Pseudo-Scientific Economics

The business cycle and a neo-classical 'mystery'

Ed Dodson

MODERN economics relies heavily on the concept of equilibrium – the point at which the market is cleared and resources are allocated efficiently.

In practice, economists have difficulty in defining – for the benefit of policy-makers – the conditions that would deliver balanced growth. The steady state appears to be unattainable. Instead, the business cycle continues to disrupt the economy.

In his review of the neo-classical tradition, Ed Dodson traces the swings in policy in the US as governments experimented with one hypothesis after another in the search for equilibrium.

As governments struggled with the global downturn of the past two years, economists were unable to provide a convincing account of the institutional safeguards that would have prevented the dot.com bubble – or a strategy for recovery that would deliver balanced growth. The explanation, suggests the author, may be in the way neo-classical economics successfully expunged the role of land in the dynamics of the 20th century economy.

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IN THEIR hard-hitting book, *The Corruption of Economics* (1994), Mason Gaffney and Fred Harrison made a strong case that the field of economics has a history tarnished by the influence of special interests. They provided historical evidence that the industrialised world's power brokers underwrote and thereby controlled the development of economics as a scholarly discipline.

The power-brokers were driven to action by the popular reception given to the writings and public addresses by Henry George in the last two decades of the 19th century. The *status quo* was under serious attack and had to be defended – not just for the moment but for generations to come. Gaining control over what was to be taught in the nation's most influential universities became an essential component of the process.

The most significant defensive measure achieved by the first generation of academic economics professors was to remove *land* from the economic equation as a factor of production distinct from goods produced by labour and capital goods. Every generation of students who studied economics and then went on to teach the subject to others accepted the new definitions without serious questioning. Why would they? Their frame of reference was to be found in textbooks written by professors in the vanguard of the new and modern science of economics. Mason Gaffney explains that the new approach to economics began with John Bates Clark, who took it upon himself to go head-to-head with Henry George in defence of the status quo, and who was brought to Columbia University with funding provided by J.P. Morgan. As quickly as possible professors trained as political economists and accustomed to making moral arguments were replaced by men schooled in the new economic theories.

By the mid-1920s the influence of Henry George's ideas (and political economists as a group) had essentially disappeared. Economic collapse in the 1930s raised new challenges to economic orthodoxy but this came from individuals who urged the strengthening of public sector intervention. Harry Gunnison Brown was one of only a small number of economics professors in the 1920s and 1930s challenging the new conventional wisdoms. Yet, as Mason Gaffney concludes, "Brown ... tried to reach [neo-classical economists] in their own paradigm, and became so habituated to it that he had no way to cope with chronic unemployment."[1] Clearly, there were few, if any, university-trained economists who grasped how to get the dominoes falling in the right direction.

The theories economists had to work with in the early part of the twentieth century fell far short of the task they were faced with. The nature of the problem was extremely dynamic – market failures brought about by dysfunctional socio-political arrangements and institutions. At most, the

measures political leaders were prepared to take were incremental. The tools applied to the problem by economists were static, imprecise and difficult to interpret:

> One of the first groups of widely known economic indicators was published in 1919 by the Harvard University Committee on Economic Research under the direction of Warren M. Persons. The Harvard Index Chart, later known as the Harvard ABC curves, represented three sectors of the economy. The A curve measured stock prices, and was interpreted to signal investor speculation. The B curve measured the dollar volume of checks drawn on bank deposits, which served as a rough guide of current business activity. The C curve measured short-term interest rates, which represented the condition of the money market. The studies of these curves indicated that they usually moved in sequence: upturns or downturns in stock prices usually were followed by turns in interest rates. The turns in interest rates then usually preceded the opposite turns in stock prices, and the sequence then occurred in the opposite direction.
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> This system of economic indicators proved widely popular during the late 1920s and remained in use into the early 1930s. During the Great Depression, however, the Harvard curves were discarded as a tool for forecasting the near-future trend of business activity, because the index allegedly failed to forecast that depression correctly. It is more probable, however, that the failure was in the interpretation of the data rather than in the Harvard curves themselves.[2]

The above assessment is offered by researchers at the American Institute for Economic Research, analysts outside the mainstream academic and financial community. This is not to diminish the importance of the observation but merely to suggest few similar views are to be found in the economic literature. For example, at a conference called in 1998 by researchers at the Federal Reserve Bank of Boston to discuss the origin and nature of business cycles, bank President, Cathy E. Minehan, made a very important admission:

> Our inability to pin down the source of some of the most important events in economic history seems to me a gaping hole in the intellectual underpinnings of modern macroeconomics. More important, can the economic behaviour behind shocks be identified, so that policymakers can anticipate an unsustainable boom, or an approaching downturn, before it happens rather than after? The ability to do that obviously relates to our biggest challenge of late, which has been trying to foresee anything that will upset the enviable success our economy currently enjoys.[3]

Sadly omitted from the papers presented at this conference and the discussions surrounding these papers was any recognition that land markets are an important variable in business cycle analysis. A primary question conference participants attempted to resolve was whether the actions of central banks are endogenous or exogenous to the business

cycle. Paul Samuelson opened the discussion by responding to the question, "Are things different in 'The Age After Keynes'?"

> Eschewing the naïve attribution of this change solely to Keynes's *General Theory*, I agree with the innuendo that changed policy ideology, away from *laissez-faire* and toward countercyclical macro policy, helps explain the better macro performance of real GDPs in the final half of the twentieth century.[4]

The fact that the United States has not suffered the same type of economic collapse experienced in the 1930s is not very strong evidence that the application of Keynesian strategies are effective. As the United States sank deeper and deeper into depression seventy years ago, analysts struggled to understand what was happening. Statistics gathered by the National Bureau of Economic Research under Wesley Mitchell and Arthur Burns were extensively analysed in the late 1930s in an effort to explain how the business cycle was operating. Not until the availability of computer technology in the 1950s, however, did researchers begin to capture and integrate data in the analysis of economic trends in ways that were previously impossible.

For a decade and a half, economists seemed to have found the approximate balance between the use of Keynesian demand management, taxation policies, trade agreements, and the supply of credit and currency necessary to keep downturns moderate and expansions more or less consistent. The promise of the managed economy emerged as a real possibility. At the same time, the leaders of the United States were faced with enormous challenges – economic, social and political. As the economy drifted in and out of a long series of recessions, economists expressing differing ideas of how markets work and how the functions of monetary institutions and fiscal policies of government agencies affect markets began to find growing – and often different – audiences.

The end of *laissez faire*?

IF GAFFNEY provided the historic basis for the failure of economists to create a reliable scientific set of tools, the details of the subsequent failures are captured by the economic journalist Alfred L. Malabre, Jr. in his own 1994 book, *Lost Prophets*, published before his retirement as economics editor of *The Wall Street Journal*.

Malabre details the rising influence of economists in the public policy arena that began with the international attention given to the anti-depression proposals put forward in Britain by John Maynard Keynes. Even more significantly, however, was the role Keynes played in conjunction with Harry Dexter White in the creation of the post-Second World War international financial institutions. During the war years,

economists in the Roosevelt and Truman administrations were among the vanguard of policy advisers convinced there was no going back to *laissez-faire* practices. Their influence, combined with the firm commitment by Truman to do all that could be done to prevent a postwar return to economic instability, set the stage for passage of The Employment Act of 1946, described by Malabre as "a victory for the Keynesian view that an entire economy, like the exchange rates of individual currencies, could be neatly managed over a prolonged period".[5]

Other economists were less certain, recalling the ineffectiveness of the Roosevelt New Deal measures. Yet, after a minor recession, the U.S. economy expanded, taking advantage of the enormous pool of savings accumulated during the war years. "As for Keynesian influence, in truth it proved to be a relatively minor factor in the economy's surprising performance,"[6] observes Malabre. The United States emerged from the war poised for expansion and with its infrastructure intact:

> With wartime rationing and the outright unavailability of many goods and services, personal savings were sky-high as the war ended. At only $719 million in 1938, the savings total reached $37.3 billion in 1944 before easing to $29.6 billion in 1945 and then falling sharply to a postwar low of $7.3 billion in 1947. ... Meanwhile, private-sector spending, suppressed during the war, rose apace. Personal consumption climbed by one-third in five years, after adjusting for inflation, and business investment jumped nearly fourfold. Outlays by state and local governments also rose sharply.[7]

U.S. Presidents now also had the services of the new Council of Economic Advisors (CEA). The CEA's first chairman, Edward Nourse, served Truman until 1949, when he was succeeded by a non-economist, Leon Keyserling. Dwight D. Eisenhower then brought in Arthur Burns in 1953 to lead his CEA. Malabre suggests that one of the things distinguishing Burns from his predecessors was a good understanding of the behaviour of business cycles. He quotes Burns from a 1949 memorial, in which Burns cautioned that during times of expansion, "costs in many lines of activity encroach upon selling prices, money markets become strained, and numerous investment projects are set aside until costs of financing seem more favourable; these accumulating stresses ... lead to a recession [until] the realignment of costs and prices, reduction of inventories, improvement of bank reserves and other developments ... pave the way for a renewed expansion".[8] As for solutions, Burns remained throughout his career a strong sceptic of Keynesian demand management. During the 1950s the Keynesian proposals seemed to Burns to be unnecessary. After all, the strength of the U.S. economy was still sufficient to absorb the cost of fighting in Korea while bringing the budget into a surplus by 1960.

Kennedy and risks of inflation

THE NEW PRESIDENT, John F. Kennedy, a graduate of Harvard University, had no training in economics. One of his initial decisions was to enlist MIT professor Paul Samuelson, a leading Keynesian in the U.S., to head an economic task force. Subsequently offered the chairmanship of the CEA, Samuelson declined. His advice to the new President, however, was that what the nation needed was increased federal spending accompanied by targeted tax breaks to stimulate investment in new plant and equipment.

Shortly before the election, Hubert Humphrey had introduced Kennedy to another Keynesian, Walter Heller, who was teaching at the University of Minnesota. Interestingly, Heller "studied under Harold Groves, an outspoken Keynesian and an expert in the linkages between various tax policies and overall business activity. Under Groves, Heller was drawn to study taxation and made this the subject of his dissertation".[9] Malabre reports that over the next three years Walter Heller and Paul Samuelson generated hundreds of memoranda for Kennedy on the economy. Heller concurred with Samuelson's prescription for economic growth and pushed for greater spending and tax cuts. Concerned with a resurgence of inflation, Kennedy pushed the labour unions to restrict the demands for higher wages as a reward for increased productivity. Pressure was also applied on the major steel producers not to raise prices.

Another component of Keynesian theory – as redefined by its U.S. practitioners – was that there was no direct correlation between federal deficits and inflation. In a 1962 address, Kennedy echoed his advisers: "Sizable budget surpluses after the war did not prevent inflation, and persistent deficits for the past several years have not upset our basic price stability."[10] Malabre reminds the reader that the country was adjusting from war to peace, to a shift from war materials production to meeting consumer demand. "Accordingly," writes Malabre, "it can be argued that the early postwar price climb would have been still sharper had not the budget been in surplus and that the subsequent easing of inflation would have come sooner and would have been more pronounced had the budget not slipped back into deficit at the decade's end."[11]

Up to this point, the postwar Presidents were more or less committed to balancing the budget and keeping the U.S. government debt under control. We cannot be sure whether a spending deficit or surplus actually existed, however, because government accounting practices were (and continue to be) both arcane and politically-influenced. In an era before computerised accounting systems became the norm, it is not hard to conclude the margin for error was enormous (perhaps as enormous as the propensity to mislead the public). Based on an expectation of stimulating business investment but without an awareness that the government was on the verge of fighting two wars – one against generational poverty, the

other against communism in Southeast Asia – the Kennedy tax cuts were implemented. The top marginal rate on personal incomes was reduced from 91% to 70%, a 7% investment tax credit was introduced, along with accelerated depreciation on new plant and equipment. After Lyndon Johnson succeeded the assassinated Kennedy, he followed with reductions in excise taxes on a long list of consumer goods. To those who point to these years as examples of successful Keynesian demand management, Malabre suggests they need to look more closely at the data:

> ... such analyses fall short in a number of ways. For one thing, the long economic expansion that we remember today as the Soaring Sixties had been under way for almost four years before the Kennedy tax cuts became law. The record makes it clear that much of the healthiest growth occurred before – and not after – the cuts were enacted.[12]

Keynesian influence continued in the Johnson White House under his own CEA chairman, Gardner Ackley. Malabre suggests "Ackley's party loyalty in fact may have occasionally clashed with his instincts as an economist."[13] Keynes argued that government should build surpluses during periods of economic expansion, then spend these surpluses to soften downturns. Lyndon Johnson ushered in the art of continuous debt service management. During 1968 – Johnson's last year in the Presidency – Ackley departed. He was succeeded by Arthur Okun. A surtax measure urged on Johnson by Ackley was having difficulty finding sufficient Congressional support. Competition for credit between the public and private sectors drove up interest rates, as those who held purchasing power sought returns above the apparent rate of inflation. Malabre observes that private sector spending on new plant and equipment came to a virtual standstill. The Keynesians had only two options – deeper tax cuts and increased government spending.

'Nothing seemed to work well'

THE 1960s was also the beginning of a new theoretical interest in and reliance on monetary policy, initiated at the University of Chicago under the leadership of Milton Friedman. Friedman arose as a proponent of steady monetary expansion to match the increased output in goods and services. By the late 1960s he became an increasingly frequent critic of the Federal Reserve's inattention to the oscillating "money supply." At the height of his influence, in 1968, Friedman met Walter Heller in debate at New York University:

> ... Heller, who as a Keynesian believed in considerable governmental intervention in the economy, confessed that the Chicago professor's concepts seemed wonderful. But unlike his own prescriptions, Heller went on, Friedman's would surely work only in heaven. By and large, Heller turned out to be right about Friedman's concepts and wrong about his own, for in an increasingly uncertain

> era, the emerging truth was that nothing seemed to work very well, at least as far as strategies for sustaining the American economy were concerned.[14]

Heller's scepticism aside, with the Keynesian prescriptions faltering under the weight of so many out of control externalities, Milton Friedman's views were finding a receptive audience at the Federal Reserve Banks as the 1970s were ending. Malabre is not alone in his assessment that "the economy's woes were largely due to monetarist procedures implemented in 1979 at the Federal Reserve".[15] Controlling the money supply proved to be far more difficult than Friedman and his monetarist collaborators forecasted. The chain of decisions that further destabilised the U.S. economy began with a three-day conference chaired and sponsored by economist Sam I. Nakagama of First National City Bank. Every speaker took up the monetarist banner. At the powerful New York Fed, monetarism had acquired a strong convert in Jim Meigs. By the time the Federal Reserve's policy committee met on October 6, 1979, consensus had been reached. The new chairman, Paul Volcker (apparently with some reluctance), announced the Fed would abandon its efforts to control interest rates and concentrate on the rate of growth of the money supply. Malabre reports on what then occurred:

> During the first six months under the new operating procedure, the rate of growth in the money supply was cut roughly in half, which pleased many of Volcker's sternest critics abroad, as well as most monetarists at home. The international value of the dollar, which had been falling uninterruptedly for about two years, reversed direction. However, interest rates went through the roof.[16]

In response, Carter advisers urged the President to put pressure on Volcker to tighten lending criteria used by the Fed's member banks. The economy went into a downturn and Jimmy Carter lost his bid for re-election to Ronald Reagan.

The Fed continued to focus on money-supply growth until the middle of 1982. Faced with double-digit and still rising unemployment and an inability to accurately determine the size of the money supply, a shift back to interest rate management was made. Reagan, however, had brought his own brand of experimental economic policy with him to the Presidency. At the heart of *Reaganomics* were the so-called *supply-side* policies championed by economics professor Arthur Laffer, journalist Jude Wanniski and U.S. Congressman Jack Kemp. They argued that an across-the-board reduction in Federal tax rates would create economic growth, increasing the tax base and generating a net increase in tax revenue. "This idea, as it turned out, was nonsense of the worst sort,"[17] says Malabre, who goes on to quote a 1978 conversation he had with Martin Feldstein, who told him, "There's absolutely no indication that Laffer's ideas will work in

the way he suggests."[18] Indeed, one result was steadily-growing deficit spending. By the end of 1986 total federal debt climbed to $1.2 trillion.

Recession as a 'cleansing' process

THE U.S. CONGRESS made matters worse by passing legislation permitting the creation of money market funds by non-banking entities – without granting the commercial banks and savings institutions the opportunity to compete. The inevitable result was the removal of hundreds of billions of dollars of savings from these depositories. The savings banks were devastated, as most of their assets consisted of low-yielding, fixed-rate mortgage loans. Commercial banks weathered this financial storm more effectively, since they historically had only a small percentage of their funds tied up in this type of asset. Despite the closing of thousands of depository institutions, the U.S. economy inexplicably began to generate new jobs. Malabre suggests the reasons have to do with the natural "evolution of the business cycle" rather than any government actions:

> Deep, long recessions, economic history shows, tend to be followed by relatively long expansions. The reason is straightforward: recessions serve to cleanse the economy of the excesses – from severe inflation and shortages to excessive debt – that invariably build up during the preceding expansion phases of the cycle. As a rule, the worse the recession, the more thorough the cleansing process and, therefore, the more sustainable the subsequent economic revival.[19]

Rhetoric aside, Reagan's Presidency was blessed by unprecedented growth – in Federal spending and the Federal debt as well as corporate profits and land prices. In the face of increasing pressures on citizens to provide revenue to their local and state governments, people acted based on their *rational expectations* of what the future held in store for them. Those who need credit to purchase homes or other goods, observes Malabre, "balk less and less at paying higher rates [of interest] because they feel repayments will be made in much cheaper dollars".[20] They also began to think of housing less as shelter than as an investment.

A number of questions come to mind. How, for example, does one rely on any theory of the economy or business cycles in an era when such a large portion of economic inputs are allocated to expenditures on the military? And what about the escalating demands by Blacks in the U.S. for greater equality of opportunity, a more appropriate slice of the pie? Although Malabre details the ongoing inaccuracies of economic forecasts and failure of economic theory to explain events, he does not raise these fundamental questions. Nor does he ask whether the neo-classical claim that "price clears all markets for goods and services" really applies to locations and natural-resource laden lands.

Another problem, highlighted by Malabre, is the statistical

measurement by which the well-being of an economy was ascertained – "inflation-adjusted GNP". He comes close to but does not directly discuss the narrowing distribution of wealth, either to the military or to rent-seekers in control of land, the discarded primary factor of production. "Absolute definitions of general living standards do not exist," he writes, "but statistics ... shows what is left of the average weekly income of non-supervisory workers after inflation and federal tax payments have been taken into account."[21] During the 1960s inflation-adjusted GNP kept increasing; for a significant percentage of households in the U.S. – starting from a point of poverty or near-poverty – their position was stabilised only by the expanding role of government transfer payments. And, with the lowering of the highest level of marginal federal tax rates, paying for guns and butter required a combination of increased reliance on borrowing (and a continuous increase in the printing of Federal Reserve notes above what was borrowed from the existing supply in private hands).

Another behaviour exhibited by individuals practicing *rational expectations* is to make purchases at the present because of the probability they will cost more in the future. This is particularly the case for households who do not expect increases in nominal income to keep pace with inflation. The opportunity to save (i.e., invest) existed for households in the top fifth of income recipients – homeowners, business owners, professionals and beneficiaries of inherited wealth. Millions of additional households were able to save as well because they had become homeowners in the 1950s, financing the purchase of their homes with long-term (30-year), fixed-rate mortgage loans. Inflation allowed them to repay these loans with dollar-denominated Federal Reserve notes experiencing a constantly declining purchasing power. Low- and moderate-income renters, on the other hand, were forced to absorb a rising claim by landlords on their gross incomes. Correctly, Malabre remarks that "inflation ... reflected factors that had little direct connection with labour costs – though for many economists, as well as editorialists and politicians, labour costs continued to be a major culprit in the price spiral".[22] He momentarily pauses to take note of where the major inflationary component could be found, then moves on:

> Even homeownership costs, up more than 20% in a decade, reflected rising land prices more than rising construction costs. The average land cost for a new home soared more than 70% between 1958 and 1968, and yet the average weekly earnings of workers who were building new homes increased roughly 50%.[23]

Malabre apparently had not made a real attempt to study economic literature or he might have developed an understanding of "rent-seeking" behaviour on the part of market participants. Economists themselves were undergoing something of a self-examination. Robert Leckachman, for

one, was a vocal critic. His *Economists At Bay* (1976) challenged the cherished claim to objectivity that economists strived to convince themselves and others they acquired by their formal education:

> Ideology is invariably buried in techniques of analysis, however neutral they appear to be. For its partisans, community control of government functions is far more than a mere technique of alternative administrative style. It is the shared value that precedes and legitimises each practical policy choice. The ideology of local control emphasises the folk wisdom of local residents and the untrustworthiness of mandarins, mercenary experts, and those crafty beasts, professional politicians. For their part, the experts deploy their own ideology; fostering exaggerated confidence in techniques which equip them to generalise beyond specific neighbourhoods, they draw strength from modes of data collection and manipulation inscrutable to the laity, and, in the end, achieve results that are often incomprehensible to their alleged beneficiaries. The experts can't help themselves: with the best will in the world, their mystery converts them into wire-pullers, practitioners of court politics, manipulators of popular opinion, and secret rulers.[24]

Lekachman paraphrased Ricardo on how most societies were organised and how they got that way, but he did not see that the course of history had continued into the modern era largely intact: "Capitalists, wage earners, and landlords quarrelled over the division of a social product inadequate to their needs and expectation. The only winners were the landowners. Land, a fixed resource, became increasingly scarce and valuable as population increased. Accordingly, rent was fated to rise as a share of national income, so long as it was left in the possession of private landlords. Wages could not fall below subsistence. Once they reached that level, the only way rents could continue to rise was for profits to drop. ...Landlords, a completely useless set of monopolists, were rewarded more and more lavishly by the pure accident of inheritance."[25] Concentrations of wealth troubled Leckachman. He advocated in a later book the elimination of all tax shelters, on the grounds they "reward successful speculation in real estate, commodities, and common stocks".[26] Finally, he advised his fellow economists to keep in mind that "[f]ull employment without inflation requires a substantial shift of net income from the affluent and prosperous to the remainder of the community".[27] He should have stressed that the income to be shifted is that which is societally-created and, therefore, unearned by any individual – the rental value of locations and natural resource-laden lands.

The World Bank's role

ANOTHER SET OF CRITICISMS of economic policies was raised by author Bruce Rich in his book *Mortgaging the Earth*, one of the first in-depth examinations of the World Bank and the impact of its activities on the lives of people in the developing world.

His conclusion was that during the years under the direction of former U.S. Secretary of Defence Robert McNamara, the World Bank funded one mega-development project after another, declaring "the fundamental case for development assistance is the moral one".[28] The problem, of course, was that McNamara could not change the socio-political arrangements and institutions of countries run by monopolistic oligarchies, despots and military dictatorships. As Bruce Rich concludes:

> The Bank's approach to poverty also assumed that powerful elites in developing nations, who were well ensconced in siphoning off the benefits of development aid from government ministries, could be induced to make institutional and structural changes for the benefit of the poor and powerless.[29]

Understanding the global economy required a full understanding of the individuals and interests controlling each factor of production, as well as the ways those in power taxed and spent. Advocating policies promising to create efficient markets meant challenging long-standing institutional relationships and even entire systems of law and regulation. Forecasting future changes in market outcomes required the kind of understanding that only an interdisciplinary approach to scholarship and research could achieve. Such was the realm of the political economist but not the individuals emerging from doctoral programs in economics. Malabre records in some detail the failure of economists of whatever theoretical perspective to accurately forecast the future:

> Credentials, I should add, seemed to matter little. Most economists, then as now, were degree-laden, typically sporting a doctorate as well as a master's degree in economics. But there was little relationship between the accuracy of individual forecasts and the academic backgrounds of particular forecasters. Few economists could match the credentials of Milton Friedman, even before the outspoken professor captured the Nobel Prize. Yet, his performance as a forecaster was abysmal.[30]

Interestingly enough, by the end of the 1980s, some economists were talking and writing as though theoretical economics offered little of value to policymakers. They acknowledged that economic theory failed to describe what occurred in the real world. They questioned government statistics and identified enormous gaps in the quality and depth of data available for analysis. Malabre quotes Lester Thurow on the scale of the problem: "We've got a world economy now and it's just not possible for forecasters to understand and take into account all the resulting complexities and uncertainties".[31] In a 2001 interview, an elder statesman in the economic profession, Robert Heilbroner, offered his own assessment of where economics had come to:

> Today, there is no economic theory of capitalism, only a highly refined theory of an imaginary world called the 'market.' But the market is not the same as capitalism. It is only a part of capitalism. There are no 'worldly philosophers' like Schumpeter or Keynes who are thinking seriously about the long-term prospects of the system as a whole.[32]

When Malabre interviewed David Hale, chief economist of Kemper Financial Services, he heard a very similar message. "In the 1990s, there will be only two kinds of business economists – those who follow the world economy and those who are unemployed."[33] Ironically, there is an oversupply of people who have obtained the requisite formal education in economics. The number of tenure-track teaching positions in colleges and universities is declining. Thus, economists must demonstrate their value in the real world, where the tools they are relying on consistently lead them to reach incorrect conclusions. Back in 1994, Malabre closed his book with what amounts to a challenge to economists to do no harm:

> As ineffective and misguided as the modern economists by and large have been, useful lessons can still be drawn from the economy's record in the difficult postwar decades, and the most valuable of these is simply, I submit, that the business cycle endures. It has survived fixed and then floating exchange rates, fiscal fine-turning and then rigid monetary rules, and seen tax slashing in the name of a balanced budget. It not doubt will continue to endure, surviving prescriptions yet to be devised.[34]

Party politics and private property

AS THE REAGAN-BUSH era came to an end, the world situation was in the process of dramatic change. The Soviet Union imploded, unable to keep up the charade of acting as a global power while unable to produce sufficient goods and basic services for its population. As the Russians retreated from their extended territory, rival ethnic groups emerged to engage in brutal territorial wars of their own. Meanwhile, the Chinese leaders took the lessons of the Soviet demise to heart and decided that one party political rule could live in harmony with private property and investment by foreign corporations. How to deal with these new global challenges and others became the problem for the Clinton team. Mason Gaffney summarised the situation as it existed in 1994:

> Neo-classical economics has dominated thinking and policy now for half a century or so. The results are better than those achieved in Eastern Europe, but NCEists cannot take credit for our market economy. The North Atlantic nations had a well-oiled market economy functioning long before NCE drove out classical and Progressive economics. ...
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> They have dismantled most of the reforms of the Progressive Era, and discredited their rationale. They have successfully stifled the movement to convert the general property tax into a pure land tax. Going further, they have shifted taxes

> off property, especially land, and onto payrolls and retail sales... They have achieved "uniformity" in income taxation, and more, given preferential treatment to land income and unearned increments. They have substantially deregulated utility and railway rates, and seen that regulatory commissions are drawn from the monopolies being regulated. They have privatised, or are privatising, much of the public domain (including fisheries, the radio spectrum, water, and the right to clean air) without compensation to the public. ... They have turned the banks loose to lend on speculative land values, and bailed them out when they failed.[35]

> Summing up, the recent harvest of NCE and its derived public policies is a worsening condition of labour, lower returns to saving, high and rising concentration of wealth and income, rising class divisions and social problems, and a fall of national stature. It should be enough to make us realise that NCE, forged as a stratagem to discomfort Henry George and Georgists, is intellectually, morally, and practically bankrupt.[36]

In a conference paper presented at a 1992 seminar at Princeton University, Mary M. Schweitzer suggests the problem goes back to Alfred Marshal. "[T]he concept of natural monopoly was not particularly good news for rising big business"[37] or neoclassical economics, writes Schweitzer. By natural monopoly, however, she was not thinking of locations in cities and towns, agricultural and resource-laden lands or any other portion of the public domain that concerned Mason Gaffney. Another economist, Paul Krugman, acknowledges that "[n]atural monopolies pose a well-known dilemma for public policy. ... [U]nconstrained monopolists do use their power to exploit consumers. Conservatives tend to dismiss concern about monopoly power as a liberal myth, but it is simply the truth".[38] True to form, even Krugman fails to recognise that the concentrated control over land – particularly absent the societal collection of its full rental value – is a primary cause of much of the misery in the world. He identifies "financial wheeling and dealing"[39] as the basis for the escalating distance between the incomes of rich and poor. His policy solution is to impose increased taxes on the rich without regard for the source of income or the form of assets held.

Ecology intrudes on economics

THE ONE REAL HOPE for economics now seems to be with economists who have decided to pursue scientific investigation in the interest of sustainable development and environmental preservation. Those who have come to these similar concerns have Herman Daly, for one, to draw energy from. Daly's 1973 book, *Toward A Steady-State Economy*, wondered at how economists could have defended for so long the policies of unthinking output growth:

> We take the real costs of increasing GNP as measured by the defensive expenditures incurred to protect ourselves from the *unwanted* side effects of production, and *add* these expenditures to GNP rather than subtract them. We

> count the real costs as benefits – this is hyper-growthmania. Since the net benefit of growth can never be negative with this Alice-in-Wonderland accounting system, the rule becomes "grow forever" or at least until it kills you – and then count your funeral expenses as further growth. This is terminal hyper-growthmania. ... As we press against the carrying capacity of our physical environment, these "extra-effort" and "defensive" expenditures (which are really costs masquerading as benefits) will loom larger and larger. As more and more of the finite physical world is converted into wealth, less and less is left over as non-wealth – i.e., the non-wealth physical world becomes scarce, and in becoming scarce it gets a price and thereby becomes wealth. This creates the illusion of becoming better off, when in actuality we are becoming worse off. We may already have passed the point where the marginal cost of growth exceeds the marginal benefit. This suspicion is increased by looking at who absorb the costs and who receive the benefits. We all get some of each, but not equal shares. ... The benefits of growth go mainly to the rich, the costs go mainly to the poor.[40]

One measurement of the cost of how we now share the earth is what is spent responding to natural disasters such as floods, earthquakes, tornadoes, windstorms and volcanoes. A growing proportion of the earth's population lives in harms way – in areas of the globe highly susceptible to the worst nature has to offer. "By destroying forests, damming rivers, filling in wetlands, and destabilising the climate, we are unraveling the strands of a complex ecological safety net",[41] concludes Janet Abramovitz of Worldwatch Institute. What at least a few of us understand is that greater well-being for all could have – should have – occurred while effectively protecting our natural environment. All that was needed was to introduce systems of law that prevented monopolistic privilege.

Even a cursory examination of conditions in many countries strongly suggests a strong correlation between widespread poverty and environmental degradation. Every year there are nearly 80 million more people added to the world's population. Most of this growth – 95 percent – occurs in countries already stressed by severe poverty and the spread of AIDS. Solving these problems will require a massive investment in health care, family planning, education and greater economic security for the billions of poor people whose lives are most at risk under existing conditions. None of these things will happen in a world organised to protect rent-seeking privilege. Far too much of the wealth produced is siphoned off by the landed either as rental charges to tenants or imputed rents enjoyed from deeded land left minimally taxed by government.

Had more economists consistently pressed for policies based on a full understanding of the role of land markets in societies, many of these problems might have been avoided. Every parcel of land has an annual rental value (from nearly zero for locations that cannot be profitably exploited for natural resources, to enormous sums for sites at the centre of commerce in the world's great cities). This value is affected by what uses

are permitted by law and the costs of meeting environmental and other regulations. A party bidding to gain access to a location will tend to bid more when restrictions are few and regulation is minimal. The rental value of a location, then, is determined by what potential users calculate they can pay while still earning an acceptable return on their investment – or would be so determined under competitive market conditions. Unfortunately, owning land has remained for centuries a central rent-seeking activity, and land markets do not operate under the same competitive pressures as the markets for goods and services.

Rent theory is less well-understood today than it was when David Ricardo took up the pen to elaborate on the insights of Adam Smith while responding to challenges raised by Jean-Baptiste Say. "A landlord by his assiduity, economy, and skill to increase his annual revenue", declared Say, "but a landlord has no means of employing his assiduity, economy, and skill on his land unless he farms it himself; and then it is in quality of capitalist and farmer that he makes the improvement, and not in quality of landlord."[42] Ricardo's political economy recognised only cash (or product) flows from tenants to landlords. He held that a landowner who also functioned as a producing farmer earned all that his labour created, subject to reasonable taxation. He warned, however, that if taxation was too high "and the price of produce did not rise, how could those farmers obtain the usual profits of stock who paid very moderate rents, having that quality of land which required a much larger proportion of labour to obtain a given result than land of a more fertile quality?"[43] He answers by first raising a different question:

> But from what fund would those pay the tax who produce corn without paying any rent? It is quite clear that the tax must fall on the consumer.[44]

Thus does Ricardo set the stage for a sustained defence of the status quo against the taxation of rent for societal purposes. By exempting the landed from any taxation of imputed rent, the argument goes, tenant farmers (and anyone who must negotiate ground leases from those who hold deeds to locations) are able to pass on the costs of paying rents and taxes to consumers – or at least to those consumers with incomes high enough to absorb increasing prices and without available substitutes at lower prices.

The role of politics in economics

FOR OVER A CENTURY, the fallacies of Ricardo's analysis have been available for analysis in the works of Henry George. As Mason Gaffney and Fred Harrison detailed in *The Corruption of Economics*, the systematic deconstruction of George's political economy by practitioners of economics determined to preserve the status

quo opened the door for a new generation of credentialed economic professors to advance their own theories of how to outmanoeuvre the business cycle. Few seem to have given any thought at all to the possibility that the business cycle is primarily an effect of unjust systems of law and methods of raising revenue for public purposes adopted by societies. The lesson to be learned is that politics does indeed dictate economic outcomes. Social democracy in the West evolved as a set of policy measures designed to mitigate extremes in wealth ownership and income without materially attacking entrenched privileges. Economists, by and large, have – often unwittingly – served privilege as a terrible master. The story has been well told by Gaffney and Harrison, Malabre and Lekachman. In this new century, let us hope a growing number of economists will emerge from their long entrapment in the practice of pseudo-science.

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