



This January 1935 photo shows a mural depicting phases of the New Deal

The Origins and Evolution of Progressive Economics

Part Seven of the Progressive Tradition Series

Ruy Teixeira and John Halpin March 2011

Center for American Progress



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With the rise of the contemporary progressive movement and the election of President Barack Obama in 2008, there is extensive public interest in better understanding the origins, values, and intellectual strands of progressivism. Who were the original progressive thinkers and activists? Where did their ideas come from and what motivated their beliefs and actions? What were their main goals for society and government? How did their ideas influence or diverge from alternative social doctrines? How do their ideas and beliefs relate to contemporary progressivism?

The Progressive Tradition Series from the Center for American Progress traces the development of progressivism as a social and political tradition stretching from the late 19th century reform efforts to the current day. The series is designed primarily for educational and leadership development purposes to help students and activists better understand the foundations of progressive thought and its relationship to politics and social movements. Although the Progressive Studies Program has its own views about the relative merit of the various values, ideas, and actors discussed within the progressive tradition, the essays included in the series are descriptive and analytical rather than opinion based.

We envision the essays serving as primers for exploring progressivism and liberalism in more depth through core texts—and in contrast to the conservative intellectual tradition and canon. We hope these papers will promote ongoing discourse about the proper role of the state and individual in society; the relationship between empirical evidence and policymaking; and how progressives today might approach specific issues involving the economy, health care, energy and climate change, education, financial regulation, social and cultural affairs, and international relations and national security.

Part seven of the series examines the rise of progressive economics as an alternative to the laissez-faire orthodoxy of the late 19th century and the challenges to progressive economics that emerged in the 1970s and 1980s.

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Introduction

What is progressive economics?

Although multiple schools of economic thought exist within the progressive tradition, there are several core assumptions that broadly define a progressive approach to economics in terms of theory, values, and practice. On the theoretical side, progressive economics is primarily concerned with striking a proper balance between private and public action to ensure greater stability and equitable growth in the economy and better achieve national goals.

The contours of progressive economics emerged in the late 19th century as a pragmatic attempt to deal with the realities of frequent depressions, workplace dangers, low wages, assaults on labor rights, mass unemployment, environmental negligence, public health issues, and political corruption at all levels of government. As with the transformation of philosophy and constitutional theory during this period (see part one, “The Progressive Intellectual Tradition in America,” for a discussion of positive and negative freedom), the original progressives charted a new and more realistic path in economics that preserved a market-based society and private enterprise while strengthening democratic control over the economy and employing the positive power of the state to advance human welfare and national prosperity.

In contrast to a free-market approach of minimal state involvement in the economy and little to no social protections promoted by classical economists, and a state-controlled approach of extensive planning and public ownership of the major means of production favored by socialists, progressive economists embraced the concept of a “mixed economy”—essentially private economic freedom coupled with government regulation, social protections, and the maintenance of public goods.

Progressives challenged the laissez-faire argument most associated with Adam Smith and David Ricardo (see timeline on pages 2-5 for a brief description of these and other economists discussed in this report) that markets are self correct-

ing, that wages must remain at subsistence level, and that the state should do very little to intervene in the natural rhythms of the economy or to address problems such as inequality, poor working conditions, or financial crises. At the same time, these progressives rejected a more radical collectivism that essentially replaced the problems of excessive private control with problems of excessive state control.

As a middle way between these economic alternatives, progressives built the modern administrative and social welfare state to help regulate the economy and provide Americans with greater economic security from unemployment, injury, old age, disability, and health problems that frequently left individuals and families desolate and poor. Progressives also championed the rise of labor unions and the not-for-profit sector as effective nongovernmental institutions that could help temper some of the excesses and problems rising from a capitalist economy. (See part two, “The Progressive Tradition in American Politics,” for a more detailed listing of progressive economic policy accomplishments.)

The progressive idea of the mixed economy dominated economic thinking in noncommunist countries for most of the 20th century. As will be discussed in greater detail later in this paper, progressive economics eventually culminated in the so-called Keynesian consensus—named after the progressive economist John Maynard Keynes—that government monetary and fiscal policy was necessary to better manage problems in the macro economy and to promote full employment. With the rise of the conservative movement in the United States during the 1970s and 1980s, and the monetarist and neoclassical ideas of Milton Friedman and others, progressive economics faced serious theoretical and political challenges.

Building upon the basic formulation that “self interest plus competition equals nirvana,” in the words of *New Yorker* economic correspondent John Cassidy, contemporary conservative economics is committed to reversing large parts of the progressive regulatory and social welfare tradition and restoring a system of minimal government and maximum private control of the

Brief timeline of economic thought

Classical economics reigns supreme

1776



Adam Smith publishes *An Inquiry into the Nature and Causes of the Wealth of Nations*, the founding text of classical economic thought. This school emphasizes that rational individuals left to their own devices will necessarily make the best decisions for themselves, and in the aggregate, society.

1798



Thomas Malthus publishes the first of six installments of *An Essay on the Principle of Population*, his most famous work. Malthus postulates that low wages are an unfortunate but inevitable consequence of a free-market economy with a growing population.

Nonetheless, he argues against state intervention on behalf of the poor, suggesting that such attempts impoverish more than they help.

1817



David Ricardo, in *On the Principles of Economy and Taxation*, describes the theory of comparative advantage, advocating that free trade between countries may be beneficial even when some countries possess absolute advantage relative to others.

1848



John Stuart Mill releases *Principles of Political Economy*, which examines the nature of labor, capital, productivity, and government—components of what we now think of as the field of macroeconomics. Mill discusses the problems of a stagnant economy that necessarily results in poor conditions

for laborers, arguing that true economic improvement will result from the betterment of the masses.

1859

John Stuart Mill completes *On Liberty*, in which he warns of the destructive power of the tyranny of the majority as well as the government against the rights and privileges of the individual. The state's interventions should therefore be guided by the “harm principle,” which posits that restrictions of individual liberty are only just if the individual actions in question cause harm to others.

economy that favors corporations and the wealthy.¹ With the collapse of the financial and housing markets in 2008, this “utopian economics” approach in turn faces serious theoretical assault as the practical consequences of two decades of deregulation and nonintervention in the economy became apparent to even some of the most libertarian thinkers, including Judge Richard Posner and even former Federal Reserve Chairman Alan Greenspan.

In terms of values, progressive economics often stresses the importance of social cohesion and cooperation over pure self-interest as the basis for a more stable and just economic order. Modern progressive economics, building on environmentalism, also promotes sustainability as a core value underlying our society. Since the 1970s, progressives have warned about the practical and moral costs of the misuse of natural resources, rising pollution, global warming and other environmental disasters, and violations of human rights in pursuit of corporate profits. These alternative economic values have been incorporated into the emerging progressive focus on national indicators that go beyond measurements of aggregate national output. Robert F. Kennedy famously summarized the limits of gross domestic product as a measure of national strength in his 1968 speech at the University of Kansas:

We will never find a purpose for our nation nor for our personal satisfaction in the mere search for economic well-being, in endlessly amassing terrestrial goods. We cannot measure the national spirit on the basis of the Dow-Jones, nor can we measure the achievements of our country on the basis of the gross domestic product. Our gross national product counts air pollution and cigarette advertising, and ambulances to clear our highways of carnage. It counts special locks for our doors and the jails for those who break them. It counts napalm and the cost of a nuclear warhead, and armored cars for police who fight riots in our streets. It counts Whitman's rifle and Speck's knife, and the television programs which glorify violence in order to sell toys to our children.

Brief timeline of economic thought

Beginnings of progressive economic thought

1885



Richard Ely, then-professor at Johns Hopkins University, creates the American Economic Association. Ely rejects the notion that economic forces are naturally deterministic, instead arguing that markets are manmade and thus can be tailored to specific needs.

1899



Thorstein Veblen publishes *The Theory of the Leisure Class*. Veblen argues that the modern division of labor—which undervalues “menial” work and overvalues the work of top earners—is a remnant of barbaric times. The “leisure class” of overvalued workers drives what Veblen calls “conspicuous consumption,” or the consumption of goods that have little intrinsic value but are sought for their visibility and status.

1910



DEPARTMENT OF LABOR

John Commons begins releasing his 10-part series, *Documentary History of American Industrial Society*, which examines the evolution of industrialism in the United States and the way the labor movement has interacted with advances in industry.

1920

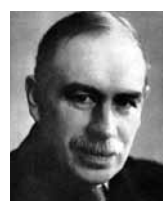


THE WARREN J. SAMUELS
PORTRAIT COLLECTION AT
DUKE UNIVERSITY

Wesley Mitchell, a student of Richard Ely, creates the National Bureau of Economic Research dedicated to quantitative measurement and analysis of the economy. The bureau is part of early progressive efforts to gain a more nuanced understanding of the workings and cycles of the economy.

The Keynesian revolution

1936



John Maynard Keynes publishes *General Theory of Employment, Interest and Money*, which argues that economies often experience demand shortfalls due to high levels of unemployment and erratic investor confidence. Under these circumstances government needs to fill in demand shortfalls and push the economy back to full-employment-level output.

Although rarely discussed in contemporary politics, the values dimension of economics occupied a great deal of political debate throughout much of the early 20th century. While those committed to the neoclassical tradition often ignored or downplayed the negative social outcomes of self-interested economic behavior, progressives focused public attention on the societal consequences of undue deference to market values. Progressive economics remains concerned with the fundamentals of growth, productivity, and employment. But it also asks broader questions about the overall goals and structure of our economy, among them:

- What is the shared responsibility between individual, businesses, and government to provide for the welfare and security of workers?
- Do we want to live in a society where those who work full time remain on the edge of poverty?
- Should 1 percent of Americans command roughly one-quarter of national income?
- Should corporations be held responsible for their treatment of the environment, their workers, and the communities in which they operate?
- Is a consumption-based economy built on personal debt desirable?
- Do workers need better workplace arrangements and policies that recognize the needs of American families?

On the practical side, progressive economics starts from the premises that markets fail and that they are not always self-correcting. Progressives understand the importance that markets play in producing wealth, creating jobs, devising new products and services, and in meeting the needs of individuals and consumers. But they also know that there are severe limits to markets. Economic history shows time and again that market economies are highly prone to speculative bubbles, monopolistic behavior, mistreatment of workers, and corruption if they are not closely monitored. Many private businesses operating under self-interested values are notorious for creating negative “externalities,” such as air and water pollution, overuse of natural resources, and systemic risk in their pursuit of profits.

Timeline of economic thought

1948



Paul Samuelson releases *Economics*, one of the most widely read and well-regarded economics textbooks in the history of the field. The book reintroduces the concept of the “paradox of thrift,” attributed to Keynes, which states that if individuals attempt to save during recessions, demand falls such that overall savings fall more than they would have if the initial propensity to save had persisted.

1958



AP PHOTO/GIULIO BROGLIO

John Galbraith publishes *Affluent Society*, which becomes his most famous work. Galbraith argues that the United States needs to do more to invest in infrastructure and public works and should work to remedy growing income disparities.

Conservative backlash

1962



EN WIKIPEDIA AND FREE TO CHOOSE MEDIA

Milton Friedman publishes *Capitalism and Freedom*, which asserts the value of free markets absent government intervention or regulation. Friedman argued that government spending interferes with economic growth, rather than promotes it.

1970



UNIVERSITY OF CHICAGO

Eugene Fama publishes the article “Efficient Capital Markets: A Review of Theory and Empirical Work,” outlining the efficient market hypothesis. This hypothesis postulates that investors are perfectly rational and fully-informed and that financial assets are therefore always priced correctly by the market.

1972



UNIVERSITY OF CHICAGO

Robert Lucas releases “Expectations and the Neutrality of Money,” which develops the theory of rational expectations. Lucas articulated the theory that government efforts to fine-tune the economy would not work due to individuals’ expectations of the result, work for which he would later win the Nobel Prize.

Similarly, the private sector has little incentive to invest in key collective goods such as schools, roads, bridges, and public transportation; research and development in new areas; and public safety measures.² The neoclassical tradition of conservative economics dismisses these failures as unimportant, arguing that markets are in fact self-correcting. Therefore, there is no need for solutions to these problems and none are put forward.

In contrast, progressives believe that government must step in to correct the failures of markets, restore efficiency, maintain full employment, and promote public needs and equity in society. It is no accident of history then that progressives devised nearly all of the laws and institutions necessary to correct the shortcomings of the market, and that conservatives opposed them almost uniformly.

Case in point: Responding to the currency problems of the late 19th century, progressives devised the Federal Reserve System to ensure a steady and stable money supply and to check inflation and excessive risk in the economy. Progressives also employed antitrust measures to stop businesses from colluding to set prices and production patterns and undermine competition, and created a variety of fees, levies, and other legal actions on businesses that extract the nation's natural resources or create environmental hazards and pollution.

Similarly, progressives at the federal, state, and local levels promoted important public investments—financed through progressive taxation and government borrowing—to help:

- Maintain a strong military and public safety measures
- Support public schools and college education
- Build and maintain highways, airports, and railways
- Provide health care and retirement security for Americans
- Invest in new energy research and other forms of innovation
- Protect the most vulnerable members of society

Brief timeline of economic thought

1980

Milton Friedman and his wife, Rose, release *Free to Choose*, a book accompanied by a 10-part PBS television series that strongly advocates individual choice criticizing most government actions as unnecessary and harmful.

Today's new progressive push

2006



KEYSTONE/MARTIN RUETSCHI

Joseph Stiglitz publishes *Making Globalization Work*. The text examines the pernicious effects of globalization and ways in which globalization can be reformulated to more equitably benefit trading countries. Stiglitz is particularly critical of the effect of liberalizing developing countries, a process advocated tirelessly by neoclassical economists.

2007



AP PHOTO/MEL EVANS

Paul Krugman releases *The Conscience of a Liberal*, which argues that government policies were instrumental in reducing poverty and inequality between the 1930s and the 1970s. Krugman further argues that since the 1970s, inequality increased because neoclassical economic theory regained dominance, and that government should focus more on social welfare programs as a means of alleviating such disparities.

2009



AP PHOTO/NOAH BERGER



AP PHOTO/DOUGLAS HEALEY

George Akerlof and Robert Shiller release *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism*, the title of which is derived from Keynes's theory that "animal spirits," or investor emotions, tend to drive markets. Drawing from Keynes's analysis, Akerlof and Shiller stress the need for decisive government intervention to stabilize markets and restore credit in times of low investor confidence.

This legacy of progressive economics paved the way for America to become one of the most powerful economies in the world and, after World War II, helped to create the largest and most secure middle class. Despite the claims of conservative economists, a proper balance between private and public actions and investments, regulation, and publicly provided social protections were essential to American success in the 20th century.

The remainder of this paper will explore in more detail the development of progressive economic theory, values, and practical solutions to societal needs. As in the other papers in the progressive tradition series, our goal is to make the often-complex ideas and history of economics accessible to progressive activists and others interested in the topic.

The progressive challenge to classical economics

In an era of highly specialized economic research, it is important to recall that from the days of Adam Smith to John Stuart Mill, economics in the 18th century was a more expansive discipline than it is today. Earlier economic thought did not suffer from the conceit that it was a natural science such as physics. As a branch of moral philosophy, the study of political economy covered not only issues like production, consumption, prices, and wages but also how political actors, laws, organized interests, institutions, ideologies, and ethics shaped economic outcomes. Progressive economics hatched within this broader tradition of political economic inquiry.

The classical consensus

In America, the English tradition of political economy dominated for most of the nation's first 100 years. Built upon the ideas of Adam Smith, classical liberalism sought to create a society where competition and the pursuit of profit within a free-market system would regulate the economy and help build national prosperity. Although Smith believed in the moral importance of social behavior and human compassion, his economic theory rested on the belief that individuals pursuing their own self-interest would create a self-regulating system of rewards and punishments that would advance national wealth.³ Smith's theory of capitalism, still in use today, rested on the famous "invisible hand" guiding men's self-interested actions toward a greater good without the intervention of the state.

The classical economic model engendered strong support in America as an alternative to an older economic order dependent on the authority of monarchies and guilds rather than the interests and talents of businessmen and merchants. It was both a moral system that valued the individual above all else and an economic model that provided a theory and set of tools for economic activity built on unimpeded competition and pursuit of profit. Initially, this system fit well within an American political tradition that grounded governmental authority in the consent of the governed and promoted the natural rights of citizens to determine the course of their own lives free from arbitrary rules and interference.

By the later part of the 19th century, however, with the rise of industrialization in England and the United States, the classical economic model had coalesced into a more problematic set of propositions that raised serious questions about the rewards of the capitalist system promised by Smith. One variation of this classical consensus stressed David Ricardo's "iron law of wages," which posited that workers could expect little more in life than subsistence-level wages in a market economy:

*Labour, like all other things which are purchased and sold, and which may be increased or diminished in quality, has its natural and its market price. The natural price of labor is that price which is necessary to enable the labourers, one with another, to subsist and perpetuate their race, without either increase or diminution.*⁴

Another classical assumption, associated with Thomas Malthus, argued that massive inequality and hardship for the masses were unavoidable conditions of a free-market economy. Since increases in wealth naturally led to population growth and greater demands for food production, those fortunate enough to own land received much higher returns for the use of their scarce land while those forced to rent or work on this land would fall inevitably deeper into poverty and deprivation.

The impact of these classical economic propositions was grim. According to the "laws" of economics, the natural order of things meant that workers could expect little from the economic system—and worse, there was nothing the government or anyone else could or should do to interfere with this process. The rise of Social Darwinism in theology and social philosophy enshrined the classical model as natural law ordained by God and carried out through the biological triumph of the strongest over the weakest in the economy.

The classical economic model was not fully without merit. It helped to advance American industry and entrepreneurship in many ways, and created extraordinary wealth for some in the process. But this prosperity came at the high cost of rising poverty and deprivation for the many, frequent economic crises and speculative bubbles that destabilized the system, increasing political corruption, and threats to democratic freedom and economic opportunity for large numbers of Americans. The practical consequences of this school of economic thought became too much to bear for many Americans.

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The historical and institutional schools of progressive economics

Beginning in the late 19th century, progressive economics developed as a non-socialist alternative to the limitations and failures of the classical tradition. Prior to the dominance of Keynesian thought in the late 1930s, progressive economics centered on the historical model of Richard Ely and the institutional school associated with John R. Commons, Thorstein Veblen, and Wesley Mitchell. These early progressive economists shared several beliefs about the interaction of society, politics, and the economy. Many spent time studying at German universities focusing their scholarship on the evolutionary development of economics within particular political and cultural environments. Some were influenced deeply by Christian ethics and social gospel reform efforts (see “The Role of Faith in the Progressive Movement”) that challenged the exploitation of people and communities for profit.

Others were shaped more by the emerging pragmatic tradition in philosophy, which stressed that the true test of ideas depended upon their practical consequences. These new progressive economists collectively pursued more rigorous gathering of economic statistics and empirical data to better assess how the economy actually worked.

Progressive economists argued persuasively that there were no “natural laws” in economics. They believed that economic ideas and the institutions designed to support them are created by men, and if they are not working, they should evolve to better meet the needs of people. As historian Eric Goldman describes, Richard Ely and his followers argued that the:

... proper kind of economics would be based on the assumption that to up-build human character in men you must establish for them right social relations; that right social relations come from a healthy economic environment; and that environments can be quickly made more healthy by state action and by encouraging the underprivileged to act through trade unions and similar organizations.⁵

Building on these themes, Ely (then a professor of political economy at Johns Hopkins University) and his colleagues formed the American Economic Association in 1885 as an institutional mechanism to advance dissident ideas about the economy and public policy. The original platform of the AEA explicitly outlines the assumptions of the early progressive approach to economics:

- We regard the state as an agency whose positive assistance is one of the indispensable conditions of human progress.
- We believe that political economy as a science is still in an early stage of its development. While we appreciate the work of former economists, we look, not so much to speculation as to the historical and statistical study of actual conditions of economic life for the satisfactory accomplishment of that development.
- We hold that the conflict of labor and capital has brought into prominence a vast number of social problems, whose solution requires the united efforts, each in its own sphere, of the church, of the state, and of science.
- In the study of the industrial and commercial policy of governments we take no partisan attitude. We believe in a progressive development of economic conditions, which must be met by a corresponding development of legislative policy.⁶

Implicit in this revision of the classical tradition was the need to update American institutions to better enable collective action to solve difficult social problems. John R. Commons, an influential economist, labor historian, and former student and later colleague of Ely at the University of Wisconsin, believed that the government must play a stronger role in mediating the conflicts between capital and labor and do more to correct the negative effects of economic development. Commons became deeply involved in the public application of economic thought by serving on the Wisconsin Industrial Commission, the U.S. Commission on Industrial Relations, and the Wisconsin Minimum Wage Board.

And through his relationship with Gov. Robert M. La Follette, Commons helped pioneer the “Wisconsin idea” of progressive reform that put social scientific research and analysis at the center of public policymaking. Commons employed empirical investigations, statistics, and impartial inquiry to help create workplace safety measures, regulation of utilities, and unemployment insurance legislation in Wisconsin that later became models for the nation.⁷

Similarly, Wesley C. Mitchell, another student of Ely’s, founded the National Bureau of Economic Research in 1920 to advance quantitative studies of the economy. Mitchell and the NBER created the first systematic measures of national income and business cycles.⁸ All of the economic data and trends that Americans see reported in the media every day resulted from the early efforts of progressive thinkers to provide a better and more realistic approach to understanding

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the economy. NBER's Business Cycle Dating Committee maintains a permanent longitudinal measurement of peaks and troughs in economic activity that many economists and governments use to officially mark recessions and recoveries.

The disruptive ideas of the early progressive economists did not reach full institutional fruition until the New Deal in the 1930s, when many unrealized progressive policies were put into action to help America recover from the Great Depression—another disastrous failure of laissez-faire economics. The classical notion that the economy would work best if left to its own devices was clearly inadequate in the face of 25 percent unemployment, collapsing crop prices, reduced industrial output, and thousands of failing banks.

During the first three months of his presidency, Franklin Roosevelt and the progressive economists in his administration devised and passed 15 major legislative initiatives including the Emergency Banking Act, the Civilian Conservation Corps, the Federal Emergency Relief Act, the Agricultural Adjustment Act, the Tennessee Valley Authority, the Glass-Steagall Act, and the National Industrial Recovery Act—all of which together marked the end of the classical tradition in American economic thought and practice and the rise of the modern interventionist and administrative state.⁹

Although the historical and institutional schools of progressive thought provided much-needed intellectual support for new economic practice in the 20th century, they were not sufficient to fully address the larger problems of macroeconomic management necessary to maintain stability and output and to reduce inequality and invest in public goods. It took the ideas of British economist John Maynard Keynes and his followers in America such as John Kenneth Galbraith, Paul Samuelson, and others to fully develop a progressive approach to the economy.¹⁰

The Keynesian revolution

Progressive economics through the 1920s was driven by ethical concerns for the common good, which led progressives to oppose monopoly and concentration of economic power, promote social programs to help the poor and workers, advocate provision of public goods that the market would otherwise fail to produce, and encourage the use of disinterested expertise in setting economic policy. In so doing, progressives implicitly and explicitly rejected laissez-faire economics as a guiding doctrine for society.

What they lacked, however, was a coherent theory of economic management that clearly articulated the role of government as a macroeconomic actor in the ongoing capitalist drama of growth and crisis. How did progressives propose to manage growth and crisis in a way that was different from classical economists (government management would interfere with growth and make crises worse) and from socialists (managing capitalism was impossible; the only important economic policy goal was to provide social services)? U.S. progressives at first had no answer to this very important question.

Across the Atlantic, however, the beginnings of an answer were being formulated by John Maynard Keynes. Keynes started by rejecting the idea that the overall performance of the economy could be effectively understood using classical economic principles—the theoretical apparatus developed by David Ricardo and later generations of economists to analyze the workings of individual markets. This view led classical economists to the belief that the overall economy tended toward full employment equilibrium where all resources were productively employed.

Although this equilibrium could be temporarily disturbed by wage and price rigidities, misguided monetary policies, and other market distortions, classical economists believed that the economy would quickly return to full employment equilibrium once these distortions were eased. The role for government in responding to recession was therefore to do nothing, letting prices and wages fall to their natural levels or, even better, to do less, since government spending simply

crowds out the private spending necessary to get the economy back into equilibrium. That is why, prior to Keynes, the orthodox budgetary approach to recessions was to cut, not increase, spending.

Keynes saw things differently. In his view, the normal state of capitalist economies was not full employment because total demand in the economy could easily fall short of total supply, creating equilibriums with high levels of unemployment—the reverse of the classical precept (known as Say’s law) that supply creates its own demand. A shortfall of demand could arise, for example, when consumers and investors start to prefer holding cash to spending and investing.

Another reason for a shortfall of demand, according to Keynes, was the instability of investment, the nonconsumption part of demand. Investment was unstable because businesses’ expectations fluctuated depending on their assessments of future possibilities for profit, which in turn were intrinsically uncertain. Classical economists, in contrast, believed businesses precisely understood their statistical probabilities of success and invested accordingly. Keynes rejected this view and insisted that uncertainty was pervasive.

Given shortfalls in demand, only the “animal spirits” of capitalists—confidence and the lack thereof—allowed capitalists to forge ahead (or not) in poor business conditions and were therefore a huge influence on their investment decisions. And if capitalists lacked confidence in their ability to make profits, they would seek to reduce costs by laying off workers, thereby reducing demand in the economy and further eroding business confidence. The process of lowering output, employment, and confidence would continue until a new equilibrium was reached—an “underemployment equilibrium” rather than the full employment equilibrium of the classical economists.

Keynes argued that because these equilibriums were a natural and recurring tendency of capitalism, there was no natural adjustment process that would lead a market economy back to full employment. Nor could monetary policy—lowering interest rates or increasing the money supply—always be relied upon to jolt businesses back into action and increase employment. Instead, government must frequently step in to make up shortfalls in demand through fiscal policy—in other words, through government spending.

Such government spending was most obviously needed in the case of an economic downturn to restore a full employment level of demand in the economy. But Keynes also argued that government spending was needed on an ongoing

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basis to maintain full employment over time, and to reduce the amplitude of recessions when they did occur. He particularly saw a continuing role for public investment in infrastructure and other public goods that the market would not provide. Such public investment served a dual purpose of helping manage demand and making society more productive and civilized over the long term.

The latter point about improving the quality of life in society is worth stressing. Keynes's attitude toward economic management was fundamentally progressive, not technocratic. Making the economy work better was not an end in itself but rather a means to an end. And that end was not to generate wealth *per se* but rather to generate enough wealth to allow ordinary people to enjoy "the good life," which included health, education, culture, and leisure. He aimed, in a sense, to generalize the life he and other privileged members of English society were able to live to the rest of society.

Keynes's ideas, of which this is only a radically simplified sketch, diffused extraordinarily rapidly in the 1930s, especially after the publication of his *General Theory of Employment, Interest and Money* in 1936. All over the world, economists and policymakers desperate for a coherent way to understand the ongoing problems of the Great Depression seized on Keynes's analysis. Progressives, in particular, saw in Keynes's analysis a way of justifying their ad hoc use of government spending to fight the depression and as a potential guide to averting future depressions.

That is how it worked in the United States. The initial interventions of the New Deal were little influenced by Keynes, deriving intellectual inspiration, where there was any, from the underconsumptionist theories of American economists William Trufant Foster and Waddill Catchings. Only later in the decade did Keynes's ideas start to be assimilated into the economic philosophy of progressives. And it really took World War II and the return of full employment to solidify the hold of Keynesian economics on progressives determined to maintain employment levels and avoid a postwar depression.

The postwar adoption of Keynesian economics among progressives was facilitated by the overwhelming intellectual triumph of Keynes's ideas within the economics profession. As Mark Blaug, perhaps the leading historian of economic thought, remarks, "[N]ever before had the economics profession been won over so rapidly and so massively to a new economic theory, nor has it since. Within the space of about a decade, 1936-46, the vast majority of economists in the Western world

were converted to the Keynesian way of thinking.”¹¹ Thus progressives found their purposes allied with the mainstream of the economics profession in a “Keynesian consensus” that underpinned economic policymaking until the 1970s.

Following the Keynesian consensus, U.S. progressives, who dominated Congress and the presidency for several decades after World War II, focused on demand management primarily through fiscal policy to maintain full employment. Also following Keynesian precepts, this activist fiscal policy included a big role for public investment. Returning GIs were provided with a free college education and low-interest, zero-down-payment home loans through the GI Bill. And government poured money into roads, science, public schools, and whatever else seemed necessary to build up the country.

Overall public investment by the federal government as a percent of gross domestic product—the sum total of all goods and services produced in the economy—climbed steadily to around 2.6 percent of GDP per year by the end of the Keynesian era.¹² Core infrastructure (transportation, energy, water management) investment increased particularly rapidly (4.3 percent per year from 1950–1974).¹³

The results of this economic regime were impressive. The GDP growth rate was 3.8 percent per year between 1947 and 1973, and the per capita GDP growth rate was 2.5 percent over roughly the same period (1950–1973).¹⁴ Unemployment, though considered high compared to booming Europe, averaged 4.8 percent over these years.¹⁵ And the growth in living standards was phenomenal: Real median family income rose at a rate of 2.8 percent per year, more than doubling over the time period. What’s more, this growth was even stronger at the bottom and a little weaker at the top so income inequality actually fell substantially, leading economic historians Claudia Goldin and Robert Margo to call this period the Great Compression.

Building upon this foundation of strong economic growth and rising incomes for the middle class and poor, progressives continued and refined the regulatory approach, social protections, and economic security measures of the New Deal. And with President Lyndon Johnson’s Great Society reforms of the mid-1960s, they dramatically expanded government action in all these areas. Most fundamentally, they attacked the continued existence of racial discrimination and oppression. President Johnson signed the Civil Rights Act in 1964 and the Voting Rights Act in 1965.

Returning GIs
were provided
with a free college
education and
low-interest, zero-
down-payment
home loans
through the GI Bill.

The continued existence of poverty, an issue popularized by Michael Harrington's book, *The Other America*, was addressed through the Economic Opportunity Act of 1964, which launched the "War on Poverty." The War on Poverty included such initiatives as the Job Corps, VISTA, the Model Cities program, Upward Bound, and Project Head Start. And the health care woes of older Americans, which frequently impoverished them, were addressed through the creation of Medicare in 1965, a universal health care program for the elderly. In the same year, Medicaid was established to provide basic medical care for the poor.

Environmental issues were targeted by a wide range of new initiatives going far beyond the federal government's traditionally limited commitments in this area. The Clean Water, Water Quality, and Clean Water Restoration Acts were passed. So too were the Wilderness Act, the Endangered Species Preservation Act, the Solid Waste Disposal Act, and many others. The stage was set for creation of the Environmental Protection Agency in 1970 and the activist environmental policy we are used to today.

Chronic money problems of low-income schools were addressed by getting the federal government into the education-funding business through the Elementary and Secondary Education Act. Federal support for colleges and universities and for assistance to low-income students was increased through the Higher Education Act. And consumer protection was enhanced through the Motor Vehicle Safety Act, the Fair Packaging and Labeling Act, the Child Safety Act, the Wholesome Meat and Poultry Acts, and a number of other laws. These acts raised the bar for consumer protection far higher than it had previously been.

So, over nearly three decades, the Keynesian consensus in the United States produced strong economic growth, low unemployment, rapidly rising living standards, and, through government, more protections and security for the average citizen. Policymakers and economists came to believe that economic problems could be easily managed with a simple set of tools reflecting that consensus.

In particular, a relationship known as the Phillips curve was embraced, which supposedly showed a stable tradeoff between levels of unemployment and inflation. Lower levels of unemployment tended to produce higher levels of inflation, while higher levels of unemployment were associated with lower levels of inflation. Therefore, the combination of unemployment and inflation in an economy was a social choice reflecting the relative value society put on unemployment relative to inflation.

Since low unemployment was so important, policymakers concluded that higher levels of inflation could be tolerated and deployed the standard Keynesian tools to achieve that tradeoff. Besides, they reasoned, if inflation and budget deficits started to edge into dangerous territory, they could simply contract the economy using monetary and fiscal policy (less spending, higher taxes, higher interest rates) to stabilize the situation.

The Phillips curve was put forward by New Zealand economist A.W. Phillips in 1958 and had no direct origin in Keynes's thought. Indeed, Keynes believed that while capitalism had a chronic tendency toward a shortfall of demand that must be remedied by government, excess demand and attendant inflationary pressures could easily arise as well and must be guarded against. He wrote about this problem in some detail in his 1940 pamphlet *How to Pay for the War*. And nowhere did he argue that there was a stable relationship between unemployment and inflation that could be easily manipulated by government. The spirit of Keynes's thought was instead that the uncertainties built into capitalism made assumptions of stable relationships and automatic adjustment processes a risky business.

As it turned out, the assumed relationship between unemployment and inflation broke down in the 1970s as the complications of a globalizing economy started to bite. These complications undermined the stable international economic relationships of the postwar Bretton Woods system, including fixed exchange rates. The *coup de grâce* was administered by the oil price shock of 1973 delivered by the Organization of the Petroleum Exporting Countries, or OPEC. Inflationary pressures that had been building up inside the United States and other advanced countries could no longer be contained, producing high inflation rates that could not be brought down by high unemployment. This combination of high unemployment with high inflation was termed "stagflation." Progressives at that time were unprepared with either an alternative to, or extension of, the postwar Keynesian system to fix this problem, which led to the end of the Keynesian consensus.

The conservative counterrevolution

Conservatives had never been happy with the Keynesian consensus. Ideologically, they were opposed to the idea that the unregulated market had intrinsic flaws that only government could correct. And many conservatives, of course, had economic interests that predisposed them to resist and resent government. So when the Keynesian system appeared to break down, they seized the opportunity to reinstate their views and discredit government's role. They succeeded beyond their wildest dreams.

Leading the charge was conservative economist Milton Friedman. In his academic work he showed how inflationary expectations could derail the Phillips curve favored by Keynesian economists. And, with his wife Rose, he published the enormously influential *Free to Choose*, a no-holds-barred polemic in favor of self-interested individuals making “rational,” unregulated decisions and against anything that interfered with this process, especially government action. As far as Friedman was concerned, government's economic role should be limited to little more than controlling the growth of the money supply.

As the conservative counterrevolution gained political and intellectual momentum, Friedman's followers built on his insight about inflationary expectations to build a more rigorous case against government intervention. This was the “rational expectations” approach. The approach assumed that individuals were perfectly rational and in possession of all available information about past and present economic events, including government actions, and, on that basis, formed rational expectations of future events. Because of these rational expectations, government actions were doomed to be ineffective. Government spending, they argued, cannot put more demand in the economy because consumers and businesses instantaneously understand the future effects of this spending on inflation, canceling out the new spending.

Rational expectations became the central assumption of the new classical economics, which argued that macroeconomics must be built directly up from the microfoundations of rational individuals and market equilibrium. Based on this

approach, new classical economists, led by University of Chicago economist Robert Lucas, concluded that government actions were not only ineffective, they were likely to be harmful by introducing uncertainty and instability into the process of attaining market equilibrium.

Left to their own devices, individuals and businesses with rational expectations would adapt quickly to economic shocks and achieve the best possible equilibrium; whatever unemployment was left at that point would, by definition, be voluntary. In this scenario, the only useful role for government in the economy was in the realm of monetary policy, through the setting of short-term interest rates by the central bank. And that should be to maintain price stability, not to affect employment or output. New classical economists differed on how active such monetary policy should be, but they were united in rejecting a constructive role for fiscal policy and most government regulation.

As new classical economics was changing overall thinking about the economy, an approach called efficient markets theory, associated most closely with another University of Chicago economist, Eugene Fama, was transforming thinking about the financial sector. Similar to new classical theory, efficient markets theory assumed that investors were perfectly rational, had access to all available information, and used that information to form rational assessments of stocks' and other financial instruments' earning potential.

An immediate implication of this theory is that financial assets are always priced correctly by the market. Financial bubbles cannot exist for any period of time because if they arose investors would quickly sell the asset in question. From this, it follows that there is little or no role for financial regulation, beyond preventing things such as insider trading (and some efficient market theorists were not so sure about that).

Nor was there any reason to worry about the riskiness of financial investments; that risk was perfectly factored into the price of financial assets. If the government possessed important information about the riskiness of investments, the proper course of action was not to regulate these investments but to make that information public so it could be factored into these assets' prices.

Finally, the fact that financial assets were always priced correctly meant that capital was always allocated to its most efficient uses by the private financial markets. This in turn implied that public investments could not hope to com-

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pete in terms of efficiency with private investments and therefore public functions should wherever possible be privatized and turned over to the market.

This economic philosophy was obviously no mere reform or adjustment of the Keynesian system but a complete turnaround—a true counterrevolution. In short order, it came to dominate economic policymaking in the United States and other advanced countries. Deregulation and privatization became the order of the day, while Keynesian fiscal policy, especially the central role of public investment, was shunted aside.

In the United States, this led to significant deregulation of the transportation, energy, telecommunications, and financial sectors. The latter included the repeal of the Glass-Steagall Act, a depression-era law that mandated barriers between different kinds of financial firms so that, for example, a low-risk commercial bank could not also be a far-higher-risk investment bank.

The results of the conservative economic regime have not been good. Indeed, in every important way it has produced economic results far inferior to those of the Keynesian era. Start with the slow growth in living standards for the typical family, accompanied by a remarkable rise in inequality. As mentioned earlier, the post-war era until 1973 was notable for a substantial decline in inequality—the Great Compression. In that era, the growth in living standards for the typical family was extraordinary: a 2.8 percent per year increase in family income over the 1947–1973 period, which more than doubled incomes.

Since 1973, however, growth in median family income has averaged just 0.6 percent per year—an equally extraordinary slowdown—producing a mere 22 percent aggregate rise in incomes over a longer time period. Moreover, in a pattern progressive economist Paul Krugman and others have termed the Great Divergence, income growth for the affluent and, even more so, the rich, has been far better than for the median family over the post-1973 period, while income growth for the poor has been worse. Among the top 20 percent of income earners, family income rose by 40 percent, and among the top 5 percent by 58 percent. In contrast, over the same period, family income for the bottom 20 percent of families grew by only 10 percent.¹⁶

Indeed, income today is increasingly concentrated at the very highest reaches of our society. The top 1 percent of income earners accounted for 23 percent of total income, most of which (19 percent) is received by the top one-half

of 1 percent. These are levels of income concentration not seen in the United States since the 1920s.

The basic facts about the rise in inequality since 1973 are fairly well-known. Less well-known is how poorly the post-1973 period compares to the Keynesian era in terms of overall growth. It's not just that post-1973 growth has been poorly distributed; there's also been less of it. This fact is particularly damning for the conservative economics that replaced Keynesianism because that new classical economics was supposed to unshackle the great capitalist growth machine from the heavy hand of government.

Instead, real GDP growth actually slowed down—to 2.8 percent per year in the post-1973 period compared to 3.8 percent per year in the Keynesian era.¹⁷ A similar slowdown can be observed in GDP per capita growth, down to 1.9 percent per year from 2.5 percent per year.¹⁸

Conservative economic policymaking has been similarly unsuccessful in keeping down the unemployment rate. Despite encouraging the capitalist economy's allegedly natural tendency toward full employment equilibrium, the era of new classical conservative economics has produced higher average unemployment rates (6.1 percent) than those in the Keynesian era (4.8 percent).¹⁹

Accompanying this underwhelming record on living standards, inequality, growth and employment has been a steep decline in levels of public investment, considered of little importance by a conservative economics enraptured with the private sector. Overall public investment by the federal government as a percent of GDP slipped from 2.6 percent per year at the end of the Keynesian era to 1.9 percent per year in the first decade of the 21st century.²⁰

And core infrastructure (transportation, energy, water management) investment slowed dramatically, from a 4.3 percent per year average growth rate in the 1950–1974 period to just 2.3 percent per year in the 1975–2007 period.²¹ Reflecting this neglect of infrastructure, the American Society of Civil Engineers has estimated that a five-year investment of \$2.2 trillion would be needed simply to repair existing infrastructure in the United States—independent of any investments that might be needed to improve our current infrastructure, such as high-speed trains, swift broadband networks, and clean energy smart grids.

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It is fair to say that, as grim as this recitation seems, conservative economics would likely still be hegemonic were it not for the financial crisis and Great Recession of 2007–2009 whose effects still haunt the U.S. economy today. This is a financial crisis that wasn't supposed to happen according to efficient market theory, and a Great Recession that wasn't supposed to happen according to the new classical macroeconomics. Indeed, these doctrines not only failed to anticipate these events but also facilitated them by blanket deregulation of the financial sector. This makes conservative economics not just mistaken but fatally flawed as an economic philosophy.

Today's challenges for progressive economics

But sometimes fatal doesn't mean truly dead. As the Australian economist John Quiggin points out in his book *Zombie Economics*, these dead ideas still walk among us and exert substantial influence on the public and policymakers.

One challenge for progressive economics, therefore, is simply to pursue these ideas and, where possible, drive a stake through their hearts. The ideas behind efficient market theory and of new classical economics—that the market always knows the right price, that bubbles can't exist, that capitalism naturally produces full employment, that shortfalls in demand can't happen, that regulation and government spending are almost always inefficient and unneeded—must be categorically rejected because they are not true and they do not work.

But simply criticizing conservative economics will not be enough. The greatest challenges for progressive economics lie in defining a viable alternative. This means defining an economic philosophy and approach to deal with at least the following problems:

- The Keynesian consensus foundered on its attempts to keep inflation in check while pursuing full-employment policies to sustain demand. A new progressive economics should be committed to full employment, including the use of fiscal tools to combat shortfalls in demand, but also have a clear plan to contain inflation.
- Globalization was another factor undermining the Keynesian consensus, and globalization's impact is of course far larger now than it was in the 1960s and 1970s. Progressive economics today must develop a way to actively manage the globalization process. This should include, as advocated by Joseph Stiglitz and others, the creation of international institutions that can do for today's global economy what the Bretton Woods system did for the Keynesian era—maintain global monetary stability through a coherent set of trade and financial rules and regulations.

- Building on the work of behavioral economists like George Akerlof and Robert Shiller, progressive economics needs to understand how the “animal spirits”—human psychological traits like uncertainty, fear, excessive confidence, concern for fairness—that drive so much economic activity can be handled effectively by macroeconomic policy.
- The Keynesian consensus included a large role for public investment, both to shore up demand and make the economy more productive in the long run. Today’s progressive economics should replicate that focus but have a clear plan for the most effective public investments in infrastructure, education, research, and clean energy.
- The budget deficit and the national debt are the subject of much hysteria in the media and, of course, the most egregious antigovernment slanders by conservatives. But it remains true that projected deficits are too high, and that the debt-to-GDP ratio is on an unsustainable course. These budgetary issues must be addressed by progressive economics not only to forestall direct adverse effects of excessive indebtedness but also to create the budgetary space for needed public investments.
- During the Keynesian era, the U.S. economy grew a full percentage point per year faster than it has since 1973. Progressive economics today should not accept the slow growth trajectory we have been on since the ascendance of conservative economics but seek instead to boost our long-term growth rate significantly. Even a half percentage point per year increase in our growth rate would make a huge difference in everything from controlling budget deficits to raising living standards.
- Finally, all of the above, including faster growth rates, will be far less beneficial if current levels of income inequality continue. Therefore, a central task of progressive economics is devising the institutions and policies that could reduce inequality and spread the benefits of growth more widely. It is time to replace the Great Divergence with another Great Compression.

These are the challenges that today’s progressive economics must grapple with to decisively defeat conservative economics and lay the basis for a new era of broadly shared prosperity.

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