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Where Did The American Economy - and Economists - Go Wrong

by

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I. Introduction

The United States is not a happy land. Only superficially is the malaise due to the still continuing war, the recent inflationary recession, and the unappealing character of recent presidents. If we use conventional indices such as growth in Gross National Product and the avoidance of serious depressions, then the years since the end of World War II have been truly successful. In terms of these measures, there was no failure that forced the sharp change in economic policy that took place in August 1971. Aside from the international weakness of the dollar – which could have been met without the domestic controls - Nixon’s hand was forced by political pressures. These pressures, while ostensibly motivated by the persistent mild paradoxical inflationary recession, were again too strong for the objective measures of the shortcomings of the economy. To look for the cause of the malaise and the sharp change in policy, we have to look at dimensions of the economy other than the conventional measures of employment, economic growth and price level stability.

With the Nixon shift of August 1971, a coherent view of the economic process and of economic policy was abandoned. It was replaced by improvisation and fiimflammery and the new economic policy reflects no consistent worked out view as to how the economy functions. Some have ‘visions’ but they may not bend themselves to equation specification.

The abandoned theory - the neo-classical synthesis - seemingly had served the country well; for it led to the policy rules and the diagnosis of the state of the economy that guided the economy through an unprecedented period of good times and growth in the 1960’s, during the Kennedy-Johnson regimes. Even its "failure" during Nixon’s term, when the inflationary tendencies did not respond quickly to constraint and the programmed unemployment increase was not quickly reversed when policy became expansionary, was more apparent than real. The theory recognized that lags occur when policy instruments are applied in order to reverse ongoing processes.
Even if Nixon threw the neo-classical view aside why did the Democrats not rise to the defense of the doctrine? For the neo-classical synthesis was the tried and true theory which guided the economy during the Kennedy-Johnson years. Instead of opposing the administration, the Democratic politicians and their economist advisors and consultants, based at Brookings, Cambridge and Minneapolis - who constitute a "government in exile" - applauded the changes.

Why was a theory and its associated rules for economic policy that had delivered what it promised to deliver cast aside so lightly by both the administration and the official opposition? Primarily because in the midst of the apparent success, our cities, public services, landscape and environment deteriorated. A crescendo of violence and fear accompanied growth and protracted prosperity. Once the threat of economic disaster was apparently banished, the policy questions in good part became qualitative rather than quantitative: for what and for whom should this productive machine be used became the issue, rather than how much can we get out of the machine. It became and remains clear that for a nation as a person conventional economic success does not assure happiness - or contentment. To a large extent, the goals established in the aftermath of the Great Depression and World War II were satisfied by the end of the 1960's. In the 1970's we recognize that this is not enough: this kind of success does not bring a good society.

The God that has failed is the American Dream that economic success - 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.

Public priorities which emphasize private income result from the way the intellectual leadership perceives problems. The perceptions of economists are
conditioned by the ruling dominant economic theory. The thrust of economic policy during the 1960's emerged from the neo-classical synthesis. Economic policy was a key ingredient in the creation of our present economic disorder.

We cannot expect to be guided to new and superior priorities by the theory that led to the present unsatisfactory state. Once the malaise is diagnosed as basic - that the economy is not delivering what is desired - and not transitory - that ending the war, the inflation, and Nixon's tenure will not cure what ails us - then the adequacy of the intellectual framework that guided us to our present situation is suspect. Bad policy and priorities are the result of inappropriate theory. Economic policy of the 1960's was based upon the intellectual baggage that accompanied the academic economists when they went to Washington to become house intellectuals to first Kennedy, then Johnson and now Nixon. Professor James Tobin, one of the leading economists of Kennedy's term defined the power of house intellectuals 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, house intellectuals define problems, select and organize information, suggest policy options, and set the standard by which success is to be judged. At each stage, 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 well represented among the leading 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 applied the academically dominant economic theory 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 Nixon replaced Johnson: that Friedman and the University of Chicago were in and Samuelson and the Cambridge, Massachusetts axis (Harvard, Yale, M.I.T.) were out. This difference is much exaggerated.

The house economists of Kennedy-Johnson and Nixon belong to the neo-classical school which integrates micro economics rooted in pre-Keynesian analysis and 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 stated 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 of the New Economists. Fundamentally, these models integrate Walrasian and Keynesian ideas. 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, Kennedy's chief economist and Stein, who is now Nixon's chief, is within a school, not between schools.

As said earlier, the house economists of the past twelve years have been positively top drawer professionals. They are leading contributors to the development of economics. They believe the results of their theory and its accompanying empirical verification and have faith in its relevance to society. As advisers they tend to overlook that as theorists 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 the framework defines as relevant.
On the whole, they have been successful if we measure success by the advisors' yardsticks. The failure has been in dimension of the economy that, to paraphrase Hamlet, are undreamt of in their philosophy.
II. An Aside on the Neo-Classical Synthesis

The neo-classical synthesis is the current standard economic theory. It is a blend of Walrasian general equilibrium and Keynesian income and employment theory. 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 associated to households and production functions associated with firms. Each household is assigned some initial bundle of resources. 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 to production units - some will be exchanges of commodities.

These preference systems, production functions and initial endowments are used to generate supply and demand curves for labor and outputs of various kinds. Equilibrium exists when supply equals demand for labor and outputs. 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 - and it will generate a growing economy.

A major result of this framework is the 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. It has been shown that there is a correspondence between competitive equilibrium and a Pareto optimum. (A Pareto optimum exists when the allocation of resources and outputs arrived at by the trading process is such that no one can be made better off without someone being made worse off.) The conditions required for this proof are sufficiently restrictive so that this result can be interpreted as showing that the model is and is not relevant to our economy.
A contrast to the Walrasian model the Keynesian model yields the proposition that less than full employment is a possible state of the economy. The analysis begins by investigating the determinants of the components of aggregate demand—consumption and investment. In the standard presentations of the neo-classical synthesis these demands are derived from preference systems and production functions. Keynes in his seminal work emphasized that capital holding and investment decisions were speculative and as a result investment was volatile. Although it really is against the spirit 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 sectors, consumption demand plus investment demand can add up to less or more than full employment output and this state can persist. When this occurs, unemployment or inflation results.

There are two ways in the literature in which the Keynesian and Walrasian results can be reconciled. In one way consumption and investment demand are increased if unemployment exists (decreased if inflation is taking place) as a result of the impact of price deflation (inflation) on the deflated money supply and thus interest rates. This Keynes effect can be limited in its scope because interest rate may not fall (rise) and investment may not react to lower (higher) interest rates. 

In the second way a parameter of shift is introduced into the function determining consumption. This parameter also operates by way of price changes. When unemployment exists, the wage and price declines will tend to increase the purchasing power of some portion of wealth and this will tend to increase the amount of consumption at every level of income or employment. As a result in principle in time consumption plus investment demands must add up to the
full employment output. Thus in principle the market mechanism will assure that in equilibrium the economy is at full employment and if markets are competitive this equilibrium will also be a Pareto optimum.

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

For a model New-New Economist, dominant during early Nixon, instability is due to inept economic policy, especially the inept management of money by the Federal Reserve. Some economists, for example Professor Friedman of Chicago, argue that the foundations of a correct economic policy is stability in the rate of growth of the money supply and that once this is achieved market forces can be depended upon to yield full employment. If past errors lead to present deviations of demand 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 and subtle — and so full of lags — 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, within a stable monetary environment the system will be moving toward equilibrium quite quickly and vigorously after any disturbance and attempts to speed this process will lead to setbacks.

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: in their theoretical work they accept a formulation of investment demand that leaves little scope for endogenously determined volatility. However, they do believe that demand—both investment and consumption—are sufficiently volatile so that over any period consumption and investment demand may be greater or smaller than full employment output.

Although there is general agreement among the New-Economists that in principle price flexibility will correctly position the consumption demand relation so that full employment rules, they also generally hold that this mechanism operates too slowly to be relied upon to eliminate unemployment or inflation. Thus active intervention—either by monetary policy or by 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 favorite policy instrument of the New Economists.

Thus the theory of the New and the New-New Economists is identical. The 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. The economists of the Kennedy-Johnson era emphasized the power of fiscal policy. The economists of the Nixon era, in their first years in power, emphasized the power of monetary policy. Today both sets of economists in their political roles have abandoned the neo-classical synthesis, with its emphasis upon free-markets and the "possibility" that monetary and fiscal policy will work as a guide to policy, to applaud or administer a program of direct market intervention designed to control prices.
III. Economic Theory and Economic Performance

Three specific shortcomings of the American economic performance are related to the content of the neo-classical synthesis:

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

(2) The 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 the conventional monetary and fiscal devices, combined with growing evidence that the financial structure is fragile. Fears of financial fragility induce fears that evil days are to come.

The deficiency and decline of public goods and the deterioration of the non-economic fabric generating social well-being are related to the thrust of pure economic theory. The absence of any income distribution policy reflects the fact that in the neo-classical view technical relations determine the distribution of income and the rewards from progress. The persistence of inflation and the growing fragility of the financial system are related to the misuse and misinterpretation of the Keynesian framework in the neo-classical synthesis.

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 are the basic unit in the Paretian analysis of welfare. The household or decision units are not imbedded in a society that creates and defines wants. Within the discipline, an economist doing this would be suspect of intruding on the domain of the scientifically 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, as in Marshall, 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. As technical processes yield the observed economic phenomena, the advisor economist can 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 does not apply. The Keynesian analysis of the neo-classical system misses the points with which Keynes struggled. The standard analysis appends the monetary-fiscal analysis to a fundamentally Walrasian general equilibrium system. The Walrasian system—in spite of complications added by analysts—is essentially a barter paradigm. Fundamental to Keynes is a view of the world as an intensely financial capitalist economy which normally functions so that business cycles take place. In particular this Keynesian analysis indicates that "fine tuning" of a capitalist economy cannot be achieved. 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 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).
IV. Marshall vs Pareto

The theory of choice is introduced into academic economics by postulating that for each household there exists a preference system and an initial allocation of goods. 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. 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 in family units with wants that can be satisfied in various ways, private commodity flows being only one among many, what are called free goods — such as fresh air — is another. In contrast to the Paretian view, 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 income. A Marshallian perspective leads to a broader concept of income, in which humane treatment and civil behavior enter into want satisfaction.

Now 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 unexpected 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 is able to judge and weigh correctly the costs, in emotions and development, to his family 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 decisions made in well nigh total ignorance as if they were made, either with perfect certainty or with full 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-appropriated 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 Gross National Product whereas a twenty minute walk does not should cast doubt upon the relevance of the measuring rod of Gross National Product 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 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 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" (op. cit. p. 22). Of course, Tobin really knows that a growth of public output is a growth of output. However, deeply ingrained habits of thought show through this passage: the meaning of his assertion seems to be that resources used to provide parks, public hospitals, public schools and the safety of person are resources wasted. Throughout the 60's, and into the 70's aside from the military, the preferred instrument for generating fiscal expansion has been some type of tax cut or loophole, i.e. the shifting of resources to private consumption and investment.

As a result of the Paretian bias 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).
That comment by so humane and decent man makes one wonder whether the commitment to Viet Nam was not of the same cloth as the Berlin crises: 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 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 a military machine that perpetuated one of the great massacres of all time.

Both in 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 for an academic economist.
V. Marxism

The dominant school of economics in the United States leads to a neglect of income distribution in the sense of Ricardo and Marx. In neo-classical economics, the proportion of gross national product going to wages and profits is not related to the accumulation process. In standard economics at full employment the proportion of income going to wages and profits is determined 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 determines income 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 per person. Because of the iron constraint of techniques, you despair of achieving a meaningful increase in the proportion 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." (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. 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 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, factory worker real 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. 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 distributional 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 Johnson's war on poverty. The main thrust for ending poverty was education and training. But education and training have to start at virtually the cradle; the pre-Kindergarten of Operation Head Start embodies this philosophy. But Operation Head Start means that all the poor who missed pre-Kindergarten or other special training are, except for the lucky or the
gifted, doomed to a life of poverty - a dead end life. The Dead 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 welfare 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 acceptable standard of life. As work is in itself a want that man strives to satisfy, the conventional neo-classical 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 neo-classical production function economics leads appears as an exercise on the "Future National Output and the Claims Upon It" in the 1970 Economic Report of the Presidents (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 $(1.045)^n$, (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 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.

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 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 percent 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 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 20% of the consumption, the next 75% of the family units had 75% and the bottom 20% had 5%.
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 man 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 $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 television set is included in Gross National Product.

Production functions and preference systems are inventions 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 neo-classical synthesis— which indicates 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. Keynesian Economics - short-run models

Keynesian economics, correctly interpreted, is a subtle and complex tool of analysis. Fundamentally it argues that a complex, 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 which mode of operation rules is the amount of current and past 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, and these expectations in turn are determined by the past of the system and views as to the robustness or fragility of institutions. 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 neo-classical 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 policy problem. The second group typically are the 'conservatives'; 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. 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 satisfactory 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 fundamental theorem of the Keynesian model and this is foreign to the neoclassical 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 monetary policy as it passes for Keynesian models in the literature 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 Kennan economists took with them to Washington was a Keynesian depression model. This model 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. Business became Stalinist, in the sense that an insatiable desire to invest was acquired and it was accompanied by 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 New Economists as they became house intellectuals was that "...a steadily growing fully employed economy is both
desirable and attainable," (Tobin, op. cit. p. 2). 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 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.
As we enter the third year of the Nixon slack we can contemplate a further period of slack growth, a continuation of 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.
VII. 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 household 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, in which economics is naively but heroically concerned with material conditions and social organizations conducive to happiness, must supplement the rigorous but narrow Paretoian view.

2. The economist has been wedded to the neo-classical way of looking at the world. The neo-classical view is valuable when efficiency in production is 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 -- need to be faced. This question is evaded by the neo-classical synthesis. 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 mean that much of what is unsatisfactory about the world today is taken to be the natural or unavoidable results of technical relations. Only after creating a new synthesis, in which the social and organizational determinants of the economic systems performance are treated, will it be possible to develop policy which will meet the felt needs of society.

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 the house intellectuals reflects, with a lag, the thinking and the ideas of the wider group of 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 1970 call for a New American Revolution.

Hg, I find this most enjoyable and thought provoking. It is more political than academic and suited for the journal mixture in your letter. However, a U.K audience would gain a great deal from reading this so try hard to secure a U.K. outlet.