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CHAPTER I

INTRODUCTION

Is the fulfillment of these ideas a visionary hope? Have they insufficient roots in the motives which govern the evolution of political society. Are the interests which they will thwart stronger and more obvious than those they will serve?


A. Introduction

The above is the first paragraph of the last section of the last chapter of Keynes' General Theory, the monumentally influential, though imperfectly understood, work that was published forty years ago in 1936. The revolution in economic theory and economic policy that followed was, as it turned out to be, more of a revolution in the attitude towards policy than in the substance of economic theory. In terms of where we now are and the path we have travelled since 1936, the major contribution of Keynes has been to transform economics, and the publics and politicians' perception of economics, into a policy science rather than an abstract statement of natural forces that guide and control the destiny of nations and of men. It is an underlying contention of this work that the revolution in economic thought that Keynes believed he was launching was aborted: The truly revolutionary insights of Keynes into the workings of a capitalist economy were overlooked, ignored, or misconstrued in the construction of today's standard theory. Even though, because of emphasis upon policy handles, today's standard theory is called Keynesian, in truth, aside from some language, today's standard theory owes little to Keynes - it is much more consistent with the doctrines that ruled prior to Keynes' great work than it is with the teachings embodied in The General Theory.
The basic theme of The General Theory of Keynes was that a capitalist economy, with the financial institutions that can be conveniently labeled as "Wall Street" or "The City", is essentially flawed in that its normal path over time is cyclical: i.e. business cycles are an inherent attribute of a financially sophisticated capitalist economy. These business cycles are often mild and, although they hurt, they are essentially benign. The movements, whether towards depression and unemployment or towards boom and inflation, are soon corrected and offset. However, from time to time, the booms get out of hand – speculation becomes rampant – and the booms, by way of a crisis and debt-deflation lead, to a deep and serious depression. Thus although the flaw in capitalism is at times not serious, the regular occurrence of deep depressions is serious: the losses of output, the human suffering and the misallocation and misuse of resources that the strong booms and deep depressions brought need correction. The problems as Keynes saw it is whether a better organization of economic affairs is possible - one that combines the economic efficiency, that decentralized markets usually imply but which decentralized markets did not lead to when booms and depressions occur, with an environment conducive to social justice and individual liberty.

Even though the full power of Keynes' insights into the functioning of a capitalist economy were not absorbed into the ruling economic theory and policy analysis, enough of the message that our economic destiny was controllable came through so that in the era after World War II conscious management of the economy became an avowed aim of government. The Employment Act of 1946, which set up the Council of Economic Advisors and the Joint Congressional Economic Committee, was a commitment to try and
manage the economy. For some twenty years after the end of World War II—from 1946 to the middle of the 1960's—the deviations from a reasonable approximation to full employment and price stability were minor. In the decade that followed, the smooth path of the 1945-1965 era was replaced with strong inflations and strong threats of financial collapse and deep depressions.

As we enter the last quarter of the twentieth century our economic world is in disarray. After what seemed like a secure quarter-century of progress—from the end of World War II until the middle 1960's—instability, as evidenced by bursts of accelerating inflation, higher chronic as well as higher cyclical unemployment, rashes of bankruptcy and "crises" or "messes" in energy, transportation, foodstuffs, welfare and our cities, have become the order of the day. Quite suddenly the world is in apparent disarray. The economic policy and social synthesis, that seemed to serve us well for the first twenty years after World War II, has broken down.

What we now need is a new policy synthesis which differs in fundamental respects from that which we have.

Even though the recognition that a problem exists is the first step towards a solution, mere assertion that something is rotten in what we have is not sufficient. Recognition that a problem exists must be accompanied by an analysis of what is wrong, an understanding of the processes that govern the behavior of our economy, and the development of an agenda for reform that responds to the problem and which does not do violence to the fundamental democratic premises and economic processes of our society. In the absence of an understanding of economic processes and a passionate, nay irrational, commitment to democracy, the agenda for
change, in response to the felt need for change, can become the property of demagogues who play upon fears and frustration and offer ends without specifying means. An awareness of process, so that the statement of goals for policy is always accompanied by a specification of how the goals are to be accomplished, is needed. A scientific scepticism needs to be wedded to a vision of a better world so that aspirations are constrained by what can be achieved. These are limits to the attainable that are set by how things work. Because of the limits imposed by process we cannot offer utopia but we can in truth offer something much better than what exists and what has been. Too often the best has been the enemy of the good: A serious program of reforms can only offer better, not perfection.

The center of our current crises lies in the malfunctioning of the economy. The non-economic concerns of safety, honesty, decorum, and integrity – which are much deeper than the purely economic – cannot be effectively attacked directly. First we need to get our economic house in order. There is an economic determinism running through the approach adopted here: that if the economy is doing well so that basic security and a feeling of worth is achieved because work is available for all, then many of the social problems recede to manageable proportions. Similarly our vision is restricted to the domestic United States concerns; the feeling on this score is that if the United States economic house is in order then the international economic concerns will be reduced to manageable proportions.

The Three Crises in Economics

Thus the central problem is the economic crisis. In fact we are now in the midst of three concurrent crises in economics: in the economy, in economic theory, and in economic policy. These concurrent crises are
as deep and as significant as the crises. In fact, in theory, and in policy of the 1930's - and our near term hopes for a better world depend upon our understanding and resolving these crises. Our future rests upon understanding of issues and an apt policy response. Hopefully our response will include a deeper understanding of the world in which we live, so that the inherited "cliche's" and slogans which no longer serve us well will be abandoned. Deeper understanding will point the way to new directions in economic policy.

Abstractly - and perhaps even practically - the most interesting of the three crises is in economic theory; a crises that exists independently of the problems posed by the behavior of the economy and the breakdown of the post World War II policy synthesis. This crisis originated in purely theoretical telling points on orthodox theory that were scored by Piero Sraffa, Joan Robinson and Robert Clower in the 1950's and 1960's. Basically the lesson to be learned from these telling points is that economic theory, as taught in the graduate schools, which is embodied in college textbooks, which is part of the intellectual fix of all who studied or practiced economics in the past thirty years, and which is the intellectual basis of policy in capitalist democracies is seriously flawed. The flaw in our current standard economic theory centers around whether the conclusions derived in the analysis of abstract theoretical economic models can be carried over to the operations of our type of economy. In particular economic theory, especially the highly mathematical economic theory developed in the post-war era, makes a nice case that an abstractly defined market mechanism will lead to a coherent, if not an optimum, result if the market mechanism does not have to deal
with time, money, uncertainty, capital-asset ownership, and investment; i.e. if all the concerns of the corporate board rooms and the "Wall Streets" of the world can be ignored. On the other hand if time, money, uncertainty, capital-asset ownership, and investment are important and relevant — if the financial organizations of the "Wall Streets" and the "Main Streets" are significant determinants of what happens — then economic theory does not yield a theoretical underpinning for a view that the result of a decentralized market mechanism is coherent. In fact the "Wall Streets" of the world generate essentially destabilizing forces, and from time to time the processes that center in "Wall Street" engender serious threats of financial instability; i.e. of incoherent economic behavior.

The flaw in standard economic theory was uncovered in what is known among economists as the Two Cambridge Controversy — a dispute between economists mainly in Cambridge, England, the home of John Maynard Keynes, and economists in Cambridge, Massachusetts, the home of Nobel Laureate Paul Samuelson. If the crises in the economy and economic policy had not occurred, the victory of Joan Robinson and her Cambridge, England cohorts over the embattled horde of Cambridge, Massachusetts "mathematicers" would have been nothing more than a tempest in the journals: It would have been written off as just another academic nit-pick.

In truth the economy, beginning in the middle 1960's, began to behave in a manner that cast serious doubts, that were independent of the logical flaws uncovered by Cambridge, England, upon the validity of standard theory. After twenty years of relative tranquility following World War II, when politicians, pundits, and the public began to take for granted that the capitalist world would never again go through the agonies
of a great depression, a near financial crisis, the so called credit
 crunch of 1966, took place. This event, initially treated as a transitory
 aberration, was the first of a set of financial disturbances that have
 characterized the economy in the past decade and which makes capitalism
 in the 1970's more like capitalism in the era prior to the 1930's, than
 in the 1950's.

 The past decade, beginning with the credit crunch of 1966, and
 covering the years 1966-1975, saw three near financial crises. Each
 financial crises was worse than the one before. Furthermore the "inter-
 crisis" periods 1966-1969 and 1970-74 were years of high and accelerating
 rates of inflation. Starting in the middle 1960's the economy began to
 behave in an apparently incoherent way, shifting rapidly back and forth
 from threatening run-away inflation to threatening a plunge towards
 truly mass unemployment.

 Perhaps President Ford's economic summit in the Fall if 1974 best
 exemplifies the futility of recent policy and the erratic behavior of
 the economy in the past decade. No sooner had President Ford arranged
 for WIN buttons to be produced and gotten a campaign to beat inflation,
 based upon the serious commitment and deep understanding involved in
 wearing a button, off the ground than the economy was plunging towards
 mass unemployment at deep depression levels. No sooner had Congress
 passed a tax rebate in the Spring of 1975, after a two quarter plunge in
 income and employment, than the fall in National Income and the rise in
 unemployment rates ceased. The four quarters beginning with the fourth
 quarter of 1974 make up a statistical year of extreme instability.
Suddenly in the 1970’s the economy is not behaving the way it was supposed to: i.e. standard theory cannot explain what is happening. The cry went up from a spate of officials and pundits that this behavior meant that our macroeconomic theory had to be abandoned and that we should return to the presumed tried and true verities of microeconomic theory. In truth the economy was behaving as a capitalist economy with fragile finance and a big government behaves: the error was in the economic theory of the officials and the pundits. 

When, in the days of the Copernican revolution and the voyages of geographic discovery, evidence accumulated that the old theory, which made the earth the center of the universe and led to the belief that the earth was flat, was not valid, no one suggested that the planetary system be changed so that the sun did revolve around the earth and that the earth be flattened to conform to theory. Economic systems are not natural systems like the planets and the earth. An economy is a social organization created by man either in the conscious process of legislation or in the evolutionary process of invention and innovation. What exists today in the way of economic institutions, be they trade unions, corporations, and government bodies, neither always existed nor are they necessary. Both the details and the overall character of our economy can be changed. Nevertheless, even though we can, in the Republic of our minds, imagine institutions and usages that are far different from that which exist, in the attempt to do better we have to start with what is. Therefore if we aim to do better we need to know how what is functions, we have to understand how our economy works so as to be able to make some judgements as to whether any change will in fact make things better, however better may be
defined. As we cannot mandate results but can only mandate processes, we can achieve desired policy objectives only as the results we aim at are consistent with the processes of our economy as conditioned by the in fact institutional arrangement, with the added proviso that the in fact institutional arrangements are negotiable.

In an era in which enough has gone wrong so that the need for economic change and reform is recognized, any program of change and reform that is going to succeed in making things better has to be rooted in an understanding of economic processes as they are within the ruling set of institutions. The understanding of economic processes is the realm of economic theory. But even as institutions and usages are not ordained by nature, so economic theory is not handed down from on high. Economic theory results from acts of creative imagination—the concepts and constructs by which our theory orders the universe are the result of human thought. There is no such thing as national income, aside from a theory which tells us how to combine elements in the economy into this special index number; demand curves do not confront sellers, customers do; the way in which money and finance affect system behavior can only be perceived within a theory which allows money and finance to affect what happens.

Thus we have a three-pronged crisis. One is a crisis in the economy, which for the past decade has seemingly oscillated between accelerated inflation and threats of widespread financial crisis. There are many possible points at which one can maintain that a capitalist economy of the kind that we have is flawed: income distribution and poverty, dominance by giant monopolies, urban crises, adulteration of
products, inability to meet social needs are all candidates for systemic flaws. None of these flaws are inconsistent with the continued operation of an economy. Distasteful as inequality and inefficiency may be there is no scientific law which says that an economic order must meet some external standard of equity and efficiency. However a capitalist economy cannot long exist with rapid oscillations between extremes of threatened imminent collapse of asset values and a resulting deep depression and threats of an explosion of asset values and a resulting runaway inflation. Social arrangements must exist to constrain uncertainty, to make behavior predictable, and to make the expected future conform to a reasonable man's extrapolation of the past. The market mechanism can function well only with a constrained domain of reasonably likely outcomes over a meaningful horizon. Over the past decade the range of outcomes in the near, let alone the more distant, future, that have to be contemplated in decision making has increased. Under these circumstances the normal functioning of the economy breaks down; all those decisions that are made today with the more or less distant future in mind tend to become erratic.

An economy that is inequitable and inefficient may survive. An economy which is unstable cannot. Over the past decade the economy has exhibited a tendency towards ever greater instability. Unless we understand why this instability exists we cannot even attempt to handle the problems of our time. Policy in the absence of a theoretical explanation of instability becomes a striking out at unknown magical forces: WIN buttons might be an effective incantation.

A second crisis is in economic theory. A theory which has to assert that which is happening cannot happen is not a good basis for
action. A theory which makes the dominant, most easily evident observations the work of devils rather than the systemic result of the economic mechanism may satisfy the wishes for a villain or a scape goat to be held responsible for what ails us, but such a theory offers no useful guide to a solution of the problem. The neoclassical synthesis—the economists label for the existing standard body of economic theory—may be a beautiful logical structure (incidentally it is not, for as the Two Cambridge Debate has shown, neoclassical theory, in spite of an impressive mathematical structure, has logical flaws in its premises) but it is not able to generate a meaningful explanation of what is happening. Only an economic theory which makes the possibility of a financial crisis something that emerges out of the normal functioning of the economy and which can explain why one period is susceptible to a financial crisis while another is not will do.

A third crisis is in economic policy. Only yesterday—in the glory Kennedy–Johnson days when so called Keynesian economists were policy advisors—claims were being put forth that the business cycle of history has been conquered. The age of science had given us atomic energy, moon shots, and a virtual elimination of polio. The age of economic science was to give us virtual unlimited growth. In fact a common assertion of those days was that not only was the business cycle eliminated but it was not possible to fine-tune the economy. After the Kennedy–Johnson "Keynesian" economists were replaced by a cadre of more conservative economists in the Nixon–Ford years the claim that the economy can be fine-tuned was maintained. The major difference between the two sets of economic policies and economic advisors was in the techniques to be used and perhaps, although this not
mentioned, for whose benefit the fine-tuning would take place. The dreams of yesterday are in striking contrast to the disarray of today. The recessions of 1969-70 and 1973-75 were interrupted by a period of inflation at record rates. Two threatened financial crises within a five year span is not evidence that a capability to fine-tune exists. If anything the evidence of the past decades is that the authorities do have the power to put the fire of a threatened debt-deflation out. Even though an economy that is not equitable and that is not efficient can survive, once economic policy is accepted as a determinant of what happens then the questions "For whom will policy be used?" and "What kind of output will be fostered?" cannot be evaded. Once it is admitted that institutions are both man-made and at least in part the result of conscious decision, the question has to be faced as to what are the implications of institutional arrangements not only for economic performance but also for social outcomes. We cannot evade the "for whom" and "what kind" questions. Furthermore because the infact market institutions are in good part the result of economic evolution and policy decisions, we cannot evade these questions by appealing to some abstract market mechanism as the determinant of what happens. But this means that policy has to be a reflection of an ideological vision: a vision of the contours of a good society has to inspire policy. And it is evident that in addition to the three crises in economics we now have a failure of vision: a crisis in the aims and objectives that economic policy is to serve.

Perhaps we can do little better than to go back some fifty years when Keynes defined the political problems as a need to combine three things: economic efficiency, social justice, and individual liberty. The first needs criticism, precaution,
and technical knowledge; the second an unselfish and enthusiastic spirit that loves the ordinary man; the third, tolerance, breadth, appreciation of the excellencies of variety and independence, which prefers, above everything to give unhindered opportunity to the exceptional and to the aspiring.*

and bring this trial of efficiency, justice, and liberty up to date.

Whenever a number of goals for a society are stated, it is naive to assume that they are always mutually consistent. It is most likely that an organization of society that emphasizes one goal will have to compromise some other goal. Thus a priority on a weighting scheme among the goals needs to be established. My personal preferences are to maximize individual liberty in the personal freedom - democratic rights dimensions. I do not view individual liberty as extending to so-called property rights as having as strong a claim to our emotions as individual liberty extending to political and individual rights. Thus on political and social freedom I tend to be unpromising, but I see no demonstrated relation between political and social freedom and so-called property rights.

In the light of the vast increase in the ability to produce that has taken place over the fifty years since Keynes wrote - the U.S. Gross National Product was over $6,600 per capita in the recession year of 1974 - the goal of economic efficiency can perhaps be compromised: Being rich, we can afford to give up some output to achieve justice and liberty. Social justice and individual liberty are best served by an economic order that maintains and encourages decentralized market processes. As social justice and individual liberty are both compromised by the existence of hugh centers of private power and vast differences in wealth, a policy

*J.M. Keynes, Essays in Persuasion, Vol. 9 of The Collected Writings of John Maynard Keynes, p. 311.
thrust that willingly foregoes some of the presumed advantages of giant firms and huge financial organizations (these advantages may or may not in fact exist) seems highly desirable. In the light of the experience of 1973-76, when the difficulties of giant corporations and huge financial empires were central to the instability that plagued the economy, if economic efficiency includes as one of its dimensions the avoidance of instability, then efficiency might very well call for a transformation of the very largest concentrations of private economic and financial power into public bodies or the devolution of the private centers of massive power and wealth into more manageable sized centers.

Social justice is perhaps best served by measures that assure dignity and independence to individuals. Dignity and independence are best served by minimizing dependency, whether the dependency be upon centers of private power or upon political power centers. Thus I have a strong bias in favor of universal rights and the maintenance of minimums, adequacy is a vague concept relative to a social minimum. Dignity is served by an economic order in which income is received either by right or by a fair exchange. Thus to foreshadow specific economic policy proposals, income from work should be the major source of income even to the poorest; the existing dependence upon permanent and expanding regimes to transfer payments is demeaning to the recipients and destructive of society. Social justice and individual liberty are best served by an organization of opportunity in which a social minimum is achieved by all except the clearly handicapped by means of the fair exchange that income from work implies.
Economic policy therefore requires a statement of goals and an awareness of economic processes. But the processes of any economy are dependent upon the institutional organizations. Thus economic policy has two dimensions: (1) the design of institutions and (2) operations within a set of institutions in an effort to achieve the best possible or targeted results. Institutions are both legislated and the result of evolutionary processes. Institutions once legislated take on a life of their own and evolve in response to market processes. We cannot, in a dynamic world, expect to once and for all resolve our problems of institutional organization. On the other hand, we cannot always be engaged in the radical practice of changing institutional arrangements. Once an institutional arrangement is set in response to a crisis which embodies the day's best perception of processes and goals, it should be allowed a run of time in which the institutional details are allowed to evolve and where policy is restricted to operations within the institutional structure. Only as an economic and social order shows signs of not delivering an adequate performance does it become necessary to engage in programs of thorough-going institutional reform.

In the difficult times we now live in we need to recognize that the major contours of the present institutional set up of our economy were set in the Roosevelt Reform era: in particular the major outlines were set in the second New Deal of 1935. This second New Deal was a reaction to the failures of the emergency legislation of 1933, together with a spate of Supreme Court decisions that ruled out of order various pieces of the first New Deal. Whereas our institutional set up is mainly the remnants of the first years of the Roosevelt era, our perception of
how the economy functions is radically changed by our interpretation of
the Keynesian Revolution. Even though Keynes' great work The General
Theory of Employment, Interest and Money cast a shadow before it appeared
in print, it is true that it did not appear until 1936. It could not
have really affected the institutional reforms that were already in the
legislative mill when it appeared.

Much discussion exists in the literature as to what Keynes really
was about: there are various schools of Keynesians - conservative, liberal
and radical - those who believe that Keynes was merely some refinements
on pre-existing economic theory and those who believed that Keynes marked
a sharp break with pre-Keynesian theory. But regardless of the view as
to what Keynes was about it must be agreed that to the extent that the
existing institutional arrangements were in the main set in the years
prior to 1936 or even 1938, the legislation determining our institutional
set up could not have been enlightened by perceptions drawn from the
Keynesian Revolution. To the extent that the Keynesian Revolution in
economic though has implications for the institutional structure of our
economy there cannot have been a Keynesian Revolution in the design of
economic institutions. All that we can possibly have had over the past
twenty years were Keynesian policy operations within a legislated economic
structure that is mainly pre-Keynesian in its intellectual foundations.

There are two "dimensions" to a strategy for economic policy: One
"dimension" has to deal with the institutional structure, the other has
to do with operations within the institutional structure. The fundamental
legislation with regard to banking institutions, Central and Commercial
banks as well as non-bank financial institutions, labor organizations, and
corporate rights and privileges are elements in the policy mix that deals with the institutional structure. Fiscal and monetary policy are the major elements of economic policy operations that take place within an institutional structure.

When an institutional structure is apt, then the within the institutional structure operations will suffice to achieve an adequate working of the economy. When, because of evolution and incremental changes in the underlying structure, a situation in which the operations within the structure no longer lead to an adequate workings of the economy arises—perhaps because standards as to what is adequate have changed or perhaps because of the effects of subtle institutional evolution—then institutional reform is called for.

The emergence of chronic instability—especially that due to the fragility of the financed system—over the past decade is the result of cumulative changes in financial relations and in institutional usages and forms over the first twenty years after World War II. As a result of the unintended and perhaps unnoticed changes in institutions, and because of the effects of successful functioning of the economy in inducing speculation and hence instability, it is quite apparent that now—early 1976—the rules for monetary and fiscal policy that were established mainly on the basis of the experience and the data of the 1950's no longer apply. The evolutionary properties of the economy has resulted in changes in the underlying structure so that the established rules are no longer valid. It now seems clear that there does not exist any set of monetary and fiscal manipulations which can reestablish the relative tranquility that ruled in the 1950's and early 1960's. If we are to
once again achieve an era of relative tranquility and smooth progress it is necessary to engage in some quite fundamental institutional changes -
we need another era of thorough-going reform similar to that which took place during the first six years of Roosevelt's terms: Reforms which embody the evidence from the past years of instability and are enlightened by a theoretical vision which fully appreciates the roots of the instability that is now so evident.

The basic premises that should underlie a new era of reform is that a decentralized market mechanism - the free market of the conservatives - is an efficient way to handle the myriad of details of economic life and that the financial institutions of capitalism, especially in the context of production processes that utilize capital-intensive techniques are inherently disruptive, in that they lead to inherent instability and thus inefficiency. Thus while admiring the properties of free markets it must be recognized that the domain in which free markets are effective and desirable is restricted. To do better than we have been doing over the past decades we have to invent economic institutions which take the speculation out of those aspects of production which require massive capital investments. It is a paradox that capitalism is flawed because it cannot readily assimilate production that uses large scale capital-assets.

In fact we have introduced many devices into our economy to constrain and contain the inefficiency and instability that is associated with the use of large scale capital-assets in production in a capitalist economy. The Central Banks of the world - our Federal Reserve System - owes its existence to the instability of asset values under capitalism. Those
who expect the Federal Reserve to act as a determiner of income tend to forget that the reason for being of the Federal Reserve is to act as a lender of last resort. The organization of industries into the quasi-cartels of oligopoly is fundamentally a way of regulating markets so that risks of large scale movements in capital-asset values are constrained, although in a financial environment that allows for speculative finance stability through cartelization turns out to be elusive. Our trade-union, minimum wage, and unemployment compensation institutions have the effect of preventing a large fall in money wages from taking place whenever substantial unemployment exists — thus tending indirectly to maintain capital-assets values. Much of the intervention in various industries by government — those aspects of our arrangements that may be characterized as "Socialism for the rich" are understandable as devices to constrain and attenuate uncertainty — particularly as uncertainty affects capital-asset values.

If we are to undertake new directions in economic policy we need to demythicise economic theory: We need broadly based understanding of an economics that is relevant to our time and our place. Thus the first effort will be an exposition of the current standard theory that is followed by an exposition of a version of economic theory that is consistent with the exhibited instability of our economy. This will be followed by an analysis of our current economic structure and its roots in the Roosevelt resolution to the problems of the Great Depression as then diagnosed.

One aspect of our recent past is that the economy seemingly worked well in the first two decades after World War II and has been working badly only over the third decade. An explanation of how a robust economy is transformed into a fragile system follows.
All of the above is prelude to the main thrust of this work:
The preparation of an agenda for reform that will attack not only the apparent malfunctioning of the economy but which also holds out hopes for a solution of the overriding social concerns. As an agenda the proposals for reform will be painted with a broad brush: The details of programs need to be hammered out in The Congress, The Administration and hopefully in Public debate. Whether the economy should be a main concern of public debate — and only an enlightened public can guide and direct reform. It is to these concerns that we now turn.

Outline of what follows