# THE OVER-BUR-DENED ECONOMY

UNCOVERING THE CAUSES OF CHRONIC UNEMPLOYMENT, INFLATION AND NATIONAL DECLINE

LLOYD JEFFRY DUMAS

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University of California Press
Berkeley and Los Angeles, California

University of California Press, Ltd.
London, England

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**Library of Congress Cataloging-in-Publication Data**

Dumas, Lloyd J.
The overburdened economy.
Includes index.
1. Unemployment—United States. 2. Underemployment—United States. 3. Poor—United States. 4. United States—Economic conditions—1981– . I. Title.
HD5724.D775 1986 331.13'7973 85-20856
ISBN 0-520-05686-8

Printed in the United States of America

1 2 3 4 5 6 7 8 9

# Acknowledgments

The fabric of this work is woven from the threads of many ideas accumulated over a long period of years. Unfortunately, it is not possible to specifically mention all the creative and caring people who have helped shape the thinking here embodied. This acknowledgment must therefore be only partial.

There is little question that many directions of thought in this analysis were triggered by the insistent, impassioned, and provocative ideas of Seymour Melman. Never one to avoid controversy, Seymour's insights derive from a combination of great personal integrity and deep understanding of and commitment to the principles of free inquiry and democracy that are this nation's greatest legacy.

Many long, late-night conversations with my friend and former colleague Robert A. Karasek are clearly reflected herein. Much was gained in sharpness and clarity by the specific comments and proddings of those who read various drafts with a critical eye. My thanks especially to Kenneth Boulding, John Kenneth Galbraith, and a number of still anonymous referees. More generally, I am grateful for the support, encouragement, and faith of my parents, Edith and Marcel Dumas, and my friends, S. Brooks Morton, Randolph Riddle, and Tina Dill. I also very much appreciate the responsiveness and enthusiasm of Naomi Schneider, my editor at U.C. Press, as well as the patience and helpfulness of Dorothy Luttrell and Cynthia Keheley, who processed much of the manuscript.

Finally, it is difficult to describe all of the many ways Dana Dunn has contributed to this work. Her professional criticisms were always pointed and insightful as well as remarkably gentle. Her patience, encouragement, enthusiasm, and ability to share seemed boundless and carried me through many rough spots. And perhaps most of all, Dana gave me the rainbow that marked the end of a storm and the beginning of a brighter new day.

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# Preface

This is a very important book. Such a statement is not easy to justify and may take fifty years to prove, but it is my considered judgment. Lloyd Dumas has challenged one of the implicit assumptions of the Keynesian revolution and the national income statistics that embodied it: the assumption that all activity which is paid for must be productive. His questioning of this assumption may well set off a reorganization of the economic information system and point a new direction for economic research that will greatly improve our understanding of economic events. There are many indications that the time is ripe for a reorganization of economic thought, a new Kuhnian revolution, stimulated by the search for a more humanistic economics. Among these indications are the development of grants economics, the study of one-way transfers, both explicit and implicit, and the growing consensus that the simpler Keynesian model has failed in the face of the inflation-unemployment dilemma. Dumas's work is a very valuable contribution to the coming transformation of economic thought.

The development of more useful taxonomies—that is, systems for classifying, and thus simplifying, the immense complexity of the real world—is vital to the growth of human knowledge. Alchemy, for example, never got anywhere because it had the elements wrong: earth, air, fire, and water are hopelessly heterogeneous aggregates. With the development of a proper classification of the elements into oxygen, hydrogen, and so forth near the end of the eighteenth century, the science of chemistry flowered, progressing in both theory and application. The problem of taxonomy in social systems is much more difficult, simply because of the immense variety and complexity of the human race, its activities, and its artifacts. Each human being is different from every other who has ever lived—even identical twins differ significantly. The human mind, however, cannot handle this complexity. We are forced to make aggregates such as nations, classes, industries, occupations, and factors of production in order to make sense of and to act upon the complexity that confronts us so disturbingly. It is very easy, however, to get these aggregates wrong and to lump things together that are essentially different while separating things that are essentially alike. I have argued that some venerable aggregates of economic taxonomy—for instance, the factors of production land, labor, and capital—are almost as heterogeneous as earth, air, fire, and water. A much more useful set of factors of production would include know-how, a genetic factor which is limited by energy, materials, space, and time in their various manifestations.

The importance of Dumas's work lies in his revised taxonomy of rewarded economic activity, which he divides into *contributive*, *neutral*, and *distractive* sectors. Some may be uncomfortable with the terminology: although Dumas specifies that these terms are not value laden, it is hard not to prefer contributive to neutral activity and neutral to distractive activity. Others might prefer the term *economic* for *contributive*, and *noneconomic* for *distractive*, but this choice too could be seen as somewhat value laden. Taking a broader perspective, Dumas insists that economic activity is not always an ultimate good: beyond the economic there is a greater good, the quality of human life. Thus, economic activity, which produces the "necessaries and conveniences of life," is itself merely an instrumental good to be evaluated in terms of the overarching good of the quality of life. This is a view that Dumas shares with Adam Smith.

Contributive activity in Dumas's more strictly economic sense is that which increases the final product, which in turn consists of things that people want enough to be willing to pay for them. Neutral activity is that which is paid for but which does not contribute anything to the final product—featherbedding, sinecures, paperpushing, the provision of useless information, and so forth. Such activity can be considered part of what I have termed the "implicit grants economy," a redistribution of income or command over the product from those who produce it to those who do not. This edges toward Marx's concept of "surplus value" (which, however, is also a hopelessly confused taxonomic class). The question of whether interest and profit become neutral beyond a certain point is one that must be faced and on which further research is needed. The most optimistic might want to identify the distractive sector with public goods, since it includes not only the war industry, but such things as monuments, public splendor, palaces, cathedrals, and wilderness areas.

For every important classification system there are marginal cases and Dumas's is no exception. There is no doubt, however, that Dumas's classification is important and useful, particularly in identifying social pathologies. The neutral and distractive sectors are not necessarily pathological, but they have a very strong tendency to become so, simply because of the positive-feedback processes generated by such phenomena as the arms race, proliferation of bureaucracies and hierarchies, and political corruption.

Was there in the Middle Ages a "cathedral race" something like our arms race, in which each city tried to outbuild the other? There was certainly a "palace race" in the eighteenth century that culminated in Versailles, a race which probably hastened the French Revolution. Self-perpetuation may characterize even the contributive sector, causing phenomena such as the conspicuous consumption of "keeping up with the Joneses." But in the contributive sector, the disease is likely to be mild, a head cold rather than a fatal fever as it so frequently is in the distractive sector. The present-day pathologies of the distractive are so extreme that the term *fatal* is surely justified.

From time to time in the history of human thought, a new idea has emerged, perhaps in a somewhat tentative form, and then has been driven underground where it continues on its course, eventually re-emerging from its tunnel. The Dumas taxonomy can certainly be traced back to an important idea in Adam Smith's *The Wealth of Nations*: the distinction between productive and unproductive labor, there formulated rather imperfectly. The idea remained underground for almost two hundred years and has now finally emerged in Dumas's work in a purified and more significant form. Such an emergence of a new idea from below ground is usually not very well regarded by those following the mainstream, or perhaps one should say turnpike, above ground. It may take some time for this idea to gain the turnpike; however, I will be surprised if it does not. The current traffic in economic ideas must make way for new vehicles; Dumas's is among the most promising. This is why I have no hesitation in again calling it an important book.

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# 1

# The Appearance of Progress, The Reality of Decline

## The Recovery That Wasn't

During the 1984 presidential campaign, there was much talk of the vigor and strength of the American economy. A powerful recovery was under way. Real gross national product (GNP) was growing at 6.8 percent in 1984, faster than at any time since the mid-1950s.[1] The consumer price index was rising at 4.3 percent, faster than the 3.2 percent rate in 1983, but slower than in any other year since the early 1970s.[2] At the same time, the civilian unemployment rate had dropped from a post-Depression record of 10.7 percent in late 1982 to 7.2 percent at the end of 1984.[3] And the U.S. dollar was showing impressive strength internationally, reaching a seven-year high against the strong Swiss franc and twelve-year highs against the German mark and Dutch guilder—and faring even better against the French franc, Italian lira, British pound, and Canadian dollar.[4]

Rapid growth, low inflation, falling unemployment, and a strong dollar: the economy was in good shape and getting better. Though there were audible grumblings, mainly about federal budget deficits and the rising national debt, most economists were optimistic. Even mildly negative signs, normally read as troubling—such as slowing growth, slightly rising unemployment, and uncertain behavior of the index of leading indicators—tended to be reinterpreted: these were actually good signs. The economy was moving to a more viable long-term growth path. America was once again an economic powerhouse.

But this was a most peculiar recovery.

*Poverty and hunger.* According to the Census Bureau, during the upswing of 1983 the national poverty rate reached 15.2 percent. This was the greatest proportion of Americans living in poverty since President Johnson's antipoverty campaign began nearly two decades earlier. The poverty rate had, in fact, grown every year since the 1970s. Six million more people were living in poverty in 1983 than in 1980, nearly 900,000 of them added between 1982 and 1983.[5] While the official poverty rate did decline to 14.4 percent in 1984, the rate was still higher than it had been in any year from 1970 to 1980. For some categories of the U.S. population the 1984 poverty rate did not change, but remained at distressingly high levels: more than 46 percent of blacks under the age of eighteen continued to live in poverty. In total, more Americans were living in poverty in 1984 than in 1964—despite the retreat from the peak level reached one year earlier.[6]

Where there is poverty, hunger is usually close by. The 1985 report of the Physician Task Force on Hunger in America testifies to the severity of the problem, bearing the ominous title "Hunger in America: The Growing Epidemic." It defines the hungry as those who either periodically exhaust their food supply or are persistently unable to purchase an adequate diet; while acknowledging that "no one knows the precise number of hungry Americans," the report estimates that the number may be as high as twenty million. According to the task force report, clinics in poor areas have reported cases of diseases usually found among severely malnourished populations in less developed countries. These include kwashiorkor (a protein deficiency disease) and maramus (a condition of advanced emaciation), as well as vitamin deficiencies, lethargy, and stunting. Soup kitchens reminiscent of the days of the Great Depression have reappeared in America, and lines at these soup kitchens and food pantries have been growing—in a nation whose bountiful harvests have made it a food supplier to much of the world! The report concludes that hunger has worsened, not diminished, during the "recovery."[7]

While the ranks of the poor have swelled, a much larger segment of the U.S. population has seen its economic improvement halted. Over the first half of the 1980s, real compensation per hour in the nonfarm business sector rose only one-tenth of one percent. That is, wages and salaries (including employer contributions to social insurance and private benefit plans), adjusted for inflation, were virtually the same in 1984 as in 1979. Though improvements occurred between 1982 and 1984, they barely made up for declines in 1980 and 1981. In fact, the 1984 increase was only three-tenths percent, less than a fifth of what it had been in 1983. In 1984, the purchasing power of wages and salaries was actually less than it had been as far back as 1976.[8]

*Bank failures.* Another disturbing trend of the eighties is the dramatic increase in the rate of bank failures: in the United States, 14 percent more commercial banks failed in 1983 than in 1982, and 65 percent more in 1984 than in 1983. By October 1985, the 1984 rate of commercial bank failures had already been surpassed. If the failure rate registered in the first nine months of 1985 continues through year's end, some 50 percent more commercial banks will fail in 1985 than in 1984.[9] Some have blamed the progressive deregulation of banks for the nearly three hundred failures since 1981. While deregulation may have played a significant role, the reduction of controls does not compel banks to engage in the sorts of practices that lead to their demise. A sufficiently buoyant economy would not have produced this phenomenon.

*National debt.* At the end of 1974, the interest-bearing public debt of the United States stood at just under $475 billion. Only a decade later the national debt had more than tripled, reaching nearly $1560 billion by the end of 1984. As of the first quarter of 1985, the federal budget deficit projected for the 1985 fiscal year exceeded that for 1984. Even if the projected 1985 deficit were cut in half, the United States will have added as much to its national debt in the first six years of the eighties as in the preceding two centuries.[10] One of the consequences of this enormous accumulation of debt is that the federal budget has become less controllable. Interest payments on the rapidly growing debt must be met: as contractual obligations of the federal government, they are not subject to the discretion of the administration or of Congress. In an interview with the *Wall Street Journal*, the chief economist of Equitable Life Assurance pointed out that the fraction of federal spending devoted simply to paying interest on the national debt has nearly doubled during this decade and, he estimated, it could nearly double again in a recession to push the federal deficit over $300 billion.[11] The burgeoning interest payments have already offset even deep cuts in nonmilitary federal programs. As the *New York Times* reported in August 1984, "Over the last three years the *increase* in interest payments on the federal debt *exceeds all the savings* . . . achieved in health, education, welfare, and social service programs" by federal budget cuts since 1981 (emphasis added).[12] In September 1985, the president of the Federal Reserve Bank of New York estimated the interest cost of servicing the federal debt in 1985 at $130 billion—"roughly equal to total personal income tax collections from every taxpayer west of the Mississippi River."[13] He went on to project: "If the current efforts at reducing federal budget deficits are not successful, then even under fairly optimistic economic conditions, the annual cost of servicing the federal debt by 1990 will be in the neighborhood of $210 billion. That will mean that for every five dollars collected from the individual income tax, two dollars will go toward paying federal net interest liabilities."[14] None of these can be regarded as positive developments.

An even more important consequence of accelerated federal borrowing since 1980 has been its dramatic impact on the real cost of borrowing money. As the federal government entered capital markets on a grand scale to finance its rapidly growing debt, real interest rates were driven sharply higher. This is, of course, the predictable result of the government's adding greatly to the demand for loanable funds in the absence of a substantial increase in the pool of money made available by willing lenders. Real interest rates (i.e., interest rates adjusted for the rate of inflation) surged upward in 1981. For example, the prime rate charged by banks, adjusted for changes in the consumer price index, more than quadrupled in 1981, rising to 8.5 percent from the 1980 level of 1.8 percent. That 1981 rate more than doubled the previous peak rate of 3.7 percent reached in 1959. In 1982, the real rate rose still higher to 8.8 percent. It did decline somewhat during the next two years, but still stood at 7.7 percent in 1984, more than double the 1959 peak.[15]

High real interest rates seriously hamper industry's ability to finance new plant and equipment expenditures needed to modernize facilities. Similarly, high real rates make purchases of big-ticket items such as houses and automobiles more difficult for consumers. The combination of inflation and high interest rates has already put home ownership beyond the means of an ever larger proportion of the new generation of would-be home buyers, tarnishing a piece of the American dream.

*Mortgage foreclosures.* The dream of home ownership has become elusive even for many Americans who thought they had already achieved it. Reports in early 1985 indicated that "the rate of home mortgage foreclosures has increased to a level close to the record set in the 1974 recession, causing anguish for tens of thousands of Americans evicted from homes for which they can no longer afford monthly payments."[16] The Federal Housing and Veterans administrations (FHA and VA), the federal agencies that together guarantee about 25 percent of home mortgages (mainly for low and middle income clients), found themselves with record numbers of foreclosed homes by early 1985. The VA foreclosed 10 percent more homes in 1984 than in 1983; the FHA's inventory of foreclosed homes rose more than 40 percent from August 1983 through February 1985—during eighteen months of the "recovery." In early 1985, the executive vice president of the Mortgage Insurance Companies of America, whose members underwrite the 75 percent of American home mortgages not covered by VA or FHA, projected the industry's 1985 insurance claim payments for home foreclosures at $425 million—three times what they were in 1982.[17]

*Foreign indebtedness.* In addition to the huge increase in the *amount* of the national debt, there has been a change in its character: a growing fraction is now owed to foreigners. As the *Wall Street Journal* pointed out in the fall of 1984, "Government deficits . . . are soaking up savings at an alarming rate, forcing the nation to borrow heavily from abroad."[18] In 1983, some 16 percent of U.S. Treasury securities outstanding—nearly $164 billion—was owned by foreigners.[19] The increased foreign purchase of U.S. government and private securities has pumped additional money into American capital markets (while draining financial markets abroad), preventing high real interest rates in the U.S. from rising still higher. But the U.S. economy has become more dependent on these foreign sources of capital, a potentially dangerous situation. Leonard Silk, economic columnist for the *New York Times*, put it this way: "If the huge net inflow of savings from abroad were to stop, chaos would follow. The Federal Reserve would be confronted with the dilemma of whether to finance the huge deficits and risk inflation, or refuse to finance them and risk depression. It would be a no-win choice."[20]

It is difficult to predict just how long foreign sources will continue to pour huge amounts of financial capital into U.S. government and corporate securities. It could go on for a long time. On the other hand, by early 1985 the European market for U.S. corporate securities was beginning to experience serious problems. In less than two months at the beginning of 1985, American corporations had raised more than $6 billion through bond issues in the so-called Eurodollar market. This was almost one-third of the record amount they had raised in all of 1984. But international commercial and investment bankers underwriting these bond issues were having a hard time selling them. The deputy chairman of the leading underwriter of Eurodollar bonds estimated that supply was outrunning demand by five to one in that market.[21] This may represent only a temporary disturbance. But it is worth noting, as the *New York Times* reported, that "this is the first time since the Eurodollar new issue market began heating up four years ago that international investors have so firmly turned their backs on the bonds of so many of America's blue chip corporations."[22] It is not a good sign.

*Net debtor status.* During the mid-1980s, in the midst of the "strong recovery," the United States rapidly approached net debtor nation status. It has been some seventy years since this country has been a net debtor internationally. Yet in 1983, total foreign holdings in the United States reached more than three-quarters of a trillion dollars—almost 90 percent as much as U.S. holdings abroad.[23] Testifying before Congress in February 1984, Paul Volcker, chair of the Federal Reserve Board, expressed serious concern at this state of affairs:

> It is ominous that the recorded net investment position of the United States overseas, built up gradually over the postwar period, will in the space of only three years—1983, 1984, 1985—be reversed. If the data at all reflect reality, the largest and richest economy in the world is on the verge of becoming a net debtor internationally and would soon be the largest.[24]

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