ECONOMIC ISSUES TODAY

Alternative Approaches

Sixth Edition

Robert B. Carson

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ECONOMIC ISSUES TODAY

Preface

Right at the outset, the senior author (you know, as in "senior citizen") offers his apologies to longtime friends and adopters of *Economic Issues Today*. A considerable time, indeed, has passed since the book has been revised and updated, and many of you have been inconvenienced by its virtual unavailability for the last couple of years. This state of affairs commenced with the decision of its original publisher (St. Martin's Press) to discontinue its college economics list and was compounded by the fact that the senior and then sole author retired from the State University of New York. One of the fascinating things that one discovers about retirement is that there simply isn't time to do anything. That sounds like—and perhaps it is—a lame excuse. In any case, those of you who helped introduce *Economic Issues Today* and its split versions to over a quarter of a million young readers or who, perhaps, encountered it as an undergraduate, deserved better, and for this the senior editor is deeply regretful.

Of course, those familiar with past editions of *Economic Issues Today* will note the addition of two new authors for the current effort, Wade L. Thomas and Jason Hecht. The senior author welcomes his two younger colleagues and friends to this venture and is certain their important efforts in keeping this book up to date, relevant, and available will be readily evident. All three of us welcome any suggestions that will improve the content and coverage of *Economic Issues Today* and its usefulness for those beginning their study of economics.

As should be expected, the current edition reflects considerable updating and revision in its introduction and fourteen Issues. Three of the issues—"Financing Government," "Welfare Reform,"and "Inflation"—are brand new. Four others—"Growth and Stability," "Unemployment," "International Economics," and "The Market Versus Planning and Control"—have been extensively rewritten. All other issues have been edited closely so as to bring data and arguments up to date.

Two decades have passed since the publication of the first edition of *Economic Issues Today* (and its macroeconomic and microeconomic split versions). Needless to say, a lot of "economic water" has gone over the dam since 1978. Accordingly, the content of *Economic Issues Today* has undergone many changes through this, its sixth edition. Yet, the underlying philosophy and pedagogical objectives of the book remain the same: to introduce those uninitiated in the ways of economists to the breadth and richness of economic reasoning.

The book continues to require no background in the methods of economic analysis, and as much as posssible it avoids the use of economic jargon in favor of everyday language. This edition of *Economic Issues Today*, like previous ones, stresses the ideological choices that exist in economic thought and that often cause ordinary citizens to be confused about what economists *do* and what economists *believe*. As ever, it is meant to be a provocative book, more concerned with provoking discussion and thought than in presenting "right" solutions to problems. It remains committed to the belief that real economic solutions are possible in a democratic society only when all alternatives are known and considered.

Although longtime users are familiar with the text's philosophy and perspectives, new readers might benefit from an explanation of why the authors undertook this project in the first place and how, in fact, the book is organized.

All too frequently, students begin their study of economics with the impression that economists are bland and monolithic when discussing important issues confronting the general society. We may as well admit that the profession sometimes exhibits a tendency to blandness in its public utterances, but surely any supposed unanimity toward social policy questions has vanished. With the rise of an influential Radical caucus within the discipline, beginning in the late 1960s, and the more recent resurgence of variations of laissez-faire ideology, any facade of consensus has clearly been broken down. The application of economic theory to issues of public policy more and more reflects a range of choice from Conservative to Liberal to Radical.

For the student struggling with basic theory and analytic tools, as well as for the ordinary citizen overwhelmed by economic data in the newspapers and on the TV evening news, it is hard to avoid confusion over what economists really think about the problems facing the nation. This book begins with the assumption that the answers economists give to policy questions can be usefully compared and analyzed according to the particular biases of their arguments and the probable outcomes of their proposals. In other words, differences in economic logic and interpretation of evidence are not so much a function of skill mastery as they are the expression of strongly held social and political opinions. The text also assumes that economics as a body of knowledge takes on greater meaning and is more readily comprehended when it is viewed in this way.

For each issue, a Conservative, Liberal, and Radical analysis and proposed solution are presented in turn as the valid approach to the problem. On one page, there may be a vigorous and unyielding defense of laissez-faire and the market economy; on another, a program for the elimination or modification of the free market. This is not the way economic analysis and theory are usually taught, but it is what the practice of economics is about. In the real world, the citizen and the economist make public policy choices that protect, attack, or modify the market mechanism. We may defend our positions in terms of economic logic, but behind our proofs lies our political and ideological view of the world. This book attempts to examine the relationship between ideological values and the economic theories and policies that are their outcome.

Since the text presents a wide range of prespectives on a number of currently sensitive issues, it should provoke disagreement, controversy, and discussion. In itself, the book does not urge a particular ideological position or a particular variety of economic analysis. The decision to select or reject this or that point of view is left—as it should be—to the reader.

Each chapter is self-contained and may be assigned in any order the instructor chooses. There are relatively few footnotes or direct references to specific economists, although the ideas of many contemporary economists and schools of economic thought will be apparent. The bibliography at the end is offered for anyone wishing to dig a little more deeply into an issue or a particular economic perspective or approach.

The senior author would like to thank Michael Weber, a longtime sponsoring editor of *Economic Issues Today* at St. Martin's Press (before St. Martin's dropped its college economics line), for signing the book with its new publisher, M.E. Sharpe, Inc. And, as with each new edition, the senior author feels duty-bound to note the kind and thoughtful encouragement of Bertrand Lummus, then the college editor at St. Martin's, that made it possible for EIT to see the light of day in the first place. Similarly, the senior author wishes to acknowledge the efforts of Paula Franklin and Emily Berleth, whose extraordinary editorial skills in the early editions of the work have survived, both directly and indirectly, right down to the current version. All of the authors are indebted to Peter Coveney, the executive editor of M.E. Sharpe, for shepherding us through the preparation and publication of the sixth edition. We also acknowledge the inspired efforts of Sean Culhane, economics editor, who joined the project in midstream with admirable vigor and interest in its success.

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costs, which in turn squeezed profits. With unemployment at very low levels, workers—unionized and nonunionized alike—enjoyed a seller's market for their labor. Real wages rose as businesses bid against each other for needed employees. Between 1960 and 1973, real (adjusted for inflation) after-tax weekly earnings rose by 35 percent. Since this exceeded productivity (output per worker-hour) growth, it translated into rising per-unit costs for producers. To make matters worse, resource costs worldwide began rising, the principal source being rising energy costs resulting from the Arabs' opting to challenge their former colonial and neocolonial masters.

At any rate, after-tax corporate profits peaked in 1965 (at about 10.5 percent on investment) and fell thereafter (to about 4.5 percent in 1974). With profits falling, businesses continued to reduce their investment outlays through the late 1960s and into the 1970s. At first the decline was scarcely felt as demand remained high for a time, but in the late 1960s, unemployment began to edge upward. By the early 1970s, regardless of expansionary fiscal policy efforts to offset the trend, unemployment grew as profits fell. Prices, meanwhile, began to rise, producing the new phenomenon of *stagflation* (rising unemployment *and* rising prices). Inflation took hold simply because demand, fueled by government and private borrowing, remained high. Without an expansion of business production facilities and with productive efficiency falling as the investment base got older and more outmoded, the high levels of demand caused price increases rather than output expansion. Meanwhile, the high levels of demand had few salutary effects on employment since profits remained low and business actually reduced its rate of investment. The outer limits of runaway Keynesianism had been reached.

There remained only one solution—the old solution: recession. Through the mid- and late 1970s, under enormous pressure from rising prices, government fiscal policy turned less expansionary. Predictably, unemployment crept upward. Inflation, however, was not significantly slowed until Conservative Ronald Reagan slew the dragon with a bone-chilling tight money policy that shut off private borrowing. The immediate result was the recession of 1981–1983, which produced Great Depression levels of unemployment.

Although Conservatives crowed about their victory over inflation and enjoyed pointing out that Keynesianism had proved itself a failure, they, as we shall see in the next Issue, understood little about what had happened. They offered no new "solution" to the capitalist system. However, as we shall see in subsequent Issues, the Conservatives have enjoyed a considerable measure of popular support during their recent return to policy-making power.

The dislodgement of the Republicans from the White House in 1992, after the brief "Bush recession," did not bring a return of traditional Liberal political economy. Although President Clinton leaned toward a Liberal position during his first two years in office, the election of Republican majorities in both houses of Congress in 1994 was a fair measure of the popular ascendancy of Conservative political and economic outlooks. Clinton quickly adapted to the new realities, winning reelection in 1996 after allowing that the era of big government was over and more or less conceding to the Conservative insistence that fiscal policy should be subordinated to the necessity of balancing the federal budget. In all this, both Clinton and Conservative economic thinking benefited from a long economic expansion through the mid- and late 1990s. Everyone seemed caught up in the boom. Simply no one was paying much attention to history or the increasing fragility of the "New World Economic Order" that had been widely celebrated since the demise of the USSR in 1992.

To Radicals, the recent resurgence of Conservative antigovernment and pro-business ideology and practice, after a generation of Liberal ascendancy, is immensely ironic. Marx, commenting on the ironies of history, once remarked that when history repeats itself, it first appears as tragedy and then as farce. However, to the more thoughtful, the idea of America returning to the "good old days" of Calvin Coolidge and Herbert Hoover is both farcical *and* tragic.

Yet, in a sense, that is precisely where we are. Indeed, production-for-profit capitalism, in any substantial sense, has never really passed much beyond the era immediately preceding the Great Depression. Is another great Depression possible? *Very definitely.*

Issue 9

Economic Growth and Stability

An Active or a Passive Policy Approach?

We must recognize that only experience can show how far the common will, embodied in the policy of the state, ought to be directed to increasing and supplementing the inducement to invest.

John Maynard Keynes, 1935

Is fiscal policy being oversold? Is monetary policy being oversold? . . . My answer is yes to both of those questions. . . . What I believe is that fine tuning has been oversold.

Milton Friedman, 1968

Originating in a liberal effort to respond to the popular will and relieve the pressures of poverty, demand-oriented politics ends in promoting unemployment and dependency.

George Gilder, 1981

Economic growth exceeded expectations in 1997, and the unemployment rate declined to a 24–year low.

Economic Report of the President, 1998

The Problem

Conservative, Liberal, and Radical paradigms are strikingly divided on the matters of long-term growth and stability and the economic role to be played by government to best ensure rising living standards. The problems of short-term economic performance tend to attract the attention of the public, policy makers, and economists. In other words, more day-to-day concern is placed on the trim of the economic ship than on what might be done if it actually capsized. Looming in the background are larger and more spectacular questions about whether living standards can rise at an appreciable pace and if the economy is actually depression-proof. The issue can be conveniently divided between the matter of short-term macroeconomic stability and how it is to be maintained, and the subject of long-term growth. The two are intertwined, but in this issue we set our sights principally on the long-run outlook for sustained economic growth and rising living standards.

Since the passage of the Employment Act of 1946, the federal government has had the responsibility

> to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with assistance and cooperation of industry, agriculture, labor and State and local governments, to coordinate and utilize all its plans, functions and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, production and purchasing power.

This rambling and wide-ranging statement has been interpreted over the years to mean that government is charged with three basic public policy objectives:

- providing high levels of employment,
- maintaining stable prices, and
- encouraging economic growth.

For better or worse (the reader may already be anticipating in the arguments to come who might think it better and who might think it worse), the government had assumed some level of responsibility, albeit indistinct, over the great trinity of employment, prices, and growth.

Table 9.1 shows how well the economy has performed in the last half of the century with respect to the three objectives. At the time of this writing, the economy is in its eighth year of economic expansion, and regardless of whether or not this expansion is sustained for much longer, the very length of the boom is impressive. The recent period has also been impressive when compared to the previous boom of the 1980s and the dismal stagflationary years of the 1970s because of its uncharacteristically high rates of economic growth and correspondingly low inflation. Not surprisingly, Conservatives used the boom of the 1980s as proof of the errors of the earlier Keynesian heresy and evidence that a policy relying predominantly on market-directed forces is capable of maintaining both economic stability and growth. Liberals could counter that the 1960s and 1990s, under political leadership of closer affinity to their views, produced economic success that surpassed the Conservative heydays. Radicals would, of course, be unconvinced by either.

Thus, even during good economic conditions, the paradigms differ on why these events occurred, the principal forces that drive the operation of the macroeconomy, and how very similar policies affect economic performance. Conservatives tend to emphasize supply-side economics while Liberals place greater faith in the demand-management theories of Keynesian heritage.* While achieving full employment and building upon the

*The supply-siders' analytical critique of Keynesian theory can be fairly easily demonstrated. For supply-siders the inflationary episode of the 1970s was directly traceable to the Keynesian error of believing that increases in demand had only a salutary effect on output and employment and no impact upon prices. The supply-side argument is illustrated in Panel 1. With aggregate demand (AD) and aggregate supply (AS), respectively, illustrating the total demand and total supply of goods at all possible combinations of GDP and price level, the economy is in equilibrium in Panel 1 where AD=AS. It can be noted at a low level of equilibrium output (Q), an increase in the total demand from AD to AD1 has a far greater impact in increasing GDP than in raising the price level. However the shift from AD1 to AD2 has greater impact upon prices. This is because as the economy approaches full employment, the aggregate supply curve slopes upward more steeply reflecting higher resource prices that are caused by increased competition for scarcer resources. The solution to the problem is demonstrated in panel 2. Actions should be taken to increase aggregate