



Why Reaganomics
and Keynesian
Economics
Failed



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Why Reaganomics and Keynesian Economics Failed

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For Gail; and in memory of my parents

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Part I

The Issues

America is becoming a stationary society with little economic growth, and therefore little opportunity for economic mobility. Productivity improvement is the crucial component of economic growth – and productivity has been moribund for the better part of two decades. Many proposals have been advanced to cope with declining productivity. Reaganomics is one of them, and it has been revealed as a failure.

The roots of American productivity decline are far deeper and more onerous than most Americans recognize. At the very heart of the matter lie theoretical problems which cause households and businesses to pursue self-interested action which may be damaging to the interests of society. Certain financial practices – such as corporate raids – may be justified by the theory taught in business schools, but they may also be deleterious to aggregate economic well-being. Only a correction of economic policy – and the correction of the economic theory which empowers it – can resolve the productivity problem which is the greatest threat to economic progress in the concluding years of this century.



1 Introduction

If the American dream is not dead, then surely it is in intensive care. Consider this. Compensation per hour, adjusted for inflation, grew at a compound rate of about 3 per cent in the twenty-year period between 1948 and 1968. This meant that the family of a typical worker could consume about 3 per cent more each year, year after year. At that rate the standard of living was doubling about once every generation. But a dramatic change took place in the American economy between 1968 and 1973, approximately contiguous with the Vietnam War. In the twelve-year period since 1973, real hourly compensation increased at a rate of about three-tenths of 1 per cent per year. This means that the standard of living of the typical American family is doubling only at a rate of about once every few hundred years!

Americans have become confused about the economic problem. During the 1970s it was thought to be inflation, while in the early part of this decade it was thought to be high interest rates. But these have been delusions that have masked the real problem, which is economic growth. Our society, as Lester Thurow describes it, has become a zero-sum society. The only way someone can become better off economically, in general, is for someone else simultaneously to become worse off.

In many ways, 1973 was the last good year. Since then growth has largely stopped and wages and incomes have shown the effects of stagnation. For instance, consider the expectations of a typical young American male passing from age 25 to age 35. During the 1950s or 1960s, his earnings would have more than doubled, adjusted for inflation. But for the typical male making the transition after 1973, earnings grew by only 16 per cent – a fraction of what was expected a few years before. The outcome has become even more bleak for middle-aged males. A man passing from 40 to 50 prior to 1973 could have expected his earnings to grow by 30 per cent. After 1973, however, a comparable individual actually experienced a 14 per cent decline in inflation-adjusted earnings.

People in their 20s, today, grew up with the television family of Howard and Marian Cunningham, their two children, and various family friends. We glimpsed 'The Great American Dream' as it might be for ourselves, if we worked hard, got a good education like Richie

did, and maybe went into business as Mr C. did. Included in the scenario were a beautiful home and a new car every once in awhile. Mrs C. was always at home making pot roast, baking cookies, and generally lending high support to the Cunningham clan.

But no more. The 1980s have been dubbed the decade of 'cutback management'. It has rendered the Cunninghams' dream remote, if not impossible for most Americans. We live in an era in which less expense is better than more revenue. It is a decade of white-collar unemployment, mounting poverty, and the decimation of former industrial giants such as steel. It is a decade of 'running lean and mean'. To compete effectively, we must accomplish more, we must do it better, and we must do it with fewer people. In our organizations there is precious little time to think, but only time to act, to react; barely enough time to keep ahead of – or perhaps only even with – the competition. Rush here, rush there, do more, excel! But with all our doing, economic society does not grow larger or better. It simply becomes rearranged like coloured pieces of a kaleidoscope. No matter how the pieces may be assembled, studied and refracted, they constitute only a stationary quantity.

LAYING THE BLAME

Upon whom do we pin the blame for this economic mess? Is it Lyndon Johnson, Jimmy Carter and the liberal 'Keynesian Democrat' presidents of the 1960s and 1970s? Or is it Ronald Reagan and the 'supply-side' conservatives of the 1980s? Actually, responsibility rests with both, for neither side possesses the 'holy grail'. Slow growth and inflation certainly plagued Americans during the 1970s because of Keynesian policies. Ronald Reagan was elected in 1980 on a mandate to get the country moving again, economically. But the economy has continued to move in the wrong direction under his stewardship, and at a perilous price.

Reaganomics alleged that a tax cut to the rich would encourage saving and investment, and therefore growth. In 1981, Congress reduced tax revenues by approximately \$125 billion per year on the assumption that economic growth would create a tax base sufficient to replenish lost revenues. But the assumptions of Reaganomics were unrealistic, if not farcical. Between 1981 and 1985 the national debt soared from 1 to 2 trillion dollars. Two-thirds of this second trillion dollars in red ink can be traced directly to the tax cut. A haemor-

rhaging of losses from international trade also propelled the United States to the status of a net debtor nation in 1985, for the first time since the First World War.

America is becoming a poorer nation and the ideologues are not without their responsibilities for the failure. Neither side has the truth. It is the reality of our time that the standard solutions of the political right or the political left cannot solve our problems. Even the nature of our problems has changed, so that we may not recognize them and take some action to avert further deleterious consequences. Indeed, we live in a time in which the paradigms upon which our economic wisdom is built have been brought to crisis.

Lots of excuses for failure are given by the defenders of both the conservative and the liberal versions of the 'conventional wisdom'. The excuses include blaming the workers, or blaming the managers, or simply disavowing that a problem exists. Simplistic solutions no longer work, nor do they even make sense. We must start afresh, by examining the very roots of economic thought. In so doing we shall find significant connections between our economic failures and the intellectual apparatus used by economists for 200 years to explain and to predict economic behaviour.

NATURAL LAW

Economics claims to be a science but its foundations go back at least 200 years to the study of moral philosophy, which had its basis in natural law. Natural law is a study of the fundamental principles that order the universe. It hypothesizes that a perfect order may exist, and that human happiness depends upon living in harmony with the laws of that order. It is significant to recognize that the foundation of economic science is not based upon verifiable observation, but upon an eighteenth-century metaphysical system. Even so, economists continue to use that system as if it is value-free, when it implicitly conveys profound judgements of value. It is the contemporary inappropriateness of some of these value judgements made 200 years ago that renders the theory unable to explain and to predict. Our goal should not be to dismiss 200 years of economic thought. Rather, it should be to correct the intellectual system so that it portrays the contemporary economic tableau realistically.

LAISSEZ-FAIRE

Literally interpreted, *laissez-faire* means to let it be or to let it go. During the eighteenth century it was a doctrinaire prescription for the organization of society. In an era of strengthening nation states, *laissez-faire* argued that the happiness of citizens would be enhanced through the minimization of government intervention. With regard to the economy, the doctrine argued that the pursuit of personal greed would ultimately lead society to a grander outcome than the one resulting from government planning and intervention. Central to the thesis is the institution of the market, in which Adam Smith's 'unseen hand' operates. The doctrine alleges that it brings buyers and sellers together in pursuit of their own self-interests so that individual welfares, and the welfare of the whole of society, are simultaneously maximized.

Implicit in Smith's system is a rejection of the intuition associated with the logic of the commons. Recall that the commons in feudal society was reserved for community use. It was not private property. Rather, its purpose was somewhat akin to a modern park or recreation area. If a feudal serf threw his garbage on the commons, he sacrificed the common good for his personal convenience. So long as his anti-social behaviour did not become commonplace, the commons could support a small amount of garbage. But if such isolated acts became commonplace and accepted as prudent by the masses – if everyone threw his garbage on the commons – then society surely lost because the commons became a garbage dump. And the individuals who threw their garbage there also lost, because the normal use of the commons was lost to them as well as to their neighbours.

A most unique character of Smith's philosophy is that it violates that logic. Almost everyone perceives that collective action to control selfish acts of individualism would enhance the commonweal. But Smith argued counter-intuitively. His position was that individual acts of selfishness could actually lead, through the market, to the enhanced welfare of the individual and of society. Even when everyone acts in his own self-interest, the commonweal is enhanced more than it would be through collective action imposed or coordinated by government.

Increases in the 'wealth of nations' during the Industrial Revolution of the nineteenth century generally vindicated the efficacy of Smith's claims. Self-interest became enshrined in America as both a legal and an economic principle. And, except for an interlude during

the 1930s, economic policies based upon *laissez-faire* continued to perform well through the seventh decade of the twentieth century. But for over a decade now, the performance of the American economy has countermanded Smith's faith that independent and self-interested action would lead to a propitious outcome for society. It would appear that the logic of the commons has again become operative. Perhaps the world has changed so subtly that the self-interest which sparked the most dramatic economic progress in the history of the world, now often leads instead to injury to the collective well-being of society.

DISEQUILIBRIUM

It is asserted that the capitalist system broke down, beginning in the 1970s, because the nature of economic reality has changed. Doctrinaire capitalism therefore requires repair and modification, in a manner similar to the way in which economic theory was refurbished during and following the Great Depression.

For prescriptive theory to work adequately, it must account for the uniquenesses and the dynamisms that are present in the actual world. But conventional economics is based upon a natural law view which is antithetic to time or change, or anything akin to societal dynamism. Conventional theory is rooted in a natural law view that embodies the 'mechanics' of the seventeenth-century physical scientist Isaac Newton. Like Newton's vision of the heavens, economic theory assumes that some proper and perfect relationship exists between the economic whole and the sum of its parts. Economists portray the economic tableau in a state of equilibrium, in which friction and time are absent, and in which all economic adjustments are made instantaneously. Once attained, equilibrium is a condition in which all opposing forces are cancelled out, and the extant characteristics of the system are perpetuated from period to period.

The problem comes, then, in the application of an equilibrium-based theory to an actual economy. To the extent that conditions in an actual economy may not reflect the equilibrium conditions implicit in the natural law-based theoretical system, then accurate explanation and prediction of economic events will be frustrated. And if poor economic performance reveals Smith's assertion to be false – that the logic of the commons is actually operative in a society modelled upon *laissez-faire* principles – then some form of collective action is indi-

cated. The ultimate goal of this book is to suggest principles of collective action that repair the *laissez-faire* system and restore its contemporary explanatory and predictive qualities.

LORD KEYNES

John Maynard Keynes is the economist who is associated with the repair of the intellectual apparatus following its debunking by the politically unacceptable outcomes of the Great Depression. His interest was in disequilibrium, and how the natural law-based intellectual system of his inheritance could be modified to improve its explanatory and predictive usefulness. Unfortunately, Keynes died at the end of the Second World War, rendering impossible any explanations he might have given for contemporary economic dysfunction.

Our quest is similar to Keynes's. It is to examine the possible linkage between contemporary dysfunction and the inability of the theoretical system to respond to disequilibrium in an actual economy. We shall see that disequilibrium may be revealed in a condition called hoarding, which is the retention of assets by wealth-holders in some non-productive use. During the Great Depression disequilibrium was revealed in the hoarding of gold. Wealth-holders who anticipated deflation found it to their best interest to hoard gold, rather than to place their wealth in current investment. A hoarding-induced reduction in the supply of money triggered the Depression era reduction of output and employment. Policies to dissuade hoarding, such as the repudiation of the International Gold Standard in 1933, and the outlawing of gold hoarding, were instrumental in moving the American economy back towards equilibrium.

Disequilibrium was manifested again during the 1970s as a response to inflation. Wealth-holders and speculators sought real estate and other inelastically supplied assets to avoid the ravages of currency depreciation. Hoarding real estate was generally more lucrative than investment placements. The outcome for the American economy was an inadequate supply of essential capital, which led to productivity declines, and ultimately to declining growth and the virtual attainment of stationary society.

Advocates of Reaganomics in 1981 argued that a tax cut to the wealthy, who are more likely to save than the poor, would stimulate saving and therefore investment in fixed capital. Buoyant growth would follow. But like Keynesian policies pursued during the 1970s,

the managers of the economy failed to take account of disequilibrium hoarding behaviour. The tax cut coincided with actions which drove interest rates sharply higher.

Rather than place saving realized from the tax cut into tangible capital, many transactors opted for the security and profitability of financial instruments instead. Saving therefore became hoarded in finance and full employment equilibrium was not realized. The economic scenario which has thus emerged is more compatible with the vision of the neoclassical scholars – the stationary state – than it is compatible with the vision of Adam Smith. In the stationary state, net investment and profit are zero, and output and employment are stationary from period to period. The economy is moribund.

FINANCIAL HOARDING

A major thesis of this book is that finance-motivated behaviour reimposes the logic of the commons upon doctrinaire capitalism, thereby rendering the theory dysfunctional. Of particular concern is the ‘profit lacuna’ which was built into the intellectual system around the turn of the twentieth century by neoclassical economists. Because of the lacuna, the conventional model provides no reward to holding capital, and therefore no proffering of entrepreneurial skill and industry. The lacuna is manifested in the blurring of the distinction between capital and finance, and therefore between profit and interest.

If all economic activities earn the same rate of return, then the distinction between profit and interest is meaningless. Entrepreneurs would rather hold finance, all other things being equal, than hold capital, because holding the former is devoid of the costs of proffering skill or industry. It is also asserted that the world has changed subtly, making it possible for those who might otherwise hold capital, to hold finance instead, and with the same reward. The societal outcome of these combined phenomena – the profit lacuna and changes in the manner in which complex markets operate – is diminished investment and growth.

The complexity of the operation of ‘real world’ economies is not addressed by the neoclassical model – refurbished near the turn of this century – which is still in use. That model does not take account of the possible divisibility of tangible capital through leases and other mechanisms, of the creation of sophisticated markets for trading

equity and finance, or of resource mobility which allows for international movement of tangible capital and finance. The outcome of these differences is that the contemporary entrepreneur may try to optimize the rate of return on finance, rather than the total profit on capital. Modern conglomerates and multinationals are examples of behaviour that is generally finance-motivated, rather than production, conservation and profit-motivated.

Mergers, acquisitions and other forms of finance-motivated endeavour are particularly important here. All these activities have as their end, not the creation of output, but the manipulation of ownership. Such manipulations and reorganizations can be terribly costly in human endeavour. They also frustrate productivity gains that might otherwise accrue to 'learning by doing'. The learning by doing hypothesis asserts that substantial productivity gains may accrue to a stable work environment as people learn to do their jobs with increasing efficiency, over time. A significant problem with continuous mergers and reorganizations is that they destabilize the productive environment, and therefore frustrate potential gains from learning by doing. As productivity lags, so also does economic growth.

Our proposal, then, is that the conventional economic theory must be patched or modified so that it can provide an effective guide for contemporary economies to approach equilibrium. By acknowledging the need for a theoretical patch, we also reject the denial by *laissez-faire* advocates of benefits to collective action. The particular kind of collective action proposed is called indicative economic planning. It has been practised most successfully by Japan since the Second World War.

America needs to overcome the 'financial leeching of capital' – particularly human capital, by providing incentives for investment, and disincentives for financial hoarding. Stronger incentives to encourage the provision of skill and industry should lead to improved conservation of tangible and human capital assets, to renewed stabilization of the productive environment, and to productivity gains through learning by doing.

To provide these incentives, it is first necessary for the American people to decide which assets they seek to conserve, and to expand. But it is not possible to specify the composition of capital unless the composition of future output is first specified. It is the contention of this book that the determination of future output, and therefore the specification of the composition of capital, should not be left to the vagaries of the free market. It should be determined by collective action.