Section on Socio-Economics
of the Association of American Law Schools
Friday, January 3, 2003

Luncheon Speaker

James Kenneth Galbraith

LBJ School of Public Affairs, Texas

"Toward a New Pragmatism"

Remarks to the AALS Socio-economics Section
January 3, 2003

Friends, we meet a difficult moment. Our political backs are to the wall, our economy is stagnant and our country is on the brink of war. Apart from that, Happy New Year.

We are lawyers, economists, progressives, populists, institutionalists, communitarians, feminists, ecologists, Keynesians and Post Keynesians. We form a diverse assembly of political, social and economic thought. We have many names, over which socio-economics floats like an umbrella. Under that umbrella, we often seem more divided than we are.

But in fact we have much in common. Our common preoccupation is the definition of social problems and the design of improvements. We are not drawn to grand explanatory systems, to what Veblen called the "metaphysics of normality and controlling principles." We are practical people. We are in the business of schemes, gimmicks, devices, and plans. We believe with Keynes that, often as not, "nothing is required, and nothing will avail, except a little clear thinking."

We also believe social ideas exist collectively. A social problem is not like a math problem. It is not to be solved by a great mind working alone. Social ideas are developed in conversation and correspondence, in discussion and debate. Progress requires a broad base of organized and informed participation. And from this, it follows that progress is more likely – though certainly not guaranteed – when decision-making is reasonably democratic.

These are, of course, the principles of pragmatism, the great American philosophical tradition. The New Deal represented the high political expression of that creed, embodying the spirit of open and flexible experiment. The economic management of the Second World War was also substantially an outgrowth from the New Deal, and that battle was, substantially if not entirely, a triumph of the pragmatic spirit.

The Cold War ended the first pragmatic moment. The communist threat differed from Nazism in that it was not perceived mainly as military and external but as internal and subversive. The revolution was to come from within; the Reds were – so they said – under the beds. A condition for the success of pragmatism had been the presumption that all parties accept democratic rules and procedures, and this disappeared. Anti-communism then became free to impose its own framework of ideas on American political discourse, to demand fealty to those ideas as the price of participation. The loyalty oath was the great weapon of those who would systematize, discipline and exclude.

Thus began the rise of market fundamentalism, of market absolutism, of the mantras of small government, privatization, deregulation, budget balance, of Hayek's notion that planning was "the road to serfdom." The triumph of these ideas over policy was delayed, however, by a continuing pragmatic imperative. It was necessary that the United States and its allies actually win the economic Cold War -- something that seems easier now than it did forty years ago. Cold War liberalism and military Keynesianism were conscripted to this task.

Many of us at the time loathed the twisting of both liberalism and Keynesianism in the service of the Cold War. We could not really build the America we wanted -- and not only wanted but would have been able to afford -- by such means. Still military Keynesianism and Cold War liberalism achieved their purposes; by the early 1980s victory in the bilateral contest was assured. The Cold War exhausted the Soviet system not long before it would have exhausted our own. And on that basis, it became possible for free-market absolutism to begin to move from the domain of principle to that of practice, a process that has consumed the last two decades. In reaction we true progressives have become the true conservatives of American political life. We are the custodians of public spirit and public purpose. Our energies are devoted mainly to defending the imperfect, yet useful, public programs created by our forebears: Social Security, Medicare, Medicaid, public services, public lands, the courts and the jury system, and the public universities and the public schools. It is a status quo of which we are, in many cases, not especially proud. It is one that as reformers we would like to improve. But we will defend it, under the circumstances, rather than see it destroyed.

In the course of its political triumph, market absolutism discarded even the pretense of functional utility or higher public purpose. Twenty years ago, Reaganism was "A Program for Economic Recovery." Monetarism was put forward to fight inflation, supply-side economics to promote "work, saving, investment." The goal of the program was economic growth. It was a goal that, let us not forget, was in fact achieved – though by Keynesian means, in the re-election boom year of 1984. Had it failed, Reagan would not have been re-elected.

Today, the Cold War is over, but its principles go marching on. The advocates of "law and economics" favor the outcomes rendered by the marketplace whatever they may be. Good or bad – it doesn't matter. Who after all is entitled to judge? The Washington Consensus for global economic policy calls privatization, deregulation, balanced budgets and tight money – whether these policies work for any particular purpose or not. If the consequences of implementing those policies are often cruel and senseless, that is regrettable but irrelevant. And the fact that they measurably serve the distributive interests of the wealthy and powerful is to be passed over without comment. These commitments remove democratic accountability for economic performance from the picture.

And so at home, the situation is only slightly more ambiguous. We find Mr. George Bush calling for new tax reductions on corporate dividends. These will flow to businesses who probably will not actually increase their investments very much, or alternatively to executives and shareholders whose consumption is barely related to their incomes. These measures lack even the pretense of effectiveness as a sustainable strategy. Does Mr. Bush have any economic goal beyond good headlines from a rising stock market in 2004? If so, no one is articulating what it might be. What Mr. Bush offers is an absolutist doctrine covering for a clientelist practice, with the timing dictated partly by budget rules and partly by the calendar of elections.

That this is related to decline in democracy is no surprise. If the winner of the 2000 election had taken office, if September 11 had not militarized our government, if the Democrats had not run a craven 2002 campaign – would we be where we are today? Of course not. The concrete strategy of those who rule is to reduce the participation of the ruled. That is the function of the registration and voting systems (including felony disenfranchisement), of the campaign finance system, of the redistricting system, even of the party system to some degree.

It is true that, even so, proposals to undermine Social Security, Medicare and the public schools must be advanced under cloak of darkness and deception. Tax cuts must be concealed under spurious distributional analyses and weird phase-in schemes. These are signs that democracy and disclosure retain, to some degree, their disinfecting force.

The difficulty for us is that defensive tactics will not win for us opportunity to once again practice the arts of reform, improvement and progress. We will not even become able seriously to develop ideas in this direction so long as we are backed into this corner. Short-term necessities conflict with long-term strategic development -- as our adversaries are well aware.

And yet the difficulty for the market absolutists is in some ways equally serious. They have power, and with it, responsibility. So long as reasonable accountability can be brought to bear, their success does depend on whether they can deliver at least moderately satisfactory economic results. And this, I think it fair to argue, they may well not be able to do.

They will – probably – not succeed for three essential reasons. First they have no program to overcome the inherent instabilities of the credit economy here at home. Second, they probably cannot stabilize the global market system which has been created since 1970. And third, they probably cannot contain the consequences of the war on which they appear ready to embark. Let me take up these issues in sequence.

The expansion of the 1990s was an economic success story in important respects. Unemployment fell, yet inflation did not rise as the professorate had collectively feared. Private asset ownership, notably of houses and corporate stocks, reached unprecedented highs. It was a prosperous time. But prosperity was built on an unstable foundation. Federal government purchases of goods and services did not grow at all. State and local governments did grow rapidly in the last few years of the boom, but only on the basis of rapidly rising revenue streams tied to the explosion of asset values. Capital flowed in, in unsustainable torrents, following successive financial crises elsewhere: Mexico in 1995, Asia in 1997, Russia in 1998. Encouraged by a chorus of commentators headquartered on Wall Street, in Silicon Valley and echoed by high authority at Constitution Avenue, capital flowed specifically into the information technology sector.

That there was a bubble in technology stocks, and later in equities overall, was not a secret to any financial economist looking at the issue in a serious way. Alan Greenspan himself made the point with the felicitous use of the phrase “irrational exuberance” early on. The bubble was discussed bluntly, we know now, in Federal Open Market Committee councils in 1997. Robert Shiller borrowed Greenspan’s phrase for his very good book in early 2000. Dean Baker hammered the point in repeated studies. Paul Krugman was quite clear about it on several occasions. History did not provide precedent for sustainable asset price increases along the lines being observed. Sooner or later they would either end, or we would have to rewrite what we knew about finance.

It is therefore quite wrong to argue, as for instance California Governor Gray Davis did last weekend, that no-one could have or did predict the bust. A bust lay ahead in plain view. But sobriety on that point was lost on the press, whose reporting was frankly subservient to the sales machinery of the stock peddling firms and their investment bankers. This was like taking a view of global warming, exclusively from the oil companies. And yet, in the face of that consensus, the media-wise Mr. Greenspan abandoned his own judgement and became a convert to the “new paradigm” view of affairs.

The right question was not whether there was a bubble, but what to do about it. In recent attempts to defend the Federal Reserve’s record, Mr. Greenspan and Mr. Bernanke – and one can only congratulate them for making their arguments in public – have spoken as though the only alternative before the Federal Reserve had been to raise interest rates and bring the entire expansion to a halt. But this is not the case – and indeed when interest rates were raised, in early 1999, the bubble and the boom intensified, for nearly another year.

Rather, the question was whether the Federal Reserve should have asserted its regulatory role. It could have done so to begin with by increasing the margin requirement on broker loans. In this way it might have encouraged investors to diversify, rather than to concentrate, their holdings. It failed to take this step, or any other, including requesting additional legislative authority. The failure of the regulator to regulate – justified by appeal to the infallibility of the markets – is the nub of the matter. Of course the point of regulation is that markets do fail. Regulators who fear to regulate are not people who should hang on to their posts.

Yet contrary to what many economists then thought, it does not appear that the stock boom had very much to do with household consumption. Capital gains cannot be consumed directly; the attempt to do so, collectively, destroys the gains. But the stock boom did fuel business investment and other spending, to the tune of around $300 billion dollars by rough estimate. And when the music stopped, the flow of funds dried up and at least half of that spending went away. This was the source of the first loop of the recession, and the most serious drag on economic expansion so far.

The minor miracle of 2002 was that consumption continued, alone, to fuel economic expansion, and even what some described as a recovery from the recession that consumed most of 2001. This miracle was, in part, an outgrowth of policy changes following September 11: increased government spending, lower interest rates, lower oil prices, the tax rebates (which had already been enacted), and the patriotic willingness of the auto manufacturers to give away cars at a loss. For these reasons, including especially low interest rates, households continued to borrow and spend. It became apparent that another bubble was underway – this one in the price of housing.

The great domestic economic issue of 2003 is therefore plain enough. When will the consumer call it quits? The issue is not wholly resolved. Balance sheets look terrible except for the value of housing. On the other hand, low interest rates have kept the burden of debt service – truly the final decisive factor – within historical limits. That being so, much depends on how quickly housing values subside, on whether deflation raises the real burden of debts, and on whether incomes continue to fall, as seems likely, in relation to debt service.

A third serious domestic threat is the chaos descending on states and localities as their revenues collapse, in consequence of the declining economy, fallen markets, and their own opportunistic and regressive revenue choices over the years. State and local governments now spend more on goods and services than the federal government does, but they chose to finance that spending from fly-by-night revenue sources (capital gains and options realizations, notably in California), and to cut taxes permanently when bubbles make matters appear temporarily flush (notably in Texas). Now comes the moment when the books have to balance, and it is an ugly and dangerous moment. It has a strong potential to destabilize aggregate demand in the year ahead.

The great international economic issue is, let me venture, the fate of the dollar. We live in a global dollar-reserve economy, and have since 1973. By the standards of the past two centuries, thirty years is a fairly long time for any particular monetary system to endure. The classical gold standard failed after just under 40 years (1876-1913); Bretton Woods was dismantled after only 26 (1945-1971). The dollar-based system requires that international capital be willing to add dollar holdings at least at the rate of our current account deficit at full employment – well over five percent of GDP. But with capital asset prices flat or falling, with Latin debtors in or near default to major banks, with the U.S. involved in what might prove a widely disapproved war, and with the Euro alternative in plain view, will they continue to do so? Will the great dollar antigravity machine, located in Tokyo, finally get turned off? We shall see. It is a fact that without that machine in full function, the Federal Reserve may find itself between the devil and deep sea. It cannot at the same time keep household spending afloat with low interest rates and defend the currency with higher ones.

Finally there is the awful question of war. Assuming we go to war, we can hope that the outcome will be favorable, swift, and inexpensive. It is a different matter, however, to hope we will go to war, and to assume that the outcome will be favorable, swift and inexpensive. Speaking strictly from the economic standpoint, war can only worsen the current account, depress the investment and export climate, and weaken the structural position of the dollar. These consequences will offset, and they might possibly overwhelm, the direct stimulus of expanded military spending.

For these reasons, I do not think Mr. Bush can count on returning America to prosperity in the time remaining in his first term. Perhaps he has no such intention anyway. Perhaps he plans only to count on war, exclusion and the native disarray of the Democrats to preserve his power. Perhaps – as I would prefer to believe – he has no one nearby who can give him a full and balanced assessment of the issues, and would find the analysis indigestible if he did.

And this brings us to the question of what we must do. I am often asked for my proposals, and I have, for some months, been publishing a bite-sized list. It includes a new program of revenue sharing, to save the cities and states. It includes a payroll tax holiday or similar relief for working households, coupled to repeal of the worst features of the 2001 tax cuts, including especially the egregious repeal of the estate tax. It includes a program of energy conservation and transportation system reconstruction, to cope with the inevitable transition to an oil-short world ahead. It includes a call for low interest rates and better financial regulation, alongside reference to the need to rebuild the world's financial system along lines that would permit national development programs a chance to succeed.

This approach is, however, inherently subject to limits. My list is short, emblematic, symbolic. Inevitably it fails to mention many vital concerns, let alone develop those that it does mention. And it may also miss the essential task. The essential task may be less to offer a particular program, than to persuade the American people of the need to reconstruct effective governing institutions, at both the national and the international levels, and to do so in a fairly fundamental way.

The American people are, I deeply suspect, open to this message. They understand the corruption of corporate power, the perversions of campaign finance, and the character of the commercial media. They know, because they have experienced it first-hand, that deregulation in energy, finance and telecommunications usually means an explosion of rip-offs. They know, because they have experienced the matter first hand, that the big operators in the financial markets are not to be trusted. At the height of the war fever last September, they made clear their preference for working within and through the United Nations, and it is clear they were right in judging that this provided the best hope of safety without war. They understand, I believe, that the extreme inequalities and instabilities of global free markets (and our attempts to dominate them) are a source, and not the cure, for the forms of violence known as the terrorist threat.

Against this understanding, the voices of market absolutism offer little, beyond an assertion of faith and comfort. They cannot even articulate, let alone solve, the problems we actually confront. Their viewpoint, built for the Cold War, lives on, tolerated and yet untrusted, mainly because we have not yet found the voice with which to challenge it.

A new spirit of pragmatism surely requires that we discard the metaphor of market determinism – whole and entire. No more, let us bow and scrape before that altar. Markets have their place – they are a reasonably open and orderly way to assure the distribution of services and goods. They are not a general formula for the expression of social will and the working out of social problems.

They work only for limited purposes and within an accepted and enforced framework of laws, institutions, protections and rights, within frameworks that require the complex articulation of social design and not merely the matching of prices and quantities under the hammer of a fast talking auctioneer.

Further, it is only within the national framework that we can build and follow democratic procedures for deciding what those laws, institutions, protections and rights must be. That is the reason we have a nation-state. The reason we reject empire, imperial pretensions and imperial wars -- including the pernicious and unilateral doctrine of preventive war -- is that we do not want the responsibility, outside of accepted international frameworks, of making those decisions for other nations.

These ideas are conservative, in that they build upon values of republicanism and democracy inherent in the American tradition. They are liberal, in that they aim to recreate conditions under which social progress can resume, toward the security, sustainable well-being and happiness of the people – and to do so without recourse to threats and fears. And they are pragmatic, let me argue, because they attempt to appeal to the problem-solver in each of us. In other words, they appeal to an ethic that remains a key element in the character of the country that we share.