitment to economic growth and more of what we have and the pseudo-radicals' call for national planning--all have one thing in common: the economic analysis that underlies their approach to policy is pre-Keynesian. Just as there never really was a Keynesian revolution in economic theory, there also never really was one in policy. Aside from Alvin Hansen's depression prescription no one has actually thought through, much less implemented, the implications Keynes' analysis holds for a desirable economic structure, institutional arrangements and economic policy. All that was assimilated from Keynes was his analysis of an economy in deep depression and a policy tool of deficit financing. Keynes' deep critique of capitalism, and serious attempt to reformulate economic thought so that it could better deal with the impact of capital-using production techniques and financial relations were lost to the analysis and formulation of policy. Keynesian economics, even in the mind of the economics profession but particularly in the view of politicians and the public, became a series of simple-minded guidelines to public policy. What we need is a policy strategy based upon an economic theory that recognizes that our economy is a capitalist economy with a sophisticated financial structure. We must base policy upon a theory that builds upon what was lost from Keynes' contribution.

The major points derived from the theoretical perspective that builds on Keynes:

1. Whereas the market mechanism is an efficient and effective control device for a myriad of unimportant decision, it fails in important equity, efficiency, and stability tests.

only does not have to grow but may be increasingly inequitable in its income distribution, inefficient in its choices of techniques, and unstable in its overall performance. The emphasis on growth through ever greater investment and capital intensity not only breeds unemployment and inflation, but instability, inequity, and inefficiency as well.

3. An extensive and expensive system of transfer payments is socially destabilizing, tends to reduce real income, and introduces a strong inflationary thrust into the economy.

4. The continued emphasis on housing and construction as a policy objective is a mistake. Because President Roosevelt many years ago said that one-third of the nation was ill-housed does not mean that it still is. A distinction must be made between building houses and the supply of housing. There is little question that we manage the stock of housing poorly. A well-constructed building can last "forever" or it can deteriorate overnight, depending on how it is managed and cared for. If we want decent housing policy should concentrate on preserving and improving the stock of housing.

5. It is difficult to decide whether the emphasis on capital-intense production should be seen as a failure of theory or policy. Certainly there is unwarranted emphasis on investment as the source of all good things: employment, income, growth, price stability. But in truth, inept and inappropriate investment deters full employment, consumption, economic growth, and price stability.

6. Our economy has been characterized by the pervasive validation of private decisions by the public sector even when such validation proved detrimental to efficiency and equity. It reflects a fear of uncertainty, even though the theory

that presumably guides policy does not recognize the fact that decentralized markets cannot deal with uncertainty without periodic threats of financial collapse.

7. A shift of emphasis from jobs to government contracts occurred during World War II. After the war there was a further shift from national-income-account spending to transfer payments by the government. These changes adversely affect economic efficiency and equity and impart a strong inflationary bias to the economy.

8. Policy must always recognize that there are limitations to what can be administered competently. The limited competence to administer biases "policy" towards those mechanisms that require the minimum of administration, in particular mechanisms that use and rig markets are to be preferred to direct regulations and controls.

A program for full employment, price stability, and greater equity is not a simple one-shot affair. There is no magic economic bullet. So single program or particular reform will set things right. Standing by themselves, unaccompanied by the requisite companion measures, the individual parts of an integrated reform program might be futile. Any program that will make things better is bound to have a price: Some units will be worse off and there will be adjustment costs. But some units are worse off and there are adjustment cost from continuing as we are. However a program of reform that builds an economy oriented to employment rather than growth should show some benefits quickly. Even national income, an imperfect measure of well being, should improve.

The primary aim is a humane economy as a first step towards a humane society. Much of which is taken to be the result of inherent trends is in reality a result of policy. Neither intrinsic characteristics nor technology nor "innate" genetic preferences determine what happens: technology and preferences are socially determined. Consumers' sovereignty is not only a myth, because of persuasiveness of education and advertising, but consumers react to prices so that subtle subsidy arrangements show up as revealed preferences.[1] The market mechanism works well enough as a rationing device and even as a supply-determining mechanism: The reform program that follows from the analysis uses the market mechanism as a social control and coordinating artifact and non-market controls where markets fail, in particular where giant corporate operators of large-scale capital-assets exist.

The existing policy strategy is an investment-transfer payment approach: Investment is the main vehicle which sustains employment and generates improvement. Unfortunately the investment strategy generates an undesirable income distribution and a large dependent population whose income is maintained by complex transfer payment schemes.

The alternative is to emphasize employment. Aside from the special cases of children's allowances and welfare for the truly disabled an emphasis upon employment means that almost all non property income will result from the exchange of labor for income. But to achieve this, we need many more jobs than we now have; there must be an infinitely elastic demand for labor at some minimum wage. But such an infinetely elastic demand for labor can only be achieved by a residual employer, which must by its nature be a "government" operation. The key to doing better is a permanent operation that is equivalent to the Works Project Administration of the Depression. An employment strategy requires such a permanent device.

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[1]See T. Scitovsky, The Joyless Economy.