Part V: Policy

12 Introduction to Policy

If to do were as easy as to know what were good to do,
chapels had been churches, and poor men’s cottages
prince’s palaces.

Portia - The Merchant of Venice

Shakespeare’s Portia eloquently sums up the problem of
economic policy: it is easy to list objectives, but much
more difficult to deliver-to establish institutions and to
start processes that will achieve those objectives. Few will
argue that full employment, stable prices, and the
elimination of poverty are desirable; the difficulty is
finding a way to attain these and other equally admirable
goals. The time when promises without effective programs
will do is past: We must go beyond "what" to "how."

Even as I warn against the handwaving that passed as
much of policy prescription I must warn the reader that I
feel much more comfortable with my diagnosis of what ails
our economy and analysis of the causes of our discontents than I do with the remedies I propose. We need to embark on a program of serious change, even as we need to be aware that a once-and-for-all resolution of the flaws in capitalism cannot be achieved. Even if a program of reform is successful, the success will be transitory. Innovations, particularly in finance, assure that problems of instability will continue to crop up; the result will be the equivalent, but not identical bouts of instability to those that are so evident in history.

Political leaders and the economists who advise them are to blame for promising more than they or the economy can deliver. The established advisers have failed to make the political leadership and the public aware of the limitations that economic processes and the ability to administer impose on what policy can achieve. Economists as advisers have failed to teach legislators and administrators that although government may propose, it is the economy that disposes. To be exact, our economic leadership does not seem to be aware that the normal functioning of our economy leads to financial trauma and crises, inflation, currency depreciations, unemployment, and poverty in the midst of what could be universal affluence—in short, that financially complex capitalism is inherently flawed.

Economic advisers, whether liberal or conservative, believe in the fundamental "soundness" of the economy. Finding fault with one thing or another, they may advocate
policies such as changing Federal Reserve operating techniques, tax reforms, national health insurance, and wars on poverty, but all in all they are satisfied with the basic institutions of modern capitalism. According to toady's gospel what faults there are due to secondary, not fundamental characteristics.

That being the case, the economists, of the policy-advising establishment differ about details: some propose to fine-tune the economy by fiscal tinkering, others want to achieve a noninflationary natural rate of employment through steady monetary growth. Neither, however, sees anything basically wrong with capitalism as such. The credit crunch of 1966, the liquidity squeeze of 1970, the banking crisis of 1974-75, the inflationary spiral of 1979-80 and the distress, national and international, of 1981-82 are, in their view, aberrations, due to either "shocks" or "errors." Since nothing is basically wrong, they also hold that incisive corrective measures are not needed.

The truth of the matter is that something is fundamentally wrong with our economy. As we have shown, a capitalist economy is inherently flawed because its investment and financing processes introduces endogenous destabilizing forces. The markets of a capitalist economy are not well suited to accommodate specialized, long-lived, expensive capital assets. In fact, the underlying theory of the policy establishment does not allow for capital assets and financial relations such as exist. The activities of
Wall Street and the inputs of bankers to production and investment are not integrated into, but are added onto, the basic allocation-oriented theory.

Economic policy discussions in recent years have centered on how much more (or less) of the one-fiscal policy-and how much less (or more) of the other-monetary policy-is necessary for economic stability and growth. If we are to better in the future, we must launch a serious debate that looks beyond the level and techniques of fiscal and monetary policy. Such a debate will acknowledge the instability of our economy and inquire whether this inherent instability is amplified or attenuated by our system of institutions and policy interventions.

As a first step, an agenda for public discussion must be prepared. The agenda is important because it establishes which alternatives are discussed and because the way the in which the alternatives are presented is likely to influence decisions. In an address at the University of Essex in 1966 James Tobin, Nobel laureate in economics, aptly described the role of the adviser as censoring evidence and phrasing questions for his prince's attention. He pointed out 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."¹ Thus, simple-minded phrases are uttered by the powers that be about a trade-off between

unemployment and inflation rates, without any awareness that the trade-off under discussion only existed for a brief period after World War II and that there is little, if any, evidence to support the idea that it still exists. Yet because this trade-off is built into the economic theory and the econometric models of the policy-advising establishment, the problems of policy are phrased in its terms. These models do not ask whether the trade-off reflects character of the output produced by the increased employment: no distinction is drawn between a lower rate of unemployment achieved through the production of more consumer goods, which is deflationary, or through government transfer payments, defense spending or the production of more investment goods, which are inflationary.

To be precise, the most important concern in court politics is access to the mind of the prince. And if economics is too important to be left to the economists, it is certainly too important to be left to economist-courtiers. Economic issues must become a serious public matter and the subject of debate if new directions are to be undertaken. Meaningful reforms cannot be put over by an advisory and administrative elite that is itself the architect of the existing situation. Unless the public understands the reason for change they will not accept its cost; understanding is the foundation of the legitimacy for reform.
Tobin's definition of the role of the house intellectual may be described as controlling the agenda. Princes and public alike depend on intellectuals to formulate issues and define alternatives. In a democracy, the definition and even the order in which they are presented for consideration affects the outcome. For example, the thrust of the reforms of the budget process by Congress in 1970s is an attempt to make the final budget the result of the overview of individual decisions rather than the ratification of an accidental sequence. Existing legislation-ranging from the agricultural programs through the various transfer-payment schemes to import quotas-is not the result of a design that reflects a consistent view of the economy but, rather, is a hodgepodge that reflects responses of the Congress, various administrations, and the public to problems as they were identified. Consequently, the existing economic structure is the result of sequential decisions that did not consider interactions among the programs and institutions.

Today's economic crisis is as profound, though not as overtly critical, as that of the 1930s. The instability, inflation, and chronically high unemployment of the years since 1965 are not satisfactory, and the policy prescriptions that may have served well enough in the earlier postwar years can no longer achieve the desired
result. Moreover, there is no consensus on what we ought to do. Conservatives call for the freeing of markets even as their corporate clients lobby for legislation that would institutionalize and legitimize their market power; businessmen and bankers recoil in horror at the prospect of easing entry into their various domains even as technological changes and institutional evolution make the traditional demarcations of types of business obsolete. In truth, corporate America pays lip service to free enterprise and extols the tenets of Adam Smith, while striving to sustain and legitimize the very thing Smith abhorred-state-mandated market power.

Liberals, instead of articulating the an incisive critique of our capitalism as such and pioneering innovative experimentation and change, are wedded to the past. They support minimum-wage increase without questioning whether these laws have served any real purpose since the Great Depression, when reflation was the policy objective. Liberals are unwilling to face up to the shortcomings of policies inherited from the past and are, fundamentally, timid about setting forth in a new direction.

As a consequence instead of analysis and ideas we get slogans: free markets, economic growth, national planning, supply-side, industrial policy-imprecise phrases that face up to neither the what nor the how of policy objectives. the various programs for change are based on misconceptions of both the strengths and the weaknesses of market processes.
One of the reasons for the intellectual poverty of policy proposals is that they continue to be based on ideas drawn from neoclassical theory. Although economic theory is relevant to policy (without an understanding of how our economy works we cannot find cures), for an economic theory to be relevant what happens in the world must be a possible event in the theory. On that score alone, standard economic theory is a failure; the instability so evident in our system cannot happen if the core of standard theory is to be believed.

Today's economic policy is patchwork. Every change designed to correct some shortcoming has side effects that adversely affect some other aspect of economic and social life. Every ad hoc intervention breeds further intervention. If we wish to improve on what we now have, we must embark upon an age of institutional and structural reforms that will check the tendencies toward instability an inflation. Standard theory, however offers us no guidance on that score, for the problems are outside the domain of relevance of the theory. A new era of reform cannot be simply a series of piecemeal changes. Rather, a thorough, integrated approach to our economic problems must be developed; policy must range over the entire economic landscape and fit the pieces together in a consistent, workable way. Piecemeal approaches and patchwork changes will only make a bad situation worse.
Poverty in the midst of plenty and joyless affluence are but symptoms of a profound disorder.\textsuperscript{2} As we have pointed out, persistent economic and financial instability is normal in our capitalist economy. The commitment to growth through private investment-combined with government transfer payments and exploding defense spending-amplifies financial instability and chronic inflation. Indeed, our problems are in part the result of how we have chosen, inadvertently and in ignorance of the consequences, to run the economy. An alternative policy strategy is needed now. We have to go back to square one-1933-and build a structure of policy that is based upon a modern understanding of how our type of economy generates financial fragility, unemployment, and inflation.

The Approach to Be Adopted

The three policy slogans—the conservatives’ call for free markets, the liberals’ commitment to economic growth, and the pseudo-radicals’ call for national planning and industrial policy—all have one thing in common: the economic analysis that underlies their approach is pre-Keynesian. Just as there never really was a Keynesian revolution in economic theory, there also never really was one policy. Aside from Alvin Hansen’s depression prescription, no one has actually thought through (much less implemented) the policy implications of Keynes. All that was assimilated from

Keynes by the policy establishment and its clients was the analysis of an economy in deep depression and a policy tool of deficit financing. His deep critique of capitalism and his serious attempts to reformulate economic thought so that it could better deal investment and financial relations were lost. Keynesian economics, even in the mind of the economic profession, but particularly in the view of politicians and the public, became a series of simple-minded guidelines to monetary and fiscal policy. What we need now is a policy strategy based upon an economic theory that recognizes that our economy is a capitalist, has a sophisticated financial structure, and as a result is unstable because of the processes internal to such an economy. In effect, we must base policy upon a that builds upon what was lost from Keynes' contribution as it was transformed into a part of orthodox theory of the 1960's and 1970's.

The major points derived from the theoretical perspective that builds on Keynes are:

1. Whereas the market mechanism is an effective control device for the myriad of unimportant decisions, it fails important equity, efficiency, and stability tests.

2. A sophisticated, complex, and dynamic financial system such as ours endogenously generates serious destabilizing forces so that serious depressions are natural consequences of noninterventionist capitalism: Finance cannot be left to free markets.
3. The decentralized market mechanism is particularly unstable and inefficient for an economy in which capital investment constitutes a significant portion of private national product, and investment goods are expensive to produce.

4. Under a capitalist form of organization, financial resources will not be risked on large-scale, long-lived capital assets without protection against market forces. As a result, legislated and institutionally legitimized monopolies and oligopolies are necessary if such industries are to be private. Capital-intensive monopolies and oligopolies are best interpreted as special forms of tax farmers. Public control, if not out-and-out public ownership, of large-scale capital-intensive production units is essential.

5. Big government capitalism is more stable than small government capitalism: this is shown by both the experience of the past century and by an economic theory that allows for financial institutions. This greater stability is because of the impact of government deficits as a contracyclical phenomenon in stabilizing profits. However, if Big Government is not to be conducive to inflation, the budget structure must be such that profits are constrained by surpluses when inflation rules.

6. Because the budget structure of Big Government must have the built-in capacity to generate surpluses when
inflation appears, the tax revenues have to be a large proportion of GNP. Thus, the design of the tax system is vital, as taxes introduce allocational inefficiencies as well as inducing behavior designed to avoid or evade taxes.

In addition to these perspectives born of theory, a number of historical facts, institutional attributes, and policy thrusts must be integrated into any new foundation for economic policy.

1. The ideas underlying the institutional structure of our economy are pre-Keynesian. The institutional structure is largely the product of the Roosevelt era and reflects a bias-born of the Depression-favoring investment and capital intensity and against labor-force participation and deflation. Once Big Government succeeds in eliminating the threat of deep and prolonged depressions, however, this Rooseveltian institutional structure lends an inflationary bias to economy.

2. The emphasis on investment and "economic growth" rather than on employment as a policy objective is a mistake. A full-employment economy is bound to expand, whereas an economy that aims at accelerating growth through devices that induce capital-intensive private investment not only may not grow, but may be increasingly inequitable in its income distribution, inefficient in its choices of techniques, and unstable
in its overall performance.

3. It is difficult to decide whether the emphasis on capital-intensive production should be seen as a failure of theory or of policy. Certainly there is an unwarranted emphasis on investment as the source of all good things: employment, income, growth, price stability. But in truth, inept and inappropriate investment and investment financing deters full employment, consumption, economic growth, and price stability.

4. A too extensive and expensive system of transfer payments is socially destabilizing, tends to reduce real national income, and introduces an inflationary bias into the economy.

5. Our economy is characterized by the pervasive validation of private decisions by the public sector, even if such validation is detrimental to efficiency and equity. This reflects a natural fear of uncertainty. The lesson of Keynesian economics is that the overall cyclical uncertainty can be constrained by apt interventions, and a system of apt aggregate interventions makes it unnecessary and undesirable to intervene in the details.

6. Policy must always recognize that there are limitations to what can be administered competently. This limited competence to administer biases policy toward mechanism that require the minimum of administration; in
particular, mechanism that use and rig markets are to be preferred to regulations and controls that affect the details of the economy.

It should be stressed that a program for full employment, price stability, and greater equity is not a simple one-shot affair. There is no magic economic bullet; no single program or particular reform will set things right forever. Standing by themselves, unaccompanied by the requisite companion measures, the individual parts of an integrated reform program might be futile. Any program that will make things better is bound to have a price; some units might be worse off, and there are adjustment costs from continuing on the present course. However, a program of reform that builds an economy oriented toward employment rather than toward growth should show benefits quickly. The primary aim is a humane economy as a first step toward a humane society.