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Where Did The American Economy--and Economists--Go Wrong

by

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A revised text of a talk prepared for delivery at Southern Illinois University, Carbondale, May 20, 1971.
The United States is not now a happy land. Only superficially is this due to the inflationary recession, the continuing war and the unloveable if not unappetizing character of recent Presidents: these items are more symptoms than causes. This current nadir of national morale exists in spite of the truly impressive economic success, as measured by the conventional indices of economic growth, unemployment, and inflation of the 1960's. Even the more exotic indices, such as the decrease in poverty, the erasure of the more blatant forms of racial discrimination, and the man on the moon support the view that improvements were taking place.

While these signs herald success our cities, public services, landscape and environment deteriorated. A crescendo of violence and fear accompany growth and prosperity. We now know that for a nation as for a person economic success does not assure happiness - or contentment. To a large extent America has achieved the goals set in the aftermath of World War II; in the 1970's we are beginning to acknowledge that these are not sufficient: success does not bring a good society.

It would be an intellectual evasion to lay the blame for the country's present state upon the war in Viet-Nam or the absorption and waste of resources by the defense establishment. The national disgrace of Viet-Nam has exacerbated the difficulties, proven most divisive and amplified the despair. It has made overt the alienation of a large section of what can best be called our candidate members of the elite. It has also demonstrated beyond a reasonable doubt the gross incompetence of the best that money can buy in the way of military brass, defense and foreign policy intellectuals and research institutes (this last if
we have a memory, can in time be a benefit). But by itself the war does not explain the malaise. In other times opulent imperial powers have gotten bogged down in equally dirty frontier wars without being forced to pay the high price in domestic tranquility, loss of national pride and erosion of purpose that we are now paying.

The current recession is mild. We know that if we have the political will we can easily end it by appropriate expansionary fiscal and monetary policy. Even though some of the ideologues in the Nixon Administration might be reluctant, they would bow to public pressure if there was a consensus that such recovery would really help. However as I read the spirit of the country, there is a resigned feeling that, as the result of such a recovery would take the form of more private income, roads and other conventional works, it would really not ease what ails us. The tolerance of less than satisfactory economic performance is indicative of the malaise; the less than satisfactory performance of the economy is not the malaise.

The God that has failed is the American Dream that economic success - as it has been defined in terms of ever more private goods - is a worthy objective for a person and for a people at our present state of affluence. This is the root of the clamor to reorder priorities, to change life styles. But the public priorities which emphasize private income are the result of the way in which the intellectual leadership perceives the problems and the preferences of the society. The perceptions with respect to economic affairs are conditioned by the ruling dominant economic theory. That is the thrust of economic policy.
during the 1960's — and to date — emerges from the accepted economic theory, and economic policy was a key ingredient in creating our present economic order.

To an overwhelming extent the post-war decades have been the age of the economist. The Keynesian Revolution transformed macro-economics into a policy science. One aspect of the post-Keynesian evolution has been the application of techniques of analysis developed in both macro and micro economics to other areas: defense, politics, diplomacy, business. Systems analysis which has been promoted as the salvation of everything from New York program in City to the pacification / Viet-Nam is no more than micro-economic modeling coupled to computational capabilities.

We cannot expect to be guided to new and superior priorities by the theories and models that led to the present policies. Once the malaise is diagnosed as basic and not transitory — that ending the war and recession will not eliminate what ails us — then the intellectual foundations that led to the unfortunate policy choices responsible for our present state must be reexamined. Bad priorities were, so to speak, the result of bad theory. A consistent and meaningful set of alternative priorities and policies can be constructed only as we restructure our economic theory and deepen our understanding of American Capitalism.

The economic policy choices that were made during the 1960's were based on the baggage of economic theory that accompanied the academic economists when they went to Washington to become the house intellectuals of first the Kennedy, then the Johnson and now the Nixon terms. Professor James Tobin, one of the leading economists of Kennedy's term defined the
power of the house intellectual 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."*

For any government, the house intellectuals define problems, select and organize information, suggest policy options and indicate the likely consequences of policy choices. At each stage of this advisory process, the input reflects the intellectuals' theory of how the world operates. In the United States during the 60's, the most important set of house intellectuals were the economists: they not only served in the obvious agencies, but they were also well represented among the defense and foreign policy intellectuals. These economists were drawn from the very top level of the professional hierarchy. They were and are leading economic theorists. They used the academically-dominant economic theory as a tool in their role as house intellectuals. Therefore, the policy choices taken by government reflect the view of the world embodied in this dominant theory.

Much has been made of the shift in advisors as the Nixon administration replaced the Kennedy-Johnson administration: that Friedman and Chicago were in and Samuelson and Cambridge, Massachusetts were out. This difference is much exaggerated.

The house economists of the Kennedy-Johnson era and the Nixon administration belong to the neo-classical school which integrates the micro economics which has its roots in pre-Keynesian economics and the macro economics mainly attributed to Keynes. The difference between the two sets of house economists - the so-called New Economists and the so-called New New Economists - is trivial. Recently, Friedman, the doyen of the New

New Economists restated his theory with greater precision than hitherto (Journal of Political Economy, April–May 1970 and April–May 1971). His model turned out to be no different than that which the leading New Economists accept. Fundamentally, it integrated Walrasian ideas with the Keynesian analytical apparatus and attained the special Keynesian result by way of wage and price rigidity. In none of the points at which I take issue with the dominant neo-classical school is there any substantial difference between the two sets of advisors. The difference between Heller and McCracken is within a school, not between schools.

As I said earlier, the house economists of the past decade have been positively top drawer professionals. They are leading contributors to the development of economic theory. They believe the results of their theory and its accompanying econometric verification and have faith in its relevance to society. As advisers they tend to overlook that they buy professional precision by often heroic abstraction. As house intellectuals they structure the problems presented for decision so that they fit within their academic framework; and they give advice which is designed to improve that which their framework defined as relevant.

On the whole they have been successful, in spite of the current inflationary recession, if success is measured by the yardsticks the advisors put forth. The failure has been in dimension of the economy that, to paraphrase Polonius, are undreamt of in their philosophy.
AN ASIDE ON THE NEO-CLASSICAL SYNTHESIS

The neo-classical synthesis is the label attached to the blending of Walrasian general equilibrium value theory and Keynesian income and employment theory. It is the economic theory which affects the thinking about economic affairs of well nigh all the publically prominent economists in the United States: the leading exception being Professor Galbraith.

This mode of economic thinking gives priority to the micro-economic foundations. Micro-economics is based upon two basic analytical constructs, preference systems associated to households and production functions, associated, by handwaving, with firms. To each household is associated some initial bundle of resources. Trading is permitted. Each household will trade only if the trade in some sense makes it better off - or at least no worse off. Some of the trades will result in furnishing services to production units - some of the trades will be the exchange of commodities.

Because interpersonal comparisons of utility are considered to be logically impossible, a definition of the economic optimum which does not rely upon such comparisons is in favor. "Pareto Optimality" is defined as a situation in which no one can be made better off without someone being made worse off: i.e. all trades are allowed as long as one or the other or both trading partners are better off. When such trading possibilities are exhausted, the resulting situation is called a Pareto-optimum.

The glory of modern general equilibrium theory is that it has succeeded in rigorously proving the equivalent of Adam Smith’s invisible hand proposition - that each by serving his own interest serves the social good - for competitive economies. Under restrictive conditions
it has been shown that there is a one to one correspondence between competitive equilibrium and Pareto Optimality. The conditions are sufficiently restrictive so that two interpretations of the results are possible - that the model is and that the model is not relevant to the problems of our economy.

One implication of the Walrasian model is that full employment rules at the equilibrium and that the trading and producing process will seek this out. This model is extended to a money using economy in the work of Patinkin.

The Keynesian model yields the proposition that less than full employment is a possible state of the economy. This depression state in the Keynesian system is the result of the speculative nature of the capital holding and investment decisions. But in the Walrasian general equilibrium model, the intertemporal choices that enter into saving, capital holding and investment are in principal the same as those that enter into contemporaneous choices; there is no place for any speculative element in decisions.

In the exposition of his views, Keynes adopted the expedient of assuming that wages and prices do not fall when excess supply of labor exists. This expedient was adopted to show that it is the fall in the price of a representative unit of capital goods relative to the price level of current output which is crucial to the existence of unemployment. However, if prices in fact do not fall, the mechanism designed to guide a competitive market system in a money using economy toward the Walrasian full employment equilibrium will not be operative.
Thus, the neo-classical synthesis results in the proposition that observed less than full employment situations are due to price level rigidity. Such price rigidity may or may not be an empirically meaningful phenomena. This assumption does allow those neo-classical economists who wish to, to be Keynesian in policy if not in analysis.
ECONOMIC THEORY AND ECONOMIC PERFORMANCE

Three specific shortcomings of the American economic performance can be related to the content of economic theory.

(1) The sharp deficiency and even decline in the standard of public goods and "public utility" output as provided by government and controlled private enterprise, as well as an apparent deterioration of the quality of life resulting from the non-economic, often informal, institutions of society.

(2) The distribution of private income and how the gains from economic "growth" and "progress" have been and are to be distributed.

(3) The emergence and persistence of inflationary pressures that seem to be resistant to the monetary and fiscal devices that are being used, combined with growing evidence of the fragility of the financial structure. This induces fears that evil days are to come.

The deficiency and decline of public goods as well as the deterioration of the non-economic fabric generating social well being are related to the framework of pure economic theory. The peculiar ways in which income distribution problems show up in the United States is related to the fact that the dominant thrust of American economic theory views technical relations as the major factor as determining income distribution and how the rewards from progress are to be distributed. The persistence of inflation as well as the growing fragility of the financial system is closely related to the misuse and misinterpretation of the Keynesian framework that is characteristic of the neoclassical synthesis. They do not recognize that capitalism by its very nature cannot stand success.
To summarize before I continue my argument with specifics: the American economists who have had the ears of our recent Princes have helped lead the country astray:

(1) By being "Paretian" rather than Marshallian in how they approach economic welfare. Commodities rather than wants are the basic unit in the Paretian analysis of welfare. The household or decision unit is not imbedded in a society that creates and defines wants; doing this would make the economist suspect by intruding on what is taken to be the domain of the academically inferior sociologist. As a result of this commodity emphasis, gross national product per capita is crudely taken to be the measure of social welfare. The limitations of this measure when want satisfactions are taken as the objective of economic life are ignored.

(2) By not having a Marxist thrust to their theorizing with respect to saving, investment and the distribution of income. Standard economic theory is based upon two constructs—the preference system and the production function—which yield saving, investment (and thus growth) as well as the distribution of income. By having technical rather than social processes yield these vital economic phenomena, the advisor economist was able to evade facing up to the questions of income distribution and the desired rate and composition of economic growth. And

(3) by using a special version of the Keynesian model in a domain where it did not apply. Keynesian analysis as it is conventionally defined fundamentally misses the points with which Keynes struggled. The standard Keynesian analysis of either Samuelson or Friedman appends the monetary-fiscal analysis to a fundamentally Walrasian general equilibrium system. The Walrasian general equilibrium system—in spite of all complications added by
analysts—is essentially a barter paradigm. The view of the world that is fundamental to Keynes is that of an intensely financial capitalist economy which normally functions so that business cycles take place. In particular the Keynesian analysis indicates that "fine tuning" of the economy cannot be achieved with the conventional monetary and fiscal weapons. Capitalism is flawed in the sense that stability is essentially destabilizing. A Keynesian proposition is that a Capitalist economy tends to explode once it is stabilized at or near full employment.

If a rational reordering of priorities is to take place it will be necessary for economic analysis to broaden its concept of human wants and goods, (become Marshallian), deepen its understanding of income distribution and growth so that the social and the technical determinants are integrated, (become Marxist) and widen its view of the possible modes of operation of a capitalist economy and of the limitations of policy, (become Keynesian.)
MARSHALL VS PARETO

The theory of choice is introduced into modern economics by postulating that for each household there exists a preference system and an initial allocation of goods. The preference systems are unexplained. They might be genetic characteristics of those involved except that in some of the parables that are told when intertemporal relations are explored, it seems as if those preference systems were there at the creation and will last until the final holocaust. Similarly, the initial bundles of goods are unexplained -- they are presumably some heterogenous manna which falls unto each unit in an undescribed manner. A trading process is defined which is a good-for-good exchange (barter) with recontracting so that no one ever makes a false trade. By barter each unit achieves its best possible commodity set.

The Marshallian view of choice or demand is in sharp contrast to the above Paretian view. Man is, in Marshall’s view, a social animal living typically in family units with wants that can be satisfied in various ways, private commodity flows being only one in which wants are satisfied, so called free goods -- such as fresh air -- is another way. In contrast to the Paretian view, there is no presumption that the maximization of those satisfactions that flow from wants that marketable commodities satisfy is the measure of welfare. In particular private wants can be satisfied by public means.

There is also no presumption that traded commodities when summed at market prices yields income. A Marshallian view leads naturally to a
broader concept of income in which humane treatment and civil behavior enter into want satisfaction.

How are public goods and those aspects of the conditions of production and living that create social benefits and costs compared with private commodities in modern economic analysis? For public goods such as subway systems and waterways, elaborate techniques for measuring the costs of road congestion, automobile pollution and pleasure boating are devised so that these benefits can be added to the expected revenue to determine the worth of projects. For other social aspects of policy, no economic measuring rod exists.

Geographic mobility has been an important factor in the 'productivity' of the American economy. For such items, the economist blithely assumes that an individual at date 0 is able to judge and weigh correctly the costs, in emotions and development, to his family and his children of moving around the country over a number of years. The decision is presumably affirmative if the present value of income minus costs is sufficiently great, negative if it is less than some threshold value. The Paretian assumption treats a decentralized decision made in well nigh total ignorance as if it were made if not with perfect certainty, then with knowledge of the alternatives, their likelihood and their likely consequences.

Similarly, the Paretian bias that welfare is maximized by exchanges among goods allows no place for free and non-appropriate goods. Thus the deterioration of the quality of air is not a major factor in economic analysis until thrust upon the economist by the environmentalist. The paradox that an hour's drive to work tends to increase national income and
employment should to any logical mind cast doubt upon the relevance of the measuring rod of national income to economic welfare.

The Paretian way of looking at choice induces a bias so that economists tend to value private consumption out of private disposable income more highly than the equivalent consumption of public goods. The costs and benefits of alternative social organization are not examined. The economists who have had the ear of our recent Princes have not been especially sympathetic to considerations such as Marshall put forth (p. 85 -- Principles)

"---the spirit of the age induces a close attention to the question of whether an increasing wealth may not be made to go further than it does in promoting the general well-being; and this again compels us to examine how far the exchange value of any element of wealth, whether in collective or individual use, represents accurately the addition which it makes to happiness and well-being."

The output of the public sector is part of gross national product and the satisfaction producing system of an economy. Nevertheless, Tobin described choices made while he was advising by remarking that "while we sympathized with the stress which J. K. Galbraith and other liberals placed upon the importance of expanding the public sector, we did not agree that total output and growth of output had ceased to be socially important" (p. 22). Of course, Tobin knows better than to assert that a growth of public output is not a growth of output. However, deep ingrained habits of thought show through this passage: the meaning of his assertion seems to be that public
output is not an output and resources used to provide parks, public hos-
pitals, public schools and safety of person are resources wasted as a
result of this bias. Throughout the 1960's, aside from the military, the
preferred instrument for generating fiscal expansion has been some type
of tax cut, i.e. the freeing of resources for private consumption.

As a result of the Pareto bias gross national product and employment,
not the satisfaction of human wants, becomes the objective of national
economic policy. Tobin in his previously cited lecture relates how Kennedy,
bowing to conservative pressures during the campaign, promised a balanced
budget. This constraint was evaded, however, when "--The Berlin crisis in
the summer of 1961 activated one of the escape clauses in the initial balanced
budget pledge, leading to a defense buildup of some $3 billion in annual
expenditures." As one recalls that comment by so humane and sensitive a
man as Tobin one wonders whether the continued commitment to Viet Nam is not
of the same cloth as the Berlin crisis: it may be bad for the country, but
it is good for gross national product.

This bias introduced by using gross national product, which includes
military expenditures, as an index of welfare and of success for economic
policy shows up in foreign aid as well as in domestic economic policy. Need
I recall that as little as three years ago Pakistan was hailed by house
intellectuals as a great success of the Foreign Aid-economic development
program. Today we know better: the result of our help was the forging of a
military machine that is perpetrating one of the great massacres of all time.

Both in our domestic policy and foreign aid the bias introduced by
modern economic theory leads to a neglect of all but one proximate indicator
of economic welfare. The Marshallian perspective that Economics is properly concerned with "man himself the chief agent and the sole aim of production--" not with abstract commodities, preference systems and trading mechanisms is needed to offset the impact upon policy of the highly formal analysis that is the road to preferment of the academic economist.
MARXISM

One aspect of the dominant school of economics in the United States is a neglect of income distribution problems in the sense of Ricardo and Marx. In neoclassical economics, the proportion of gross national product going to wages and profits is not related to the savings and investment process. At full employment, the proportion of income going to wages and profits is determined not by social conditions but by characteristics of the production function: technique determines relative shares. A well known proposition is that if production conforms to a linear Cobb-Douglas function, as is often assumed, then the shares of wages and profits in gross national product are fixed and independent of the proportions of capital and labor used.

If you believe that technique as embodied in production functions determines distribution, then the only way in which the absolute lot of the poor and near poor can be improved is by the growth of output. Because of the iron constraint of techniques, you despair of achieving a meaningful increase in the relative share of income going to the poor. This theory will make a man of good will an almost devout believer in the virtue of economic growth.

The neglect of the distributional aspects of the saving and investment process is shown in the orientation of the Kennedy's liberal Democratic Council of Economic Advisors. Once again, citing Tobin's Essex Lecture, their growth orientation disposed the Council and the Administration "---to favor a policy mixture which would provide for a high proportion of public and private investment in full employment g.n.p."
Thus, policy measures such as "a tax credit for investment and a liberalization of depreciation values" were adopted. In the years 1964, 1965, 1966 and again in 1968 and 1969 these measures, together with the expectational climate, led to an investment boom. After the event, in an accounting sense, this investment boom had to be offset by a saving boom. The social process that generates more saving depends upon a shift of income to profits.

The investment boom which took off in 1964 together with the war in Viet Nam were quite successful in reducing unemployment and thus inducing a sharp rise in the income of the poor. As a result, starting in the middle 1960's and continuing to date, a large group of workers, mainly blue collar factory workers, who had been employed prior to the achievement of tighter labor markets, did not enjoy any increase in their real per capita disposable income.

Average spendable weekly earnings
Worker with 3 dependents 1967 prices:

<table>
<thead>
<tr>
<th>Year</th>
<th>Earnings</th>
<th>Change</th>
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<tbody>
<tr>
<td>1960</td>
<td>90.32</td>
<td>+13-1/3%</td>
</tr>
<tr>
<td>1965</td>
<td>102.41</td>
<td></td>
</tr>
<tr>
<td>66</td>
<td>102.31</td>
<td></td>
</tr>
<tr>
<td>67</td>
<td>101.26</td>
<td>-2.5%</td>
</tr>
<tr>
<td>68</td>
<td>102.45</td>
<td></td>
</tr>
<tr>
<td>69</td>
<td>101.49</td>
<td></td>
</tr>
<tr>
<td>70</td>
<td>99.83</td>
<td></td>
</tr>
</tbody>
</table>

Some of the observed resentment, social disarray and community disorganization reflects these facts; over a five year period, 1965-70, factory worker take home income declined by some 2.5%; this followed a five year period, 1960-65, in which 13-1/3% growth took place.
Simultaneously, this group -- the employed lower middle income worker -- suffered a decline in income received in kind from public goods.

There is an inconsistency between guns and butter once full employment is achieved. Similarly, at full employment there is an inconsistency between investment and consumption. In the multiplier formulation of income generation at less than full employment, investment and consumption are complements, at full employment investment and consumption are substitutes. Growthmanship tries to raise the rate of growth of full employment GNP by increasing the proportion of investment in income. It will succeed as it raises the proportion of profits in income. A rise in guns along with a rise in investment and a distribution of the increased wage bill toward previously unemployed workers leads to an inflationary process which tends to constrain middle incomes. The attempt by middle income workers to sustain a level or a trend in consumption reduces household ex-post saving ratios. This furthers the inflationary process. The combination of private consumption demand, private investment demand and increased military spending leads to a decline of resources allocated to providing public consumption goods. The anti-public sector bias of the economist is reinforced by the way in which resources are made available for investment and military spending by an inflationary process. Public consumption goods diminish in supply.

Given the facts of American political life we can state the following: the rich get relatively little of their income from public services, the poor almost always get inferior public goods. Once again
it is the middle income group who get a meaningful amount of their income through publicly supplied goods and services; and a deterioration hits them hard. Thus the distribitional impact of the adopted policies has seen slow or no growth in middle level private real income combined with a sharp deterioration in the quality and quantity of public goods they receive. No wonder they have flirted politically with the right and that safety in the streets (the most important public good) is such a potent political issue.

I believe I can now state what I take to be the essence of a Marxist approach to economic analysis. In an era where slogans such as Friedman's *Money Matters* epitomizes what passes for an intellectual revolution, the Marxist view might be stated as *Social Phenomena are Socially Determined*. Income distribution is not determined by the technique of the economy.

Recall the war on poverty. The main program for ending poverty was education and training. But education and training have to start at virtually the cradle; Operation Head Start embodies this philosophy. But Operation Head Start means that all the poor who missed pre-Kindergarten are, except for the lucky or the gifted, doomed to a life of poverty—a dead end life. The Dead End Kids of the Depression years were such because of system behavior. Their poverty was not their fault. The poor of the liberal's war on poverty are poor because they personally are deficient. The liberal's war on poverty was born out of neoclassical theory in which it is the poor—not the organization of the economy—that is to blame for poverty. The war on poverty tried to change the poor, not the economy.
The negative income tax is an admission that the economic system cannot be made to operate so that all who desire to work are able to achieve a socially acceptable standard of life. As work is in itself a want that man strives to satisfy, the conventional neoclassical theory, as it confronts the issues of poverty in the midst of plenty, offers a truly dismal solution: the unworthy poor are to be barred from even the satisfactions and social intercourse of work by a perpetual dole.

A further example of the dead end to which neoclassical production leads function economics/appears as an exercise on the "Future National Output and the Claims Upon It" in the 1970 Economic Report of the President (pp. 78-84).

This exercise consists of projecting Gross National Product available by taking the 1969 actual gross national product of $932.3 billions and multiplying it by $(1.045)^n$, where $n$ is the number of years, from 1 to 6 in the exercise. The projected gross national product available in 1975 is $1,200 billions.

The claims on gross national product are obtained by taking the actual division of gross national product in 1969 among Federal Government, State and Local Government, Personal Consumption and Gross Private Investment and multiplying each component by an assumed appropriate growth rate. The first conclusion of the exercise is that "...existing claims upon the growing available national output already exhausts the probable output and real national income that the economy can generate for several years to come". This is so in spite of the reduction in Federal Government purchases from $92 to $84 billions over the years 1969-75.
However, this conclusion is reached by not looking into the distribution of income and consumption. Consumption is by far the largest claim on available Gross National Product. In the exercise, consumption rises from $576 billions in 1969 to $769 billions in 1975, a compound growth rate of 5% per year. Given that the labor force is assumed to grow at 1.75% per year, this projection assumes a 3.25% growth in consumption per labor market participant: that is over the 6 years the projection assumes it worthwhile to use resources so that the consumption of those in the upper five per cent of the income distribution grow in excess of 20% per labor market participant.

In a country hard pressed for resources it is worth asking whether a proper sense of national priorities is evidenced by a projection which blithely assumes that the national interest is served equally well by increasing the personal consumption standard of representative upper income family, say one now making $30,000 per year, by 20% in real terms over a six year period as by increasing the consumption standard of a family now making $3,000 per year in the same ratio.

Let us assume that a feasible policy with respect to income distribution has the following contours: the real income of a representative family in the top 5% of the income distribution is not to increase, the real income of a representative family in the next 75% of the families in the income distribution will rise at 1.75% per year, and the real income of a representative family in the bottom 20% of the families will rise at 3.25% per year. Let us also use the rule of thumb that in 1969 the top 5% of the family units had 20% of the income and consumption, the next
75% of the family units had 75% and the bottom 20% had 5% of the aggregate income and consumption.

<table>
<thead>
<tr>
<th>Consumption</th>
<th>Administration Example</th>
<th>Text Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top</td>
<td>5% $115.2</td>
<td>$127.9 (1.75% growth)</td>
</tr>
<tr>
<td>Next</td>
<td>75% 432.0</td>
<td>531.5 (3.5% growth)</td>
</tr>
<tr>
<td>Bottom</td>
<td>20% 28.8</td>
<td>38.6 (5.0% growth)</td>
</tr>
<tr>
<td>100%</td>
<td>576.0</td>
<td>698.0</td>
</tr>
</tbody>
</table>

The 1975 projected consumption in the President's Economic Report is $769 billions. The modest change in national priorities which asserts that it really is not important for the consumption standards of representative rich man to increase, that a modest rate of growth of consumption of the broad middle group is feasible and desirable and that sustaining the rate of growth of the poor's private income is important will free $71 billions for social consumption. This means that the Federal Government budget could be well nigh twice as large in 1975 as Nixon's council projected — or State and Local Government budgets could be some 50% greater than projected.

It is evident that the major potential for reordering national priorities lies in redistributing income and directing the distribution of the
benefits of growth. A significant redistribution of income requires a
decrease in the share of profits in income - which in turn means not only
taxes directed at high income from all sources but also a decrease in
the proportion of private investment in Gross National Product. This
in turn might mean that the projected growth objectives might not be
achieved - but that would be mainly because the measuring rod of Gross
National Product is in itself biased toward giving great weight to
privately produced and privately used output than to the alternative
use of resources. The public investment made possible by the freed
resources is also productive, but a walk in a park is not, whereas a
drive is included in Gross National Product.

To summarize: Production functions and preference systems are in-
ventions of theorists designed to order and interpret phenomena of nature.
Economic theory based upon these constructs indicates that it is futile
to attempt to redistribute income and implicitly therefore to redirect
priorities. Alternative varieties of economic theory exist— theories
which have in many ways better predictive track records than the neoclassical
synthesis— which indicates that income distribution and an economy's
priorities are socially determined and that by modifying institutions and
usages both income distribution and economic priorities can be reordered.
KEYNESIAN ECONOMICS

Keynesian economics as I interpret the doctrine is a subtle and complex tool of analysis. Fundamentally it argues that a complex, financially sophisticated Capitalist economy can operate in a number of different ways. One is a post crisis stagnation, (the Great Depression of the 1930's), another is slack, or small cycle-growth (the Eisenhower era) and a third is an explosive euphoric boom (late Kennedy-Johnson). Although within the theory the proximate determinant of which mode of operation rules is the amount of current and past investment, the underlying determinant of behavior rests with the speculative portfolio preferences of business firms, households and financial institutions. Portfolio preferences reflect expectations with regard to the uncertain future, and these expectations in turn are determined by the past of the system and views as to the robustness or fragility of institutions, views which reflect experience. Thus Keynesian economics is historical in perspective and its propositions are conditional. It embodies the view that in a capitalist framework decisions are often speculative.

The fundamental locus of speculative activity lies in the portfolios of households, business firms and financial institutions. In the Keynesian view privately owned real capital are assets in portfolios. Capital holding and expanding the capital stock (investing) are speculative activities.

Furthermore, the Keynesian model views the behavior of the economy as being subject to influence and control by policy. Throughout most of the Capitalist era policy has been inadvertent. Economic theory offered no guide -
and neoclassical theory is fundamentally incapable of acting as a guide, to policy relating to the dynamic attributes of the economy. Thus the big conclusion by Patinkin, a leading creator of the neo-classical synthesis, is that the quantity theory of money is more general and the Keynesian propositions are less general than their advocates and critics believe. However "this conclusion in"--no way diminishes the relevance of Keynesian unemployment theory for the formulation of practicable full-employment policy" [Patinkin, D. *Money, Interest and Prices* Second Edition p. XXV.]

The neo-classical economists of today fall into two camps: those who virtually ignore their economic theory when they give policy advice and those who give policy advice that is consistent with neo-classical theory. The first group typically are the 'liberals' and are often called Keynesian. Their policy advice is heavily dependent upon the policy rules worked out when the Great Depression posed the dominant policy problem. The second group typically are the 'conservatives'; sometimes they might be called monetarists. Fundamentally they hold that no policy is the best policy - but cannot agree what constitutes "no policy". In detail they argue that there are 'natural' rates of unemployment and economic growth and that monetary and fiscal policy should be directed at avoiding the distortions that accompany inflation. Active monetary policy is viewed as dangerous because it is potentially destabilizing. One view, advanced by Friedman and Schwartz is that monetary
change caused the business cycles of experience. Hence monetary stability—
not allowing monetary phenomena to rock the boat—is the major contribution
that policy can make toward achieving policy objectives. Fundamentally the
Friedman view is dismal, for it holds that these natural unemployment rates,
growth rates and income-distributions are given and if they are not satis-
factory it is too bad. Nothing which can be done, consistent with freedom,
can appreciably affect them.

The interpretation of Keynesian economics advanced here—that Keynesian
economics is relevant to economics in which speculation is important—is at
variance with that given in textbooks—whether Keynesian or anti-Keynesian
in their policy perspective. In particular, the standard neo-classical device
of wedding the Keynesian apparatus to a Walrasian output determining system
is not legitimate. That speculative considerations dominate production
function characteristics in determining economic system behavior is a funda-
mental theorem of the Keynesian model and this is foreign to the neo-classical
view. In particular, the Keynesian view of a capitalist economy is of an
essentially cyclical dynamical process in a financial environment whereas the
Walrasian view is a 'barter' paradigm, where activities which result in
steady growth are carried on as if goods were to be traded for goods. As a
result of the simplification of the Keynesian model which has taken place,
economic policy when guided by what passes for Keynesian models in the litera-
ture ignores the transitory nature of a particular mode of operation.

In the stagnant mode of system operations, households and firms have
recently experienced sizeable losses and they view the future with apprehension.
The desired liability structure of firms includes little in the way of debt instruments, in fact the existing liability structure is viewed as being too risky. Symetrically households and financial institutions insist upon a great deal of protection in the assets they hold.

As the stagnation continues, fears are eroded so that stagnant behavior is succeeded by a mode in which some slight adventures in liability structure and asset composition are hazarded. Investment will be accompanied by increases in corporate debts and asset owners portfolios will hold an increasing proportion of risk assets. In this second stage the system might exhibit short cycles, monetary policy might very well seem to be effective.

In the third mode of behavior, the economy is euphoric in the sense that long run expectations are taken to be very favorable. Capital goods, productive capacity and liability structure are viewed as being too conservative. Simultaneously asset holders and financial intermediaries are willing to diminish the ratio of money and safe assets in their portfolios.

The transition from the second state of cyclical and slack growth to the third state of euphoric expansion is at issue in determining how the shortcomings of economic theory led to our current malaise. The model for policy which the new economists took with them to Washington was a Keynesian depression model. This model, in the works of Klein, Suits, et al, takes the form of a complex econometric model. Upon closer inspection, this presumably sophisticated model is fundamentally no more than a blown-up expanded multiplier: it is a depression complementarity model. Neither the complexity of the financial structure nor the subtle interactions between the financial
and the real that characterizes the work of Keynes are evident in these models.

Given the amount of slack that developed during the Eisenhower years, this model was not too bad a guide to policy when Kennedy took office. Fiscal and monetary devices could expand the economy so as to absorb the slack. The tools and techniques that Professor Alvin Hansen had developed before World War II for a deeply stagnant economy were for the moment appropriate to the moderately stagnant economy. There was no need to make an allowance for differences between desired and actual balance sheets for households and business firms.

However, as the policy was successful in sustaining expansion so that the slack was absorbed, the expectational climate changed. As I like to put it business became Stalinist, in the sense that they seemingly acquired an insatiable desire to invest and a well-nigh unlimited capacity to finance investment by adjusting liability structures and eliminating what was felt to be excess liquidity in their asset structure. Similarly households, banks, and other financial institutions became willing to modify their portfolios to accommodate the demand for finance by firms.

One of the articles of faith of the New Economists as they became house intellectuals was that "...a steadily growing fully employed economy is both desirable and attainable." A corollary to this belief was that this objective can be achieved by manipulating a limited number of monetary and fiscal policy instruments. But this view was derived by manipulating models of a stagnant or slowly growing Capitalist economy. But, and this is the essential Keynesian contradiction, given capitalist financial institutions success in achieving a growing fully employed economy will lead to the euphoric bullish speculative mode of behavior of the economy.
In the euphoric mode, as long as the fundamentals of capitalist finance remains unchanged, monetary and fiscal constraint will not be effective unless they first affect expectations. The ruling expectations of the euphoric mode are such that velocity increases will offset monetary or fiscal constraints. Such velocity offsets will cease only after expectations are affected. This typically will result from a financial crisis, crash, crunch or squeeze, which reveals the essential fragility of capitalist financial institutions. Such a change ushers in a stagnant phase—either a deep stagnation of the Great Depression or a more moderate stagnation consistent with the large and activist government of today.

The current difficulties of a high level slack economy with inflationary tendencies are compounded out of a lack of understanding that the policy weapons which are sufficient to move an economy from slack to sustained full employment are not sufficient to sustain full employment. The promises made by the New Economists proved to be illusionary: success once achieved proved to be transitory. The concentration upon the analysis of how a slack capitalism works left them without an understanding of the dynamics and the appropriate policy for a fully employed economy.

As we enter the second year of the Nixon slack we can contemplate an extended period of slack growth for the economy: another high level stagnation. If this is so, the next activist administration will find that during its initial period, the by now tried and partially successful weapons of monetary and fiscal expansion will be applicable and effective. However the success will be transitory unless the standard expansionary weapons are supplemented by investment controls and portfolio constraints as full employment is first achieved and then sustained.
CONCLUSION

The current shortcomings of American society reflect the failures of the analysis of the economy that academic economists bring with them when they join the households of the Prince. Three failures have been identified:

1. The modern economist tends to take a narrow view of man, his nature and aims. The broader Marshallian view of economics, in which economics is naively but heroically concerned with material conditions and social organizations conducive to happiness, must supplement the rigorous but narrow Paretian view if theory is to be of greater use in policy.

2. The economist has been wedded to the neoclassical way of looking at the world. The neo-classical view is valid when the determinants of efficiency in production are being investigated. It is not an enlightening way to analyze income distribution or even the proper borders between the private and public sectors.

3. The official economist has tended to a superficial view of Keynesian economics. Perhaps our greatest immediate need is to broaden our horizon with respect to the modes of operation of this capitalist economy -- to do Keynesian economics in its full generality. To acknowledge that American Capitalism can do better, while simultaneously recognizing that doing better will involve a greater scope of policy interventions than in the past, is the task before us.

In the famous closing passage to the General Theory Keynes noted that "At the present moment (1935) people are unusually expectant of a more fundamental diagnosis; more particularly ready to receive it; eager to try it out, if it should be even plausible. But apart
from this contemporary mood, the idea of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else." (p. 383)

The mood of the 70's is comparable to that of the 30's. Both marked the end of an era of easy belief, of confidence that the wounds of war would quickly be healed and that economic success was a necessary and sufficient condition for a good society. Keynes came forth in the middle of the 30's with a new view of the economy, which provided both a powerful tool to help mobilize resources for war and an effective guide to peacetime policy, so that the deep depression of the 30's did not reoccur in the 1950's and 60's.

However, once the simple Keynesian lessons that full employment can be maintained has been learned, the more subtle problems envisioned but not answered by Keynes -- what and for whom is this full employment to be used -- needs to be faced. To this question the dominant contemporary economic analysis -- what I have called the neo-classical synthesis -- offers little in the way of answers. Not only is the dominant view of what enters into economic welfare narrow, but the production function constraint and the simplified view of the influence of finance in economic theory mean that much of what is unsatisfactory about the world today are taken to be the natural or unavoidable results of technical relations. Only by creating new theory in which the social and organizational determinants of the felt shortfalls are emphasized will it be possible to develop policy which will meet the felt needs of society.

We must remember that the priorities of a society are born out of the analysis of its problems by the official or house intellectuals, and that the
view of these house intellectuals reflects, perhaps with a lag, the thinking and the ideas of the wider group of, in the United States, heavily academic intellectuals. Without a rethinking of the how why and what for of American Capitalism, the priorities cannot be effectively reordered. Under these circumstances the cry for reordering priorities is naught but a glib phrase — as empty as President Nixon's call for a New American Revolution.