The Creation of Economic Chaos: Inflation, Unemployment, and the Keynesian Revolution

Ideas often have consequences far beyond those expected or intended by their originators and adherents. One cannot fully understand the 1970’s without reference to the Keynesian Revolution and the failure of macroeconomists to understand the implications of the revolution. Just as Adam Smith set the stage for the free trade environment of the nineteenth century, so did Keynesian macroeconomic thinking establish the foundation for the policies which provided us with the inflation, unemployment, and stagnation of the 1970’s.

The Keynesian orthodoxy which dominated western economic thinking during the post-World War II era had three preeminent elements. First, Keynesians believed that unemployment was almost exclusively a problem of aggregate demand. They argued that budget deficits, particularly those reflecting an expansion in government spending, stimulated aggregate demand and thereby helped to alleviate the hardship unemployment. The supply-side of the economy was almost universally ignored, since Keynesians perceived that, at least until full employment was attained, “demand would create its own supply.”

Second, because of their emphasis on the linkage between budget deficits and aggregate demand, Keynesians ridiculed the significance of a balanced federal budget. The view that federal revenues and expenditures should be equalized was thought to be an archaic idea, totally unacceptable to any enlightened person of the twentieth century. Economic conditions replaced the “balanced budget doctrine” as the proper criteria for the determination of budget policy. When unemployment was excessive, a budget deficit was not only acceptable, it was prudent. If inflation was a problem, a budget surplus was deemed proper. However, with the passage of time, the view developed that unemployment was a far more serious problem than inflation. Thus, even Keynesian theorists adhered to the view that the requirements of “high pressure economics” generally called for budget deficits, even while recognizing that a budget surplus might occasionally be needed to combat serious inflation.

Third, by the 1960’s the idea that policymakers could trade-off a little inflation in order to promote a higher level of employment was an integral part of the Keynesian orthodoxy. In 1958 A.W. Phillips, an English economist, noted that historically a low rate of unemployment was usually associated with a rapid rate of increase in wages (and prices). Observing this historical “Phillips curve” linkage between a low rate of unemployment and the rate of price (and wage) inflation, most of the Keynesian economists of the 1960’s

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jumped to the conclusion that a lower rate of unemployment could be "purchased" at the expense of moderate inflation. The late Arthur Okun, chairman of the Council of Economic Advisors during the Johnson years, expressed the dominant view of the era:

On an optimistic-realistic view, the best hope is that a 4 percent rate of unemployment and a 2 percent annual rate of price increase will prove compatible and that such a combination will be regarded as a satisfactory compromise by the American public. This was the hope before the Vietnam spurt in mid-1965, and nothing that has happened since then demonstrates that it is unattainable.¹

Since economic policy is instituted by political entrepreneurs, the "real world" implications of economic theory often involve elements of both economic and political theory. In recent years professional economists have become increasingly aware that economic tools can enhance our understanding of the political process. In fact, during the last 20 years, an entire area of study, public choice theory, has developed and greatly enhanced our understanding of how the democratic political process works.² The Keynesian economists of the 1960's, however, paid little heed to public choice theory as it grew from its infancy. Caught up in the optimism of the 1960's and failing to grasp fully the practical implications of the Keynesian orthodoxy, macroeconomists were unable to warn the American people of the impending dangers ahead.³

Keynesians and Politics

The Keynesian doctrine indicates that macroeconomic stimulus and restraint, if they are properly timed, can help smooth out economic ups and downs. Thus, economic policy, if correctly instituted, can conquer the business cycle.

Although macroeconomists have long debated the technical limitations that reduce our ability to time macropolicy properly, they have virtually ignored the limitations imposed by the interaction between politics and economics. Real-world economic policy is instituted by politicians, not economists. Competitive pressures force successful politicians to give primary consideration to policies that enhance their chances of winning the next election. Vote-seeking political entrepreneurs have a strong incentive to support public policy that yields immediate, easily identifiable benefits at the expense of future costs, which are difficult to identify. Macroeconomic stimulus is precisely of this nature. Even when the economy is at or near its long-run capacity, macroacceleration initially will exert a very positive influence. During the initial phase, the primary impact of macroacceleration will be on output and employment, not prices. Inflation and rising unemployment will come later—sometimes as much as 18 to 30 months after the initial acceleration.

Since the initial impacts of macroacceleration (for example, a reduction in unemployment, a rapid growth in real income, and lower interest rates) are usually both beneficial and easily identifiable, political entrepreneurs have a strong incen-

tive to follow this course during the period preceding a major election. If the macroacceleration is properly timed, the costs (most likely, higher rates of inflation, unemployment, and interest in the future) will be observable only after the election. In addition, since there is generally a time lag between the macroacceleration and the negative effects that it generates, most voters will fail to associate the two. This lag will enhance the ability of political entrepreneurs to blame big business, big labor, or perhaps foreigners such as OPEC for the inflation. Thus, macroacceleration can be used to generate easily identifiable perception benefits at the expense of costs that are difficult to identify and are observable only in the future. This characteristic of macroacceleration makes it very attractive to political entrepreneurs during the period immediately prior to a major election. Therefore, the timing of macroacceleration is likely to be determined by political considerations, rather than economic conditions. When macropolicy is left in the hands of the politicians, public choice analysis suggests that it will be used (and abused) for political purposes. Economic stabilization can be expected to take a backseat.

Acceleration of the growth in the money supply and budget deficits (or surpluses) are the major macroeconomic tools available to policymakers. History indicates that these tools have been used for political purposes. Corporate taxes were also reduced. As Table 1 illustrates, the policymakers accelerated the growth rate of the money supply (12 month moving average) from 4.7 percent in late 1966 to more than 7 percent at the time of the 1968 presidential election. While the budget deficits during the calendar years 1965-66 summed to only $1.0 billion, the deficit soared to $30.4 billion during 1967-68—a post-war high for a two year period at the time. The 1971-72 period was a replay. The Nixon Administration's 1971-72 budget deficits topped $42 billion, up from $5.9 billion during 1969-70. Simultaneously, the growth of the money supply accelerated from 3.8 percent in late 1970 to 7.4 percent at the end of 1972. During 1975-76 the Ford Administration followed precisely the same strategy—huge budget deficits and money supply acceleration.

Soon after his election, President Carter pledged to balance the budget in fiscal year 1980 (ending in September). As of early 1980, the Administration's projections indicated that the 1980 FY budget would be in deficit by $46 billion. Under the pressure of nearly 20 percent inflation, the Carter Administration revised its budget plans in March of 1980. As public choice theory would predict, the spending plans of the Administration for 1980 were not changed significantly. Instead, President Carter proposed to submit a balanced 1981 budget, which would permit him to have the best of both worlds. The President could argue that he had kept his promise to balance the budget even while continuing to spend billions of dollars in excess of tax revenues through the November election.

<table>
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<th>Period Ending</th>
<th>Percent</th>
<th>Budget Deficit</th>
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<td>(quarter in parenthesis) of the Money supply (Previous 12 months)</td>
<td>Calendar Year</td>
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| 1968(4) | 4.7 | $1.0 |
| 1969(4) | 7.2 | $30.4 |
| 1970(4) | 3.8 | $5.9 |
| 1971(4) | 7.4 | $42.1 |
| 1972(4) | 5.1 | $18.0 |
| 1973(4) | 5.6 | $131.7 |
| 1974(4) | 7.2 | $94.9 |


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The Inflationary Bias of
Applied Keynesian Policy

The macroeconomists of the 1960's also failed to recognize the inflationary bias of the Keynesian doctrine. Put simply, spending money on projects that yield clearly demonstrable benefits to their constituents will enhance the image of a political entrepreneur with the voters. Thus, public sector spending is attractive to vote-maximizing politicians. In contrast, politicians abhor the necessity of taxation, particularly if the taxes can be easily identified, since taxes impose a burden on constituents. The imposition of taxes will not be an attractive activity for political entrepreneurs. Thus, politically speaking, budget deficits and surpluses are asymmetrical.

When the budget is in balance, political entrepreneurs favor public sector projects only as long as the expected political support from the spending exceeds the loss of voter support resulting from higher taxes. Deficit spending gives politicians an opportunity to enjoy the political support created by additional spending projects without experiencing the political damage caused by the equivalent increase in taxation. Thus, the concept of deficit spending is attractive to political entrepreneurs. In contrast, politicians find the idea of a budget surplus repugnant. A budget surplus requires them to vote for taxes that are not used to finance politically attractive expenditure projects. In short, a budget surplus imposes costs on voters without generating an easily identifiable benefit.

Sound Keynesian policy calls for budget deficits to combat recessionary conditions and budget surpluses to deal with inflationary booms. However, it is clear that, in the real world, these two are not equally attractive. Vote-seeking politicians can be counted on to run a budget deficit at the first sign of an economic slowdown, but they will be highly reluctant to legislate a surplus even during good times. Predictably, the Keynesian prescription will not be followed in an even-handed fashion. Public choice theory indicates that rational, vote-seeking politicians will happily follow the deficit-spending course. The 1961-1979 record of 18 fiscal-year budget deficits and 1 surplus is testimony to the strength of public choice analysis as it applies to macroeconomic policy.

The Phillips Curve—The Dream and the Reality

As recently as the mid-1970's, many if not most, economists believed that expansionist policies (rapid growth in the money supply and budget deficits) could promote growth and reduce the unemployment rate if we were willing to tolerate a little inflation. The confusion surrounding this trade-off results from the failure to distinguish between the short-term and long-term consequences of economic policy. Policies which accelerate demand beyond the expectations of buyers and sellers are capable of reducing the short-term rate of unemployment. However, neither economic theory nor the empirical evidence indicates that inflationist policies reduce the long-term rate of unemployment. Quite the contrary, such a course will inevitably lead to high rates of both inflation and unemployment.

Initially, an expansion in aggregate demand will generally cause an increase in employment for two reasons. First, neither the acceleration of the rate of inflation nor the current strength of demand was incorporated into the long-term wage settlements negotiated before the macrostimulus. In real terms, these wage rates will be abnormally low given current demand and price levels. Second, workers (and their union representatives), failing to anticipate fully the future rate of inflation, are misled into accepting money wage rates that are unattractive once one accounts for the impact of increased demand. Put simply, workers and their union representatives are initially fooled by both the strength of
the short-run demand for labor and the rising rate of inflation.

However, as Abraham Lincoln noted more than a century ago, political entrepreneurs cannot fool all the people all the time. Soon decisionmakers will recognize that they need to incorporate the higher rate of inflation into their decisionmaking. The terms of newly negotiated contracts, including collective bargaining agreements, will eventually incorporate the expected future rate of inflation. Learning from their past experience with inflation, workers and their union representatives will no longer accept long-term money wage offers that are attractive only if one assumes stable demand and prices (or rates of increase lower than those of recent years). Measured in real terms, wage rates will return to normal. Similarly, job search time will return to normal once workers fully recognize that inflation has shifted the money wage (although not necessarily the real wage) opportunities available to them. Once the inflation is anticipated fully, it will no longer be possible to "purchase" a lower rate of unemployment at the cost of a little inflation. The inflation will persist, but without any observable benefits in the employment sector.

After decisionmakers anticipate the inflation, what would happen if the policymakers seek to follow a less expansionary course? As in the case of macroexpansion, the initial impact of a more restrictive course will be on output and employment, rather than prices. After the previously negotiated long-term contracts and the job search decisionmaking of workers incorporates the expectation of inflation, efforts to fight inflation with macropolicy will initially lead to recession and unemployment.

Expansionary macropolicy, motivated by the fallacious logic of the Phillips curve, has taken us down a disastrous path. The high rates of inflation experienced during the 1970s have retarded saving and contributed to uncertainty. The capital formation necessary for the maintenance of a healthy growing economy has been slowed by the process. Far from stimulating growth and reducing unemployment, the expansionary policies have had the opposite effect. The 1950's are often pointed to as a period during which stimulative policies were absent. Except during the Korean War, relative price stability was the norm during the 1950's. Nonetheless, the average annual rate of growth of real GNP during the "stagnating" fifties was 3.9 percent, compared to 2.6 percent during the Inflation-plagued period from 1967 to 1979. Similarly, the average rate of unemployment during the 1950's was 4.5 percent compared to 5.5 percent during 1967-1979. Clearly, the easy money, deficit spending policies of the 1970's have given us the worst of both worlds—a high rate of inflation accompanied by stagnation and unemployment.

The Phillips curve economists, who argued that an expansionary course would permit us to trade off unemployment for inflation, must shoulder much of the blame. It is one thing to observe an historical linkage, albeit an imperfect one, between low unemployment rates and in-
flation. It is quite another to argue that policies which result in inflation will lead to lower rates of unemployment. Economists should have recognized that decisionmakers would adjust to the inflationist policies, and that their adjustments would negate the temporary positive effects. The problem was not a deficiency of economic theory. Rather, it reflects the failure of economists to apply their tools properly.

The Exclusion of Supply-Side Factors

Within the Keynesian framework, aggregate demand calls the tune. Reflecting this view, the macroeconomists of the 1960's virtually ignored the supply-side of the market. They failed to perceive the negative impact of high tax rates on total output. While inflation and the progressive income tax were pushing workers into higher and higher tax brackets, income transfer payments were penalizing the productive efforts of low-income families to help themselves. As Great Society programs (and the taxes to fund them) were put into place in the late 1960's and throughout the 1970's, productive citizens were permitted to keep less and less of their earnings. Simultaneously, low income individuals often found that they were as well off drawing government transfer payments as they would be if they worked. As both high and low income recipients confronted high marginal tax rates—they were permitted to keep less of what they produced—they made adjustments. Some substituted leisure or unreported activities for productive market effort. Others purchased less-desirable tax-deductible items rather than saving and investing which would only increase their tax burden. Still others "invested" valuable resources in the tax shelter industry, as they sought to reduce the burden of rising tax rates. The waste and inefficiency which resulted, retarded aggregate supply.

Similarly, the inflation discouraged saving. Human decisionmakers are not fools. They adjust their plans to the policies pursued by the government. Confronting double digit inflation, more and more individuals shifted their resources away from paper money and toward physical assets and precious metals. Rather than have their savings eroded by inflation, individuals bought cars, houses, gold, silver, and even foreign currencies (particularly German marks and Swiss francs). But savings provide the lifeblood for capital formation which is the foundation of economic growth. An economy that saves (and invests) little will be unable to provide the tools, high level of technology, and modern machinery which make high levels of production per man-hour possible.

The impact of high taxes and the "inflation induced" flight from savings were predictable. Unsurprisingly, the policies which promoted high levels of taxes, income transfers, and inflation bled the life out of the U.S. economy during the 1965-80 period. By February of 1980, the average weekly spendable income, adjusted for taxes and inflation, had tumbled from a 1972 high to the level of 1964. If we fail to reverse the policies which penalize in-
dustriousness, self-reliance, and thrift, while encouraging waste, idleness, and improvident spending, the economic slide will continue. The Keynesian doctrine, with its infatuation with aggregate demand to the exclusion of supply, has directed us to the current fork in the road. It is now imperative that we again recognize the vital linkage between productivity (including thrift) and personal reward, as we begin to restore balance between aggregate demand and the supply-side in our economic policies.

Learning From Our Past Failures

More than most economists, John Maynard Keynes recognized the power of ideas. While drafting the General Theory, Keynes informed the playwright George Bernard Shaw that he was “writing a book on economic theory which will largely revolutionize...the way the world thinks about economic problems.” His words were prophetic. Earlier Keynes noted:

The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually slaves of some defunct economist.

Understandably, the practice of economics is an imperfect science. However, we must profit from our failures. As the American philosopher and poet, George Santayana instructed, “Those who cannot learn the lessons of history are condemned to relive the pitfalls of the past.” The 1970’s are now history. It is time to profit from the experience, reversing the policies which caused the stagnation, inflation, and economic hardship of the decade.

Good intentions and optimism are not enough. We must recognize the importance of incentives in both the political and economic sectors. Only then will good politics and good economics come together.