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INEQUALITY AND STAGNATION BY POLICY DESIGN: MAINSTREAM DENIALISM AND ITS DANGEROUS POLITICAL CONSEQUENCES

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ABSTRACT

This paper argues the mainstream economics profession is threatened by theories of the financial crisis and ensuing stagnation that attribute those events to the policies recommended and justified by the profession. Such theories are existentially threatening to the dominant point of view. Consequently, mainstream economists resist engaging them as doing so would legitimize those theories. That resistance has contributed to blocking the politics and policies needed to address stagnation, thereby contributing to a political vacuum which is being filled by odious forces. Those ugly political consequences are unintended, but they are still there and show the dangerous consequences of the death of pluralism in economics. The critique of mainstream economists is not about "values" or lack of "change": it is about academic practice that suppresses ideas which are existentially threatening.

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Abstract

This paper argues the mainstream economics profession is threatened by theories of the financial crisis and ensuing stagnation that attribute those events to the policies recommended and justified by the profession. Such theories are existentially threatening to the dominant point of view. Consequently, mainstream economists resist engaging them as doing so would legitimize those theories. That resistance has contributed to blocking the politics and policies needed to address stagnation, thereby contributing to a political vacuum which is being filled by odious forces. Those ugly political consequences are unintended, but they are still there and show the dangerous consequences of the death of pluralism in economics. The critique of mainstream economists is not about "values" or lack of "change": it is about academic practice that suppresses ideas which are existentially threatening.

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Keywords: Income inequality, stagnation, neoliberalism, Keynesianism, pluralism.

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1. Ideas and interests: the debate over inequality and stagnation

The scientific method rests on the principle of falsification (Popper, 1959), but science does not operate in a vacuum. Instead, it operates in a social context in which competing interests can interfere with the process, and the history of science is replete with examples of such. If a theory is sufficiently threatening to the *status quo* it may be denied hearing, or even actively suppressed, and this may be done all the while invoking the name of science. Such behavior is a real possibility in economics as the distribution of income and wealth rests, in part, on the explanations economists provide which rationalize and justify existing patterns.

This paper argues the increase in inequality, the financial crisis of 2008, and the ensuing stagnation are substantially attributable to neoliberal policy design. Design must be distinguished from intention. The triumph of neoliberalism means that economic policy over the past forty years has been designed according to neoliberal ideas, and that policy design contributed significantly to the current situation. However, though aiming to increase the profit rate and the power of capital relative to labor, neoliberal policymakers did not intend to create financial crisis and stagnation. The latter were unintended consequences of neoliberal policy.

The fact that neoliberal economic policy has created those damaging outcomes now creates a scientific dilemma for mainstream economists. Those economists are existentially threatened by theories that explain the financial crisis and stagnation as resulting from policies they justified and recommended. Merely acknowledging the possible legitimacy of those theories would be analogous to signing one's own death warrant. Consequently, mainstream economists resist engaging them to avoid legitimizing them.

That resistance has contributed to blocking the politics and policies needed to address stagnation, thereby contributing to a political vacuum which is being filled by odious forces. These ugly political consequences are also unintended, but they are still there. When wrong-headed ideas get to rule the roost, powerful sociological and economic interests may keep them in charge and the unintended consequences can be ugly.

Pluralism is the great social defense against such outcomes. It works by promoting competition of ideas, thereby diminishing the likelihood that wrong-headed ideas prevail. However, pluralism requires a level playing field, and that is no longer the case in economics which is dominated by a neoclassical monopoly (Palley, 2008). That monopoly makes the political challenge of reforming the current neoliberal order even more difficult, which in turn makes the current moment more dangerous and the threat to shared prosperity more enduring.

2. The failures of mainstream economics

A good starting point is recognition that the last decade has not been kind to mainstream economists. They have been repeatedly surprised by major economic developments which have forced economists to come up with “after the fact” explanations. First came the financial crisis of 2008. The failings of orthodox economists were symbolized by the inability of the faculty of the London School of Economics to answer the Queen of England’s simple question (November 5th, 2008) as to why no one foresaw the crisis. After that came the failure to recover from the Great Recession as predicted. Initially, the expectation among mainstream economists was for a quick V-shaped recovery. When that failed to materialize, expectations were downgraded to a slower U-shaped recovery. And when that also failed to materialize, talk turned to L-shaped recovery and then to chatter about stagnation.

The theoretical and analytical failures of mainstream economics are mirrored in the economic forecasts. Figure 1 shows the Federal Reserve’s Federal Open Market Committee (FOMC) projections of real GDP versus actual GDP by vintage, from 2008.Q4 through to 2015.Q4. Actual GDP is shown by the broken line. Predicted GDP is shown by the blue lines – with each blue line being a fresh updated prediction. The figure shows the FOMC totally failed to anticipate the Great Recession (2007.Q4) – the starting blue line is far above the broken black V. During the recession (2008.Q1 – 2009.Q2), the FOMC systematically under-estimated its severity – again the blue lines are above the broken black V. And once the recovery began (2009.Q3 – 2015.Q3), the FOMC systematically over-estimated the strength of recovery – again the blue lines are all above the black line.

Figure 1. FOMC projections of US real GDP growth versus actual by vintage.
Source: Kahn and Palmer (2016)

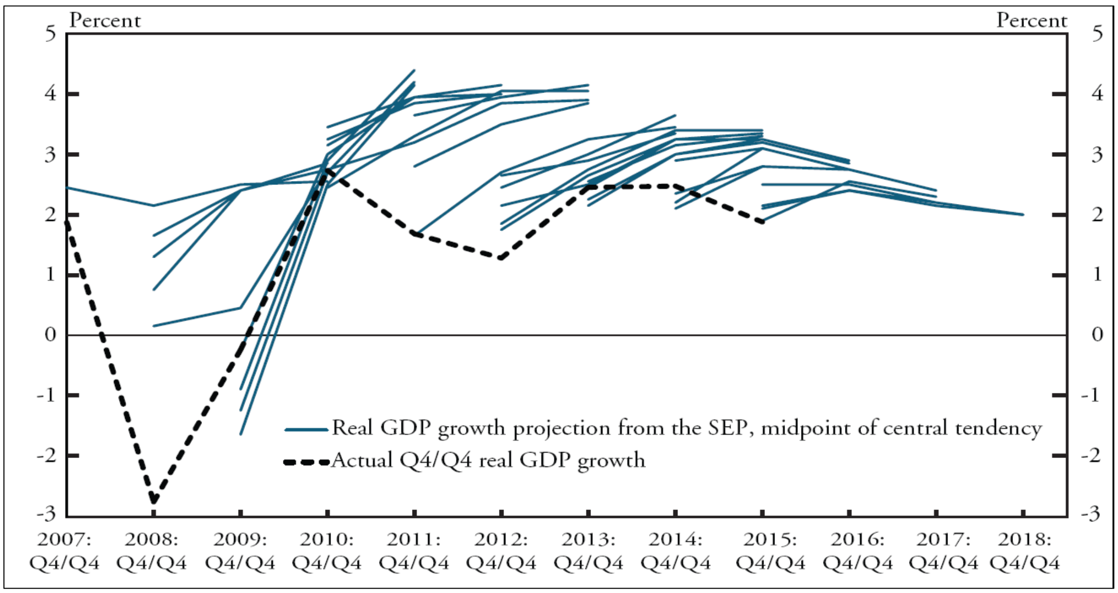
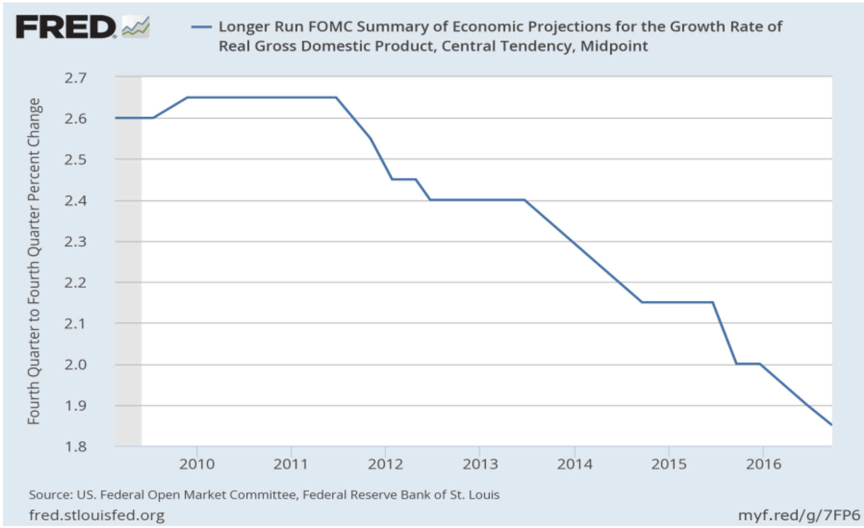


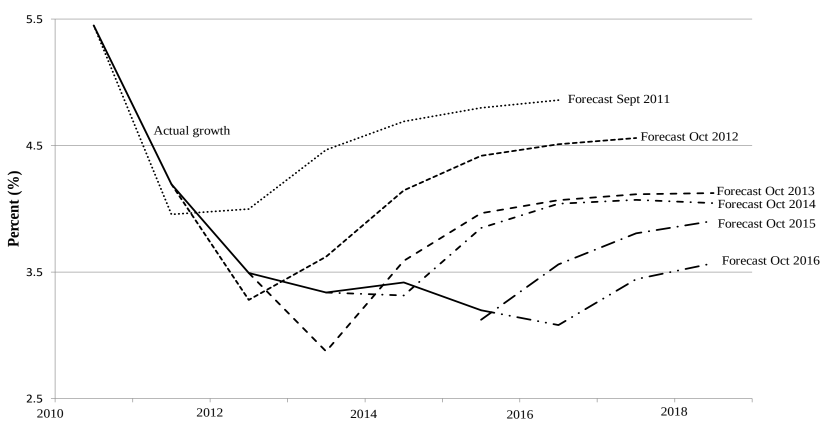
Figure 2 shows the FOMC's estimate of long run growth of potential GDP. After being revised up fractionally in 2009, it has been persistently and significantly revised down, reflecting the slow embrace of the reality of stagnation.

Figure 2. FOMC projections of the US economy's long run growth rate.



Lastly, Figure 3 shows the IMF has also had to persistently revise down its forecast of global real GDP growth, and its forecasts have consistently over-optimistic relative to actual growth. The solid line is actual global GDP growth. The broken lines are IMF forecasts of growth by vintage, and they consistently lie above the solid line.

Figure 3. IMF's forecast of global real GDP growth by vintage.



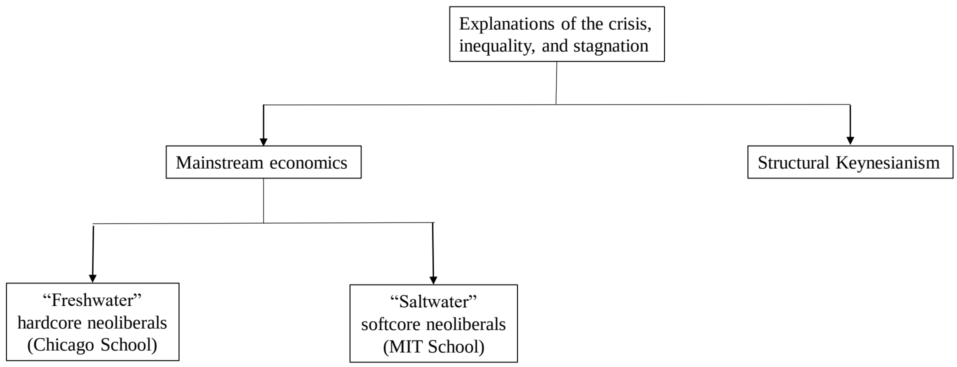
In sum, these figures show the forecasts of leading elite economic policymaking institutions have been systematically wrong. They all failed to anticipate the financial crisis; underestimated the severity of the Great Recession; and have all been persistently over-optimistic regarding recovery. The one-sided nature of the forecast errors suggests something is profoundly wrong with their models. The systematic forecast errors are the empirical twin of the analytical failure of mainstream economics to anticipate events.

3. Economists' response to the crisis, inequality, and stagnation.

The failure of mainstream economics to anticipate developments has forced an on-going process of catch-up. Stage 1 involved attempts to concoct ex-post explanations of the financial crisis and Great Recession. During this period, the issue of inequality began to seep into mainstream explanations of the crisis and recession. Stage 2 has involved developing explanations of stagnation which has further surprised mainstream economists.

Figure 4 decomposes the different responses of the profession to the challenge of explaining the crisis, income inequality and stagnation. The mainstream is divided between the "freshwater" hardcore neoliberal Chicago School response and the "saltwater" softcore neoliberal MIT school response. These twin mainstream responses are contrasted with the "structural Keynesian" account of events (Palley, 2012).

Figure 4. Understanding the debate: competing explanations of the crisis, inequality, and stagnation.



3.a Hardcore neoliberalism

The hardcore neoliberal position can be labelled the *“government failure hypothesis”*. This view is associated with the Republican Party and with the economics departments of Stanford, the University of Chicago, and the University of Minnesota.

Hardcore neoliberals argue the crisis was rooted in the U.S. housing bubble. They claim the bubble was due to excessively prolonged loose monetary policy (Taylor, 2007, 2009) plus politically motivated government intervention in the housing market aimed at increasing ownership (Rajan, 2010).

With regard to monetary policy, the Federal Reserve pushed interest rates too low for too long following the recession of 2001. With regard to the housing market, government intervention via the Community Reinvestment Act and Fannie Mae and Freddie Mac, supposedly drove up house prices and encouraged homeownership beyond peoples’ means.

Hardcore neoliberals explain rising inequality as the result of skill-biased technical progress, which means the labor market has been working as it should (Rajan, 2010). The significance and importance of rising inequality is it prompted politically motivated government intervention in the housing market, which supposedly caused the bubble. Consequently, rising inequality is not an economic problem *per se*, and does not reflect mal-functioning of the economy. Instead, it is an ethical concern and a political problem.

When it comes to explaining stagnation, hardcore neoliberals embrace a collection of arguments. First, there is an argument that the economy remains over-regulated, and the situation has been worsened by post-crisis financial regulation such as the Dodd – Frank Act (2010). According to the hardcore view, the right response to the financial crisis of 2008 should have been to double-down on neoliberal policies rather than to reform them.

Second, the recession and stagnation were deepened by mistaken expansionary fiscal policies that increased government debt, delayed needed economic adjustments, and worsened financial fragility. According to hardcore economists, expansionary fiscal policy is ineffective and stagnation is the result of failure to "bite the bullet".

3.b Softcore neoliberalism

The softcore neoliberal view can be labeled the *"market failure hypothesis"*. It is identified with the Obama – Clinton wing of the Democratic Party, and economics departments such as those at MIT, Yale and Princeton.

The softcore neoliberal view is the crisis was due to excessive financial de-regulation and perverse incentive pay structures within banks. That permitted and Wall

Street to engage in "loan pushing" rather than "sound lending", which generated a housing bubble. When the bubble burst it triggered a financial crisis that deepened an ordinary recession, transforming it into the "Great Recession".

Softcore neoliberals initially ascribed no economic significance to rising inequality which they also explained as due to skill-biased technological change. They also expected the economy to bounce back from recession, which did not happen. That has forced them to also develop a second stage agenda that makes a collection of adjustments aimed at explaining the role of inequality and the failure to bounce back.

The main softcore argument for stagnation is the so-called zero lower bound (ZLB) to interest rates. The claim is the ZLB has prevented monetary policy from lowering interest rates sufficiently to restore full employment (Eggertsson and Krugman, 2012). Subsequently, softcore neoliberals have added an argument about hysteresis (Summers, 2014). According to that argument, the financial crisis and Great Recession caused a "shock" that has permanently lowered the economy's growth rate and increased equilibrium unemployment. However, the details of the hysteresis mechanism are unclear, making the argument a black box.

What about income inequality? Initially, it was viewed as a non-factor and just a political and social concern, but that has also changed under the pressure of facts. Krugman (2013a, 2013b) has made a political economy argument that worsened income inequality twisted politics against the use of fiscal policy. Consequently, the policy response to the Great Recession was inadequate, which contributed to failure to recover. Now, there are indications softcore neoliberals may be turning to borrowing the long-standing Keynesian argument that increased inequality increases saving, which allows them to claim inequality has worsened the ZLB problem by pushing the full employment interest rate even further below zero (Palley, 2016).

The bottom line is both branches of mainstream economics have had to play catch-up and patch their theory. First, they had to come up with explanations of the crisis which they had completely failed to anticipate. After that, they have had to come up with explanations of stagnation which they also failed to anticipate.

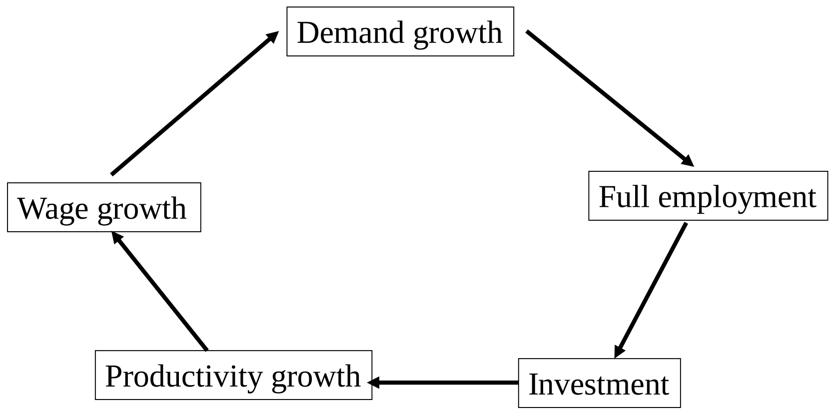
3.c Structural Keynesianism

The structural Keynesian hypothesis holds that the crisis was rooted in the neoliberal economic paradigm which was adopted in the late 1970s and early 1980s and has guided economic policy since (Palley, 2009, 2012). The analytical implication is that the financial crisis, inequality, and stagnation are the result of policy design.

An important feature of the argument is that, though the U.S. is the epicenter of the crisis, all countries are implicated as they all participated in the adoption of a systemically flawed policy paradigm. That is why it was a global crisis.

For the period 1945 - 1980 the U.S. economy was characterized by a "virtuous circle" Keynesian growth model built on full employment and wage growth tied to productivity growth. This model is illustrated in Figure 1 and its logic was as follows. Productivity growth drove wage growth, which fueled demand growth and created full employment. That provided an incentive for investment, which drove further productivity growth and supported higher wages. This model held in the U.S. and it also held throughout the global economy - in Western Europe, Canada, Japan, Mexico, Brazil and Argentina.

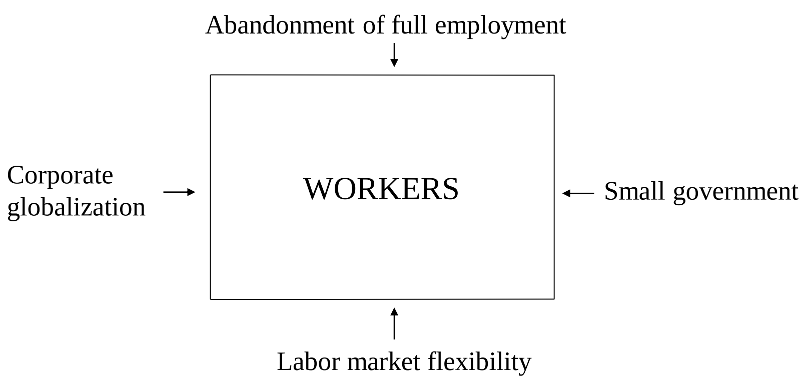
Figure 5. The 1945 – 80 virtuous circle Keynesian growth model.



After 1980 the virtuous circle Keynesian growth model was replaced by a neoliberal growth model. There were two key changes. First, policymakers abandoned the commitment to full employment and shifted to targeting low inflation. Second, policy helped sever the link between wages and productivity growth. Together, these two changes created a new economic dynamic. Before 1980, wages were the engine of U.S. demand growth. After 1980, debt and asset price inflation became the engine.

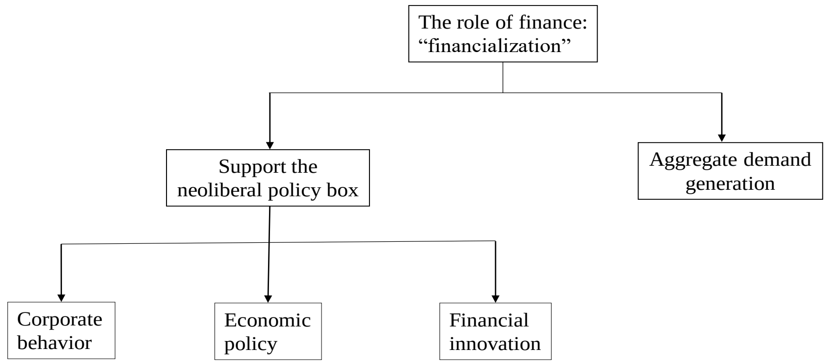
The new economic model was rooted in neoliberal economic thought. As shown in Figure 6, it can be described as a neoliberal policy box that pressures workers on all sides. On the left hand side, the corporate model of globalization put workers in international competition. On the right hand side, the “small” government agenda attacked the legitimacy of government and pushed persistently for deregulation regardless of dangers. From below, the labor market flexibility agenda attacked unions and labor market supports such as the minimum wage, unemployment benefits, employment protections, and employee rights. From above, policymakers abandoned the commitment of full employment. Like the post-War Keynesian growth model, the neoliberal policy box was also implemented on a global basis, in the North and the South. This global diffusion multiplied its impact and explains the importance of the "Washington Consensus" that was exported by the World Bank and International Monetary Fund.

Figure 6. The neoliberal policy box.



The second critical component of the structural Keynesian story concerns financialization and the role of finance. As shown in Figure 7, finance had a dual role. First, it provided structural support to the neoliberal policy box. Second, it supported the AD generation process.

Figure 7. The role of finance in the neoliberal model.



With regard to structurally supporting the neoliberal policy box, finance did so in three ways. First, financial markets captured control of corporations via enforcement of the shareholder value maximization paradigm of corporate governance. Consequently, corporations were reoriented to serve financial market interests along with the interests of top management. Second, financial markets and corporations lobbied politically for neoliberal policies, and they supported think-tanks and economic research advocating those policies. Third, financial innovation facilitated and promoted financial market control of corporations via hostile take-overs, leveraged buyouts and reverse capital distributions. By capturing and re-engineering corporations, financial markets changed business behavior. Together with neoliberal economic policy, that produced an economic matrix which suppressed wages and raised inequality.

The second vital role of finance has been to support aggregate demand. The neoliberal model gradually undermined the income and demand generation process via wage stagnation and rising inequality, creating a growing structural demand gap. The role of finance was to fill that gap. Deregulation, financial innovation, speculation, and mortgage lending fraud enabled finance to fill the demand gap by lending to consumers and by spurring asset price inflation. Along the way, it also created a house price bubble, the bursting of which became the trigger for the financial crisis and stagnation.

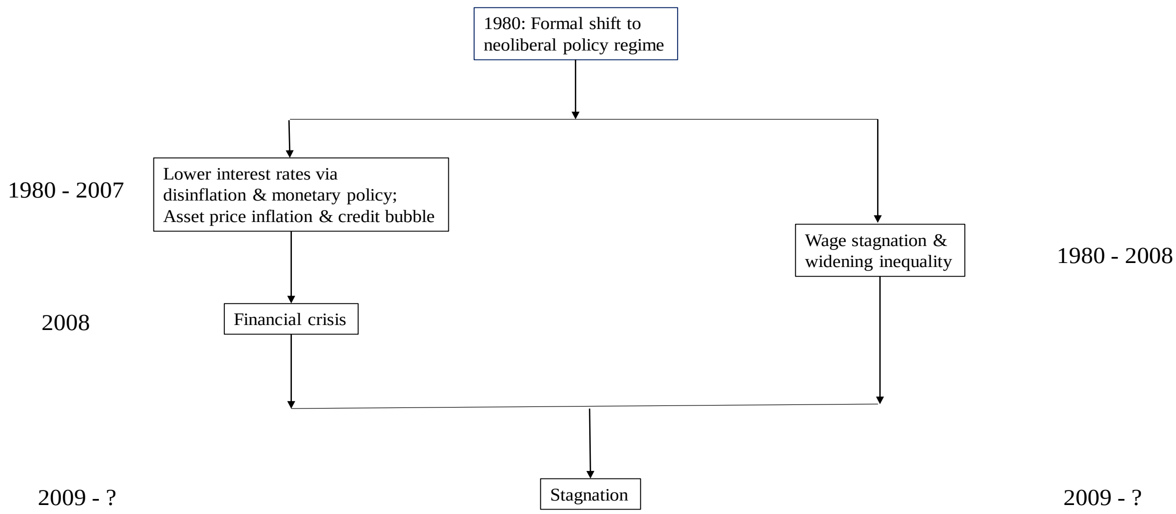
3.d The fallacy of the Great Moderation

Additionally, the structural Keynesian story provides an explanation of the so-called "Great Moderation" and why the crisis appeared out of nowhere. The Great Moderation refers to the period 1980 – 2007 when the US economy experienced disinflation, longer booms, and shorter shallower recessions.

Mainstream economists believe the Great Moderation was because of improved monetary policy based on mainstream economists improved theoretical understanding of the economy. That explains why they were so self-congratulatory before the crisis and why they were clueless regarding imminent major developments.

Structural Keynesianism always viewed the Great Moderation hypothesis as false, and this is explained in Figure 8. The shift to neoliberal policy in 1980 initiated a dual process. On one side there was wage stagnation and rising inequality that drove disinflation and slowly undermined the aggregate demand generation process. On the other side, disinflation allowed lower interest rates, while financialization initiated an era of asset price inflation and a thirty year-long credit bubble. That increased wealth and increased the quantity of easy credit, which covered over the emerging problem of demand shortage. Every time the economy got into trouble, the Federal Reserve lowered interest rates and restarted the credit bubble - asset price inflation mechanism, thereby generating the illusion of a Great Moderation.

Figure 8. Deconstructing the Great Moderation: the US economy in the neoliberal era.



Lastly, the process in Figure 8 also explains why the saving rate fell despite rising income inequality. That is because the increased saving of the rich was recycled as consumption and mortgage credit to lower income households.

3.e The Structural Keynesian explanation of stagnation: exhausted paradigm

The structural Keynesian hypothesis also provides a clear and simple explanation of stagnation. It has no need for invention of auxiliary theories like the zero lower bound (ZLB) or hysteresis.

The financial crisis of 2008 put a sudden stop to the credit-bubble that had created the illusion of a Great Moderation. Policymakers then used bail-outs to address the financial system’s insolvency, and massive fiscal and monetary policy stimulus to prevent the Great Recession from becoming a second Great Depression. However, nothing was done to change the underlying neoliberal economic model described by the neoliberal policy box in Figure 6. Given that, stagnation was inevitable as the model inevitably produces structural demand shortage via wage suppression and increased income inequality.

When the neoliberal model was implemented in 1980, the income and AD generation process were still robust and income inequality was much lower. Additionally, the economy had room for asset price inflation and extended credit growth as asset prices and indebtedness were both much lower. Those favorable initial conditions meant the economy could expand despite the stagnationist effects of neoliberal policy. However, now, those conditions are exhausted so that debt and asset price inflation can no longer adequately fill the structural demand gap. Analytically, it was easy to predict stagnation. Here is the conclusion to a paper published in July 2009:

> “(T)hough the economy may stabilize, it will likely be unable to escape the pull of economic stagnation. That is because stagnation is the logical next stage of the existing paradigm (Palley, 2009, p.33).”

4. The link between mainstream economists and the crisis

The structural Keynesian hypothesis emphasizes the role of economic policy in causing the financial crisis, inequality, and stagnation. Scratch any side of the neoliberal policy box and you find a justification that comes straight from mainstream economics.

Corporate globalization has been justified by appeal to the theory of free trade based upon comparative advantage, and by appeal to neo-classical arguments for deregulating financial markets and allowing uncontrolled international capital flows.

The small government agenda comes straight from Milton Friedman’s (1962) arguments for a minimalist or “night watchman” state. The retreat from full employment policy is based on Friedman’s (1968) theory of a “natural” rate of unemployment which was adopted and endorsed by almost the entire economics profession. The theory says monetary policy cannot affect the long run rate of unemployment and there is no trade-off between inflation and unemployment. That provided policymakers with the justification for abandoning full employment and shifting to inflation targeting. Since monetary policy has no lasting impact on employment, policy should instead minimize inflation which is undesirable and the only thing monetary policy can permanently affect. Employment should just be left to market forces.

The "flexible" labor markets agenda has also been driven by neo-classical economics. The argument is competitive labor markets ensure workers and CEOs are paid their contribution to value of production. This is the theory in all conventional textbooks, and it has fueled an attack on unions, minimum wages, and employment protections, all of which are characterized as labor market "distortions" that lower employment and increase unemployment.

Increased corporate power has been justified by the shareholder value model of corporations, which claims wealth and income is maximized if corporations maximize shareholder value. Lastly, expansion of financial markets has been promoted by appeal to the theory of efficient markets and claims that speculation is stabilizing. Portfolio theory was invoked to justify exotic financial innovation in the name of risk spreading. The claim was such financial engineering effectively created additional wealth and provided a free lunch. Meanwhile, portfolio diversification would render a collapse near impossible.

Putting the pieces together, modern mainstream economics played a critical role in the making of the financial crisis and Great Recession. According to the structural Keynesian account, the fingerprints of mainstream economists and modern economic theory are all over the neoliberal policy box and financialization. Together, the neoliberal policy box and financialization caused the crisis and undermined the demand generating process, which now causes stagnation.

5. The hypothesis mainstream economists cannot consider: political, psychological, and sociological barriers to openness in economics

The financial crisis and ensuing stagnation have compelled mainstream economics to come up with *ex-post* explanations of those events, which they failed to anticipate and initially lacked the capacity to explain. The need to play catch-up holds for both branches of the mainstream, the "freshwater" hardcore neoliberal branch and the "saltwater" softcore neoliberal branch.

In stark contrast, structural Keynesian economics provides a comprehensive account of events from the crisis to stagnation; anticipated the crisis; and predicted stagnation long before it was an issue. Yet despite this superior performance, the structural Keynesian account remains largely suppressed within the economics profession and economic policy circles. Why is that? The answer lies in powerful political, psychological, and sociological forces that support the *status quo* and block change.

5.a Politics

With regard to politics, neoliberalism is a political project that has advanced the interests of business and wealthy elites. Those elites have an interest in maintaining the "Freshwater vs. Saltwater" construction of economics because it is supportive of neoliberal policy and justifies current economic arrangements.

Both freshwater and saltwater economics are rooted in Arrow – Debreu (1954) competitive general equilibrium theory. Where there are differences, they are differences of degree regarding the extent and severity of market failures and the capacity of government to remedy those failures. That contrasts with the Structural Keynesian view which rejects competitive general equilibrium theory as the benchmark for theoretical economics, and is politically threatening to dominant business interests. The support of elite interests for the intellectual *status quo* resonates with Karl Marx's abiding observation in *The German Ideology* (1845) on the social foundations of dominant ideas:

> "The ideas of the ruling class are in every epoch the ruling ideas, i.e. the class which is the ruling material force of society, is at the same time its ruling intellectual force. The class which has the means of material production at its disposal, has control at the same time over the mental means of production, so that thereby, generally speaking, those who lack the means of mental production are subject to it."

5.b Psychology

With regard to psychology, the close connection between mainstream economics and the neoliberal policy box makes it near-impossible for mainstream economics to even acknowledge the structural Keynesian story. The structural Keynesian argument is increased income inequality and stagnation are the result of policy design. For mainstream economics to admit, or even acknowledge the hypothesis as legitimate, would be tantamount to admission of comprehensive intellectual failure. That is a very hard thing for any person to do.

Instead, the mainstream response has been consistent with social psychologist Leon Festinger's theory of cognitive dissonance, which Festinger described as follows:[1]

> "Suppose an individual believes something with all his heart…suppose that he is presented with evidence, unequivocal and undeniable evidence, that his belief is wrong; what will happen? The individual will frequently emerge, not only unshaken, but even more convinced of the truth of his beliefs than ever before. Indeed, he may even show a new fervor about convincing and converting people to his view."

5.c Sociology

[1] Cited by Mirowski (2010, p.35).

Lastly, with regard to sociology, mainstream economists have an economic interest in preserving the intellectual *status quo* and they have the power to do so. They are trained in neoclassical economics; have built their professional reputations on it; are well rewarded for their support by business and governing elites; and have nothing to gain from creating space for rival critical points of view.

Academic economics is also governed as a club in which existing members elect new members. Existing members control entry to the club via the tenure system. They also control elite journals that impact dissemination of ideas and professional visibility; control the production of new Ph.D. economists that influences the intellectual allegiances and open-mindedness of next generation economists ; and they control the classroom, the curriculum, and the textbook which influences how society thinks about the economy and the knowledge claims of mainstream economics. Those tremendous powers are used to exclude and suppress the ideas of those who do not share the beliefs of existing club members (Palley, 1997).

Instead, at best, the mainstream profession selectively borrows ideas from its critics and tries to capture and incorporate those ideas within its own discourse. However, that process of capture and incorporation takes the form of “Gattopardo” economics (Palley, 2013) – change that leaves things the same as before. Thus, ideas like stagnation are incorporated and explained as the result of a technical glitch in the market mechanism, but the deep fundamentals of neoliberal theory remain unchanged. At the same time, no reference is made to existing prior work on stagnation by critical economists as that would legitimize the critics. In this fashion, the idea is captured and defanged, without giving legitimacy to other perspectives and outsider economists.

6. Conclusion: the dangerous unintended consequences of the death of pluralism in economics

Current political conditions echo the ugly conditions of the 1930s, with the economy being at the center of much political discontent and anger. Economic hardship and disappointment have been primary factors driving the success of Donald Trump in the US, Marine Le Pen in France, and Brexit in the UK.

Those conditions speak to need for a full and open discussion about the economy so as to identify what has gone wrong and what should change. However, that has not happened because forty years of neoliberal dominance have destroyed pluralism in economics, atrophied popular economic understandings, and curtailed society's economic conversation. Instead of opening discussion for an evidence-based assessment of the competing explanations, mainstream economics has come up with a series of patches that leave their theoretical model essentially unchanged. That has provided justification for establishment policymakers and politicians to stick with the policy *status quo*.

We should be crystal clear. The critique of most mainstream economists is not about "values" or lack of "change". Many mainstream economists share the same values as their structural Keynesian critics. Mainstream economics has also updated and changed its ideas in response to the challenges posed by the financial crisis and stagnation. Instead, the critique is of the intellectual practice of mainstream economics, which has replaced pluralism with a neoliberal friendly neoclassical monopoly. That monopoly limits the economic policy conversation, thereby helping block the politics and policies needed to address the perilous political moment.

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