IN MEMORIAM

CHARACTER ISSUES

SYMPOSIUM

ECONOMISTS ON THE WELFARE STATE AND THE REGULATORY STATE: WHY DON’T ANY ARGUE IN FAVOR OF ONE AND AGAINST THE OTHER?

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In Memoriam
Economists on the Welfare State and the Regulatory State: Why Don’t Any Argue in Favor of One and Against the Other?

A Symposium Prologue

Daniel B. Klein

Suppose that you, situated in the United States, encounter some particular American economist for the first time, and upon doing so you see that she leans against the welfare state. You would then expect, I think, that she leans against the regulatory state, too, or at least not toward it. And, conversely, when you encounter an economist who leans toward the welfare state, you guess he also leans toward the regulatory state, or at least not against it. The two policy realms—the welfare state and the regulatory state—tend to elicit parallel positions, for any given economist.

Leading figures illustrate the conjecture: Friedrich Hayek, Milton Friedman, and James Buchanan all leaned against the welfare state and against the regulatory state. John Maynard Keynes, Paul Samuelson, and John Kenneth Galbraith all leaned toward both. And among leading public-discourse economists we see the same sort of pattern over the two policy realms, as suggested by Figure 1.

Several qualifications need to be discussed, of course, most importantly, that many economists are neutral, reticent, in the middle. But, is it possible to find an economist who argues in favor of the welfare state and yet also against the regulatory state? And, is it possible to find an economist who argues against the

1. George Mason University, Fairfax, VA 22030.
welfare state and yet in favor of the regulatory state? I am unable to identify a person of either sort.

**Figure 1. Two sets of American economists**

<table>
<thead>
<tr>
<th>Robert J. Barro</th>
<th>Henry J. Aaron</th>
</tr>
</thead>
<tbody>
<tr>
<td>John H. Cochrane</td>
<td>Eileen Appelbaum</td>
</tr>
<tr>
<td>William Easterly</td>
<td>Dean Baker</td>
</tr>
<tr>
<td>David Friedman</td>
<td>Alan Blinder</td>
</tr>
<tr>
<td>David R. Henderson</td>
<td>J. Bradford DeLong</td>
</tr>
<tr>
<td>Arnold Kling</td>
<td>Nancy Folbre</td>
</tr>
<tr>
<td>Steven Landsburg</td>
<td>James K. Galbraith</td>
</tr>
<tr>
<td>N. Gregory Mankiw</td>
<td>Paul Krugman</td>
</tr>
<tr>
<td>Deirdre McCloskey</td>
<td>Robert Kuttner</td>
</tr>
<tr>
<td>Jeffrey Miron</td>
<td>Lawrence Mithel</td>
</tr>
<tr>
<td>Mario Rizzo</td>
<td>Michael Perelman</td>
</tr>
<tr>
<td>Russell Roberts</td>
<td>Robert Reich</td>
</tr>
<tr>
<td>Vernon Smith</td>
<td>Jeffrey Sachs</td>
</tr>
<tr>
<td>Thomas Sowell</td>
<td>Robert Solow</td>
</tr>
<tr>
<td>Scott Sumner</td>
<td>Joseph Stiglitz</td>
</tr>
<tr>
<td>many GMU economists</td>
<td>Mark Thoma</td>
</tr>
</tbody>
</table>

So, although not everyone is in either the anti-and-anti ‘corner’ or the pro-and-pro corner (because many are, in one or both realms, strewn in between or simply reticent), there seems to be no one in either of the off-diagonal corners, that is, in the anti-and-pro corner or the pro-and-anti corner. Such impression is verified by data from surveys of economists, as shown below.

The question is: Why? Is it because the arguments regarding the welfare state are quite similar to those regarding the regulatory state? If true, that would explain it: Embracing the case for (against) the welfare state, one naturally also embraces the basically similar case for (against) the regulatory state.

But it isn’t clear that the arguments regarding the welfare state are so similar to those regarding the regulatory state. If the cases for (against) are similar in the two policy realms, we would like to see the similarity: What is the case (whether for or against) that applies to issues of both policy realms? How are issues of progressive taxation, redistribution, and universal government provision so much like, say, the issues of public utility regulation, antitrust, consumer protection, workplace safety and labor standards, environmental protection, financial regulation, insurance regulation, land-use controls, housing regulation, agricultural regulation, healthcare regulation, transportation regulation, energy regulation, and so on?

One may say that the welfare state generates dependencies and deadweight losses and is therefore ill advised. Okay, but why can’t one say that but approve of most of our government interventions to deal with market imperfections of various sorts?
And, inversely: One may say that charity or redistribution by voluntary means is a free rider problem, and hence a public goods problem, and hence that government should use its special powers to address that. Okay, but why can’t one say that and then also say the government should lay off, or at least just lighten up, when it comes to most regulatory issues?

The arguments regarding redistribution do not seem to be much like those regarding, say, consumer protection or antitrust. Why don’t we see a wider variety of mixing and matching?

Jonathan Haidt (2006; 2012) has likened the mind to an elephant carrying a human rider. He writes:

"The mind is divided, like a rider on an elephant, and the rider’s job is to serve the elephant. The rider is our conscious reasoning—the stream of words and images of which we are fully aware. The elephant is the other 99 percent of mental processes—the ones that occur outside of awareness but that actually govern most of our behavior." (Haidt 2012, xiv, italics in original)

Haidt’s metaphor is tempting. Economists clearly disagree greatly on many important matters. Each economist is likely to say that opposing economists are letting their elephants carry them away, that they are failing to guide their elephants. Each of us will be tempted to think that some economists are carried away by fundamental allegiances of some kind, allegiances that impel one to lean consistently in the same direction on mainstream issues of policy reform.

As I see it—and I see as a pragmatic libertarian or classical liberal—the best way to formulate the most important dimension of reform is as making social affairs either more or less governmentalized. In that dimension, one direction is the governmentalization direction; it consists of defending or advancing such things as intervention, taxation, and government as player in social affairs (as benefactor, employer, creditor, owner/operator of resources, facilities, etc.). The other direction, the degovernmentalization direction, consists of defending or advancing the contrary features: free private action and ownership, liberalizing or repealing interventions, reducing taxation, and downsizing government as a player in social affairs.

Maybe for some economists the elephant and the rider work together. Maybe you are such an economist: Your elephant and your rider basically agree on where to go, and they just help one another. The thing to which you give your faithful allegiance is sound, responsible, proper, and virtuous judgment. But if so, and assuming that your positions in the two realms are broadly parallel, what is your
rider’s explanation for the parallel positions on the welfare state and the regulatory state?

Perhaps you will articulate the reasons for your positions in both realms. But will two economists, one anti-and-anti and one pro-and-pro, both do so? If not, is it fair to suspect that the policy-position profile of one or both sorts is determined by an unarticulated allegiance of some kind?

If so, what then explains that unarticulated allegiance? May we conjecture that it derives from subterranean dispositions and penchants?

If the two economists were asked about the matter, perhaps both would say:

“I can articulate the reasons that justify my positions in both realms, but those other economists are ideologues. They are acting out in a way to preserve a misguided allegiance. I guide and control my elephant; they are carried away by their elephant and rationalize its movements.”

If both said that, would they be able to resolve their disagreement?

The thing to be explained is the observed pattern of policy positions among economists, particularly the emptiness of the off-diagonals. My goal here is not to offer an explanation, but to entice others to do so. In what follows I specify the thing to be explained, the explanandum, and then pose questions to prompt explanations.

The thing to be explained

In contrasting the two sets of economists in Figure 1, we do not want to overstate the differences. First, let’s think in terms of the point of view from the status quo, and then focus on whether the economist contends one way or the other from that ‘50-yard line.’ The contrast is not so much about ideal destinations, a vision of an ‘end zone,’ but patterns of contending, and how strongly one contends one way or the other. Friedrich Hayek and Milton Friedman both wrote things agreeable to some basic welfare-state functions, but leaned against expansions in the welfare state and in favor of reducing its size and scope. Similarly, virtually all the economists in the second column of Figure 1 have endorsed proposals to raise the minimum wage to about $10,2 but those same people probably would not support

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2. A 2014 petition to raise the minimum wage (link) was signed by all of the economists in the second column of Figure 1 except for Robert Kuttner and Paul Krugman, who endorses doing so in Krugman (2013).
raising it to $20. So our conceptualization of positions is framed in terms of direction of reform from the status quo, not in terms of ideal destinations.

Second, in observing whether the economist contends one way or the other we observe the important phenomena of not contending one way or the other. At the 50-yard line, one may posture oneself squarely there—either steadfastly, withstanding pressure from either direction, or aloofly, quietly, taking no part in struggle. Consider the case of Robert H. Frank. He defends tax progressivity and advocates making it steeper. When it comes to the regulatory state, however, it is my impression that on the whole he does not particularly contend one way or the other. Our explanandum recognizes that many economists are strewn through the middle of the two dimensions. But there is still a notable pattern: No one actively contends pro-and-anti or anti-and-pro: The off-diagonals are largely empty.

Third, let me clarify two sides of contending. An economist who contends in favor of the welfare state might have two roles to play, ‘defense’ and ‘offense.’ When the opposing team, as it were, advocates reductions in the welfare state, he may defend or justify current welfare state measures so as not to lose ground. At other times he may seek to gain ground by advocating expansions of the welfare state, putting the opposing team on defense. The two sides of contending are worth separating, if only because the abstention from defending the status quo puts fine points on our explanandum: Some anti-regulatory state economists might, it is true, not advocate reductions in the welfare state, but, still, it is remarkable how rarely we find them defending against reductions in the welfare state. And some pro-welfare state economists might, it is true, not advocate expansions of the regulatory state, but, still, it is remarkable how rarely we find them defending against expansions of the regulatory state. Such abstentions from defending the status quo are especially notable because, generally, the status quo enjoys a certain presumption.

Finally, I have spoken of two sets of issues, ‘the welfare state’ and ‘the regulatory state.’ These denominations are best discussed in conjunction with the survey data. The main question becomes: Which policy questions will be denominated as a welfare-state issue, and which a regulatory-state issue?

Data from 2010 survey of economics professors

In 2010, William Davis, Bob Figgins, and I conducted a large survey of economics professors in the United States. We believe the survey was of quite high quality, but there is one concern: The 299 respondents constituted a response rate of only 15.2 percent. A description of the survey is found in Davis et al. (2011, 127-128). We explain there why, despite the low response rate, we feel comfortable
proceeding on the presumption that the sample is more or less representative. The survey instrument and complete data are available here.

The survey included 17 policy questions, all of which took the form as shown in the sample statement below:

Each of the policy-issue questions offers a reform in relation to the status quo. Please mark your disposition toward each.

Higher minimum wages:

- [ ] support strongly
- [ ] support, not strongly
- [ ] neutral
- [ ] oppose, not strongly
- [ ] oppose strongly
- [ ] have no opinion

The 17 reforms offered were:

- Q10. Higher minimum wages
- Q11. Tighter restrictions (e.g., tariffs and quotas) on imported goods
- Q12. Tighter requirements for the permitting of new pharmaceuticals and medical devices
- Q13. Tighter restrictions on private parties engaging in discrimination (on the basis of race, gender, age, ethnicity, religion or sexual orientation) against other private parties, in employment or accommodations?
- Q14. Tighter restrictions on the buying and selling of human organs
- Q15. Tighter workplace safety regulation (e.g., by the Occupational Safety and Health Administration (OSHA))
- Q16. Tighter air-quality and water-quality regulation (e.g., by the Env. Protection Ag. (EPA))
- Q17. Tighter requirements on occupational licensing
- Q18. Tighter restrictions on prostitution
- Q19. Tighter restrictions on gambling
- Q20. Tighter controls on immigration
- Q21. Tighter restrictions on adult women having an abortion
- Q22. Tighter restrictions on “hard” drugs such as cocaine and heroin
- Q23. More redistribution (e.g., transfer and aid programs and tax progressivity)
- Q24. More funding of the public school system
- Q25. More benefits and coverage by Medicaid
- Q26. More American military aid or presence abroad to promote democracy and the rule of law
Thus all of the policy questions posit a reform to the status quo in the direction of ratcheting up the government restriction or activism. It should be noted that opposing such a reform wouldn’t necessarily imply support for reform in the contrary direction, since one might stand steadfastly on the status quo, opposing both higher and lower minimum wages, say. But it is reasonable to suppose some relationship of that sort—e.g., that strongly opposing higher minimum wages is correlated with supporting lower ones.

Here I use questions 23, 24, and 25 (equally weighted) to represent a Welfare State dimension. In this dimension, I seek to include taxation and spending programs that are thought to help the less well off. On the taxation side, the key feature is taxation such that the proportion of one’s income or wealth paid in taxes goes down the lower one’s income or wealth is (progressivity, luxury taxes, etc.). On the spending side, the most exemplary feature is means testing or some other form discrimination thought to favor lower-income recipients; but I also include the school-funding question, because I count indiscriminate, universal spending also as within the welfare-state concept, on the notion that, overall, resources are redistributed from the more well off to the less well off.

As for the ‘regulatory state,’ the chief connotation is governmental action to regulate social processes, to tinker with or adjust otherwise self-propelling and self-directing activities; to intervene. The rationale is to improve human well-being overall. On that very broad view of the regulatory state, one might count virtually all government restrictions on private ownership and voluntary association.

In that broad spirit, let us first define a broad set of the survey questions, a set called Restriction, including all of the questions except for the Welfare State questions and the “military aid or presence abroad” question. Thus, Restriction consists of Q10 through Q22 (equally weighted). This broad set of issues may not sit well as representing the ‘regulatory state.’ We will come back to that. But does it sit okay as representing something broader, what might be called the ‘restrictive state’? It seems to me that it does.3

Figure 2 is a scatterplot of the survey respondents, using these two sets of Likert items, Welfare State and Restriction. Each item response is coded from 0 to 4, where 0 is “support strongly” the posited reform and 4 is “oppose strongly,” and then a mean is calculated for a respondent’s responses in the set. The Welfare State and the Regulatory State

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3. Some will point out that the Restriction concept is one of the government’s initiation of coercion and say that tightening restrictions on abortion, as posited in Q21, is not an initiating of coercion, because abortion, like murder, is itself the initiation of coercion, against the fetal human being. Although I respect that interpretation of abortion, I reject it in the end (which is not to say I necessarily oppose restrictions on abortion), and hence I include abortion. Some might make a similar point with respect to air-quality and water-quality regulation (Q16), but again I include it in Restriction.
State scale runs along the x-axis, and Restriction the y-axis. All scatterplot figures are generated in Stata using jitter7 to separate coincident dots.4

**Figure 2.** Scatterplot of economists, Welfare State scale (x-axis) x Restriction scale (y-axis)

The regression line in Figure 2 has slope of 0.43. The y-intercept is 1.63, with an R-squared of 0.51. Strong support for ratcheting up the welfare state (around zero on the x-axis) finds a very substantial constituency in the sample. The scatter has a heavy base beginning right at x = 0. In contrast, if one looks at y = 0, we see hardly anyone very close to zero. There is no heavy base of strong support for ratcheting up the restrictive state.

The next thing to point out is that, starting with the dots at x = 0, concentrated in the lower left corner, the scatter generally moves up to the upper right corner: As support for the welfare state declines, support for the restrictive state tends to decline.

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4. The Welfare State scale value for a respondent Joe who answered, say, only two of the three Welfare State policy questions is the mean of the two questions he answered. So Joe is not thrown out just because he did not answer all questions. The same logic is applied in all such calculations in this paper.
Look at the lower right corner: If one opposes ratcheting up the welfare state, it is almost a certainty that one is at least neutral, and likely that one leans against ratcheting up restrictions.

As for the inverse corner, the upper left, the emptiness is less pronounced, but there is still a basic symmetry. We can say that if one supports ratcheting up the welfare state, it is very unlikely that one strongly opposes ratcheting up restrictions.

The Restriction scale has 13 components. Does the three-question Welfare State scale move positively with each of them individually? The answer is no, as shown in Table 1, which gives bivariate regression results between the Welfare State scale and each of the 13 components. For every bivariate regression, the coefficient is statistically significant at the 0.01 level. All of the coefficients are positive with two notable exceptions: immigration (Q20) and abortion (Q21).

<table>
<thead>
<tr>
<th>Q10</th>
<th>Q11</th>
<th>Q12</th>
<th>Q13</th>
<th>Q14</th>
<th>Q15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Min. wage</td>
<td>Import restr.</td>
<td>FDA</td>
<td>Discrimination</td>
<td>Organs</td>
<td>OSHA</td>
</tr>
<tr>
<td>Coeff.</td>
<td>0.67*</td>
<td>0.67*</td>
<td>0.63*</td>
<td>0.61*</td>
<td>0.48*</td>
</tr>
<tr>
<td>t-value</td>
<td>(20.3)</td>
<td>(8.4)</td>
<td>(13.1)</td>
<td>(16.2)</td>
<td>(10.5)</td>
</tr>
<tr>
<td>Intercept</td>
<td>0.22*</td>
<td>-0.65*</td>
<td>0.27*</td>
<td>0.78*</td>
<td>0.62*</td>
</tr>
<tr>
<td>t-value</td>
<td>(2.5)</td>
<td>(2.2)</td>
<td>(2.1)</td>
<td>(10.0)</td>
<td>(5.1)</td>
</tr>
<tr>
<td>R²</td>
<td>0.58</td>
<td>0.19</td>
<td>0.38</td>
<td>0.48</td>
<td>0.29</td>
</tr>
<tr>
<td>N</td>
<td>294</td>
<td>295</td>
<td>283</td>
<td>291</td>
<td>277</td>
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</table>

<table>
<thead>
<tr>
<th>Q16</th>
<th>Q17</th>
<th>Q18</th>
<th>Q19</th>
<th>Q20</th>
<th>Q21</th>
</tr>
</thead>
<tbody>
<tr>
<td>Air/water</td>
<td>Occup. licensing</td>
<td>Prostitution</td>
<td>Gambling</td>
<td>Immigration</td>
<td>Abortion</td>
</tr>
<tr>
<td>Coeff.</td>
<td>0.73*</td>
<td>0.66*</td>
<td>0.32*</td>
<td>0.42*</td>
<td>-0.16*</td>
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<tr>
<td>t-value</td>
<td>(19.6)</td>
<td>(13.5)</td>
<td>(4.9)</td>
<td>(7.6)</td>
<td>(2.7)</td>
</tr>
<tr>
<td>Intercept</td>
<td>0.81*</td>
<td>0.10</td>
<td>0.80*</td>
<td>0.68*</td>
<td>2.15*</td>
</tr>
<tr>
<td>t-value</td>
<td>(12.1)</td>
<td>(0.7)</td>
<td>(4.1)</td>
<td>(4.5)</td>
<td>(11.6)</td>
</tr>
<tr>
<td>R²</td>
<td>0.57</td>
<td>0.04</td>
<td>0.08</td>
<td>0.17</td>
<td>0.02</td>
</tr>
<tr>
<td>N</td>
<td>290</td>
<td>274</td>
<td>286</td>
<td>292</td>
<td>297</td>
</tr>
</tbody>
</table>

* t-values in parentheses; * p < 0.05; ** p < 0.01

In defining the Restriction scale, we excluded not only the three Welfare State questions, but also the “military aid and presence abroad” question (Q26). It is worth noting that a bivariate regression between the Welfare State scale and Q26 shows a coefficient of −0.22 with a t-value of 3.25 (p < 0.01).

So the data suggests a strong relation between favoring the welfare state and favoring ratcheting up restrictions in general, as represented by the Welfare State and Restriction scales. But, we’ve seen that at a more granular level the relationship is often only weak, and in at least a few policy areas is actually negative.
Let us now create another scale, one closer to the notion of the ‘regulatory state.’ I take the central concept to be restrictions on private producers and sellers in industries that are permitted, officially recognized, albeit regulated. On this concept, we remove the restrictions on prostitution, gambling, and ‘hard’ drugs—all which are generally thought of more as the control of ‘sinful’ personal behavior, often by outright prohibitions (‘the nanny state’)—as well as abortion and immigration. Paring those away as well, I define Business Regulation to include Q10 through Q17 (equally weighted): the minimum wage, import restrictions, FDA, discrimination, organ policy, OSHA, air and water quality, and occupational licensing. For each of these, the idea is that regulation guides and adjusts legitimate, respectable economic activities, so as to enhance overall outcomes. Many major areas of the regulatory state are not covered here—antitrust, public-utility regulation, energy policy, and so on—but the eight questions included here seem to represent the concept reasonably well. Adding, if we could, any prime regulatory-state issues probably would not change the results.

Figure 3. Scatterplot of economists, Welfare State scale (x-axis) x Business Regulation scale (y-axis)
In Figure 3 we have the Business Regulation scale along the y-axis. The results are like the previous scatterplot, only stronger and tighter. The regression line has slope of 0.66. The y-intercept is 1.02, with an R-squared of 0.69. Again, we see that many economists are rock-solid on ratcheting up the welfare state, but almost none are as solid on ratcheting up business regulation.

This scatterplot best represents our thing to be explained, our explanandum. Now the off-diagonal areas are even emptier. Why does opposing ratcheting up the welfare state make it so unlikely that one supports ratcheting up business regulation? And why does supporting ratcheting up the welfare state make it so unlikely that one strongly opposes ratcheting up business regulation? Again, how are the three issues in Welfare State so parallel to the eight issues in Business Regulation? If the issues are different, what is it that prevents economists from mixing and matching positions so as to land deeper in the off-diagonal areas?

If we can come up with a satisfactory explanation, the explanation will surely help to explain another curious fact about economists: their frequent lack of consensus on individual policy reforms (Klein et al. 2013, 121).

The patterns discussed here probably conform to one’s casual impressions about different kinds of economists. Moreover, in 2003 I did a survey of members of the American Economics Association (as well as five other scholarly associations), and those data show very similar patterns.\(^5\)

Questions for contributors to consider

The main question, number (1) in the list below, has already been posed. Here I pose some follow-on questions to prompt contributors

1. On issues of the welfare state and the regulatory state, why do so few economists argue in favor of one and against the other? The symposium asks you to speak to the question from any angle that seems appropriate to you.

2. Explanations may themselves call for explanation. For example, perhaps your explanation would involve the political parties (by the way, there was a party voting question in the 2010 survey; see the 2013 paper). If party allegiance were part of your explanation, that would prompt further questions such as: Why do the two parties have the position profiles they do? Why would an econo-

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5. The 2003 data on AEA members is available upon request, as is some preliminary analysis showing that the patterns are the same as those shown here for the 2010 data. The 2003 survey instrument as well as links to paper using the data is [here](#).
must be influenced by a party line? How are economists influenced by the two parties?
3. Can you think of some economists who defy the patterns described here? Can you think of any who argue in favor of the welfare state and against the regulatory state? Any who argue against the welfare state and in favor of the regulatory state?
4. What are your own views in the two areas? If your judgment tends to be parallel across the two areas, how would you account for that?
5. If your judgment tends to be parallel across the two areas, how do you explain why many economists do not share your views? Where are they going wrong? What prevents them from seeing as you see?

Appendix

Everything concerning the 2010 survey of economics professors is available here. A file containing data and code for the results shown in this paper is here.

References


About the Author

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Do Welfare State Liberals Also Love Regulation?

Dean Baker

One can infer that supporters of major welfare state programs like Social Security and Medicare are not necessarily enamored of market outcomes. From this perspective, it may be expected that they would also favor government regulations like minimum wages and strict rules on consumer protection. This is a simple story, but it is wrong.

First, it is a serious oversimplification to treat supporters of Social Security and Medicare in their current form as simply lovers of big government. There are strong efficiency arguments for the public provision of these forms of insurance. Second, only a very selective view of the economy would find that supporters of welfare state programs are more pro-regulation than opponents.

Rules and regulation: Those who set the rules don’t need regulation

Starting with the second point, the perceived need for regulation depends on how the rules are drawn. Suppose we take the case of the Consumer Financial Protection Bureau (CFPB). The rationale for this protective agency comes from the belief that the financial industry will structure its products and contracts in ways that disadvantage consumers. The presumption is that consumers may not fully understand the terms to which they are agreeing; therefore they need a government agency to protect them.

It is possible to disagree over the extent to which consumers misunderstanding contracts is actually a problem, but suppose that we step back and change the rules on financial contracts. Suppose that in order for a financial contract to be considered valid it must be written in the simplest possible way, with unnecessary complexity being a basis for voiding the contract. If this were the standard for enforcing financial contracts, then it is likely that fewer people would see any need for an agency like the CFPB to intervene in markets.

If having a legal standard that makes simplicity a basis for having an enforceable financial contract seems like a stretch, then we need look no further than the treatment of insurance contracts to find a comparable standard. The norm in enforcing insurance contracts is that the insuree has an obligation to disclose information that can be reasonably expected to affect the risk against which they are being insured. This is true even if the specific activity in question is not explicitly prohibited in the contract.

There is a sound economic argument for this treatment of insurance contracts. The person getting insurance is, compared to the insurer, in a better position to know the risks they face, and also to take precautions against these risks. This means that we would want them to bear the full cost of properly insuring against the risks they are taking or imposing on others. This would give them the incentive to reduce risk to the extent risk reduction is economically efficient.

It is possible to make a similar argument with reference to a rule requiring simplicity for a financial contract to be enforceable. Professionals in finance can easily write complex financial contracts that will be difficult for most customers to understand. They can also take advantage of research in psychology that will show them how to adjust contracts so that consumers will be most likely to pay the most money for the least expected value.

If we allow all financial contracts to be fully enforced, and do not have any regulatory mechanism to prohibit deliberately deceptive contracts, then we can expect the financial industry to devote considerable resources to finding ways to deceive consumers. This would be a major waste of economic resources on both the part of the industry and the part of consumers, who would now need to spend large amounts of time going over contracts to be sure there were no hidden clauses that would lead to substantial costs.

To avoid this waste of resources, it is desirable to put a check on the ability of the industry to deliberately issue contracts that are difficult for consumers to understand. The need for a regulatory path is the result of the way in which the rules are set. The vast majority of supporters of the CFPB would probably be content with closing the Bureau tomorrow, if the law was structured so that any unnecessarily complex contract was simply treated as being unenforceable.
There is a similar story with the minimum wage. Supporters of minimum wage legislation want to ensure that workers have a decent standard of living in a context where the labor market may not achieve this outcome. However, the labor market outcome is very far from a natural result. It is affected by a wide variety of macro and micro policies.

The most obvious policy on the macro side is the Federal Reserve Board’s decision to target low rates of inflation with its monetary policy. When it raises interest rates to slow the economy and to ensure that the inflation rate doesn’t rise above its target levels, it is deliberately keeping workers from getting jobs and putting downward pressure on the wages of workers at the middle and bottom of the wage distribution.\(^2\)

The priority that the Fed places on low inflation is not a given. It could pursue a policy that focuses on keeping the unemployment rate low, with the understanding that this could imply a somewhat higher rate of inflation. In that case, there might be less interest in or need for a minimum wage, since the labor market might then sustain wages at a level that would meet or exceed the targets for a minimum wage.

Of course, many would argue that central bank policy cannot have an enduring impact on the unemployment rate and that the most useful economic path is therefore pursuing price stability. However, this objection implies differences in our understandings of the economy, not differences in the extent to which the government should interfere with the market.

In the same vein, the value of the dollar is hugely important in determining the trade balance for the United States, since it is the main factor determining the international competitiveness of U.S. goods and services. This has both macroeconomic and microeconomic effects on labor markets. On the macro side, in the context of a labor market that is well below full employment, the trade deficit that results from an overvalued dollar keeps many Americans from working and puts downward pressure on the wages of those who are working.

On the microeconomic side, the high dollar disproportionately puts downward pressure on employment and wages in the sectors of the economy that are most vulnerable to international competition. First and foremost, this means the manufacturing sector, which still accounts for the vast majority of international trade. This sector has historically been a source of relatively well-paying jobs for

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2. In *Getting Back to Full Employment: A Better Bargain for Working People* (2013), Jared Bernstein and I estimated that a sustained 10 percent reduction in the unemployment rate is associated with a 9.4 percent increase in the wages of workers at the 20th percentile of the wage distribution. There was also a substantial negative effect on the wages of workers at the middle of the distribution, but the effect on workers at the 90th percentile was insignificant.
less-educated workers. An overvalued dollar therefore puts downward pressure on the wages of U.S. workers at the middle and bottom of the wage distribution.

This also is a matter of policy. In trade negotiations the United States has pushed its trading partners to respect patent and copyright monopolies of U.S. corporations. It has also pushed for more open markets for the foreign expansion of a wide range of industries. Alternatively, it could have pushed for a lower valued dollar, trading off concessions in other areas. In addition, the fact that less-educated U.S. workers are put in competition with low-paid workers in the developing world is not an accident. We could have designed trade agreements that focused on eliminating the barriers that make it difficult for foreigners to become doctors, lawyers, or other highly educated professionals in the United States. If that had been the focus of trade policy it would have led to enormous economic gains in a way that made the U.S. distribution of income more equal.

Similarly, we can envision a different structure of labor law that is more advantageous to workers. As it stands now, employers can rush into court and get an injunction against workers for a number of illegal labor practices, such as a wildcat strike or secondary boycott. This means that workers face imprisonment if they continue the action.

By contrast, if employers break the law, for example by firing a worker attempting to organize a union, the case is brought to the National Labor Relations Board. This typically takes months and the potential penalties are trivial. No employer ever risks going to jail for violating the law to break a union.

It is easy to imagine a world where the legal sanctions are reversed. Suppose workers could get an injunction threatening an employer with jail if he did not immediately rehire a worker fired for union activity. In such a world, unions would have considerably more power than they do today. This would increase the power of labor relative to capital which would likely mean a larger share of income going to labor.

If we envision a world in which the rules have been structured to favor workers instead of employers, it is likely that most workers would be earning much higher wages. In this world, there may be much less interest on the part of liberals in minimum wage laws. It would likely be the case that nearly all workers would already be earning enough to ensure a decent standard of living (recognizing this as a relative concept) as a result of the natural workings of the market.
Government welfare state: Statement of values, or efficiency?

Turning to the first point, it is at least an oversimplification to argue that supporters of government programs like Social Security and Medicare in their current form are necessarily supporters of big government, in contrast to people who want to reform these programs. There are strong efficiency arguments for these programs in their current form, which is a separate issue from the question of values and the role of government.

Taking the case of Social Security, with which I am most familiar: In more than twenty years of debating the program I have never once been opposite someone arguing for the strong libertarian position that retirement savings should be entirely left to the individual. Many people have argued that we can better meet workers’ needs for retirement savings with private systems of mandated savings, but not one person has ever said that retirement savings should be entirely the responsibility of the individual—that those who fail to save should suffer the consequences in their own age. (Whether the mandated-private-savings position reflected their actual views, or was simply a posture they were taking for political purposes, I have no idea.)

If there is agreement that the government has responsibility for ensuring that workers save for their retirement, then the next question is the best mechanism for accomplishing this result. There is a large body of research showing that a centralized system like the Social Security program in the United States has far lower administrative costs than privatized systems like the ones in Chile and the United Kingdom (see, e.g., Orszag and Stiglitz 2001; National Academy for Social Insurance 1998). The costs are an order of magnitude lower with Social Security spending around 0.6 percent of annual benefits on administration compared with the privatized systems in Chile and the UK spending between 10 percent and 20 percent of annual payouts. In addition, the cost of annuitizing an accumulation can easily exceed 10 percent of the sum, further increasing the cost differences.

Given the efficiencies of a centralized system, there is a strong argument for a government-run system like the one in the United States regardless of whether someone is in general a supporter of big government or prefers outcomes being left to the market. If the point is to ensure that workers have a minimal retirement income, the evidence strongly indicates that this is done most efficiently through a public system.

There is an argument as to how large the benefit should be and the extent to which it should be related to lifetime earnings. Positions on how large may to
some extent reflect individuals’ attitudes towards the government, although even here that is not entirely clear. If nearly everyone except for the very wealthy will want to ensure that they have a relatively high replacement rate in retirement, then a program that offers a high replacement rate would reduce waste in the economy.

The link between the benefit structure and earnings also does not provide a clear basis for a pro-government/pro-market divide. A uniform, near poverty-level benefit may seem more consistent with a minimal government approach. However, if the benefit is financed through a payroll tax mechanism, this makes the program into a tax-and-transfer scheme rather than an income-related pension. That is not obviously smaller government.

There is a similar story with Medicare and indeed publicly run health care programs like the ones in Canada or the system of socialized medicine in the UK. The administrative costs in these public systems are far lower than in the private systems in the United States. It is entirely reasonable to support these programs on the grounds that they are more efficient than their private sector counterparts rather than out of any desire to see the government take over a larger share of the economy.

In short, it is misleading to see the world as divided between those who support big government programs and those who support leaving matters to the market. There are important empirical questions on the relative efficiency of centralized systems—which don’t have to be public—compared with decentralized market systems. It is possible that people’s prejudices towards or against the government influence how they view this evidence, but, in principle, the choice of systems can be driven by evidence rather than prejudices.

**Conclusion: The divide between the government and the market is not obvious and simple**

I have argued that the perceived need for various forms of regulatory interventions stems in large part from how the rules are structured. In the United States at present, many of the rules have been written in ways that work to the advantage of the rich and powerful. Under these circumstances, many liberals who identify with the less advantaged are pushing for regulations that will protect their interests. This does not reflect an inherent preference for government intervention in market outcomes, but rather a recognition that the rules have been rigged to work against the vast majority of the population.
In the same vein, the desire to protect welfare state programs stems at least in part from the fact that these programs are the most efficient way to provide the security that people across the political spectrum claim to value. If in fact the public programs are the most efficient way to ensure an agreed upon level of public well-being, then the opponents of these programs effectively want to deliberately waste resources to reduce the role of government.

It is an open question as to the extent to which either liberals or conservatives are amenable to having their views change on these issues in response to contrary evidence. However, it is certainly arguable that the differences are as much or more in perceptions of the relative strength of the evidence as in political preconceptions.

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Yes, There Are Hayekian Welfare States (At Least in Theory)

Andreas Bergh

Many economists tend to be skeptical towards government intervention. There are several reasons for such skepticism, but all reasons do not apply to all types of interventions. This note identifies two common but very different lines of argumentation against government interventions: the Hayekian knowledge problem and the problem of distortionary taxation. While many government programs suffer from both problems, there are exceptions. In particular, there is a possibility of what I will call Hayekian welfare state programs, which require high levels of public expenditure but do not suffer severely from the Hayekian knowledge problem, and where taxes and benefits are designed to minimize distortions. I propose that the correlation between economists’ views on the regulatory state and the welfare state, as presented by Daniel Klein (2015), is partly a result of the survey questions failing to capture the possibility of a Hayekian welfare state.

Two reasons for opposing government intervention

There are different types of government intervention, and there are different reasons for opposing (or favoring) such intervention. Consider two of the most common reasons for opposing government intervention: The neoclassical problem of distortionary taxation, and the Hayekian knowledge problem.

The neoclassical reasons, taught in textbooks, are based on the fact that public funds are raised by taxation and entail excess burdens: The cost of raising x

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dollars for public spending will exceed $x$ dollars by some amount that depends on the type of taxes used. Theoretically, the size of the excess burden is proportional to the tax rate squared, suggesting that, from an efficiency point of view, low taxes are much better than high taxes (Stiglitz 2000, ch. 19).²

The Hayekian reason comes from the view that the information necessary for the government to succeed with any government intervention exists “solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess” (Hayek 1945, 519). Even under the unlikely scenario that the government is fully informed at one point in time, this information is likely to become obsolete in a rapidly changing world. When the government has incomplete information about preferences and circumstances of the actors in society, centrally planned interventions imposed by force may do great harm.

There are, of course, qualifications and counter-arguments to both reasons. In some situations the knowledge problem may be less severe, and the alternative—voluntary, spontaneous action—may suffer from severe collective action problems. Similarly, there may be situations when taxes are not terribly distortionary and where public funds are used in ways that redeem the distortionary effects.

At this point, I do not wish to claim anything about the relative strength of the various arguments. But I do suggest that the two reasons are conceptually very different, and that there are types of government intervention that would suffer substantially from the neoclassical problem but much less from the Hayekian problem, and vice versa. Some examples might clarify the idea.

## Four examples of government intervention

Using the two reasons for opposing government intervention described above, government programs can be classified in two dimensions: the amount of knowledge needed and the amount of public funds needed. Programs that require a lot of funds need high taxes and are vulnerable to the neoclassical distortion problem. Programs that require a lot of knowledge are vulnerable to the Hayekian knowledge problem.

Table 1 gives examples of government interventions that differ in the two dimensions. Intervention types A and B include government programs that require

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² The neoclassical distortions are sometimes of substantial magnitude. In a welfare state with high average taxes, the marginal cost of public funds raised from progressive income taxes may well be six times the amount raised, as for Sweden during its most extreme period around 1980, as shown by Hansson (1984). U.S. estimates average around $1.40 for an additional tax dollar (Bohanon et al. 2014, 281-284).
relatively little public funds but that differ a lot in how much knowledge the
government needs to implement the programs successfully: Type A interventions
require relatively little knowledge, and Type B interventions require much knowl-
edge.

<table>
<thead>
<tr>
<th>Knowledge needed</th>
<th>Type A: Example: Income-tested welfare</th>
<th>Type B: Example: Seed capital and encouragement of entrepreneurs</th>
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<tr>
<td>Relatively little</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Level of public</td>
<td>Low</td>
<td>High</td>
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<tr>
<td>funds needed</td>
<td>Low</td>
<td>High</td>
</tr>
</tbody>
</table>

An income-tested welfare program, which is an example of Type A, will
enjoy majority support if a majority of voters would be willing to contribute to such
a program provided that everyone is actually contributing, and it might actually be
justified under the Pareto criterion if everybody has such preferences. For those
who care about Benthamite utility, the circumstances under which such a program
will increase total utility are probably not very strong; basically, if everyone has
decreasing marginal utility of income, there are utility gains created by redis-
tribution that must exceed the costs of redistribution.

There are, of course, plenty of opportunities for governments to fail also
with programs of Type A. In the case of income-tested welfare, the level guaranteed
by the program might be set too high, in which case the work disincentive effects
may dominate. Still, as several scholars have noted, Hayek goes beyond the idea of
income-tested support and argues for a basic income guarantee in *Law, Legislation
and Liberty*:

> The assurance of a certain minimum income for everyone, or a sort of
> floor below which nobody need fall even when he is unable to provide
> for himself, appears not only to be wholly legitimate protection against
> a risk common to all, but a necessary part of the Great Society in which
> the individual no longer has specific claims on the members of the
> particular small group into which he was born. (Hayek 1981/1979, 55)³

³ On Hayek and parts of the welfare state, see also Nell (2013, especially ch. 3 by Daniel Kuehn) and von
Weizsäcker (2003).

Type B contains programs that require a lot of knowledge but that still do
not require high taxes. Examples include public encouragement of entrepreneurs,
public seed capital, and any program that requires the government to pick winners.
In this case, there is consensus that the government is faced with a very difficult

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³ On Hayek and parts of the welfare state, see also Nell (2013, especially ch. 3 by Daniel Kuehn) and von
Weizsäcker (2003).
task that requires a lot of knowledge, and the most critical would probably recommend that the government does not even try.

Types C and D contain programs that require a lot of public funds, but that differ in their knowledge requirements. Similar to income-tested welfare, pension schemes are basically motivated by decreasing marginal utility of consumption, but with particular attention to the need for smoothing consumption over one’s lifecycle, in effect creating an insurance scheme to account for the uncertain longevity most people face. Successful design of pension schemes and social insurance require that moral hazard problems and adverse selection are accounted for. Needless to say, these are non-trivial issues, but compared to the knowledge needed for governments to successfully implement the Type D example—Keynesian stabilization policies—social insurance arguably is less challenged by the knowledge problem.

Why don’t economists argue in favor of the welfare state and against the regulatory state?

Finally, I offer two thoughts on the idea that very few economists share my position of being rather friendly towards a well designed welfare state and skeptical about most government regulations.

First of all, regarding the evidence put forward by Klein, I am not convinced that the correlation shown is very sound. Upon examining the three survey questions used by Klein (2015, 6-9) to construct his “Welfare State” index, I believe that two of the three questions are at least slightly biased against the welfare state. In Klein’s question 23, both the phrases “transfer and aid programs” and “tax progressivity” suggest a welfare state with a substantial degree of vertical income redistribution from rich to poor. Such a welfare state not only will create more severe distortions than a welfare state that provides risk-pooling social insurance schemes financed by proportional taxes, but it will also be more vulnerable to the knowledge problem. The effect will be that if there are economists who for Hayekian reasons oppose most regulations but are more enthusiastic about social insurance, their existence will not be revealed by this set of questions. I suspect that the mentioning of Medicaid, in Klein’s question 25, had a similar effect.

Secondly, I believe that, when it applies, the Hayekian argument against government intervention is much stronger than the neoclassical argument. The

4. It might be noted that while countries with big, universal welfare states unsurprisingly have higher average taxes, they are also typically less progressive than in countries with smaller welfare states (cf. Bergh 2014).
commonly held view that neoclassical economics as taught in a typical Econ 101 course is anti-government is highly debatable. If a professor is honest about the circumstances under which markets can be expected to allocate resources efficiently, the standard economics course is much more interventionist than it is pro-market. As discussed by James Gwartney (2012), most introductory economics textbooks devote much more attention to market failure than they do to political failure. One could add that they also do not do justice to the Hayekian knowledge problem, if they treat it at all. The neoclassical analysis consists largely of a set of blueprints for supposedly welfare-improving government interventions. But taking the knowledge problem seriously should lead to a highly skeptical view of knowledge-intensive government interventions. Most of what Klein (2015) includes in his “Business Regulation” index falls under this category. The Hayekian argument has the power to turn people into rather convinced and passionate opponents of government interventions.

Perhaps the typical Hayekian economist assumes that government interventions that require more funds also require more knowledge, and that the Hayekian knowledge problem implies that smaller government (in terms of expenditure relative to GDP) is always preferable. My position, however, is that deploying this simplifying assumption is a major error. There are government programs that require a lot of funds without being very vulnerable to the Hayekian knowledge problem. A welfare state consisting only of such interventions and otherwise characterized by low levels of regulation and high levels of economic freedom—a Hayekian welfare state—could theoretically exist.⁵ If I am right, many economists would be sympathetic to such a welfare state.

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⁵ It could be argued that some Nordic countries have, at times, come fairly close; see Bergh (2014) on the case of Sweden.
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The Strange Career of Regulation in the Welfare State

Marjorie Griffin Cohen

The ‘welfare state’ is a relatively stable concept, despite the differences between countries in the intensity of policies developed to meet the needs and foster the well-being of people. One main assumption of the welfare state is that there is an integral relationship between strong economic performance and policies related to social reproduction. Another significant idea is that the state has an important role in maintaining economic stability by using both fiscal and monetary policy to avoid excessive economic volatility. There is a strong association between such ideas about the harmony of capital and social well-being in the welfare state and the theories of John Maynard Keynes.

The concept of ‘regulation’ is not as stable over either time or space. Regulation is a much more flexible term than welfare state, and it is not as clearly identified with specific political ideas about the role of the state. Throughout history the perception of the state’s role in ‘regulation’ has been either market-controlling or market-expanding, supportive of either liberalism or conservatism, and either working in tandem with the welfare state or working to undermine it.

1. Simon Fraser University, Burnaby, BC V5A 1S6, Canada.
2. Social reproduction includes the activities of both males and females, along with the ways that the market, the state, the community, the household, and the individual are involved in meeting the direct needs of people. The state’s role includes activities that directly and universally support the household (e.g., medical care, education, pensions, and labour regulation), as well as specific programs that are more targeted to meet the needs of specific populations (social assistance, disability aid, employment insurance, pensions, child care, and housing). At various capitalistic stages each share undertaken by the actors in this process is different, with the state assuming a larger or smaller influence on the social security systems designed to support social reproduction depending on the time, state of development, and political ideology in ascendance (Cohen 2013, 235).
In this symposium we have been asked to examine the proposition that when embracing the case for the welfare state one would naturally embrace the case for a regulatory state. I would argue against this notion, primarily because regulation does not necessarily support the welfare state, and, in particular, it does not in the current formulation of state policy in capitalist countries like the United States, Canada, and the United Kingdom and other states that embrace the ideas of austerity, or in economists’ terms, “Expansionary Fiscal Contraction.”

In order to demonstrate my point about the flexibility of the term regulation, I will briefly explain its different connotations over broad distinctions in economic systems over time and then examine regulation’s changing role in association with the welfare state. My main point will be that the post-Keynesian shift in the capitalist economy increasingly uses government regulation to undermine primary elements of the welfare state.

**Early capitalism**

Regulation was originally squarely on the conservative side of the political spectrum. Early capitalist liberalism fought tight regulations of the pre-capitalist era that were normally exercised through the guild system, custom, and the crown’s privilege. The regulation imposed on economic activity usually attempted to level the playfield between producers, ensure quality, and maintain uniform prices. It did this by strictly regulating inputs, outputs, production design and quality, labour qualifications, labour relations, and prices. While this regulation promoted petty commodity production, it also constrained innovation, the development of markets, and capitalist economic growth.

Proponents of laissez-faire, the rallying cry of liberalism, worked especially hard to remove state influence over market-controlling activities and particularly argued against the regulation of industrial activities. At the same time, they tended to favour many of the state’s market-creating activities such as support of industry through infrastructure development, direct subsidies, and all of the heavy lifting the state needed to do to ensure free trade and finance flexibility. This was regulation, in the sense that the state was directly active in market-creating activities in order to stimulate private productive relations. The spin, however, was that the state

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3. For examples of the ideas associated with “Expansionary Fiscal Contraction,” see Alesina and Ardagna (2010). The significance of this concept will be explained later in this piece.

4. In essence this regulation created conditions similar to the economic model of ‘perfect competition,’ in that every single producer would be a price taker and no individual unit could influence prices.

5. The term regulation is used in terms of a ‘mode of regulation,’ or how productive relations were regulated in different periods of capitalism (see, for example, Boyer and Saillard 2002).
was receding from impeding the ‘free market’ and any type of direct regulation of industry. Regulations that would protect labour, the environment, or inhibit the massively destructive speculative activities of finance were depicted as inherently limiting on capital and, therefore, were to be avoided.

Over time the destructive tendencies of a market relatively free of regulation on capital became obvious and a long process of intervention by groups of people (trade unions, moral and health reformers, feminists, environmentalists, abolitionists, etc.) forced the state to regulate the industrial sector and the shape of the market system. This aspect of capitalist transitions were best analyzed by Karl Polanyi's *The Great Transformation* (1944).

The development of the welfare state was a very long process and ultimately it did, indeed, begin to regulate capital. The idea that a healthy economy was compatible with a state’s focus on social well-being led to the creation of institutions to regulate the economy. That is, how people were treated in a society—through providing education, health care, equity initiatives, housing, untainted food, and so on—was understood to require economic activity that not only could be supported through state action, but also could actually improve economic performance of the nation.

Some aspects of state support became a basic right, such as education, but others, such as unemployment relief, were more temporary and instituted as a necessary action when the economy was not robust enough to support a reasonable level of social reproduction. John Maynard Keynes provided the theoretical justification for state intervention in the economy through measures dealing with social reproduction. Keynesian ideas also provided some justification for the redistribution of income: transfers to those with low income, who tend to spend money rather than save, are among the methods of injecting money into the economy that go furthest and have the biggest impact during recessions.

But Keynes’s analysis was not the only or even primary justification for changes that occurred to bring about the welfare state. Throughout the second half of the 19th Century and into the 20th Century, huge efforts were expended by various sectors of society (labour, women, abolitionists, social reformers) to regulate the behaviour of the industrial classes and the very wealthy, and also to redistribute wealth so that the very gross inequalities that existed could be eliminated—both in the name of justice and in the name of the greater good of society (Piketty 2014).
Two faces of regulation

The tenets of the welfare state were at their apex in North America from the end of World War II through the 1970s. During that apex, two aspects of ‘regulation’ existed side-by-side. One was the idea that the state could regulate the economy through fiscal and monetary policy to produce good economic outcomes, an approach that was theoretically justified by Keynes. This type of regulation was of a market-creating nature, and it was embraced by capitalism at the time because it was largely exercised in the interest of stimulating business activities.

The other idea of regulation was related to the direct regulation of capital so that it did not have free rein to exploit workers, consumers, or the environment. These were distinct forms of regulation that became integral to the welfare state for a specific period of time. This was the period when employers were required to financially support workers through a variety of state-sponsored programs such as unemployment insurance, minimum wages, old-age benefits, and healthcare systems (this last in Canada and Europe, but not the U.S.). In most countries it was also a period characterized by higher corporate tax rates and progressive income taxes, with the marginal rate for the wealthiest being confiscatory in some countries (in order to minimize income inequalities). It was also the period when trade unions greatly expanded their influence, a factor that was enabled by government regulation.

Regulation had been generally identified with the construction of the welfare state in primarily a positive way because of the crucial post-war period when the objectives of the welfare state and regulation worked more or less together. During the time before the massive internationalization of capitalist state regulation in the 1990s, the welfare state and its capacity to place significant controls on the capitalist sector functioned relatively well in meeting the needs of both capital and people. But, beginning with the early crisis of the 1970s, the conditions under which Keynesian policy succeeded began to change. The slowdown of growth at the same time that prices rose created a new phenomenon—stagflation. The failure of Keynesian tools to solve this problem soured governments on Keynesian solutions.

6. Without doubt there were certain negative and controlling aspects of the welfare state that received constant criticism from not only libertarians, who in principle were against collective action of this kind, but also from groups that were marginalized in the ‘regulation’ of their behaviour and condition. These were most notably women, racialized groups, aboriginal peoples, the disabled, and the poor (Cohen and Pulkingham 2009).
The most significant change in the way the capitalist system operated as a result of ‘stagflation’ relates to free trade. As economies became more open, the effectiveness of stimulus spending decreased when money increasingly tended to be spent outside the domestic economy within countries. These economic factors, combined with the political influence of the corporate sector, shaped an increasingly significant rejection of Keynesian approaches. This meant that governments, over time, no longer tried to prevent economic crisis with Keynesian methods, although they would occasionally return to Keynesian stimulus spending when a crisis became dire, as occurred during the 2008–2010 crisis. But the driving force of both ideas and corporate interests insisted that governments adopt programs of ‘austerity’—at least for government spending on programs related to social reproduction.

The capitalist regulatory state

In the era that established the international regulatory apparatus of integrated capital markets and free trade, capitalism changed, and with it changed the regulatory nature of both the state and governance in general. In the terms of understanding a ‘mode of regulation’ (i.e., the relationships that govern various elements of the system), seismic shifts occurred—shifts that became cemented within the capitalist nations through international institutions.

At the international level, through institutions like the World Trade Organization, the World Bank, the International Monetary Fund, bilateral trade agreements, and the European Union, the regulation imposed is solely focused on the actions of states. There is essentially no international economic regulation of the corporate sector. The defining feature of international trade agreements is that they have one subject, which is the state, and one primary objective, which is to create markets, not to control them. This placed international corporations in the enviable context of world markets without regulation of their behaviour.

Under the trade agreements, huge regulatory apparatuses have been established to control states’ actions in the name of market creation. In most cases the adjudication mechanisms for this regulation is removed from democratic processes through third-party governance. This was a deliberate outcome of international regulation: One of the leading pro-free trade economists, Michael Walker from the Fraser Institute, explained that “a trade deal simply limits the extent to which

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7. Giandomenico Majone (1997) was one of the first public policy analysts to appreciate the significance of the shift to external regulators through his examination of the EU. It should be noted that he did support this external form of control.
the U.S. or other signatory government may respond to the pressure from their citizens” (Walker 1992). As market-creating institutions the international institutions of governance were effective in undermining regulation of capital within nations. This could occur through the requirements of the institutions themselves, but also through the political rationale that deregulation of capital would support international competitiveness.

The hyper-internationalization of capital fostered increased state competitiveness in attempts to be attractive to investment. The major features of the austerity regimes were low taxes, restrictions on public sector spending, low provisions for social reproduction, and policies to depress wages. Theoretically this austerity approach to the state’s role in the economy was justified by ideas that stressed three main issues about government regulation. One was that fewer regulations on capital would promote investment; the second was that privatization and fewer services provided by the state would eliminate the crowding out of private forms by the public sector; and the third was that the potential of lower taxes would stimulate future spending for both individuals and corporations (Blyth 2013).

By adopting austerity, state actions followed the rationale of international institutions’ regulatory regimes in a free-trade era. In this sense the welfare state and the regulatory state were routinely considered trade-offs, or in the words of David Levi-Faur, “alternatives and competing forms of state organization” (2014, 599). State regulation was not abandoned, but its objective shifted from market control to market creation. The primary purpose of regulation shifted from insulating the population from the worst aspects of unregulated capitalism to re-regulating markets so that they could expand.

**Conclusions**

State regulation of economic activity and corporate behaviour has been a significant feature of the welfare state in the post-World War II era. But regulation itself is not an inherently stable concept. With the increased internationalization of capitalist regulatory institutions and the turn toward austerity within national governments, the nature of regulation has changed. In most wealthy capitalist countries a re-regulation of economic activity has occurred, focusing state activities more squarely on market-creating initiatives than on market-controlling ones.

8. The free trade agreements are seen as typifying a new form of constitution in the ways that they constrain a state’s actions and encourage the implementation of one type of economic direction. (See, for example, Stephen Clarkson 2004; Stephen Gill 1998.)
This shift in the nature of state regulation does not mean that regulation itself is now insignificant. Rather, it highlights the ways that regulation can be used with very different outcomes depending on the goals of the state and the impact of international institutions of regulation. Regulation can protect citizens, or it can further constrict rights; it can enhance the welfarist nature of the state, or it can constrict it. These are attributes of regulation that vary with regimes of capitalism and the changes that occur over time. The re-regulation to reduce the controls on corporations and to enhance state support for expanding markets is still ascendant in most wealthy countries. This is a shift from the role regulation had in supporting the welfare state. Under the current configuration of international institutions that support trade, along with the institutions of austerity that governments currently favour, regulation is less inclined to protect people from corporate behaviour and more inclined to help corporations expand their influence.

Clearly, regulation can shift its focus again. Should capitalist nations come to a point where, as in the past, the inequalities in income and wealth reach unsupportable dimensions, unemployment continues to grow, and environmental degradation becomes uncontrollable, such a shift may occur. The instruments of market-controlling regulation are known and can be used to improve the lives of people when a state has a will to do so.

References


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When I was an undergraduate economics student at San Francisco State College from 1963 to 1965, several of my professors were people who had earned their Ph.D. degrees at UC Berkeley. During their lectures, they would sometimes make passing references to Milton Friedman. Although I did not understand why they broke into laughter after making such references, I surmised that this Friedman fellow must be some kind of economic quack or charlatan and that any reference to him or his ideas was intended to provide comic relief during a serious classroom presentation. None of my professors ever assigned any of Friedman’s writings for students to read, and it never occurred to me to seek out such writings.

Later, when I was a graduate student at Johns Hopkins from 1966 to 1968, I found that Friedman’s writings were treated with respect. Friedman’s price theory text was one of the assigned books in the first micro course, along with James Henderson and Richard Quandt’s text and other readings, and Friedman’s articles on the demand for money and other topics were assigned in the macro courses. As I read these sources, I thought back to my undergraduate experience and wondered why my teachers at San Francisco State had treated Friedman as such a joke.

Later still, after I joined the economics faculty at the University of Washington in 1968, I encountered this professional split from the other side. At that time the dominant faction in the department at Washington consisted of Chicago Ph.D.s and others sympathetic to the Chicago School. These people viewed the superstars of the MIT–Harvard–Berkeley group at least as contemptuously as my undergraduate professors had viewed Friedman and his associates and disciples.

1. The Independent Institute, Oakland, CA 94621.
By this time, I was beginning to gain an understanding of the social structure of the U.S. economics profession. For a while I gravitated toward membership in the Chicago–UCLA crowd, although I never became quite as dismissive as they were of the professionally dominant group led in those days by Paul Samuelson, Robert Solow, and other likeminded luminaries.

Having discovered F. A. Hayek’s writings in the late 1960s, which led me in due course to the writings of Ludwig von Mises, Israel Kirzner, Murray Rothbard, and other members of the Austrian School, I gradually parted company with my Chicago-oriented views, at least in regard to the fundamental epistemological and methodological underpinnings of economics. From my new, more professionally estranged vantage point, I could see even more clearly what was going on in connection with the various frictions and disagreements between the two main competing factions in the mainstream economics profession.

So, at least forty years ago, perhaps under the influence of my Chicago School colleagues at Washington, I began to divide the mainstream profession crudely into a group whose members believe that “markets work” and an oft-opposing group whose members believe that “markets fail.” From these broad default positions, many consequences arise in regard to how economists go about their work, interpret their findings, view the economy, and determine what government policies, if any, they should recommend to improve the economy’s operation.

Of course, many, perhaps most, mainstream economists stand somewhere between these two groups, inclining sometimes toward the one and sometimes toward the other, depending on the particular issue at hand. In my comments here, I confine my attention to the two groups I’ve identified, in part because of space constraints and in part because these two groups have had, and continue to have, highly disproportionate influence in the profession.

Markets-fail economists have been trained for the most part in graduate programs that place heavy emphasis on the construction of formal mathematical models. In such models, the conditions for equilibrium and stability are precise and well defined. So, if the economist constructs a model subject to stipulated assumptions and the model’s solution displays inefficiency or other suboptimality, he has thereby shown that such theoretical “market failure” is possible in the real world to the extent that the model adequately represents actual conditions. Now, the map is never identical to the territory, and therefore a skeptic might be inclined to dismiss such a showing of possible market failure on the grounds that the model does not in fact capture all relevant aspects of how real-world markets operate or take into account all the factors that enter into their operation. But markets-fail economists, perhaps because they invest so much of their time, intelligence, and identity in model building itself, are more inclined than others to take seriously the
idea that the model does adequately capture the workings of real markets and hence that if one can build a model in which market failure arises, one has ipso facto shown that such failures occur in reality. It’s as if the working mantra were: whatever can go wrong (in the model) does go wrong (in the real world).

Markets-work economists have been trained for the most part in graduate programs that place less emphasis on the construction of formal mathematical models. Hence they generally regard such formal showings of market failure as suggestive at best and wholly worthless and misleading at worst. Members of this group make less precise demands on the real world. They believe that because formal models cannot capture every aspect of how real markets work or take into account everything that enters into their operation, it is inevitable that real-world conditions will always diverge from strict satisfaction of formal-model conditions for optimality; that is, given the nature of the formal models, “market failure” in the real world is effectively preordained. However, in their view, such divergences condemn the actual markets less than they condemn the models—or at least the insistence that policy makers should try to force real markets into conformity with the conditions required for optimality in a formal model. For this group of economists, models are worthwhile for the insights they allow economists to gain into aspects of how real markets operate, but such models, by themselves, can never justify policies by which the government purports to intervene in real markets in order to bring about an actual correspondence between a model’s efficiency requirements (e.g., price equals social marginal cost [whatever that might mean], general equilibrium throughout the entire economy, no uncompensated external effects, etc.) and the conditions prevailing in the real world.

Thus, markets-fail economists put more stock in blackboard models as such than do markets-work economists. Indeed, notwithstanding their avowed commitment to Friedmanesque standards of empirical testing, markets-work economists, when they encounter a finding of market failure in an empirical test, are inclined to think that something must be wrong with the data or that something must have been faulty in the test setup or its implementation. Whereas markets-fail economists jump readily from the blackboard to proposals for actions by the administration, Congress, or a regulatory agency, markets-work economists are far more hesitant to make this leap, and they give serious thought to the possibility that even if the theoretical market-failure is manifest in the real world, the government’s intrusion into the market process may still do more harm than good. Although markets-fail economists have gradually been compelled to recognize at least the possibility of “government failure,” they tend to place little weight on it and often ignore it entirely.

Differences between these two groups of economists, however, are not entirely the product of differing degrees of devotion to formal model building. Their
differences also spring from differences in the default conception they bring with them when they undertake their work. They differ in what Joseph Schumpeter called “preanalytic cognitive acts” or “vision.” Moreover, as Schumpeter observed, ideology “enters on the very ground floor, into the preanalytic cognitive act… the way in which we see things can hardly be distinguished from the way in which we wish to see them” (Schumpeter 1954, 42). One expects, therefore, that an overarching ideological coherence will apply within each of the groups. Markets-fail economists tend to be more aligned with socialist or social-democratic political programs; more inclined to trust government officials and regulators to act in the general public interest; more skeptical that private actors in general and business people in particular can or will bring about socially desirable outcomes; and more inclined to see private actors as ignorant, irrational, and incapable of acting in socially responsible ways. Markets-work economists, in contrast, tend to be more aligned with conservative political programs; less inclined to trust government officials to do anything well, aside from lining their own pockets and those of their key supporters; and more inclined to view private actors in general as sufficiently rational and informed to serve their own interests better than anyone else—not to mention that private actors are often highly inventive and innovative when left to themselves, even in devising ways to remedy problems that markets-fail economists attribute to imperfections in the market order. Markets-work economists have been much more inclined to take Public Choice analysis seriously and to contribute to this field of study. In contrast, markets-fail economists tend to contribute disproportionately to Social Choice Theory and to Public Economics, where a presumption that government intervention is (or at least might be) desirable holds greater sway.

One sees, therefore, that methodological and ideological differences merge naturally into differences in personal-cum-professional identities. (On the critical connection between ideology and identity, see Higgs 1987, 42-43.) Such differences impede an analytical meeting of the minds between members of the two groups because on each side the practitioners look with some suspicion on members of the opposing group, viewing them as “not my kind of folks.” Institutional affiliations reinforce and perpetuate such distinctions in the profession, as friends, colleagues, and fellow travelers tend to promote the professional activities and achievements of like-minded others. It is not a coincidence that the same names keep appearing year after year on the program for the AEA meetings; indeed, the same person’s name often appears there more than once in a given year. Although these individuals may be well qualified to present their work at such a prominent conference, it is difficult to dismiss entirely the hypothesis that an element of “who you know” also plays a role. Similar factors affect the submission of grant proposals to the National Science Foundation and other research support institutions, as well as the
likelihood that one’s proposal will be favorably reviewed and selected to receive support.

If one believes that markets tend to fail, one is more likely to support not only regulation of the particular markets perceived as failing, but also interventions aimed at altering the personal distributions of income and wealth, which are seen as the ultimate outcomes of the entire aggregate of “imperfect” markets. So the associations documented by Daniel Klein (2015) and others are exactly what we would expect to find—indeed, what many of us have found already, albeit by less systematic observations and by personal experience.

The irony is that the income and wealth distributions viewed as justifying welfare-state intervention are in many cases the end products not simply of an aggregation of imperfect markets, but also of countless government interventions (e.g., minimum-wage laws, occupational licensing requirements, crony-capitalist subsidies and bailouts, and product bans, taxes, and business restrictions that inhibit the formation and success of small firms). Whereas economists in the markets-fail group see an obvious need for welfare-state measures to “correct” the distributions of income and wealth that markets have produced, those in the markets-work group see an equally obvious need to remove the government intrusions that have done much to generate a perceived need for the welfare state in the first place. Here, once again, the differences between the groups have a great deal to do with how their members conceive in general of the government vis-à-vis private-sector actors. Which is to say, once again we see reflections of ideological differences that play themselves out in a variety of ways within the mainstream economics profession.

References


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Discuss this article at Journaltalk:
http://journaltalk.net/articles/5863
Economists view activist government policy and social insurance as potentially protecting individuals from risks and from market failure. Perhaps differences among economists in support for activist government policy in social insurance and regulation reflect differences in beliefs about the relative efficacy of government and markets. Economists for whom market failure is relatively more salient and government failure is relatively less salient will tend to favor government activism, and conversely.

Start with four propositions, two of which concern values and two of which reflect one’s assessment of alternative social mechanisms.

1. Consumer satisfaction: A good society is one in which individuals are able to make choices as consumers that serve their long-term interests.

2. Risk protection: A good society is one in which individuals are able to obtain insurance against major risks to economic well-being, including expensive health conditions, uncertain longevity, unemployment, and being born into adverse circumstances.

3. Market failure: Decentralized decisionmaking and market processes can sometimes leave consumers unable to make decisions that serve their long-term interests and unable to obtain insurance against major risks to economic well-being.
4. Government failure: Centralized decisionmaking and political processes can easily fail to achieve desired goals and leave consumers worse off.

In theory, economists could differ in their support for government activism on the basis of differences in values. For example, an economist who does not value consumer satisfaction or risk protection very highly might have little motivation to support government policies intended to further those objectives.

In practice, however, I believe that economists’ views on government activism are not explained by differences in values. I suspect that nearly all economists value consumer satisfaction and risk protection highly, and that differences about how those desirables might be traded off with other social goals are relatively unimportant.

If it were the case that differences in values were a dominant factor, then it is unclear how one would explain the fact that support for activist regulation and high levels of social insurance are correlated. Why should placing a high value on consumer satisfaction and placing a high value on risk protection be correlated?

I find it much more plausible to believe that economists differ in their support for government activism because as an analytical matter some economists assign great significance to market failure relative to government failure, while other economists tend toward the reverse. If this view is correct, then the correlation of views is easily understood. An economist with relatively high trust in markets and relatively low trust in government is going to be inclined against government activism in both regulation and social insurance, and conversely.

To explore further this source of divergence, let me next propose a list of what most economists would agree are sources of market failure and government failure.

Sources of market failure

- Time-inconsistent preferences (consumers choosing today what they will regret tomorrow)
- Miscalculation (particularly in decisions about risk, e.g., a failure to properly apply the laws of probability)
- Inadequate information (choices based on misleading or inaccurate information or that go against expert advice)
- Market power (firms able to exploit dominant positions)
- Externalities (high cost of addressing these through multi-party bargaining or other decentralized mechanisms)
• Uninsurable risks (for example, the risk of being born into adverse circumstances; also, for someone already diagnosed with an illness, health risk may not be insurable)

Sources of government failure

• Preference aggregation (problems with expressing consumer/voter preferences: for example, an individual vote may not matter; also, voters choose from among candidates representing large bundles, not narrow specific policies)
• Principal-agent problems (the mechanisms for aligning the interests of government agents with those of the consumer/voter principals are weak)
• Rent-seeking (manipulation of government for private ends)
• Government monopoly (the absence of competitive pressure to innovate, discard ineffective programs, and evolve toward excellence)
• Socialist calculation (overriding or doing without information provided by the price system)

Why economists disagree with one another

Suppose that one could construct a survey that elicits from economists their beliefs about the relative significance of each of these sources of failure. For example, one could present an economist with the eleven sources of failure listed above. Next, ask the economist, “In teaching students about how to think about economic issues, which of these is the most important? Take 99 points and allocate them among the 11 sources of failure. If they are equally important, give 9 points to each. If one is much more important than the others, you may give it all 99 points.”

My conjecture is that (a) some economists would give noticeably more points to the government failure sources than would other economists and that (b) the economists giving relatively high points to government failure sources would also be less supportive of activist government policy.

If my conjecture is correct, then there is a great deal of logical consistency in the views held by economists. If my conjecture were not correct, then I would be inclined to turn away from rational explanations for economists’ beliefs and instead be open to suggestions from social psychologists.
Assuming that my conjecture is correct, there still may be room for social psychology to explain why some economists see government failure as salient while others see market failure as salient. Indeed, one cannot rule out the possibility that economists start with views on the role of government and then work backward to their views on the relative salience of market failure and government failure. However, I think that in principle we ought to be able to conduct rational discussions in which economists with differing points of view are able to justify their positions to one another, and even to set up thought experiments which might lead someone to change his or her mind.²

Explaining hypothetical survey responses

How would you have answered the survey question that I posed? For what it is worth, I would have assigned 70 points to government failure (30 for government monopoly, 20 for preference aggregation, 10 for rent-seeking and 5 each for principal-agent problems and socialist calculation) and 29 points to market failure (8 points for externalities, 7 points for uninsurable risks, 6 points for miscalculation, 5 points for inadequate information, 2 points for market power, and 1 point for time-inconsistent preferences). I tend to be skeptical toward the current level of government activism in both regulation and social insurance in the United States, but I am supportive of some government activism in each.

I think that most neoclassical economists would provide different weights. They would give little weight to government monopoly and more weight to other factors. That is because neoclassical economics treats the economy as a mechanism for production and allocation using existing resources and knowledge. My own orientation stresses the importance of learning through experimentation, evaluation and evolution.³

In the past, I have offered this glib characterization of economists’ differences:

Chicago economists say, “Markets work. Use markets.”
MIT economists say, “Markets fail. Use government.”
I and others like me say, “Markets fail. Use markets.”

² Note that there is a case to be made that all disagreements must be unreasonable to some degree (Cowen and Hanson 2004).
³ Another way to put this is that neoclassical economics focuses on static efficiency, meaning optimal allocation of resources taking technology as given. The alternative is to emphasize dynamic efficiency, meaning the ability of the economy to generate and incorporate new methods of production. Nick Schulz and I have elaborated on this distinction (Kling and Schulz 2009).
What I term a Chicago economist believes that markets generally work well and that government tends to move the economy toward outcomes that are inefficient. What I term an MIT economist thinks that markets often fail and that government can frequently improve on market outcomes. My own position emphasizes that inefficiencies in current arrangements are better corrected through the market’s experimentation/evaluation/evolution mechanism than through government mechanisms.

In terms of the survey above, I would expect market-oriented neoclassical economists (Chicago) to place low importance on the factors that adversely affect the ability of consumers to make decisions in their long-term interests. For example, they might view as suspect findings in behavioral economics that consumers tend toward miscalculation. The Chicago economist might argue that such findings are obtained under artificial experimental conditions, rather than in real-life situations in which consumers soon learn how to avoid mistakes. At the same time, I would expect Chicago economists to place a great deal of emphasis on preference aggregation and principal-agent problems. That is, they believe that the choices that we make as individuals for ourselves, spending our own money, are very likely to prove better than choices made for us by government agents who are spending other people’s money. I would cite the late Milton Friedman as an exemplar of that point of view.

Conversely, I would expect neoclassical economists who favor government activism to assign high importance to each of the sources of market failure. They would have more confidence in the ability of technocrats to design mechanisms to improve consumer choice and less concern about preference aggregation or principal-agent problems. For example, MIT’s Jonathan Gruber was an architect of both the Massachusetts health care reform passed under Governor Mitt Romney and the Affordable Care Act passed under President Obama. Gruber would argue that government-enforced insurance mandates and limitations on choice are necessary in order to guide consumers to make decisions that are in their long-term best interest.

What leads different economists to have these different points of emphasis? My guess is that we are affected by undergraduate courses, graduate courses, and general life experience. Someone whose formative coursework is with Chicago economists is more likely to end up sharing their viewpoint. Someone whose formative coursework is with MIT economists is more likely to end up sharing their viewpoint.

My own formative coursework was as an undergraduate at Swarthmore College, under professor Bernard Saffran. Saffran was an eclectic economist, equally comfortable suggesting that we read “What Do Bosses Do?” (Marglin 1974) and “The Uneasy Case for Progressive Taxation” (Blum and Kalven 1952). I recall
Saffran describing the Chicago-MIT divide by saying, “Friedman and Samuelson each teach the same elementary price theory, but Friedman applies it to policy.”

In contrast, my graduate education at MIT, where I earned my Ph.D., was disappointing. I regarded the courses as exercises in mathematical hazing that I had to get through in order to stay with the program. Subsequently, I became disillusioned with my main field of macroeconomics.4

I also spent much of my career in business, where I found that the production-and-allocation story fails to capture what people in business think about and focus upon. The main efforts in real-world business seem to go into trying to figure out better ways of operating and then persuading people inside and outside the firm to adopt new methods.

Getting off the academic track also allowed me to be influenced by a wider set of authors. Reading George Gilder’s Microcosm (1989) helped me appreciate the role of human ingenuity in wealth creation. Reading Douglass North’s Structure and Change in Economic History (1981) helped me to see the importance of institutions. There are other avenues to these insights. However, the typical graduate school curriculum, at least as I encountered it, is more narrowly focused on teaching mathematical techniques.

In short, my hypothesis is this: If your formative experiences were undergraduate or graduate courses with Chicago economists, then you are somewhat more likely to share their views. If your formative experiences were undergraduate or graduate courses with MIT economists, then you are somewhat more likely to share their views. Or if your formative experiences led you to appreciate the role of human learning, ingenuity, and institutions, then perhaps you ended up more like me.

References


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The Moral Narratives of Economists

Anthony Randazzo\(^1\) and Jonathan Haidt\(^2\)

**LINK TO ABSTRACT**

Why is it that, as the Prologue to this symposium (Klein 2015) suggests, practically no U.S. economists favor the welfare state but oppose the regulatory state, or vice versa? Our answer is that it would be *morally incoherent* to do so.

There are two basic narratives about capitalism circulating in Western society today. One says that capitalism is exploitation (or at least is highly conducive to exploitation); the other says that capitalism is liberation. If you endorse the exploitation narrative, then you are more likely to see government as the main force that protects innocent victims. It protects them with a welfare state and with a regulatory state. But if you endorse the liberation narrative, then you'll want government to step back as much as possible and let capitalism work its magic. You'll want to shrink both the welfare state and the regulatory state.

We believe that economists, as human beings, also possess such narratives, and we expect that, on average (not in all cases), these moral narratives shape economists’ substantive conclusions—positive and normative.

This hypothesis, we recognize, runs counter to the predominant view among economists, which is that economists can do technical and empirical work independent of bias. Of course, the normative views of economists may inform their personal policy preferences. But economists should also be able to step back and assess the welfare state and regulatory state free from their personal value judgments. Or so it is said.

In this essay we'll present the two narratives about capitalism, followed by a summary of some new data we have been collecting on the influence of value judgments in economics. We’ll end by elaborating on our explanation as to why...
there seem to be no U.S. economists who take diverging views on the welfare state and the regulatory state.

**Two stories about capitalism**

Here are fairly extreme versions of the two stories about capitalism.³

**Story 1: Capitalism is exploitation**

Once upon a time, work was real and authentic. Farmers raised crops, and craftsmen made goods with their own hands. But then, capitalism was invented, and darkness spread across the land as the smokestacks of the Industrial Revolution covered everything in soot. The capitalists became ever more skilled at extracting productivity from workers and pocketing the gains from their labor.

The workers eventually fought back by unionizing. In the early 20th century, as the brutality and stupidity of capitalism were exposed, many governments granted workers some protection from the predators. Democratic welfare states were born.

But the capitalists and their right-wing cronies were unrelenting, and in many countries they have destroyed the unions, slashed regulations, and given the corporations free rein to exploit at will. So the rich get richer, the rest of us get poorer, our democracy gets weaker, and the planet gets hotter. It is now the duty of every decent person to join the fight against global capitalism and the super-predators it has unleashed upon us.

**Story 2: Capitalism is liberation**

Once upon a time, almost everyone was a peasant, a serf, or a slave. Kings and feudal lords took most of what people produced, so nobody had much reason to work hard. But then, in the 17th century, capitalism was invented, and the liberation began. In England, Holland, and America, they discovered that when you give people property rights, the rule of law, and free markets, you turn on a switch in their hearts. People *want* to work, when they can keep the fruits of their labor. They *want* to invent new products, provide for their children,

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³. These two stories were written by Haidt for his forthcoming book on capitalism and moral psychology. You can see the two stories in animated form at EthicalSystems.org/capitalism.
and be useful to others. Free market capitalism enables them to do these things. In the 20th Century, some countries embraced communism and centralized planning, always with the same result: shortages of everything, including food and freedom. But countries that embraced capitalism have grown prosperous in a single generation. Yet despite the evidence of history, the left-wing egalitarians are unrelenting, and whenever they get control of a government, their first target is economic freedom. The egalitarians don’t want to live in a world in which people who create more value for others get to enjoy more wealth for themselves. They’d rather that everyone be equal, and equally poor. It is now the duty of every decent person to join the fight to protect capitalism, and to extend its blessings to all of humankind. Of course these narratives are simplistic, one sided, and moralistic. They are the sort of stories easily found on talk radio or cable news, rather than in an academic journal. Few economists would endorse either story in such a form. Left-leaning economists in particular would have difficulty with the exploitation story, because few of them take such a negative view of capitalism. Yet we believe the underlying story elements are still at work for economists on both sides. The two stories lead inexorably to pairs of conclusions: If you think of capitalism as exploitation, even partially, you’ll find yourself more open to arguments for the welfare state and the regulatory state. If you think of capitalism as liberation, you’ll find yourself more open to arguments for shrinking the welfare state and the regulatory state. But this is just speculation on our part. We have not yet polled economists to ascertain their views on these two narratives. We have, however, polled economists to ascertain their views on many of the moral values expressed in those two narratives.

The moral foundations of economists

Milton Friedman famously argued that “positive economics is in principle independent of any particular ethical position or normative judgments” (1953, 4). This position continues to be the standard banner of mainstream economics: that economists can and should separate their work between empirical observations and measurement (positive) and personal opinion (normative). There has been plenty of debate in the social science community about whether economists can

4. See, for example, Mankiw (2014, 28).
be objective, but as Friedman further contended, “No value judgments can explain why I have been led to the conclusion that...inflation is primarily a monetary phenomenon” (1968, 9).

Our thesis stands in clear opposition to Friedman’s theory. We place ourselves firmly in the camp of those who have argued that economists’ value judgments permeate economics. This belief emphasizes the humanity of economists, which is at the center of their work. Gunnar Myrdal (1953, vii) noted “There is an inescapable a priori element in all scientific work. Questions must be asked before answers can be given.” James Buchanan (1959) concurred, pointing out that when economists analyze the world they inherently consider the behavior of agents through their own worldview and unconsciously imprint their own values on the research through the way they use assumptions. And Paul Heyne (1978, 18) reached the conclusion that “Statements, propositions, or judgments are made and held by subjects and are therefore always subjective. ... There is consequently no way to establish the validity of a proposition in economic science except by persuading other economists. ... Science is a social activity.”

We see clear evidence for the position taken by Myrdal, Buchanan, and Heyne in the responses to a recent survey of economists that we conducted to consider whether methodological differences between economists were driven by their moral values. The results of the survey are pending publication elsewhere, but we can preview the findings here in a general way to illustrate our thesis.

Our questionnaire asked respondent economists to agree or disagree, using a seven-point Likert scale, with each of 22 positive economic statements and four normative economic statements. Then our questionnaire asked economists to rate on a six-point scale the moral relevance of a series of 22 propositions or factors, in order to gauge how they defined right and wrong (versions of these questions...
can be found in the Moral Foundations Questionnaire available at YourMorals.org (link).

Using cluster analysis, we grouped economists based on similarity in response to just the economic theory propositions. Then we examined the average responses to moral propositions within each of those clustered groups.

We first found a close association between the moral values of economists and their normative economic views. Economists who believe governments should not interfere in markets to address income inequality also tended to define fairness in proportional terms (i.e., being rewarded in proportion to your contributions), rather than in terms of equality. Meanwhile, economists who did believe there should be a role for government in reducing income inequality tended to see equality as a moral imperative.

This is not a surprising finding; we would expect a relationship between moral worldviews and public policy opinions. What is surprising is that we found a relationship of roughly the same magnitude between economists’ moral narratives and their empirical, technical, ‘positive’ economic theory views, too.

Economists responding to our survey who tended to take Neoclassical economic theory positions also tended to show a moral judgment profile similar to what you would find amongst political conservatives in America. For example, economists that tended to favor fiscal austerity during a recession defined fairness in proportional terms and gave equal weight to reducing physical harm and preserving individual rights. This is the pattern reliably found for political conservatives (see Haidt 2012, ch. 8).

We found the same sort of match for economists who took New Keynesian positions on our economic theory propositions, such as opposing austerity during a recession. These economists tended to have moral worldviews similar to political progressives, such as defining fairness in terms of equality and being less likely to consider today’s federal budget deficit harmful to the economy (Haidt 2012, ch. 8).

Finally, our survey data shows that responses to moral propositions can be used to predict responses to empirical (positive) economic theory propositions. For example, how much importance an economist assigns to the moral foundation of “care” predicts views on whether austerity is good or bad for economic growth, whether a single-payer healthcare system would reduce national healthcare costs or not, whether minimum-wage laws benefit or harm workers, and whether or not national debt and deficits adversely affect economic growth.

Collectively, this data shows that economists’ substantive conclusions about the workings of the economy are suspiciously correlated with their moral values. We cannot prove causation with our survey design, but given everything else we know about the power of motivated reasoning (Nickerson 1998; see review in Haidt 2012, ch. 4), causal effects are quite likely.
Conclusion

In a debate with Walter Heller on PBS, Milton Friedman clarified his long-held view that economists can be objective: “I doubt very much that there are any value-free economists. But that doesn’t mean that there cannot be value-free economics” (1979, 7:55). Given the humanity of economists, though, we believe that “value-free economics” is no more likely to exist than is the frictionless world of high school physics problems.

Consider the recent global debate about income inequality. An economist who takes up a research question in this area must start by choosing some methodological measurement of income inequality, including whether to measure wealth pre- or post-taxation, whether to count transfers like healthcare subsidies or social security, and whether to use data from tax returns or household surveys. Methodological choices are inevitable and there is no objective, empirical guide to what is the right approach. The research project, thus, already is dependent on the judgments of the economist before a single regression is run or a correlation is interpreted.

Starting from the research agenda to the construction of a particular model to the selection of a particular methodological approach, the work of economists, and subsequently their economics, is shaped by their moral values and narratives.

How an economist defines fairness (as equality or as proportionality) will strongly influence their views on income inequality, and those views will, in turn, guide their choice of what to measure, depending on whether they would prefer to produce an alarming picture or a calming picture of recent trends. Thomas Piketty and Emmanuel Saez (2003) prefer to use pre-tax, pre-transfer, tax data, and they emphasize a growing income and wealth gap. Unsurprisingly they have expressed a clear normative preference for an egalitarian society with extremely high taxes on the rich (Piketty 2014; Piketty and Saez 2013; Saez and Piketty 2013).

In contrast, Richard Burkhauser, Shuaizhang Feng, S. P. Jenkins, and Jeff Larrimore (2012) argue that the better measure of inequality is using post-tax, post-transfer, household data, and depending on what transfers are counted they have found little to no growth over the past few decades in the divide between Americans at the top end of the income scale and the rest of society. As might be expected, Burkhauser (2013) views fairness as proportionality, and he has little interest in an egalitarian society for the sake of equality in the abstract.

Just as economists are influenced by their own moral values and narratives when making methodological choices about technical questions, so too will they be influenced in their thinking about larger and more ambiguous questions, such as the proper size and behavior of the welfare state and the regulatory state. If
you embrace the exploitation story of capitalism and the moral values it supports (such as equality and resistance to oppression), you’ll want a larger welfare state to carry out more redistribution, and you’ll want a larger regulatory state to limit the predations of corporations and the super-rich. But if you embrace the liberation story of capitalism and the moral values it supports (such as proportionality and individual liberty), you’ll want a smaller welfare state and a less intrusive regulatory state. It would take a great deal of creativity to mix and match those two kinds of states in a way that was not morally incoherent.

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Ideological Differences in Economics: Why Is the Left-Right Divide Widening?

Scott Sumner

Years ago I would discuss economics with my father, who was a heavy smoker. He would tell me that a higher cigarette tax would not discourage people from smoking. People like him were addicted. Many years later, my mother mentioned that she had smoked cigarettes when she was very young. I asked her why she had stopped, and she told me, “When your father and I got married we decided that we could only afford to have one smoker in the family.” I often think of this anecdote when conversing with non-economists.

Much of economics is based on the notion that people respond to incentives in an at least somewhat predictable fashion. But I’ve always noticed that non-economists tend to be quite skeptical of such claims. If you don’t believe me, ask a non-economist what they think of the argument that seatbelts result in more pedestrian deaths, or that having car insurance causes people to drive more recklessly.

And it’s not just non-economists. I find many economists to be almost as skeptical of many of our models. It also seems to me that the skepticism is somewhat more pronounced on the left side of the political spectrum. I studied at the University of Chicago in the late 1970s and was exposed to many empirical studies that showed surprising impacts of incentives on human behavior. One example might be Isaac Ehrlich’s 1975 study of the death penalty, which estimated that each execution saved about eight lives by deterring murders. Years later I would discuss this sort of study with other economists who had not attended the University of Chicago. Many would roll their eyes; to them the claims seemed quite far-fetched.

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Later I will suggest that over the last two decades there has been a widening of the gap between the left and the right of the economics profession. But the gap has always been there, I think, with economists on the right being much more open to arguments that the Federal Deposit Insurance Corporation encourages banks to take excessive risks, that minimum-wage laws induce firms to hire fewer workers and adjust non-wage job attributes, that extended unemployment benefits discourage the unemployed from looking for jobs, and that high marginal income tax rates discourage work, savings, and investment. There is a sense in which right-wing economists could be characterized as economists who take economic incentives very seriously. An economist’s economist.

Of course it is an empirical question as to how strongly people respond to incentives, so one might assume that these views should have nothing to do with one’s political orientation. But the empirical questions are often difficult to settle—an epistemic problem. People tend to fall back on what seems plausible to them. Perhaps the epistemic difficulty and the tendency to resolve it with one’s personal gut feeling explains the different voting patterns of economists on the left and the right, and why both groups are well to the right of other social scientists.

I’ll use the term right to refer to economists with pro-free market, small government views, and left to refer to economists who favor more government regulation and/or greater income redistribution. In the U.S., economists on the left almost always have liberal or progressive views on non-economic issues, and they tend to vote Democratic. But those on the right don’t necessarily hold conservative or Republican views on non-economic issues. Indeed the number of economists in America with relatively libertarian views is greatly disproportionate to the libertarian share of the overall population.

**Why would utilitarians ever disagree?**

Many economists seem to have a roughly utilitarian value system, and even those that don’t often rely on utilitarian arguments to try to convince their colleagues. Let’s assume for the sake of argument that (as I believe) the ‘Chicago’ view of the world, i.e., that the effect of incentives on behavior is much stronger than common sense would suggest, is roughly correct. In that case, you might expect a split in the economics profession between those holding the Chicago view of the world and those holding what I will call a ‘folksy’ view—that people don’t respond very strongly to economic incentives.

If most economists are indeed well-intentioned utilitarians who merely differ on empirical questions such as the impact of the minimum wage on the poor, then you’d expect economic views to evolve over time as new information tended to
support either the Chicago view or the folksy view. And, I submit, this is what happened.

In the 1930s, the folksy view of the Great Depression was that not only was capitalism somewhat unfair (due to inequality), but also that it didn’t work very well in general. After the 1930s, governments dramatically expanded the role of the state in the economy in two very distinct ways. First, governments greatly increased the amount of regulation and in some cases even government ownership of business. Let’s call these policies ‘statist.’ Second, governments sharply increased the amount of taxation, income redistribution, and social insurance. Let’s call these policies ‘egalitarian.’

If the policy changes sprang from utilitarian values mixed with hope and idealism, then you would expect each of the following to be true:

1. The change in government policies would be roughly mirrored by changes in the attitudes of academic economists.
2. If new information arrived that suggested these policies were counterproductive in a utilitarian sense, the reforms would then be reversed or mitigated.
3. Any reversal in government policies as a result of new information would be expected to occur more rapidly in countries with a high level of civic virtue, that is, where selfish, rent-seeking special interest groups have less control over the policymaking process.

Regarding the first claim, I cannot give data but I can give my impressions. In my own area of expertise, macroeconomics, the change in government policies was unquestionably paralleled by a similar change in the views of economists, especially between, say, 1929 and 1975. Even in the 1920s, macroeconomics was not as ‘classical’ as it is sometimes portrayed. But there’s no doubt that between the 1930s and the 1960s the profession moved in a strongly Keynesian direction, as did policymaking in many countries. I suspect the same shifts occurred in many other areas of policymaking.

The liberalization wave

In an earlier study (Sumner 2010), I looked at the policy regimes in the 32 developed countries that in 2007 had per capita GDPs above $20,000 per year. I used the Heritage Foundation Index of Economic Freedom to rank countries in terms of statism and egalitarianism. The Heritage index has 10 categories, of which

2. Middle Eastern oil producers were excluded.
two, taxes and spending, are loosely related to income redistribution and social insurance. The other eight categories are loosely related to the level of statism, i.e., regulation and public ownership.

It turned out that countries often had very different rankings in statism and egalitarianism. For instance, in 2008 Denmark had, according to the eight statism categories, the freest markets in the world. But when looking at taxes and spending, Denmark also comes out as one of the most egalitarian countries. Danes might be puzzled by the topic of this symposium; I suspect that a scatterplot for Danish economists would look rather different from the one for American economists shown in the Prologue to this symposium (Klein 2015).

Then I looked at two measures of civic virtue: responses to a poll question, and a corruption ranking developed by Transparency International. The poll question asked the public to specify under what circumstance people were justified in “claiming government benefits to which they were not entitled.” I take an answer of “never” to reflect a higher level of civic virtue. Of course talk is cheap, which is why I also looked at the external rankings made by Transparency International. My two measures of civic virtue were highly correlated, despite completely unrelated methods.

Interestingly, Denmark had far and away the highest level of civic virtue—and Greece, the country with the most statist economic regime in the developed world, had the lowest level of civic virtue. Overall there was a very strong and negative correlation between civic virtue and statist economic policies in 2008. Of course, cross-sectional correlations are relatively easy to find and tricky to interpret. Both civic virtue and market-oriented policies might be caused by some third factor.

Beginning in the late 1970s, much of the world was swept by a liberalization wave. Over the next few decades, almost all countries sharply reduced their top marginal income tax rates, reduced trade barriers, reduced the regulation of prices and market access, and privatized state-owned enterprises. This wave reflected a growing disenchantment with statist policies during the stagflation of the 1970s. Obviously these changes played out differently in different locations, depending on local conditions and the extent to which statism had made inroads during the previous half-century. But the direction of change was the same almost everywhere between the late 1970s and 2008.

By 1979, economists had received new information, and they continued to receive new information. The new information was much more unfavorable to statist economic policies than to egalitarian policies of redistribution. Thus while policy regimes became less statist during the last part of the 20th century, the size of governments in terms of taxes and spending as a share of GDP changed relatively little. If the liberalization wave reflected idealistic utilitarian policymakers...
reevaluating the virtue of a market economy, then you would expect changes to occur in precisely those areas where government regulation fell into the greatest disrepute. And that is what happened.

According to the preceding hypothesis, one would also expect the pace of economic reform to be faster in countries with a higher level of civic virtue, relative to places where rent-seeking special interest groups were able to block reforms that opened their industry to greater competition. To test this hypothesis I looked at the degree of statism in the same 32 developed countries back in 1980. The degree of statism was proxied by the gap between the economic freedom ranking (excluding size of government and taxes) and a perfect score. The pace of reform was the percentage reduction in statism between 1980 and 2008. My hypothesis was that liberalization reforms would occur faster in countries with a higher level of civic virtue.

When a regression equation was estimated, the results strongly supported the hypothesis. Countries with a high level of civic virtue such as Denmark and New Zealand abandoned statism at a relatively rapid rate, whereas countries such as Greece did relatively little in the way of market reforms. The correlation was strong and highly significant. When new information about the virtues of free markets arrived during the 1970s and 1980s, countries with a relatively virtuous policymaking apparatus move much more quickly to embrace those new findings. By the 1990s, there was talk of a “Washington consensus” that embraced free markets, combined with a reasonable amount of social insurance (Williamson 1990). Denmark’s regime is termed “flexicurity,” combining the flexibility of free markets with the security of social insurance (see Algan and Cahuc 2009).

What happened to the Washington consensus?

This symposium is considering the question of why in the United States economists with small-government views on regulatory issues often have small-government views on seemingly unrelated questions such as income redistribution. Without denying that this correlation exists, I would argue that the division would have been less pronounced in the 1990s, and especially less pronounced in countries outside the United States and Britain. In the United States and Britain the liberalization wave was thought of as a sort of right-wing movement, associated with Ronald Reagan and Margaret Thatcher. But in fact, during the 1980s and 1990s many left-wing governments embraced these policies with equal vigor, and when compared to the U.S. arguably even more aggressively.

By the 1990s, the Cold War was over and the economics profession was far less polarized over the socialism/capitalism issue. Paul Krugman became famous
for his brilliant polemics against pundits who favored managed trade, often pundits associated with the Democratic Party (see Krugman 1996). In 1992, Bill Clinton promised to “end welfare as we know it.” Clinton supported and signed the North American Free Trade Agreement. The *New York Times* (1987) editorialized for the abolition of the minimum wage. Textbooks written by left-leaning economists taught students that unemployment insurance encouraged workers to live off the dole.

Today, Krugman is one of the world’s most famous left-wing pundits and rarely has anything good to say about free-market policies. Today’s *New York Times* would view anyone who favored abolishing the minimum wage as a heartless, hard-right libertarian. Indeed, even though the federal minimum wage was recently increased by roughly 40 percent during a period of extremely low inflation, the *Times* (2013) recently asserted that the U.S. economy could “easily support” another increase of more than 100 percent! Thomas Piketty (2014) wrote a popular book on wealth inequality that is notable for being almost entirely devoid of what I regard as the heart of economics: It denies the importance of supply-side effects in a wide range of areas. Economics as accounting.

In my own field of macroeconomics, the new Keynesian consensus of the 1990s has been almost completely abandoned. As recently as ten years ago, graduate students at the top schools were taught that monetary policy should be used to control inflation and stabilize the business cycle, and fiscal policy played almost no role in cutting-edge models of countercyclical policy. The emergent New Keynesian consensus in the 1990s synthesized certain monetarist ideas about monetary policy and Keynesian interest-rate targeting, and largely discarded fiscal stabilization policy (see DeLong 2000).

But from 2008 things have looked very different. In the wake of the global financial crisis and subsequent recession, much of the profession has drifted to the left, in both microeconomic policymaking and macroeconomic stabilization policy. Just as the folksy view of the Great Depression was that free-market capitalism is unstable and monetary policy is ineffective at the zero bound, the folksy view of the Great Recession was that an unregulated financial system is unstable and monetary policy is ineffective at the zero bound. My own view is that both crises were partly misdiagnosed, but I’m not surprised that folksy thinking induced a shift in opinion back to the left after the gains made by the right during the liberalization movement.

One difference between the Great Depression and the Great Recession is that this time around the right side of the profession did not lurch to the left; indeed in some respects they moved even further to the right. During the period before the Great Recession it was not uncommon to see right-wing economists advocate monetary stimulus, carbon taxes, and universal healthcare plans (such as
that advanced by Mitt Romney in Massachusetts, which was partly designed by the Heritage Foundation). Some still do, but overall the right side of the profession seems to have drifted a bit further to the right. Meanwhile, those on the left side have moved further left, producing a fairly large divide between the two sides.

Earlier I spoke of the epistemic difficulty in treating empirical questions of how responsive people are to changing incentives. Again, in the face of such difficulties people often go with gut-level judgments, based on what they feel they understand. In my own field of macroeconomics, it’s much easier to explain to people why fiscal stimulus would ‘work’ than it is to explain monetary stimulus. With fiscal stimulus one can point to the folksy views that public works projects put people back to work or that tax cuts cause people to go shopping. In contrast, monetary policy works much more indirectly. Unlike with tax cuts, the Fed doesn’t ‘give’ money to the public; it swaps base money for financial assets such as Treasury bonds. The increase in the supply of base money reduces its value, and since base money is the unit of account this raises the equilibrium price level. Then, because wages and prices are sticky in nominal terms, a higher equilibrium price level also tends to raise output. That’s much harder to explain to the average person than jobs created in building high-speed rail.

I think, however, that epistemic difficulties and differences do not adequately account for the widening of the divide between economists. Let’s consider two other factors: values and partisan/ideological tribalism. On the right, a significant minority of economists do not accept the utilitarian value system. They place much more emphasis on deontological values such as natural rights and just deserts. Thus, even if income redistribution raises aggregate utility, it is unjustified if it involves taking money from people who have worked hard to create value and redistributing the money to others who have chosen not to work. Or, even if health and safety regulations such as seatbelt laws reduce injury, they may be unjustified because they limit personal freedom.

In my view, partisan/ideological tribalism also plays a role. One must be careful here, because tribalism is generally regarded as a pejorative. It is often difficult to disentangle views based on honest differences of empirical facts and relationships and those based on differences of values or ideology. However, it seems to me that just as the American public has since the 1990s become much more polarized in its voting patterns and news viewing habits, the economics profession has also become somewhat more polarized. Economists have always tended to believe empirical studies that they want to believe a bit more than those that they don’t want to believe, but it seems that in the past ten years or so this tendency has grown even stronger.

3. For an example of such values-based argumentation on the right, see Mankiw (2013).
Consider the debate over global warming. There are certainly economists on the right, including me, who believe global warming is real and who favor carbon taxes. But on the left, I think it’s fair to say, a far larger share of economists embrace this view, evidencing a divide on the issue. The global warming example is especially notable because, whatever the fact of the matter is regarding global warming, it’s completely unrelated to the earlier discussion of the responsiveness of people to economic incentives. Ideology must, at least subconsciously, be affecting the way economists evaluate scientific studies of climate. Perhaps economists on the right see themselves as a part of ‘team free market,’ and hence are more reluctant to accept empirical findings that point to the need for more government regulation or taxes.

I think that sort of wishful thinking may also occur on the left, at least to some extent. There was a famous study suggesting that minimum-wage laws may not have much effect on unemployment, but it’s hard to see how this sort of study would dramatically alter anyone’s views, including those of economists on the left, unless they were already predisposed to favor such a policy. And this sort of receptiveness to government-intervention arguments may be even more of a factor in the shift away from the consensus that unemployment insurance increases the unemployment rate. The previous consensus was based on pretty solid empirical research, including studies during periods when the unemployment rate is very high (see Mulligan 2010).

Concluding remarks

The apparent tendency of economists to clump together into left and right blocks on a wide range of seemingly unrelated issues can be partly explained by differing views on the empirical matter of whether people are highly responsive to economic incentives. However, this purely epistemic explanation does not fully explain the tribal nature of American economics today. In other times and places the tribalism has been much less pronounced. Recall that it was, for the most part, moderate or left-wing governments that pushed liberalization policies in Australia, New Zealand, and much of Europe.

In Denmark, there might be no mystery to explain. Perhaps their scatterplot, whether of economists or others, would look more like a blob around what they have, which is relatively free markets and a relatively comprehensive system of social insurance. And as noted earlier, the tribalism we observe in America today was much less pronounced during the 1990s, the heyday of the “Washington consensus.”
Here I have discussed my 2010 paper, which examined the ways in which changing worldviews explained the upticks in statism between the 1930s and 1960s and the liberalization wave the began in the late 1970s. That paper had a mono-causal explanation: The changing relative persuasiveness of folksy versus Chicago worldviews. The paper, written in mid-2008, however, already seems obsolete. Just over a decade ago, the Heritage Foundation was helping Mitt Romney create a universal healthcare regime in Massachusetts not unlike Obamacare. Paul Krugman was defending third-world sweatshops, and he derided the view that fiscal stimulus could end deflation in Japan (Krugman 1997; 1999). Now all of that seems like a long, long time ago. It seems to me that in the past ten years or so the economics profession in America has experienced an increase in tribalism and, on the right especially, a move away from utilitarian thinking.

References


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Unhelpful Abstractions
and the Standard View

Cass R. Sunstein

Consider this question: Are you in favor of the regulatory state? That is an im-
possibly abstract question. True, many people (including many economists) are
skeptical about the Occupational Safety and Health Administration. Many other
people (including many economists) do not believe that the Environmental Protec-
tion Agency should issue more stringent regulations for ozone and sulfur dioxide.
But most of those skeptics do not oppose the regulatory state as such, and they
do not even ‘lean’ against it. After all, the common law is emphatically a regulatory
system insofar as it establishes rights of private property and the rules of contract
and tort law. Under reasonable assumptions, a competitive system works best if
there are rules against violent crime and also against fraud; it probably should
have some kind of antitrust law as well. As Friedrich Hayek wrote, “An effective
competitive system needs an intelligently designed and continuously adjusted legal
framework as much as any other” (1944, 29). Whatever they say, few people, and
few economists, are against the regulatory state as such.

Now consider two other questions. Do you favor tighter workplace safety regu-
lations? Do you favor more aggressive controls on air pollution and water pollution? These
questions are also pretty abstract. It makes no sense to favor (or to oppose) tighter
workplace safety regulations or more aggressive environmental controls as such.
We need to know what workplace safety and environmental regulations would
achieve, and at what cost. True, we could imagine a person, or an economist,
purporting to believe that both kinds of regulations are objectionable as such. But
in view of the diversity of potential regulations, and the likelihood of at least some

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market failures in both domains, it would be a bit a priori—a little like a grunt—to say ‘no’ to both questions. The same is certainly true for a ‘yes.’

To be sure, it would be possible to give direct answers to some abstract questions about regulation. Consider two: Do you favor legalizing marijuana? Should prostitution be banned? For such questions, we can imagine intelligible responses, on the ground that some kind of welfare analysis, made intuitively or on the basis of expertise, could support it. But those who say that they want to legalize marijuana and prostitution have not declared any kind of position on the regulatory state. They need not have any particular views on the common law, on the Sherman Act, on occupational safety standards, or on clear air regulation.

Now consider this question: Are you in favor of the welfare state? That question may be slightly better than the regulatory state analogue, but it too is unhelpfully abstract. From the far right to the far left, Americans, and American economists, favor some kind of welfare state. A ‘no’ answer is probably a kind of posturing, not anything real. Perhaps we could stipulate a general ‘yes’ in response to that question, but if so, the answers would not tell us anything.

Better tests would be these questions: Do you think that the Earned Income Tax Credit should be increased? Do you believe that the government should ensure that all Americans have access to health insurance? It is true that some people, including some economists, would answer ‘yes’ to the first question (as I would), while others would disagree. But from the answers to the first question, we would have no logical commitment to an answer on the second question, where people, including economists, also disagree (largely for empirical reasons).

In this light, it seems unhelpful, even a recipe for confusion, to puzzle over the question whether economists (or others) ‘like,’ or ‘lean toward,’ both the regulatory state and the welfare state, or neither, or one but not the other. But there is a more fine-grained position on something like that question, and I believe that many (not all) economists would support it. The position is this: The regulatory state should restrict itself to the correction of market failures, and redistributive goals are best achieved through the tax system. Let’s call this (somewhat tendentiously) the Standard View (Kaplow and Shavell 1994). The Standard View is an abstraction, to be sure, but it has real bite, and it is a productive way to understand the relationship between the regulatory state and the welfare state. It suggests that the two have altogether different functions. For regulations, we should fix market failures, with careful attention to cost-benefit analysis, and when our goal is redistribution, we should use taxes and transfers. The Standard View cautions that when we think about occupational safety regulation or the Clean Air Act, we do best to maximize net benefits, while leaving redistribution for the tax laws.

The Standard View leaves some important open questions. How do we define market failures? Should we include “behavioral market failures,” as empha-
sized by behavioral economics—as, for example, in the forms of myopia, limited attention, and unrealistic optimism? In my view, we should (Sunstein 2013). How, exactly, should we understand the idea of redistributive goals? To answer that question, we need to separate strictly empirical questions from strictly normative ones. If pursuit of redistributive goals would have harmful effects—by, for example, hurting the very people that one is trying to help—redistributors must proceed with caution. This is so even if on strictly normative grounds, there is a compelling argument for ensuring that morally irrelevant differences (such as family background or even talent, as determined by the “natural lottery”) are not turned into systematic sources of social disadvantage (Rawls 1971).

Objections might be raised to the Standard View even if it is correct on its own terms. Suppose that a regulation would help poor people a great deal and not hurt wealthy people so much; suppose too that the tax system would be more efficient as a redistributive tool but that it is unavailable as a practical matter. What then? On these assumptions, should regulators pursue distributive goals through regulation? In my view, cases of this kind—which are admittedly quite rare—do raise a problem for the Standard View. There are also questions about whether the Standard View is correct on its own terms (Sanchirico 2000), though it appears to have largely survived critical scrutiny (Kaplow and Shavell 2000).

My conclusion is that it is not fruitful to puzzle over the question whether economists and others ‘favor’ or ‘lean’ toward the regulatory or welfare state, and that it is better to begin by emphasizing that the first should be designed to handle market failures, and that the second should be designed to respond to economic deprivation and unjustified inequality. In short, the Standard View is the appropriate starting point. True, it leaves open many questions, and it also runs into reasonable objections; but at least it can be said that those are the right questions and objections to explore.

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Unconventional Confidence Bands in the Literature on the Government Spending Multiplier

Ryan H. Murphy

LINK TO ABSTRACT

In recent decades, vector autoregression, especially structural vector autoregression, has been used to study the size of the government spending multiplier (Blanchard and Perotti 2002; Fatás and Mihov 2001; Mountford and Uhlig 2009). Such methods are used in a significant proportion of empirical research designed to estimate the multiplier (see Ramey 2011a). Despite being published in respected journals and cited by prominent members of the profession, much of this literature does not use the conventional standard of statistical significance that economists are accustomed to in empirical research.

Results in the literature on the fiscal multiplier are typically communicated using a graph of the estimated impulse-response functions. For instance, the effect of government spending on output may be reported by reproducing a graph of an impulse-response function of a one-unit (generally, one percentage point or one standard error) change in government spending. The graph would show the percent change in output over time following the change in government spending. To report statistical significance, authors of these studies may then draw confidence bands around the impulse response function. Ostensibly, if zero lies outside the confidence band, it is statistically distinguishable from zero. But very frequently in this literature the confidence bands correspond to only one standard error. In other words, instead of representing what corresponds to rejecting the null hypothesis at a 90% level or 95% level, the confidence bands correspond to rejecting the null hypothesis at a 68% level. By conventional standards, this confidence band is insufficient for hypothesis testing. Not every useful empirical study must achieve

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significance at the 95% level to be considered meaningful, of course, but a pattern of studies which do not use and reach the conventional benchmark is a cause for attention and perhaps concern. Statistical significance is not the only standard by which we should judge empirical research (Ziliak and McCloskey 2008). It is, however, a useful standard, and still an important one.

Here I examine papers in the fiscal multiplier literature which apply vector autoregression methods. Sixteen of the thirty-one papers identified use narrow, one-standard-error confidence bands to the exclusion of confidence bands corresponding to the conventional standard of 90% or 95% confidence. This practice will often not be clear to the reader of a paper unless its text is read rather carefully.

**Methodological preliminaries**

It is a mistake for economists to take statistical significance too seriously. Without understanding the limits of data availability, or by too stubbornly adhering to arbitrary rules, worthwhile research may never reach the audience it deserves. The mere fact that one regression fails to achieve a certain p-value does not mean that a result is worthless, even though that notion is taught all too frequently via the frequentist interpretation of statistics.

On the other hand, statistical significance is a useful standard by which to judge empirical research. In some ways statistical significance is an arbitrary construct, but it offers one potential way for applied economists to decide which empirical results they find most credible. It is not to be ignored, or perhaps worse, obscured. And while economists should not use $p < 0.05$ as a lazy litmus test, it remains an important point of reference. The onus is on the practitioners of a subfield whose favored econometric method does not pass the conventional standard to demonstrate why they should not be suspected of simply moving the goalposts.

In certain contexts, when a lack of robustness has been made especially obvious, economists will change their minds. An example of this is the work of William Easterly in casting doubt on the then-fashionable belief that foreign aid could encourage growth in developing nations when the developing nations adopt good economic policies. Craig Burnside and David Dollar (2000) had previously developed evidence across many specifications that such an interaction term was statistically significant and in the ‘correct’ direction. Easterly (2003) showed that this result was contingent on the definitions of aid and of good policy; when these definitions were adjusted, the statistical significance of the results disappeared. Easterly’s evidence led economists to be far more skeptical of the work of Burnside and Dollar, even though in most of Easterly’s specifications the point estimate of the
aid-policy interaction term remained the same in sign and magnitude. Several of Easterly’s specifications even resulted in t-statistics for the redefined aid-policy interaction greater than one, as high as 1.41 (2003, 41-44). Yet showing the fragility of the reported statistical significance made development economists more circumspect in their support of aid.

Unconventional standard error bands in studies of the fiscal multiplier

The standard error bands shown are only 68% bands, based on bootstrap standard errors. Although this is common practice in the government spending literature, it has no theoretical justification. … Some have appealed to Sims and Zha (1999) for using 68% bands. However, there is no formal justification for this particular choice. It should be noted that most papers in the monetary literature use 95% error bands. (Ramey 2011b, 11, 11 n.11)

The numbers in brackets are the one standard error confidence bands from the bootstrap distribution of multipliers. (Bachmann and Sims 2012, 244)

The asterisks indicate significance within the one-standard-deviation bandwidth. (Burriel et al. 2010, 265)

As Valerie Ramey (2011b, 11) notes, the decision to use confidence bands of one standard error is an ad hoc departure from professional standards. There are sometimes, to be sure, good reasons to include more bands than only the ones corresponding to two standard errors. The inclusion of bands corresponding to the 68% level, in addition to 95% bands, may communicate the “shape” of the results better than the latter alone (Sims and Zha 1999). This paper takes no issue with such a practice of using multiple bands, but the exclusion of those bands corresponding to conventional notions of statistical significance is problematic. Authors who employ the narrower bands should provide a rationale for doing so and make their use of unconventional confidence levels obvious to the casual reader. It is not cynical to expect that most readers of journal articles skim the

2. “We argue that the conventional pointwise bands common in the literature should be supplemented with measures of shape uncertainty… [F]or characterizing likelihood shape, bands that correspond to 50% or 68% posterior probability are often more useful than 95% or 99% bands” (Sims and Zha 1999, 1113, 1118).
articles, reading only to the point that they believe they can understand the model or results. Economists are trained to perceive confidence bands as implicit hypothesis testing, and so there is a danger that unconventional confidence bands may project a false sense of the power of the result. Figure 1 and Figure 2 are two examples of graphs that at first glance may seem to convey statistical significance as conventionally understood; however, the confidence bands employed correspond to 68%, not the usual 90% or 95%.

Regrettably, some economists have further muddled the matter by using one standard error as the threshold for deploying the term “statistically significant.” Raffaela Giordano et al. (2007) do so, despite providing both one- and two-sigma bands graphically. Giordano and collaborators provide no rationale for this use of “statistically significant” save for the remark that the same was done “in most previous studies” (2007, 716). But the argument that providing the 68% bands is desirable for certain technical reasons, such as the capacity to convey notions of shape with greater precision, does not tell us that the 68% level is also an acceptable standard for hypothesis testing. If one wishes to argue that the two-sigma confidence level is too high of a standard to apply to one’s empirical research, one should offer a compelling reason why the field of study in question can be held to a lower standard of significance or explain why economists in other fields should reevaluate their methods.

**Literature review and results**

To investigate the prevalence of these issues, I studied 31 papers which applied some variation of vector autoregression in measuring the size of the multiplier. These papers varied from unpublished manuscripts to publications in the *Quarterly Journal of Economics*. A similar exercise could be performed for the tax multiplier. I consider only the debate on the size of the government spending multiplier because the debate over that is most in vogue. Also, the most prominent line of contemporary research on the tax multiplier does not emphasize vector autoregression.

3. Giordano et al. (2007) cite Sims and Zha (1999) for the idea that “error bands corresponding to 0.50 or 0.68 probability…provide a more precise estimate of the true coverage probability” (Giordano et al. 2007, 716 n.8).

4. These papers were collected from work from an in-progress larger literature review which attempts to review all existing empirical literature on the size of the government spending multiplier. The thirty papers are those which employ vector autoregression as described in this paper. One additional paper was identified by a referee.

5. A recent and important paper in the literature on the tax multiplier, Romer and Romer (2010), includes a vector autoregression that uses the one-standard-error confidence bands.
A table of the 31 papers can be found in Appendix A, giving the number of papers citing them (according to Google Scholar) and whether the result was published in a top-100 journal (according to RePEc’s “simple” journal rankings). Such metadata allows me to evaluate whether, say, only the less prominent papers use the unconventional confidence bands. Full bibliographic information on the 31 papers is given in Appendix B.

Sixteen of the thirty-one papers use the unconventionally narrow confidence bands at the exclusion of other confidence bands. Papers which provide the 90% or 95% confidence bands, even once in the paper, are not included among the sixteen. Five of the six papers with at least 500 citations use the unconventionally narrow bands. As for papers with between 100 and 500 citations, there are eleven, and four of these used the unconventionally narrow bands. Looking at papers with less than 100 citations, eight of fourteen used the unconventionally narrow bands. Regarding journal placement, thirteen of the thirty-one papers were published in a top-100 journal. Of those thirteen, six use the unconventionally narrow bands and seven do not. Of the eighteen papers not published in a top-100 journal, ten use the unconventionally narrow bands and eight do not.

A narrative consistent with these facts is that the papers on the frontier of empirical macroeconomic methodology used the unconventionally narrow bands and others followed. In the middle (still respectably cited) tier of the literature, the one-standard-error practice is less pervasive. Finally, there is no strong evidence that the top journals are playing an important role in limiting the use of these narrower bands. It seems fair to say that the usage is pervasive within the literature and that those who employ the practice are following the most cited papers in the field.

Final remarks

Further research may bring even further into question whether this literature is held to the same standard as other areas of applied econometric analysis. As Ramey (2011a) has shown, the disagreement among macroeconomists today is whether the government spending multiplier is less than 1 or greater than 1, not whether it is greater than zero. That being the case, an important hypothesis to test is whether a multiplier point estimate is statistically different than 1, not zero, but that test is rarely performed. Where it has become common practice to lower the threshold to one standard error, it is hard to imagine point estimates are commonly

Another obfuscating issue is the lack of standardization in reporting the results of an impulse-response function, as quite often papers will merely report the first period (‘impact’) multiplier or the value of the impulse-response function at its highest point (‘peak’). Beyond the narrow issue of confidence bands, statistical significance generally is an issue with which the literature struggles.

Proponents of vector autoregression should be more transparent about its limitations. While in some ways it may be uniquely useful for macroeconomic topics (Sims 2010), its inability to pass conventional standards is demonstrative of its low power. When a headline point estimate is not statistically significant as conventionally defined, that fact should be made clear, not obscured. Otherwise, we could be holding this method to a lower standard than we hold competing methods. If that is the case, then other empirical methods tending to have smaller standard errors and tighter confidence intervals/bands, such as those pioneered by Valerie Ramey and Robert Barro (see, e.g., Barro and Redlick 2011), or those using clever research designs (e.g., Wilson 2012; Shoag 2013), should be held in higher relative esteem than they are presently.

**Figure 1.** Reproduction of “Figure 1” in Jordi Galí et al. (2007, 232)
Figure 2. Reproduction of “Figure V” in Olivier Blanchard and Roberto Perotti (2002, 1348)

Figure V
Response to a Spending Shock
Appendix A.
Use of unconventionally narrow confidence bands in the literature on the fiscal multiplier

<table>
<thead>
<tr>
<th>Paper</th>
<th>Use 1 s.e. confidence bands</th>
<th>Google Scholar citations</th>
<th>Top-100 Journal (RePEc)</th>
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<tbody>
<tr>
<td>Bachmann and Sims (2012)</td>
<td>Yes</td>
<td>50</td>
<td>Yes</td>
</tr>
<tr>
<td>Beetsma and Giuliodori (2011)</td>
<td>No</td>
<td>65</td>
<td>Yes</td>
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<td>Beetsma et al. (2008)</td>
<td>No</td>
<td>128</td>
<td>Yes</td>
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<td>Bénérix and Lane (2009)</td>
<td>Yes</td>
<td>28</td>
<td>No</td>
</tr>
<tr>
<td>Blanchard and Perotti (2002)</td>
<td>Yes</td>
<td>1999</td>
<td>Yes</td>
</tr>
<tr>
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<td>No</td>
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<td>Yes</td>
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<td>Burriel et al. (2010)</td>
<td>Yes</td>
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<td>Caldara and Kamps (2008)</td>
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<td>No</td>
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<td>No</td>
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<td>Corsetti et al. (2012)</td>
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<td>130</td>
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<td>62</td>
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<td>Fazzari et al. (2013)</td>
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<td>Kuttner and Posen (2002)</td>
<td>No</td>
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<td>Monacelli et al. (2010)</td>
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<td>Mountford and Uhlig (2009)</td>
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<td>Pereira (2008)</td>
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Appendix B.
Bibliographical information for the papers listed in Appendix A


References


### About the Author

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It’s Not a Minsky Moment, 
It’s a Minsky Era, Or: 
Inevitable Instability

M. June Flanders

LINK TO ABSTRACT

The economist Hyman P. Minsky wrote extensively and prolifically throughout the latter half of the 20th century. Hardly anybody listened. When the storm broke in 2007 a number of financial journalists discovered, or thought they had discovered, him and his work and began to talk about a ‘Minsky Moment’ without showing awareness of what Minsky was really about.

The present paper discusses some of Minsky’s work and its development over the decades and argues that ‘Minsky Moment’ is a misnomer. We are in a Minsky Era. The concept of a sudden crash and panic in financial markets, as described by Walter Bagehot and others since, is not what Minsky was about. He

1. Tel Aviv University, Tel Aviv 6997801, Israel. More than the usual recognition of helpful comments is due to Ariell Reshef. Thanks also to Ady Ne’eman, and to an anonymous referee.
2. Major exceptions emanate from Annandale, New York, where the Levy Institute at Bard College was Minsky’s host and professional home for the last six highly productive years of his life, and Kansas City, Missouri, where his former student Randall Wray is the center of activity of a research group and conferences. There is also a great deal of interest in his work in Italy, particularly in Bergamo. In addition there were a number of interesting and interested reviews in earlier years. For example, Harcourt (1977) is perceptive and succinct: “Minsky combines the institutional settings of [Keynes’s] Treatise with the analytical concepts of the General Theory, especially of Chapter 17, to show that there is a coherent story of the cycle implicit in Keynes. One short-run state carried within itself the ingredients of an inevitable transition to the next in a definite sequence.” Another such review is Tobin (1989). But other than reviews I find very little work involving a discussion (pro or con) of his ideas. Astonishingly, even Paul Davidson (2007) in his fine biography of Keynes does not reference Minsky in his index or bibliography.
3. An outstanding exception is Martin Wolf (admittedly not a run-of-the-mill financial journalist). Wolf (2012) shows an understanding and appreciation that Minsky’s work as expressed in Stabilizing an Unstable Economy involves a process, not an accidental or incidental ‘moment.’
was concerned with the ongoing behavior of agents in financial markets, primarily banks, systematically behaving in a way that leads to increasingly speculative activity followed, virtually inevitably, by a crash. The process by which this occurs, involving the relationship between banks and their customers, was the subject of his analysis. As time went on during the 20th Century, the role of banks changed, and other institutions such as mutual funds took their place. This too was subject to his analysis. Minsky knew and understood what was happening on the street and within banks better, I am convinced, than any of his contemporary academic economists. He was consultant to the Comptroller of the Currency and was for thirty years the director of a bank. Trained in mathematics and analytical economics, he was nevertheless aware of, and deeply concerned with, what was happening in ‘real life.’

This paper describes and discusses Minsky’s ideas and the trajectory of his thinking, which evolved as events and institutions (and hence appropriate policy) changed from the 1970s up to the time of his death in 1996. His theoretical and ideological outlook, however, remained essentially the same. The paper aims to bring some of his work to the attention of the mainstream of economics, which has by and large neglected it.

I propose to deal here with a very small portion of Minsky’s written output, the motivation for the selection of which I hope will become clear. Perry Mehrling (1999) has provided us with a complete Minsky bibliography and, more important, a thorough and insightful discussion and analysis of the main body of the published work. Mehrling presents an excellent summary of a theme that permeates all of Minsky’s subsequent work: Minsky was “arguing that attempts to control the money supply by controlling the reserve base were misguided and that the Federal Reserve had better focus on controlling the pattern of interest rates by encouraging use of the discount window and controlling the discount rate. The pattern of his subsequent research can be best understood as an attempt to develop this view, first by deepening his understanding of modern bank operations and,

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4. Janet Yellen, in an incisive discussion of the pros and cons of various types and levels of central bank interventions, seems to have ignored what I consider the essence of Minsky’s instability hypothesis, that is, the endogeneity of the sequence of events: “As Minsky’s financial instability hypothesis suggests, when optimism is high and ample funds are available for investment, investors tend to migrate from the safe hedge end of the Minsky spectrum to the risky speculative and Ponzi end” (Yellen 2009, 40). As we shall see below, it is not wholly a matter of being seduced into optimism: Minsky would say, in part, that during the course of an investment boom, the obligations of firms cannot continue to be hedge-financed—there is a debt which must be paid, but the quasi-rents (profits) that are expected to accrue when the investment is completed and begins to pay off are not now available—therefore hedge financing here is impossible and the finance must be at least speculative even if not yet Ponzi.

5. In Minsky (1957, 171) he thanks “the Joint Committee on Education of the American Securities business” for a fellowship.
second, by reformulating it in the terms of modern academic monetary discourse” (Mehrling 1999, 133). In a later work Mehrling presents an incisive summary and account of Minsky’s analysis of financial instability and of his place outside of both “the optimistic Keynesian camp…and the optimistic monetarist camp” (Mehrling 2011, 65-69).

Minsky summarized his own views in the section of his Stabilizing an Unstable Economy titled “Economic Theory,” in three densely packed chapters. For him the bottom line is that:

Today’s standard economic theory is largely a creature of the years since World War II. It integrates some aspects of Keynes’s theories with the older classical analysis that he believed he was replacing. This neoclassical synthesis now guides economic policy. (Minsky 2008/1986, 110)

Standard economic theory not only does not lead to an explanation of instability as a system attribute, it really does not recognize that endogenous instability is a problem that a satisfactory theory must explain. (ibid., 109)

Keynes’s investment theory of business cycles and his financial theory of investment in the face of uncertainty were lost as the standard interpretation of Keynes’s General Theory evolved into today’s orthodox theory. … [Keynes’s] understanding into basic relations guiding our economy was reduced by the interpreting economists who followed into a banal set of prescriptions for guiding aggregate output. (ibid., 133)

I have characterized Keynes’ accomplishment as the development of an investment theory of the determination of income and a financial (monetary) theory of investment. (Minsky 1975)

I would note that a similar interpretation of John Maynard Keynes is taken by a few other writers, most notably G. L. S. Shackle (1983). Minsky, incidentally, takes Keynes himself to task for not emphasizing this interpretation sufficiently. Still, Minsky felt that “unreconstructed Keynesianism” is still better than the alternative (1975, 144).

Minsky argued against the convictions of the “policy-advising establishment” that “the credit crunch of 1966, the liquidity squeeze of 1970, the banking crises of 1974–75, the inflationary spiral of 1979–80 and the distress, national and international, of 1981–82 are…aberrations, due to either ‘shocks’ or ‘errors’” and
that “nothing is basically wrong…incisive corrective measures are not needed” (2008/1986, 320). On the contrary:

The major flaw of our type of economy is that it is unstable. This instability is not due to external shocks or to the incompetence or ignorance of policy makers. ... The dynamics of a capitalist economy which has complex, sophisticated, and evolving financial structures leads to the development of conditions conducive to incoherence—to runaway inflations or deep depressions. But incoherence need not be fully realized because institutions and policy can contain the thrust to instability. We can, so to speak, stabilize instability. (Minsky 2008/1986, 11, my emphasis)

That “institutions and policy can contain the thrust to instability” is the key statement; this theme pervades his work. Previously, he had written that “capitalism is inherently flawed—but financial instability need not lead to a great depression” (1982b, vii). Some of his policy recommendations, as we shall see, are one-time alterations intended to make the economy function better. Other recommendations would require ongoing intervention.6

The insistence on the built-in instability of the macroeconomy in the latter half of the twentieth century has led to Minsky being ignored or rejected by mainstream economists. One reason for this, I believe, is a hatred for non-equilibrating systems. Another reason I’ve been given, by one very able, prominent economist, is that mainstream economists haven’t been able to express Minsky’s model/theory/story in mathematical terms.7 I have also been told of a perception among influ-

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6. I would question the use of the word stabilizing in this context, but this raises issues of linguistics, or mechanics, which I do not propose to explore.

7. A number of people on the ‘fringe’, centered at the University of Missouri–Kansas City and at the Levy Institute at Bard College, are working on formalizing Minsky. They seem to be attacking specific aspects of his model/theory, but as far as I can tell, they’ve attracted very little attention from the mainstream of the profession. A very mathematical Australian economist, Steve Keen, has claimed to formalize Minsky’s thesis, and is constructing an elaborate model (for which he appeals to his readers for financial contributions), called “Minsky” (link). In the latest version I have seen, Keen applies this to parts of Can “It” Happen Again?, a collection of Minsky essays; however, the later Stabilizing an Unstable Economy represents a fuller, more complete and ‘messier’ model than any essay in that collection. Keen’s models seem much less nuanced than Minsky’s, and I am not aware of his making the broad policy recommendations that Minsky made. However, I am not familiar with all of Keen’s discussions, which appear periodically on his blog (link). Minsky himself was more than comfortable with mathematics but felt he could not simplify to the extent required. This reminds me of Keynes’s comments on the neglect of the concept of “Effective Demand,” which “could only live on furtively, below the surface, in the underworlds of Karl Marx, Silvio Gesell or Major Douglas” (1936, 32).
entia l economists that Minsky offers nothing but a reiteration of Bagehot’s knowledge that there are periodic liquidity crises.

The issue of the changing nature and growing instability of the (United States) economy over time is paramount with Minsky. In an earlier work, “Can ‘It’ Happen Again?” (1982a/1963), Minsky argued that while the deflation of 1933 was triggered by the stock market crash of 1929, the sharp decline in stock prices of 1962 did not similarly lead to a deflationary process. The reason, he argued at some length, is the buffering effect of the larger size of the federal budget: the expenditure by the government and the reduction in tax receipts mitigated to some extent the decline in output, and the increase in the stock of liquid assets due to the resulting federal deficit softened the effect of the decline in liquid assets. We return to this line of thinking in discussing his policy recommendations.

Minsky believed the growing inherent instability of the economy over time is due to changes in the role of money and to the way business is financed. He rejected the concept of money as determinate of the actual and expected price level but divorced from the real economy, as well as the view that the quantity of money is determined exogenously. Minsky saw the quantity of money as endogenous. Banks make loans and then acquire the necessary reserves (Minsky 2008/1986; more on this below).

Money and finance are intimately related, since money is created in the course of activating finance. Finance is required to enable expenditure on investment outlay or consumption, and such expenditure is effected with money. A number of writers, from Bagehot onward (and before), have stressed the importance of finance in development and in economic activity. Minsky was saying more than this. For him, finance is crucial in determining the real equilibrium of a modern capitalist economy.

Minsky found that the economic system is necessarily cyclical. There is no long-run stable equilibrium. Or, in the vernacular: Stuff doesn’t just happen; it necessarily happens. Meanwhile, as he wrote:

> In the modern (Friedman, Lucas, etc.) versions of the Quantity Theory monetary variables are allowed into the model, but always in such a way that they can lead only to transitory disturbances of the equilibrium values of variables, but they cannot permanently affect the equilibrium values. (Minsky 1996a, 72)

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8. This comes as something of a shock to those who, like me, have drilled hundreds of undergraduate students in the textbook arithmetic of the ‘money multiplier.’
In some respects Minsky’s analysis is not unlike Hayek’s, though their conclusions are 180 degrees apart. For both, endogeneity of money figures importantly, and money matters. But for Hayek it is the equilibrium money supply that is endogenous. If I understand Hayek correctly, if individuals and firms could have the quantity of money they wanted, the economy could reach a stable equilibrium. But when he tried to formulate an operating procedure for the authorities to adopt in order to achieve this, he was unable to produce a satisfactory rule. I take this to be the reason why, near the end of his life, he became the leader of the ‘free banking’ movement.\(^9\) Essentially, Hayek argued that the problem was the unattainability of the equilibrium money supply, whereas Minsky essentially argued that the actual quantity of money was endogenous both in and out of equilibrium, even in an economy with a government and a central bank.

Minsky ‘believed in’ the functioning of the market mechanism in the sense that individuals and firms behave rationally; they respond to market signals. He notes more than once that the “neoclassical synthesis” will explain adequately the allocation of goods and factors and the micro equilibrium of a capitalist economy; but such micro explanations do not amount to an explanation of the macro system, including money and banks, a system that is inherently unstable (2008/1986, 112, 114).

[...]

Failure to understand the dissonance between the financial and real sectors, he says, has led policy advisors to miss the main point.

Minsky examines the history of United States banking after WWII (2008/1986, 78-87). At the end of the war, commercial banks held large stocks of government securities, mainly Treasury bills. These could be converted quickly into reserves if the banks needed to close their positions. But by 1974, U.S. government agency obligations were an increasing percentage of government obligations; though secure, “their markets tend to be thin.” Furthermore, government obligations constituted a decreasing percentage of total financial assets, from 57% in

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\(^{9}\) See Flanders (n.d.) for a survey of Hayek’s proposals over time for appropriate monetary rules. An earlier working paper, “Left- and Right-Endogenous Money” (Flanders 2009) might also be of interest since it discusses the differences between the Austrian and the Minskian approaches to money.
1946 to a low of 11.2% in 1974 (ibid., 83-84). In response, the market created other sources of liquidity, from the federal funds market (overnight interbank loans of excess reserves)\(^{10}\) to Eurodollars (borrowing from foreign branches) to CDs (which required lower reserves). The result was a longer “lag between restrictive actions by the Federal Reserve and a supply response by banks and financial markets” (ibid., 86). He writes:

Policymakers’ impatience to get results will tend to make for serious excesses and overshoots when relations have been loosened. The likelihood that policy action will result in the economy going to the threshold of a financial crisis increases with the number of markets used for position-making, and with the proportion of bank assets bought through the various markets. Thus, as the financial system evolved over the postwar period, the potential for instability of the economy increased. (Minsky 2008/1986, 86)

As the expansion of the 1960s progressed, spending by nonfinancial corporations on physical assets increased rapidly and outpaced the growth of corporate internal sources of funds. (ibid., 98, citing Federal Reserve Flow of Funds Accounts)


Let us take a brief look at some of Minsky’s definitions pertaining to finance. Before introducing the definitions, a few remarks about how Minsky saw things: Banks are typically highly leveraged and by their very nature always borrow shorter than they lend. Most of their indebtedness is sight or very liquid; their lending is always longer, since they finance the operations of firms in their production and sale of goods and services. Nevertheless when loans are directed at wages and salaries and current expenditures, they are repaid as the product is sold. (This is the textbook story.)

Now Minsky uses common terms but defines them explicitly. Bank lending of the longer sort is *hedge* financing. When the economy is going well and expectations are buoyant, firms will borrow—or arrange a line of credit—to finance expenditure on capital equipment. Since the returns to the investment have not begun to flow, the loans may become *speculative*, in that additional borrowing may be needed to cover the current payments due. And if the delay is so great that additional borrowing is required to pay the interest on the loans, the loans are de-

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10. This in fact had been developed earlier, in response to higher interest rates, which made it profitable for banks to monitor their excess reserves more carefully as their opportunity cost rose (Minsky 1957).
defined as Ponzi. Ponzi finance, not necessarily fraudulent, involves borrowing in order to pay interest and dividends, that is, “the capitalization of interest” (2008/1986, 225 n.7).

At the same time, the profit-seeking drive of the banks and financial innovation may exceed the demand for funds from business for investment, and banks look for other outlets; Minsky says this “can trigger a boom from seemingly stable expansions” (2008/1986, 278). If the boom is in its early stage and interest rates are low, both businesses and banks will be tempted to “not only leverage investment but also to (i) use short rather than long-term debt financing, and (ii) refinance lightly indebted positions in capital assets so as to increase indebtedness” (Minsky 1996a, 83). The system then goes from being “robust” to being “fragile.” These are favorite terms and concepts of his, with “fragile” meaning that small changes cause large responses (ibid.).

Furthermore, in the course of a cycle, during an investment boom, costs rise and the costs of continuing an ongoing investment project increase. Aside from those mentioned above, “[e]ndogenous forces make a situation dominated by hedge finance unstable, and endogenous disequilibrating forces will become greater as the weight of speculative and Ponzi finance increases” (Minsky 2008/1986, 238). As wages and costs of materials rise during a boom, the projected profits from an ongoing project decline. If there are delays and bottlenecks, that further reduces the gain to the project upon completion. At the same time, as interest rates rise, the present value of the expected future income, the quasi-rents, from the project declines, and the longer the gestation period of the investment, the more the sunk costs of the project compound. “Interest rates thus enter in both the cost of the project and the value of the capital asset [the present value of expected quasi-rents]” (ibid., 241). The expected income stream from the completed project must be large enough “for its capitalized value to exceed the cost of the completed project, including such interest payments” (ibid.). This is true even if the investment is internally financed; if it’s being financed by bank borrowing, this is even more the case.11 “Any transitory tranquility is transformed into an expansion in which the speculative financing of positions and the external financing of investment increase. An investment boom that strips units of liquidity and increases the debt-equity ratios for financial institutions follows” (ibid., 244). All of this entails an erosion of the profit margins and of “the ability to validate the past” (ibid.). In sum, “events that trigger the start of a debt deflation are normal results of the financing relations that lead into and take place during an investment boom” (ibid., 242, my emphasis).

11. If the project is financed internally, the rise in interest rates during a boom increases the costs of other operations of the firm, so if it was amply financed at its inception, the project is running into a shortage of internal funds.
The fact that investment is financed by debt in the first place, rather than by internal funds, seems to be the root cause of the instability, because the intermediation necessarily becomes increasingly speculative, eventually taking on Ponzi characteristics, as the boom progresses. This is reminiscent of Hayek's insistence that investment has to be equal to (that is, financed by) savings. But then, Minsky is explicit in his statements that capitalism has become more fragile as finance and production have become more integrated.

A brief history of the American economy illustrates the point. Thanks to a “robust financial structure—the legacy of World War II and financial conservatism induced by the Great Depression,” the United States enjoyed a period of stability in the 1950s and early 1960s. Things began to change with “profit opportunities open to financial innovators within a given set of institutions and rules; a drive to innovate financing practices by profit-seeking households, businesses, and bankers; and legislative and administrative interventions by governments and central bankers” (Minsky 2008/1986, 219). “The regulated financial structure was…legitimized by the financial debacle of 1929–33, and the deregulation mania occurred in the 1970s and 1980s after a long run without a fully realized debacle.” Traditional wisdom was cast aside partly “due to the giant banks' belief that the Treasury, the Federal Reserve, and other government agencies will provide them with a bailout in order to prevent a big crash. The experience of the 1970s and early 1980s validated this belief that the giant financial institutions will be protected” (ibid., 221).

Industrial and industrializing economies need financing not only for commerce and inventories, but also for long-lived capital assets, which were becoming increasingly important by the mid-1980s.

This means that a lack of synchronization between contractual payments on debts and receipts from operations can be built into the banker-business relation as positions in long-lived assets are financed by short-term liabilities.

Capitalism may very well work best when capital assets are cheap and simple. Instability may very well be exacerbated as production becomes more capital intensive and as the relative cost and gestation periods of investment goods increase, for in such a capitalist economy financing arrangements are likely to appear in which debtors pay debts not with cash derived from income production but with cash obtained by issuing debt. (Minsky 2008/1986, 222)

Then, of course, we have a drift to speculative and Ponzi finance. There follows a “taxonomy of cash flows” (ibid., 222ff.) that I have not the space to record, but
which is a detailed description of different types, riskiness, maturities, returns, and, most important, time paths of different capital assets. As noted previously, Minsky was closely familiar with the details of Wall Street of his day.

Minsky’s conclusion: “Our economy is unstable because of capitalist finance. If a particular mix of hedge and speculative financing of positions and of internal and external financing of investment rules for a while, then there are, internal to the economy, incentives to change the mix” (2008/1986, 244, my emphasis).

My primary reaction to reading *Stabilizing an Unstable Economy* was to wonder how relevant it would be to the present-day economy. Two important changes have occurred: (1) the economy has been dominated by different kinds of firms, and (2) banks are doing different things. The question arises now of how important it is that much firm expenditure today is not for plant and machinery but rather for salaries, etc., for ‘development.’ A caricature of that is that today we have an economy dominated by Apple, Google, and Microsoft, whereas Minsky in *Stabilizing* is talking about an economy where heavy weight was given to General Motors and U.S. Steel. Second, banks are doing things different from the activities Minsky was describing, which was providing finance to firms for operations and investment. These trends are related, but they are not rigidly tied to one another.

When I looked further into Minsky’s later work, I discovered that he had come to discuss at least one of those issues. Since, as noted, Mehrling has surveyed almost all the published work, I have examined some of the very late drafts and notes that were not published, in Levy (and a few Italian) working papers and in drafts of unpublished papers that are to be found in the Levy archives. These continued almost until his death in 1996. Many deal explicitly with the changes in financing and ownership that had taken place in the decade after *Stabilizing*, which he labeled “money market capitalism.” Minsky was clearly planning another book.

Prominent among these financial changes is the financing of enterprise by equities rather than by bank loans and the acquisition of equities by funds (pension funds, mutual funds, et al.). In that case the precise nature of production firms (whether they are physical-capital intensive or not) becomes irrelevant. The financing of large and medium firms is no longer carried out through the banks, so the firms are less relevant to the financial system. It’s tempting to speculate that the shift from bank to equity finance reflects, at least in part, a growth in the size of the modal firm in the U.S. economy. In any event, the fund managers have taken over. Meanwhile, the banks began to look for other sources of earnings; the proliferation of vehicles for earning interest and betting on appreciation is too well known to require elaboration. In the last decade this was tied in with the boom in housing. One can only speculate whether, had the boom been in some other sector, it would have led to the same outcome; my own guess is that it would have.
I shall concentrate on two of the many drafts in the Minsky archives: a paper on reform or reconstitution of the financial structure, which he presented at a conference in Turkey (Minsky 1992), and that of his planned testimony to the House committee on Glass-Steagall reform or repeal (Minsky 1995).

In the 1992 draft, Minsky begins with a discussion of required changes in financial structure, a major element of which, he argues, is recognition of the fact that “the role of organizations chartered as banks in providing financial services in the United States has been much reduced” (1992, sec. III).

In a brief historical sketch, he notes that the financial linkages connecting the capital assets of the economy and the wealth of households have undergone marked changes over the history of capitalism. There was a progression from “commercial capitalism,” in which banks primarily financed commerce, not production, to “finance capitalism,” which was the era of the big banks and finance houses which imported funds from abroad to build canals and railroads, primarily in the 19th century. The Depression and WWII constituted a hiatus. But with recovery the wartime household savings led to a large number of small holdings of stocks. This meant that management of many of the great firms was virtually free of stockholder control. This era can be characterized as managerial capitalism.

In terms of the breadth of ownership of wealth the United States may be called a people’s capitalism. However, over the postwar era, aside from the ownership of houses, this people’s capitalism has increasingly become a capitalism of owners of interest in funds. Households own interests in funds, be they pension funds, mutual funds or annuity liabilities of insurance companies. These funds make up a great body of managed money. The managers of this money have a great impact upon what is financed and the way it is financed. This stage of capitalism which is currently in the ascendancy can be called money manager capitalism. …

Much of what has taken place in the financial markets of the United States (and perhaps the world) in the past decades can be explained by the omnivorous demand of these funds for assets, their impetuous pursuit of short term performance and the ingenuity of market operators in developing instruments for such managed portfolios. …

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12. A companion piece about the problems of transition from communism makes fascinating reading, but I shall not discuss it here. These he also labeled as projected chapters for a book.
Systemic over indebtedness may well be a legacy of the emergence of Pension Funds in the United States. Over indebtedness was the initial condition hypothesized by Fisher for the debt deflation process that in his view led into the great depression of the 1930's. (Minsky 1992, sec. III)

Here Minsky refers to “pervasive casino capitalism.”

At the same time, a different phenomenon arose as a result of Paul Volcker’s high interest policy, which destroyed the equity of the banks and encouraged them and the savings-and-loan organizations to engage in risky behavior, such as leveraged buyouts. Volcker’s policy was part of his successful attempt to combat the inflation and rise in nominal interest rates of previous years. The resulting inflow of financial capital and balance-of-trade deficit hit certain areas (steel, automobiles, inter alia) very hard, as became manifest in the Rust Belt. 13

As to other trends in bank behavior:

Electronic funds transfers and especially credit cards may well be breaking the hold of commercial banks on the payment mechanism. The main economic innovation of the credit card is the vender’s discount…[which] together with the economies of the electronic based processing systems that have emerged, have created a profit yielding payments mechanism. …

Banks cannot compete with money market funds unless they first transform the check system into an independent profit center. This will only take place when banks succeed in substituting debit cards for checks, keep a vender[’]s discount on debit card payments and fully price checks… (Minsky 1992, sec. III)

Elsewhere Minsky expresses a favorable view toward such fee-for-service sources of income for the banks, as an accompaniment to the proposals for 100% reserve banking.

Invoking a contrast between Adam Smith and Keynes, Minsky contrasts the invisible hand to inherent instability:

From the Smithian point of view the endogenous generation of debt deflations is a non-starter. Inasmuch as debt deflations and threats of debt deflations (often called systemic instability in today’s discourse) do occur, the Smithian program needs to impute these events to

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13. My thanks to an anonymous referee for stressing this point.
deviations, however minute, from free markets. Thus deregulation is a preferred policy option.

From the Keynesian point of view the susceptibility of the financial and economic interactions to a debt deflation reflects a transformation of financial structures from being robust to being fragile as a normal reaction of agents in the economy to the successful operation of the economy. (Minsky 1992, sec. IV, my emphasis)

Something fairly similar appeared in Stabilizing an Unstable Economy and other later papers:

Keynesians and macroeconomists in general need to distinguish between relative price flexibility and price-level flexibility. Relative price flexibility serves a useful purpose in resource allocation, whereas the usefulness of price-level flexibility in response to excess supply of labor is questionable. (Minsky 1996a, 80)

But while price-level flexibility may not eliminate unemployment, the level of money prices does matter:

... in a capitalist economy resource allocation and price determination are integrated with the financing of outputs, positions in capital assets, and the validating liabilities. This means that nominal values (money prices) matter; money is not neutral. (Minsky 2008/1986, 159-160)

I interpret this to mean that changes in the level of money prices are not neutral.

A period of success leads to conditions conducive to failure. This process and its effects can be contained by apt interventions, and apt interventions are possible if policymakers, as legislators and administrators, understand the flaws in market mechanisms that lead to the undesired results. In particular, “interventions to prevent or contain the need for units to make positions by selling out positions and devises [sic] that sustain aggregate cash flows are needed for capitalist economies to function well” (Minsky 1992, sec. IV). 14

14. He is concerned, incidentally, about the large part of costs and incomes that are not due to the actual costs of production but rather to the ancillary costs of marketing, advertising, etc. These are included in prices. Casual observation suggests to me that these costs may be even higher today, relative to ‘physical’ costs of production, than they were at the time of writing. However, he expressed concern that the decline in spending as these higher paid recipients consumed less (?) would impose a deflationary bias to the economy. This is one of the few places where Minsky got it wrong; he noted that fact in some of his late writings.
Underlying [any] program of reform lies a model of the model. Unfortunately as the need to reform the financial system is evident, the underlying model maintained by much of the administration, central bankers and even the Congress [] seems to be Smithian. One bit of evidence which indicates the Smithian bias in the policy establishment is that the discourse is often framed in terms of achieving a financial structure that minimizes the potential “Cost to the tax payer” of sustaining the payments mechanism, rather than in terms of achieving a financial structure that will facilitate doing the capital development well so that the United States can achieve and sustain a close approximation to [a] full employment economy that is also internationally competitive. (Minsky 1992, sec. V)

In 1995 Minsky prepared to testify to the House on repeal or amendment of the Glass-Steagall Act (Minsky 1995). As I read it, he hadn’t really made up his mind whether it was a good idea or not to repeal Glass-Steagall: would it make a difference? It seems he was uncertain, nor was he alone in that. Nevertheless, his discussion of the issues is both interesting and incisive. It gives us some insight into an understanding of what he was predicting with respect to the future path of banking, at any rate in the United States.

In a brief survey of the history of U.S. banking from 1788 to the present, he notes that the Glass-Steagall Act separated commercial banks (specializing in commercial, self-liquidating loans) from investment banking on the grounds that supervisors would more easily understand the ‘routine’ operations of the former, whereas the investment banks were supposed to be innovative and hence more difficult to supervise.

The insurance schemes that were established as part of the legislation were not needed until the 1980s, at which time there were commercial bank failures, which the FDIC was able to cover, and S&L failures, which the insuring agency could not cover and that required rescuing by the federal government. The insurance agencies weren’t looking when the S&Ls and banks went into construction and land development, which they weren’t supposed to—their legitimate territory was solely the financing of home loans. But the very high interest rates of the late 1970s and 1980s destroyed the net worth of the S&Ls, so the supervisors let them venture into new areas, such as construction and, land development, and,

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15. The bill was finally repealed by the Gramm-Leach-Bliley Act in 1999. The jury seems to be still out as to whether or not the repeal was either necessary or effective and specifically whether the repeal contributed to the events of 2007–2008.
16. References to the destruction of bank net worth by high interest rates arise frequently in Minsky’s discourse. It reminds us again that he served as a director of a bank for 30 years.
notoriously, acquisition of junk bonds.\textsuperscript{17} From the vantage point of 2014 this raises the issue of the possible disjunction between the legal and institutional/legislative framework and the actual sophistication or vigilance or dedication of the supervisory and enforcement agencies.

Minsky felt that, with modern electronics, telephone banking, and the ATM, “the monopoly power due to location, which was important when the Glass-Steagall Act was passed, has been much diminished” (1995, 7). (Today, of course, this is even more the case, with online banking.) Now, he argued,

…banks are special only because their liabilities serve as part of the money supply. It is still believed that any serious disruption of the ability of banks to meet their commitments on that part of their liability structure that is part of the money supply would lead to serious disruptions of the economy. The model of the economy that underlies the treatment of banks as something special, both in their chartering and in the government’s protection of the value of their deposit liabilities, needs to lead to propositions which assert that if some banks fail and their deposit liability holders are not “made whole” by government intervention then a serious depression is likely to occur. In other words financial instability, such as we experienced between 1929 and 1933, is a necessary and perhaps even a necessary and sufficient condition for a great depression… (Minsky 1995, 8-9)

At the time Glass-Steagall was passed, banks served a number of purposes: giving information to other banks about local business, vetting business propositions and profitability, estate management, and so on. Now, he says, these functions are not needed and are provided by other institutions. (However, later in the document he seems to contradict this.) The only really necessary function of a bank is to provide legal money. In this case there is something to be said for 100% reserve money. It was worth considering the advocacy of Henry Simons and Irving Fisher for 100% money, the idea being that capital development and the creation of money should be separated.\textsuperscript{18} There is a slight disjunction here, since at one point he noted the function of the bank in advising and financing small businesses, executing wills, and similar activities.

\textsuperscript{17} The entry of S&Ls and banks into real estate was also encouraged by the drying up of the traditional channels for bank lending that accompanied the development of fund ownership and equity financing of firms.

\textsuperscript{18} In the wake of the recent J. P. Morgan escapade, the notion of separating money creation from the supply of finance seems increasingly attractive.
Minsky’s testimony proceeds to a detailed exploration of the possible/probable outcome of repeal: universal bank holding companies, which hold different kinds of financial companies or institutions, each with its own capital position, riskiness of assets, and type of activity. Presumably these are to be isolated from one another. In hindsight, I suggest that he did not accurately predict the permeability of the walls between these ‘separate’ banking departments. Perhaps the following shows where he went wrong:

Every universal bank will need to set a precise limit to the equity it allocates to merchant banking activities. Given the size of the possible capital losses and gains in such merchant banking, some means of “insulating” commercial banking activities from merchant banking activities of conglomerate organizations chartered as universal banks will be necessary. …

The development of what can best be called money manager capitalism, in which mutual and pension funds are the dominant proximate “owners” of the equity and debt liabilities of corporations[,] is a major change in financial arrangements since the 1930’s reconstruction of the financial system. These mutual and pension funds presumably act for the benefit of the households who are the ultimate owners of the assets these organizations have in portfolio: they stand in a fiduciary relation with the owners of their liabilities.

There is ample evidence that the ethics that guides many operators in the financial services industry, including some in our most prestigious outfits, is summarized by a remark cited in The Economist in April 1994: “If God had not meant them to be sheared, He would not have made them sheep” [Hodgson 1994]. …

Given the evolution of institutions over the past decades I would like to suggest that those institutions which manage money and are in a fiduciary relation with households be separated from institutions whose primary focus is upon trading and investing for the benefit of the owners of the firm’s capital and their staff whose compensation is based upon performance. Universality may well exclude pension and mutual funds.

Thus even as the wall between investment and commercial banking that found expression in the Glass Steagall separation in the 1930’s we may need a new separatism as the 21st century approaches, one that separates investment banking and the managing of mutual and pension funds. Managers of mutual and pension funds are presumably in a fiduciary relation with the owners of positions in the
funds. The personnel of a broad post Glass Steagall “Bank” are guided by profit maximizing and own income. The fiduciary and the merchant banker-trader are different personality types and have quite different objectives. Thus a Bank holding company may well be forced to choose between having an investment bank or a mutually [sic] fund management affiliate.

A possible adverse effect of universal banking is that the number of independent banking institutions will decline even as their equity bases are likely to increase. The natural financing habitat of a banking institution is given by its capital accounts and a prudential limit on its exposure to any one account. This natural habitat will increase as the consolidation of banking into fewer but larger institutions takes place. This evolution would leave unsatisfied pockets of potential bank clients. Any formal move towards universal banking will need to meet such unsatisfied fringes by allowing entry into banking to be relatively unrestricted.

The elimination of Glass Steagall does not guarantee that either the safety and security of the payment mechanism will improve or that the financing of the capital development of the economy will be done any better than under the old regime. Perhaps it is of greater importance to think through how the emergence of the new dominant player in finance, the pension and mutual funds, affects the capital development of the economy. (Minsky 1995, 19-22, my emphasis)

In sum, Minsky (1995) saw issues and problems ahead, and he hadn’t worked out how they would—or should—be handled. I venture to suggest, however, that despite the very sophisticated understanding of the financial establishment that he possessed, he like many others underestimated the aggressiveness, ingenuity, and sheep-shearing abilities of a number of agents in the financial sector in the decade after his death, as well as the failure, or absence, of oversight and the lack of insistence on the separation of functions, which he had advocated and perhaps taken for granted. However, Minsky was confident of the ability of the authorities to handle any problem, if the will existed.

[The] assurance that cash flows will be sustaining is provided by the combination of a fiscally prudent big government, which by its deficits can sustain profits, wages and government tax receipts, and central bank lender of last resort operations, which in the modern world not only support liquidity but also the equity base of institutions whose failure, it is felt, may trigger systemic instability. (Minsky 1992, sec. III)
That is, ‘too big to fail.’

In 1996 Minsky was granted the Veblen-Commons Award, given by the Association for Evolutionary Economics. His speech for the award ceremony was, to the best of my knowledge, his last publication (Minsky 1996b). Here he reaffirms his long-standing identification as an institutionalist and notes that Keynes evidently was one, as well. I suggest that this publication shows us the way Minsky was going at the time of his death. He starts with a summary of what is to follow; a summary of his summary follows here.

Minsky (1996b) welcomed Thomas Sargent’s *Bounded Rationality in Macroeconomics* (1993) as a recognition of the importance, stressed by Keynes, of uncertainty (as distinguished from risk) in economics. Its incorporation in economics was, however, incomplete, he asserts, because the New Classical economists continued to restrict their analysis to the real sector. Minsky (1996b) throughout is concerned with the inclusion of money in the model and its (money’s) endogeneity:

Keynes aimed to develop a theory of an economy in which, because of its structure, money cannot be neutral. He achieved this by dividing prices into those which are dominated by the need to recover costs and those which are determined by the value placed upon future income flows. The former consisted of the current outputs of current consumption and investment goods, and the latter consisted of the prices of the outstanding financial and capital assets.

The bounded rationality approach retains the assumption that preference systems are over the reals and that outputs and relative prices can be determined independently of monetary and financial variables. The impact of nominal values and financial relations are only of transitory significance. …

A premise of Keynesian modelling is that the capitalist economy cannot be understood by splitting it into a real and a financial or monetary sector. Keynesian modelling holds that a basic aspect of the structure of capitalist economies is given by interrelated balance sheets, income statements, and the time series of cash flow commitments that are embodied in financial instruments. (Minsky 1996b, 361)

We see that Minsky’s theme of the non-separability of the money and the real sectors of the contemporary capitalist economy has remained through the decades.

Minsky emphasizes the significance of the new stage of American capitalism, “money manager capitalism,” which he had discussed and explored in earlier papers.
The total return on the portfolio is the only criteria [sic] used for judging the performance of the managers of these funds, which translates into an emphasis upon the bottom line in the management of business organizations. It makes the long view a luxury that only companies that are essentially owned by a single individual and that are not deeply dependent upon external financing can afford. (Minsky 1996b, 358-359)

Capitalism is different in different countries.

For the United States, the financial stages of American capitalism can be characterized as: commercial capitalism; industrial capitalism and wild cat financing; financial capitalism and state financing; paternalistic, managerial, and welfare state capitalism; money manager capitalism. …

[T]he evolution has been from a financial structure where external finance was mainly used for trade to a structure where there is ever greater use of external funds to finance the long-term capital development of the economy. (Minsky 1996b, 362)

The public dislikes uncertainty. In its time, Minsky says, the New Deal reduced uncertainty. For example, agricultural price supports in the New Deal promoted the mechanization of agriculture and a huge productivity increase. But “[t]he evolution of the economy has decreased the effectiveness of the New Deal reforms, and money manager capitalism has radically increased uncertainty” (Minsky 1996b, 359). What is required is big, and presumably variable, government. New institutions are required to limit the effects of uncertainty. “The success of business in the era after World War II was assured by rigging the game in favor of business profits” (ibid., 364). This advantage too has been eroded in recent decades. “For a modern capitalist economy to be able to avoid debt deflations, and therefore great depressions, governments need to be able to run deficits when the incentive to invest by the business sector is compromised” (ibid.).

He concludes with an inventory of measures which will reduce “the insecurity bred by the attenuation of the effectiveness of the New Deal structures along with the heightened uncertainty due to money manager capitalism” (Minsky 1996b, 359). He is concerned about the size of the federal deficit and recommends a reform in the tax structure designed to lessen it. At the same time, he advocates a large Federal sector, so that there will be ability to vary this as needed in response to private sector fluctuations. He refers to the need for rethinking the system of intervention in capitalist economies that evolved out of the New Deal. In
particular, there is a need to make full employment the main goal of economic policy. “A full employment economy is supportive of democracy whereas an economy based on transfer payments supports resentment” (ibid., 367). (On that one, perhaps, the Tea Party might agree with him.) Furthermore, a large government budget allows provision of public goods, which promote social stability. “Wide disparities in personal incomes and wealth are compatible with a well-functioning society, as long as ambience, health care, and education incomes are available and open to all” (ibid., 365).

The policy recommendations are similar to those which constitute chapter 13 in Stabilizing, but an additional one mentioned there is noteworthy: to eliminate the corporate income tax. “A corporate income tax…induces debt-financing and is therefore undesirable. A corporate income tax also allows nonproduction expenses such as advertising, marketing, and the pleasure of the executive suites to be charged against revenues in determining taxable income” (Minsky 2008/1986, 340). When Minsky wrote this, U.S. corporate profit tax rates were of the same order of magnitude as those of the rest of the OECD countries. Since then, most of the others have been halved, leaving the U.S. with rates roughly twice that of most of the rest of the world. The incentive to switch corporate registration abroad to avoid these taxes has been widely discussed by both ‘right’ and ‘left.’

What would Minsky have said about the events of 2007 and after? I expect that it would be as different from what he said in 1996 as the latter was from the analysis of 1986. His basic epistemological, theoretical, and political position remained unchanged over the years. The specifics of the analysis and policy recommendations were adapted to the changing facts on the ground. Today I suppose that he would emphasize that the government should be an employer of last resort, especially in relation to young people, and I think he would tie this in with infrastructure development—replacement and addition. More than that, I do not have the chutzpah to guess.

References


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Skepticism About Minsky’s Financial Instability Hypothesis: A Comment on Flanders

Lawrence H. White

Hyman Minsky was an important heterodox monetary economist. His work has enjoyed increased academic and public attention since the 2008 crisis, manifestations of which include republications of his books, an Elgar Companion to Hyman Minsky (Papadimitriou and Wray 2010), and several blog mentions by Paul Krugman (e.g., 2009), in addition to the examples that June Flanders (2015) gives. From my perspective Minsky’s writings are often insightful and thought-provoking, particularly as they concern developments in modern banking and finance. It is clear that he was on to something. But seldom do I find him persuasive about the causes of observed developments. Flanders’s paper, based on a diligent study of the online archive of Minsky’s unpublished work, provides a useful introduction to his views. Where her account of Minsky’s argument seems to involve non sequiturs, the fault is generally due to Minsky rather than to Flanders.

In an earlier survey of Minsky’s thought, Perry Mehrling (1999, 129) rightly noted that Minsky was rooted in “the American institutionalist tradition of monetary thought, a tradition deeply influenced by roots in American progressivism.” Mehrling observed that Minsky drew ideas from four prominent economists: Henry Simons, from whom he took an antipathy to debt finance; Oskar Lange, from whom he took market socialism as an ideal; Alvin Hansen, from whom he took a Keynesian emphasis on aggregate demand failures; and his dissertation ad-

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viser, Joseph Schumpeter, from whom he took the idea that entrepreneurial capitalism subverts its own institutions.

Flanders (2015, 89) offers a more surprising comparison: “In some respects Minsky’s analysis is not unlike Hayek’s.” I see some commonalities. Both Minsky (1994) and Hayek (1931) put intertemporal coordination failure at the heart of business cycle crises. The crisis reveals a mismatch between the plans of debt-financed investors—that is, plans to sell future output for enough revenue to repay the debts incurred in financing their projects—and the plans of consumers—that is, plans to buy future output at such cost-covering prices. Both Minsky and Hayek (under certain conditions) propose that the commercial banking system, independently of the central bank, can be expected to act in a way that amplifies cyclical fluctuations in the economy. For Hayek, however, this is only one of three possible scenarios (and the only one in which one can say, as does Flanders, that Hayek treats money as endogenous). Hayek gives more emphasis to two other scenarios in which exogenous money injections by the central bank (either to lower interest rates, or to stop them from rising in response to an increased demand for loanable funds) are to blame for interest-rate distortion and intertemporal discoordination. For Minsky, by contrast, the commercial-banking amplification of fluctuations is essential. It is the foundation of what he calls the “Financial Instability Hypothesis.” Minsky slights or rejects the normal role of the financial system in coordinating intertemporal plans, a role that Hayek (2007/1941) emphasized in his debate with Keynes.

Hayek’s arguments for expecting disequilibrating commercial bank behavior are weak, (White 1999a; 1999b), and for like reasons so are Minsky’s. Essentially, they rest on implausibly non-optimizing behavior by bankers, plus an unexplained failure of freely determined interest rates to clear intertemporal markets. We do not get a satisfactory account of why, in the absence of exogenously shifting constraints, we should find investors, in Flanders’s words, “systematically behaving in a way that leads to increasingly speculative activity” (2015, 85).

Minsky’s analysis shares a few features with the banking analysis of the modern free banking school. Neither is institutionally antiseptic. Both stress the importance of a sound monetary and banking system for macroeconomic stability. But the two views differ in fundamental respects. Following Henry Simons, Minsky considers debt-based finance, and a fortiori debt-funded intermediaries like banks, to be inherently unsound. He recognizes no tendency in the financial system toward intertemporal equilibrium, even in the absence of external disturbances. Instead the financial system tends to puff itself up until it explodes. In Minsky’s words, a “theorem [of the financial instability hypothesis] is that, over periods of prolonged prosperity, the economy moves from financial relations that make for a stable system to those that make for an unstable system” (1994, 157). In contrast to
George Selgin (1988) and myself (White 1999c, ch. 3), Minsky offers no baseline model of equilibrium in a competitive banking system. His theory of free banking, unrestricted and unprivileged, is entirely undeveloped and hence unavailable for critical scrutiny (see Selgin 2014).

Minsky refers to “money of the kind we have, which is created by banks as they finance capital asset production and ownership” (1982/1978, 91). It is important to recognize that we actually have two kinds of money today, the kind issued by commercial banks (checking account balances, which are IOUs) and the kind issued by the state (fiat money units, which are IOU-nothings). It would be a mistake to think that we only have the first kind. It would also be a mistake to think that the volume of checking account balances identically equals the volume of bank loans, or that banks automatically issue money in amounts corresponding to the quantity of investment and housing loans demanded by approved borrowers. Banks fund loans with non-deposit as well as deposit liabilities, and they intermediate deposit liabilities into non-loan assets (e.g., by holding reserves or bonds) as well as into loan assets.

Absent accommodative central bank intervention to enlarge the quantity of base money (currency plus bank reserves), the first effect of an increase in the demand for loanable funds is to drive up interest rates. The volume of commercial-bank-issued money increases only to the (possibly minor) extent that the public wants to hold additional monetary deposits (per unit of base money) at higher interest rates. Because market forces constrain the quantity of commercial-bank-issued money, it is not a market-disturbing kind of money. Disturbances come rather from central bank actions, particularly changes in the volume of base money.

Part of the reason that Minsky’s work is hard (at least for conventional and Austrian economists) to follow is that he does not reason in terms of the supply and demand for money, nor in terms of monetary equilibrium and disequilibrium. For reasons I don’t grasp, he rejects even the basic Quantity Theory propositions that for a fiat money economy (1) there is a price level that clears the market for money balances, and (2) in a ceteris paribus comparative statics thought experiment the quantity of money is neutral toward real variables. Minsky writes that the “innovative characteristic of banking and finance invalidates the fundamental presupposition of the orthodox Quantity Theory of money to the effect that there is an unchanging ‘money’ item whose velocity of circulation is sufficiently close to being constant” (1994, 156). The statement suggests a serious misunderstanding of the theory. The Quantity Theory is a ceteris paribus theory. It isn’t refuted by saying that in practice other things do not remain equal over time.

Moreover, understood in comparative-static terms, the Quantity Theory does not rest on any presupposition that the velocity of some monetary aggregate remains close to constant over historical time. All that rests on such a presup-
position is the claim that constant growth in a monetary aggregate (viz., enactment of Milton Friedman’s ‘k-percent rule’) will yield a constant rate of inflation. But that is something distinct from the Quantity Theory.

Whether the nominal revenues of firms are sufficient in the aggregate for them to repay bank loans at a normal rate (and default at a normal rate) depends in part on whether the public’s nominal spending is great enough. Minsky does not use the equation of exchange to decompose the size of nominal aggregate demand into the quantity of money times the velocity of money, but rather, in Keynesian C+I+G fashion, he takes aggregate demand to vary mostly with aggregate investment. Declining to think in terms of the equation of exchange, or the supply and demand for money, prevents Minsky from offering a satisfactory explanation of inflation. As Mehrling (1999, 146) notes, “Inflation was difficult for Minsky to understand because of the thoroughgoing nominalism of his thought. … In Minsky, there is no margin along which the ‘real’ value of money might be established.” Institutionalism without reference to the rate at which the quantity of dollars is growing simply doesn’t explain the rate at which the purchasing power of the dollar is being diluted, that is, the inflation rate.

Minsky offered a three-fold distinction among banks’ default risk positions, referring to “hedge,” “speculative,” and “Ponzi” positions. Basically, “hedge” finance means low leverage and a very low risk of default, “speculative” means higher leverage and higher risk, and “Ponzi” the highest leverage and the highest risk. Fragility in the banking system grows if banks shift toward higher risks of default. That much is a classificatory truism, not an explanatory theory. There would seem to be potential non-truistic explanatory power in the Financial Instability Hypothesis (FIH), which proposes that a banking system tends on its own to move from robust to fragile. In Mehrling’s account, “this is so because in a world of uncertainty, especially endogenous uncertainty, expectations about the future have little objective foundation so that mistakes are inevitable” (1999, 141).

But the FIH does not in fact follow from uncertainty. Mistakes do not imply a systematic tendency in one direction. It needs to be explained why mistakes are not randomly distributed around an unbiased mean. We should expect systematic mistakes to trigger correction mechanisms. A natural stochastic equilibrium concept is therefore that of a system where the realized frequency of borrower defaults varies randomly around the expected frequency of defaults, creating no chronic tendency toward increasing banker optimism (or pessimism). As George Stigler (1984) once noted, attributing something to errors isn’t a helpful explanation “unless I manage to explain when errors are made and why and what kind…since one of the graceless things about errors is that they can come from anywhere and go in any direction.”
If, in standard fashion, we regard banks as optimizing agents, then to explain why they shift to riskier positions we need to appeal to parameter changes that cause them to change their chosen positions. What prompts banks to “drift to” speculative activities, as Flanders (2015, 92) puts it, when they do, and not sooner, given that they could have been pursuing those activities all along?

Note that the observed instability in current-day banking regimes is not prima facie evidence for the hypothesis that a banking system makes itself fragile. Current-day systems are characterized by central banks and other government agencies with the power to disrupt the system.

Accordingly, an appeal to swings in investor optimism/pessimism or ‘animal spirits’ is not wrong, so much as it merely pushes the question back one stage: What explains the swings in investor enthusiasm? In the main Mises-Hayek scenarios, it is variations in central bank policy that enlarge or narrow the apparent prospects for profitable investment. Somewhat more generally, to use Roger Koppl’s term, “Big Players” in the economy can stimulate investment through cheap money or targeted tax cuts, or discourage it through tight money, tax policy, or greater regime uncertainty (see Koppl 2014, 130-131; van den Hauwe 2014). Koppl rightly notes that, by contrast to the Big Player approach, “The financial fragility hypothesis of Hyman Minsky does not have a clear mechanism or clear empirical implications” (Koppl 2014, 40 n.12).

Mehrling (1999, 145) describes Minsky as concerned that, with a decline in animal spirits, investment spending will collapse and thus “reduce aggregate demand and so also aggregate income sufficiently that cash flows elsewhere in the economy fall short of their expected levels, so turning hedge finance units into speculative units, speculative units into Ponzi units, and so increasing the fragility of the system.” To the extent that causation runs from a reduction in nominal aggregate income (for whatever reason) to an increase in financial fragility—which is certainly a plausible linkage—then financial fragility is a symptom of macroeconomic trouble rather than an independent and self-feeding source of trouble. What banks experience is not mood swings that lead them to take positions of greater risk, but bad draws in the optimizing risk positions they have already taken.

It would also be a non sequitur to conclude from the FIH, were it to survive empirical evidence, that on cost-benefit grounds the government should be assigned either the task of correcting bank finance strategies in good times or the task of providing a lender-of-last-resort safety net in bad times. Government agents assigned such a task might be no less immune than investors to waves of optimism and pessimism, and as a result might (say) encourage greater leverage in housing finance in good times. It might be that an official lender of last resort facing no insolvency constraint, such as the Federal Reserve Bank of New York, becomes captured by the major banks who stand to benefit from bailouts and forbearance.
A lender of last resort might generally create moral hazard costs in excess of its benefits. My hypothesis is that, in practice, the behavior of official regulators and lenders of last resort is not wiser or more prudent than that of bankers—or private clearinghouse association officers—with skin in the game, who are left unrestricted but also unsheltered.

I find that David Prychitko (2009) and Ludwig van den Hauwe (2014) usefully contrast Minsky’s FIH to the Austrian theory of the business cycle. Unlike the Austrians, Prychitko (2009, 200) notes, Minsky neglects “the role that money plays in initiating the cycle by distorting relative prices within the capital structure.” As a result, “the so-called Minsky moment—a feature of the recent housing bubble—is something that the Austrian theory of the cycle is already fit to explain” (ibid.). To explain an episode of increasing leverage, as seen in investment banks during the 2002–2007 housing bubble, an Austrian account points mainly to two factors: (1) cheap-money central bank policies that fed rising housing prices, which reduced current defaults and perceived default risks on mortgage-backed securities; and (2) with other neoclassical economists, housing-finance policies that increased morally hazardous behavior by lenders and borrowers. Flanders (2015, 100-101) quotes Minsky as recognizing the moral hazard factor created by too-big-to-fail policies, but not the cheap-money factor. Van den Hauwe (2014, 21) notes that both Minsky and the Austrians see trouble building during the upswing, whereas Keynes focused on the problems of the slump. But where the Austrians look to decentralized and competitive monetary and banking institutions to constrain the unsustainable boom, Minsky pins his hopes on better behavior by the big players: regulatory, monetary, and fiscal policymakers.

To evaluate possible reforms, we need to ask: Which institutional arrangements foster more financial fragility, which less, and why? To answer those questions it helps to look across different historical banking regimes to see where fragility was less, a method neglected by Minsky and Flanders. Doing so will be an eye-opener to anyone who thinks that banking is inevitably fragile. The broad lesson I draw from comparative historical studies (Cameron et al. 1967; Dowd 1992; White 1995; Briones and Rockoff 2005; Calomiris and Haber 2014) is that free banking systems are naturally robust—or even antifragile (White 2013). In such systems the banks that behave prudently, with adequate capital, liquidity, and diversification of assets and liabilities, are the banks that survive. Crisis-prone banking systems are those in which legal restrictions and regulatory institutions have weakened banks’ incentives or muted the survival advantage of operating prudently.
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