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The Hall Memorial Lectures

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THE HALL MEMORIAL LECTURES

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God has cared for these trees, saved them from drought, disease,
avalanches, and a thousand tempests and floods.
But he cannot save them from fools.

John Muir

INTRODUCTION

Historical records are sometimes worth preserving although their value depends, among other things, on their age and the inches of accumulated dust thereon. This slim volume is an aged and dusty record of the Hall Memorial Lectures in Economics delivered at the University of Nevada, Las Vegas, in the 1980s.

The Hall Endowment

Sherwood James Hall (1897-1968) was a woodsman, timberman. Raised in upstate New York, he served a stint as a doughboy in World War I, and then studied forestry at Syracuse University earning his degree in 1920. His initial employment was with James D. Lacy and Company as a timber cruiser and project manager in the Jacksonville, Florida, area. While there, he did a land use plan for a tract in Clay County owned by J. C. Penney; the land is now the site of Penny Farms, a village and retirement center. He was also instrumental in developing the pulp and paper industry in the region. And he bought timber land in the area at Great Depression prices.

In 1948 Hall, along with two partners, S. E. Fogelberg and J. Ollie Edmunds, bought a 30,000 acre tract of partly cut over redwood and douglas fir land on the coast of California in southern Mendocino and northern Sonoma Counties. Here, Hall and his partners, in collaboration with Emanuel Fritz, Dean of the College of Forestry at the

University of California, Berkeley, developed and practiced sustained yield redwood forestry. The successful business, the Gualala Redwoods Inc., remains today but under different ownership, perhaps enterprising Chinese.

Health considerations forced Hall to take up residence in a dry climate. So he moved to Las Vegas, Nevada. Here, he acquired more – not forest – land. In his final years Hall turned his attention to philanthropy. He endowed educational programs in the College of Forestry at UC, Berkeley. The annual S. J. Hall Lecture in industrial forestry is still presented on Homecoming Weekends at the Berkeley Campus. Then in 1965 he donated two parcels of Las Vegas land to the Department of Economics at the University of Nevada, Las Vegas. Proceeds from the sale of this land were to be used to finance educational efforts to enhance community understanding of the principles of economics. These parcels of land were sold in 1978 creating the S. J. Hall Endowment. And in 1982 Hall's widow, Dessie, donated two additional parcels of land to UNLV. Proceeds from the sale of these lands supplemented the original Hall Endowment and the holdings of Lied Library.

The S. J. Hall Professorships in Economics

A portion of the Hall Endowment was used to support the S. J. Hall Professorships in Economics at UNLV in the 1980s. There were three such Professorships. In addition to teaching classes and pursuing research, the appointments gave the S. J. Hall Memorial Lectures.

Wallace C. Peterson (1921-2012) was the Hall Visiting Professor in the 1983-84 academic year. Peterson held B.A., M.A., and Ph.D. degrees from the University of Nebraska, Lincoln, and was the George Holmes Professor of Economics at the same institution. Professor Peterson was Keynesian in that he considered *The General Theory of*

Employment, Interest, and Money the foundation of macroeconomic analysis; he was Post-Keynesian in that he found much of the Neoclassical apparatus discordant with the Keynesian framework; and he was an Institutionalist in that he regarded historical developments, and social and political institutions as important elements in the analysis of economic behavior and processes. Peterson published numerous articles, and his volume, *Income, Employment, and Economic Growth*, was a widely used text in macroeconomics in American colleges and universities. Professor Peterson gave two lectures: Lecture 1, "Contemporary Macroeconomics: A House Divided," was delivered on December 1, 1983; and Lecture 2, "Economic Stabilization and Inflation," was presented on May 8, 1984.

Murray N. Rothbard (1926-1995) was Hall Visiting Professor in the 1984-85 academic year. Rothbard held B.A., M.A., and Ph.D. degrees from Columbia University. He was Professor of Economics at the Polytechnic Institute of New York prior to his visitorship at UNLV. Professor Rothbard was a founding member of the Cato Institute and was therefore in the Libertarian fold; he was a disciple of the Ludwig von Mises branch of the Austrian School of Economics; and he was a proponent of stateless Anarcho-Capitalism. Rothbard was a prolific writer; his signature work is *Man, Economy, and State: A Treatise on Economic Principles* (1962). During his visitorship Rothbard gave two lectures: Lecture 3, "The Five Faces of Reaganomics," was delivered on November 27, 1984; and Lecture 4, "The Terrible Simplifiers: The Case Against the Flat Tax," was presented on May 7, 1985.

Larry D. Singell (1937-) was Hall Visiting Professor in the Spring Semester of 1986. Singell holds a B.A. degree from Eastern Nazarene College in Quincy, Massachusetts, and M.A. and Ph.D. degrees from Wayne State University in Detroit, Michigan. He was on leave from the University of Colorado, Boulder, where he was Professor of Economics.

Professor Singell's fields of specialization are Human Resource Economics and Urban Economics. He has published numerous articles and monographs in his field, and he has edited a number of volumes in *The Collected Papers of Kenneth E. Boulding* published by the Colorado Associated University Press. Professor Singell gave one lecture: Lecture 5, "Youth Unemployment: An American Crisis," was delivered on May 14, 1986.

Professor Rothbard returned to UNLV as resident Hall Chair Professor in 1987. He held this position until his death in 1995. In the resident professorship Rothbard gave two lectures: Lecture 6, "Is There Life After Reaganomics?" was delivered on October 22, 1987; and Lecture 7, "Deficits and Taxes: The Economics of the Next Four Years," was presented on c. January 11, 1989.

Taken as a series the lectures reveal some of the ragged edges of the dismal science. In the first lecture Peterson, the Keynesian-Post Keynesian-Institutionalist, shows macroeconomics in a crisis, a crisis of schools of thought; in the second lecture he examines the American economy mired in another crisis, inflationary recession, stagflation. In the third lecture Rothbard, the Libertarian-Austrian-Anarcho Capitalist, caricatures Reaganomics as a polycephalic creature; in the fourth lecture he rants against all manner of flat, even bumpy, taxes imposed by his always malicious government. In the fifth lecture Singell, the Human Resource-Urban Economist, portrays an economy noticeably inclined toward youth abuse. Then, in the sixth lecture Rothbard, the resident, returned to bury Reaganomics; and in the seventh lecture he prepared a grave for the anticipated economic program of George H. W. Bush. All-in-all the lectures are a jovial read, even at this late date!

Lewis Karstensson
May 10, 2017

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time-path for it to grow, then the fundamental issue is whether or not
forces natural to or inherent in markets will bring the economy to this path.

Wallace C. Peterson

LECTURE 1

CONTEMPORARY MACROECONOMICS: A HOUSE DIVIDED

Wallace C. Peterson

(Delivered on December 1, 1983)

In the introduction to his provocative book, *John Maynard Keynes*, Washington University Professor Hyman P. Minsky says, "There are times in the intellectual history of a discipline when its theoretical house is in good order; at other times this house is in disarray."[1] This accurately describes the state of contemporary macroeconomic theory. Macroeconomics is a term economists use to designate the branch of economic theory which explains the forces in a market economy which determine output and employment, the rate of inflation, and the growth of production over time.

It was not always thus. In the 1960s, especially during the Kennedy presidency, a broad consensus existed on the content and utility of macroeconomic theory. To use Thomas Kuhn's fashionable terminology, there was an accepted "paradigm" which was enshrined in the textbooks and defined the boundaries of the discipline.[2] No longer is this true. The unity which once prevailed in the house of macroeconomics is now shattered; the theory is in disarray. In the Kuhnian sense, there is a crisis, and the reigning paradigm is being

challenged. My purpose this evening is to explore this crisis, showing how it came about and offering speculation on its ultimate resolution.

1. The Central Issue in Macroeconomic Theory

The point of departure for my remarks is what I regard as the central, unresolved issue in macroeconomic theory. This is the extent to which the modern market economy is a self-regulating system, one which when left to its own devices will settle down and grow steadily in a manner which utilizes all of its resources, especially labor. There is irony here, because this is the issue that divided economics in the 1930s, and it is the issue dividing it today. In a 1935 article in *The New Republic*, John Maynard Keynes said that the basic gulf in economics was between those who believe that in the long-run the economic system is self-adjusting and those who rejected this view.[3] In this article, which predated publication of *The General Theory*, Keynes aligned himself with the heretics (those who questioned the self-adjusting character of the economic system), and dropped hints that he was developing an alternative theory.

From an historical viewpoint, two fundamental and very broad "visions" have emerged in macroeconomics in answer to this basic question. By "vision" I mean a rough model of how the market economy works with respect to such fundamentals as output, employment, the price level, and growth. A brief overview of these alternative "visions" provides an appropriate frame of reference for later discussion of the theories now competing with the reigning paradigm.

If it is assumed that there exists for a market system an ideal time-path for it to grow, then the fundamental issue is whether or not forces natural to or inherent in markets will bring the economy to this path. Historically, the oldest vision is that of the classical

economists, a term used roughly (and not wholly accurately) to describe the body of economic ideas and theories which developed during the century and a half following the publication of Adam Smith's *The Wealth of Nations*. Although classical economics has many facets, its dominant thrust with respect to the issue posed here is that a system of market capitalism, if unfettered by the state or groups with monopoly power, will of its own accord seek out and follow the ideal time-path of growth. This time-path is ideal because it involves the fullest possible use of all society's resources and the maximum production of the things which people want. The system is self-regulating not only in the sense that it will gravitate toward this path, but also because if displaced from the path by external events – say a war, or an oil embargo – forces are set in motion which will return it to the ideal path.

As one may readily surmise, the alternative "vision" of how market economies work rejects the foregoing view. Not only is there no automatic tendency for the economy to reach the ideal time-path, but there is no assurance that it will stay there if, by chance, it reaches such a path. Furthermore, in this view of the economic universe, destabilizing forces, whether from inside or outside the economic system, tend to be cumulative in their effects. Consequently, instability, not self-regulation, is the norm for the market economy, a point of view which implies that some external intervention into the market system is necessary if we are to depend on something other than chance to put the economy on the ideal time-path of growth. In advanced market economies in the modern world the appropriate entity for such intervention is the central government.

2. The Legacy of Keynes

Historically, it is the latter vision which is the most recent, and which has dominated macroeconomic thinking in the last half-century. It is a point of view born out of

the bitter experience of the Great Depression of the 1930s and which as an intellectual discipline is primarily a legacy from Keynes. More than any other economist of the 20th century, he is recognized as the father of modern macroeconomics. Thus, it is appropriate that we turn first to Keynes and his ideas if we are to understand the current disarray in macroeconomics and how it came about.

British economist and Nobel Laureate, Sir John Hicks, has said that future historians will designate the quarter-century after World War II as the "Age of Keynes."[4] In this he is undoubtedly correct. From 1945 until 1970 Keynesian ideas formed the theoretical core for the reigning paradigm in macroeconomics. For a guide to appropriate policies for managing their economies, most Western governments after World War II looked to Keynesian economics. In the mixed economies in the West, the quarter century after World War II represented an extraordinary success story. Growth was rapid, unemployment was low, and inflation was not a serious problem. Most important, there was no indication that the catastrophic collapse of the 1930s might repeat itself, even though the fear of another major depression never entirely disappeared. Rightly or wrongly, Keynesian theory got the credit for most of this success.

The book that changed the way we think about how the economic world works was published early in 1936 under the title, *The General Theory of Employment, Interest, and Money*. It is an abstruse work, not recommended for the general reader. Keynes said in the Preface that it was directed chiefly to his fellow economists, although he hoped it would be "intelligible to others." *The General Theory*, John Kenneth Galbraith has said, is, like the *Bible* and Marx's *Das Kapital*, "deeply ambiguous," a fact which helped to win converts. Keynes explained the book's abstruseness and ambiguities as the result of his "long struggle

to escape from habitual modes of thought and expression."[5] The latter were those of the classical economics upon which Keynes was brought up at Cambridge.

To understand the full importance of *The General Theory*, one must realize that Keynes's objectives in the book were twofold. First, he sought to demonstrate that the classical theory, which dominated British and American economies before the 1930s, was wholly inadequate either to account for or deal with a major social and economic catastrophe like the Great Depression. Keynes has been criticized for attacking a caricature rather than the real substance of classical thinking, a viewpoint not without merit. Nevertheless, it is primarily because of Keynes's criticism that we have a better idea of the scope and shape of classical economic thinking with respect to the aggregate performance of the economy. Keynes may not have invented classical macroeconomic theory, but he certainly forced the economic profession to explicitly identify the variables and relationships which governed the performance of the aggregate economy. Before Keynes they were only implicit in the economics taught at Cambridge.

Keynes's other and more important objective was to develop a better theory, one which truly would explain how output, employment, and the price level are determined under all circumstances. As Keynes said in a letter to George Bernard Shaw shortly before *The General Theory* was published, his new book would "largely revolutionise . . . the way the world thinks about economic problems."[6] The book did exactly that. Keynesian theory as it developed after 1936 – and especially as it unfolded in the post-World War II years – largely displaced classical economics as the reigning macroeconomic paradigm. Keynesian economics became the new orthodoxy, an orthodoxy now under attack from several directions. Parenthetically, it is appropriate to note that it was a particular version or

interpretation of Keynes's thought which assumed this role. Technically among economists this interpretation is known as the "income-expenditure" approach to macroeconomic analysis, the reason being that it focuses primarily upon total, or aggregate, spending as the primary explanatory variable with respect to the overall performance of the economy.

For a full appreciation of the "Revolution" in economic thought caused by *The General Theory*, it is necessary to know something of the system of classical economics which Keynesian economics attacked and displaced. There are two reasons for this. First, understanding in a broad way how the classical economists viewed the world not only helps make Keynesian economics intelligible, but also enables us to put the latter in the appropriate historical perspective. Second – and perhaps more important – the contemporary theoretical challenges to the Keynesian paradigm look back to the classical schema for ideas and inspiration. Consequently, comments on the nature of classical economics are in order.

3. The Nature of Classical Economics

In *The General Theory* Keynes used the term "classical economics" to characterize the whole body of economic theorizing which preceded his own work and which stretches back at least to Adam Smith.[7] Technically this is not correct; historians of economic thought distinguish classical economics from neoclassical economics. Roughly speaking, the former embraces economic thought from David Ricardo to John Stuart Mill, while the latter refers to the theories of economists who came after John Stuart Mill. For our purposes, however, this distinction is not of major importance, the reason being that contemporary macroeconomics generally uses the term "classical" as Keynes used it, namely to describe pre-Keynesian theorizing about the determinants of output, employment, and the price level.[8]

In this broad sense, "classical economics" refers to the body of theoretical concepts and ideas which explain how an economy organized on the basis of free, competitive markets and the private ownership of land and man-made capital (i.e., structures and machines) is supposed to work. In the classical lexicon, a "competitive" market is one in which neither buyers nor sellers can by their own actions determine or in any way influence the prices which the market establishes through the interaction of the buyers and sellers. To explain how the system works means to explain how through markets the system establishes prices for everything that is produced and prices for the resources required so that production can take place (land, labor, and capital); how efficiency in the use of resources is obtained; and how the material welfare or well-being of all participants in the system is maximized. In a sense, the classical economics as developed and refined throughout the 19th century was really concerned with explaining in a formal way how Adam Smith's "invisible hand" working through markets harnessed personal greed – the pursuit of self-interest – to the social good, the maximum production of the things people want.

What Keynes was interested in with respect to classical economics was how the system was supposed to bring about the full and continued use of all resources in production, especially the employment of labor. As he pointed out in *The General Theory*, classical economics, while explaining in elegant detail how a market system allocates its resources between different uses and how prices are established for the goods and services produced and for the resources used in their production, it seldom examined in detail the theory of what determines the actual employment of the resources available to a society.[9] There is such a theory, Keynes maintained, even though it is rarely mentioned. This being the case,

Keynes proceeded to set forth what he regarded as the essentials of the classical theory of employment.

Classical employment theory, as outlined by Keynes and as it is now found in most textbooks, consists of three basic propositions. First, the level of employment is determined by the total demand for and supply of labor. A corollary to this is that once employment is determined, output is also determined since the two obviously go together. In classical macroeconomic theory the overall labor market is essentially the labor market for the individual business firm writ large and applied to the whole economy. What is unique about the classical theory is that the supply of labor is defined in a way to preclude any unemployment except unemployment which is voluntary. Practically speaking, the classical school regarded the full employment of labor as a normal state for the economy, a proposition mocked by the mass unemployment confronting the economy in the 1930s. The second classical proposition is the rather curious doctrine known as Say's Law of Markets, after Jean Baptiste Say, an early 19th century French economist. Even though the level of employment is determined by the total demand for and supply of labor, and this level utilizes all workers seeking work, the possibility exists that the output produced with this labor might not be sold. Isn't overproduction or a glut of unsold goods possible? Common sense and experience suggest that the obvious answer is yes. But not according to Say's Law. In its simplest form, Say's Law asserts that "supply creates its own demand," which means that every act of production creates income and therefore demand equal to the value of that production. No general overproduction is possible. In a crude form, Say's Law is valid in a barter economy, since no person would bring goods to market except to exchange them for other goods. In an economy which uses money, matters are not so simple. Production

generates money income for the producers, but one of the virtues of money is that one doesn't have to spend it immediately. Thus, in a money-using economy the possibility exists that some income arising from production may not be spent immediately – it might, in other words, be saved. Classical economics got around this problem by adding a corollary theory to Say's Law, namely a theory which links the supply of savings to the rate of interest and the latter to borrowing by the businessman to purchase new capital goods, i.e., structures and equipment. Therefore, if more is saved, interest rates will fall, and more borrowing and spending for real capital will take place. If less is saved, the reverse will happen. The essential point is that in the classical theory, saving cannot cause a decline in spending and thus be responsible for more being produced than could be sold. Say's Law works in a money-using economy as well as in a barter economy. At least this was the classical view, echoes of which are heard today in the argument that the economy is suffering from a shortage of saving. This brings us to the third classical proposition, namely the role of avoiding the clumsiness of barter. Money serves, primarily, as a medium of exchange, which is to say it is generalized purchasing power readily convertible into almost anything. This being the case, any change in the amount of money will lead to more or less spending, but since resources are normally fully employed, more or less spending primarily affects the price level. The idea that prices are linked directly to the money supply is known as the quantity theory of money. It is an old idea, dating back to the 18th century or earlier, but one which has been reconstituted in modern dress by former University of Chicago economist, Milton Friedman. We shall examine his ideas shortly.

Combining the foregoing propositions with competitive markets and the free play of self-interest by businessmen, workers, and consumers gives us all the necessary ingredients

for a self-regulating economic system, one which employs all resources fully and in the most efficient way possible. The logical – or "natural" – policy conclusion derived from this view is that of *laissez faire*, or non-interference by government in the running of the economy. Classical economics thus did what any good theory should do: it explained (how employment, output, and prices were determined); it predicted (full employment would be the norm); and prescribed (governments should keep their hands off the economy).

4. The Keynesian Revolution

In Thomas Kuhn's classic study of how scientific progress proceeds through "revolutions" he argues that an accepted body of theoretical ideas – a paradigm in his words – is in trouble when, increasingly, anomalies appear. Anomalies are events or happenings which cannot be explained adequately by the prevailing paradigm. The stage is then set for a crisis and the emergence of a new paradigm – in short, for a scientific revolution.

If we view the classical ideas just discussed as the ruling economic paradigm prior to 1929, then the anomaly which set the stage for the Keynesian Revolution was the Great Depression and the mass unemployment therein. Here was something that simply could not be explained by the ruling paradigm. Events made a mockery of the classical belief that the economy was inherently stabilizing, that market forces on their own would bring about full employment. Economic theory confronted a scientific crisis as described by Kuhn. Ultimately, and also in accord with the Kuhnian scenario, a new paradigm emerged to displace the classical system. This was the Keynesian "revolution," the essence of which is quickly described.

Instead of asserting, as classical theory did, that employment (and output) depended upon the interaction between the total demand for and supply of labor, Keynes took a

different tack altogether. In a sense, he stood the classical analysis on its head. The economy's level of employment, he said, depends upon the interaction between total spending – which he called aggregate demand – and the economy's capacity to produce. In a system of market capitalism, decisions to produce goods and services are the province of the businessman, but production, which is also the source of employment, will take place *only* if business experiences or foresees a market in which the goods produced can be sold at prices which will cover their production costs. Lacking demand – either actual or expected – productive capacity will stand idle and people will go without jobs.

The foregoing idea, simple as it seems, is the essential core of the Keynesian "revolution." It is aggregate demand, by which Keynes means total spending for goods and services by consumers, businesses, and governments which triggers action in a market economy. Only when sufficient demand is present or expected will businessmen make the decisions which lead simultaneously to production and jobs. Nothing in the way that the system works guarantees that sufficient total spending – i.e., demand – will exist to insure that enough is produced to provide jobs for every person wanting work.

Contrast this with the classical view. Through Say's Law of Markets, the classical paradigm assumes that markets always exist for whatever is produced. There may be from time to time a mismatch between the supply of and demand for particular goods, but overall (or in total) such a mismatch is impossible. If this is the way the world works, then it makes sense to explain the actual level of output by explaining, first, how labor markets in the aggregate determine employment, and then how the amount of employment determines output. Since there is always a demand for labor in the classical world if its price (i.e., wage) is not too high, then any unemployment is the result of either wages being too high, a

condition workers could correct by agreeing to work for less, or simply because workers choose not to work at the prevailing wage. In either case, unemployment is voluntary, and consequently of no concern to society. Keynes saw it differently, arguing that it is production which determines how much labor will be used, and that no production will take place unless there are markets for what is being produced. If markets don't exist, or are weak, production doesn't take place, or is low, and workers find themselves without jobs. The fault is not theirs; it lies elsewhere. Unemployment is involuntary and society does have an interest in the matter.

There is, of course, much more to Keynes's *General Theory* than this. In market capitalism, spending by consumers (households) and businessmen (firms) make up most of the spending taking place. Keynes, we should remember, wrote *The General Theory* at a time when spending by governments was a much smaller share of total spending than is now the case. Much of *The General Theory* is devoted to explaining how the spending by consumers and business firms is determined, and how and why this spending changes. If these spending aggregates can be explained satisfactorily, then the level of total spending – aggregate demand – can be explained. As far as spending by consumers is concerned, Keynes believed that it was relatively stable, being dependent upon the income that is generated when production takes place. But spending by business firms is a different story. The business spending which concerned Keynes was capital spending, that is, the purchase of equipment and structures so that a business firm may produce more goods and services in the future. This spending is highly volatile, subject to sudden and unforeseen changes. The reason is that in a market economy, capital spending is undertaken only in the expectation that it will be profitable. Profitability depends upon the ability to sell *in the future* goods and

services to be produced using capital goods purchased *in the present*. Since the future is unknown, spending decisions for capital equipment rest upon an uncertain and flimsy foundation. Keynes said there was no scientific basis whatsoever for determining future profitability. It is the volatility of capital spending which accounts for the inherent instability of market capitalism, those alternating periods of boom and bust which have plagued capitalism since the industrial revolution.

Two broad conclusions can be drawn from this brief sketch of the Keynesian paradigm. First – and as already mentioned – there is nothing in Keynes's vision of how a market system works to insure continuously that total spending (or aggregate demand) will be at a level sufficient to provide jobs for every person able and wanting to work. Full employment, in other words, is not automatically attained. On the contrary, Keynes believed that "full, or even approximately, full employment is a rare and short-lived occurrence."[10] Keynesian theory thus stands 180 degrees at variance from the classical theory on the crucial issue of whether full employment is the norm for a market system.

The second conclusion, which follows logically from the first, is more far-reaching in its implication. If private spending by consumers and businesses is not sufficient to push the economy to full employment levels of production, then government should make good on the deficiency. This is the straight-forward policy message from *The General Theory*. What Keynes did was to provide the necessary intellectual justification – that is, the needed theory – for intervention by government into the workings of the market economy in order to achieve full employment. The triumph of Keynesian theory meant the end of *laissez faire* as policy, an event codified in this country by the Employment Act of 1946. This act explicitly

recognizes the federal government's responsibility for maintaining "maximum employment, production, and purchasing power."[11]

5. Keynesian Economics in Practice

So much for the basic theory of Keynesian economics. Of more critical importance is its validity and effectiveness. Economic theorizing is an attractive activity for many people, especially for the mathematically inclined, but it is also a pointless activity unless it is aimed ultimately at doing something about the economy's real problems. Experience over the long era of Keynesian ascendancy suggests three conclusions. First, World War II provided an unplanned, undesirable, but effective "laboratory" test for Keynes's basic proposition. As is generally recognized, it was the war, not Roosevelt's New Deal which ended the Great Depression. Once war came, public spending mounted rapidly and by 1944, the unemployment rate dropped to a record low of 1.2 percent. The injection of massive amounts of new public spending into the economy did the trick. There is little doubt that a depressed economy can be stimulated by Keynesian measures. An unfortunate byproduct of this experience was the emergency of "military Keynesianism." Joan Robinson argues, for example, that a major slump was avoided during the "Age of Keynes" primarily because of large scale government spending, made possible only because of a willingness of governments and the public to spend money on armaments.[12]

Second, the evidence is clear that the economy in the post-World War II era enjoyed greater stability and prosperity than in the earlier decades of this century. During the quarter century after the war – the "Age of Keynes" – real growth was higher than prewar, and variations in the rate of growth were smaller. The latter means that the business cycle, though not eliminated, was much tamer when compared to prewar. The late Arthur Okun

found, for example, that between 1945 and 1975 the typical expansion period lasted nearly twice as long (48 months) as did an upswing in the years between 1854 and 1937 (26 months). Postwar contractions were only about half as long (11 months) when compared to downswings in the same prewar time-span (21 months).[13] "This quantum jump in stability – this taming of the business cycle," Okun said, "Must, in my judgment, be credited to public policy. It was made in Washington."[14] Whether or not this postwar success is a direct result of Keynesian policies is a question scholars will debate for a long while.

Finally – and unfortunately – experience taught that Keynesian theory was asymmetrical.[15] By means of fiscal and monetary policy spending could be stimulated to bring the unemployment rate down, but when the policy machinery was thrown into reverse to combat inflation, the economy did not respond as expected. Rather than leading to an immediate fall in the inflation rate, a policy reversal caused output and employment to fall, thereby putting the economy into a recession but not ending inflation. Such has been the pattern since the end of the 1960s. Four times since 1969 administrations have attempted to slow the growth of money demand – i.e., spending – in the hope of slowing inflation, and each time the result was the same: recession and rising unemployment.

The earlier success of Keynesian economics in conjunction with its alleged failure to cope with inflation made economics ripe once again for a paradigm crisis. Keynesianism was now the established orthodoxy, and like classical economics, it was vulnerable to attack once anomalies appeared which it could not explain. In the contemporary scene, the major anomaly is, of course, inflation, which the critics say is not only a social and economic problem of major importance, but also one that Keynesian theory will exacerbate rather than cure. To this point, a Kuhnian scenario has been followed. But now there is a difference. In

Kuhn's scheme, the crisis is resolved when a *new* paradigm emerges to displace the older paradigm. But this is not happening in macroeconomics. Instead of revolution, we have counter-revolutions, attempting not only to displace the Keynesian paradigm, but contending with each other. They are "counter-revolutions," because, rather than take macroeconomic theory into new and unexplored territory, they look back to classical economics for ideas and inspiration. It is to these I now turn.

6. The Counter-Revolutions

Since 1945 three "counter-revolutions" have emerged to challenge the Keynesian orthodoxy, winning significant support among economists and some policy-makers. The year, 1965, was a pivotal year for these developments because it marked the beginning of the Vietnam escalation and the ensuing inflation which Keynesian-oriented policy-makers found so intractable. The counter-revolutions are, respectively, Monetarism, the New Classical Economics, and Supply-Side Economics. They are not the same, although they have common roots in the classical theory displaced by the Keynesian Revolution. In the time remaining, I shall sketch out, in a broad way, characteristics of each of these challenges.

a. <u>Monetarism</u>.

Monetarism – or the modern quantity theory as it is also called – is practically synonymous with Milton Friedman, Nobel Laureate and long-time Professor of Economics at the University of Chicago. Friedman, who never really accepted Keynesian theory, even though working within a Keynesian framework, argued consistently during his long professional career on the primacy of money in macroeconomic theory. When Keynesianism after 1965 seemed unable to control inflation, monetarism came into its own, gaining significant support within the economics profession.

What is the basic issue between the Monetarists and the Keynesians? In the income-expenditure version of Keynes – i.e., the post-World War II textbook model of Keynesianism – fiscal policy which operates through the surpluses or deficits of the federal budget is looked on as the primary means for controlling the level of aggregate demand (i.e., total spending). Friedman and the monetarists dispute this, asserting that the money supply provides a better link, not only to the price level as in the older, classical quantity theory, but also to output and employment – at least in the short run. To the extent this is the case, and to the extent that any policy actions are necessary, policy-makers are better off by manipulating the money supply rather than changing taxes or government spending in managing the economy.

The rub in the foregoing is the phrase, "to the extent that any policy actions are necessary." Contrary to Keynes and the Keynesians, Friedman and his disciples believe that a market economy is inherently stable, that the forces of the market are truly self-regulating. This being the case, the obvious question is how do the Monetarists account for the observed instability of the economy, for the presence of the business cycle since the Industrial Revolution? This answer, like all aspects of their theory, centers on money. Money and its management by governments is the real cause of instability. This is the basic conclusion Friedman reached in his massive empirical study, *A Monetary History of the U. S. 1867-1960.*

From the foregoing theoretical tenets, Monetarism derives its primary policy recommendation. To prevent instability, discretionary monetary changes by the monetary authority (the Federal Reserve in the U. S.) must be avoided. In place of discretion there should be a "monetary rule," one which would establish a fixed annual rate of growth for the

money supply. The rate selected would depend upon the growth rate for key long-term determinants of output, such as the labor force and technological change. Since Monetarists also believe that there is a long lag between changes in the money supply and prices, establishing a fixed rate of growth for money and sticking with it would insure the long run stability of prices. From October 1979 through mid-1982, the Federal Reserve opted for a quasi-Monetarist position, not in the sense of abandoning discretion in policy, but in focusing on the money supply rather than interest rates as a policy target. Inflation has come down, but at a cost in terms of unemployment and lost output which many economists consider too high.

b. The New Classical Economics.

Far more sweeping in its implications for macroeconomic theory and policy is the radical counter-revolutionary challenge to Keynesianism which Professor James Tobin of Yale University calls the "New Classical Economics."[16] Intellectually it is the most powerful of the challenges to the Keynesian orthodoxy, a fact which makes it highly attractive to many economic scholars. It was the late Harry Johnson who pointed out that a necessary characteristic for a new economic theory seeking to displace an older economic theory is a sufficient degree of difficulty.[17] It must be difficult enough to discourage senior colleagues from attempting to understand it, but not so difficult as to prevent younger scholars from mastering it with a reasonable intellectual investment. Johnson saw this as one of the reasons for the success of Keynes's theory, but the New Classical Economics also meets this requirement.

Basically, the New Classical Economics is a marriage of two ideas, one essentially new and the other older and drawn directly from classical economics. These ideas are the

theory of *rational expectations* and the theory of *continuous market-clearing*. Both are subtle theories, not easily reduced to a few sentences. The rational expectations hypothesis (REH) starts with the common sense proposition that our expectations about the future affect the decisions we make today. The crucial question for economics is how people form their expectations. The answer of the rational expectations school is that economic agents (there are no flesh and blood people in the REH literature, only "agents") form their expectations using all available information and they use this information efficiently. There is nothing particularly novel in this, except that it is assumed that the knowledge includes an understanding of how any governmental policy measure will affect the economy. In the jargon of economics, it is assumed that agents have knowledge of the relevant economic model used by policy-makers. The significance of their argument is that any policy actions by government will be ineffective, the reason being that policy results are anticipated by being incorporated into the information used in forming expectations. In short, governmental policy won't work, unless people don't have accurate information. This is interpreted by proponents of the rational expectations school to mean that the only way a government can make policy work is to fool people systematically, not a pleasing idea for a democracy.

Expectations don't exist in a vacuum. They are acted on in the real world economy through market decisions. This is the point at which the other part of the New Classical Economics enters the picture, the theory of *continuous market-clearing*. The idea behind this is that markets are efficient, which is to say that prices established will not lead to either a surplus or shortage of whatever is being traded in a particular market. In a market which is efficient in this sense, all relevant information known to buyers and sellers is reflected in price which clears the market. The efficient market theory was applied initially to financial

markets – stocks and bonds – but the New Classical Economics has taken it over and applied it to all markets, including the market for labor. Essentially, this is a restatement of the classical view that all markets are competitive and all prices are flexible. When this is combined with rational expectations, the result is a view which holds that the economy is self-regulating, that full employment is the norm, and that any governmental intervention into the economy will be counter-productive. Fluctuations in real variables – output and employment – when not caused by governmental mismanagement, result solely from insufficient or inaccurate information. Basically, the New Classical Economics abolishes macroeconomic theory.

c. Supply-Side Economics.

The third counter-revolutionary challenge to the Keynesian paradigm, Supply-Side Economics, is the one best known to the public, primarily because it provided the rationale for the Reagan administration's massive tax cut in 1981. It also has the least substance of the three challenges discussed, being primarily a creation of the news media, rather than a product of serious economic scholarship. Simply put, Supply-Side Economics combines a belief that all productive effort is inversely related to taxation with a faith in Say's Law of Markets.

The first proposition is the message provided by Arthur Laffer's now-famous curve, originally sketched out on a napkin in a Washington, D. C. restaurant. Laffer, a University of Southern California economist, argues that a cut in taxes will result in a near miraculous burst of production and growth. The supply response to a tax cut will be so great that government revenues would actually increase. Also there is no need ever to worry about selling the added output, for, as George Gilder says in his book, *Wealth and Poverty*, the

definitive statement of the supply-side philosophy, "the essential thesis of Say's Law remains true: Supply creates demand. There can be no such thing as a general glut of goods."[18] The tax cuts of 1981-83 provided as near a "laboratory" test for an economic theory as we are likely to get. Supply-side economics failed the "test" miserably; instead of growth and rising revenues, we got near-depression conditions in 1981-82 and staggering deficits for the foreseeable future.

7. Concluding Comments

In concluding my comments I wish to make a few broad observations on the ultimate resolution of the crisis in macroeconomics. That there is such a crisis I do not deny. But I don't believe any of the three counter-revolutions just discussed will succeed in becoming the new world view for macroeconomics. There are several reasons for this. The ultimate test of the validity of any economic paradigm is not its theoretical elegance, but its success or failure in the policy realm. It must address itself to and offer solutions for crucial economic problems. Harry Johnson has said that *The General Theory* was successful because it had something sensible to say about a major problem, mass unemployment.[19] Monetarism promises in the long-run to solve the inflation problem, but its short-term costs of high unemployment and lost output are a price society is unwilling to pay. Supply-Side Economics simply can't deliver what it promises. As to the New Classical Economics, it denies the historic reality of a system of market capitalism constantly in flux, never in equilibrium, always moving between boom and bust. There is nothing in this paradigm to explain the *observed* existence of rising prices and wages alongside high unemployment and excess capacity. As James Tobin suggests, the New Classicals seek to bend the real world to

fit their paradigm, rather than construct a model which explains the economic world in which we really live.[20]

I believe that ultimately a new and more satisfactory macroeconomic paradigm will come from an entirely different direction, a direction now being charted by a small and still heterogeneous group of economists known as the "Post Keynesians." Currently, neither their names nor their ideas are well known to the public, or even within the economics profession for that matter.[21] But this will change. Their goal is to develop a macroeconomics suitable for the world as it really exists, not as it might exist if the assumptions of classical economics were really true. They carry the label "Post Keynesian" because in part they look to neglected elements in *The General Theory* for an understanding of how the economy really works. They contend that the standard post World War II interpretation of Keynes – the income-expenditure approach described earlier – overlooks many of Keynes's keener insights into the actual workings of market capitalism. Those include, for example, seeing capitalism as an economic system operating in real, historic time, not as a timeless equilibrium system; understanding the crucial role that expectations rooted in uncertainty play in capitalistic behavior; and paying attention to how money and financial institutions are a major factor in the endemic instability of the system. In the real world economy many key prices and wages are set administratively rather than in competitive markets, a fact largely ignored in the classical analysis, but not by the Post Keynesians. Perhaps the major and most important way in which the Post Keynesians differ from classical economics is in their time perspective. Classical macroeconomics is essentially long-term analysis, but as Keynes said in a famous passage, the ". . . long run is a misleading guide to current affairs. *In the long run* we are all dead. Economists set themselves too easy, too useless a task if in tempestuous

seasons they can only tell us that when the storm is long past the ocean is flat again."[22] This is sound advice which we should heed today.

Footnotes

1. Hyman P. Minsky, *John Maynard Keynes* (New York: Columbia University Press, 1975), p. vii.

2. Thomas Kuhn, *The Structure of Scientific Revolutions* (Chicago: University of Chicago Press, 1970), p. 10.

3. John Maynard Keynes, “A Self-Adjusting Economic System,” *The New Republic*, Feb. 20, 1935, pp. 35-37.

4. Sir John Hicks, *The Crisis in Keynesian Economics* (New York: Basic Books, 1974), p. 1.

5. John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (New York: Harcourt Brace Jovanovich, 1964), p. v.

6. John Maynard Keynes quoted in R. F. Harrod, *The Life of John Maynard Keynes* (London: Macmillan & Company, 1951), p. 462.

7. John Maynard Keynes, *The General Theory*, p. 3.

8. No specific classical macroeconomic model as such can be found in any of the writings of the classical economists. It was only after the appearance of *The General Theory* that economists did turn to the writings of the classical theorists and began to construct models which might be compared with the Keynesian model.

9. John Maynard Keynes, *The General Theory*, p. 4.

10. John Maynard Keynes, *The General Theory*, p. 250.

11. *The Employment Act of 1946*, Public Law 304, 79th Congress, 2nd Session.

12. Joan Robinson, “The Second Crisis in Economic Theory,” *The American Economic Review*, May, 1971.

13. Arthur Okun, “Postwar Macroeconomic Performance,” in *The American Economy in Transition*, Martin Feldstein, ed. (Chicago: University of Chicago Press, 1980), p. 163.

14. *Ibid*.

15. Milton Friedman and Anna J. Schwartz, *A Monetary History of the U. S., 1867-1960* (New York: National Bureau of Economic Research, 1963).

16. James Tobin, *Asset Accumulation and Economic Activity* (Chicago: University of Chicago Press, 1980), p. 20.

17. Elizabeth S. Johnson and Harry G. Johnson, *The Shadow of Keynes* (Chicago: University of Chicago Press, 1978), p. 188.

18. George Gilder, *Wealth and Poverty* (New York: Basic Books, Inc., 1981), p. x.

19. Elizabeth S. Johnson and Harry Johnson, *op. cit*., p. 186.

20. James Tobin, *op. cit*., pp. 33, 43.

21. Some of the economists associated with the Post Keynesian movement include Hyman Minsky, Joan Robinson, Nicholas Kaldor, Sidney Weintraub, Paul Davidson, and Axel Leijonhufvud.

22. J. M. Keynes, *A Tract on Monetary Reform*, reprinted as Vol. IV of *The Collected Writings of John Maynard Keynes* (London: Macmillan & Company, 1971).

In the modern economy there are two sets
of basic forces contending with one another and through
which the economy works. There are those which center on competition
and market relationships, and those which center on power and power relationships.

Wallace C. Peterson

LECTURE 2

ECONOMIC STABILIZATION AND INFLATION

Wallace C. Peterson

(Delivered on May 8, 1984)

For nearly two decades the United States and other major industrial democracies have struggled to reach full employment without inflation. None have succeeded, a failure that has caused both laypersons and professional economists to question the wisdom of much contemporary economic theory as well as the policy measures based upon this theory. Since the failures of the 1970s followed a quarter century (1945-1970) in which Western nations successfully managed their economies on the basis of Keynesian principles, it was inevitable that the failure in the 1970s to contain inflation while striving for full employment be laid at Keynes's doorstep. More recently, however, contemporary monetarism and supply-side economics, theories which reach back to pre-Keynesian classical ideas for their inspiration and substance, have been brought to bear on the problem. They, too, have been found wanting. Recently, the inflation rate has been brought down sharply from the double digit levels which prevailed as the 1970s ended, but the cost of this was a severe recession and the highest unemployment since the Great Depression of the 1930s. So the question remains: is

it possible for systems of market capitalism to enjoy simultaneously full employment and stable prices?

This is the problem discussed in this lecture. My procedure is relatively straight-forward. First, I shall discuss our recent experience with inflation and its causes. After that, I shall examine some policy proposals appropriate to the 1980s, policies which will lead to full employment without inflation, a goal which to date has eluded our grasp. I will conclude with a few observations on some basic economic changes we will have to make to put the house of our mixed economic system in order.

1. The Legacy of the 1970s

It is well recognized by now that the roots of the inflation which plagued the economy in the 1970s had its origins in the Vietnam War. The impact of military spending for Vietnam in 1966 and subsequent years provides a near perfect "textbook" case of how *not* to manage the economy. Consider the following: in 1966 when the Vietnam build-up began, the unemployment rate was 3.8 percent, slightly below the targeted Kennedy-Johnson full employment figure of 4 percent; the Federal Reserve capacity utilization rate in manufacturing was 91.7 percent, a figure not equaled before or since in the post-World War II period; and there was practically no inflation, the annual percentage change in the CPI for the prior six years being 1.3 percent.[1] The picture is one of the economy being as near to a full utilization of all its resources as is possible other than in the circumstances of an all-out World War II style mobilization.

Whether or not the Johnson administration deliberately underplayed or underestimated the size of the military build-up – 1966 was an election year – is a matter to be left to the historians. What we do know *ex post* is that federal defense spending jumped

$10.9 billion during the year, a sizable increase under full employment conditions. The proper policy response should have been an immediate tax increase of equal or greater magnitude, a course of action urged upon the administration by the nation's leading economists.[2] The administration chose to ignore this advice, hoping, perhaps, that the war would be resolved quickly and it would be spared the painful task of asking for a tax increase.

No one knows, of course, if economic events in the 1970s would have been significantly different had the Johnson administration chosen to act decisively during 1966 and requested the tax increase called for by the circumstances. By 1966, primarily because of the success of the 1964 Kennedy-Johnson tax cut, there was widespread public acceptance for the macroeconomic theories and policies which were taught after World War II in a majority of the nation's colleges and universities. The failure of the administration to reverse course in 1966 and apply the remedy of a tax increase, painful as this would have been politically, turned out to be extremely costly, not only for the economy, but also for the economics profession. Given the fact that there is evidence that when a tax increase finally did come in 1968, it worked as the theory predicted.[3] It is not unreasonable to conclude that prompt enactment of a tax increase during 1966 might have kept inflationary pressures in check, and even, perhaps, prevented the collapse of the administration's wage-price "Guideposts" policy.[4] For the economy the price for this policy failure was the inflation of the 1970s; for the economics profession the price was lost credibility, a blow from which it has not yet recovered.

All the foregoing is speculation. What actually happened is also well known. Although mild in comparison with recent experience (1979-81), prices jumped significantly

under the stimulus of excess demand. Between 1966 and 1969 the economy experienced a classic "demand-pull" inflation, one which saw prices rising at a 6.1 percent annual rate by the end of the period. Thus, the stage was set for the dismal "stop and go" performance of the 1970s.

By 1969, the stimulus to expansion from the war in Vietnam was over, but the inflation continued. Why the inflation continued once the Vietnam war build-up ended is a question I shall address shortly. As a consequence, however, ending inflation became a prime policy objective of every administration from Nixon through Reagan, with each administration following essentially the same pattern. Whenever the inflation rate accelerated (as it did in 1969, in 1973, and in 1980), the standard response was to apply the monetary and fiscal brakes with the results always the same. Fiscal and monetary restraint plunged the economy into a recession, as happened in 1970, 1974-75, 1980 and again in 1981-82. Unemployment rose and the inflation rate came down, although usually the latter lagged a year or so behind the recession and rising unemployment. "Stagflation" is the unlovely term coined to describe this situation. The Reagan economic experiment fit this pattern. A restrictive monetary stance was a key element in the Reagan program, and as happened three times previously, the result was recession.

What is not clear as the economy moves into a new expansion following the fourth measurable recession since 1969 is whether this pattern will continue into the future. The restrictive policies of the Reagan administration led to the same results prior administrations experienced, but with an important exception. And this is that the inflation rate came down more rapidly and sharply than in any of the three prior recessions, a development which has led some economists to believe that the inflation's upward momentum has finally been

broken. Whether or not this is true, still remains to be seen, but it is not difficult to pinpoint the reasons for the sharp decline in the inflation rate. First, the 1981-82 recession was the most severe since the Great Depression of the 1930s, at least as concerns the unemployment rate. The latter reached 10.7 percent in December, 1982, the trough of the recession.[5] Second, the economy for all practical purposes had been in a stagnant condition for four years, industrial production having been either flat or declining since 1979. Since President Reagan's restrictive policies were applied to an economy suffering from what Keynes would have described as an "underemployment equilibrium," it should not come as any surprise that there was a weakening of prices, even given the strong oligopolistic structure and administered price behavior in the strategically important sectors of the economic system. Finally, the disarray in OPEC and plentiful food supplies kept the rate of increase in energy and food prices – two key elements in the CPI – far below what it had been in the prior three recessions.[6]

What general conclusions can we draw from the 1970s experience? First, it should be obvious by now that neither monetarism nor supply-side economics has the answer to the economy's *systemic* excess of both inflation and unemployment. It is clear that restrictive monetary policies will slow down the inflation rate, but the price is recession and excessive unemployment. Monetarism's implied promise is that by strict adherence to the monetary rule inflationary expectations can be reduced quickly, thereby obviating the necessity for any lengthy period of high unemployment. This has not happened. The unannounced shift of the Federal Reserve in mid-1982 from targeting the money supply to targeting interest rates represented tacit admission of monetarism's failure. As for supply-side economics, it is obvious that the expected burst of productive activity and growth which was supposed to

flow from the 1981 tax cuts never materialized. Instead, the tight money policy pursued during the first 10 months of 1981 pushed the economy into a deep recession long before the effect of any tax cuts were felt.[7]

What is surprising in view of the record of the 1970s is that any serious economic observer would expect anything different to happen. What is also discouraging, though not necessarily unexpected, given the contemporary conservative orientation of the economic profession, is the failure of mainstream economists to point out what ought to be obvious: the recent recession, like all post-war recessions, did not turn into a major depression primarily because of: (1) the sheer size of government and the stabilizing role such size imparts to the economy, and (2) the magnitude of social spending by the federal government, spending which sustains personal incomes and spending power in the face of an economic downturn. There is irony in this because the Reagan administration, which has not hesitated to claim full credit for the recovery, although disdaining any responsibility for the recession, has made "big" government and "excessive" social spending prime targets for reduction. Furthermore, as the recovery proceeded through 1983, it acquired a distinctly Keynesian flavor. Little was heard during the spring and summer about supply-side incentives being at work, but the tax cut was praised for its favorable impact on consumer spending, particularly for houses and automobiles.

A second point concerns unemployment. The secular upward drift in the unemployment rate since the late 1960s confirms that something more is involved than cyclical fluctuations in the jobless rate. What we are seeing is a growing inability of the economy, even under the best conditions, to provide jobs for all persons able and seeking work. Conservatives have to a considerable degree chosen to sidestep the issue, primarily by

redefining upward the acceptable rate of unemployment that can be achieved through macroeconomic policies without causing a resurgence in inflation. The Reagan administration's Council of Economic Advisers puts what it terms the *inflation threshold* – the point at which inflation increases with further reductions in unemployment – in the range of 6 to 7 percent.[8] What the 1970s experience confirms is that if the economy is stimulated by conventional means, namely an expansionary monetary and fiscal policy, prices respond more quickly than does the unemployment rate. The problem is to discover both reasons and remedies for this, a central objective of this lecture.

Our final observation at this point is related directly to the foregoing, taking us to the heart of the problem. By the end of the 1960s the character of the inflation underwent a basic change, from a "demand-pull" inflation to one of the "cost-push" variety. The evidence? Simply put, an inflation which persists and even accelerates at times in the face of continued (and even growing) slack in the economic system can only be accounted for in "cost-push" terms. For evidence on the slack state of the economy during the 1970s, we need only point to the fact that capacity utilization was below the average of the prior two decades, unemployment was on average significantly higher than in either the 1950s or 1960s, and the "gap" between potential and actual output was greater on average than it was in the 1950s.[9] The crucial question, the issue to which I now turn, is how can we account for the persistence of inflation in the face of such tendencies toward chronic stagnation?

2. The Roots of Inflation

If we leave aside the clear case of an inflation caused by excess demand under full employment conditions (the situation from 1966 to 1969), we are left with two contending explanations. The one is the modern quantity theory, fathered by Milton Friedman, and the

other is the explanation offered by Keynes in *The General Theory*, an explanation which, inexplicably, has been seriously neglected.[10] Of the two, it is my contention that Keynes's approach provides the best explanation for the events of the 1970s.

As is well-known, the modern quantity theory maintains that the money supply is the primary determinant in the short-run of not only the price level, but also output and employment. Numerous statistical studies have shown that there is a close correlation between money (however defined) and the general level of economic activity, a result not unexpected since in a money-using society little can be done without the use of money. But what such studies do not – and probably cannot – resolve is the causation problem. Is the direction of causation from money to action to output and prices, or the other way around, from action to money, and then to prices and output? A literal interpretation of monetarist theory holds the first to be true, namely that it is the availability of money which necessarily precedes and triggers the decision to act. Such a viewpoint, however, stretches credulity, especially in view of the fact that the overwhelming bulk of whatever passes for money in contemporary society comes into existence because some entity – consumers, business firms, or governments – has decided to do something, the doing of which requires the spending of money. If the money is not available from current income flows, borrowing will take place; consequently, the money supply will expand. In even the most elementary textbook treatment of the expansion and contraction of demand deposit money, it is clear that the only thing that the central bank can ultimately control is the monetary base, namely the reserves of the banking system. Whether or not there is an actual expansion of money in circulation *always* depends upon the willingness of the public (and the government) to borrow.

Observation and common sense tells us that "willingness to borrow" must of necessity be preceded by the decision to act, to do something tangible.

In her now famous Ely Lecture to the American Economics Association in New Orleans in 1972, the late Joan Robinson pointed out that in *The General Theory* Keynes not only explained how the level of output is determined by investment and consumption spending, but that his analysis also made it clear that "if continuous nearfull employment was maintained without *any change in traditional institutions and attitudes in industrial relations*, there would be an irrestible pressure to inflation."[11] It was this element in Keynes which, she said, was swept under the rug. Continuing she went on to say:[12]

> It seems that the extraordinary vogue in recent years of an argument so implausible as the Quantity Theory of Money was due to a refusal to accept the fact that the main influence on the general price level in money terms is the level of money wage rates and the level of wage rates at any moment is more or less an historical accident, depending upon conditions in the labor market over a long past. This was such a serious blow to notions of equilibrium and the rationality of a market economy that any theory was better, even a theory that consisted of a set of incantations.

Not only do her biting remarks represent an outright rejection of monetarism as a satisfactory theory of the price level, they succinctly state the essence of Keynes's own explanation for aggregate pricing behavior. In Chapter 21 ("The Theory of Prices") in *The General Theory* Keynes argued that there was a false dichotomy in the classical economics, the dichotomy being that at the level of the individual firm and industry – the microeconomic level, in other words – economists resorted to one kind of theory to explain prices, but when they passed to the economy as a whole, they looked to an entirely different theory. In the first instance, Keynes said, prices in a single industry depend partly upon the rate of remuneration of the factors of production which enter into *marginal* cost and partly on the

scale of output. In the second instance, however, it is argued that prices in general depend upon the quantity of money. What was necessary, he argued, was an escape from this "double life," one which would show that the same forces which determine prices at the microeconomic level also account for the overall behavior of prices.

The details of the argument Keynes developed need not detain us. His broad conclusions are, however, crucial. As economists have long taught, individual prices are determined by conditions of supply and demand in competitive markets, a point of view which Keynes did not challenge, and a point of view representative of current microeconomic thinking. What is crucial are marginal costs. Their general level is determined primarily by money wages whereas their behavior as output changes depends upon the *scale* of output in the short-run and upon productivity changes in the long-run. Here we have the gist of Keynes's thinking on the determination of prices at both the micro level and for the economy as a whole. For the long-term his basic conclusion was:[13]

> The long run stability or instability of prices will depend primarily on the strength of the upward trend of the wage-unit (or, more precisely, of the unit cost) compared with the rate of increase in the efficiency of the productive system.

Restated, the essence of the argument is that in the absence of a situation which clearly can be defined as one of demand-pull, the primary determinant of the economy's basic inflation rate is the relationship between the rate of growth of money wages and the rate of growth of productivity. The first is what Keynes meant by the "upward trend of the wage-unit" and the second is what he meant by "increase in the efficiency of the productive system." The basic inflation rate refers to general changes in prices which grow out of the interaction of demand and supply forces at the level of the firm and industry. It is termed

basic because in the absence of random shocks, such as the four-fold increase in energy prices engineered by OPEC in 1973 or large increases in aggregate demand, the overall price level must be explained by the same forces which determine prices at the firm and industry levels.

3. The Theory and the Evidence

The foregoing gives us the bare bones of Keynes's basic explanation for inflation, an explanation which he believed provided the necessary linkages between the determination of prices at the level of the firm and industry and the determination of prices in general. Restated simply as possible, the theory holds that the economy's basic inflation rate depends upon unit labor costs, which in turn depend upon the relationship between changes in money wages and changes in productivity. At this point, I wish to examine briefly the available statistical evidence from the past 22 years to determine how well the theory fits the facts of experience. This will set the stage for some policy recommendations.

In Table 1 at the end of the lecture we find data for five year intervals for the period, 1960-1982, which shows annual average rates of change in the strategic variables which enter into this approach. The variables include productivity, compensation per hour, unit labor costs, and two inflation rates, the GNP deflator and the consumer piece index.

The story told by these data is direct. First, they show clearly the pronounced deterioration in the rate of growth of productivity in the American economy, a phenomenon noted by economists of every persuasion, but for which there is no agreed-upon explanation. Second, money wages (including fringes) grew at an accelerating pace during the period, even though the 1970s were marred by three recessions. Third, the combination of deteriorating productivity growth and escalating money wages had its inevitable effect, an

acceleration in the rate of growth of unit labor costs. Finally, and not unexpected, given the widespread practice of mark-up pricing in industry and commerce, prices as measured by either the GNP deflator or the CPI rose almost in direct proportion to the rise in unit labor costs. In the absence of significant shifts in the distribution of factor income as between labor and property sources, there is no alternative but for prices to rise in approximately the same proportion as unit labor costs.

We should also note that these data reflect the basic relationships which were embodied in the "Guideposts" for noninflationary wage and price behavior initially developed by the Kennedy administration in 1962. In the 1962 *Economic Report of the President*, Kennedy's economic advisers said that:[14]

> If all prices remain stable, all hourly labor costs may increase as fast as economy-wide productivity without, for that reason alone, changing the relative share of labor and nonlabor incomes in total output. . . . If hourly labor costs increase at a faster rate than productivity, the share of labor income in the total product will increase or prices will rise, or both.

The latter, of course, is what actually happened in the period covered by the data in Table 1. Before turning to some questions which the data raise but do not answer, one point of clarification is in order about the relationships contained in Table 1. They do not imply that workers, because they push for higher wages, are the basic cause of inflation. Money wages may lag significantly behind changes in the price level, as actually has been the case over the last decade, leaving workers in the position of trying to play "catch-up" with respect to their real wages.[15] Yet the relationship between wages, productivity, and the inflation rate is fundamental. This is a matter of arithmetic, not an issue of causation.

The foregoing discussion offers solid support for the view of Keynes, Joan Robinson, and others that the level of money wages is the prime determinant of the

economy's basic inflation rate. In contrast, let us note that there is practically no statistical correlation between the rate of growth of money (M1) and the inflation rate for the period covered by the data in the Table. If there is any validity to the modern quantity theory there should be some relationship.

What is left unanswered by the data, however, is what determines the level of money wages at a particular time. Joan Robinson said that this level at any particular time is more or less an historical accident. True enough, but we still need to be more specific, particularly with respect to the rate of increase. The question of why money wages were able to rise almost continuously given the depressed state of the economy during much of the period must be answered. This is crucial both for understanding the inflationary process and ultimately for policy actions.

Until the economy encountered the chaotic conditions of the 1970s, the most widely accepted view of how the rate of increase for nominal or money wages is established was embodied in the concept of the Phillips curve. As is well-known among economists this curve shows that traditionally the growth in money wage rates was inversely related to the unemployment rate. A low unemployment rate was associated with a rapid rate of increase in money wages, and the reverse prevailed when the unemployment rate was high. The Phillips curve is a device for describing the state of demand in the economy's labor markets. It says simply that when the demand for labor is high (unemployment low), there will be strong upward pressure on wage rates as workers take advantage of favorable economic conditions to improve their economic status. When demand is slack (unemployment high) the pressure on wages will recede. The Phillips curve analysis has always recognized that this relationship was asymmetrical, since workers strongly resist wage cuts, a condition

which Keynes also stressed in *The General Theory*. Consequently, a rise in unemployment may not lower the rate of increase in money wages as much as a reduction in unemployment increases it.

The problem is that this standard version of the relationship between changes in money wage rates and the unemployment rate does not adequately explain what happened in the 1970s, nor can it explain what had happened more recently as a result of the policies of the Reagan administration. To complete this theoretical framework and relate it to the facts of experience, we must take into account two additional variables. These are: (1) the expected inflation rate, and (2) the bargaining strength of workers. Essentially, the level of money wages in the economy is determined first by the wage bargains of workers with their employers. Such wage bargains are, of course, tempered by the general state of the economy, by whether labor markets are tight or loose (the Phillips curve analysis). But they also depend upon the foregoing additional factors, namely expected inflation and bargaining power. Once the economy has moved from a state of price stability (1960-65) to a period of rising inflation (1966-69), it is logical to expect that expectations about future inflation rates would enter into the wage bargaining process. The extent to which workers can translate their nominal wage demands, including a premium for expected inflation, into contract agreements will depend obviously upon their bargaining power, given the overall state of demand for labor. Thus, we can say that at any given time, and given too, the background of the historical level of wages, the *actual* rate of increase in money wages depend upon an interaction between the foregoing three factors: (1) the state of labor markets; (2) the expected inflation rate; and (3) bargaining strength. These are the forces which were at work all through the 1970s.

This analysis means that the economy confronts a troublesome dilemma. To bring inflation down in the face of a strong bargaining position on the part of workers requires that the *expected* inflation rate be lowered since the latter is a crucial variable which enters into the wage bargain. But this can be done only by lowering the inflation rate itself. Thus, is the dilemma, the vicious circle in which the economy is caught. To date the only way we have found to break out of this vicious circle is to create a recession of sufficient length and severity that weak labor markets and their ensuing downward pressure on wages will overcome the upward pressure on wages generated by past inflation and bargaining power. Recessions eventually work their will on labor markets, hourly rates of change in worker compensation, unit labor costs, and eventually prices, but the price is high – millions without work and billions of dollars in lost output.

4. Some Policy Suggestions

This brings us to the fundamental question of what is to be done? What policy options are viable for the American economy? A careful analysis of and reflection upon the economy's behavior and the alleged policy failures in the recent past suggest two practical approaches to the economic management of our society which ought to be vigorously pursued. First, we must develop a new policy tool, and second – and more important – we must change in a fundamental way our conception of how Keynesian ideas should be applied to managing the macroeconomy.

One of the major post-World War II failures of "mainstream" economics – including "Keynesian" economics as taught in the textbooks – was the failure to recognize that a serious inflationary problem would arise out of the combination of sustained full employment and the concentration of economic power in strategically important areas of the

economy. As Thomas Balogh, a leading British economist, points out, market power lodged in the giant corporation enables it to shift readily onto prices the burden of increased wages, the latter being determined in many instances by powerful trade unions.[16] What is called for is a workable incomes policy.

An incomes policy is easy to define but difficult to implement. In its essentials an incomes policy involves finding the means to keep increases in money incomes within the bounds set by productivity gains. Ideally, an incomes policy should encompass *all* forms of money income, including profits, but as a practical matter a workable incomes policy will probably be limited to changes in money wages. But since wages make up nearly three-fourths of the national income and thus are the major element in production costs, an incomes policy built around wage income alone has the potential to control inflation.

By now the need for an incomes policy should be obvious, although it is by no means clear that even a majority of economists are willing to endorse the concept. Within the present institutional framework, modern governments have only two major tools to call upon for managing the economy, namely fiscal policy and monetary policy. The experience of the 1970s makes it apparent, however, that an incomes policy has become a badly-needed complement for the standard monetary and fiscal measures, at least if any attempt is to be made to pursue an aggressive full employment policy. Given the brute fact of market power, and as the experience of the 1970s demonstrates, it is impossible to use conventional monetary and fiscal means in pursuit of full employment without having in place an incomes policy to contain the pressures on the price level any expansion may set loose. And as the 1970s also demonstrated, this pressure becomes manifest and well-nigh irresistible long

before the economy reaches full employment, even by the lax standards conservative economists accept these days.

At the moment there is no agreement among economists as to how an incomes policy should be constructed. Basically, there are two approaches, one involving using the tax system and the pricing mechanism to get the desired results, and the other involving direct control over price and wage decisions in the strategic sectors of the economy where oligopolistic firms dominate and wage settlements are reached under conditions resembling bilateral monopoly. TIP, standing for "tax-based incomes policy," is the acronym used to describe the first approach. This may involve a "carrot" version in which corporations and wage-earners get tax refunds if they adhere to a designated set of wage and price guidelines, or a "stick" approach in which they are subject to tax surcharges if they fail to adhere to the guidelines. The appeal of TIP stems from its indirect approach, one of using the market to obtain the desired results. On the other hand, direct control over wages and prices in sectors with a high degree of concentration substitutes the judgment of public officials for private judgments, the reason being that most prices (and wages) in these sectors are established administratively, rather than by the impersonal forces of the market.

While an incomes policy is the missing element in the Keynesian policy triad, and, without it we cannot make headway toward the desired goals of full employment and price stability, something more is required. We need to rethink in a fundamental way the meaning of Keynesian theory and its application to the management of the economy. Only if this is done will it be possible to attain greater economic success than heretofore, even within the constraints of existing institutions.

The conventional wisdom with respect to the uses of Keynesianism in the post-World War II era – a view accepted pretty much by liberal and conservative economists – runs somewhat as follows. As suggested in the opening paragraph of this essay, the quarter century after the end of World War II is seen as an era of economic success, much of which is attributed to the successful application of Keynesian ideas for managing the economy. Sir John Hicks has called this period the "Age of Keynes," but also noting that while many judge the era as having been one long boom, it is an open question as to how far this economic success was due to Keynesian policies.[17] In the United States, in any event, Keynesianism came into its own in the 1960s with the advent of the Kennedy administration and its commitment to an active policy of demand management. The high point came with the success of the 1964 tax cut. Even President Nixon was moved to proclaim early in his first term, "I am a Keynesian." And then came the 1970s and the twin disasters of excessive unemployment and excessive inflation. Consequently, and just as Keynesianism was given credit for earlier successes, now it was accorded the blame for rising unemployment and the failure to curb inflation. "Federal economic policies bear the major responsibility for the legacy of stagflation," President Reagan's Economic Advisors said in their 1982 *Report*.[18]

The difficulty with the widely-accepted conventional view that Keynesianism has failed is that it is wrong. It is wrong because Keynesianism in the best sense of the word has never been fully tried in the American economy. When the Full Employment Bill (which later became the Employment Act of 1946) was introduced into the wartime Congress in 1944, the bill as the title suggests, embodied a strong commitment to full employment and conscious economic planning. Using the powers of the government to guarantee jobs for all was seen by the bill's supporters as the essential, bedrock element in Keynesianism. What

happened, however, was that the commitment to a full employment economy was too much for conservatives, who saw such a commitment as socialistic and a threat to the free enterprise system. As a result, the bill which finally emerged from the Congress – the Employment Act of 1946 – contained little more than a symbolic commitment to full employment. As a matter of fact, the phrase “full employment” does not appear in the Act.

The change in language between the original Full Employment Bill and the Employment Act is more than a matter of semantics. The essential difference is between the belief of Keynes and his supporters that government should be used to ensure full employment which in turn would produce economic growth, and what is basically the conservative viewpoint that economic growth in the private sector is what will ensure full employment.

The logical outcome of this was that economic growth in the private sector became the primary means by which full employment was to be generated in the postwar era. Once Keynesian economists had yielded through changes in the language of the Employment Act on the fundamental promise that the full power of the state would be used to attain full employment, the only way left to secure the jobs for all was by generating expansion in the private sector. The basic thrust of policies in the postwar era became “counter-Keynesian.” Instead of economic planning and government intervention on the supply-side to insure full employment, policy became oriented primarily to the expansion of the private sector, using demand management techniques as the major means to this end. The “politics of growth” replaced, in a sense, the “politics of Keynes,” even though the policies pursued were developed by well-known Keynesian economists and carried out under the Keynesian label.[19] Growth would not only provide full employment, but avoid the necessity of having to make

difficult and controversial decisions affecting income and its distribution. As long as growth continued, all was well, but once growth ceased as it did in the 1970s, the economy was in deep trouble.

How did all this come out in terms of policy specifics? It was not until John F. Kennedy became president that there was an administration which committed itself ostensibly to using Keynesian theory as a guide for economic management. The two crucial policy actions taken by this administration (including the successor Johnson administration) were the 1964 tax cut aimed at consumers and the introduction of the investment tax credit for business. These policies were important for two reasons. First, their primary objective was to encourage economic growth by applying a stimulus to the private sector. When faced with the various alternatives for "getting the economy moving again," President Kennedy opted for measures which would enhance the private sector, not the public sector.[20] Second, the pattern was set for the rest of the postwar era as to what it meant to use Keynesian theory for economic management: the emphasis was to be on the private sector with special efforts being made to stimulate investment through the device of investment tax credits. This is the essence of what is meant by the "counter-Keynesian" thrust of post-World War II policy.

If we grant this premise that post-World War II policy has in effect stood Keynes on his head (counter-Keynesianism), the logical question which follows is what policy mix within the framework of existing institutions would be truly Keynesian? Assuming that a workable incomes policy has been developed and put in place, the application of Keynesian theory to the overall management of the economy involves, at minimum, the following three propositions. First, full employment must become the bedrock policy objective. Without jobs for all who want them, little else in Keynesianism makes sense.

As a second proposition, the high-investment and high-profit strategy adopted during the Kennedy-Johnson years and pursued by every successive administration must be abandoned. Because the end objective of this strategy was to promote a high rate of economic growth, the abandonment of the strategy also means abandonment of "the politics of growth" which has dominated the postwar era. In its place, we should adopt a high consumption strategy, one designed to ensure minimal standards of well-being for all citizens, as well as enriched standards of community consumption. Such a view runs counter to the contemporary conventional wisdom to the effect that a major need of the American economy in view of its productivity crisis is to increase the rate of investment. Aside from the fact that the share of the GNP going into equipment investment did not decline as productivity was falling, there are two other weaknesses in this argument. First, the high investment strategy pursued through investment tax credits and other tax breaks for corporate enterprise did not succeed in increasing investment appreciably in the American economy. Second, it overlooks a fundamental point of emphasis in *The General Theory*, to wit, that the *raison d´être* for investment spending is the expectation of profit, which in turn depends upon the existence of a future demand for consumption goods. The best way to stimulate investment spending in a market economy is to stimulate consumption, not the other way around.

The final proposition concerns interest rates. If there is any single idea which Keynes propounded in *The General Theory* and adhered to throughout his life, it is the absolute necessity for interest rates to be (and remain) low if market capitalism is to function effectively. Keynes's belief that we might look forward to the "euthanasia of the rentier" may be, perhaps, too extreme a view, but there cannot be any quarrel with his steadfast belief

that interest rates should be kept low. Unfortunately, interest rates, both nominal and real, have moved in just the opposite direction since 1950; both short-term and long-term rates are now at levels never before reached in this century, a trend which runs 180 degrees counter to what Keynes believed necessary. Instead of moving in any sense toward the "euthanasia of the rentier," we have moved drastically in the opposite direction. In 1950, for example, interest income accounted for but 1.3 percent of national income; by 1982, this percentage had jumped to 10.9, a more than eight-fold increase in the share of income going to the rentier class. Since, as Keynes says, "Interest to-day rewards no genuine sacrifice, anymore than does the rent of land," we have an intolerable situation. Only the economically naïve still believe that the level of interest rates is governed by the interplay of supply and demand forces in competitive markets. Interest rates can – and should – be brought down, but not in isolation. The drive to lower interest rates must be a part of an overall effort to apply Keynesian theory to managing the economy in a manner not yet seriously attempted in the post-World War II era. It is not claimed that the propositions just discussed are the last word on "what Keynes really meant," but it is claimed that they are more nearly in harmony with the basic thrust and spirit of *The General Theory* than many of the actions taken in the postwar era described as "Keynesian."

5. Looking Toward the Long-Term

I shall bring these remarks to a close with a few comments on the long-term. The propositions discussed above are offered as basically a Keynesian-based program designed to make the economy perform better within the existing institutional framework. The demonstrated failures of monetarism, supply-side economics, and growth-oriented "counter-Keynesianism" of the 1960s and 1970s make a new approach essential.

It is important, however, that we don't overestimate the results that can be expected from attempting to make Keynesianism work in ways not yet attempted. The successes we can expect from implementing the propositions discussed in the prior section will be relatively modest, although clearly superior to the "stop and go" cycle of rising unemployment and rising inflation characteristic of the economy since the mid-1960s.

What we cannot realistically expect is that implementing the Keynesian ideas we have been discussing will provide a total solution to the fundamental dilemma confronting all market economies – how to get full employment without inflation.

This is the point at which more fundamental changes of an institutional and longer-term character enter the picture. If we are to improve and perfect the short-term management of the economy using standard Keynesian techniques, then we must direct our attention to basic change and reform in three areas. First, there is the question of jobs. Experience since the mid-1960s shows that we confront a rising level of joblessness which cannot be explained by the ups and downs of the business cycle. As presently structured, the economy is not able to provide jobs for all persons able to work and wanting employment. Keynesian measures such as discussed above do not provide the whole answer. In part this problem will be solved by recognition of the necessity for public employment as a permanent fixture of the economy.

Second, there is the matter of the distribution of income and wealth. We cannot continue indefinitely to sweep this basic issue under the rug, because it is one which goes directly to the nub of the problem of getting sustained full employment without inflation. As has been argued in this lecture, we must have an incomes policy, some set of arrangements whereby increases in money incomes are kept within the boundaries established by

productivity changes. However, for an incomes policy to be successful, there must be a rough consensus that the division between wage income and non-wage income is fair. In the absence of such consensus, the incomes policy will collapse, as labor and management pit their bargaining strengths against each other in a struggle to increase the relative share of each in the income total. This is what brought about the collapse of the Guideposts after 1966. To prevent an endless and fruitless "war" between labor and management over relative shares and the inflation which will follow in the train of such a "war," we need a new consensus on the distribution of the social product between wage and non-wage income – a "social contract." Without such a consensus, no incomes policy will be workable and the goal of full employment without inflation will continue to elude us.

Finally, the issue of the necessity for the attainment of a new "social contract" necessarily forces us to confront the fact of market power in economic relationships. In a narrow sense this involves the power of trade unions to bargain for money wages and the power of the corporations to set prices. In a broader sense we shall have to look at the entire institutional structure through which economic power manifests itself. In the modern economy there are two sets of basic forces contending with one another and through which the economy works. There are those which center on competition and market relationships, and those which center on power and power relationships. Conventional theory has taught us much about the way in which competitive forces working through markets affect economic activity, but we have only begun to scratch the surface in exploring the realm of power and power relationships and how they affect the economy. This is the task which awaits us.

Table 1

Productivity, Unit Labor Costs, and Inflation: 1960-82
(In percent, annual average rates of change)

Period	Productivity	Compensation Per Hour*	Unit Labor Costs	Inflation Rates GNP Deflator	CPI
1960-64	2.9%	3.9%	1.0%	1.2%	1.2%
1965-69	1.9	5.8	3.6	3.3	3.4
1970-74	1.4	7.5	6.0	5.3	6.1
1975-79	1.3	8.6	7.2	7.4	8.1
1980-83**	1.1	8.4	7.3	7.2	8.3

*Wages and salaries plus all fringe benefits, including employer contributions.
**Four year period.

Source: *Economic Report of the President*, 1984.

Footnotes

1. All figures are from the *Economic Report of the President* (Washington, D. C.: U. S. Government Printing Office, 1984).

2. A petition signed by over 1,000 economists urged this course of action on the administration.

3. Arthur M. Okun, “The Personal Tax Surcharge and Consumer Demand, 1968-70,” *The Brookings Papers on Economic Activity*, No. 1, 1971.

4. For details on the “Guideposts” policy, see *Economic Report of the President*, 1962, pp. 185-190.

5. *Current Economic Indicators*, May 1983, p. 12.

6. In 1974 energy prices rose by 29 percent and again by 23 percent in 1979, but in 1982 they rose by only 1.4 percent. For food, the price increases were 14.4 percent in 1974, 10.9 percent in 1979, and 4.0 percent in 1982. These data are from the *Economic Report of the President*, 1983.

7. From January to October, 1981, there was a steady decline in the rate of growth in the money supply. During this period the rate of growth for M1 fell from 10.3 percent in January to -0.2 percent in October.

8. *Economic Report of the President*, 1983, p. 37.

9. Data on unemployment and capacity utilization are from the 1983 *Economic Report of the President*. For a discussion of the “gap” analysis see the author’s text, *Income, Employment, and Economic Growth* (5th Edition; New York: W. W. Norton & Company, 1984).

10. John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (New York: Harcourt Brace Jovanovich, 1964), pp. 292-309.

11. Joan Robinson, “The Second Crisis in Economic Theory,” *The American Economic Review*, May 1972, pp. 1-10. (Italics added).

12. *Ibid*., p. 5.

13. John Maynard Keynes, *The General Theory*, p. 309.

14. *Economic Report of the President*, 1962, p. 186.

15. Between 1970 and 1982 hourly earnings in current dollars grew by 142 percent, but hourly wages in constant dollars fell by 2.5 percent. See *Economic Report of the President*, 1983, p. 206.

16. Thomas Balogh, “Is Keynes Dead?” *The New Republic*, June 7, 1980, p. 16.

17. Sir John Hicks, *The Crisis in Keynesian Economics* (New York: Basic Books, Inc., 1974), p. 3.

18. *Economic Report of the President*, 1982, p. 23.

19. Seymour Harris, Leon Keyserling, George Soule, and Alvin Hansen are among the Keynesian economists who pushed in the late 1940s for a program of full employment and economic planning as a means to implement Keynesian ideas in the United States.

20. This was a victory for Leon Keyserling who, as a member of the Democratic Advisory Council during the 1950s, argued that the most realistic way to implement Keynesian ideas was to cut taxes. John Kenneth Galbraith, also a member of the Council, favored an expansion of public spending. Galbraith lost the argument and President Kennedy, after being elected, followed Keyserling’s advice.

Reaganomics is not a single monolithic entity. It is a label attached to the pronouncements and policies of a diverse, shifting coalition of groups of economists and writers. Each group has a very different set of values, theories, and programs, and each group regards all the other groups with a thinly-concealed mixture of distaste, suspicion, and even hatred.

Murray N. Rothbard

LECTURE 3

THE FIVE FACES OF REAGANOMICS

Murray N. Rothbard

(Delivered on November 27, 1984)

"Reaganomics" is one of the most talked about phenomena of our times. Most people regard it as a monolithic entity, and vest it with the magical properties of King Canute trying to command the tides. But generally the tides proceed on their own, and so in most cases does the economy. To attribute everything that happened in the economy in the last four years, or that will happen in the next four, to "Reaganomics" is to grant it far too much power for good or for ill.

But, more than that, Reaganomics is not an "it" at all. Reaganomics is not a single monolithic entity. It is a label attached to the pronouncements and policies of a diverse, shifting coalition of groups of economists and writers. Each group has a very different set of values, theories, and programs, and each group regards all the other groups with a thinly-concealed mixture of distaste, suspicion, and even hatred. Usually, these antagonisms are papered over in the interests of influencing the policies of the Reagan Administration, but sometimes, as in the war between the monetarists and supply-siders, or, as in the open

brawling over the former chairman of the Council of Economic Advisors, Martin Feldstein, the quarrel bursts into public view.

Trying to analyze what is going on becomes more complicated when we realize that some highly placed leaders will shift their position toward the likely winners. Even more problems are created by the fact that each group tries to take full credit for the perceived successes of Reaganomics, while at the same time passing the blame for its failures on the shoulders of the other groups. Since the President is necessarily the ultimate decision-maker – at least officially – in the executive branch, each of the groups is careful never to criticize, much less denounce, the President personally even if their counsel is no longer heeded, the President like the kings of old, remains always a great and good man, temporarily and unaccountably surrounded by false and even evil advisers. With enough enlightenment and education, the President will surely come to agree, get rid of the false prophets, and replace them with the true ones (that is, the out-group in question). For each of these groups proclaims its loss of power to be only temporary. Soon they will be restored to the President's favor. And sometimes, this restoration may, even occur, or, as in the case of the lately resurgent supply-siders, may be *seen* to have happened, which may be at least as important in politics as what is actually going on.

In this murky and sometimes bizarre atmosphere of court intrigue, and shifting power blocs masked by public agreement, it is difficult for the analyst to try to figure out what is actually going on. But still we will plunge fearlessly into the task.

I contend that under the monolithic surface of Reaganomics we can discern at least four very different policy groups. But first we will be dealing here only with Macro-Reaganomics – that is, the popular areas of spending, taxes, deficits, and money. On Micro-

Reaganomics we need only say that all the groups agree that the economy should be thoroughly deregulated, and also that almost no such deregulation has taken place. But on to our four Macro-Reaganomics groups, our Four Faces of Reaganomics. (I hasten to point out that these groups aren't monolithic either, but they can still be strongly distinguished from each other.) perhaps the most

1. The Old-Fashioned Conservatives

The first group is lovable, but perhaps not coincidentally, the least influential of the four. I don't know exactly what to call them; there is no one label that has been attached to them. So I will call them "Old-Fashioned Republicans" or "Old-Fashioned Conservatives." Unfortunately for them, they have been a lot stronger in the ranks of politicians and among voters, than they have been among economists, intellectuals, or opinion-molders. Before the advent of the Reagan Administration, they were strong in the House of Representatives, and they also included Ronald Reagan *before* the Republican Convention of 1980. These were the Congressmen who stood up on the floor of the House, shortly after the beginning of the Reagan Administration, some of them literally with tears in their eyes, as they explained that for the first time in their political lives they were voting for an increase in the national debt limit, they who had always been strongly committed to a balanced budget. But they were voting now for an increase in the debt limit because they were totally convinced that Ronald Reagan was dedicated with every fiber of his being to a balanced budget. Therefore, they knew with certainty that he would keep his pledge to balance the budget by 1984. The rest is history. The balanced budget is long gone and forgotten, and I doubt whether many of these Congressmen cry any longer as they vote routinely and periodically for yet another increase in the debt limit.

What then have been the cherished policies of the Old-Fashioned Conservatives? A balanced budget; a large massive cut in taxes; and to achieve a balanced budget, an even more drastic cut in government expenditures. How "Massive," how "Drastic"? These are matters of considerable difference among this group, but the basic thrust is clear enough. So much for fiscal policy. In monetary policy, these Old-Fashioned Conservatives favor ultra-hard money, marked by a return to, or an advance toward, a gold-coin standard for the dollar.

The historic function of this group, it is clear, was to provide the *rhetoric*, but in no sense the reality, of the Reagan Administration, and particularly the campaign rhetoric of Ronald Reagan in his campaigns of 1972, 1976, and 1980, and for his numerous speeches in between. For their pains, this group has been virtually destroyed politically, as can be seen in the fate of the balanced-budget conservatives in the House of Representatives.

I can only think of four of this group who achieved any sort of influence in the Reagan Administration. The leading one was Martin Anderson, an Economist at the Hoover Institution at Stanford, who was Reagan's Chief Adviser in Domestic Policy during his 1976, 1980, and 1984 Presidential Campaigns. Anderson became Head of Domestic Policy at the White House at the beginning of the Reagan Administration. In leaked stories to the press, Anderson was repeatedly ridiculed by leading White House aides as the "Keeper of the Scrolls", a man who kept inconveniently reminding the President of his campaign promises and supposed principles. By the end of the first year of the administration, 1981, Anderson was out and back at Stanford, part of the general "purge" of "extremist" economists that occurred at the end of 1981. Doug Bandow, aide to Anderson, left the White House shortly thereafter. Steve Hanke, of the Council of Economic Advisers staff, left about the same time, after his plan, initially adopted by the White House, to sell part of the public land to private

enterprise ran into the powerful environmentalist steamroller. Hanke returned to Johns Hopkins. Martin Anderson's wife, Annelise, lasted considerably longer as Deputy Head of the Office of Management and the Budget. Her appointment to what has now become the female spot on the Federal Reserve Board was announced by the White House, but was then reversed when vetoed by Chairman Paul Volker, a Keynesian. Annelise then returned to the Hoover Institution, and the position was filled by an obscure disciple of the Keynesian, Paul McCracken. Of the four, only Hanke and Bandow have gone public with their criticisms of what they regard as the betrayal of its founding principles by the Reagan Administration.

Old-Fashioned Conservatives were the principal losers in the ideological power struggle in the sense of what happened to their personnel. Reaganomic *policies* were also the reverse of Old-Fashioned Conservative policies down the line. When President Carter left office he was denounced by conservatives as a big spender. In his last full fiscal year, 1980, Federal Government spending totaled $577 billion. In President Reagan's last fiscal year, 1984, total Federal spending has been estimated at $854 billion, and projected total spending for next year is $968 billion. Now, whatever this is, it is *not* a massive cut in government spending; it is not even a moderate or *slight* cut. It is a huge increase, an increase of 48 percent in four years. President Reagan, with every new year, becomes that year by far the biggest spender in American History.

Even if we try to mitigate the record by looking at the percentage of federal spending to the national product, the Reagan budget still looks more statist and less libertarian than President Carter's. In Carter's last fiscal year in office, government expenditures totaled 21.9 percent of Gross National Product; in fiscal 1984, Reagan's expenditures amounted to 23.1 percent of GNP.

On deficits, Reagan's record is all too well known. President Carter left office with a deficit of $60 billion. In the last two years, the annual deficit has at least tripled, in the neighborhood of $180 to $200 billion. More important, the deficit seems now to have struck permanently at that level, and the administration holds out little hope of lowering it significantly for many years. Far from balancing the budget by 1983 and 1984, the President brought, in those years, the biggest deficits in American History. Even if we again try to mitigate the problem by taking the deficit as a percentage of GNP, the percentage deficit has more than doubled, from 2.3 percent of GNP to over 5.0 percent, and it seems to have been made permanent at near that level.

We will deal with taxes when we get to our next group of economic thinkers, the supply-siders. In the field of money, President Reagan clearly felt he had discharged his obligation to the pro-gold standard forces by employing the time-honored governmental method of burying a possibly embarrassing conflict: appointing a commission. The President appointed a U. S. Gold Commission in the fall of 1981 to study and make recommendations about a possible return to the Gold Standard. In the usual method of government, however, the supposedly impartial researchers were heavily stacked in advance – against gold. The overwhelming majority – indeed, all but two or three – consisted of dedicated monetarists and Keynesians united in their long-standing hostility to gold. The staff director, Anna Jacobson Schwartz, was a veteran monetarist and anti-gold partisan. The result was inevitable. After holding a few largely unattended hearings, the staff and the commission overwhelmingly recommended against a gold standard, and that – except for the minority report of two – was that.

2. The Supply-Siders

We turn now to the second of our faces of Reaganomics, the supply-siders. Along with the Old-Fashioned Conservatives, the supply-siders also supplied a good deal of the Reagan rhetoric before the election of 1980. Supply-siding began as a conscious movement quite late, in 1975. But while remarkably few in number, and lacking any sort of general treatise expounding their views, the supply-siders have been blessed with an enormous talent for self-promotion, for adroit manipulation of the media, and for organizing intellectually and politically as a self-conscious cadre. Their major intellectual and media center has been their control of the editorial page of *The Wall Street Journal*, from which has emerged its major philosopher and agitator, Jude Wanniski, author of the best-selling book, *The Way the World Works* (1978). The supply-side ranks also include columnists, Evans & Novak, and George Gilder, Ripon Society Republican leader and author of several best-selling works. The supply-side's major political figure is New York Congressman, Jack Kemp, and its most important organizer and fund-raiser is ex-Trotskyist intellectual, Irving Kristol.

The supply-siders philosophy of politics was best expressed in Wanniski's *The Way the World Works* designed to provide a world historical framework for Ronald Reagan's forthcoming 1980 campaign and projected tenure as President. The theme of Wanniski is that, throughout history, the masses, the general public, is always right. The public needs no education from intellectuals or political leaders. There is no need for that, since the general public is always correct. If the wishes of the public appear inconsistent, then it must be a *seeming* inconsistency. It is up to intellectuals and political leaders to articulate the will of the masses and to embody that will in political institutions. The leaders are also to find the underlying consistency in any seeming contradictions in the desires of the public.

In short, the heart and the consistent motif of supply-side programs is a very simple one. It is clearly a philosophy of demagogy. That is, a philosophy of finding out what the public wants and then rushing to give it to them. I suppose this program can be called "expanding American democracy," especially if we adopt H. L. Mencken's definition of "Democracy," which is: "The people know what they want, and deserve to get it, good and hard."

Armed with this doctrine, the supply-siders set about to formulate their economic program. What does the public want, they asked? In the fiscal sphere, three things: first, they want to keep up the supply of goodies they receive from the modern welfare-warfare state, so they want government expenditures to stay high and go higher; second, the public wants a big income tax cut; and, third, the public wants a balanced budget. Considering that the deficit was already $60 billion at the end of the Carter Era, this was a tall order indeed. Common sense asked: If you are going to increase expenditures, and also cut taxes, how in blazes are you going to give us a balanced budget?

The public seemingly wanted three terribly contradictory things. But Wanniski had already informed us that the public is always right. How to save the theory? The answer came with the famous bit of legerdemain, known in song and story as the Laffer Curve, the product of supply-side economist Arthur Laffer. Not only was the Laffer Curve *the answer*, it was so simple that it could be drawn on a cocktail napkin to explain the theory to busy bureaucrats and congressmen on the run.

We will cut tax rates sharply, said the Lafferites, and those cuts, especially the marginal income tax rates, will stimulate productivity, effort, and investment. As a result, total production will increase so much that the lower tax rates will generate enormously more

tax revenue. Presto changeo! And the lower tax rates and consequent higher tax revenues will balance the budget. The public is correct, you see, after all. The instincts of the masses have proved to be sounder than the ditherings of effete intellectuals.

The Laffer Curve proved to be catnip for the Republican politicians of 1980, all struggling to maintain these three contradictory policies. Thus, a moment of truth came when columnist Mary McGrory in effect asked the televised Republican Presidential candidates debating in 1980: "Gentlemen, you say you favor keeping up spending, cutting income taxes, and balancing the budget. How can you do all these things?" Even George Bush, whose horrified Keynesian economics advisers had led him to call the Laffer Curve "Voodoo Economics," gave what was in effect the Laffer answer to this crucial conundrum.

Nineteen-hundred-and-eighty-one was a banner year for the supply-siders, who have been on a virtual roller-coaster during the four years of Reagan. The President initially gave to each of the conflicting groups power over the particular Macro-Area that most interested them: the supply-siders got control over taxation, the Keynesians over spending, and the monetarists over the Federal Reserve and the money supply. The supply-siders got the two top tax posts at the Treasury: Paul Craig Roberts and Norman Ture, with Secretary of Treasury Regan, a man of no firm views, at least friendly to them. And they *thought* they had their own David Stockman in the powerful post of head of the Office of Management and the Budget. The supply-siders gleefully took full credit for the Reagan tax bill victory of 1981, trumpeting the tax cuts centering around the famous Kemp-Roth three-year income tax cut.

But then, in the last half of 1981, everything began to sour. Two cataclysmic events temporarily discredited Reaganomics, and with it discredited the supply-siders who had

seized full credit for the good days in the early part of the year. Those two events were (1) the plunge into the biggest recession (actually, "Depression") since the 1930s, and (2) the obvious fact that, instead of the supply-side tax cut quickly balancing the budget, the country was plunging into an enduring deficit of unprecedented proportions. The supply-siders were quickly tossed overboard by the end of 1981, with Roberts and Ture returning to private life.

During the dark days of 1982, the supply-side cadre decided to adopt three fallback positions. In the first place, they pointed out that the Reagan Administration had not really tried supply-sideism in the first place. So that the failure of Reaganomics was in no sense *their* failure. They pointed, quite properly, to the fact that the first year's initial 10 percent cut had been whittled down to zero, and that the moderate income tax cut remaining was more than offset by two factors: the Social Security Tax, which kept increasing, and "bracket creep," by which inflation wafted everyone into higher income tax brackets. As a result, the average person paid higher income taxes after the Reagan "tax cut" than he had paid before. The Reagan tax "cut" was really a tax increase. Thus, the public paid $517 billion in taxes in the last Carter fiscal year, 1980. During the first Reagan year, taxes rose to $618 billion. The last Carter year revenue amounted to 19.6 percent of GNP; the first Reagan year revenue equaled 20.3 percent of GNP.

The supply-siders were quite right, but the forces of their criticism would have been stronger had they not taken previously full credit for the alleged tax cut. They were on firmer ground when they pointed in anguish to the secret betrayal by their old ally, Stockman, who, in the private counsels of the administration, had defected to Keynesianism in early 1981 and persistently argued, then and since, for tax increases to offset what turned out to be the virtually non-existent tax cut. Not only that: Stockman broke the rules of politics by leaking

his anti-supply-side criticisms to the *Atlantic Monthly,* which published his views without his approval in late 1981. While Stockman was then "taken to the woodshed" by the President, he is still on the job, while the supply-siders have long since gone.

If the supply-siders were not responsible for the grave 1981-82 Depression, *who was*? In the second part of their fallback critique, the supply-siders pinned the blame on their enemies, the monetarists, who had been put in charge of the Fed and of the monetary arm of the Treasury. The monetarist-dominated Fed, the supply-siders charged, tightened up the money supply too much, as did the Keynesians after them during 1983 and 1984. Money should be cheap and loose, and because the supply-siders were not in charge of money, the result was tight money and depression.

It is not sufficiently known that the supply-siders are not just income-tax cutters. The supply-siders have two arrows to their macroeconomics bow. One is income tax cuts. The other is cheap and inflating money. Why? Once again, because that is clearly what the masses want. In their philosophy of demagogy, the supply-siders stood against the monetarists and Old-Fashioned Conservatives who claimed *tanstaafl*, "there ain't no such thing as a free lunch." The supply-siders charged *tanstaafl* to be a counsel of pessimism, of doom-and-gloom, of scrooge-like attitudes properly repudiated by the optimistic masses. The entire supply-side doctrine was based on the counter-claim, *tistaafl*, or, there is too a free lunch, part of the magic free-lunch was the Laffer Curve: the other was loose money, which also allegedly stimulated productivity and supply. But won't there be a problem of inflation? Not after a while, replied the supply-siders soothingly, because supply will increase so much as to offset monetary inflation. Just as we will naturally grow out of a deficit, so we will also grow out of inflation. The supply-siders do not consider that, no matter how greatly the

productive growth of the American Economy, it can never grow as fast as the printing of new money, which is virtually costless and under the unlimited power of the Federal Reserve.

The supply-siders have a new twist on inflation; however, they are nothing if not bold and creative. For while their soundings of public opinion have informed them that the public likes cheap and easy money, they *also* like the idea of a gold-backed dollar. The supply-siders have therefore come up with an ingenious gimmick: we will go back to the gold standard, thereby inspiring confidence in the dollar, and bringing down interest rates and stimulating saving and investment. But at the same time, the Fed will be instructed to expand the money supply at a rapid rate, thereby keeping everyone happy with cheap and abundant money and credit. Here is another seeming supply-side contradiction, resolved by the alleged growing out of inflation, *and* by the fact that their gold standard is in no sense a genuine one. Instead, it would be a sham gold standard, designed to lull the public and the market into an ungrounded sense of confidence in the dollar. No one would be able to redeem dollars in gold coin, and the Fed would be able to change the price of gold at will, in order to fine tune the macro-economy. Essentially, the supply-siders are calling for a return to the unlamented Bretton Woods System, which collapsed of its own inner flaws in 1971.

Basically, the supply-side attitude is one of "after us, the deluge." They care not at all about the consequences, and make Keynes's famous, "in the long run we are all dead," a model of sober long-run foresight. If inflation came headlong as a result of their cheap money policies, they would find some way to cross that bridge when they came to it.

The third plank in the supply-side fallback position was to jettison Arthur Laffer and his famous curve. History was busily rewritten as the supply-siders such as Paul Craig Roberts assured us that Laffer was an extremist never followed by the rest of the group, who

never promised or expected revenues to rise so much as to assure a balanced budget. The dumping of Arthur Laffer was made easier by the fact that Ronald Reagan had gotten rid of Laffer as one of his main advisers after the 1980 Republican Convention, presumably as one price to be paid for the influx of George Bush's and Jerry Ford's Keynesian economic advisers. Laffer had already proved to be expendable.

And so the supply-siders moved to phase two of their position on deficits. Whereas before they had assured us that tax cuts would lead to a balanced budget, now their tack changed completely. Now the line was: who cares about deficits anyway? And so the supply siders adopted the extreme Keynesian line that "deficits don't matter." One almost saw the ghosts of Abba Lerner and the left-wing Keynesians of the 1930s saying: "Who cares about the debt? We only owe it to ourselves." The problem, of course, is that now that the Federal debt is not \$50 billion but moving rapidly toward \$2 trillion, and now that interest rates are very high instead of close to zero, it makes an enormous difference whether any of us is a member of the "we" or of the "ourselves."

With the economic recovery and the lowered inflation of 1983 and 1984, the supply-siders reversed course once again, as they rushed to embrace a Reaganomics that now seemed successful. They loudly took credit for the "success" of the very same policies they had, the previous year, claimed to be a failure because their policies had not been followed. Their personnel have in no sense been restored to power, but now, as Jack Kemp positions himself to be the heir-apparent in 1988, the once bitter criticisms of the administration having been long forgotten. The Reagan Administration is no more supply-side in reality than it was in 1982, but it is now as fervently embraced by the supply-siders as it was at the very beginning.

3. The Keynesians

We come now to the group who, characteristically, has supplied virtually none of the rhetoric but virtually *all* of the policies of the Reagan Administration: The Keynesians. This might come as a surprise to many who think that all Keynesians are liberal Democrats. But that is not true. Keynesians come in a wide spectrum of ideological shapes and sizes. There are Democratic Keynesians. But not *too* conservative, of course. Republican Keynesians are what is often called "enlightened" or "responsible" conservatives, which means that their cherished policies are 180-drgrees from the Old-Fashioned Conservatives. The Republican Keynesians are the folks who brought us Eisenhower, Nixon, and Ford Administrations, and who are, when all is said and done, bringing us the Reagan Administration. Their ranks are legion: some of the most prominent are George Shultz, now Secretary of State; Arthur Burns, now Ambassador to West Germany; Paul McCracken, already mentioned; Martin Feldstein, the last Head of the Council of Economic Advisers; and Alan Greenspan, who presided over the Bipartisan Reagan Commission that at least temporarily, salvaged the Social Security Program.

In fact, until the crisis years of 1972-74, Keynesians comprised virtually all the economists in the country. Beneath all the equations and charts, the Keynesian creed was a simple one: recessions and depressions, marked by bankruptcies, falling prices, and heavy unemployment, are caused by under-spending on the part of the public; inflationary booms, marked by full employment and rising prices, are caused by over-spending on the part of the public. While free markets might work well in the micro-sphere, the Keynesians asserted, they are subject to fatal instability in the larger macro-sphere. But fortunately, salvation is at hand. There exists government, not subject to the irrationalities and instabilities of

individuals in the free market. Government can step in, see the problem on its control dials, and then correct the failing capitalism by pumping in more spending in recessions and taking out spending in booms. In that way, permanent full employment without inflation will be achieved. So confident were the Keynesians in their ability to fine-tune the system, so convinced were they that the business cycle was no more, that graduate schools stopped teaching courses in business cycles. Why teach courses that could only be of antiquarian interest, a lot of fuss about a dead issue?

There were many nuanced differences among Keynesians about how the spending levers were to be pushed. Government could either spend more itself or else cut taxes so as to stimulate private spending, and while technically either could be done, the natural bias of government meant that increases in government spending were massive, while tax cuts were few, minimal, and far between. Similarly, in booms the government could either cut its own spending, or else raise taxes and thereby "sop up excess purchasing power" – *our* purchasing power. Naturally, government almost never cuts its spending, and so that option got discarded very early in the game. Even more quick to be lost down the Orwellian Memory Hole was the original Keynesian commitment to what they called a "cyclically balanced budget." Sure, they told the skeptical Old-Fashioned Conservatives of the 1930s, *we too* are committed to a balanced budget. But we're simply not tied, like you are, to the narrow accounting unit of a *year*. We'll balance the budget too, but over the cycle; we'll incur deficits over the years of recession, but then we'll have surpluses over the years of boom, so that over the years of the full cycle, the budget will be balanced.

Well *that* promise was, of course, soon forgotten, as it became all too clear that the idea of a substantial budget *surplus* had joined the dodo bird on the list of extinct species.

Soon, the Keynesian doctrine underwent a subtle shift: we should have *big* deficits in a depression, they declared, and *smaller* deficits in boom times. Taxes, on the other hand, might be cut slightly in recessions, only to be increased a great deal in booms. The general trend, of course, was for ever-greater increases of the burden of government, both in taxation and spending, upon the American economy.

The Keynesians have been running the economic policies of government for the last 40 or 50 years. But something dramatic happened in the deep recession of 1973-75, something which had been threatening to happen in previous post-World War II recessions. There was a steep recession, with bankruptcies, unemployment, and cuts in production; and yet at the same time, prices went up a great deal, in fact at a steeper rate than in any previous peace-time year in American History. If we suffer from inflationary recessions, what can Keynesians do, since their whole doctrine is geared to pressing the accelerator in recessions and stepping on the brake during booms? How can government step on the accelerator and the brake at the same time?

Keynesianism was thrown into permanent confusion by the 1973-75 experience and by the fact that all subsequent recessions have been marked by price inflation rather than deflation. After Arthur Burns resigned as Chairman of the Council of Economic Advisers in the late 1950s, he gave a lecture in which he outlined his Keynesian prescriptions. When asked about the 1958 recession, which was already beginning to show signs of prices rising slightly instead of falling, he predicted correctly that that recession was almost over. When pressed about what he would do if inflationary recession should ever recur on a much greater scale, he answered: "Then we'd all have to resign."

But, of course, one law of politics is that no one ever resigns. Keynesians haven't resigned, but they are certainly punchy, going through the motions, lacking the old assurance and swagger. It is typical, by the way, of the bad luck of Richard Nixon that he announced, "we are all Keynesians now," at just about the time when Keynesianism was losing its grip. Essentially, Keynesians remain champions of the status quo, calling for more of the same: higher spending, higher taxes, moderately cheap money, etc. Worried about the huge deficits that have grown and persist even during booms, they have during the Reagan Administration been clamoring consistently for higher income taxes to close the deficit at least partly. And they did succeed to some extent, in raising taxes ever since the picayune 1981 tax cut. Certainly they have succeeded in keeping spending high and rising. On the monetary front, as I will note shortly, Paul Volker was allowed to return to his Keynesian instincts by late 1982. And, despite making the requisite tight money noises, the Fed has succeeded, over all, in increasing the money supply at a rate slightly higher than even the substantial rate of monetary inflation under Jimmy Carter.

But still: the continuing crisis of Keynesianism since 1973 has broken up the once overwhelming Keynesian consensus in economics, and has opened the door to newer and fresher, if not necessarily sounder, approaches: especially fresher to the supply-siders and particularly to the monetarists, who have managed to corral a large chunk of the economics profession in the past decade.

4. The Monetarists

And so we turn to our last Reaganomic group, the monetarists. Here we have to distinguish between Milton Friedman, the founding father of monetarism, and his numerous disciples. Friedman is not only a monetarist but a man devoted, except in the area of money,

his specialty, to classical liberal values and programs. Hence, he joined the Old-Fashioned Conservatives in pressing for substantial cuts in government spending. He even linked up with the hated supply-siders in calling for tax cuts, but for very different reasons: not because he believed in the Laffer Curve, but because he felt that politically, if Congress sees a loss in revenue, it will cut spending proportionally in order to avoid a huge increase in the deficit. Friedman has, of course, turned out to be wrong in this conjecture, since nothing seems to induce either Congress or the Executive Branch to cut spending – by which I mean a cut-cut as in an actual reduction, not cuts in the rate of increase, or similar bits of semantic trickery we have endured in recent years.

But the other monetarists are not Friedman. The monetarists give not a hang for taxes or spending or deficits. To the monetarists none of this matters. The only thing that matters is the famous "money rule": the idea that we should retain fiat money controlled by the Fed, but that the Fed should be ordered to expand the supply of money at a fixed, constant rate. *What* that rate should be has curiously varied among monetarists, but it is usually somewhere between three and five percent. The whole trouble with macroeconomics, say the monetarists, is a Fed that insists on increasing the money supply in a volatile and erratic manner. And so they called for the Fed to abandon the Keynesian doctrine of trying to fix interest rates, and instead concentrate on fixing the total money supply, increasing at the constant money rule rate.

At the beginning, as I have mentioned, Reagan settled the war among his economists by giving to each group control over their major interest and so the monetarists got control of the money supply. In particular, Beryl W. Sprinkel was put in as Under Secretary of Treasury in Charge of Monetary Policy. After a bit of public bludgeoning of

Paul Volker by Sprinkel, the Fed Chairman swung into line and faithfully pursued monetarist policies from early 1981 until October 1982. During this period, no Fed Chairman could have stuck more closely to the monetarist prescription.

The monetarists, we must add, did not only counsel the money rule. They realized that a rapid drop in money growth to the three or four percent from the existing seven or eight percent would precipitate a recession. The monetarists were just as anxious as Keynesians to avoid recessions, since neither group believed that recession performed any necessary or important economic function, such as liquidation of the unsound investments undertaken during the preceding inflationary boom. And so the monetarists counselled that the Fed slowly and steadily reduce the rate of money growth each year by a small amount. In that way inflation would be gradually brought down without incurring a recession. We would have a "soft landing."

And so this was done. Unfortunately for the monetarists, however, even a moderate drop in the rate of money growth to 5.5 percent was enough to precipitate not only a recession, but by far the steepest and most severe recession since the 1930s. Not only that: Friedman and the monetarists had promised the Reagan Administration that, as inflation came down, interest rates would decline to the same extent. The specter of high interest rates would be lifted. For it was an article of faith among the monetarists that "real" interest rates, that is, the interest rate minus the inflation rate, would always and forever be at three percent. Lower inflation by reducing the rate of money growth, they assured everyone, and interest rates would come down to preserve the magic three percent real rate. But while inflation came down greatly, from approximately 13 to three percent, interest rates scarcely fell at all,

and we were plunged into unprecedentedly high and seemingly permanent high real interest rates.

These two failures discredited the monetarists totally within the Administration, apparently beyond hope of redemption. Jerry Jordan, the top monetarist on the Council of Economic Advisers, was sent back to academia, and while Sprinkel is still there, he has been uncharacteristically quiet ever since October 1982, when Paul Volker shifted back toward making interest rates a preferred target, and pumped in money at a frantic rate of 13 percent per year in order to inflate our way out of the recession. Exit monetarism, leaving some form of Keynesianism in complete control, leavened by continuing supply-side rhetoric.

The monetarists' fallback position proved not to be nearly as effective as that of the supply-siders. They claimed that the Volker of 1981-82 had not been totally and completely monetarist. His heart had not been in it. But he had come so close that such an excuse cut very little ice. The desperation of the monetarists was revealed by their major excuse: namely that reserve requirements were not imposed on the banks instantaneously, as they had been before 1968. Instead, since 1968 the Fed had allowed a two-week lag for the banks to meet reserve requirements, and thereby Fed control over the money supply had been fatally weakened. Two weeks! Never had so picayune an explanation been offered for so catastrophic an economic failure. And, indeed, in February 1984 the Fed finally reinstalled instantaneous reserve requirements (known as contemporaneous reserve accounting), and it didn't make a dime's worth of difference. But, of course, by that time monetarism had been abandoned.

As for the enormous rise in real interest rates, the monetarists had really no answer, and at one point, Milton Friedman actually threw up his hands and conceded that he couldn't

understand what had happened. Admirably honest no doubt, but decidedly not the way to win out in the great game of politics.

5. Ronald Reagan

We have now dealt with Four Faces of Reaganomics. What about the fifth? The fifth, of course, is Ronald Reagan himself. What are *his* preferred economic policies? Well, who knows? None of us is equipped with a crystal ball to see into the heart and mind of the President. One thing we *do* know: the cherished conservative analysis, held both by Old-Fashioned Conservatives and by supply-siders, doesn't work. This explanation is summed up in the famous conservative cry: "Let Reagan be Reagan!", first raised when the President argued with equal fervor for the $100 billion tax increase of 1982 as he had for the tax cut only a year before. The theory goes that the good and wise Reagan, who *really* agrees with us, is surrounded by wicked pragmatist and Keynesian advisers preventing him from following his true instincts. Hence: "Let Reagan be Reagan!" The problem with this scenario is that it conveniently overlooks the key question: Who appointed these wicked advisers, and who keeps them in power? The answer, of course, is Reagan himself.

We can only assess the President on the record of his words and especially his deeds. We do know that he employs the rhetoric of the Old-Fashioned Conservatives and the supply-siders, while largely following the policies of establishment Keynesians. All this was explained patiently to the anguished conservatives of 1982 by Representative Barber Conable of New York, a shrewd veteran Republican politician. The President, he explained admiringly, has the remarkable ability to separate his mind into two air tight compartments: the realm of rhetoric, where he employs the doctrines of conservatism, and the realm of policy, where he continues Keynesian programs. And, pointed out Conable, there is *no*

relation whatever between the two realms. Conservatives, therefore, should wise up to the realities of this situation and quit complaining. All well and good, and sound, as far as it goes. But what Conable neglected to explain was, if rhetoric has no relation to policy, why does the President bother to employ rhetoric at all? Once this question is posed, the answer should be obvious. President Reagan has forged a mighty coalition, a coalition of fervent conservatives harnessed to the shrewd "pragmatic" beneficiaries of the big government status quo. In this coalition, each group, the ideologues and the pragmatists, get what they are most interested in. The pragmatists get to keep the status quo Keynesian big government welfare state, and the ideologues get the libertarian, free-market, get-government-off-our-backs rhetoric. Thus, both sides are kept happy, as was shown in the landslide victory of Ronald Reagan in November. *Politically*, at least, many-faced Reaganomics has proven to be a smashing success.

I am sure that all of us . . . could live fairly
comfortably with the idea of each of us kicking in, say,
a grand total of ten dollars a year to the federal government.

Murray N. Rothbard

LECTURE 4

THE TERRIBLE SIMPLIFIERS: THE CASE AGAINST THE FLAT TAX

Murray N. Rothbard

(Delivered on May 7, 1985)

All "right thinking" groups in our society, all across the political spectrum, republicans and democrats, conservatives and liberals, left and right, warmly support the flat tax. By "right thinking" I mean all people who have managed successfully to identify their own views, whatever they may be, with the common good or the public interest or the general welfare. Mainly, such people are found in the ranks of intellectuals, including academics, writers, and media pundits. The latest scheme to draw virtually unanimous support from all these people is the flat tax. A few weeks ago, I had the dubious pleasure of watching no less than three TV programs in one night devoted to praising the virtues of the flat tax. By this time, however, the cautious and the wary should be on the alert: namely, any policy that draws unanimous support from academics, writers, and media broadcasters can't be all good. There must be a catch somewhere.

The flat tax has been cleverly labelled a tax "reform," the very word "reform" being heavy with the implication that no man or woman of good will, be they liberal or

conservative, democrat or republican, can possibly stand opposed to such a plan. My favorite writer, H. L. Mencken, once pungently wrote that he had learned at his father's knee in Baltimore what "reform" in politics really meant: "mainly a conspiracy of prehensile charlatans to mulct the taxpayer." In fact, we can set it down as an intelligent working rule of politics that when some plan comes at us either as a "reform" and/or as the unanimous proposal of all right-thinking intellectuals, we had best keep a careful eye on our wallets and our pocketbooks.

1. "Special Interests": Good or Bad?

So convinced are the flat-taxers that only they have a pipeline to interpret the common good or the general welfare, that they invariably charge that any and all critics of their scheme are simply spokesmen for a sinister and shadowy group they commonly refer to as "the special interests." "Special interests" seems to be an effective way to write off substantial opposition to the flat-tax, especially since the convenient tendency of intellectuals is to dismiss all other interests but their own as "special" and hence somehow narrow and sinister. I would like to suggest instead that special interests aren't all bad, and to propose a criterion for distinguishing between beneficial and unfortunate effects of special interest. I would like to distinguish between "aggressive" and "defensive" actions of special interest groups. Take, for example, the sugar program to which all of us have been subjected for a half-century. In order to maintain and expand the inefficient U. S. sugar industry, the sugar interests have for decades propped up sugar prices by use of government, and lobbied for severe quotas on the import of sugar. As a result, American consumers (to say nothing of foreign sugar producers) have been hurt severely, the supply of sugar sharply restricted and the price artificially raised – so that the support price of sugar in the U. S. is now no less than

seven times higher than the world market price. Here is a clear-cut example of aggressive action by special interests.

But there are also cases of special interests acting defensively, rather than aggressively. Several years ago, for example, the movie theatres circulated petitions against a new tax on movie admissions and urged that it be repealed. Here were special interests acting, not aggressively but defensively, trying to remove a millstone from their operations, battling for their right to keep more of their own money. I was happy to sign that petition both because I believed that the cause of the movies was just and also that my own and other movie consumers' rights and interests were being invaded by the government. But wasn't this special pleading on the part of the movie theatres? Yes, and so what? There is no reason to expect that movie companies will be in the forefront of action to protect rights and incomes of, say, liquor stores, as they will be in protecting their own. In all cases where special interests are acting defensively, the front fighters for the rights of consumers will naturally be the particular firms or industries that happen to be under attack. Who else would we expect to sound the alarm than the special interests most deeply under fire?

To return to the flat tax: the seductive rhetoric of invoking the "special interests" has led most people to believe that everyone will benefit from the flat tax except a few wicked corporations or multi-millionaires. Nothing could be further from the truth. If the flat tax is enacted, millions of us will find out, too late and to our chagrin, that, to paraphrase the immortal words of the philosopher Pogo: "We have met the 'special interests' and they are us." Or as Senator Dole (Republican, Kansas) put it recently on the issue of the flat tax as an allegedly "fair" tax: "everybody believes in fairness unless they're involved."

Before we go down the list of so-called “special interests” who will be hurt by the enactment of a flat tax, I want to stress that I’ll be talking about the *pure* flat tax concept, rather than about the current approach to it submitted last fall by Secretary of the Treasury Regan, and supported by the administration. The Regan plan, which for example proposes three income tax brackets instead of one flat one has been called a “flat tax with bumps.” It presents as much of the flat tax that the Treasury Department thought they could get away with politically, and presumably this will soon be modified further in the final Reagan Budget proposal. But the important point is that the arguments for the Regan plan are solely that it approaches the ideal of the flat tax, and so it is that ideal that should be examined.

The flat tax, quite simply, proposes that every individual and every organization be subjected to the same, uniform proportionate income tax. To achieve that uniformity, the flat taxers propose the ruthless suppression of all credits, deductions, exemptions, and shelters, all of which are sneered at as “loopholes” in the tax system. In the flat taxers’ pure theory, the proportional income tax would apply to everyone regardless of income. But early in the development of the flat-tax movement they decided that, politically, the poor would have to be exempt from the tax. As a result, all flat tax schemes are now “degressive,” that is, they are proportional above an arbitrary minimum income floor, below which line the income receiver pays no taxes. The “degressivity” leaves an important element of progressivity in what has been touted as a strictly proportional plan.

2. What Is a “Loophole”?

It is instructive to pause for a moment to examine the pejorative term “loophole.” What *is* a “loophole,” anyway? It is never defined, but the flat-taxers seem to make the implicit assumption that the government really owns, or should own, all of what everyone

makes, at least up to some arbitrary percentage decided by the government. Hence, any failure of government to confiscate everyone's property up to that amount is somehow a moral blot that needs to be rectified. But to me it is far from self-evident that the government, rather than we ourselves, should have the primary right to our own earnings. And we must realize that what the "closing of loopholes" will mean under a flat tax is a merciless and continuing search-and-destroy mission by which the government will root out and obliterate every little cherished nook and cranny, every little hidey-hole, in which many of us have been able to squirrel away a bit of our own earnings and our own property, and keep them safe from the ever-expanding, all-encompassing maw of the federal government.

Wrapped up in the confusion over the role of "special interests" is a muddle over the concept of "subsidy." Flat-taxers call these exemptions, deductions, and loopholes "subsidies," and being staunchly opposed to subsidies, flat-taxers propose to eliminate them. But is it *really* a "subsidy" to be allowed to keep more of your own money? *Only* if we agree with the curious implicit assumption of the flat-taxers that the government, not us, really owns our earnings and our property, and that therefore being allowed to keep some of them is an arbitrary indulgence on its part. I submit, to the contrary, that there is a big and crucial difference between the government's taxing Peter to pay Paul, which is a "subsidy" to Paul, and the government's allowing Paul to keep more of his own funds. *That* can only be called a "subsidy" on the grotesque assumption that the government really owns all of our property to begin with.

Before examining the "special interests" who will lose, and often lose heavily, from the imposition of a flat tax, let me say that, strictly for the sake of argument I will begin by granting the flat taxers their insistent point that the shift to their tax will be strictly "revenue-

neutral," that is, that total tax revenue will remain exactly the same from the shift, and will not increase. I will grant that point for the time being, but I also remind you of the perceptive and sardonic motto of the typical, street-wise New Yorker: "If you believe *that*, buddy, there's a bridge in Brooklyn I'd like to sell you."

Let us now go down the list of heavy losers from the imposition of the Flat Tax:

a. <u>Receivers of "Imputed" Income</u>.

The flat taxers are nothing if not sophisticated economic theorists, and they realize that we receive our incomes, not only in money but also in other ways, by goods or services "in kind," or in various psychic ways. They also realize that much of the flowering of non-money incomes, to which they "impute" monetary value, has come about precisely in order to avoid some of the confiscations of the taxing system. Since income taxes are levied on money income, people tend to shift as much income as possible from monetary to non-monetary forms.

And so, people pay and receive income in non-monetary ways: If a carpenter goes to a physician for treatment, he may meet his bill by fixing the doctor's house rather than by money payment. Employees receive much of their income in non-monetary "fringe benefits," which may accrue in money only in the future. Salesmen and executives take some of their salary, not in money income, but in blissfully tax-free "perks" such as expense accounts, and the much-cherished three-martini lunch.

But the flat-taxers, in their puritanical frenzy at seeing anyone escape their allotted payment of taxes, are out to get rid of all that. It is good-bye to the tax-free fringe benefit, the expense account, the three-martini lunch. And what will happen to the restaurant business, the hotel business? What indeed will happen to Las Vegas? I shudder to

contemplate it. But the flat-taxers, like all puritans, like all fanatics, care not; they are ready to wreak unlimited havoc in the name of attaining their ideal.

Labor groups are already complaining about the taxing of their health care, life insurance, and retirement fringe-benefits in the Reagan Plan. But to quote a popular Reaganism: "They ain't seen nothin' yet!"   For one thing, there is the American homeowner. Every homeowner is going to get it, but good, under the flat-tax regime. The flat-taxers, for example, have figured out that homeowners benefit, in a real though non-monetary way, by *not* having to pay rent. And so the flat-taxers propose to tax every homeowner on the "imputed rent" they are earning by not having to pay rent to a landlord. If, for example, you own your own home, and some officials figure out that you would have been paying $1,200 a month if you had been renting the home, then you will have to pay a proportional tax on this imputed total.

I applaud the sophistication by which the flat-taxers realize that we earn income in imputed or non-monetary forms. There is just one big hitch in their scheme: that no one has yet figured out a way to pay "imputed" taxes. Unfortunately, the IRS insists on cold hard cash. And so it is going to be very painful for many people to have to pay taxes in money on income which is only psychic. As we will see shortly, the flat-taxers are out to tax capital gains fully as much as if they were earned income, as indeed they are. But if they had their druthers, they would tax these gains, not when we realize them in money form, but every year, as they accrue. It is going to be very difficult for many people to pay through the nose on capital gains from increases in the value of their stocks or their homes, gains which they can only reap when they come to sell their asset. In the regime of the flat-taxers, there will

be a great deal of painful forced-selling of homes and other assets. And to think, all this in the sacred name of the twin watchwords of the flat-taxers: "Simplicity" and "Fairness!"

It's a good thing that the flat-taxers haven't yet figured out how to tax us on our leisure, although as good puritans I'm sure they're working on it.

b. Payers of Interest.

Interest payments are expenses that the government allows us to deduct from taxable income. They will be brought under the heel by the flat-taxers. But if interest payments are no longer deductible, this means that one of the great economic advantages of owning a home, being able to deduct mortgage interest payments from taxes, will disappear. Notice that all of America's homeowners are going to be clobbered four ways by the ruthless ideologues of the flat-tax movement. One, as we have seen, homeowners will lose by being forced to pay taxes on their "imputed rent;" two, they will no longer be able to deduct interest payments on mortgages; and three and four, the value of their homes, on which they count when they wish to move, will be forced down because the after-tax return on the house will decline from the two increased tax levies.

I fail to follow the logic on this one: I can see why those who *earn* interest have to pay taxes on this income; but I fail to see why those who *pay* interest have to shell out more as well. In fact, this looks to me like double taxation on the same income, and if the flat-taxers were not the self-proclaimed experts on "fairness," I would even go so far as to say that double taxes on the same income are unfair.

c. Receivers of Capital Gains.

The flat-taxers are also astute enough to realize that capital gains constitute income. But, on the other hand, profits add to capital gains, and since they propose to tax profits too,

they are once again, double-taxing the same income. At the very least, then, profits should no longer be taxed if capital gains are as well. Relentless in pursuing any bit of untaxed income, the flat-taxers note that capital gains have been taxed much less in recent years than other income, and so they propose to pile on higher taxes so as to bring about the desired uniformity.

But higher capital gains taxation will strike hardest and foremost at the new, young, venture capitalists going into high-risk, progressive industries. Heavy capital gains taxation will strike a deadly blow precisely at new, high-risk venture capital. Do we really want to cripple these firms and ventures?

We have already pointed to the extra difficulties if flat-taxers pursue their prey to the last ounce and insist on taxation of accrued, and not just realized, capital gains.

It is common knowledge that great Britain's economy, since World War II, has suffered grievously from very high levels of income tax. One of the reasons that the British economy has not gone completely down the drain is that, fortunately, its government has levied no tax on capital gains, thus allowing many capital ventures to flourish. Our implacable flat-tax Jacobins would make sure to close *that* loophole.

d. Accelerated Depreciators and Investors.

But let it not be thought that our flat-taxers are only out to make life difficult for new venture capitalists. The old-line smokestack industries, already in decline, will get theirs too. One of the great problems of the older, heavily capitalized smokestack industries is that their profits have not been high enough to permit them to maintain and particularly to modernize their capital and allow them to compete with newer firms at home and abroad. Two highly beneficial tax reforms of the first year of the Reagan Administration were (1)

allowing investment credit on corporate and personal income tax for investing in capital; and (2) permitting business firms to accelerate the depreciation of their capital at virtually any speed. The investment credit allowed heavily capitalized firms to keep more of their profits, and invest in maintaining, modernizing, and expanding their capital. Accelerated depreciation has permitted firms to keep more of their current profits out of the hands of the IRS and to plow them back into badly-needed replacement and modernization of equipment.

Now, under the thrall of the flat-tax ideologues, the Reagan Administration in an about-face, proposes to get rid of its own salutary reforms. Both of them are now derided as "subsidies." But, once again, the investment credit allows people to keep more of their money if used for investment. Neither can we call accelerated depreciation a subsidy. There is no reason why a business should not be able to depreciate its capital at any pace it wants. Its total, long-run tax bill does not even decline; what a business is permitted to do is, instead of extending a depreciation allowance over, say, the 10-year life of the machine, to choose instead to take the entire allowance off now, so as to be able to buy a new machine and pay the same total tax bill out of the returns of the new machine over the next nine years. Accelerated depreciation simply allows every firm to arrange the time-schedule of its payments in ways that are most convenient and efficient.

e. Owners of Natural Resources.

Let it not be thought that owners of natural resources, such as oil, natural gas, and metallic mines, will get off scot free. On the contrary, they will be among the worst losers from the tyranny of the flat-taxers. Economists in general, let alone flat-taxers, have long denounced depletion allowances of natural resource owners as an outrageous subsidy. Since oil and natural gas companies, in the public's folk mythology, are considered especially

wicked, this part of the flat-tax creed enjoys particularly wide popularity. Yet, in actuality, apart from the fact that the right to keep one's own money can hardly be called a subsidy, there is another important fallacy in calling depletion allowances a subsidy. An income tax, by its very name, is designed as a tax on annual income, not on accumulated wealth. A tax on wealth directly confiscates property and brings about a decline in the structure of capital and hence of everyone's standard of living. But then we must realize that if we make the grave mistake of treating a using up of capital as a firm's income, and tax it accordingly, we will precipitate a decline in its capital structure and impose severe losses upon the firm. Suppose, for example, that a crude oil company produces and sells oil, and makes a net income from the sale of $100 million. But the oil in its reserves has now been diminished; if we can determine, say, that the value of its underground oil has gone down by $70 million, then the net income of the company has only been $30 million. To tax it as if its income has been $100 million will unwittingly impose crippling losses upon the company. And yet, our flat-taxers, true to form, propose to do precisely that. And the value of stock investments in oil and mineral resource companies will, of course, decline as well.

f. Corporations.

Lest we think that only the new venture firms and the older smokestack industries will get the axe from our flat-taxers, we should know that *all* corporations will suffer, for the corporate income tax will increase substantially, to make the tax on a par and uniform with the tax on the income of individuals. Everything, again, looks neat and "fair," with all individuals *and* organizations paying a uniform rate.

But hold; for in this instance, the flat-taxers are cutting against what I consider to be a correct trend in modern economics. That is, if, in the famous Milton Friedman formula,

tanstaafl (there ain't no such thing as a free lunch), then we can also add the term *tanstaac* (there ain't no such thing as a "corporation"). There is no existing entity called a "corporation" that feels, works, thinks, earns income, and then enjoys that income. A "corporation" is only a label for individuals who organize themselves, and hopefully earn income, in certain ways. There is no income-earning *thing* called a "corporation" that exists and earns income above and beyond the people, that is, the stockholder-owners, who constitute that corporation. Therefore, a tax on corporate income is an unjust and "unfair" (if I may use that term) double tax on the same income, as well as a tax hitting at savings and investment. Instead of raising income tax rates on corporations, as the Reagan Plan and the flat-taxers would do, we should move in the other direction, end double taxation, and cut the corporate tax to zero. Stockholders should be taxed just once, on the income they individually earn from the corporate firm. And oddly enough, before he succumbed to flat-taxism, Ronald Reagan himself has been known to voice such sentiments.

g. State and Local Taxpayers.

And now we come to a category of losers from the flat tax that I, as a New Yorker, find particularly outrageous. I speak here in this glorious land of Nevada, where all of you are blessed with no state income tax, no city income tax, and what we consider a small sales tax. But I and millions of other hapless and exploited citizens live in New York City, where we are mulcted and coerced into paying the highest state income tax in the nation, the highest city income tax in the country, and the highest sales tax. *Why*, you may ask, are the unfortunate residents of New York groaning under such an unprecedented and massive tax burden? You all know why. Our remarkably low crime rate is celebrated in song and story throughout the length and breadth of America, our public schools are a schoolhouse of crime

rather than the three Rs, our glorious streets and sidewalks are celebrated for their cleanliness and sparkle, our roads have even fewer potholes than Tijuana, and our fire department has managed to limit the massive destruction of buildings by arson to only one-half of the Bronx, and even lesser fractions of Manhattan and Brooklyn. For this glorious roster of "urban services" we have been forced to pay through the nose.

And now the cup of New Yorkers runneth over. After having been chastised for so many years with whips, the flat-taxers now arrive on the scene to chastise us with scorpions. It seems that being able to deduct our massive state and local taxes from our federal taxable income has only been a wicked "subsidy," and so now even that small consolation will be snatched from us. Why? Why in the name of "fairness" and "simplicity" are the unfortunate serfs of New York City who have already suffered the trials of Job, to be clobbered yet again?

It goes without saying that flat-taxers are zealots in favor of taxing the interest from municipal bonds – a long-standing goal of liberals in order to aggrandize the power of the federal government as against the states. If municipal bonds are taxed, their value will of course plummet, as will the credit and the power of state and local governments to float bonds. More and more spending will then be centralized in the hands of a super-powerful federal government. Is that what we all really want? I suppose there is no reason to raise the point that federal taxing of municipal bonds is clearly unconstitutional, as would be state taxation of Treasury bonds; for since when has anyone worried about the provisions of the Constitution of the United States?

h. The Charitable and the Non-Profitable.

One important tax deduction to be swept away would be gifts to charities or other non-profit organizations. Since much charity is now done under the gun of the IRS, the result of the flat-tax would be a drastic crippling of private charitable and educational organizations. Why should giving to charities, the arts, and educational institutions be hobbled and penalized, in the name of “simplicity” and “fairness”? The severe losses of many of these organizations, would lead them to turn to the federal government to bail them out, in effect nationalizing private charity and expanding and aggrandizing the federal welfare state. All universities and non-profit institutions that depend on voluntary giving would be victims of the zeal of our single-minded flat-taxers.

i. Victims of Fire, Sickness, and Accident.

There are even more helpless victims who will fall under the heel of the flat-taxers. Every man or woman who falls sick and whose medical payments are not insured, will, in flat-taxland, be unable to deduct these payments from his taxable income. No victim of fire, uncovered by insurance, will any longer be able to deduct his losses. And so the flat-taxers will have found another set of helpless sitting ducks for them to mow down: life’s unfortunates, run over by accident or disease, will be run over a second time, this time in the name of “equality” and “fairness.” How many victims of such “fairness” are we going to permit?

j. Entrepreneurial Losers.

Some entrepreneurs make profits; others suffer losses. That is the essence of entrepreneurship. While I don’t believe that losers should be bailed out or subsidized by government, it seems like excessive punishment for government to kick them, once again, while they’re down. But, this is precisely what our flat-taxers are planning to do. While it is

difficult to claim that losses, like profits, somehow constitute net income, this is precisely how flat-taxers regard them: as hidden income to be ferreted out and taxed. We have heard for years about those evil “tax shelters” which “they,” the wicked rich, like to indulge in. But mainly these “shelters” are losing propositions, the losses of which partially offset net income in other areas. How can we call such shelters “income”?

I, for example, in addition to being a salaried professor, am a self-employed author and lecturer. Some years, I make a net income from this business, other years I suffer losses. Who are the flat-taxers to come swooping down, they or the IRS try to pry into my soul, and announce either that I am a genuine but sometimes losing entrepreneur, or that in my secret heart of hearts I rejoice in my losses because it lowers my taxable income? Are the flat-taxers or the IRS truly qualified to examine everyone’s heart and soul and decide on everyone’s inner motives? And, in the last analysis, how dare they anyhow?

Let everyone, then, realize that the “they,” the “special interests” who will be hurt, and perhaps hurt badly, from the flat tax, are not just a few shadowy and malevolent millionaires. If you are a homeowner, or a stockholder, a venture capitalist, an owner of natural resources, a holder of a municipal bond, a payer of state and local taxes, a contributor to charity or non-profit activities, or a sufferer from uninsured sickness, accident, or entrepreneurial loss, you will be a loser from the flat tax. While it is not really possible to average out pain or loss among individuals and make it disappear, there is every reason to believe that, on the average, upper income groups will probably benefit on net from the fall in tax rates under the flat tax, whereas the middle class, as usual, will be hit and hit hard. So what else is new?

3. What Price "Pareto Optimality"?

Thus, the flat tax is a drastic and radical scheme that, at the very least, will impose pain and heavy losses upon large numbers of people. And for *what*? As the English would say, what's it all in aid of? In the discipline known as welfare economics, economists like to pay lip-service to the so-called criterion of Pareto-optimality: that is, that no government action, no matter how beneficial, shall injure even one person. It is not surprising that economists honor this criterion more in the breach than in the observance, for it is hard to know how any action of government could ever fulfill it. But still, there *is* a point we can learn from the Pareto criterion. For it seems to me that if we are to consider any radical and drastic change, we should at least have a good reason for doing it. A radical change for the sake of abolishing slavery? Fine. To achieve freedom? To roll back Leviathan government? Also fine. But, on the flat tax, surely we should stop, look, and listen! For are we to impose severe losses on so many people, merely for the sake of *symmetry*?

The burden of proof, then, should be on the shoulders of the flat-taxers. For the sake of *what* are they proposing to put so many of us through the wringer? Their arguments may be boiled down to three: fairness, neutrality to the market, and simplicity.

4. The Argument From Fairness

The major argument for the flat tax is not economic but moral, namely that this is the only fair way to distribute taxation. The assumption is that, *given* an arbitrarily determined total revenue to the government, that revenue should be distributed in a uniform, flat tax manner.

But the flat taxers do not really *argue* their point; they simply assume it as self-evident to all people of good will. Well, sorry, but I don't see it. I don't see why it is

particularly "fair" to clobber the sick, the sufferers from accidents, or the homeowners, or why it is fair to impose monetary taxes on earners of non-monetary income. More specifically, I don't see why proportional taxation is any "fairer" than many other possible patterns of distribution. Take, for example, Mr. A and Mr. B, each of whom earns a net income of, say, $50,000 a year. But Mr. A is a young man, just starting in life, with virtually zero assets. He depends on personal savings to build up his wealth and to finance a future business.

Mr. B, on the other hand, is an older man who has already built up or inherited millions of dollars in assets. Why is it manifestly fair for him to pay the same tax as Mr. A? Neither is it obvious to me that a sick person with heavy medical bills should pay the same tax as a healthy man with the same income. Note that I am not saying the opposite: I am not advocating a tax on health or on wealth. I'm simply saying that there seems to be no convincing argument for the fairness of one pattern of taxation over another.

In fact, I will go even further, and say that fairness has little or nothing to do with the matter, that, in fact, *tanstaaft* ("there ain't no such thing as a fair tax"). Conservative flat-taxers like to analogize to the free market, and maintain that they are trying to achieve neutrality to the market. But consider: What in the world is a "fair" price on the market? Many medieval economists came to grief on this issue. What is the "fair price," for example, of Wonder Bread? Who knows? For my part, as a Wonder Bread consumer, I'd love to see the price down to about a penny a loaf, and the Wonder Bread Company would undoubtedly love to be able to charge one-hundred dollars a loaf. As it is, after the higgling and haggling of the market, we all settle for about one dollar a loaf. There seems to be no sense to the

concept of fairness in price *except* what is arrived at, from day to day, as the result of voluntary transactions on the market.

But what of taxation? Unfortunately, we can't even apply the voluntary transaction criterion here, because by its very nature taxation is coercive, and is not arrived at by the voluntary bargaining of individuals on the market. So what then is a "fair" tax? I submit that the concept simply doesn't apply. All I know is that, as a taxpayer, I would like my taxes to be as low as possible. I suggest, then, that we cease the impossible quest for fairness in taxation, and try to arrive at taxes as low as possible. For whom? For everyone.

Let us note, for example, the analysis of taxation by one of my favorite economists, the nineteenth century Frenchman, J. B. Say. After pointing out that taxation is a coercive transfer from individuals and groups to the government, crippling their ability to produce and consume, Say's concluding recommendation on the tax question was trenchant and clear-cut. "The best scheme of finance," Say wrote, "is to spend as little as possible; and the best tax is always the lightest." In short, to paraphrase Jefferson, "That government is best which spends and taxes least."

I submit that instead of worrying about distributing taxes "fairly," or what is supposed to amount to the same thing, allocating tax suffering equally, we should set about trying to *minimize* tax suffering as much as we can down the line. And if we approach the problem *that* way, we should find it easier to gain broad agreement. Rather than trying to figure out whether a proportional, digressive, regressive, or progressive income tax structure is "fairest," we may find we can agree on reducing the tax burden of everyone.

Thus, let us compare two hypothetical tax systems. In system A, there is a steeply progressive income tax, ranging from zero to ten percent in the highest income brackets. In

system B, in contrast, everyone pays a flat, strictly proportional income tax, of forty percent. I have a hunch that, in choosing between these systems, even the upper income groups would plump for the far more progressive, but much lower tax burden. The central point is the lowness of each tax, rather than the distribution of the burden.

I submit that what people are, or should be, interested in is lowering their own tax burden rather than zealously and enviously trying to aggravate the burdens of other people; in short, defensive rather than aggressive pursuit of their special interests. And here is a genuine basis for solidarity among taxpayers of all groups and sizes. The point, then, is not that "they" – whoever "they" are – are paying too little taxes and should be brought to heel. The point is that all of us are paying too much. The flat tax movement is part of a process by which the government and its allies have been able to split and deflect the tax protest movement from trying to lower the taxes of everyone, into trying to force everyone into paying some arbitrarily defined "fair share."

5. The Argument From Neutrality to the Market

An important argument of the flat-taxers, especially those who claim devotion to the free market, is that their plan is needed to restore the allocation of resources to what would have been the pattern on the market: in short, that the flat tax is uniquely neutral to the market. The argument runs as follows: credits, deductions, and loopholes distort resources relative to the free market because more resources go into the loopholes than would otherwise. Thus, an investment tax credit means that more resources will go into investment than would on a free market. Let us take a simple case to highlight the argument: suppose that there are only two industries in the economy, machine tools and wheat. If machine tools receive an investment tax credit, more resources will be poured into machine tools relative to

wheat than on the purely free market. Therefore, the tax credit distorts resources, and a flat tax, by eliminating that credit, will correct the distortion and restore genuine market conditions.

But this argument overlooks a crucial point: namely, that even in our simple model, much less in the real world, there is still *another* channel for the allocation of resources, namely *government*. In our example, if resources did not go into machine tools because of the special credit, they would have gone not into wheat but into government, and *government* is far less neutral to the market than any other allocation. In other words, from the point of view of the free market, *any* allocation of economic resources in the private sector, whether machine tools, wheat, or whatever, is better, that is, closer to the free market, than those resources going into the maw of government. If neutrality to the free market is really the consideration, then free-marketeers should rejoice with the creation of one more loophole, one more nook and cranny safe from the tax-man. The key point to focus on is private resources vis a vis government.

Oddly enough, it has been completely overlooked that the Reagan Administration, while submitting the Reagan flat-tax plan, has at the same time called for further tax credits: for private school tuition and for enterprise zones. Both are laudable, but both are completely opposed to the flat tax concept.

There is another important point about neutrality to the market, one which also speaks to the fairness issue. The flat-taxers have strongly implied that, in contrast to the progressive tax, the uniform proportionate tax is neutral to the market – for the market would pay in this way for the services of government. But would it really? Where *on the market* is the price of *anything* proportionate to the income of the customer? I pay approximately one

dollar a loaf for Wonder Bread; if and when David Rockefeller goes to the market to buy a loaf of Wonder Bread, is he forced to pay one million dollars a loaf – or whatever the proportion would be for our respective annual incomes? Certainly not! One of the great things about the market is that every good or service tends to be at one price: regardless of the race, creed, personality, or income of the customer. So if the flat-taxers really wish to emulate the market and try to be neutral to that market, they would advocate, *not* a tax proportionate to everyone's income, but a genuine flat tax, that is, an annual tax paid equally by everyone, in absolute terms; a tax that would be *truly* equal and truly flat, with no exemptions or special burdens on income. But how, you might ask, could the poor person pay a tax equal to a wealthy one? A good question, one that can be answered by pointing to the price of Wonder Bread. That is, it wouldn't be a problem, if the price, or the tax were low enough. I am sure that all of us, for example, could live fairly comfortably with the idea of each of us kicking in, say, a grand total of ten dollars a year to the federal government.

6. The Argument From Simplicity

Perhaps the most seductive argument of the flat-taxers is the argument from simplicity: that, in contrast to the maddening complexity of today's tax code, a code that even the IRS itself cannot fully understand, the flat tax would be simplicity itself. Everyone, they promise, would be able to make out their income tax "on a postcard."

But in the first place, it wouldn't be that simple. We would still need a complex process to determine what our net, taxable income might be. Those of us who are self-employed would still have to figure out our expenses and net incomes. But let us set that aside. What the flat-taxers don't seem to realize is that there are, after all, worse things in the world than complexity. And one of them is paying higher taxes. In short, they don't seem to

understand some of the reasons for all the tax complexity. The reason is that many people are willing to wade through a great deal of complexity in order to lower their tax burden. So that, in a sense, given the tax system, much of the complexity that everyone denounces is voluntary. In fact, if we desire simplicity, we can achieve it right now, and without the flat tax. Two-thirds of Americans do so now by filling out the simple short form for their taxes. The one-third of us who choose the wearying long-form route do it for one reason alone: to lower our tax bills. Why in the name of simplicity, are the flat-taxers trying to take this choice away from us? That is one reason I call them "the terrible simplifiers." Let them keep their gift of simplicity to themselves, thank you.

One variant of the simplicity argument proved so alluring to a friend of mine that he was almost persuaded by the flat-taxers: the promise that the flat tax would get rid of what are apparently one of the most disliked groups in our society: Tax Lawyers and Accountants. Apart from the fact that the flat tax would still require a lot of cogitating over net income, let me be one of the few Americans to put in a good word for this much vilified and beleaguered group. Denouncing tax lawyers and accountants is like blaming doctors for the existence of disease, or attacking expenditures on guards, locks, and fences for protecting oneself against crime. Our complaint should not be with tax lawyers and accountants, but with the system that makes them necessary. So long as that system exists, we must realize that they are our shield and our buckler, our defense against the depredations of the tax system. Besides, if we are truly interested in getting rid of tax lawyers and accountants, there is one surefire way to do so. During the Joe McCarthy era, my friend the libertarian writer and theorist Frank Chodorov sat down and wrote: "The way to get rid of communists in government jobs is to abolish the jobs." Similarly, we might say that the way to get rid, once and for all, of tax

accountants and lawyers is to abolish the income tax. This suggestion would meet all the cherished criteria offered by the flat-taxers: it would surely be simple, it would certainly be neutral to the market; and it would be uniform, "fair," and equal: a flat income tax of zero, across the board, with no loopholes, credits, or exemptions.

7. Revenue-Neutral?

It is now time for us to relax the original assumption that I granted the flat-taxers: that their plan would be, and remain, revenue-neutral. Even if the flat tax would not raise total revenue immediately, who here is naïve enough to believe that the government will sit still for long for revenue-neutrality? The government may be willing to lull us into a false sense of security by promising no increase in total revenue. It doesn't mind cutting tax rates a bit temporarily, for the sake of bringing more revenue sources into its clutches. It is worth a lot to bring previously sheltered hiding places into the grasp of the federal government. I can make that point most dramatically by pointing to the fact that eminent left-liberal economists like Walter Heller champion the flat-tax plan. We might almost point to a picture of Professor Heller, and ask: why is this man smiling? He is smiling because, as he has frankly written, the cut in present tax rates is worth the broadening of the tax base, that is, the bringing of previously exempt income under the grip of the federal taxing power.

8. Conclusion: The Terrible Simplifiers and the "General Interest"

We end on the note with which we began: by remarking on the curious fact that academics and media people, that is intellectuals, are almost to a man enthusiastic about the flat tax, regardless of their position on the ideological spectrum. But if the flat tax is neither evidently fair nor genuinely simple nor neutral to the market, if it is merely a snare, a delusion, for more confiscatory taxation, it is easy to understand why politicians and

bureaucrats may love the idea. But why the enthusiasm of the intellectuals – the alleged spokesmen for the "general" or "public" interest? The answer is that the intellectuals may well have a "special interest" of their own.

Here I come to the title of my talk. Jacob Burckhardt, the great nineteenth century Swiss historian, referred to many of the intellectuals of his day as "terrible simplifiers." What he meant is that many intellectuals, right, left, or center, are opposed to the messy individuality, the untidy diversity of real life. It is an occupational disease of intellectuals to simplify the reality of people, of *other* people that is, in order to try to understand them. And so intellectuals like to pigeonhole their subjects – other people – into neat, orderly, and simple categories, and to classify and then deal with them in neat and orderly ways. From that way of thinking it is an easy step to classify and then treat people as mere pawns to be pushed around. And to do so, the intellectual turns to the secular arm – that is, the enforcement power of government – to do the pushing. Intellectuals, in short, are all too often terrible simplifiers, willing and eager to impose massive pain and losses upon other people for the sake of symmetry, uniformity, flatness, or some other simple and abstract ideal. The nature of the creed, the specific content of the ideal, is not nearly as important as the eagerness to override and bulldoze out of existence the diverse and rumpled reality of individual life. We have, alas, come to know in the twentieth century that totalitarianism can have many faces.

When the Reagan plan toward a flat tax was announced last winter, an anonymous White House aid attacked the proposal as one "that looks like a tax system designed by a lot of academics." And a leading New York broker charged that "those guys at Treasury are tax lawyers, assistant professors or statisticians. They have no understanding of what makes an

entrepreneur tick." Indeed, the main designer of the Reagan plan, Deputy Assistant Secretary of Treasury, Charles E. McClure, Jr., a former academic, proudly proclaimed his lack of realism. Admitting that the plan was written "in an ivory tower," he declared that "one nice thing you get from the ivory tower, is that you get opinions that tend to be unbiased, that are not affected by special interests, that have the public interest in mind." I hope that we will now begin to treat such arrogant claims with the skepticism they so richly deserve.

Forced idleness means not only that the individual is
denied an opportunity to earn income, but also society loses the goods
or services the individual could have produced. However, in the forty years since
the end of World War II, even in periods of recession, over 90 percent of adults
seeking employment have found acceptable jobs. Joblessness among young
people seems, therefore, to be temporary and "cured" by aging.

Larry D. Singell

LECTURE 5

YOUTH UNEMPLOYMENT: AN AMERICAN CRISIS

Larry D. Singell

(Delivered on May 14, 1986)

The difficulties that young people experience in finding employment have perplexed society from the very beginning of time. Indeed, the record reports that Adam and Eve experienced some frustration in getting their offspring happily established in suitable career paths. It is, therefore, hardly surprising that widespread concern is expressed over the employment difficulties of this generation of young people. But there is evidence that young people now face even greater difficulty entering the world of work than past generations. Rates of unemployment for individuals between the ages of 16 and 24 are alarmingly high, exceeding 50 percent for blacks and 25 percent for whites in a number of large American cities. Prior to the 1970s, youth unemployment rates nationally averaged between 1 to 2 times the adult rate. However, since then they have increased to between 4 to 5 times the adult rate. Currently, young people between the ages of 16 and 24 account for one half of the nation's unemployed although they comprise only one quarter of the nation's labor force.

Economists have always been concerned with involuntary unemployment for any member of society because it represents an unrecoverable waste of resources. Forced

idleness means not only that the individual is denied an opportunity to earn income, but also society loses the goods or services the individual could have produced. However, in the forty years since the end of World War II, even in periods of recession, over 90 percent of adults seeking employment have found acceptable jobs. Joblessness among young people seems, therefore, to be temporary and “cured” by aging.

Nevertheless, social action to reduce youth unemployment is both necessary and desirable, for several reasons. First, early work experience is critical to making the transition from school to work and is central to learning job search techniques, effective work habits, self-respect, confidence, and reasonable career expectations. Research, based on recently available data which has followed a group of young people from childhood through their adult years, demonstrates a significant connection between early labor market success and earnings throughout adult life. For example, teenagers who are both out of school and unemployed for extended periods are more likely to experience more lifetime unemployment as well as lower lifetime earnings. Because of this, a year of unemployment for a typical youth in the United States, on the average, results in a loss of $20,000 income over the workers lifetime. In addition, there is evidence that opportunities for employment for young people have fundamental effects on their motivation to seek education and training, and therefore, impact on the growth potential of the country.

There is also a fear that youth unemployment is associated, perhaps in a causal way, with other social problems such as youth crime, drug abuse, and so forth. Clearly, there is a growing malaise among young people in America. In the 1950s, crime rates for young people were below those of the adult population. But both violent crime and crimes against property for young people have grown more rapidly and, currently, they exceed adult rates.

Suicide rates for individuals 15 to 24 have increased almost three times since 1950. Illegitimate births among teenagers have more than doubled since the mid-1950s. Violence in schools along with drunkenness and narcotics offenses have increased at dramatic rates. While this increase in youth crime, violence, illegitimacy, and suicide are brought about by a complex set of social forces, an inadequate number of legitimate employment opportunities clearly contributes to the anxiety that young people face in growing up. A healthy society must provide adequate opportunities for its young to obtain training and work experience as well as opportunities to earn income.

The purpose of this lecture is to analyze what can be done to increase the employment opportunities for young people. A word of caution is in order. One of my distinguished colleagues, Kenneth Boulding, has advanced what he calls the "law of political irony" which says basically that what people do to help others usually hurts them, and what they do to hurt them usually helps them. The contrary results are typically the outcome of good intentions combined with inadequate understanding, or confusion, regarding both the nature and causes of the problem, as well as the way humans respond to help efforts. Toward such a purpose, I shall start with an analysis of the nature and causes of youth unemployment and, out of this analysis, abstract some recommendations for policy.

1. The Size and Nature of the Problem

The magnitude of the youth unemployment problem is enormous. The number of unemployed people between the ages of 16 and 24 is currently between three and four million. These are individuals who are actively seeking work but are unable to find a job. In addition there are: (1) an estimated 300,000 to 500,000 young people who say they would be looking for work if they thought jobs were available; (2) an additional 700,000 minority

youth who have disappeared out of the system, in the sense that they are out of school and out of work, but as far as we know they are not seeking work. They are on the streets; and (3) another one million youths who are employed part time who say they are looking for more hours of work than they have. In all, there are somewhere between five and six million young people who are unemployed or underemployed.

Table 1 at the end of the lecture provides data on the percent of the work force employed and unemployed by age, race and sex for 1954, 1977, and 1983. The years 1954 and 1977 were selected because adult unemployment rates were comparable in these two years, and 1983 was the latest year for which data could be obtained. Several important observations should be made from these data. First, the fraction of young, white males who were employed has remained steady, while the fraction of young, white females employed have increased dramatically over this period. This constant or expanding percent of employed white youth, together with their increasing unemployment rates suggest that for this group much of the problem is brought about by increased labor force participation. Second, unemployment rates for young blacks have increased dramatically while the fraction who were employed has also declined sharply. Thus, while the unemployment problem for all youth is significant, black teenagers face severe difficulties, with one half of those actively seeking work unable to find employment.

Four alternative and sometimes competing explanations for the high and rising levels of youth unemployment have been put forth by experts who have studied the problem. Briefly, the explanations are that youth have been increasingly; (1) *pushed out* of jobs by economic recession and a slowing in the rate of economic growth; (2) *crowded out* both by

growth in their own numbers and the expansion in female labor force participation; (3) *priced out* by minimum wages or union pressure to raise wages; and (4) *dropped out* of employment possibilities because of failure of the education system, the lack of job training possibilities or structural changes in the economy along with numerous other conditions which result from living in poverty amid affluence. While most scholars recognize that all four of these forces may be operating simultaneously, there is little agreement on the relative importance of each to the growing problems of youth joblessness. However, these differences in view have an important impact on the policy mix that is recommended. Therefore, we turn to a somewhat more detailed analysis of these four causes before proceeding to policy recommendations.

a. <u>The Pushed Out Hypothesis</u>.

Growth rates in family income and gross national product per worker in the United States from 1970 to 1985 were less than half those from 1955 to 1970. This sluggishness in demand has increased unemployment rates for all workers. Some researchers have argued that the higher youth unemployment rates are largely the result of these recessionary conditions. The argument is essentially as follows: Because young people are exploring alternative jobs, they change jobs more frequently than adults. In recession conditions, it takes longer for the average worker to locate suitable employment. Hence, the higher youth unemployment rates may simply be the product of the less favorable economic climate of the recent period and the need for young people to try different jobs.

A great deal of effort by economists has gone into analyzing how youth unemployment rates change when general economic conditions improve. From these efforts we have learned that: (1) youth labor market activity is very responsive to general market

conditions. For example, when adult unemployment rates go down by one percentage point, the proportion of the youth population that are employed increases by between two and three percent. However, youth unemployment rates fall by approximately one percent because a number of young people, who were not in the labor force previously, begin looking for work. (2) An important difference exists for youth enrolled in school. For youth enrolled in school, almost all of the expansion in employment is from those who were not in the labor force, suggesting that youth in school simply wait for job opportunities. If such offers are not forthcoming, they do not enter the labor force. This means that the number of jobs that must be made available to bring about full employment for young people is significantly greater than the reported number of unemployed youth. Indeed, this suggests that policy decisions for young people should focus on both employment and unemployment rates. In short, it is possible to provide a number of jobs for young people without changing the youth unemployment rate significantly. (3) Even if general economic conditions improved to the point where adults were fully employed, the unemployment rate for teenagers would remain unacceptably high. There are a number of researchers, including myself, who have tried to estimate how much youth unemployment rates could be reduced if we could restore a strong national economy. For example, Table 2 presents the most optimistic forecasts of youth unemployment rates if full employment rates for prime age males were achieved. These are most optimistic because they are based upon achieving unemployment rates for prime age males that are the lowest achieved since World War II. Even under these most favorable conditions, overall unemployment rates for white and non-white teenagers would be 10.8 and 24.5 percent, respectively. These results suggest that some important part of youth

unemployment must be due to factors that go beyond the sluggish performance of the national economy.

b. The Crowded Out Hypothesis.

The post war baby boom resulted in a very large increase in youth population in the United States beginning in the 1960s. For example, in the United States the number of persons aged 16 to 19 and 20 to 24 was virtually constant between 1929 and 1959. However, between 1960 and 1970, the population of 16 to 19 year olds increased by 50 percent. Correspondingly, the population of 20 to 24 year olds increased by a similar percentage between the mid-1960s and the mid-1970s. This large influx of young, relatively untrained workers clearly imposed some problems of adjustment on the labor market.

Another factor which must also be considered in this context is the expansion in female labor force participation. In the United States in 1940, 28.1 percent of all females participated in the labor market. Since that time, changing social attitudes reduced discrimination against females, and a host of other factors led to a steady expansion in female labor force participation. Since 1978, more than half of the female population has been in the labor force. A large percentage of these females were competing for entry level jobs. This clearly put greater pressures of adjustment on the labor market which may have impacted on youth opportunities.

It is reasonable to believe that such developments contributed to higher youth unemployment rates at least in the short run. In fact, the Congressional Budget Office estimated that the increased number of young people in the market raised the unemployment rate of 16 to 19 and 20 to 24 year olds by four and one percentage points, respectively, in the 1970s. There is, however, no reason this expanded labor force should cause unemployment

in the long run if market forces work freely. In short, an expansion in the supply of any resource can be accommodated by appropriate price adjustments. Hence, debate exists as to how much of this unemployment is caused by rigidities introduced by social policy (exemplified by legislated minimum wages to which we shall turn momentarily) or possibly some other inefficiencies in the process of market adjustment. There is evidence that the market does adjust to even short run changes in supply if these changes are anticipated. For example, each year between May and July, teenage employment in the United States increases substantially as four to five million additional young people seek and find summer employment. Employers clearly anticipate this seasonal increase in supply and organize production to take advantage of the availability of these teenagers. Some economists argue that if production can adjust so rapidly to a seasonal shift in demographic composition, it seems reasonable that it could adjust significantly to a much slower change over several decades. Of course, such changes must be anticipated.

c. <u>The Priced Out Hypothesis</u>.

A substantial amount of the work on youth unemployment in America has focused on the impact of minimum wages on teenage employment. Economists long ago demonstrated the critical role of flexible wages and prices in the economy's adjustment to changes in consumer demand, productivity, and factor supplies. Thus, minimum wages represent a general barrier to labor market adjustment which could impact on all workers. They may, however, disadvantage young workers in more significant ways because they have lower levels of skill and experience, and therefore, lower productivity. Furthermore, if some group is the victim of economic or social discrimination (e.g., blacks, females) or if employers prefer one group of workers over others, minimum wage laws can result in a

relative concentration of unemployment among these groups. Studies in the United States show that 80 to 90 percent of employers preferred workers 22 years of age or older, even for relatively unskilled jobs. In such cases, minimum wages contribute to unemployment because, with the minimum wage set above the full employment equilibrium wage, the excess supply of labor allows employers the freedom to consider factors that don't relate to worker performance without sacrificing profits. Thus, on theoretical grounds, minimum wages could clearly account for some potentially important fraction of youth unemployment, and for the concentration of unemployment within groups suffering from prejudice.

Unfortunately, policymakers who consult the research on the impact of minimum wages on youth unemployment are likely to come away confused. It is easy to find some experts arguing that the minimum wage is responsible for a considerable amount of teenage unemployment, while others argue that the minimum wage has no impact on teenage unemployment. A study by the United States Department of Labor concluded that, ". . . while there are hints of adverse effects of minimum wages in available data, no firm statements can be made about the magnitude of such effects."

The reasons for the confusion are important for considering what impact minimum wages have had on teenage unemployment. Basically, there are two difficulties. First, the fraction of employment covered by minimum wage laws has changed over time. This is important because if a significant fraction of employment opportunities are not covered by the law, workers who might be unemployed in the covered sector may seek jobs in the uncovered sector where wages are flexible. For example in 1950, 95 percent of all manufacturing workers were covered, while only three percent of retail trade and 19 percent of service industry employees were covered. Agricultural workers were completely exempt.

Between 1950 and 1960, there was no extension in minimum wage coverage although the minimum wage rates were increased.

It might also be noted that the significant increase in teenage population described above resulted in wage adjustment. For example, 18 to 20 year old men who worked full time earned 54 and 66 percent, respectively, of adult male earnings in 1967. By 1977 this was down to 49 and 58 percent, respectively. As wages adjusted, the fraction of young people who were employed also increased illustrating the market's ability to adjust. These relatively lower wages brought the average wage of young people closer to the minimum. In 1961 and 1966, however, Federal legislation extended coverage of minimum wages, and by 1970, 59 percent of all employees in retail trade, 99 percent of construction workers, and 71 percent of all service industry workers were covered. Coverage was also extended to agricultural workers on large farms. Expanded coverage thus reduced the alternatives for employment.

A second difficulty involves the long-run adjustment which further compounds the difficulties described above. As the coverage of minimum wages expands, higher wages might encourage labor-saving innovations. Thus, in addition to changes in the minimum wage, changes in coverage and the effects this may have had on technology must be considered.

When these developments are taken into consideration, it appears as if 10 to 15 percent of white teenage unemployment and perhaps as much as 25 to 30 percent of the unemployment of black teenagers can be accounted for by minimum wages.

d. The Dropped Out Hypothesis.

This hypothesis regarding youth unemployment includes a wide and diverse set of explanations of youth unemployment, but there are two central threads. The first focuses on the growth in formal education and the associated patterns for labor market entry that have taken place over a long period. Because of these changes a redefinition of youth unemployment seems necessary. The second focuses on structural changes in the economy which make traditional policies to stimulate the economy ineffective. These structural changes in the economy and changing educational requirements have changed the employment needs of some youth, and left others with so little hope for a job that they have quit searching. They have dropped out. As a result a more focused set of youth employment policies must be developed to reach and deal with the problems faced by this group of young people.

2. The Redefinition of Youth Unemployment

In the American economy the definition of unemployment and the methodology for its measurement is based upon the labor market attachment of adult males. In general it is deemed personally and socially desirable for adult males to be working full time. If they are actively seeking work and cannot find a job, they are counted as unemployed. Hence, the percent of adult males who are unemployed is an acceptable index of an “unsatisfactory status” for these workers. On the other hand, increasingly young people need to be engaged in education or a number of other activities. For example, in addition to school, they can be in an apprenticeship program, the military, or beginning to raise their own families. Since a large fraction of youth is not in the labor force at any one time, the unemployment rate is not a good measure of unsatisfactory status for young workers. Indeed, because of recent efforts

to keep people in school, more than 85 percent of those between the ages of 16 and 17 are in school. Thus, having a job is not necessarily the preferred activity for many young people. Attending school, training programs, or other similar activities may require that young people take part time jobs and have more flexibility than other workers. Thus, "actively seeking work" may not mean the same thing to the young who face a variety of options in comparison to the adult who desires full time employment. In short, higher unemployment rates for young people, as they are currently measured, may or may not indicate some real social problem. Some economists have argued that improved measures of "unsatisfactory status" should be developed and utilized. In my view, these arguments are clearly valid, but caution is important. Unemployment, like so many intractable social problems, is most easily solved by redefinition.

The unemployment rate is useful for adult males because it gives us the percentage of that group (the labor force) who are unable to engage in socially desirable activity (that is they are unemployed). If we use this concept for young people, we should compare the number of youth who are unemployed with the number of youth engaged in activities deemed desirable for young people. For example, we might use those who are in school, the military, or working (but not in school). Using 1983 data for the United States, I have calculated unemployment rates for young people using two different definitions. These data are provided in Table 3. U_1 is youth unemployment that the Labor Department collects, which is based on the same definition used for adult males. The second measure, U_2, is the percent of youth who are in school, whether they are working or not, at work, or in the military, and who are unemployed. I refer to the group of youth in school, the military, and

working as the augmented labor force because these young people are working at activities society deems desirable. An alternative measure, U_3, is also provided which compares the augmented labor force to the number of young people who are simultaneously out of school and unemployed.

While the above are not perfect measures they do help us understand the problem. For example, they show that unsatisfactory conditions exist for a small fraction of young people. Approximately 90 percent of young white workers and 95 percent of all 16 to 17 year olds may be said to be in satisfactory situations. That is, they are either in the military, at school, working, or both working and at school. For this group, unemployment results because they cannot locate a job that accommodates their educational program. Young people are not only staying in school longer, the ones who stay in school are also trying to work. Between 1960 and 1980 labor force participation rates of teenagers in school increased from 56 to 68 percent. The slower growth in family income and the rapid increase in schooling costs may also have accelerated this need to work. Keeping young people in school may require an expanding number of part time jobs.

On the other hand, these data highlight the difficult transition between school and work reflected in the high rates of unemployment for older young people, and the persistently high rates of unemployment for minority youth. Unemployment rates for minority youth remain alarmingly high no matter what definition is used. Indeed, for blacks, unemployment of out of school youth between the ages of 18 and 24 are at great depression levels, or greater. The high rates of unemployment for young black females may be explained by their increased involvement in raising their own families, but it is not clear why their unemployment rates should be three to four times greater than those for white females.

Perhaps the most important finding of researchers, who have examined the transition from school to work, is that most teenage joblessness is accounted for by a small part of the population who are out of work for extended periods of time. For example, a major study, which followed a large group of teenagers as they moved from school to work, and in and out of the labor force, found that almost half of all job changes among teenagers occur without intervening unemployment, and close to two thirds of entrances into employment occur without measured unemployment. In general, periods of unemployment are very short for most young people. However, for teenagers who drop out of school, 54 percent of the measured unemployment and 76 percent of those who leave the labor force because they think there is no hope of finding a job, are persons out of work for more than six months. Thus, a small hard core of perhaps only five to 10 percent of the teenage population account for most of the unemployment. The question is what accounts for the persistence of this hard core?

3. Increased Labor Market Segmentation

For the past three or four decades, most economists characterized the labor market as if individuals who wanted jobs were arranged in a single line. The people with the highest level of skill and ability were at the head of the line and those with the lowest level of skill at the end. As economic conditions improved employers made their way down the line, hiring the most skilled people first. Full employment was thought of as a situation where all workers who want to work at prevailing wage rates obtain a job regardless of their skill level. This view seemed to explain the problems faced by youth in the labor market. Since, in general, young people were among the least skilled, they would naturally be at the end of the line. As such, they would be the "last hired and the first fired," and predictably their

unemployment rates would generally be higher than adults. The gap in adult and youth unemployment rates would also widen in times of recession.

Recently, however, evidence has emerged which suggests that this old view of the labor market might not be valid anymore. Indeed, the unemployment of the "hard core" group described above does not seem to change very much when general economic conditions improve. Based upon their experiences in a local labor market (Boston, Massachusetts), Doeringer and Piore, for example, argued that the labor market works as if people are organized in two lines. A group of people who are typically employed in high wage, steady jobs which provide upward mobility are in one line, while those who tend to work in low wage, unstable, and dead end jobs are in another. This second line has come into existence because firms found it profitable to subcontract more unstable work, and workers in this type of job have little or no reason to become attached to their jobs. Workers who get stuck in this second line experience chronic unemployment.

There are a number of developments in the United States economy which increasingly force young people into this second line. For example, older workers are increasingly protected by job security legislation, collective bargaining agreements, and conventional personnel practices. Growth in capital intensity has increased the risk of employing young and inexperienced workers. Young people in school only want temporary jobs. A further structural change, which has particularly disadvantaged young, black workers, is that these primary jobs are moving out of the city to the suburban ring, and urban transportation systems provide inadequate access to these jobs. Although these secondary jobs are unstable, they may provide acceptable employment for youth who are in school.

However, if young people cannot make the transition to primary jobs, they suffer chronic unemployment.

4. Conclusions and Policy Considerations

Approximately 6 million young workers are currently unemployed or underemployed in the United States. Unemployment rates for young people are clearly at socially unacceptable levels indicating a substantial waste of resources and, perhaps more important, a destruction of the incentives for young people to develop and use their talents effectively. But what can be done? I have analyzed the causes of youth unemployment in this lecture so that the policy options and constraints will be clearer.

Briefly, the problem stems from four basic sources: (1) Sluggish economic growth and recession conditions have increased unemployment rates for all groups. If full employment conditions could be restored for adult males, it is predicted that youth unemployment rates would fall to approximately half their current levels. Thus, moving the economy toward full employment must be given top priority. However, even if this could be achieved, youth unemployment rates, particularly those for minorities, would still be unacceptably high. Full employment will alleviate, but not eliminate the problem. However, current fears of rekindling inflation are likely to forestall achievement of full employment. In my view, the economic recovery under way cannot be expected to bring youth unemployment rates for whites below 15 percent and for non-whites below 30 percent. (2) Demographic factors, in the form of the "baby boom" and expanded female labor force participation, have exacerbated the problem. These developments, combined with weak demand, caused difficulties for market adjustment and clearly raised youth unemployment rates. There is evidence that the economy can adjust to such changes, but more important the

number of teenagers is now declining. This smaller number of teenagers will have to compete with the relatively larger number of older workers who are unemployed. (3) Minimum wages and other restrictions on wage flexibility have made labor market adjustments more difficult, particularly for minority youth. Repealing minimum wage laws would clearly help, although an important part of the problem would remain. Unfortunately, the minimum wage law is deeply entrenched politically. Subminimum wages have been considered for young people, but the possibility that youth would be substituted for adult workers, thus raising adult unemployment rates, limits the attractiveness of this proposal. However, the problem would likely be eased somewhat if minimum wage rates are held constant or increased slowly. (4) Structural changes in the role of education and training for young people, along with other social changes, have altered the labor market attachment of young people. A small hard core of youth suffers from long term unemployment and some have dropped out of the labor market completely.

This analysis argues for a policy emphasis on youth employment, and a major redefinition of youth unemployment. This is so, first, because youth unemployment substantially misstates the size of the problem. On the one hand, more jobs for young people will expand substantially the number of youth who want one. The number who benefit may be large even though unemployment rates do not change significantly. On the other hand, for many youth, unemployment is the natural outgrowth of a necessary exploration in the market which results in their eventually settling down after a few years in a stable career. In addition to this exploration, young people need to be concerned with education, training, and other activities so that the unemployment rate as it is currently defined does not provide a good measure of unsatisfactory conditions for young people. Improved definitions illuminate two

major problems regarding youth employment: providing jobs that facilitate attending school or training, and obtaining steady career oriented jobs for a relatively small group of hard core unemployed. An unacceptable number of minority youth and others who face multiple socio-economic disadvantages seem to experience long term and chronic unemployment. This group of hard core unemployed young workers includes an estimated 300,000 to 400,000 young people. In general, society must avoid the potential time bomb of large numbers of young people with bad or poor work experiences being thrown into the labor force.

It is important to stress at the outset that there are no easy solutions. To help the hard core, significantly greater targeting of resources is necessary although admittedly difficult. Indeed, to the extent that social policy is aimed at the problem of the hard core unemployed youth, efforts will be directed at the group where the problem is most intractable. Selective job creation and on-the-job training will clearly be important. The frustrating experience of American efforts to assist the hard core unemployed in the "War on Poverty" have produced numerous testimonials of how results should not be overpromised. In general, however, what has been learned is that if these individuals can be placed in a real world adequate wage job, particularly in the private sector, with the assurance that if they master the job, it is theirs, the program works in the sense that social benefits significantly exceed costs.

In the long term the problem of youth unemployment, in general, as well as hard core unemployment will be reduced if the linkage between school and work can be improved. The school system will have to play a greater and more effective role in preparing youth for the job market. Many efforts at employing the hard core unemployed are

handicapped because the level of basic education is inadequate. In addition, employment counseling services could be much better developed in the schools. Expanded apprenticeship programs need to be considered. Occupational training must also be supplemented with labor market information. Schools, of course, must have the resources to do this.

In all of this, there is the difficult problem of allocating such resources to the young when there are adult heads of households who are also unemployed. Policy makers are in a particularly precarious position. The youth of today represent the prospects for the future, and failure to provide adequate opportunities for them now may be very costly in the future. But programs to assist youth must be provided by expansion, or young people will be substituted for adult heads of households. The resource costs of existing programs are already straining government budgets. No other issue looms larger than the setting of priorities for allocating the limited funds available to the government sector.

Table 1

Employment and Unemployment Rates
By Age, Race and Sex
1954, 1977, 1983

		White			Blacks and Others		
		1954	1977	1983	1954	1977	1983
Men							
		Percent Employed					
Age:	16-17	40.6	44.3	36.3	40.4	18.9	11.8
	18-19	61.3	65.2	58.0	66.5	36.9	29.0
	20-24	77.9	80.5	74.3	75.9	61.2	54.5
	25-54	93.8	91.3	87.8	86.4	81.7	74.9
		Percent Unemployed					
Age:	16-17	14.0	11.6	22.6	13.4	36.7	52.2
	18-19	13.0	13.0	18.7	14.7	36.1	47.3
	20-24	9.8	9.3	13.8	16.9	21.7	31.4
	25-54	3.9	3.9	7.0	9.5	5.2	12.1
Women							
		Percent Employed					
Age:	16-17	25.8	37.5	34.5	19.8	12.5	10.7
	18-19	47.2	54.3	53.6	29.9	28.0	23.1
	20-24	41.6	61.4	67.4	43.1	45.4	40.3
	25-54	40.1	54.1	63.1	49.0	57.4	59.4
		Percent Unemployed					
Age:	16-17	12.0	18.2	21.4	19.1	44.7	48.6
	18-19	9.4	12.3	16.8	21.6	37.4	48.0
	20-24	6.4	9.3	10.3	13.2	23.6	31.8
	25-54	5.0	5.8	6.4	8.3	9.8	13.0

Table 2

Predicted Unemployment Rates for Individuals 16-24 Years of Age by Sex and Race with Unemployment Rate for White Males Aged 25-54 at 1.5 Percent*

Population Group		Unemployment Rate: White	Unemployment Rate: Non-White
		Males	
Age:	16-17	13.1	29.1
	18-19	9.3	22.7
	20-24	5.6	10.6
		Females	
Age:	16-17	14.2	35.2
	18-19	11.5	31.7
	20-24	6.2	13.2

*Estimated from linear specifications from M. Feldstein and B. Right, *High Unemployment Groups in Tight Labor Markets*, Discussion Paper 488, Harvard Institute of Economic Research, Harvard University, Cambridge, Massachusetts, 1976.

Table 3

Unemployment Rates Using Three
Alternative Definitions of Youth Unemployment

Group in the Population	U_1 Conventional Measure	U_2 Augmented Labor Force	U_3 Unemployment for out of School Youth with Augmented Labor Force
		White	
		Male, age	
16-17	22.6	19.1	2.6
18-19	18.7	16.9	10.6
20-24	13.8	12.8	9.1
		Female, age	
16-17	21.4	18.2	3.0
18-19	16.4	16.1	9.2
20-24	10.3	10.0	8.2
		Non-White	
		Male, age	
16-17	52.2	41.2	8.2
18-19	47.3	36.6	26.6
20-24	31.4	26.3	22.6
		Female, age	
16-17	48.6	43.8	6.3
18-19	48.0	46.3	40.4
20-24	31.8	30.3	27.1

Wherever we look, then, on the budget, in the domestic economy, or in foreign trade or international monetary relations, we see government even more on our backs than ever. The burden and the scope of government intervention under Reagan have *increased*, not decreased. Reagan's *rhetoric* has been calling for reductions of government; his *actions* have been precisely the reverse.

Murray N. Rothbard

LECTURE 6

IS THERE LIFE AFTER REAGANOMICS?

Murray N. Rothbard

(Delivered on October 22, 1987)

I come to bury Reaganomics not to praise it – and there can be no more fitting epitaph for Reaganomics than the October massacre, especially the Black Monday of October 19th. The stock market crash brought an end to the so-called Reagan "miracle" not with a whimper but a bang. The crash showed dramatically once again that every time, as in the late 1920s, when the financial and political establishment begins to talk about a new era of permanent prosperity and perpetual boom in the stock market, the time has come to head for the hills. Before Monday, the largest stock collapse had occurred in October, 1929, when stock prices fell 12.8 percent in one day; this Monday, stock prices fell almost twice as hard, by 22.6 percent. That is a *crash*, not a "correction."

As usual, the crisis was met by deception and soft soap. Day after day, as the crash continued, our political, economic, and financial leaders continued to assure us that nothing was wrong, that stock prices are bargains and we should all buy right now, that stocks could not drop further, that 1929 could never happen again. At first, we were told that the market

crash was unimportant because trading volume was small, only to be greeted a few days later by unprecedented and enormous trading volume, setting records at over 600 million daily shares.

Leading the parade was President Reagan. Delivering a bromide eerily reminiscent of Herbert Hoover, the President assured us that the "economy is fundamentally sound," a dubious consolation for those who lost one-half trillion dollars in wealth on Black Monday, and one trillion dollars since the stock market began its steep decline this August.

In his now traditional "press conferences" shouted over the roar of helicopter motors, President Reagan followed up his assurance by yelling, "there is nothing wrong with the economy," and, besides, "Congress is responsible for the deficit." However, it was hardly reassuring for him to shout that if a recession *does* come, the fault will be the media's for alarming us, a classic case of the king reacting to bad news on the front by shooting the messenger.

The crash came because several years of monetary expansion finally resulted this year in the return of price inflation, which accelerated from about one percent last year to about five percent in 1987. But during the years of the Reagan "miracle," – heavy monetary expansion, prosperity, but low price inflation – real interest rates still remained high, a sign that the public still remembered the bad not so old days of double-digit inflation. As inflation accelerated in 1987, interest rates rose inexorably in response to the return of inflation, and in anticipation of more to come. High interest rates put a chronic damper on the stock market during the inflationary boom of the 1970s, and only the fall in nominal interest rates caused by the whopping recession of 1981-82 could generate the boom of the

last few years in the stock market. Now that inflation and higher interest rates reappeared, the stage was set for the stock market crash.

The timing of the crash was insured by the Federal Reserve. After pumping more money into the economy at the rate of over 10 percent a year for several years, the Fed became worried at the rising inflation and interest rates this April and stopped its policy of monetary inflation. From April on, the money supply has been flat, an admirable policy, but one that almost always triggers a recession. A recession is inevitable once a credit boom has been launched. The stock market is often an indicator of the near future of the economy, and so it is very likely that this crash presages an imminent recession, and one that is long overdue.

It is the view of the Austrian School of Economics that a boom in bank credit will lead inevitably to a corrective recession, and that the sooner the boom is stopped, and the recession is allowed to liquidate the unsound investments of the boom, the better. Having expanded credit and brought about a return of inflation, the Reagan administration quickly reacted to the crash by promising to protect us by virtually unlimited doses of inflation in the future. Thus, our monetary czar, Federal Reserve Chairman Alan Greenspan, assured the banks and the financial markets of enough liquidity (that is, new money) to bail everyone out. On Tuesday Greenspan declared that, "the Federal Reserve . . . affirmed today its readiness to serve as a source of liquidity to support the economic and financial system." Hence, the "cure" for what ails us – monetary inflation – is to be a lot more of the same. Consistent with this program, the Fed has already pressured the banks to lower their prime interest rates, and has already driven down the federal funds rate by pumping in more bank reserves. On the international front, Secretary of the Treasury James Baker, who had been

having trouble with the West Germans trying to induce them to inflate and lower their interest rates, announced success in the wake of U. S. pressure after the crash.

Unfortunately, the Fed and the administration are caught in a trap of their own making – in what the British call a "cleft stick." As the Fed expands credit and pushes interest rates down, price inflation will accelerate, and this will inexorably raise interest rates via an inflation premium – precisely what happened in the double-digit inflation of the late 1970s. By frantically trying to stave off an inevitable recession, the administration can only make it worse – and also make it inflationary, as in the 1970s. The administration is busily working to bring about its own worst fears; the so-called "nightmare scenario" of a simultaneous inflation and recession, accompanied by a falling dollar and a collapsed stock market – all neatly in time for the presidential election year of 1988.

Let us now turn from the stock market crash for the moment and assess how well Reaganomics has done over the seven years of its reign.

The first question to ask is: How well has Reaganomics achieved its own goals? Perhaps the best way of discovering those goals is to recall the heady days of Ronald Reagan's first campaign for the presidency, especially before his triumph at the Republican National Convention in 1980. In general terms, Reagan pledged to return, or advance, to a free market, and to "get government off our backs." Specifically, Reagan called for a massive cut in government spending, an even more drastic cut in taxation, particularly the income tax, a balanced budget by 1984 (that wild-spender, Jimmy Carter, you see, had raised the budget deficit to $74 billion a year, and this had to be eliminated), and a return to the gold standard, where money is supplied by the market rather than by government. In addition to a call for free markets domestically, Reagan affirmed his deep commitment to freedom of

international trade. Not only did the upper echelons of the administration sport Adam Smith ties, in honor of that moderate free-trader, but Reagan himself affirmed the depth of the influence upon him of the mid nineteenth century *laissez-faire* economist, Frederic Bastiat, whose devastating and satiric attacks on protectionism have been anthologized in economics readings ever since.

The gold standard was the easiest pledge to dispose of. President Reagan appointed an allegedly impartial gold commission to study the problem – a commission overwhelmingly packed with lifelong opponents of gold. The commission presented its predictable report, and gold was quickly interred.

1. Government Spending

Let's run down the other important areas. First, government spending. How well did Reagan succeed in cutting spending, surely a critical ingredient in any plan to reduce the role of government in everyone's life? In 1980, the last year of free-spending Jimmy Carter, the federal government spent 591 billion dollars. In 1986, the last recorded year of the Reagan administration, the federal government spent 990 billion dollars, an increase of 68 percent. Whatever this is, it is emphatically *not* reducing government expenditures.

Sophisticated economists say that these absolute numbers are an unfair comparison, that we should compare federal spending in these two years as a percentage of gross national product. But this strikes me as unfair in the opposite direction, because the greater the amount of inflation generated by the federal government, the higher will be the GNP. We might then be complementing the government on a lower percentage of spending achieved by the government's generating inflation by creating more money. But even taking these percentages of GNP, we get federal spending as a percent of GNP in 1980 as 21.6 percent,

and after six years of Reagan, 24.3 percent. A better comparison would be the percentage of federal spending to net private product, that is, production of the private sector. That percentage was 31.1 percent in 1980, and a whopping 34.3 percent in 1986. So even using these percentages, the Reagan administration has brought us a substantial increase in government spending.

Also, the excuse cannot be used that Congress massively increased Reagan's budget proposals. On the contrary, there was never much difference between Reagan's and Congress's budgets, and despite propaganda to the contrary, Reagan never proposed a cut in the total budget.

2. Deficits

The next, and admittedly the most embarrassing, failure of Reaganomic goals is the deficit. Jimmy Carter habitually ran deficits of $40-$50 billion and by the end, up to $74 billion; but by 1984, when Reagan had promised to achieve a balanced budget, the deficit had settled down comfortably to about $200 billion, a level that seems to be permanent, despite desperate attempts to cook the figures in one-shot reductions.

This is by far the largest budget deficit in American history. It is true that the $50 billion deficits in World War II were a much higher percentage of the GNP, but that was a temporary, one-shot, situation the product of war finance. But the war was over in a few years; and the current federal deficits now seem to be a recent, but still permanent part of the American heritage.

One of the most curious, and least edifying, sights in the Reagan era was to see the Reaganites completely change their tune of a lifetime. At the very beginning of the Reagan administration, the conservative Republicans in the House of Representatives, convinced that

deficits would disappear immediately, received a terrific shock when they were asked by the Reagan administration to vote for the usual annual increase in the statutory debt limit. These Republicans, some with literal tears in their eyes, protested that never in their lives had they voted for an increase in the national debt limit, but they were doing it just this one time because they "trusted Ronald Reagan" to balance the budget from then on. The rest, alas, is history, and the conservative Republicans never saw fit to cry again. Instead, they found themselves adjusting rather easily to the new era of huge permanent deficits. The Gramm-Rudman Law, allegedly designed to eradicate deficits in a few years, has now unsurprisingly bogged down in enduring confusion.

Even less edifying is the specter of Reaganomists who had inveighed against deficits – that legacy of Keynesianism – for decades. Soon Reaganite economists, especially those staffing economic posts in the executive and legislative branches, began to find that deficits really weren't so bad after all. Ingenious models were devised claiming to prove that there really *isn't* any deficit, that it's only a mirage. Bill Niskanen, of the Council of Economic Advisors, came up with perhaps the most ingenious discovery; that there is no reason to worry about government deficits, since they are balanced by the growth in value of government assets. Well, hooray, but it is rather strange to see economists whose alleged goal is a drastic reduction in the role of government, cheering for ever greater growth in government assets. Moreover, the size of government assets is really beside the point. It would only be of interest if the federal government were just another private business firm, about to go into liquidation, and whose debtors could then be satisfied by a parceling out of its hefty assets. The federal government is not about to be liquidated; there is no chance, for example, of an institution ever going into bankruptcy or liquidation that has the legal right to

print whatever money it needs to get itself – and anyone else it favors – out of any financial hole.

There has also been a fervent revival of the old left-Keynesian idea that "deficits don't matter, anyway." Deficits are stimulating, we can "grow ourselves out of deficits," etc. The most interesting, though predictable, twist was that of the supply-siders, who, led by Professor Arthur Laffer and his famous "curve," had promised that if income tax rates were cut, investment and production would be so stimulated that a fall in tax rates would increase tax *revenue* and balance the budget. When the budget was most emphatically *not* balanced, and deficits instead got worse, the supply-siders threw Laffer overboard as the scapegoat, claiming that he was an extremist, and the only proponent of his famous curve. The supply-siders then retreated to their current, fallback position, which is quite frankly Keynesian; namely, deficits don't matter anyway, so let's have cheap money and deficits, relax and enjoy them. About the only Keynesian phrase we have *not* heard yet from Reaganomists is that the national debt "doesn't matter because we owe it to ourselves," and I am waiting for some supply-sider to adopt this famous 1930s phrase of Abba Lerner without, of course, bothering about attribution.

One way in which Ronald Reagan has tried to seize the moral high road on the deficit question is to divorce his rhetoric from reality even more sharply than usual. Thus, the proposer of the biggest deficits in American history has been calling vehemently for a constitutional amendment to require a balanced budget. In that way, Reagan can lead the way toward permanent $200 billion deficits, while basking in the virtue of proposing a balanced budget amendment, and trying to make Congress the fall guy for our deficit economy.

Even in the unlikely event that the balanced budget amendment should ever pass, it would be ludicrous in its lack of effect. In the first place, Congress can override an amendment at any time by a 3/5 vote. Secondly, Congress is not required to actually *balance* any budget, that is, its actual expenditures in any given year are not limited to the revenues taken in. Instead, Congress is only required to prepare an *estimate* of a balanced budget for a *future* year; and of course, government estimates, even of its own income or spending, are notoriously unreliable. And third, there is no *enforcement* clause; suppose Congress *did* violate even the requirement for an estimated balanced budget: What is going to happen to the legislators? Is the Supreme Court going to summon marshals and put the entire U. S. Congress in jail? And yet, not only has Reagan been pushing for such an absurd amendment, but so too have many helpful Reaganomists.

3. Tax Cuts

One of the few areas where Reaganomists claim success without embarrassment is taxation. Didn't the Reagan administration, after all, slash income taxes in 1981, and provide both tax cuts and "fairness" in its highly touted tax reform law of 1986? Hasn't Ronald Reagan, in the teeth of opposition, heroically held the line against all tax increases?

The answer, unfortunately, is no. In the first place, the famous "tax cut" of 1981 did not cut taxes at all. It's true that tax rates for higher-income brackets were cut; but for the average person, taxes rose, rather than declined. The reason is that, on the whole, the cut in income tax rates was more than offset by two forms of tax increase. One was "bracket creep," a term for inflation quietly but effectively raising one into higher tax brackets, so that you pay more and proportionately higher taxes *even though* the tax rate schedule has officially remained the same. The second source of higher taxes was social security taxation,

which kept increasing, and which helped taxes go up overall. Not only that, but soon thereafter, when the Social Security System was generally perceived as on the brink of bankruptcy, President Reagan brought in Alan Greenspan, a leading Reaganomist and now Chairman of the Federal Reserve, to save Social Security as head of a bipartisan commission. The "saving," of course, meant still higher Social Security taxes then and forevermore.

Since the tax cut of 1981 that was not really a cut, furthermore, taxes have gone up every single year since, with the approval of the Reagan administration. Except, to save the President's rhetorical sensibilities, they weren't *called* tax increases. Instead, ingenious labels were attached to them; raising of "fees," "plugging loopholes" (and surely everyone wants loopholes plugged), tightening IRS enforcement, and even "revenue enhancements." I am sure that all good Reaganomists slept soundly at night knowing that even though government revenue was being "enhanced," the President had held the line against tax increases.

The highly ballyhooed Tax "Reform" Act of 1986 was supposed to be economically healthy as well as "fair;" supposedly "revenue neutral," it was to bring us (a) simplicity, helping the public, while making the lives of tax accountants and lawyers miserable; and (b) income tax cuts, especially in the higher income brackets and in everyone's marginal tax rates (that is, income tax rates on additional money you may earn); and offset only by plugging those infamous loopholes. The reality, of course, was very different. In the first place, the administration has succeeded in making the tax laws so complicated that even the IRS admittedly doesn't understand it, and tax accountants and lawyers will be kept puzzled and happy for years to come.

Secondly, while indeed income tax rates were cut in the higher brackets, many of the loophole plugs meant huge tax increases for people in the upper as well as the middle income brackets. The point of the income tax, and particularly the marginal rate cuts, was the supply-sider objective of lowering taxes to stimulate savings and investment. But a National Bureau study by Hausman and Poterba on the Tax Reform Act shows that over 40 percent of the nation's taxpayers suffered a marginal tax *increase* (or, at best, the same rate as before) and, of the majority that *did* enjoy marginal tax cuts, only 11 percent got reductions of 10 percent or more. In short, most of the tax reductions were negligible. Not only that; the Tax Reform Act, these authors reckoned, would lower savings and investment overall because of the huge increases in taxes on business and on capital gains. Moreover, savings were also hurt by the tax law's removing tax deductibility on contributions to IRAs.

Not only were taxes increased, but business costs were greatly raised by making business expense meals only 80 percent deductible, which means a great expenditure of business time and energy keeping and shuffling records. And not only were taxes raised by eliminating tax shelters in real estate, but the law's claims to "fairness" were made grotesque by the retroactive nature of many of the tax increases. Thus, the abolition of tax shelter deductibility was made retroactive, imposing huge penalties after the fact. This is *ex post facto* legislation outlawed by the Constitution, which prohibits making actions retroactively criminal for a time period when they were perfectly legal. A friend of mine, for example, sold his business about eight years ago; to avoid capital gains taxes, he incorporated his business in the American Virgin Islands, which the federal government had made exempt from capital gains taxes in order to stimulate Virgin Islands development. Now, eight years later, this tax exemption for the Virgin Islands has been removed (A "loophole" plugged!)

but the IRS now expects my friend to pay full retroactive capital gains taxes plus interest on this eight-year-old sale. Let's hear it for the "fairness" of the tax reform law!

But the bottom line on the tax question, is what happened in the Reagan era to government tax revenues overall? Did the amount of taxes extracted from the American people by the federal government go up or down during the Reagan years? The facts are that federal tax receipts were 517 billion dollars in the last Carter year of 1980. In 1986 revenues totaled 769 billion dollars, an increase of 49 percent. Whatever that is, that doesn't look like a tax *cut*. But how about taxes as a percentage of national product? There, we can concede that on a percentage criterion, overall taxes fell very slightly, remaining about even with the last year of Carter. Taxes fell from 18.9 percent of GNP to 18.3 percent, or for a better gauge, taxes as a percentage of net private product fell from 27.2 percent to 26.6 percent. A large absolute increase in taxes, coupled with keeping taxes as a percentage of national product about even, is scarcely cause for tossing one's hat in the air about a whopping reduction in taxes during the Reagan years.

In recent months, moreover, the Reagan administration has been more receptive to loophole plugging, fees, and revenues than ever before. To quote from the Tax Watch column in the *New York Times* (October 13, 1987): "President Reagan has repeatedly warned Congress of his opposition to any new taxes, but some White House aides have been trying to figure out a way of endorsing a tax bill that could be called something else." In addition to closing loopholes, the White House is nudging Congress to expand the usual definition of a "user fee," not a tax because it is supposed to be a fee for those who use a government service, say national parks or waterways. But apparently the Reagan administration is now expanding the definition of "user fee" to include excise taxes, on the

assumption, apparently, that every time we purchase a product or service we must pay government for its permission. Thus, the Reagan administration has proposed not, of course, as a tax *increase*, but as an alleged "user fee," a higher excise tax on every international airline or ship ticket, a tax on all coal producers, and a tax on gasoline and on highway charges for buses. The administration is also willing to support, as an alleged user fee rather than a tax, a requirement that employers, such as restaurants, start paying the social security tax on tips received by waiters and other service personnel.

In the wake of the stock market crash, President Reagan is now willing to give us a post-crash present: higher taxes that will openly be *called* higher taxes. On Tuesday morning, the White House declared: "We're going to hold to our guns. The President has given us marching orders: no tax increase." By Tuesday afternoon, however, the marching orders had apparently evaporated, and the President said that he was "willing to look at" tax-increase proposals. To greet a looming recession with a tax increase is a wonderful way to bring that recession into reality. Once again, President Reagan is following the path blazed by Herbert Hoover in the Great Depression of raising taxes to try to combat a deficit.

4. Deregulation

Another crucial aspect of freeing the market and getting government off our backs is deregulation, and the administration and its Reaganomists have been very proud of its deregulation record. However, a look at the record reveals a very different picture. In the first place, the most conspicuous examples of deregulation; the ending of oil and gasoline price controls and rationing, the deregulation of trucking and airlines, were all launched by the Carter Administration, and completed just in time for the Reagan Administration to claim

the credit. Meanwhile, there were other, promised deregulations that never took place; for example, abolition of natural gas controls of the Department of Energy.

Overall, in fact, there has probably been not deregulation, but an increase in regulation. Thus, Christopher DeMuth, head of the American Enterprise Institute and a former top official of Reagan's Office of Management and the Budget, concludes that " the President has not mounted a broad offensive against regulation. There hasn't been much total change since 1981. There has been more balanced administration of regulatory agencies than we had become used to in the 1970s, but many regulatory rules have been strengthened."

In particular, there has been a fervent drive, especially in the past year, to intensify regulation of Wall Street. A savage and almost hysterical attack was launched late last year by the Securities and Exchange Commission and by the Department of Justice on the high crime of "insider trading." Distinguished investment bankers were literally hauled out of their offices in manacles, and the most conspicuous inside trader received as a punishment (1) a fine of one-hundred million dollars; (2) a lifetime ban on any further security trading, and (3) a jail term of one year, suspended for community service. And this is the *light* sentence, in return for allowing himself to be wired and turn informer on his insider trading colleagues.

All this was part of a drive by the administration to protect inefficient corporate managers from the dread threat of takeover bids, by which means stockholders are able to dispose easily of ineffective management and turn to new managers. Can we really say that this frenzied assault on Wall Street by the Reagan administration had no impact on the stock market crash?

And yet the Reagan administration has reacted to the crash not by letting up, but by intensifying, regulation of the stock market. The head of the SEC strongly considered closing down the market on Monday, and some markets were temporarily shut down – a case, once again, of solving problems by shooting the market – the messenger of bad news. Today the Reagan administration collaborated in announcing early closing of the market for the next several days. The SEC has already moved, in conjunction with the New York Stock Exchange, to close down computer program trading on the market, trading related to stock index futures. But blaming computer program trading for the crash is a Luddite reaction; trying to solve problems by taking a crowbar and wrecking the machines. There were no computers, after all, in 1929. Once again, the instinct of the administration, particularly in relation to Wall Street, is to regulate more and more. Regulate, and inflate, seem to be the Reaganite answers to our economic ills.

Agricultural policy, for its part, has been a total disaster. Instead of ending farm price supports and controls and returning to a free market in agriculture, the administration has greatly increased price supports, controls, and subsidies. Furthermore, it has brought a calamitous innovation to the farm program; the PIK program ("Payment In Kind") in which the government gets the farmers to agree to drastic cuts in crop acreage, in return for which the government pays back the wheat or cotton surpluses previously held off the market. The result of all this has been to push farm prices far higher than the world market, depress farm exports, and throw many farmers into bankruptcy. All the administration can offer, however, is more of the same disastrous policy.

5. Foreign Economic Policy

If the Reagan administration has botched the domestic economy, even in terms of its own goals, how has it done in foreign economic affairs? As we might expect, its foreign economic policy has been the exact opposite of its proclaimed devotion to free trade and free markets. In the first place, Adan Smith ties and Bastiat to the contrary notwithstanding, the Reagan administration has been the most belligerent and nationalistic since Herbert Hoover. Tariffs and import quotas have been repeatedly raised, and Japan has been treated as a leper and repeatedly denounced for the crime of selling high quality products at low prices to the delighted American consumer. In all matters of complex and tangled international economics, the only way out of the thicket is to keep our eye on one overriding question: Is it good, or bad, for the American consumer? What the American consumer wants is good quality products at low prices, and so the Japanese should be welcomed and admired instead of condemned. As for the alleged crime of "dumping," if the Japanese are really foolish enough to waste money and resources by dumping – that is, selling goods to us below costs – then we should welcome such a policy with open arms; anytime the Japanese are willing to sell me Sony TV sets for a dollar, I am more than happy to take the sets off their hands.

Not only foreign producers are hurt by protectionism, but even more so are American consumers. Every time the administration slaps a tariff or quota on motorcycles or on textiles or semiconductors or clothespins – as it did to bail out one inefficient clothespin plant in Maine – every time it does that, it injures the American consumer.

It is no wonder, then, that even the Reaganomist Bill Niskanen recently admitted that "international trade is more regulated than it was 10 years ago." Or, as Secretary of Treasury James Baker declared proudly last month: "President Reagan has granted more

import relief to U. S. industry than any of his predecessors in more than half a century." Pretty good for a Bastiat follower.

Another original aim of the Reagan administration, under the influence of the monetarists, or Friedmanites, was to keep the government's hand completely off exchange rates, and to allow these rates to fluctuate freely on the market, without interference by the Federal Reserve or the Treasury. A leading monetarist, Dr. Beryl W. Sprinkel, was made Undersecretary of the Treasury for Monetary Policy in 1981 to carry out that policy. But this non-intervention is long gone, and Secretary Baker, aided by the Fed, has been busily engaged in trying to persuade other countries to intervene to help coordinate and fix exchange rates. After being removed from the Treasury, after several years, Sprinkel was sent to Siberia, and ordered to keep quiet, as head of the Council of Economic Advisors; and Sprinkel has recently announced that he will leave the government altogether.

Moreover, the policy of foreign aid and foreign lending conducted or encouraged by the government has proceeded more intensely than even under previous administrations. Reagan has bailed out the despotic government of Poland with massive loans, so that Poland could repay its Western creditors. A similar policy has been conducted in relation to many shaky or bankrupt third world governments. The specter of bank collapse from foreign loans has been averted by bailouts and promises of bailout from the Federal Reserve, the nation's only manufacturer of dollars, which it can produce at will.

Wherever we look, then, on the budget, in the domestic economy, or in foreign trade or international monetary relations, we see government even more on our backs than ever. The burden and the scope of government intervention under Reagan have *increased*, not decreased. Reagan's *rhetoric* has been calling for reductions of government; his *actions*

have been precisely the reverse. Yet both sides of the political fence have bought the rhetoric and claim that it has been put into effect. Reaganites and Reaganomists, for obvious reasons, are trying desperately to maintain that Reagan has indeed fulfilled his glorious promises; while his opponents, intent on attacking the bogey of Reaganomics, are also, and for opposite reasons, anxious to claim that Reagan has really put his free market program into operation. So we have the curious, and surely not healthy, situation where a mass of politically interested people are totally misinterpreting and even misrepresenting the Reagan record; focusing, like Reagan himself, on his rhetoric instead of on the reality.

6. What of the Future?

What of the Future? Is there life after Reaganomics? To assess coming events, we first have to realize that Reaganomics has never been a monolith. It has had several faces; Reaganomics has been an uneasy and shifting coalition of several clashing schools of economic thought. In particular, the leading schools have been the conservative Keynesians, the Milton Friedman monetarists, and the supply-siders. The monetarists, devoted to a money rule of a fixed percentage increase of money growth engineered by the Federal Reserve, have come a cropper. Fervently believing that science is nothing else but prediction, the monetarists have self-destructed by making a string of self-confident but disastrous predictions in the last several years. Their fate illustrates the fact that he who lives by prediction shall die by it. Apart from their views on money, the monetarists generally believe in free markets, and so their demise has left Reaganomics in the hands of the other two schools of Reaganomics, neither of whom are particularly interested in free markets or cutting government.

The conservative Keynesians – the folks who brought us the economics of the Nixon and Ford administrations – saw Keynesianism lose its dominance among economists with the inflationary recession of 1973-74, an event which Keynesians stoutly believed could never possibly happen. But while Keynesians have lost their old éclat, they remain with two preoccupations: (1) a devotion to the New Deal, Fair Deal, Great Society, Nixon-Ford-Carter status quo, and (2) a zeal for tax increases to moderate the current deficit. As for government spending, never has the thought of actually cutting expenditures crossed their minds. The supply-siders, who are weak in academia but strong in the press and in exerting enormous political leverage per capita, have also no interest in cutting government spending. To the contrary, both conservative Keynesians and supply-siders are prepared to call for an increasing stream of goodies from Big Daddy government. Both groups have also long been keen on monetary inflation. The supply-siders have pretty much given up the idea of tax cuts; their stance is now to accept the deficit and oppose any tax increase. On foreign monetary matters, the conservative Keynesians and the supply-siders have formed a coalition; both groups embrace Secretary of Treasury Baker's Keynesian program of fixed exchange rates and an internationally coordinated policy of cheap money.

Politically, the Republican presidential candidates can be assessed on their various preferred visions of Reaganomics. Vice-President Bush is, of course, a conservative Keynesian and a veteran arch-enemy of supply-side doctrine, which he famously denounced in 1980 as "voodoo economics." Secretary of Treasury James Baker is a former Bush campaign aide. White House Chief of Staff Howard Baker is also in the conservative Keynesian camp, as was Paul Volker, and is Alan Greenspan. Since former White House Chief of Staff Donald Regan was a fellow-traveler of the supply-siders, his replacement by

Howard Baker as a result of the Iran-Contra affair was a triumph of conservative Keynesians over the supply-siders. This year, in fact, our troika of Economic Rulers, Greenspan and the two Bakers, has all been squarely in the conservative Keynesian camp.

Senator Robert Dole, the other Republican front-runner for President, is also a conservative Keynesian. In fact, Bob Dole carried on the fight for higher taxes even when it was relatively unfashionable inside the administration. So devoted to higher taxes is Bob Dole, in fact, that he is reputed to be the favorite presidential candidate of the Internal Revenue Service. So if you like the IRS, you'll love Bob Dole.

Congressman Jack Kemp, on the other hand, has been the political champion of the supply-siders ever since supply-side was invented in the late 1970s. Kemp's call for higher government spending, and approval of deficits, monetary inflation, and fixed exchange rates, all attest to his supply-side devotion. Jack Kemp, however, has for some reason not struck fire among the public, so Mrs. Jeane Kirkpatrick stands ready in the wings to take up the cause if Kemp should fail to rally. I confess I have not been able to figure out the economic views of the Reverend Pat Robertson, although I have a hunch they do not loom very large in his world outlook.

Although there are a lot of Democratic candidates out there, it is hard at this point to distinguish one from another, on economic policy or indeed on anything else. As Joe Klein recently wrote in a perceptive article in the *New York* magazine, the Republicans are engaged in an interesting clash of different ideas, while the Democrats are all muddily groping toward the center. To make the confusion still greater, Klein points out that Republicans are busily talking about "compassion," while the Democrats are all stressing "efficiency." One thing is

fairly clear; Congressman Gephardt is an all-out protectionist, thoroughly jettisoning the old Democratic commitment to free trade, and is the most ardent statist in agricultural policy.

On monetary and fiscal policy, the Democrats are the classic party of *liberal* Keynesianism, in contrast to the Republican policy of *conservative* Keynesianism. The problem is that, in the last decade or two, it has become increasingly difficult to tell the difference. Apart from supply-sider Kemp, we can expect the President of either party to be a middle-of-the-road liberal/conservative Keynesian. And so we can expect the next administration's economic policies to be roughly the same as they are now. Except that the *rhetoric* will be different. So we can, therefore, expect diverse perceptions and responses to a similar reality by the public and by the market. Thus, if Jack Kemp becomes President, the public will wrongly consider him a champion of hard money, budget cutting, and the free market. The public will, therefore, *underestimate* the wildly inflationist reality of a Kemp administration. On the other hand, the public probably perceives the Democrats to be wilder spenders relative to the Republicans than they really are. So should the Democrats win in 1988, we can expect the market to *overestimate* the inflationary measures of a Democratic administration.

All of this, along with the universal misperception of Reaganomics, illustrates once more the wisdom of those incisive political philosophers, Gilbert and Sullivan: "Things are not always what they seem; skim milk masquerades as cream."

As far as I can make out, a “loophole”
is any income that any of us have earned that
hasn’t yet been taxed away by the federal government.
Or, rather, a loophole is money the *other guy* has earned that you wouldn’t
at all mind him having to fork over to the government. In short,
my money is fairly earned and shouldn’t be taxed away;
the other guy’s money constitutes one vast loophole.

Murray N. Rothbard

LECTURE 7

DEFICITS AND TAXES: THE ECONOMICS OF THE NEXT FOUR YEARS

Murray N. Rothbard

(Delivered on c. January 11, 1989)

The economics of the next four years depends on the new George H. W. Bush Administration, and the first question to ask about Mr. Bush is: Did he receive any mandate from the American voters? It is generally held that he did not because of the negative nature of his campaign. But it is clear from Bush's repeated campaign themes that he *did* receive three clear mandates from the American people. One is never, never to join the American Civil Liberties Union. Second, is to make sure that Willie Horton is not released once more from jail. Mandates indeed, but unfortunately it is not very clear what they have to do with the functions and powers of the President.

1. Tax Hike Hysteria

But there is one clear Bush campaign theme that *does* involve the powers of the Presidency: The famous "read my lips: no new taxes."

Traditionally, incoming presidents enjoy a "honeymoon" for their first year, or at least the first one hundred days, in office. But George Bush's honeymoon might prove to be the shortest on record. He wasn't even allowed to savor his victory overnight. Only a few

minutes after Bush was declared the winner by the networks, the media pundits came on and announced: "Well, that's it. George Bush's honeymoon is now over. He is now in for four years of exquisite torture." In particular, the signal for the end of the honeymoon was given about an hour after the victory by Robert Dole, Republican minority leader in the Senate. Dole, with the characteristic lack of the conventional courtesies that makes him the delight of the Washington press corps, bitterly denounced the president-elect. In the course of his philippic, Dole, of whom it is said that he has never met a tax increase he doesn't like, particularly mentioned Bush's failure to come out for an increase in taxes in order to lower the deficit.

Starting the next morning, the day after the election, the media, almost as one man, joined by a concerted chorus of businessmen and, of all things, serried ranks of named and unnamed economists, jumped with both feet on the president-elect. They sternly lectured Bush that he must, immediately and without delay, give up the nonsense about no raise in taxes and commit himself to whopping tax increases. Their only worry was that Bush might gum up the works by taking his repeated pledge to the voters seriously.

The political arguments about a tax increase are fairly obvious. Liberal Democrats and moderate Republicans claim that Bush must work in conciliatory fashion with Congress and go along with tax increases. Conservatives insist that Bush stick by his pledge and stand firm against Congress and against increasing taxes. The nation's economists, however, claim to be above the political fray and to speak in the name of "value-free economic science." Federal Reserve Board Chairman Alan Greenspan has warned Bush that unless the budget deficit is reduced immediately, we might face a financial crisis and recession. It turns out that one of Greenspan's favorite proposals is a stiff fifteen-cent-a-gallon increase in gasoline

taxes, a proposal that is perhaps understandable coming from a multi-millionaire who is driven around in a limo paid for by the American taxpayers. It is not surprising that an even bolder proposal comes from Greenspan's beloved predecessor as Fed Chairman, Paul Volcker, who has called for a *sixty-cent* a gallon increase in the gasoline tax, plus increased taxes on alcohol and tobacco. I suppose that, if we should ever face Volcker's huge boost in gas taxes, we could all take consolation in the great sacrifice Volcker would be making by paying a higher tax on his famous cigars.

C. Fred Bergsten, head of the Institute of International Economics, has been all over the media insisting on a tax increase. If there is no increase by Easter, he warns, there is a "grave risk" of financial crisis and recession. Equally insistent and ubiquitous has been Lawrence Chimerine, head of the economic forecasting firm, The WEFA Group, who adds sharply that "anybody who knows how to do arithmetic knows there has to be a tax increase." In an open letter to Mr. Bush the day after the election, Mark Memmott, economic writer for *USA Today*, claiming to speak for a consensus of business leaders and economists, demands a big tax increase. Memmott and Company then highlight the advice of Professor Murray Weidenbaum, former Chairman of The Council of Economic Advisers under Reagan. Weidenbaum claims that this tax increase could be successfully pushed through, provided that every group in the country suffer equal pain. As we saw in the so-called Tax Reform Act of 1986, economists are specialists in the infliction of equal pain, or at least in plenty of pain period.

The mania for a tax increase among economists came to a head in a comment by the distinguished Harvard economist Richard Cooper. Noting that last October's stock market crash persuaded President Reagan to agree to raise taxes, Cooper suggested that a similar

crisis might persuade Mr. Bush to break his unfortunate pledge. "In that context," opined Professor Cooper, "a crisis might actually be welcome." Note the interesting shift in emphasis: Whereas Chimerine, Bergsten, Greenspan, and others demand a tax increase in order to stave off a financial crisis, Professor Cooper, in his infatuation with higher taxes, actually welcomes a crisis in order to bring about the increase! Notice too that economic policy has gotten curiouser and curiouser; in the old days a tax *cut* was supposed to be the way to help cure a recession; now a tax *increase* does the same thing. Which once again gives point to the old joke that economics professors ask the same exam questions year after year and they guard against students cheating by continually changing the answers.

Many of the nation's businessmen also joined the chorus, calling loudly for a tax increase to lower the deficit. In addition to being persuaded, or bamboozled – depending on your point of view – by the nation's economists, some of the pro-tax business leaders seem to have something else on their minds than altruism. One clue is provided by one of the nation's most astute economists, Jerry Jordan, chief economist of First Interstate Bancorp, and formerly a member of Reagan's Council of Economic Advisers: "The business people mostly want him [Bush] to raise taxes because they think it won't be *their* taxes that will go up." Jordan explained that since business taxes got raised a great deal in the so-called tax reform of 1986 – such as repeal of the investment credit, reduction of depreciation allowances, and a large increase in capital gains taxes – "that it should go to the consumers this time." But there is another obscure but important point: many existing corporate managers, especially inefficient ones, dislike above all else hostile takeovers outbidding them for control of their corporation. Thus, Robert E. Mercer, Chairman of Goodyear Tire and Rubber, so eager for a tax hike that he suggests that Congress be "responsible" enough to

override a Bush veto, particularly wants a tax that would stop or restrict hostile takeovers and leveraged buyouts. Echoing this sentiment, Senator Dole has claimed that huge corporate takeovers do not benefit the economy, and therefore that tax deductions on leveraged buyout loans should be eliminated, or, in a phrase we will analyze later, that this "loophole" should be closed. In fact, corporate takeovers benefit the stockholders and the economy by shifting control of assets from less efficient to more efficient owners.

Foreign dignitaries quickly joined in the seemingly orchestrated bombardment for higher taxes. In a series of press interviews in the two days following the election, European and Japanese finance officials joined in the strident call for a tax increase in the United States. These governments have been helping the U. S. government to stabilize exchange rates of the dollar at current levels, and they warned that they expect a U. S. tax increase and deficit reduction as the price for their continued cooperation. The Bank of Japan issued a report timed to come out on November 9th, calling for higher U. S. taxes, and similar peremptory demands were made by Pierre Beregovoy, Finance Minister of France, Nigel Lawson, Chancellor of the Exchequer in Great Britain, and Onno Runing, Finance Minister of the Netherlands. Dominique Graber, an economist with the Banque Paribas in France, warned that "the only solution is to increase taxes and to do it in a substantial way," although Onno Runing of the Netherlands was gracious enough to leave the specific path of reducing the deficits, reducing expenditures or raising taxes, "up to the Americans." And Timothy O'Dell, international economist with UBS Phillips and Drew in London, threatened us with what we might call the "Cooper solution." He warned that European financial officials may decide to pull the plug on the dollar, or as he put it, to decide "that the Americans may need,

if you like, to face a more substantial crisis in the financial markets to come to their senses" – that is, to agree to increase taxes. [*New York Times*, November 12, 1988]

But the foreign finance officials see a ray of light on the horizon: their former counterpart as Secretary of Treasury James Baker. Baker's appointment as Secretary of State was hailed immediately by the German and French Finance Ministers.

So frantic are these pundits and establishment experts that they are even managing to conscript the stock and foreign exchange markets into their campaign. Usually, everyone acknowledges that the markets hardly speak in a single, clear voice, especially in short-run, day-to-day movements, which are notoriously murky and difficult to interpret. But the fall in stock prices in the few days after the election, as well as the fall of the dollar in the exchange market, are being uniformly interpreted as messages from the market oracle that George Bush must raise taxes. It certainly seems strange that both sets of markets, which have not seemed to give much of a darn about the American budget deficit for many months, should suddenly decide to speak with one voice beginning November 9th.

Let us instead put the movement of the dollar in perspective. It is true that, from November 8th to November 11th, when the foreign exchange market was supposedly giving its clarion call for the U. S. to raise taxes, the value of the dollar in terms of Japanese yen fell by 2.3 percent. But, on the other hand, it is conveniently forgotten that on the five days *before* Election Day, November 8th, the dollar *rose* by 1.1 percent in terms of the yen. So what are we supposed to conclude? That the market was happy about U. S. deficits just before the election and suddenly turned gloomy the next day? Come on, assorted pundits, economists, and financial officials: Give us a break!

Unfortunately, I haven't got time to go into the crisis warned against or threatened by the foreign dignitaries, but it concerns a threat to stop cooperating in keeping up the value of the dollar in exchange markets by buying dollars with their currencies. I can only say here that the entire aura of crisis around the value of the dollar is an artificial creation of attempts by governments and central banks, ever since James Baker became Secretary of the Treasury in 1985, to fix the exchange rate of the dollar at some level or other – usually any existing rate – which these politicians and experts think to be superior to rates set by the supply and demand forces of the market. Here is a continuing and losing struggle of governments against the market, and the governments are doomed to lose, bringing repeated currency crises in their wake. As usual, the main cause of any economic problem turns out to be government intervention.

I would like to pause for a moment and note a refreshing contrast to the tax hike mania of all these distinguished economists and statesmen: the resounding vote on Election Day by which 82 percent of our fellow Nevadans endorsed a constitutional amendment to prohibit, ever, any income tax in the State of Nevada.

2. "Wiggle Room"

Unfortunately, as they well realize, there is hope for our massed phalanx of high tax hysterics. That hope lies in what we might call "advanced semantics." When his aides and handlers found Ronald Reagan stubbornly resistant to the idea of a tax increase, they were repeatedly able to convince him to back such increases by the simple but effective device of *calling it by a different name*. "No Mr. President," they would say, "this is not a tax increase, no indeed. It is [and here take your pick] 'a rise in Social Security premiums'; 'an increase in user fees'; 'a tax reform'; 'fairness, or equity, in taxes'; 'tightening IRS enforcement'; and

(my two favorites) 'closing the loopholes' and 'revenue enhancement.' We're not raising taxes, Mr. President, we're just enhancing revenue." "Oh, ok, then."

Governor Dukakis's favorite form of not-raising taxes – I guess every politician has his favorite – was, you may remember, to double the number of IRS agents. This pledge was, I am sure, one of the reasons that Dukakis did not exactly endear himself to the American people. In denouncing his suggestion, in fact, George Bush eloquently declared that "we need *fewer* IRS agents, not more." This sentiment met with thunderous applause, including my own, but I am afraid that I would not bet my life on reductions in the IRS staff during the next four years.

Advanced semantics led Ronald Reagan to raise taxes, in the name of not-raising taxes, in every year of his administration, very often in the name of "closing loopholes." We may ask: what are these "loopholes" that we are supposed to close? As far as I can make out, a "loophole" is any income that any of us have earned that hasn't yet been taxed away by the federal government. Or, rather, a loophole is money the *other guy* has earned that you wouldn't at all mind him having to fork over to the government. In short, *my* money is fairly earned and shouldn't be taxed away; the other guy's money constitutes one vast loophole.

To return to George Bush, in his press conference the day after Election Day, he reiterated his adamant dedication to not raising taxes. However, he gladdened the hearts of the tax hike hysterics by allowing himself what the *Los Angeles Times* enthusiastically called "wiggle room." The wiggle method: our old friend advanced semantics. Thus, Bush went out of his way to endorse a tax increase taking effect next January 1st. This is an income tax surtax of fifteen percent on all Medicare recipients with incomes over $10,000 to help pay for Reagan's new program of catastrophic health insurance. "I don't consider that taxes,"

George Bush commented, “some charge that that was a tax increase. I don’t think it was.” Well, *that’s* interesting. If that’s not taxes, what in the world *is* it? We haven’t been told yet, but I am sure that President Bush will come up with a linguistically entertaining, if not exactly convincing, answer.

As might be expected, C. Fred Bergsten led the cheering section at Bush’s statement on the Medicare tax. “What Bush said,” Bergsten exulted, “looks like a very skillful way to start opening the door to various revenue increases. By volunteering when he didn’t have to that the Medicare approach is ok, he appears to be signaling that certain tax increases might be acceptable.” Indeed.

Not only that: at this same news conference, George Bush was pressed on whether he would resist all kinds of “revenue enhancements,” which, as the *Los Angeles Times* neatly explained, is “a code word on Capitol Hill for various types of subtle rather than explicit tax increases.” [November 10, 1988] Bush answered, “You’d have to define for me what you mean by revenue enhancement.” But surely, Mr. Bush has been around Washington long enough to know all too well what “revenue enhancements” are – tax increases by a sweeter name – and his answer signals that he is prepared to go the enhancement route. What price lip-reading now?

3. Analyzing the Deficit

Having discussed the sudden post-election hysteria designed to pressure George Bush into raising taxes, let us analyze the deficit itself. The federal government has been blithely sailing along on an annual deficit of approximately $200 billion since 1983.

But what about the much-ballyhooed Gramm-Rudman Law? Doesn’t that law insure a phased reduction of the deficit until a balanced budget is achieved in a few years?

The answer is no. What Congress giveth, Congress can take away. No law by a past Congress can bind a current one. There has been a law on the books since the 1970s prohibiting Congress from incurring any deficit. Why haven't we heard of this law? Because it is a dead letter, since who is going to enforce it? Short of the courts sending federal marshals to lock up every Congressman, I don't see how such a law can be enforceable. Similarly, there is a law on the books putting a rigid ceiling on the total accumulated national debt. Congress deals with that rigid cap by simply raising that cap every year or two. The same can be done to the Gramm-Rudman targets; they can simply be changed every year and the balanced budget postponed indefinitely into the rosy but increasingly hazy future.

Avoiding such defective crutches as Gramm-Rudman, then, let us look at Mr. Chimerine's stern arithmetic. If we want to reduce the deficit, or even eliminate it altogether, do we *have* to raise taxes?

We should, in the first place, look at the supply-side doctrine. The supply-side economists claim that orthodox economists, by which they mean everyone except themselves, overlook the crucial distinction between tax *rates* and tax *revenues*. A lowering of tax rates could so stimulate saving or income or whatever is being taxed, that the government would wind up with more revenue, and everyone would be happy. The most famous and extreme version of this doctrine was the notorious "Laffer Curve," in which a cut in income tax rates, particularly marginal tax rates in the upper income brackets, would so stimulate savings and income that federal revenues would increase and balance the budget.

But scarcely more convincing is the common Reaganomic view that we don't have to worry about the deficit because we will eventually "grow out of it" – that is, keep tax rates

the same and wait for revenue to grow over the years. For even this milder variant of the supply-side doctrine is subject to the devastating and unanswerable question: How long are we supposed to wait for this pie in the sky?

Actually, supply-side theory makes far more sense when it is applied to taxes that are more specific, and less sweeping, than the income tax. Thus, a few years ago, the government of the District of Columbia, searching, as governments are wont to do, for higher revenue, seized on the idea of an enormous increase in the gasoline tax in the District. Since it is duck soup for drivers in the District to nip across the border to Maryland or Virginia to fill their gas tanks, the District government rapidly found that the amount of gas sold fell drastically, and so did their gasoline revenues. Shamefacedly, they had to back down and repeal the tax increase.

George Bush's proposal for a cut in the capital gains tax falls somewhere in the murky zone between the D. C. gas tax and the income tax. In the tax reform act of 1986, the capital gains tax suddenly rose from a top of 20 percent to a top of 33 percent. George Bush has proposed lowering the capital gains tax back to 15 percent.

Would this cut raise or lower tax revenues, and so would it help or hurt the deficit problem? Which will outweigh the other, the lower tax rate on capital gains, or the greater volume of investments and capital transactions? Well, who knows? As usual in such matters, expert economic forecasters differ drastically. Harvard economist Lawrence Lindsey, using Treasury Department models, forecasts an *increased* revenue from a Bush capital gains tax cut of between $6 and $10 billion per year – itself a hefty range. On the other hand, the Congressional Budget Office estimates, from the same tax cut, a *decreased* revenue of from $4 to $8 billion per year.

Perhaps the best way to tackle this problem is to forget about the deficit in this case and do what is best on the capital gains question itself, which would mean, in my view, to adopt the tax cut with enthusiasm. But this would also imply, of course, that there are other questions in economic life than the deficit, and that some of these problems might even be more important.

Forgetting about the supply-siders, then, let us return to Mr. Chimerine's lesson in arithmetic. If we want to reduce or eliminate a $200 billion or $150 billion deficit, do we have to increase taxes? Sorry, but that's not the answer my own arithmetic comes up with. If you spend more than you take in, you have two choices: either keep the deficit and finance it, or eliminate the deficit. If you decide to finance it, you again have two choices: you can either borrow the money from someone, or you can sell your assets to pay for the deficit. (Or, of course, some combination of the two.) If you are an individual, or organization, or a state or local government, these are the only ways you can finance a deficit. If you are the *federal* government, however, there is another cherished arrow in your quiver. You can *also* finance your deficit by printing money. The central government of any country has the monopoly power to print as much money as it desires. In older and simpler days, the Treasury Departments of each country would simply print the currency outright and spend it; in these more sophisticated times, the same deed can be accomplished less directly by financing the deficit through the banking system, guided by the central bank, which in our case is the Federal Reserve.

If you have ever wondered, then, why it is that even governments of wealthy states and localities habitually turn to the federal government for aid and comfort, *there* is your

answer. State and local governments can tax their citizens, but they can't legally print money to finance their cherished expenditures.

Let us linger a moment on a neglected way to finance a deficit: selling your assets. An individual who did that would be rightly considered financially unsound. But since the federal government can always bail itself out of potential bankruptcy either by taxing more or by printing money, ordinary financial considerations do not apply. In fact, those of us who believe that government has grown far too large and owns far too many assets compared to the private sector, would welcome the sale of federal assets – now known as "privatization" – for its own sake. Useful assets would be transferred from government to the productive private sector. And at the same time, the deficit would be financed without having to raise taxes. Critics of selling government assets to finance a deficit object that this is a one-shot solution, and that *next* year more such assets will have to be sold to the private sector. As far as I am concerned, that's ok. I am willing to continue the process for as long as it takes to finance the deficit.

This brings us to our main question: What's so terrible about the deficit anyway? I have long objected to deficits, and I have been particularly critical of free-market economists who had attacked deficits all their lives, and then, after a few months in the Reagan Administration, found all sorts of ingenious reasons why deficits are harmless after all. I haven't changed my views on any of this. But I think it is important not to succumb to anti-deficit hysteria, and to ponder the question: Are deficits the worst thing in life? Or, is there anything worse than deficits? Surely, before jumping out of the deficit frying-pan, we should take care we don't jump into some more dangerous fire.

So what's so terrible about deficits? First, it means sustaining a high level of government spending, which means in turn that huge amounts of resources are being siphoned out of the productive private sector to be largely wasted in governmental boondoggles. But this brings us back to the final vital bit of deficit arithmetic. If we set aside the sale of government assets, there are two ways to cut or eliminate a deficit: either raise taxes or *cut government spending*. If the government is spending $200 billion more than it is taking in, it can either raise taxes by $200 billion *or* it can cut its own spending by $200 billion. *There* is the crucial arithmetic that Mr. Chimerine and his colleagues have apparently forgotten. And that means a real cut, a cut-cut, and not a cut in the rate of increase, or a cut in the percentage of spending to GNP, or a cut in projected future estimates, or all the other ways in which the federal government has managed to redefine the word "cut" in the public arena. Another example of creative semantics! A cut of $200 billion in government spending would yield two glorious benefits at the same time: (1) it would stop wasting $200 billion of resources in the government sector, and (2) it would get rid of the deficit.

Where can federal spending be cut? The standard analysis is that almost nothing can be cut, everything is locked in some entitlement or other. But as I have already pointed out, *nothing* can lock Congress in: whatever it has locked, it can unlock. My favorite proposal is simply to go back to the last year of the much maligned wild-spending Carter Administration. If Congress simply passed an overriding law decreeing that no government agency can spend more than it did in fiscal year 1980, that would mean an over 40 percent cut in federal spending. We could then enjoy a hefty tax cut and even some reduction of the national debt. There is my plan: an immediate spending cut, a tax cut, a balanced budget

and even a little reduction of the debt. Of course, I would prefer going back to some previous fiscal year, maybe Thomas Jefferson, but heaven forbid that I be considered unrealistic in my policy proposals.

George Bush also has a proposal on government spending, but I'm afraid it is not nearly as satisfactory. He proposes a "flexible freeze" of federal expenditures. To me "flexible freeze" sounds like what Bill Buckley would call an "oxymoron," a contradiction in terms. Apparently he means a freeze of total spending adjusted by the rate of inflation, with each item going up and down within it. Frankly, I will believe it when I see it. In the meanwhile, I'll take my own *inflexible* retroactive freeze.

Reluctantly setting aside the sale of government assets or a drastic cut in government spending, we finally complete the question: what's so terrible about a deficit? Given a level of government spending, one bad thing about a deficit is that it will be inflationary if financed by the banking system. If it is financed by the public it will not be inflationary, but it will increase the tax load on future generations, *and* it would, as would monetary inflation, crowd out private investment. That is, it would take private savings, which are low anyway compared to other developed countries, and funnel them into government boondoggles. But does raising taxes improve the situation? No, because raising taxes doesn't just *crowd out* private savings; it taxes them away altogether. Even inflation, as destructive as it is, is not quite as bad as an equivalent tax. For inflation means that you might have to pay $100 for a loaf of bread; but the equivalent in taxation would mean that you wouldn't have money to buy bread *at all*. I submit that raising taxes to eliminate a deficit is the equivalent of a doctor curing a patient of bronchitis by shooting him to death; the cure is worse than the disease.

In short, deficits are bad and the budget should be balanced: but only if the balance comes by cutting government spending or the deficit is financed by selling government assets. Otherwise, raising taxes is worse than continuing the deficit.

4. George Bush and the Dread "L" Word

Finally, the more we contemplate the likely policies of the Bush Administration, the more it seems that his proposed spending will be more "flexible" than "freeze." On health care, for example, we have already seen that Bush supports the new Reagan program of catastrophic health insurance. He also advocates expansion of the existing health care program for mothers with infants, spending an estimated $180 million in the first year – and the first year, for all federal spending programs, is but the foot in the door. Mr. Bush wants to expand Medicare programs, and proposes to allow families with incomes above those now eligible for Medicaid to "buy in" to this subsidized program: once again, the annual estimate of $120 million is only for the first year. Indeed, Princeton Professor Uwe Reinhardt estimates that if George Bush is serious about this Medicaid buy-in program it would incur "at least $30 billion" in additional federal expenditures per year. [*New York Times*, November 1, 1988]

And this is just the beginning. The nation's savings and loan industry is now not only philosophically bankrupt, it is rapidly going down the tubes. Once again, good old papa government, Democrat or Republican, stands ready to bail out the entire industry. FSLIC, the federal "insurance" agency for savings and loans, has supposedly "insured" all their deposits, but "insurance" in this field is only a grisly joke, and the FSLIC itself is now admittedly bankrupt. The next savior is supposed to be the Federal Deposit Insurance Corporation, which already has its hands full "insuring" all the deposits in the nation's

commercial banks. But FDIC "insurance" is just as pathetic; it has no money either. The government estimates that soon the FDIC will have to pour out somewhere between 50 and 100 billion dollars to save the savings and loan banks – and government always underestimates its future costs. Where will the FDIC get the money from? Not to worry, for as everyone knows, behind the FDIC stands the might of the U. S. Treasury and the Federal Reserve, and *they* can always get the money – either by taxing us more or by printing the money and handing it to the banks or depositors.

Mr. Bush has also pledged to pour far more federal resources into the war against drugs. Since the drug problem seems to have escalated in direct proportion to the amount of money government has spent to combat it, the money and manpower that the Bush Administration might pour into this war can prove to be endless. Mr. Bush has also advocated spending more money on housing; also, since he has pledged to go down in history as the "education president," presumably that means pouring a lot more federal money into some form of education. He has also promised to be an environmentalist president, dedicated to cleaning up Boston Harbor, setting aside a great deal more land for national parks, and pledging to prohibit oil drilling off the California coast.

George Bush spent a great deal of his presidential campaign pinning Dukakis with the dread "L" word, liberalism. Since acknowledging or fleeing from the "L" word has now become a vital part of American politics, it might be well to figure out what liberalism *is*. I have always believed that a liberal is a person who believes in expanding government, and especially the federal government, intervention and power over every aspect of economic and social life. In that case considering his likely programs if Mr. Bush is searching out liberals, he might well be advised to look in the mirror. Conservative Republican Congressman

Connie Mack has just eked out a victory in the Florida Senate race over his moderate Democratic opponent, Representative Buddy Mackay, by using the blunt but effective slogan, “Hey Buddy, you’re a liberal!” But in view of the shaky nature of his resistance to higher taxes, and considering Mr. Bush’s likely programs for the years ahead, from expanded health care to fixing exchange rates, we might well conclude, “Hey George! You’re a liberal!”

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