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THE BREAKDOWN OF THE 1960S POLICY SYNTHESIS

by Hyman P. Minsky

A Keynesian-Rooseveltian policy synthesis for the United States ruled from the end of World War II to the inauguration of Reagan. It emerged out of the union of the structural reforms of the 1930s and the active use of fiscal policy in the post-World War II period. This policy regime was a response to the shortcomings of the small government, laissez-faire capitalism that were apparent in the performance of the economy in the 1920s and early 1930s, and to Keynes' demonstration in *The General Theory* that any economy with the production and financial characteristics of American capitalism was inherently flawed. That is the policy synthesis that ruled for 35 years (1946-1980) was based on what happened between 1920 and 1933 in the advanced capitalist economies and on an economic theory that made business cycles a normal result of the structure of production, the sources and uses of cash and the financial system of an advanced capitalist economy.

However the Keynesian theory that made depressions normal results of the economic process also indicated that 1929-33 was not inevitable; regulation and apt fiscal intervention could much improve the performance of the economy. This vision of American capitalism, as an inherently flawed system which required regulation and fiscal intervention if it were to function well, faded as the economy experienced its prolonged era of success after 1946. Furthermore, over the years 1946-80 the economic analysis that guides the policy advisors and that informs American opinion became neoclassical and apologetic for, rather than Keynesian and critical of, American capitalism. As the neo-classical synthesis of Samuelson, Friedman *et al.* became the dominant frame of reference for the policy advising economists, the reasons for intervention, in the form of market regulations, taxation to reduce savings coefficients, and government big enough to run serious deficits, were lost. Over the last 35 years, neither the performance of the economy nor the dominant economic theory made the flaws of market capitalism evident, even as a chorus of academic economists identified the "unregulated" result of market capitalism with the abstract entities of their theory. Economic theory in the hands of current practitioners is poverty stricken in what it contemplates as possible. Within the current theory, as exemplified by the economics of the rational expectations and the orthodox Keynesian economists, the serious business cycles of history, with their debt deflation processes, just cannot happen.

Without system malfunctioning and an economic theory that made malfunctioning on a serious scale a normal intermittent result of market processes, the regime of regulation, government intervention and biting taxes that characterized the Keynesian-Rooseveltian synthesis became a burden without felt benefits. Any economic or social system that imposes costs without delivering benefits loses its legitimacy. The Reagan administration's smashing victory in the summer of 1981 in changing the economic structure

almost by fiat reflected the weakness of the rationale for the system that was in place when they took power, rather than the strength of the arguments for radical changes. It is one of the ironies and paradoxes of American politics that the classes and regions that benefitted most from the institutional reforms and policy interventions of the Keynesian-Rooseveltian synthesis became the pillars of the reaction against the synthesis (Texas and Arizona were poor in the 1920s and destitute in the 1930s) whereas the "liberal synthesis" retained support in the middle west and north east (which were the heart of American industrial strength and affluence in the 1920s).

The weakness of the theoretical understanding of the American economy by American policy makers is shown by the intellectually bankrupt political defense of the inherited economic structure put forth in 1981; this defense largely emphasized "compassion." The much stronger argument, to the effect that the performance of the economy in the years of the interventionist state was much superior to that achieved in the prior era of free market capitalism, was not advanced. One reason why "liberalism" did not advance cogent arguments defending big government interventionist policy regimes was that the economic analysis, used by the defenders of interventionist welfare capitalism, is not able to show that an interventionist capitalism is superior to a "free market" capitalism. This failure occurred because the "liberal" economists of the policy advisory establishment accepted pre-Keynesian economic theory as the apt way to structure the analysis of American capitalism.

Staying within the confines of capitalism (i.e., assuming that whatever program of social and economic reform, however radical in intent, is adopted will take the form of incremental changes of a "reasonably well functioning" system) big government capitalism is superior to small government capitalism for an economy that uses expensive and special purpose capital assets and has a sophisticated, complex and innovative financial structure. This is so because the large government deficits that big government capitalism can generate guarantee that gross capital income cannot collapse. As long as gross capital income — in the aggregate — is large enough to enable business on the whole to meet the commitments that are embodied in liabilities, then the wholesale, across the board deflation of asset values and capital asset prices along with a collapse of income, employment and prices, such as occurred in 1929-33, cannot occur.

In a big government interventionist capitalism, the financial system will experience from time to time local shocks and disruptions. This can be sufficient to induce a shift to liability or balance sheet conservatism, which in turn will induce a decline in investment, income and profits. However, if profits are maintained, this shift of what Keynes called liquidity preference is transitory. If government is big, so that the swings in the government deficit (either because of built-in stabilizers or because of discretionary fiscal intervention) are big enough to offset or more than offset swings in investment and the trade balance, then profits will be maintained. With profits maintained, a recession cannot escalate to a deep and long-lasting depression.

For completeness' sake, it is necessary to add that the central banks of advanced capitalist economies also play a part in preventing deep depressions. To do this they need to actively intervene as lenders of last resort whenever the combination of liability structures, financing charges and the flow of profits leads to a crisis in financial markets. The intervention takes the form of refinancing threatened financial institutions or markets on concessionary terms. Such refinancing increases the ability of banks to finance activity and confers respectability and protection to some extra-bank financial practices.

The result of the combined use of deficits and central bank refinancing of disrupted financial markets has been that the thrust towards a deep depression, that is a normal functioning reaction in a capitalist environment to financial difficulties, has been transformed into the peculiar behavior known as stagflation: slow growth, rising unemployment rates and stepwise increasing but not runaway inflation rates. In comparison to the first 21 years after World War II (1946-66), the last 15 years (1967-81) have been disappointing; in comparison to the 21 years that preceded 1939, the last 15 years have been quite successful.

Incidentally, the welfare state (social security, unemployment insurance, aid to families with dependent children, etc.), together with a tax system where current revenues are sensitive to fluctuations in income and employment, can be interpreted as a set of conservative instruments for assuring an increase in government deficits whenever private investment demand falters; such deficits sustain profits. The welfare state is good for capitalists. It is not especially good for the direct recipients of benefits. This is especially true if the welfare state is seen as a substitute for a full employment policy and the innovative extra market, extra private enterprise production and employment schemes that are necessary if full employment is to be achieved and sustained. After all, welfare — and even devices like old age pensions — can be best interpreted as ways to blame the poor rather than the economy for poverty.

This repudiation in 1981 of the Roosevelt-Keynesian policy synthesis took place in spite of its success in achieving the objectives set for reform in the 1930s. The major objective of Roosevelt's era of reforms was to achieve a variety of capitalism in which Great Depressions cannot occur. To paraphrase Keynes, the objective was to achieve a closer approximation to full employment on a sustained basis than had hitherto been achieved. A second objective was to ameliorate poverty, both urban and rural. Both objectives were achieved and sustained over 1946-1980.

It is important to note that the Roosevelt era of reform and innovation with respect to the economic structure occurred before Keynes' *General Theory* appeared. Thus the structure that was built, mainly between 1933 and 1936, did not benefit from a Keynesian diagnosis of the flaws of capitalism. The Rooseveltian policy structure was not aimed at overriding the flaws of capitalism (which, in Keynes' diagnosis were largely due to the way in which capital asset prices and investment are related to financing and through the banks to money) by fiscal policy measures.

The reforms of the economic structures during the Roosevelt era were largely structural. They reflected the belief that the Great Depression was largely caused by the downside flexibility of price and imperfections together with fraud in the financial system. The imperfections of the financial system were in part structural but in addition it was argued that the financial and corporate systems gave opportunities for malefactors of great wealth. Thus the New Deal industrial reforms set minimum wages, supported agricultural prices, encouraged trade unions and tolerated cartelization with government participation (regulation in today's "language") in the belief that these structures would constrain the downside flexibility of prices. The reforms of the financial system reflected the views that fraud and the failure of the Federal Reserve to be an effective lender of last resort led to the breakdown of the financial system. These views were translated into laws and regulations that attempted to protect against fraud and to assure that lender of last resort interventions would occur when needed.

Because of the breakdown of the financial system and the weakness of asset values, a class of impoverished mature and older adults of middle class origin emerged in the 1930s. The "inability" of private schemes and personal savings to provide for old age and some other contingencies seemed to be a "self-evident" truth for an economy that periodically had big depressions and sharp falls (even unto zero) of asset value. These self-evident truths led to "populist" political movements (Long, Townsend, Caughlin are names of leaders) that emphasized old age pensions. The social security system was a defensive response to these pressures.

Fundamentally transfer payments, as exemplified by the social security system, were of secondary importance during the New Deal days. In Roosevelt's view, transfer payments, such as relief, were transitory devices made necessary by the emergency. The major income maintenance schemes were "work oriented"; work relief was preferred to direct relief.

An ideological underpinning of the Roosevelt program was the view that the state has a responsibility to guarantee that income from work was available to all and that the only way this guarantee could be affected is if the government had "open ended" employment efforts. This commitment to managing markets and creating institutions so that a "minimal" income from work was available to all stands in sharp contrast to the transfer payment emphasis that became fully dominant with the great society of Johnson and his war on poverty. The poor and the aged as a permanent class of "remittance men" became the basis of American liberalism and radicalism in the Kennedy-Johnson days. The Great Society and the war on poverty were conservative responses to the employment and distribution failures of capitalism. They were based upon compassion rather than an understanding of the determinants of income distribution and employment.

Aspects of the Johnson-Nixon economic regime were internally contradictory. The program emphasized both an improvement of the lot of the "poor" through transfer payments and the subsidization of investment through tax benefits. If the economy is going to simultaneously improve the lot of the "welfare poor" and increase the portion of output that goes to

investment then the consumption standards of the working-wage earning population must decrease. But part of the working-wage earning population is protected by strong trade unions and another part by their scarce skills in the high technology part of the economy. The end result of these social and political forces is that the lot of the poor could be improved only by a deterioration in the lot of the near poor. The behavior of the real take-home pay of the American "blue collar workers" in the past 15 years shows the divisive character of an exploding welfare-transfer payment system in the context of a commitment to growth through investment.

Transfer payment schemes in the United States always have "eligibility" requirements which set conditions for recipients to satisfy to receive "benefits." Eligibility means that administration is necessary. Often quite arbitrary lines are drawn between those eligible and those ineligible. The end result is that schemes become increasingly complex and difficult to administer. "Inefficient" universal schemes, in the sense that they deliver significant sums to not necessarily "deserving," may be more efficient than "efficient" schemes which deliver benefits to clearly defined targets, if the "inefficient" scheme is cheaper to administer and felt to be fair. A universal children's allowance, for example, may be "inefficient" in that the children of the "rich" receive benefits, even as it is "efficient" because it is much less costly to social harmony than aid to families of dependents that is both means tested and viewed as being unfair.

One of the characteristics of the hurry-up reforms of the Johnson era in the United States was that administrative complexity was not taken to be a problem. Much of funds that are allocated to housing, urban renewal, health and environmental protection involve complex time-consuming and often demeaning negotiations with authority, in the form of dispensing civil servants, by potential recipients. Any successful program of reform and reconstruction must be simple to administer.

There are about as many answers to the question of "What is Keynesian economics?" as there are economists who seriously address the question. In the Anglo-American tradition answers to the question fall into two main camps. One camp takes Keynesian economics as a special case of the Walrasism General Equilibrium Theory. This main Keynesian tradition also holds that the more conservative monetarist school is a special case of the same Walrasism General Equilibrium Theory. In this view, the difference between the two schools comes down to specifications of reactions to changes in a common analytical framework which normally is the IS-LM scheme of J.R. Hicks.

The view that Keynesian economics is a special application of the General Equilibrium Theory of Walras means that the fundamental view of the economy is that the system out there in the world is an "equilibrium seeking and sustaining mechanism." Disruption of equilibrium must come from outside the economic mechanism — either from government, the monetary system or entrepreneurial innovators. In the visions of the orthodox Keynesians and Monetarists there are no endogenous disequilibrating forces

within the economy that can "cumulate" over time so that by internal economic processes equilibrium is ruptured. Although some economists who live in the overall framework of this neo-classical synthesis favor interventionist policies, the true flavor of the neo-classical synthesis is captured by the "rational expectations economists" who essentially argue that policy and intervention are not capable of altering the "natural rate of unemployment" or "the real wage" except as policy intervenes in particular markets. This result is achieved by working with a model in which very little can happen. In particular, financial crises and, with financial crisis, the possibility of a Great Depression are non-events within the neo-classical framework.

The alternative minority views of what Keynes was about are perhaps united only in that they hold that the orthodox version of Keynes, as a set of specifications of functional shapes and market reactions within an analytical framework that is consistent with orthodox price theory is wrong. However there is an emerging consensus among these dissidents that the apt interpretation of Keynes places him squarely in the intellectual tradition of Riccardo and Marx (formalized by Van Neimann and Sraffa). This means that the primary emphasis is on accumulation seen as a social process of extracting a surplus that is allocated to investment. Keynes can be viewed as an extension of Marx that is reduced to an essential analytical economic core and stripped of its pejorative language. Keynes — like Schumpeter — can be considered to be a "Marxist" economist who is conservative and pro-capitalist. (In the light of various asides and Chapter 24 of the *General Theory*, perhaps Keynes can be taken as a guide to a practical socialism-interventionist capitalism that may in fact work much better than any system that is theoretically pure.)

Keynes, standing on the shoulders of both Marx and Marshall and knowledgeable of the ways sophisticated financial markets of advanced capitalist economic work, produced an analysis of capitalism that focused on an accumulation process that is dependent on financing arrangements. Financial arrangements create payment commitments. The theory he developed showed that in a world where complex liability structures and financial intermediates exist, financial crises, debt deflations and deep depression cycles are possible and they will in fact occur from time to time. There is no necessity to posit external shocks or policy errors to explain the existence of cycles: within Keynes' theory, they are normal functioning events.

In Keynes, capitalism is flawed because the accumulation process, taking its full financial ramifications into account, leads from time to time to deep depressions. However, to Keynes, the alternative of a thorough-going planned economy, where decision on the pace and allocation of accumulation and of the use of existing production capacity are planned, is administratively complex; so complex that it cannot be achieved in a democratic society. The socialization of the accumulation process — of investment — but not of the use of productive capacity became to Keynes a path by which the flaws of

capitalism would be overridden even though they could not be wholly eliminated.

Economists are always aware of the "power" of decentralized markets to generate coherent results in the production and distribution of commodities and services within given production capabilities and some taken as a given distribution of initial resources. The proposition that decentralized markets are capable of yielding coherent results out of complex independent decision-makers is a first and not trivial lesson that economics teaches. Unfortunately, to neo-classical theories, this is the only lesson; they do not go into the second lesson, which is that when the complexities of capital assets, money and finance are added, then any coherence that is achieved by market processes is transitory, for there are inside the system coherence rupturing processes at work. Thus, decentralized markets are useful social instruments once it is recognized that potentially disruptive results have to be avoided by apt interventions and regulations.

The major virtue of decentralized markets is that they require little or no ability to administer by the state. Furthermore, if production and distribution of commodities and services are carried out by means of markets, then excise taxes, subsidies and relatively easy to administer standards can be used to guide production and distribution without a need for the complex administrative structures of a full-blown planned economy. Taxes, subsidies and regulations are devices that enable society to improve the way decentralized markets effect the details of production and distribution even as fiscal policy and the socialization of investment prevent the aggregate malfunctioning that leads to business cycles.

Decentralized markets and decentralized decisions to produce can and do do a good enough job for the multitude of unimportant details of the economy. Decentralized markets do a poor job of distributing income and because of the instability of the investment process, decentralized market economies with modern capitalist finance are prone to serious depressions. Even the perpetuation of poverty in the midst of overwhelming capacity to produce plenty is due to the impoverishing effects of depressions. The success of the advanced capitalist countries in ameliorating poverty over the 35 years since World War II is due to the absence of a deep depression rather than to the welfare state-transfer payment schemes that have proliferated.

In Keynes' view, the first priority of policy is to tame or socialize the investment process. The economist's "model" of socialism — the Lange-Lerner solution to the problem of allocation and pricing under socialism — clearly separates the utilization of existing resources from the creation of resources. In Lange-Lerner market socialism, producers using given resources are to produce to maximize profit, given market-determined prices. The market is the socialist device for coordinating production with a minimum of bureaucracy.

In the Lange-Lerner model, the role of planning is to determine the pace and the direction of investment. For minor investment decisions — particularly for farms and small-scale enterprise — a socialist banking system

will function more or less like the banking system now does in providing finance for feasible projects. It is a practical rather than an ideological question as to whether smaller scale enterprise would be privately, cooperatively or publicly owned. Even if public ownership is the chosen path for some parts of the economy, the precepts of Lange-Lerner socialism indicate that units must not be protected from competition. Decentralized markets have a virtue in that they allow for selection and evaluation through competition. One of the apparent weaknesses of interventionist economies is that they get frozen into a particular set of interventions — whether it be collective farms, aid to families with dependent children, or protected, nationalized railways.

The "Sloan" prototype organization of General Motors, in which a finance committee determines the major plant, plant-expanding and lines of business investment decisions and how investment and capital assets are to be financed, whereas various product-line managers produce with the resources placed at their command, is an analogue to the Lange-Lerner division between the market-determined and planned faces of socialism.

A regular steady growth of investment, without inflations or depressions, can only be achieved if today's investment decisions are cut off from today's profitability of business and if the total of financed investment, government spending, and private consumption demands is constrained to available output at existing prices. Lange-Lerner socialism can be interpreted as a way of socializing investment so as to get around the instability of capitalism that Keynes identified as the critical and essential flaw of capitalism. Keynes' theory links this flaw in capitalism to the way capitalist economics determine investment. Lange-Lerner socialism provides for a process that determines investment which does not lead to the same instability of investment and profits that is evident under free market capitalism.

Welfare state capitalism allows for investment to be unstable without an accompanying instability of profits by interposing government deficits. But if government deficits achieved through transfer payments are the profit stabilizer, then a decrease in output accompanied by stabilized profits must lead to prices that contain a higher mark-up on labor costs than was true in the earlier higher output period. In a welfare state, profits are sustained by a process that leads to inflation.

In as much as with a lag, investment leads to output, the sustaining of investment, through either market process or by means of some socialization solution, will be inflationary only in the interval until output increases. An investment strategy for income maintenance implies that inflation will be offset by a flow of output, but this strategy can succeed only if investment and investment financing are largely removed from the market.

One of the theorems of neo-classical theory is that the relative prices of outputs are determined by production possibilities and consumer preferences (technology and tastes). However, in a world with accumulation and government, the mark-up on labor costs in the price of consumer goods reflects the relative strength of investment and government demands in the economy. The relative prices of output — and especially the ratio between a

price index of consumer goods and a price index of wages — depends on the share of investment and government in total output. Relative prices in any economy reflect the political and social phenomena that determine investment and the size of government. A large investment-large transfer payment system economy will tend to have a real wage that is depressed relative to that of an economy in which income is maintained by employment.

As a result of the evolution of the financial system bewteen 1946 and 1965, the financial system became fragile. As a result, beginning in 1966 there were periodic threats of a financial crisis and thrusts of the economy towards a deep depression. The response of the United States authorities to credit crunches and recessions was to cut taxes, increase transfer payments and use the offices of the Federal Reserve to refinance threatened financial institutions. After 1964 tax cuts were overwhelmingly biased to favor investment and to reduce the "burden" of taxes on the well-to-do (Reagan's reforms are to a large extent a continuation of a trend). The result of these sustaining interventions was that economic growth slowed down, the population dependent on transfer payments increased and the real income of the workers unprotected by strong trade unions began to decline.

The increasing differential between the progress of the real wage of protected and unprotected workers has led to a decline in the power and coverage of trade unions. Today a minority of the industrial labor force in the United States is protected from declining or static real wages by effective trade unions.

In an indirect way, policy that determines the scope of government and the techniques available to finance investment and government spending will determine relative prices and the production techniques that will be used. In any economy, what will be produced and for whom production will take place reflects social and political conditions. The notion of an impersonal market that makes consumer sovereignty the effective determinant of what is produced is false. The market is not an independent determinant of values. It is a social artifact that can and should be used to achieve social goals.

On the supply side, the market is most effective when the individual units have no market power. The entire apparatus of conglomerate firms, in the form of finances, advertising, marketing and the use of expensive special purpose capital assets in production, is designed to achieve protected market positions, i.e., market power. Market power leads to production inefficiencies and distributional injustice.

A problem that the economic reconstruction that will follow the debacle the Reagan program is facilitating will have to face is how to organize those productions that, because of the nature of the capital assets and the scale of production, will only be financed if the units engaged in these productions have market power. The Sloan structure for organizing giant corporations indicates that control over the "finance committee" of giant corporations is the path to a decentralized socialism (or alternatively to a guided interventionist capitalism, the label is of little importance). In this structure the exploitative and inefficient aspects of market capitalism that depend upon private market powers are eliminated, even as the instability due to

private ownership, investment planning and financing are much attenuated by the socialization of investment.

In thinking about and in hammering out the contours of an economic program for life after Reagan and Thatcher, we would do well to go back to the square zero of the policy synthesis that I called Roosevelt-Keynes for the United States. It is necessary to reconsider the details of the inherited structure in the light of experience and of our current understanding of how our complex economy works. The structural reforms that gave the United States big government interventionist capitalism were largely in place before Keynes' *General Theory* appeared. As a result, the post-war fiscal policy interventions took place in an institutional environment that had been constructed on the assumption that institutional rigidities rather than aggregate demand management was to sustain income, employment and profits.

Keynes' solution to the instability of capitalism was to socialize investment. In a private enterprise economy, one of the major effects of investment is to generate (force) profits. The analysis of Keynes and Kalecki leads to the view that government deficits also generate (force) profits. A big government, where government is big because of transfer payment schemes and national defense, is just as good in generating profits as a government whose "investment" expenditures are big because investment in particular types of capital intensive activities has been socialized. However, profits that are sustained by transfer payment and defense spending are not associated with increases in productive capacity whereas profits that are generated because of government financed productive investments do leave a permanent residual of productive capacity and therefore potential output.

Thus a post-Reagan reform of the American economy that aims not at perfection but to do better than the performance between 1966-81 could begin by reorganizing the basic urban and rail transportation networks so that investment in these facilities are both removed from the private domain and are adequately funded. Any post-Reagan reform must look to the substitution of by-right children's allowance for today's means-tested tax rebates and welfare schemes. But most important, a "by-right" program of public employment in useful projects must become the pillar of the policy.

How to achieve full employment within the context of decentralized markets without using transfer payments to "pump up" demand, even as they do not increase supply, so that inflation results, is the critical policy problem of capitalism and mixed economies. Instead of throwing interventionist capitalism out, as Reagan is doing, it would be far better to recognize that the interventionist capitalism of 1946-81 was far superior to what preceded it and strive to improve the workings of the interventionist system rather than to dismantle it. One must fear that if intervention is dismantled, American capitalism and the other advanced economies will repeat the "dismal" performance of 1929-1933.