Where the American
Economy - and Economists - Went Wrong

by

Hyman P. Minsky
Professor of Economics
Washington University
St. Louis, Missouri
I. Introduction

An oppressive malaise is abroad in the United States. This is only superficially due to the unending war, the persisting inflation joined to high unemployment and the unappealing nature of recent presidents. By the usual economic indices - the growth of gross national product and the absence of a serious depression - the times are quite good. By indices of a political-economic nature, such as the overt and wide dissatisfaction with and resentment of the way in which the economy distributes its benefits and burdens, and the justified feeling that the politicians and their intellectuals do not have the answers to our problems, the times are truly bad.

Today's crisis is not the result of the uncontrollable and inevitable working of nature: our plight is largely man made. We have just come off of more than a decade of unprecedented activism in economic policy. The confident and often arrogant house economists of the Kennedy, Johnson and Nixon regimes announced that they knew what our targets should be and that they had the capacity to control and guide - nay fine tune - the economy so as to hit the targets. They both defined the nation's priorities and manipulated policy instruments as their theory dictated. Our present plight is the result.

We should not underestimate the power of house intellectuals. As Professor Tobin of Yale, who served Kennedy and now advises McGovern, wrote "The terms in which a problem is stated and in which the relevant information is organized can have a great influence on its solution."* A political leader is a captive of his house intellectuals and they in turn are prisoners of their theories - of their intellectual baggage.

During the past three administrations a special brand of economic theory — the neo-classical synthesis — has been the intellectual baggage of the economists who have acted as policy advisors. Much of what is wrong with the American economy is due to the "tilt" that this theory has given to economic policy. This neo-classical synthesis is not only responsible for where we are but it cannot, because of the way in which it sets up problems, serve as a guide to the resolution of our current crisis.

The economic root of our malaise is that even though we have succeeded in preventing serious depressions and in assuring that growth in measured gross national product takes place we have failed miserably in those dimensions of our economy that determine the quality of life. Our cities and our suburbs are in shambles, and our rural society has been well nigh liquidated. Public services and the services from vital organizations such as hospitals and utilities have deteriorated. The landscape and the environment have been despoiled. A crescendo of violence and fear has accompanied what passes for prosperity and growth. Civil behavior, rights, and liberties are apparent victims of our economic progress. It has become obvious to all that the highly touted success of the economy depends upon a debilitating addition to military spending and adventures. In many ways poverty has spread even as gross national product has grown. Above all the fairness of the system is now in question. "Perhaps American capitalism is efficient, however it most certainly is not equitable" seems to be the judgment of the 1970's.

Today's dominant economic need is not more but better. The vital questions are for what, for whom and how shall our economic capabilities be used. Vast amounts of resources are used to induce waste, we are locked
into myths such as a "housing shortage" when entire neighborhoods of good housing are being abandoned. The need is for equity and justice to dominate narrow efficiency and growth as the goals of economic life. Social objectives - if a pun will be pardoned - the humane society - are now more important than increasing private wealth.

Three aspects of the neo-classical synthesis - the narrow definition of income and objectives, the technological treatment of income distribution and the abstraction from capitalist finance - are mainly responsible for the bias given by economic theory to economic policy that led to today's crisis.

Our malaise is deep because it reflects the failure of both an ideal and a dominant theory. The American dream - that private economic success measured in terms of ever more private goods - is all that is needed for a person and for a nation - has collapsed. The theory which rationalized that dream and gave us policies to realize it has proven to be irrelevant as new problems of the economy arise. Our theory and our dominant intellectuals have both lost their power to impress and their capacity to lead.

Thus an intellectual vacuum and real problems coexist. Keynes in the famous closing passage to "The General Theory..." wrote "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 ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else." (p. 383)

The 1970's are like the 1930's. Once again to meet the problems of an economic crisis it is necessary to search out new directions in economic theory.
II. An Aside on the Neo-Classical Synthesis

The neo-classical synthesis is the current standard economic theory. It is a blend of Walras-Pareto general equilibrium theory designed to generate rules for efficiency and Keynesian income and employment theory designed to establish rules for controlling business cycles. It guides the thinking of well nigh all the publicly prominent economists in the United States, the leading exception being Professor Galbraith.

This system of thought is based upon two fundamental analytical constructs, preference systems which embody household's subjective valuations of commodities and resources and production functions which embody the techniques open to firms. Preference systems rank 'bundles of goods' and can be 'revealed' in markets by the way income is spent. Production functions give us the technology of the economy - they describe how firms can combine inputs - labor, materials and machine time - to yield outputs.

In the theory each household is assigned some initial endowment. Trading takes place. Each household is assumed to trade only if the trade makes it better off - or at least no worse off. Some of the trades will result in furnishing services (labor) to production units - some will be exchanges of commodities.

From these preference systems, production functions and initial endowments supply and demand curves for labor and outputs of various kinds are derived. Equilibrium exists when supply equals demand for every variety of labor and output. Trading processes are defined so that such an equilibrium will be achieved and the shapes of preference and production functions are specified so that this equilibrium will be stable. This equilibrium will be at full employment - or at a natural rate of unemployment. It is now usual to set the model up so that it will generate a growing economy.
This framework leads to a mathematical rigorous proof that under restrictive conditions, the equivalent of Adam Smith's invisible hand proposition - that each by serving his own interest serves the social good - is true: efficiency is served by avarice. The conditions required for this formal proof are sufficiently restrictive so that this result can be interpreted as showing that the model is or that it is not relevant to our economy.

The Keynesian component of the neo-classical synthesis yields the proposition that equilibrium at less than full employment is possible. The analysis begins by investigating how the private components of aggregate demand - consumption and investment are determined. In the standard presentations of the neo-classical synthesis these demands are derived from preference systems and production functions. Keynes emphasized that capital holding and investment decisions are speculative and as a result investment is volatile and cannot be explained by productivity and thrift. In the Keynesian part of the neo-classical synthesis it is assumed that due to either the volatility of investor's views of the world or the inducements or constraints flowing from the monetary and fiscal system, consumption demand plus investment demand can add up to less or more than full employment output. Furthermore this state can persist. When this occurs, unemployment or inflation results.

The neo-classical synthesis reconciles the unemployment equilibrium of Keynesian theory with the full employment equilibrium of Walrasian theory. This is accomplished in two ways.

In one way consumption and investment demand are increased if unemployment exists as a result of the impact of price deflation on the deflated money supply and thus interest rates. This Keynes effect can be limited in
its scope because interest rates may not fall and investment may not react to lower interest rates.

In the second way, the function determining consumption is modified so that wages and prices decline due to unemployment; the purchasing power of some portion of wealth increases. This leads to an increase in consumption at every level of income or employment. As a result in principle consumption plus investment will in time add up to the full employment output. Thus in principle the market mechanism will assure that in equilibrium the economy is at full employment. Furthermore if markets are competitive this equilibrium will also satisfy Smith's dictum. (An argument symmetrical with that for unemployment is made for inflation)

The above is the agreed upon core of the neo-classical synthesis. Policy differences among believers arise from two sources: differences as to the determinants of the volatility of investment and the extent to which an active monetary or fiscal policy is necessary or effective. We will contrast the policy views of a model New-New Economist (or monetarist) with those of a New Economist (or conventional Keynesian).

For a model New-New Economist, dominant during early Nixon, instability is due to economic policy, especially the inept management of money by the Federal Reserve. Some economists, for example Professor Friedman of Chicago, argue that the foundation of a correct economic policy is stability in the rate of growth of the money supply. Once this is achieved market forces can be depended upon to yield full employment. If past errors lead to deviations from full employment demand then the appropriate current policy is to set and sustain the required stable monetary growth. The ways by which money works its "magic" are so complex, subtle, and powerful that attempts to react to current deviations of income or employment from target can only aggravate the situation by either too much stimulus or too much constraint. In other
words, the establishment of a stable monetary environment is the best task for policy. Within such an environment, after any disturbance the system will move toward equilibrium quickly and vigorously. Attempts to speed this process will lead to overshooting the target.

The New Economists, dominant during Kennedy-Johnson, do not have this faith that the economy will settle down into and sustain full employment if left to its own devices. On the whole the New-Economists do not offer any cogent explanation of the volatility of private demand: their theory of investment demand leaves little scope for volatility. Nevertheless, they believe that demand - both investment and consumption - varies so that over any period consumption and investment demand may be greater or smaller than what is necessary for full employment output.

Although there is general agreement among the New-Economists that in theory price flexibility will lead to full employment, they also generally hold that this mechanism operates too slowly or that there are serious barriers to wage and price changes. Thus market forces cannot be relied upon to eliminate unemployment or inflation. Active intervention - either by monetary or fiscal policy - is needed to offset the shortfalls (and excesses) of demand. Fiscal policy which operates upon demand directly by government expenditures and indirectly by taxes is the favored policy instrument of the New Economists.

Thus the economic theory of the New and the New-New Economists is identical. Policy differences follow from judgments as to the causes of the volatility of demand and beliefs as to the efficacy of monetary and fiscal measures to offset changes in private demand. Whereas the economists of the Kennedy-Johnson era emphasized the power of fiscal policy, those serving Nixon in their first years in power, emphasized the power of monetary policy.
III. Economic Theory and Economic Performance

Three specific shortcomings of the American economy are due to the biases introduced into policy as a result of the neo-classical synthesis:

(1) The deficiency and decline in the standard of public goods and "public utility" output provided by government and regulated private enterprise, together with an apparent deterioration of contributions to the quality of life from non-economic institutions.

(2) The unequal and unfair distribution of private income and the gains from economic "growth" and "progress."

(3) The emergence and persistence of inflationary pressures and recessions that are resistant to conventional monetary and fiscal devices, combined with growing evidence that the financial structure is fragile.

The deficiency and decline of public goods and the deterioration of the non-economic fabric generating social well-being are related to the definitions of well being used in the theory. The absence of any income distribution policy reflects the neo-classical view that technical production relations determine the distribution of both income and the gains/growth. The persistence of inflation and the growing fragility of the financial system are related to the misinterpretation of the role of finance in the Keynesian framework and the resulting misuse of policy instruments.

The American economists who have led the way of our recent Princes have helped lead the country astray:

(1) By being Waisanen and/or in their approach to economic welfare. Commodities are the basic unit in the Waisanen analysis of welfare. In this view households are not imbedded in a society that creates and defines wants. As a result of this commodity emphasis, gross national product i.e. the
summation of the value of commodities (and services) produced per capita is 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 and investment (and thus growth) as well as the distribution of income. The advisor economist believing in the validity of the neo-classical synthesis can evade facing up to 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 does not apply. The standard theory appends the "Keynesian" monetary-fiscal analysis to a Walrasian general equilibrium system. The Walrasian system—in spite of complications added by analysts—is essentially a timeless barter paradigm. Keynes treated an intensely financial capitalist economy which normally experiences business cycles. "Fine tuning" of such a capitalist economy cannot be achieved. Capitalism is flawed, in the sense that stability is essentially destabilizing, i.e. a Capitalist economy tends to explode once it is stabilized at or near full employment.

If meaningful changes in policy are 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 understand the limitations of policy, (become Keynesian).
IV. Human Wants and Goals

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

The above is the Walras-Pareto view of choice theory. The alternative Marshallian view is very different. In this view man is a social animal living in family units with wants that can be satisfied in various ways, private commodity flows being only one among many. There is no presumption that the maximization of those satisfactions that flow from wants that marketable commodities and services satisfy is a fit 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 the relevant concept of income. A Marshallian perspective leads to a broader concept, in which humane treatment and civil behavior yield satisfaction.

The Paretoian view that welfare is maximized by exchanges among goods allows no place for free and non-appropriated goods. Thus the deterioration of the quality of air was not considered a major factor in economic analysis until thrust upon the economist by the environmentalist. The paradox that an
A one-hour drive to work tends to increase Gross National Product whereas a twenty-minute walk does not. In evidence that Gross National Product does not in any meaningful sense measure economic welfare.

The neo-classical way of looking at choice induces a bias so that economists tend to value private consumption out of private disposable income highly and to discount the value of the consumption of public goods. The costs and benefits of alternative social organizations are not examined. The economists who have helped mold policy 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 whether "..."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, Professor Tobin described choices made while he was advising Kennedy 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" (op. cit. p. 22). Of course, Tobin really knows that a growth of public output is a growth of output, nevertheless the meaning of his assertion seems to be that resources used to provide parks, public hospitals, public schools and the safety of persons are resources wasted. Throughout the 60's, and into the 70's aside from the military, the preferred instrument for generating expansion has been a tax cut or loophole, i.e. the shifting of command over resources to private hands.
Even when dissatisfaction with poverty or income distribution is manifest, the neo-classical bias leads to advocating policies such as the Nixon welfare reforms, the McGovern social dividend, or a negative income tax. This is so even though there are strong indications that large scale improvements in welfare programs will lead to inflation which "inflates out" a large portion or even all of the welfare gain. There is an apparent inability to conceive of poverty as being system caused: all that is needed to correct the lot of the poor is to have the government act as a lady bountiful.

To a neo-classical economist gross national product and employment, not the satisfaction of human wants, is 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." (op. cit. p. 10). This comment makes one wonder whether to Viet Nam was not of the same cloth as the Berlin crises: it is good for gross national product, whether it is good for the people is not relevant.

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 four years ago Pakistan was hailed by house intellectuals as a great success of the Foreign Aid Program. Today we know better: the result of our help was the forging of the army that carried out the great massacre of Bengali.
The bias introduced by modern economic theory leads to a neglect of all but gross national product as an indicator of aggregate economic welfare. Concern with the shape of gross national product is needed as an antidote to the current practice: military expenditures while using resources do not in general contribute to "welfare" as measured by private and public consumption: other dimensions of public expenditure - such as parks and schools - do. Unless an economic theory makes this distinction it cannot be useful as a guide to redirecting priorities.
V. The Distribution of Income and of the Benefits of Economic Growth

The neo-classical synthesis leads to a neglect of income distribution as a matter of prime policy concern. In neo-classical economics at full employment the proportion of gross national product going to wages and profits is determined by characteristics of the production function: technique determines relative shares. A well-known proposition in this theory is that if production conforms to a particular relation, a 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 technique determines income distribution, then the lot of the poor and near poor can be improved only if growth of output per person takes place. The iron constraint of techniques implies that a meaningful increase in the proportion of income going to the poor cannot be achieved. This theory will make a man of goodwill an almost devout believer in the virtue of economic growth.

The neglect of the distributional aspects of the saving and investment process was shown by Kennedy's liberal Democratic Council of Economic Advisors. Once again, citing Tobin, 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." (op. cit., pp. 22-23). Thus, policy measures such as "...a tax credit for investment and a liberalization of depreciation values" (op. cit., p. 23) 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. This investment boom had to be offset by a saving boom. The social process that generates more saving results in a shift of income to gross profits.

The investment boom which took off in 1964 together with the war in Viet Nam succeeded in reducing unemployment. This induced a sharp rise in the income of the poor. As a result, starting in the middle 1960's and continuing through 1970,
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. Some of the observed resentment, social disarray and community disorganization reflects these facts; over a five-year period, 1965-70, real take home income of a representative factory worker declined by some 2.5%; this followed a five-year period, 1960-65, in which a 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. 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 shift of some of the increased wage bill toward previously unemployed workers leads to an inflationary process which tends to reduce the real income of previously employed workers. The attempt by middle-income workers to sustain a level or a trend in consumption reduces household saving ratios. This further aggravates the inflationary tendency.

Furthermore, the combination of private consumption demand, private investment demand and increased military spending leads to a decline of real 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 in a full employment economy. Public consumption goods diminish in supply.

Given the facts of American political life we can posit the following: the rich get relatively little of their consumption from public services, the poor almost always get inferior public goods. Once again it is those in the middle who get a meaningful amount of their consumption through publicly supplied
scology and curriculum. A deterrence has been their task. Thus the classi-
cational impact of the policies adopted has been shown on an average in middle-class
private and public schools combined with a sharp deterioration in the quality and
quantity of public schools. It to an extent that defines given a following,
that safety in the street (the most important public good) and the quality
of schools-including home-are such potent political issues.

Recall Johnson's war on poverty. The main thrust was education and training,
which had to start at virtually the cradle. The pre-Kinder garden of Operation
Head Start embodies this philosophy. The philosophy of Operation Head Start
means that all the poor who missed pre-Kinder garden or other special training are,
except for the lucky or the gifted, doomed to a life of poverty; what is calling
a dead-end life. The Head-End Kids and the unemployed 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 are deficient. The
liberal's war on poverty was born out of neo-classical theory in which it is the
poor—not the economy—that is to blame for poverty. The war on poverty tried
to change the poor, not the economy.

The negative income tax, which with another label is part of Nixon's (and
McGovern's) program, 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 accept-
able standard of life. Work is in itself a want that man strives to satisfy.
The conventional neo-classical theory, as it confronts poverty in the midst of
plenty, offers a truly dismal solution: 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 neo-classical economic theory leads
appears as an exercise in the "Future National Output and the Claims Upon It"
in the 1970 Economic Report of the President (pp. 78-84).
This exercise consisted of projecting gross national product available by taking the 1969 actual gross national product of $769.7 billions and multiplying it by \((1.045)^n\). It is assumed that gross national product will grow at 4.5% per year; 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 exhaust 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.

This conclusion is reached by ignoring the distribution of income and consumption. Consumption is by far the largest claim on available gross national product. In the President's 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 grows at 1.75% per year, this projection assumes a 3.25% growth in consumption per labor market participant. The projection assumes it worthwhile to use resources so that the consumption of those in the upper fifth percent of the income distribution grow in excess of 20% per labor market participant between 1969 and 1975.

In a country hard pressed for resources it is worth asking whether a proper sense of national priorities is evidenced by a policy which bilaterally assumes that the national interest is served equally well by increasing the personal consumption standard of representative upper income families, say one now making $40,000 per year, by 20% in real terms over a six year period as by increasing the consumption standard of a poor family, say one now making $3,000 per year, in the same ratio.
Let us assume that a policy with respect to income distribution that achieves the following contours is feasible: the real private consumption of a representative family in the top 5% of the income distribution is not to increase, the real private consumption of a representative family in the next 75% of the income distribution will rise at 1.75% per year, and the real private consumption 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 30% of the consumption, the next 75% of the family units had 75% and the bottom 20% had 5%.

**Personal Consumption**

**Billions of Constant Dollars**

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<th>1969</th>
<th>Administration</th>
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<th>Assumed Growth</th>
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<td>75%</td>
<td>432.0</td>
<td>576.6</td>
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<td>100%</td>
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The 1975 projected consumption in the President’s Economic Report is $769 billions. A modest change in national priorities, which reflects the view that it really is not important for the private consumption standards of representative rich men to increase, that a modest rate of growth of private consumption of the broad middle group is feasible and desirable and that sustaining the rate of growth of the poor’s private consumption is important, will free $91 billions for social consumption. This means that the Federal Government budget could be well over twice as large in 1975 as 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 profit in income. This means that taxes on high incomes from all sources be raised. It also implies that the ratio of private investment to gross national product decreases. This in turn means that the productive capacity of the private sectors will not grow as fast as projected. But this does not mean that true capacity does not increase as projected. As we know the measuring rod of gross national product is in itself biased toward giving greater weight to privately produced and used output than to the alternative public use of resources. The public investment made possible by the resources freed from private investment is productive, but a safe walk in a pack is not whereas a television program is included in gross national product.

Production functions and preference systems are inventions of theorists designed to order and interpret nature. Economic theory based upon these constructs indicates that it is futile to attempt to redistribute income and implicitly therefore to re-direct priorities. Alternative varieties of economic theory exist which indicate that income distribution and an economy’s priorities are socially determined. By modifying institutions and usages both income distribution and economic priorities can be reordered.
VI. The Stability of Full Employment

Correctly interpreted, Keynesian economics is a subtle and complex analysis. Fundamentally it argues that a financially sophisticated Capitalist economy can operate in a number of 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 the mode of operation is the amount of investment, the underlying determinants are the speculative portfolio preferences of business firms, households and financial institutions. Portfolio preferences reflect expectations with regard to the uncertain future. Expectations are determined by the past of the system and views as to the robustness or fragility of business institutions. Thus Keynesian economics is historical in perspective and its propositions are conditional. It embodies the view that in a capitalist framework vital 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 stock of capital (private investing) are speculative activities.

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 pre-Keynesian theory was fundamentally incapable of acting as a guide, to policy relating to the dynamic attributes of the economy.

Standard 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 the neo-classical synthesis. 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 policy problem. The second group typically are the 'conservatively' sometimes they are 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. Hence monetary stability—not allowing monetary phenomena to rock the boat—is the major contribution that policy can make. Fundamentally this view is idealist, for it holds that these natural unemployment rates, growth rates and income distributions are given by "nature" and if they are not satisfactory it is too bad. Nothing can be done to appreciably affect them.

The interpretation of Keynesian economics advanced here—that Keynesian economics emphasizes the dominance of speculation—is at variance with that given in textbooks.

In particular, the standard device of the neo-classical synthesis, wedding the Keynesian apparatus to a Walrasian output determining system, is not legitimate. That speculative considerations centering around financial markets can dominate production function characteristics in determining economic system behavior is a fundamental theorem of the Keynesian model. This is foreign to the neo-classical synthesis. The Keynesian view is that a capitalist economy generates a cyclical dynamical process in which the evolving financial environment determines the system state. The Walrasian view is a 'barter' paradigm, where activities which result in steady growth are carried on as if goods were traded for goods. As a result of the way in which the standard Keynesian model has developed, economic policy when guided by that passes for Keynesian theory ignores the transitory nature of a particular mode of system behavior.
In the stagnant mode of system behavior, households and firms have recently experienced sizable 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. Symmetrically, households and financial institutions insist upon a great deal of protection in the assets they hold.

As the stagnation continues, fears are attenuated 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 the point at which the shortcomings of the neo-classical synthesis led to our current malaise. The model for policy which the Kennedy economicists took to Washington was a Keynesian depression model. This model often takes the form of a complex econometric model. Upon closer inspection, this presumably sophisticated model is economically naive, it is no more than an expanded multiplier. It is a depression model in which both consumption and investment (in guns and butter) can be obtained. Neither the complexity of the financial structure nor the subtle interactions between the financial and the real that characterize both the economy and the theory of Keynes are evident in these models.
Given the amount of slack that developed during the Eisenhower years, this model was an adequate guide to policy when Kennedy took office. The tools and techniques that Professor Alvin Hansen had developed at Harvard before World War II for a deeply stagnant economy were for the moment appropriate to the moderately stagnant economy. There was no need to allow for differences between desired and actual balance sheets for households and business firms in making policy decisions.

However, as the expansion was sustained and the slack absorbed, the expectational climate changed. Business developed a seemingly inescapable desire to invest and a well-nigh unlimited capacity to finance investment by adjusting liability structures and eliminating "excess" liquidity in the 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 Kennedy economists was that "...a steadily growing fully employed economy is both desirable and attainable," (Tobin, op. cit., p. 2). Furthermore this objective could be achieved by manipulating a limited number of monetary and fiscal policy instruments.

This view was derived by manipulating models of a stagnant or slowly growing Capitalist economy. But, and this is the essential contradiction, success in achieving a growing, fully employed economy will lead to an euphoric bullish speculative mode of behavior of the economy.

In the euphoric mode, as long as the fundamentals of Capitalist finance are unchanged, monetary and fiscal constraint will not be effective unless expectations are affected. The ruling expectations of the euphoric mode are such that monetary or fiscal constraints will be offset. Such 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 fundamentals. Such a change where in a stagnant phase—either a deep stagnation of the Great Depression or a more evident stagnation consistent with the large and activist government of today.

The policy difficulties posed by a high level slack economy with inflationary tendencies are due to a lack of understanding that 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.
Conclusion

The current dispirited mood of America reflects the failure of both the economy and the dominant economic theory. It is bad enough when the economy does not deliver what is expected, say, promised. It is even worse when the policy advisors cannot offer a diagnosis and a program to solve the fault shortcomings. Rather than take the economic doldrums seriously, policy advisors offer for the currentills more of the policy that has failed.

In the work of Marshall, Marx and Keynes there exists ideas that can be welded into a new synthesis—one which recognizes that man, the object of economic life, is not simply a consumer of gross national product, that at our present stage of affluence growth and efficiency may have a low priority compared to equity, and that capitalism is flawed because of its financial system. Furthermore, we have to make do with the flawed system because once controlled, capitalism is more flexible and responsive than the alternatives. Our devotion to capitalism is in spite of its known flaws. However being flawed we should subject it to fundamental reforms and continuing control.

The fundamental flaw of capitalism centers around its financial system which is inherently unstable. The financial system is also the instrument by which the social surplus is appropriated to private business. Because of this managers of large aggregations of capital are fundamentally public servants and owners of large accumulations of wealth are fundamentally trustees for the public. The civil management and social use of capital aggregations becomes a major thrust of reforms. The name of the game of reform will be power and income distribution. But to undertake this adventure we first have to discard the neo-classical synthesis as a guide to public policy. The economics that is in the current generation of Text or Principles books will not do.