The Social Wage, Welfare Policy and the Phases of Capital Accumulation

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INTRODUCTION

Over the last three decades, the future of the welfare state has become one of the most contentious areas of debate in public policy. In recent years, most OECD countries with institutional structures as diverse as those of the United States and Sweden have rolled back the welfare state. The rationale for these austerity measures is that the welfare state has been a drag on economic activity and has reduced economic performance. Thus, it is held, cutbacks are necessary raise in order to raise economic growth and lower unemployment or, in the case of the U.S., maintain high future growth rates. Social transfer expenditures such as unemployment insurance, income transfers to the poor, the elderly and the indigent are seen as the primary targets in this new social policy orientation (Atkinson, 1999).

As articulated by an important document of the European Union prepared by Jacques Drèze and Edmond Malinvaud, the orthodox standpoint rests on three main objections to welfare programs:

a) they introduce labor market distortions;

b) they increase both the level of government spending as well as taxation rates needed to fund such programs: both factors reduce the efficiency of the private sector;

c) they lead to rising deficits and public debt.

The proposed solution is to make the welfare states "leaner and more efficient" (Drèze and Malinvaud 1994, p. 83). The first objection stems from the marginalist view of the labor market: the ideal, as usual, is the perfectly competitive factor market where the equilibrium price is established by supply and demand. Unemployment insurance or other forms of income support introduce distortions which lead to inefficiency. The other two objections follow from the standard marginalist analysis of government spending. A rise in the budget deficit needed to finance welfare provisions stimulates private consumption and therefore leads to a fall in the aggregate savings rate. This in turn raises the interest rate and crowds out investment.

Until about the mid-1960s there was a broad consensus that some optimal combination of social justice and economic efficiency could be attained within the context of capitalism.

This particular approach to social policy was consistent with the Keynesian[1] approach to macroeconomic management that was dominant at the time. However, this consensus began to unravel with the onset of the worldwide economic crisis in the 1970s and the demise of Keynesianism. Since the 1970s the conventional wisdom has become that, at some fundamental level, the pursuit of policies that reduce social inequalities conflicts with the logic of capital accumulation. Monetarist and rational expectations versions of neoclassical economics constitute the basis for this new view on social policy.

This paper uses an alternative theoretical framework to analyze the American welfare state. Its central premise is that welfare policies need to be studied within the context of the balance of social forces that emerges in a *phase of accumulation* (Kleinknecht, Mandel, and Wallerstein, 1992; Sterman, 1986). Political struggles and alliances and the institutions to which they give rise within a phase of accumulation determine the contours of the welfare state and the extent to which the working class can appropriate a portion of the social product for itself as its *social wage*.

This paper has several goals. First, we discuss rationales for the *existence* of the welfare state found in both traditional and contemporary marginalist analyses. Our aim is to expose the analytical core of these arguments and the strict limits that they impose on government intervention in the form of social policy. We also contrast the contemporary marginalist arguments drawn from the economics of information with the traditional liberal and Keynesian arguments.

Second, we discuss the history of U.S. welfare policy and the nexus between social and macroeconomic policy in the post-New Deal period. Our overview also aims to understand in a historical context the punitive nature of contemporary policies towards the poor. We hope to demonstrate the inability of marginalist theory to explain the actual historical processes that led to the rise and the decline of the American welfare state.

Third, we focus on the work of Atkinson (1999), who uses a neoclassical endogenous

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[1] We use the adjective "Keynesian" in the conventional sense throughout this paper. In recent years, a few authors have forcefully argued that Keynes's own views on macroeconomic policy had a decidedly long-run orientation rather than being confined to purely short-run demand management issues. Our views on macroeconomic policy is closer to Keynes than the Keynesians. See Kregel (1985), Brown-Collier and Collier (1995), Crotty (1999).

growth model to study welfare policies. While Atkinson uses a variety of labor market, institutional and macroeconomic issues to pose questions that are critical of contemporary polices, our purpose is to evaluate those parts of his discussion that pertain to savings, investment, and economic growth.

Fourth, we use an alternative model of cyclical growth in the classical-Harrodian tradition developed by Shaikh (1989) and extended by Moudud (1999a), to evaluate social policy. In this discussion, the purpose is to understand the theoretical underpinnings of Keynesian social policies in the "golden years" after the second world war, the limitations that the neoclassical paradigm hoped to overcome, and the extent to which a classical-Harrodian perspective provides a bridge between these two theoretical traditions. Our aim is to demonstrate that the classical-Harrodian tradition provides a framework for the analysis of the welfare state. This framework has certain features that it shares with both the Keynesian and the neoclassical traditions; but, it offers new insights that are very different from these two perspectives.

Fifth, we ask whether the extreme cutbacks that the American welfare state has experienced in the last twenty years were *economically necessary* to bring about the long expansion that began in the mid-1980s. In other words, to what extent is it true that there is a trade-off between social policy and logic of accumulation? More specifically, given the current long boom, is the rollback of the welfare state in the1990s justifiable on economic grounds? We answer these questions by examining, partly drawing from the work on the social wage by Shaikh and Tonak (1999), whether there is any macroeconomic basis to the claim that the welfare state has been a "drag" on capital accumulation.

Finally, we ask whether alternative policies could have been implemented that would have provided such a sustained stimulus to the economy. The methodological framework developed by Shaikh and Tonak (1994) on the distribution of the social product as well as Pechman's seminal work on taxation policy (Pechman, 1987; Pechman, 1989; Pechman and McPherson, 1992) are particularly helpful in addressing this question. Our conclusion is that the classical-Harrodian perspective does suggest such alternative policies. These policies will not affect the economy's basic laws of motion but will only modulate growth cycle crises while supporting social expenditures. Our analysis suggests that because economic growth and crises are endogenous, there may be no tension between social policy and economic performance.

THE MARGINALIST RATIONALE FOR STATE INTERVENTION

The marginalist rationale for state intervention in a private ownership, capitalist economy is built on two pillars: equity, or distributional concerns and market failure. We will first address the equity question briefly and then turn to a more extended discussion of the second rationale.

Equity concerns were raised by marginalist economists quite early on. Pareto, the progenitor of several key concepts in marginalist theory, emphasized that the economic equilibrium brought about in a neoclassical world can be objectionable on distributional grounds. The Arrow-Debreu model generalized this idea by putting forward two propositions that now adorn all graduate microeconomic textbooks. Under certain assumptions—convexity of production and consumption sets, and complete markets being the crucial ones—it can be shown, first, that a perfectly competitive equilibrium is Pareto-optimal and second, that any Pareto-optimal allocation can be arrived at as a competitive equilibrium by an appropriate redistribution of initial endowments. As pointed out by Arrow, these two propositions imply that "any complaints about its (i.e., the capitalist economy's) operation can be reduced to complaints about the distribution of income, which should then be rectified by lump-sum transfers." (Arrow, 1983, p.136).

The precise mechanisms through which such transfers can be affected so that social welfare is maximized and efficiency losses minimized are addressed in the enormous literature on welfare economics and social choice theory. An underlying tension in this body of work surrounds the notion of social welfare, a tension that has its roots in the rather crude view of society or classes as simple aggregations of atomistic individuals. Thus, lump-sum transfers to enhance social welfare can increase or decrease inequality. While Pareto appealed for a more equitable distribution for the sake of avoiding "imminent revolution" (Pareto, 1971, p.288), Amartya Sen has noted that the framework pioneered by Pareto can sanction injustice to the least well-off if it maximizes social welfare: "The trouble is ..that maximizing the sum of individual utilities is supremely unconcerned with the distribution of that sum." (Sen, 1973, p.13). For our purposes, it is sufficient to note that the rationale for state intervention to attain a more or less egalitarian distribution of income lies deep within the core of marginalist theory.

While the equity argument can be used within the marginalist framework to justify state

intervention, we must note that the scope of state intervention is strictly limited by the same argument to income transfers alone. State involvement in any form, in the provision of goods and services is completely ruled out on efficiency grounds—unless there is a certain kind of market failure. Generally, market failure is the concept employed in marginalist theory to describe situations where for some reason or another any one or more of the assumptions that guarantee the two central propositions are violated. The state can in such instances attempt to restore Pareto-optimality via quantity intervention (basically, quotas), price intervention (taxes and subsidies) and regulation.

Two stages in the development of marginalist analysis of market failure can be identified. In the first stage, the focus was mainly on external effects, imperfect competition, and public goods. The discussion of the rationale (or the lack thereof) for state intervention centered around the importance of these phenomena. The analytical core of this discussion was presented with remarkable clarity by William Baumol in his doctoral dissertation (Baumol, 1993).

Baumol attempted to develop an economic theory of the necessity of state intervention, or as he put it, to answer the question as to "why with rational citizens (and particularly in a democracy), governmental interference in the operation of the economy is tolerated at all." (Baumol, 1993, p.52). His attempt involved reconstructing the traditional argument about external economies in a rigorous way as to overcome some of the ambiguities in the traditional discussion and extending it to examine the issue of state intervention. While he held to the position that external effects (especially stemming from technology) are quite pervasive and can cause deviations from the Pareto-optimal allocation ("ideal output" as it was referred to in those days, following Pigou), his conclusion was that a properly designed system of taxes and bounties (subsidies) can resolve such instances of market failure (Baumol, 1993, p.104). Of course, perfect competition in all markets is assumed to support this claim, but then, departures from perfect competition can be, at least in theory, remedied by judicious government regulation.[2]

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[2] For the sake of completeness, let us note that Baumol did recognize that involuntary unemployment, may provide a rationale for government intervention. The type of government intervention favored was, however, *not* stimulating aggregate demand but removing factor market rigidities in industries where they are pronounced which leads us to suspect that he did not consider at that time, the possibility of recurring *mass* unemployment. (Baumol, 1993, pp.139-140).

While the framework of analysis has become more complicated since Baumol's graduate school days, the marginalist position in this respect, that is, the treatment of externalities and imperfect competition, has fundamentally remained the same.[3] These instances of market failure call for state intervention, but strictly in the form of devising a suitable incentive structure (taxes/subsidies) and a regulatory framework. Direct state involvement in the production and distribution activities in industries affected by these types of market failure are ruled out as inefficient. The only exception to this rule occurs when a particular kind of externality is present. This is the well-known case of public goods, where externalities among the consumers of such goods—the free-rider problem—produce departures from the Pareto-optimum. Public provision can be efficient in this instance, but the private sector can do an equally good job, if the government exacts the right amount of taxes and provides the right amount of subsidies. Only in the case of extreme failure of the exclusion principle (Musgrave, 1959, p.86), for example, national defense, can public production can be justified.

Thus, the type of market failures which were the overriding concern of the first stage in the marginalist analysis of market failure, gave limited room for state intervention and almost no room for state provision of goods and services. Summarizing the discussion so far, it appears that the rationale for state intervention in the marginalist world, can be made on distributional grounds (equity) and on market failure (efficiency). The scope and nature of state intervention is limited to:

- income transfers to achieve a desirable distribution;
- implementation of a suitable tax/subsidy structure to overcome inefficiencies introduced by externalities and public goods, coupled with the public production of some public goods; and,
- provision of an adequate regulatory framework to overcome imperfect competition.

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[3] We are ignoring here the burgeoning literature on incentive and mechanism design because it is unclear to us what *specific* implications it has for the *rationale* for state intervention. For a textbook exposition, see Mas-Collell, Whinston and Green (1995, pp.857-910). An important root of this body of research lies in introducing informational asymmetries in the case of externalities—for example, the effect of an externality may be privately-held information by the agent, as in the case of a firm that withholds information regarding the pollutants it dumps in a river (Clarke, 1971).

By the 1950s and the 1960s, if not earlier, it must have been fairly obvious, even to the ardent marginalist theorist, that the role of the state in any advanced capitalist economy far exceeded the boundaries demarcated for it by marginalist theory. State policies to promote full employment (mass involuntary unemployment is of course impossible in the marginalist world), as well as active involvement in social insurance, medical care and several other important areas had become, to varying degrees, integral components of state intervention in all advanced capitalist countries. Given the discrepancy between theory and reality, the stage was set for a new phase in marginalist analysis that attempted to provide a rationale for the extended role of the state.

It must have been clear from the outset that the rationale for important new instances of state intervention had to be constructed solely on efficiency grounds. Consider, for example, the provision of health care insurance. Arguments of the type that "government should provide health insurance to those who can not afford it" can not be sustained within a strictly marginalist framework. If it is believed that the reason why some can not buy health insurance in the private insurance market is that they can not afford it, the optimal policy is redistribution which will enable them to do so, *not* government provision of medical insurance (Barr, 1987, p.99).

As is well-known some of the major areas of state intervention in the post-Second World War period centered around medical insurance (in the form of Medicare and Medicaid), unemployment insurance and old-age insurance (Social Security). It was therefore not surprising that the initial attempts at characterizing market failure focused on insurance markets. If indeed insurance markets functioned like any other perfectly competitive market, there is no reason why state intervention would be required. The clever move by Arrow (1963, 1983) was to argue that the commodities to be traded in the insurance markets, i.e., risks, have certain innate characteristics stemming from uncertainty and imperfect information that prevented markets for risk-bearing from functioning in a perfectly competitive manner. Notions prevalent in the insurance industry such as moral hazard and adverse selection were given an analytical content within a marginalist framework by him and others who followed in his footsteps.

The research program thus inaugurated is now known as the economics of information and it is striking how the market-failure justification for state intervention is now almost entirely conceived by marginalist theory in these terms. Nicholas Barr thus began his 1992 survey of

economic theory and welfare state by stating that much of the welfare state's "efficiency justification derives from its properties as a device for ameliorating what, in effect, is a series of principal-agent problems." (Barr, 1992, p.42) This is a remarkable change from earlier liberal arguments which justified the state provision of health, social and unemployment insurance for "national interest" as well as its stabilizing role as a counter-cyclical policy. These arguments stand in stark contrast to the currently popular wisdom which is nicely illustrated by its attitude towards unemployment insurance: "..the main efficiency justification for publicly organized unemployment compensation arises out of insurance market failures which make private unemployment insurance incomplete or impossible." (Barr, 1992, p.747)

Of course, we do not mean to suggest that the two positions are incompatible. In fact, the arguments based on informational problems and uncertainty can be seen as a double-edged sword with respect to the old-fashioned liberal and Keynesian thinking: on the one hand, it provides a rationale for liberal and Keynesian state policies *within* the framework of marginalist theory. But, simultaneously, by placing that rationale firmly within the confines of marginalist theory, the theoretical anchors on which the rationales were based are discredited. The Keynesian emphasis on recurrent mass unemployment as an inevitable feature of free-market economies and the institutionalist emphasis on inequalities of wealth and power which lies behind the economic insecurity faced by large masses of people under capitalism are now *passé*. In its place, we now have insurance market imperfections which prevent certain individuals from obtaining insurance! The next section presents a historical and institutionalist analysis of the origins and the dynamics of the American welfare state which reveals that actual social policy has far less to do with uncertainty and insurance market failures than suggested by contemporary marginalist analyses.

A BRIEF HISTORY OF WELFARE POLICY

Despite its long history and many travails, several authors have commented on certain common assumptions that have underpinned U.S. welfare policy (Skocpol, 1987; Mink, 1998). We need to understand the contemporary assault on the welfare state within this context.

As Skocpol discusses, American political discourse makes a sharp evaluative distinction

between “welfare” and “social security”. Policies in the Clinton era with regard to these two arms of the welfare state should be understood within this light. “Social security” refers to old-age insurance and other insurance programs such as disability and survivor’s insurance, as well as medical coverage for the elderly. These programs are generally seen as sacrosanct since they are funded by the contributions of those who are employed. On the other hand, what is pejoratively called “welfare” is seen as a governmental crutch for the undeserving poor who have not made the effort to seek employment.

Skocpol points out that this distinction between “social security” and “welfare” was already implicit in the original Social Security Act and was explicitly emphasized in the Act after 1935. Moreover, this is a distinction which is rooted in American political history. While in the nineteenth century “the United States had a precocious system of extensive public social benefits that was already in place just as the ‘modern welfare state’ was born in Europe” (ibid., p. 39) it took place within the context of what might be called patronage democracy in which local party bosses channeled public spending in order to gain political constituents. Thus by the end of the nineteenth century about one out of every two native-born white men in the North received old-age pension under the pretense that they were Civil War veterans, and over a quarter of the federal budget was allocated for this purpose.

It was in response to this form of patronage democracy that made Progressive Era politicians, many of whom went on to formulate the Social Security Act during the New Deal, oppose what they considered to be open-ended government handouts which would lead to corruption and budget deficits. “Public assistance” programs to the unemployed were to be minimal and temporary and kept separate from “social insurance” programs that every worker would be entitled to as a right since the latter were to be funded via the tax contributions of workers and employers. “Those who formulated the Social Security Act hoped that most Americans would earn protections from contributory social insurance programs and cease to need public assistance at all” (Skocpol, 1987, p. 40-41). On the other hand, the respectful place that it had in American social policy allowed social security to expand its coverage in the postwar period to include higher benefits and new disability and medical insurance programs.

And yet despite its relatively respectable status, especially with regard to social security, the development of social insurance did not take place without conflicting political struggles

between different segments of American society. Dr. I. M. Rubinow, who was a physician and actuary, was one of the earliest and foremost proponents of social insurance in the U.S. Rubinow argued that "the ideal purpose of social insurance, the purpose to which the best insurance systems tend,...is to prevent and finally eradicate poverty, and subsequent need of relief, by meeting the problem at the origin, rather than waiting until the effects of destitution have begun to be felt". On the other hand, the purpose of public poor relief is "to grant the necessary *minimum* for a physiological existence, *and that only* (Rubinow, 1913, pp. 480-81; cited from Blaustein, 1993; emphasis added). Rubinow, who became associated with the so-called Ohio school of thought which emphasized the alleviation of poverty, was inspired by the European unemployment insurance programs and wanted an American program to emulate these. In essence such programs recommended public spending on social insurance programs.

An opposing point of view was proposed by Professor John R. Commons, who was the intellectual leader of the famous Wisconsin School. Commons' aim was the *prevention* of poverty by preventing unemployment. The means to obtain this goal was to hold employers alone responsible for involuntary unemployment. In contrast to the European system, the Wisconsin school's central premise was that the stabilization of employment and the reduction of industrial accidents could be accomplished via appropriate labor legislation that offered financial rewards to firms that behaved in humane ways towards their workers and punishments to those that did not. Employers *alone* would be taxed to set up unemployment reserves that would be disbursed as temporary compensation to laid off workers. Companies that maintained stable employment would not be burdened with further taxes. Moreover there would be no industry-wide or state-level pool of funds to insure workers. Those laid-off workers who were not covered or those whose companies' funds had been exhausted would have to find "other assistance" (Skocpol, 1995, p. 149).

By the end of World War I, the Wisconsin preventative approach to industrial regulation began to have a powerful influence on the American Association for Labor Legislation (AALL), an association of reform-minded middle- and upper-class professionals and social scientists many of whom were university professors. Founded in 1906, the AALL was in the early part of the twentieth century at the forefront of progressive labor advocacy groups that through careful research sought to convince public opinion of the need for a comprehensive social insurance

program that would shield working people from the vagaries of industrial capitalism. The AALL was to a significant degree funded by wealthy benefactors, many of whom were at times opposed to each other on issues having to do with social legislation and the role of the government.

In order to understand the nature of these proposed social policies one needs to understand the political climate within which they were being proposed (Skocpol, 1995). As discussed above, the corrupt nature of nineteenth century patronage democracy made even progressive middle- and upper-class people oppose public spending at the state or federal level. To the extent that the opinions of this strata of the society gained the widest currency, it was inevitable that there was large-scale opposition to public social spending. The fears of both conservatives and progressive social reformers were particularly strong about non-contributory old-age pensions although this was a type of social spending that was favored by organized labor and the larger society. In fact, progressive social reformers were proponents of contributory insurance programs, especially for health and unemployment. However, by the 1930s widespread opposition from powerful economic groups such as the American Medical Association and private insurance companies effectively prevented public health insurance from being part of the Social Security Act.

The end of World War I brought with it a sharp reaction against federal programs from Congress. The U.S. Employment Service, which might have provided a basis for a national system of unemployment insurance as in Britain, underwent drastic budget cuts by Congress and most other wartime federal agencies were also made to reduce their activities. The regulationist policies of the Wisconsin school gained currency in such a political climate. The purpose of such policies was to nudge private industry into more humane treatments of their workers while the federal government would play an "associative role". This is what Skocpol calls "welfare capitalism" which describes that set of innovative labor-management practices that were adopted by major U.S. corporations such as Proctor and Gamble, Eastman Kodak, and General Electric. Stock-ownership by workers and employee representation plans were part of the institutional changes that were transforming U.S. corporations so as to undercut the political clout of unions. Further, innovations such as pension plans, company safety and health benefits, as well as guarantees of stable employment, with some promises to pay compensation for workers temporarily laid off, also reduced the necessity of public social insurance.

Ironically, the non-statist solutions to economic welfare problems that were supported by both progressive reformers as well as large corporations in the halcyon 1920s also obtained support from organized labor at the national level (including its more radical wing under Gompers), although state federations of labor tended to be supportive of progressive social legislation. The American Federation of Labor's (AFL) surprising stance on social insurance was due to its suspicion of and hostility towards the government. Gompers argued that the trade union movement would take care of itself through voluntary contributions and by demanding higher wages. The opposition to state involvement in the provision of social insurance was based on two objections. The first one was that the federal agency overseeing such a program would itself not be subject to democratic control and might have wound up being controlled by the employers. Second, "[C]ompulsory social insurance is in its essence undemocratic. The first step in establishing social benefits is to divide people into two groups-those eligible for benefits and those considered capable to care for themselves. The division is based on wage-earning capacity. This governmental regulation tends to fix the citizens into classes, and a long established insurance system would tend to make these classes rigid" (Gompers, 1917; cited from Skocpol, 1992, p. 210). One should note, however, that the AFL only endorsed one type of social insurance- national, non-contributory old-age pensions for poor Americans.

We can thus see that the different political forces in American society in the early twentieth century were deeply divided in their views on social policy. The divisions within the working class (that is, the conflicting perspectives of the AFL at the national level and state labor federations), the absence of any labor-farmer coalition as in Sweden, the rise of welfare capitalism, and the influential views of the Wisconsin school with its emphasis on the associative state, effectively prevented the development of any large-scale welfare state before the Great Depression.

However, mass unemployment and growing social misery gave rise to an upsurge of protests in the Great Depression. Rising business bankruptcies and the increased financial strains put on state budgets led to growing pressure for federal action. It was in this period that radical demands for unemployment insurance and old-age pensions were made by the various social movements. Such pressures from below from some local unions, many state labor federations, reformist social activists, and groups of unemployed workers affiliated with leftist parties grew as

both welfare capitalism and the notion of the minimalist federal government, popular in the booming 1920s, were discredited as the long wave crisis deepened. As in previous and future historical periods, it was pressure from below that precipitated federal action. Waves of protests demanding "bread or wages" led President Franklin D. Roosevelt to push for a relatively progressive relief program in the spring of 1933. Within eighteen months, 20 million Americans, almost 16 percent of the population, were receiving relief payments (Piven and Cloward, 1971). This was the first important step in the development of the modern American welfare state.

However, despite widespread popular agitation for a national social program, the process through which Social Security was planned in the mid-1930s was remarkably insulated from broad mass participation (Skocpol, 1995). The program was planned by a small core group of experts who were recruited by executive branch leaders. Both organized and unorganized labor as well as social activists and voluntary groups played a minimal role in this planning process.[4] While such groups "on the outside" were calling for social insurance at the national level, the formulation of Social Security was largely determined by experts who were sympathetic to the ideas of the Wisconsin school. At the heart of such policies was the rejection of a nationalized social insurance program. The key post for policy planning and legislative drafting of the Social Security Act went to Edwin Witte who was formerly the secretary of the Wisconsin Industrial Commission and chief of the Legislative Reference Library for the state of Wisconsin. Distinguished proponents of the Ohio plan such as Rubinow were excluded from the planning process.

The intellectual influence of the Wisconsin school led to a tax - offset financing plan for social security. According to this plan, the federal government would assess payroll taxes but would forgive 90 percent of these if employers paid their contributions to insurance funds. These funds were to be set by states according to their individually-set criteria for eligibility, benefits, and taxes. It is perhaps important to note that the political climate of the times was such that Witte and his associates faced an uphill battle in pushing through such a decentralized

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[4] See Witte (1963, 1972) for discussions of how labor did not have an independent impact on Social Security and how certain labor leaders were coopted into the policymaking process. As Skocpol notes, one should also remember that the split between the American Federation of Labor and the Congress of Industrial Organizations in the 1930s further weakened the political role of labor within the Democratic Party.

and "market friendly" social insurance program when there were powerful political forces representing labor unions and some welfare capitalists who were pushing for a national system.[5] In the end, however, the federal tax-offset plan for unemployment insurance was pushed through a reluctant Committee on Economic Security (CES). Thus, any hopes for a national welfare state were dashed yet again.

Certain other elements of the Social Security Act of 1934 such as the old-age insurance system did make it to the national level, albeit in a severely curtailed form. CES attempts to install national standards were undermined by Congress. To push the national old-age insurance through Congress it was necessary, as Edwin Witte noted "to tone down all clauses relating to supervisory control by the federal government" since "some southern senators feared...[any] entering wedge for federal interference with the handling of the Negro question...[and] did not want to give authority to anyone in Washington to deny aid to any state because it discriminated against Negroes..."(Witte, 1963, pp. 135-36, 141; cited from Skocpol, 1995, p. 159). The marked reduction of federal control over states' administration led to the elimination of the provision that states "furnish assistance sufficient to provide, 'when added to the income of the aged recipient, a reasonable subsistence compatible with decency and health'" (Witte, 1963, pp. 144; cited from Skocpol, 1995, p. 160). In fact, all national minimum standards to the Act were severely restricted.

In addition to social security, the New Deal also gave birth to a public assistance program called the Aid to Families with Dependent Children (AFDC) which expanded greatly with the turmoil of the Great Depression and again in the 1960s during Johnson's Great Society program. Its principal clients were poor single mothers. Along with other Great Society programs, AFDC became the most visible symbol of "welfare". It is no surprise that such public assistance programs came under increased political scrutiny following the slump of the 1970s.[6]

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[5] The welfare capitalist proponents of such a national system were motivated by the need for a level playing field for all firms in all states, so that "progressive" employers would not be undercut by ow-cost competitors.

[6] A small but increasingly influential body of academic work can be traced to this period which was critical of social spending on the grounds that it was dragging down economic growth. See, for example, Feldstein (1974).

Thus during the Reagan years the "welfare" programs bore the biggest onslaught against the welfare state despite the fact that at the time low-income public assistance constituted less than 18 percent of federal social spending and was far less than the proportions allocated to Social Security and Medicare. There was more or less a linear progression from the Reagan cutbacks to the dramatic changes in social policy in 1996 when AFDC was repealed and was replaced by the Block Grants for Temporary Assistance for Needy Families (TANF) as Title I of the Personal Responsibility and Work Opportunity Act. In some fundamental sense, we see American social policy moving to the kind that existed before the New Deal. One is tempted to wonder whether these drastic social cutbacks will reduce the American welfare state to the rudimentary form that existed in the late nineteenth century, given the strength of the conservative ideological offensive and the increasingly moralistic and punitive nature of contemporary policies.

As discussed above, this offensive does not come from nowhere: it is rooted in the historical bifurcation in U.S. welfare policies between "deserving" and "undeserving" beneficiaries. Mink (1998) argues that the particularly punitive nature of current welfare policies towards the latter has a long tradition and ideological continuity in which "carrot and stick" methods were employed by using combinations of explicit moral stipulations and economic sanctions to regulate the poor, especially women.

Seen in this light, it is not surprising that social policy in this country was never part of a broader macroeconomic strategy to generate full employment. Unlike their British counterparts, American policymakers had at a fairly early date rejected a commitment to full employment via fiscal, monetary, and labor market policies. However, this was not the case in the early years after the New Deal was formulated. By the late 1930s many New Dealers had become what Skocpol calls "social Keynesians" who wanted to tie relatively high levels of social spending with macroeconomic policies so as to maintain full employment. A variety of social programs had been instituted by this time. Probably the most important social welfare program in 1939 was that which was concerned with public employment. The cost of these public employment programs in 1939 was around $1.9 billion, which was around 20 percent of total federal expenditures and about 47 percent of federal social welfare expenditures (Skocpol, 1995, Ch. 5).

In the second world war, and immediately afterwards, the National Resources Planning

Board (NRPB) became a forum in which left-wing Keynesians proposed measures to create full employment via activist state policies. However, for a variety of reasons these policy measure never gained wide currency.[7] For one thing, no Scandinavian type of coalition between industrial labor and farmers appeared to push for such policies (Skocpol, 1987). Furthermore, in contrast to Britain, the comprehensive social and economic measures proposed by the NRPB were very far-reaching and ambitious. For example, echoing the viewpoint of the Committee of Economic Security, the NRPB advocated social policies that would assure an "American standard" of economic security as a *right* of every citizen (Skocpol, 1995, p. 174). The wide-ranging American plans advocated new social insurance policies as well as the centralized administration of unemployment insurance. Put simply, these goals were too ambitious and new in the American context: the NRPB planners did not have a blueprint of tried - and - tested social policies to launch their program. On the other hand, building on a longer tradition of social insurance, the Beveridge report was more modest in its aims and sought to build on existing social programs. Thus it had a greater chance of succeeding.

The different trajectories of social policies in the two countries were also not unrelated to the political positions of organized labor. The Conservative - dominated coalition government with Labour in the war years gave the latter a number of key ministerial positions from which it could influence pro-labor policies. Such a situation was not possible in the U.S. in which wartime cooperation between the Republicans and Democrats was very informal and, moreover, organized labor had very little say in the policymaking process during the wartime. Finally, the comprehensive social insurance system advocated by the NRPB planners was opposed by the more conservative rural Democrats. Thus, ironically, while the NRPB social and economic program was in some sense more radical than the proposals of the Beveridge Report, ultimately a much weaker welfare state developed in the U.S.

From the 1940s to the 1970s, a mild version of Keynesianism came to dominate policymaking. The activist government policies of the NRPB was replaced by much more gentle fine-tuning monetary and fiscal policies based on what Joan Robinson has called the "bastard" Keynesian tradition. As Skocpol put it, the "commercial Keynesians" won the battle to make

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[7] In fact, in1946 the Full Employment Bill was replaced by the Employment Act.

policies. To be sure, various national labor market and job training programs did emerge as part of Johnson's War on Poverty but "these programs remained adjuncts to the predominant 'antipoverty' and 'welfare reform' themes of the period" (Skocpol, 1987, p. 44).

One can therefore understand, that despite the commercial Keynesian interlude that ended in the early 1970s, American policymakers had much greater faith in the functioning of the free market. The failure to coordinate social and macroeconomic policies together with full employment as the goal reinforced the political belief that every person can pull themselves up by their bootstraps. Thus the stigma attached to "welfare". It is not surprising that with the onset of the growth cycle decline in the 1970s, the gradual erosion of the welfare state went hand-in-hand with the rise of the monetarist-rational expectations school. Henceforth, *laissez faire* and "personal responsibility" would become the rallying cries of the conservative forces that became dominant. The punitive moralism that has always been at the core of poverty alleviation policies in the U.S. and elsewhere (Handler, 1995; Mink, 1998) rose to prominence and launched the ideological offensive against the welfare state.

This discussion should also make clear that there was far more to the rise and the decline of the U.S. welfare state than can be explained by the simplistic market failure type argument that marginalist theory uses to explain state intervention. Insurance market imperfections surely cannot be used to describe the struggles between the various social classes that led to the rise and the decline of the welfare state. Nor can it explain the different *kinds* of welfare states that have evolved in the twentieth century in different capitalist nations. It is much more fruitful to situate the dynamics of the welfare state within the context of the power relations in capitalism. Persistent economic insecurity (the extent of which is governed by the phase of accumulation) under which ordinary citizens find themselves gives rise recurrently to pressures from "below." Persistent pursuit of profits by capital creates pressure from "above" on restricting social policy or encouraging it only to the extent that it does not threaten the pursuit of profits. The manner in which the capitalist state mediates the conflicting demands of the different social classes and the outcome of such mediation determine the contours and the specifics of social policy during any given phase of accumulation. In the final instance, it is not market failure but rather the contradictory nature of the capital accumulation process itself that propels the rise of social insurance.

MACROECONOMICS AND THE WELFARE STATE: THE ORTHODOX PERSPECTIVE

We now turn from the economic rationales for the welfare state to the macroeconomic consequences of welfare spending. We will address the set of questions that revolve around this issue by first examining two versions of the orthodox perspective. An alternative framework based on the classical-Harrodian tradition is presented next, followed by an evaluation of recent U.S. social policy based on our alternative framework.

Household savings play key role in the orthodox macroeconomics literature. Thus it is not surprising that in his analysis of social security Feldstein (1974, 1976, 1995, 1996) investigates the impact of social security on household savings. A central concept in his work is *social security wealth* (SSW) which is defined as present actuarial value of the Social Security benefits to which the current adult population will be entitled at age 65 minus the present actuarial value of the Social Security taxes that they will pay before reaching that age. Feldstein finds econometrically that SSW is like private wealth in that it stimulates private consumption and thereby crowds out private capital accumulation. He also argues that high replacement rates act as a disincentive for households to save. Feldstein's solution is to privatize the Social Security system so that private funds would be mandatorily invested in private capital markets. This would stimulate private saving and thus capital accumulation.

Feldstein (1973, 1974) also discusses the impact of business savings. He concludes that an increase in business retained earnings raises share values and thus the higher capital gains boost private consumption so that there is at least a partially offsetting fall in personal savings. Share values rise because households are said to be able to penetrate the "corporate veil", although it is not clear from his analysis what the underlying mechanism is which brings this about. Using an econometric model which regresses consumption on income, wealth, social security wealth and retained earnings, he finds a positive coefficient on the retained earnings term. However, one could equally well argue that this positive coefficient arises because an increase in retained earnings stimulates investment and employment and thereby raises

consumption. Finally, it is not clear why the social savings rate[8] should fall in this process.

Atkinson's book *The Economic Consequences of Rolling Back the Welfare State (1999)* is an important contribution to the growing literature that has been critical of contemporary social policies. It is not critical of Feldstein's analysis. However, while warning his readers right at the onset that his book "does not attempt to determine whether or not spending should in fact be cut" (ibid., p. 3), Atkinson's main goal is to point out that the welfare state can make both positive as well as negative contributions to efficiency and economic performance. Thus cutbacks may well raise more problems than they were intended to solve. While his criticisms are based on a variety of issues, our intention is to focus on those aspects of his arguments that pertain to savings, investment, and economic growth.

The thrust of Atkinson's criticism rests on the argument that the orthodox view is rooted in the perfectly competitive model in which all markets clear; thus in this model the welfare state has unambiguously negative effects. Atkinson contends that since the real-world economy departs from this model, the impact of the welfare state is more complicated. Put simply, while recognizing the strengths in the arguments of Feldstein and other orthodox authors, Atkinson uses the neoclassical framework to point out some of the countervailing factors that may not raise the long-run growth rate if the welfare state is scaled back. In what follows, I discuss certain specific areas on which Atkinson focuses his criticisms. It should be emphasized that one of Atkinson's innovations is that he distinguishes between static and dynamic specifications of output.

Welfare Spending and Aggregate Economic Performance

Atkinson reports that data from the OECD on advanced capitalist countries show that in general high GDP per capita is correlated with high social security transfers[9] per capita. Thus, as far the *level* of GDP per capita is concerned, there does not appear to be a negative correlation between

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[8] That is, aggregate savings as a share of GDP.

[9] Social security transfers consists of sickness and old age benefits, family allowances, social assistance grants and unfunded employee welfare benefits paid by the general government.

welfare spending and aggregate economic performance. However, Atkinson does not seek to draw a causal relationship from this correlation; in particular, he seeks to dispel the Keynesian argument that higher welfare spending produces higher national income although he does admit that this could be a hypothesis. Instead, he hypothesizes that this correlation might well be explained by the fact that successful countries, with high incomes per capita, are better able to provide a more generous welfare state. As another hypothesis he argues, echoing Polyani, that the process of industrial development might generate the need for a more developed welfare state as national income grows.

With regard to the relationship between welfare spending and the *growth* of output, Atkinson makes use of the growth version of the Cobb-Douglas production function:
Growth rate of GDP = $ x Growth rate of capital + (1 - $) x Growth rate of labor + Rate of technical progress
Atkinson identifies different channels via which the growth rate might be influenced by the welfare state. Social transfers could affect the growth of factor supply and/or the growth of productivity. For example, a social safety net may reduce aggregate uncertainty and encourage risk-taking activities that spur the generation of new ideas or methods of production. Atkinson claims that the rational expectations endogenous growth (EG) model provide a better framework for the analysis of the feedback effect of productivity.

Econometric evidence of the links between the growth rate and the size of the welfare state cited by Atkinson reveals mixed evidence since some studies show that high spending on social transfers produces lower growth rates while others show the reverse.

Savings, Pensions, Private Capital Markets and Economic Growth

Atkinson uses two versions of neoclassical growth theory to study the impact of cutbacks in welfare spending. In the Solow growth model technology is exogenous; a rise in the savings rate will in the steady state lead to a rise in the capital/output ratio. Thus the level of output rises but the steady state growth rate is unchanged. On the other hand, in the EG models technology is endogenous so that an increase in the savings rate increases the rate of technical progress and raises the rate of growth permanently.

The question is, what are the implications of the impact of social transfers within the context of the EG model? According to Atkinson, the salient point to note is that the existence of a state pension scheme (or any similar social insurance system) reduces aggregate savings and therefore, following the EG model, the long-run growth rate of the economy. However, Atkinson argues that from this it does not follow that a cutback in the state pay-as-you-go program will necessarily raise the long-run growth rate. Suppose that it is replaced by a means-tested program in which the level of state pension provided to those with no other resources is kept unchanged but is reduced progressively for those with other income sources. The rationale for such a program is that it would still be an anti-poverty measure while involving a scaling back of public expenditure. The disadvantage, Atkinson argues, is that such a program might be a disincentive for some people to save: they could reduce their savings to zero in order to rely on the state pension. Thus a means-tested program might have uncertain effects on net savings and therefore long-run growth.

It is not obvious at all that a state pension scheme would reduce savings. What if it were financed by an equivalent or even higher taxes on wages? Assuming that the bulk of private savings arises from business retained earnings and savings from capital income, this would either leave the social savings rate constant or even raise it. We do not make this criticism as a policy prescription but raise it because of the important empirical finding by Shaikh and Tonak (1987, 1994, 1999) that taxes on the working population have generally exceeded social benefits received from the state. Thus, in the entire postwar period, American welfare recipients did not reduce national savings. As discussed in further detail below, a number of mainstream and heterodox authors make this crucial mistake of not adequately taking into account the transfers *from* the working class *to* the state to finance the latter's welfare activities. By not taking this transfer into account, an illusion is created that the welfare state is more of a drag on national savings than it is in reality.

What about a complete privatization of the pension system? From the orthodox perspective, this would have the dual positive effects of reducing government expenditure and of infusing further private funds into the capital market: the additional injection of loanable funds would lower interest rates and fuel new private investment. Here again, Atkinson argues that the final outcome of the privatization may be more uncertain. His basic argument is that a tension

might exist between the objectives of corporate managers, who seek to maximize the long-term growth of investment, and those of pension fund managers who seek to maximize share values. The increased ownership of shares by pension funds might therefore influence the role of their managers and thereby sacrifice long-run growth. This analysis of course totally bypasses an important empirical fact, which is that only a small fraction of shares issued in the stock market are new ones, i.e. the bulk of private savings flowing into the stock market are used to purchase stocks of *existing* rather than new investments.

While no doubt some of the feedback effects discussed by Atkinson might be important, the most puzzling feature of his analytical framework is that crowding-out from welfare expenditures is discussed within the context of the so-called AK models (Aghion and Howitt, 1998) that are based on the important rational expectations models of Romer (1986) and Lucas (1988). And yet in a rational expectations world "...a decrease in public saving (implied by a larger budget deficit) leads to an exactly offsetting increase in desired private savings, and hence to no change in desired national saving" (Barro, 1991, p. 136). This *policy ineffectiveness* proposition in turn implies that within the EG framework budget deficits are innocuous. Thus all the complicated theoretical gyrations which Atkinson uses in his book can be entirely avoided by applying the household savings behavior described by Barro in the above quote in an EG context. The point is, in a model based on intertemporal utility optimization why cannot households always adjust their discount rate to adjust their savings in line with government dissavings so as to pay for possibly higher future taxes?

One can in fact go further and raise questions about the very theoretical framework that Atkinson uses in his analysis of the welfare state. The complete absence of money and uncertainty from this framework removes the possibility for any imbalance to arise between the savings decisions of households and the investment plans of firms[10]. And yet in a world characterized by Keynesian uncertainty, a rise in household liquidity preference could make households hoard their money (either as liquid bank deposits or government bonds) rather than

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[10] In fact, the representative agent methodology which underpins neoclassical models implies that "[T]he problems of coordination emphasized by Keynes and other macroeconomists - between investors and savers, borrowers and lenders, capitalists and workers - are finessed" (Haliassos and Tobin, 1990, p. 909).

purchase risky private securities. Thus whether or not household savings are affected by a particular welfare policy, it is not obvious at all there has to be a one-to-one and direct correspondence between the savings decisions of households and business investment, as neoclassical theory suggests. Put differently, if the means-tested program does succeed in raising the national savings rate by boosting household savings the additional savings could end up as higher bank deposits rather than be used to purchase equity; what is crucial is the actual *phase of accumulation* (Kleinknecht, Mandel, and Wallerstein 1992) and the influence it has on households' portfolio decisions. One does not have to invoke the mechanisms discussed by Atkinson to raise questions about the orthodox belief that higher household savings will raise the long-run growth rate.

Neoclassical authors would counter this line of objection by arguing that even if the additional household savings end up as higher bank deposits, banks will loan them out to firms via the money multiplier relationship. And yet a critique of the money multiplier story has been one of the most significant contributions of the post-Keynesian and endogenous money schools (Moore, 1988; Wray, 1990; Palley, 1996) which have argued that the supply of credit to finance investment depends on the demand for credit and thus, in the final instance, on the rate of investment growth.

This line of argument also suggests that privatizing social security may not affect capital accumulation at all if, faced with declining corporate profitability and a weak stock market, private pension fund managers choose to invest in more liquid short-term financial assets rather than in long-term capital investments. This becomes particularly relevant in the late expansion-early recession phase of a growth cycle when interest rates on bonds and deposits are high and the rate of profit is low.

Finally, we question the production function methodology that Atkinson employs to suggest some of the ambiguous effects of welfare spending. The whole notion of production functions has been subjected to serious criticism by authors in the heterodox tradition (Shaikh, 1974, 1980; McCombie, 1998). Of course, given his neoclassical framework it is not surprising that Atkinson utilizes production functions. However, the fundamental flaws in the production function methodology as well as the above criticisms suggest that we should reject the neoclassical framework *in toto* and use an entirely different one to study the question of welfare

policy.

Shifts in the Conventional Wisdom and the Need for an Alternative

With the notable exception of the United States (Skocpol, 1987), in the two decades or so after the Second World War the discussion of social security generally took place within the context of macroeconomic policy. As Harris points out in *The Economics of Social Security* (1941), there was the "need for a study of social security that would utilize the recent developments in theory and especially in the fields of money, fiscal policy, and economic fluctuations" (Harris, 1941, p. vii; cited from Atkinson, 1999). It was recognized that the pursuit of social security policies killed two birds with one stone: it satisfied the goal of social justice as well as that of full employment through demand management policies. Lord Beveridge's *Full Employment in a Free Society* (1944) and *Social Insurance and Allied Services* (1942) can be seen as mutually complementing plans. In fact, as Peacock points out in *The Economics of National Insurance* (1952), social security policy was subsumed under the demand management policies of the State. Not surprisingly, the influence of Keynes was central to this dual policy goal.

While the British state had a stronger commitment to full employment and activist policies, the American version of Keynesian policy was much milder. However, on both sides of the Atlantic Keynesian policies of every color came under attack with the severe downturn of the 1970s. Not surprisingly, the break-up of the Keynesian consensus coincided roughly with the gradual dismantling of the welfare state over the next three decades. The long wave downturn beginning in the late 1960s which led to faltering economic growth and inflation in the 1970s made it the conventional wisdom for commentators of diverse political persuasions to argue that there is in fact a trade-off between long-run economic growth and social policy.

We would argue that the rise to dominance of this point of view was to a large extent due to the short-term nature of Keynesian theory: fine tuning was far from adequate in dealing with a growth cycle downturn. Thus the replacement of Keynesian macroeconomics by new classical macroeconomics has shifted policy discourse away from demand management to the study of various supply-side measures that can be used to raise the long-run growth path of the economy.

Austerity is the key policy implication of this supply-side approach. As Lucas (1990) demonstrated within the context of an EG framework, the best taxation policy for an economy along a balanced growth path with a balanced budget is for all revenues to be raised from labor income and none at all from capital income, including capital gains. According to his own conservative estimates, such a policy would "more than double the annual growth rate of capital" (ibid., p. 314). The rationale for balanced budgets and contractionary fiscal policy follows from analyses such as his: "...such an enormous capital expansion requires a *long period of severely reduced consumption* before the long-run gain can be enjoyed" (ibid., p. 314, emphasis added).

The focus on the long-run, initiated by the neoclassical tradition, is a positive development in itself. Unfortunately, the unrealistic assumptions of this framework - rooted in household intertemporal utility maximization, rational expectations, Say's law, and the full employment assumption - limit its applicability to the real world. Further, the rational expectations assumption along with the exclusive focus on the long run rules out the possibility of endogenously generated macroeconomic disequilibria; thus demand management as an important policy tool gets scant attention in this literature.

Both the short-term nature of the old Keynesian policies as well as the unrealistic assumptions that are at core of new classical macropolicies point to the need for an alternative perspective. Such a framework has to be able to analyze both short-run fluctuations in economic activity as well as its long-run determinants. Morever, such an alternative approach has to begin with what are surely the driving forces of capitalist accumulation: investment and profitability. The growth and cycles framework that we choose to use is rooted in the classical tradition of the Physiocrats, Marx, and Sraffa as well as von Neumann and Harrod's seminal work on growth and cycles[11]. We now turn to a study of the welfare state within the context of this framework.

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[11] The growth cycles research program is not peculiar to our theoretical framework: it is a standard area of research in the neoclassical tradition (Aghion and Howitt, 1998). The neoclassical version of growth and cycles consists of combining real (or equilibrium) business cycles (RBC) with an endogenous growth model. Such a research program has four features that, from our standpoint, are shortcomings: (1) fluctuations are the results of impulse propagation mechanisms as in the Slutsky-Frisch tradition and originate in random technology shocks (2) the technology shocks have to of the high frequency kind whereas generally they are of the low frequency kind as Schumpeter pointed out (Flaschel, Franke and Semmler, 1997) (3) unemployment can only be shown to exist via a labor-leisure trade-off and (4) Say's law holds continuously. One can thus characterize this

MACROECONOMICS AND THE WELFARE STATE: A CLASSICAL-HARRODIAN PERSPECTIVE

This framework, developed by Shaikh (1989, 1991, 1992a) and extended by Moudud (1998a, 1998b, 1999), is one in which both growth and cycles are endogenous. In line with Marx's schemes of reproduction, growth is internally driven by the investment decisions of firms and cycles arise endogenously because firms' production plans take place under conditions of Keynesian uncertainty on the basis of expected demand; cycles arise as aggregate demand and supply chase after each other along a growth path of output. This disequilibrium dynamic is the model's *fast adjustment process*; since it represents undesired changes in the stocks of inventories and thus describes the 3-5 inventory cycle (Niemira and Klein, 1994).

The model has as its basis a social accounting matrix (SAM) which relates all monetary flows from the various sectors to each other in a complete interlocking system with no "black holes", to use the term by Godley (1999) who is one of the pioneers of the SAM methodology. As with other heterodox models, and in contrast to both the ISLM and general equilibrium frameworks, in our classical-Harrodian model money is endogenous (Moore, 1988; Wray, 1990; Palley, 1996), with bank finance and debt playing a central role in its fast adjustment process. Finally, the model deals with two kinds of investment: investment in materials and labor (circulating capital) which expands output à la Leontief and von Neumann while investment in fixed capital expands potential output or capacity. As Shaikh (1991) demonstrates, it is this distinction that solves Harrod's knife-edge problem and produces a stable warranted growth path with persistent cycles. The long run or *slow adjustment process* essentially describes the 10-11 fixed capital cycle as actual and desired (normal) capacity utilization move toward equality.

As with Keynesian models, the driving force of growth in the classical tradition are investment decisions by firms. This point of departure is central to the distinction between the classical/Keynesian traditions and the neoclassical one in which the *consumption* decisions of households constitute the basis of growth. The neoclassical perspective does not treat firms as expansive and profit-seeking entities; instead their behavior is a replica of that of the individual

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research program as a study of endogenous growth and exogenous cycles.

consumer (see, for example, Aghion and Howitt, 1998, p. 27). However, the similarity between the classical and Keynesian traditions conceals an important difference: the Keynesian perspective is entirely short-run and "lacks any real treatment of the long term and, therefore offers only *ad hoc* and unrealistic extensions of the short term (for example, mark-up pricing at a constant rate) to achieve the long term (Duménil and Lévy, 1993, p. 6)".

The classical tradition recognizes the importance of the short-run cyclical dynamics of Keynesian economics (Minsky, 1986) in which exogenous demand injections play a crucial role. But the focus of the classical tradition is the long-run in which growth is driven by the normal rate of profit whose determinants are income distribution and technology (Sraffa, 1960). Since the long-run growth path of the economy was also Harrod's central concern, we present here a synthesis of what we call the classical-Harrodian framework. A variant of Harrod's warranted growth rate is derived from:

1. $I = S = sP = suP_n$

where s = savings propensity (rate of business retained earnings), P = mass of profits, P_n = mass of profits at normal rate of capacity utilization, and u = actual rate of capacity utilization. Diving through by the stock of capital, K:

2. $g_K = \frac{I}{K} = su\frac{P_n}{K}$

In other words, if $r_n = P_n/K$ = normal rate of profit then

3. $g_K = sur_n$

But $u = u_n$ = normal capacity utilization along the warranted path. Let $u_n = 1$ by construction (Shaikh, 1989) then

4. $g_K = sr_n$

Then long-run growth is determined by variations of the normal rate of profit which in the classical tradition is regulated by technological and distributional changes (Shaikh, 1992b;

Duménil and Lévy, 1993).

The following key equations describe the dynamics of the classical-Harrodian model (all variables are written as shares of output):

5. $e / (a_c + a_f + a_v - s) + (g - t) = m_G + d_B - m_d$ *Dual Disequilibria Relationship (Fast Adjustment Process)*

where e = excess demand in the goods and services markets, a_c = circulating investment, a_f = fixed investment, a_v = inventory investment, s = private savings rate, (g - t) = budget deficit, m_G = money injected from the budget deficit, d_B = money injected from bank credit, m_d = desired money holdings (money demand).

6. $a_c^{\cdot} = h_1 e - h_2 (1 + i) \frac{D_B^{\cdot}}{Y}$ *Circulating Investment*

where D_B = level of business debt, and h_1 and h_2 are positive reaction coefficients.

7. $\frac{Y^{\cdot}}{Y} = \mu a_c = \frac{\mu}{(1 + \mu v)} [e - a_f + s - (g - t)] = \frac{\mu}{(1 + \mu v)} (e + d)$

Warranted Growth Path[12]

where μ = input-output coefficient, v = desired inventory/sales ratio.

8. $\frac{a_f^{\cdot}}{a_f} = \theta (u - 1)$ *Fixed Investment (Slow Adjustment Process)*

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12 Alternatively, the warranted growth rate can be written in terms of the growth rate of the mass of profits P:

7a. $\frac{P^{\cdot}}{P} = \frac{m}{(1 + mv)} [e - a_f + s - (g - t)] = \frac{m}{(1 + \mu v)} (e + d)$

where m is the profit margin on costs.

where $\theta > 0$.

Moudud (1998a, 1999a, 1999b) analyzes the various interactions between the above variables when there is an increase in government spending. These will not be repeated here. We will limit ourselves to the two key features of the model. Over the course of the fast adjustment process, a jump in government spending raises excess demand and stimulates investment in circulating capital. The extent of the stimulus is determined by the accumulation of the finance charges from the credit needed to finance the investment; thus a greater degree of monetization of the deficit and/or a lower interest rate will enhance the acceleration of output. Over the long run or slow adjustment process excess demand equals zero, actual capacity utilization fluctuates around the normal level and the economy grows at the warranted growth rate.

Along with the above features of the model, two other aspects of the framework lead to the following implications for government spending in general and welfare policy in particular. First, it should be remembered that, as with the Keynesian tradition, in the classical perspective wages are determined primarily by institutional and historical factors and not by purely market forces. Thus, unlike the neoclassical perspective, there are no automatic forces that lead to full employment. Second, because all economic decisions are made under uncertain conditions, underutilized capacity and macroeconomic disequilibria are endogenous and recurrent features of a market economy. These features of the model imply that increased spending on welfare would both lower the rate of unemployment by injecting demand as well as provide a safety net for those who are unemployed. The positive effects could be amplified by more expansionary monetary policies. Thus, we would argue that the rationale for the old Keynesian policies are still valid, although these polices are discussed in a growth context.

We should mention that this particular role of stabilization policy in the short run would probably resonate with some mainstream authors, notably those in the New Keynesian tradition (Mankiw, 1994) and others who still use the ISLM framework. However, in the mainstream view macroeconomic disequilibria arise principally because of exogenous shocks or factors such as sticky prices and wages. On the other hand, our view is that unemployment and recurring unutilized capacity are *structural* features of the capitalist economy; sticky prices or technology

shocks are of secondary importance in the generation of disequilibria. Thus stabilization policy plays a more fundamental role in the classical and Keynesian views.

However, in order to counter the neoclassical perspective, our principal concern is with the determinants of the long run or warranted growth path. Equation 7 (or 7a) shows that two of the key determinants of long-run growth are the input-output coefficient μ (or the profit margin m) and the social savings rate $s^* = s - (g - t)$. These equations imply that the key determinant of growth is profitability. Given μ or m, the social savings rate shows the division of the aggregate surplus product into the portion that is held by businesses as retained earnings and the remaining component which is absorbed by the government. Thus, given costs, any analysis of fiscal policy along the warranted path will have to deal squarely with the fate of the social savings rate.

The emphasis on savings as a key determinant of long-run growth in the classical and neoclassical traditions conceals an important difference. Savings in the classical tradition originate in surplus value which arises from investment, as described by the circuit of industrial capital: M - C....P....C'- M' where M is the initial amount of money that is used to purchase raw materials and labor power (C), P is the process of production, C' is the output, M' = M + m is the money value of output and m is the money form of surplus value. A part of the surplus value is consumed and the remaining portion is invested which constitutes the basis for a new round of accumulation. Given the rate of profit, this is a process which perpetuates itself endogenously.

In the neoclassical tradition, however, savings arise from the consumption decisions of households. This naturally follows from the fact that firms are assumed to pay out all their profits as dividends to households (McCafferty, 1990). Savings out of dividends and wages then flow back to the business sector to purchase new equity.

This discussion should underscore the reasons why policy interventions will be different in the two traditions although the end goal is the same: raise the social savings rate. In the neoclassical perspective, one of the key policies is to increase loanable funds by compressing private and public consumption. The result would be to lower the interest rate and thereby raise investment. While the classical perspective does not deny the effectiveness of such a policy to raise long-run growth, it recognizes that this does not necessarily entail cuts in unproductive government expenditures. The social savings rate could also be raised by increasing the share of

business retained earnings.

However, a rise in government spending does not *per se* tell us whether or not the social savings rate has been affected over the long run. It should be remembered that ours is a dynamical model. Following Harrod, its starting point is a continuous growth of output (Kregel, 1980). It is because of this dynamic specification that all the variables have been written in terms of movements in the ratio of the budget deficit to output. As discussed in Moudud (1998b, 1999) this implies that a rise in the government spending-to-output ratio g will not be equivalent to a one-time increase in the level of government spending G. In the static general equilibrium model these are of course equivalent policies since output is continuously at the full employment level Y_f[13].

The fact these are not equivalent policies in a dynamic context can be illustrated by the following function for the level of the deficit

$$8. \qquad (G-T) = \alpha_1 Y + \alpha_2 \qquad \alpha_1 > 0, \alpha_2 > 0$$

which is equivalent to

$$9. \qquad (g-t) = \alpha_1 + \frac{\alpha_2}{Y}$$

Then a jump in (G - T) caused by a jump in α_2 will allow (g - t) to rise, but only temporarily since over time the term $\alpha_2/Y \to 0$ since Y is growing continuously. Thus (g - t) will eventually revert to its structural value given by α_1. On the other hand, given t, a rise in g is equivalent to an acceleration of G relative to Y.

It is quite curious that this distinction between levels and shares is completely missing from the mainstream fiscal policy literature which uses a growth framework (Lucas, 1990). It is

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[13] That is

$$\frac{C}{Y_f} + \frac{I}{Y_f} + \frac{G}{Y_f} = 1$$

so that increase in $g = G/Y_f$ is indistinguishable from an increase in G.

even more curious that Atkinson (1999), who realizes that one has to make a distinction between a static and a dynamic context in the investigation welfare policy, does not deal with the existence of the above analytical distinction.

And yet what is at stake is more than a mathematical relationship. In the classical tradition, if the private savings rate is given, then a rise in the share of unproductive government expenditures is an increase in the absorption of the surplus since the social consumption rate will have risen (Shaikh and Tonak, 1994). The fall in the social savings rate lowers long-run output growth although there is a short-run crowding-in effect.

This policy of an increase in government spending, however, does not lead to a vindication of the neoclassical view for three different reasons. First, because the mechanism at work conceals fundamental differences between the neoclassical and classical perspectives, as discussed in Moudud (1999). Second, as discussed above, if the *level* of government spending is increased rather than its *share* the short-run stimulus will still take place although there will be no long-run crowding out (Figures 1 and 2).

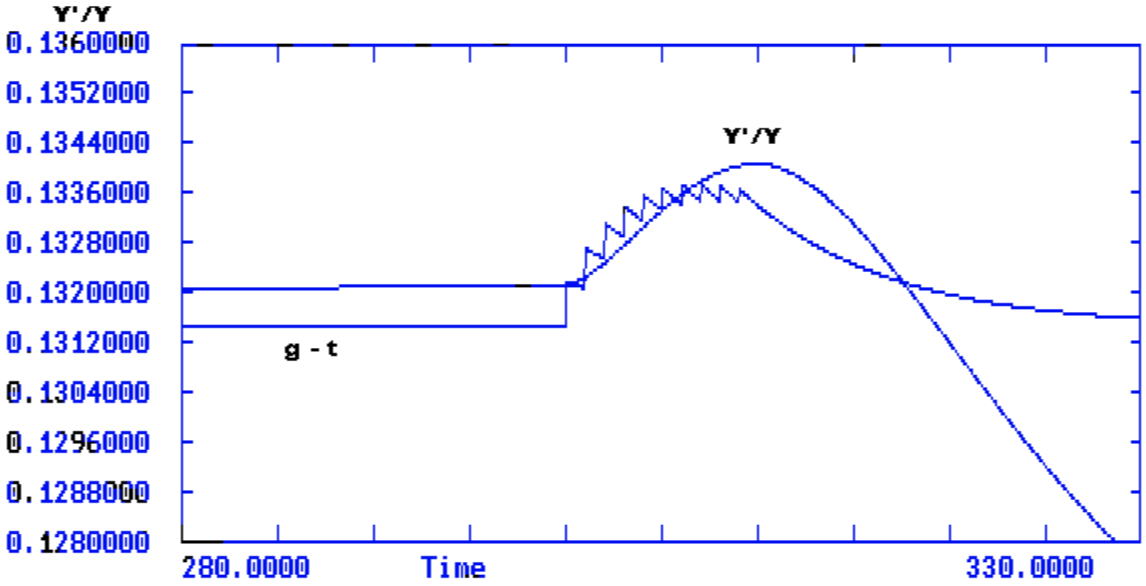

Fig. 1. The Effect of an Increase in the Level of Government Spending on Short-Run Growth
(Note: This simulation is based on hypothetical data)

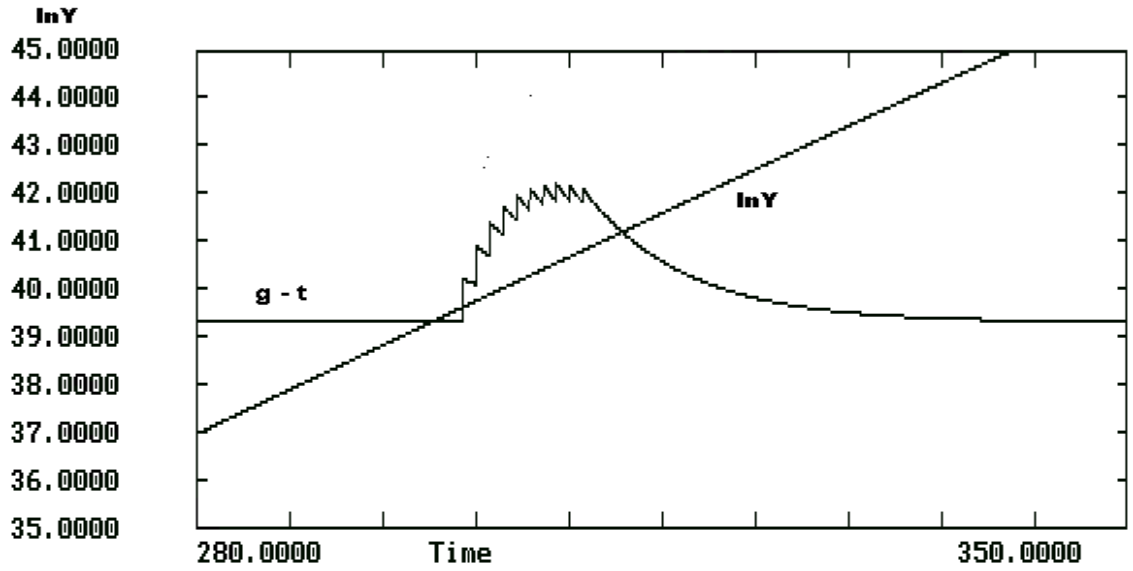

Fig. 2. The Effect of an Increase in the Level of Government Spending on Long-Run Growth
(Note: This simulation is based on hypothetical data)

In other words, if welfare spending is increased in steps that are spaced by appropriate intervals

all its benefits can be captured without any negative long-run consequences.

Third, the above experiment was done by holding the private savings rate constant. Suppose, however, that appropriate policies are implemented to stimulate the growth of business retained earnings. This rise in s would allow for (g - t) to rise so that s^* would either remain constant or increase. In other words, in the latter case the rise in the deficit would be consistent with the long-run *crowding-in* of output (Figure 3).

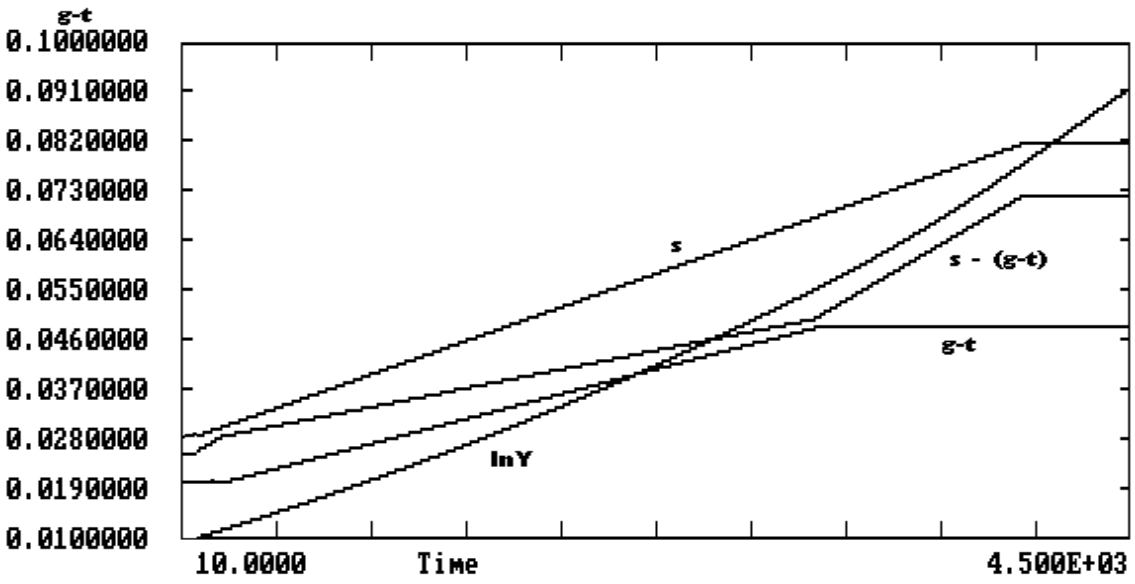

Fig. 3. The Effect of Increases in the Share of Government Spending and the Social Savings Rate on Long-Run Growth
(Note: This simulation is based on hypothetical data)

P

olicies to raise business retained earnings include investment tax credits, lower rates of corporate taxation, and accelerated deductions for capital depreciation (Fazzari, 1993). These measures, which are designed to lower the tax burden on corporations, could be accompanied by higher taxes on various kinds of capital income, including capital gains and STETS (securities transactions excise taxes)[14]. The purpose of all of these measures would be keep the taxation rate constant while allowing both s, g and therefore the social savings rate to rise.

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[14] These policy measures are fundamentally opposed to those proposed by Lucas (1990), who argues that all forms of capital income should be abolished to maximize growth.

Would not an increase in capital gains taxes have a negative effect on private investment? The voluminous literature on the determinants of investment seems to suggest that it will not (Fazzari, 1993; Fazzari and Herzon, 1996). The results of these studies show that the growth of demand and profitability (i.e. retained earnings) are the most powerful determinants of investment. Cost of capital effects, such as those from a capital gains tax, are very weak. One would similarly expect the effects of STET to be very weak also. First, because a low tax on securities transactions will have only a small effect on the cost of capital and, second, because cost of capital influences are very minor according to the above investment studies.

Finally, Feldstein (1974) reports that since the introduction of social security in 1937, rising marginal personal income tax rates have induced companies to reduce dividend payments and increase retained earnings. Feldstein (1970) finds similar evidence for British firms. Pechman (1987) shows for the period 1929-86 that high individual taxes on regular income stimulated lower dividend payout rates[15].

Figure 4 plots retained earnings and dividends as shares of the post-tax profits of nonfinancial businesses for the period 1946-98.

[15] Although these higher retention rates were given a further stimulus by investment tax credits and generous depreciation allowances.

One important pattern stands out. For the period 1946-80 the retained earnings share (dotted line) was around 60% and that for the dividend share was around 40%. However, after 1980 one sees a dramatic shift in these two shares with the dividend share hovering around 80% and the retained earnings share fluctuating around 20%. One important reason for this shift must have been the dramatic tax cuts received by

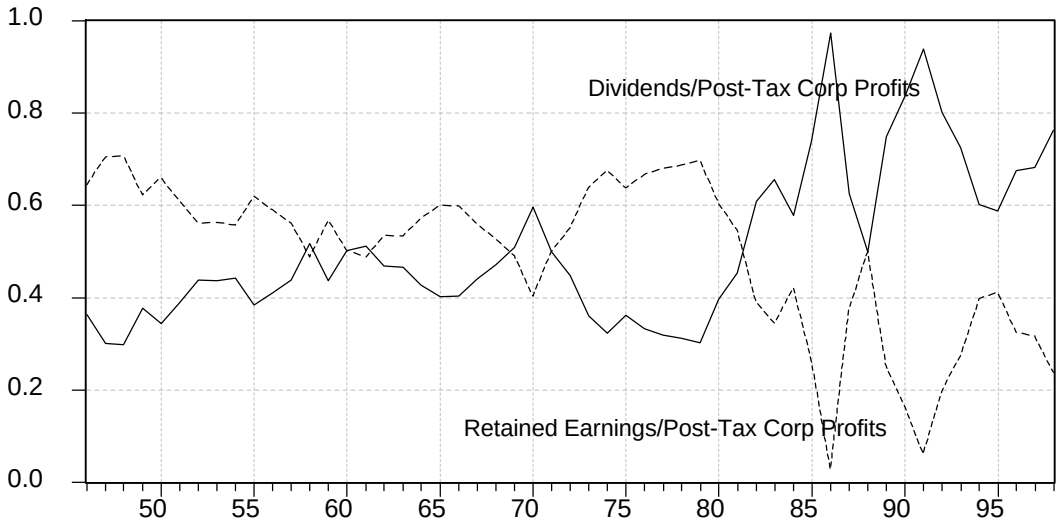

Fig. 4. Retained Earnings and Dividends as Shares
of Post-Tax Profits of Nonfinancial Corporate Businesses
(Source: Haver Analytics)

wealthy households in the Reagan period, thereby leading to a rise in the dividend payments by businesses as Feldstein and Pechman argue. Put differently, firms retained a greater proportion of their profits when taxation policy was more progressive, i.e. upper income households paid at higher tax rates. Significantly, since 1995 we see a reduction in the retained earnings share and a rise in the dividend share.

This pattern points to the sensitivity of the dividend payout rate to household taxes. It suggests that if the dividend payment rate does indeed fall as a consequence of higher taxes on households receiving dividends, then such a taxation policy is a powerful lever that can be used to raise the economy's growth rate of investment.

The line of argument advanced above suggests that to the extent taxation policy needs to support government expenditures[16], the portion of the surplus product that flows into capitalist households as dividends and net interest earnings and into the financial sector should be redirected to the productive sector of the economy that generates the surplus [17]. Shaikh and Tonak (1994) make an economic distinction between two sectors in the economy. The *primary sector* consists of production and trading activities that are involved in the domestic production and realization of the total product. The *secondary sector* consists of all those activities that are involved in the recirculation of the value and money streams generated in the primary sector. Included in the secondary sector are financial flows, ground rent, royalties etc. Thus our tax policy proposal entails (a) a transfer of surplus value from the circuit of revenue (capitalist households) to the circuit of capital and (b) from the secondary to the primary sector. The latter policy would entail a transfer from one component of the circuit of financial capital (such as the stock market through STETS and Tobin taxes on foreign transactions) to the circuit of industrial capital[18]. Both policies would have the effect of increasing the total amount of surplus value within the circuit of productive capital.

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16 Though the experiment involving a rise in G does not necessitate any of the above taxation policies since over the long run the social savings rate remains unchanged.

17 Equities channel a portion of personal savings to the business sector via the stock market, whereas such a taxation policy would bring about this allocation more directly.

18 The banking sector will be immune from such higher taxes given the crucial role of bank credit in the process of accumulation.

This is not an unrealistic argument given that business retained earnings constitute the single most important source of finance for new investment. To put it differently, the policy implication which follows from the classical-Harrodian perspective seeks to stimulate precisely that key component of the economy which is the source of surplus value and growth: the firm.

Thus, in light of this conclusion, the neoclassical fixation on households savings can be seen to be completely off the mark. From the classical context, household savings from dividends and wages are in the final instance a *residual* from the process of capital accumulation. This is so because investment determines employment and therefore the savings out of wages; it also determines profits which in turn regulates the payment of dividends. Moreover, the purchase of equity is financed to a large extent from the portion of dividends that is saved. Thus whatever maybe the savings decisions of households, their total mass of savings will over the long run be regulated by the rhythms of capital accumulation, the total mass of profits that businesses have in hand, and the dividend payout rate. Attempts to stimulate household savings may be futile in a long wave downturn with growing bankruptcies and mass unemployment.

Our proposal that certain kinds of taxes could support government spending without hampering investment is nothing new. A number of authors such as Gramlich (1992), Pechman (1989), Pechman and McPherson (1992), Peterson (1991) have argued along these lines. For example, among other measures such as levying energy taxes and taxes on externalities, Gramlich (1992) suggests raising revenues by closing tax loopholes such as the deduction of mortgage interest on the personal income tax and deductions on fringe benefits. He quotes a CBO (1988) study which estimated that if Congress had completely removed fourteen such loopholes by 1993, government revenues would have risen by $137 billion or 2.1 percent of GNP.

The seminal work of Pechman in the area of taxation policy is particularly interesting, as his concern is with choosing an appropriate tax structure that would both support government social policy and yet at the same time raise the social savings rate. Limitations of space prevent us from a detailed analysis of Pechman's argument. Broadly, though, Pechman bases his ideas regarding the comprehensive income taxation (CIT) on Henry Simons who argued in his *Personal Income Taxation* (1938) that the personal tax should be based on an economic definition of income. Simons argued that, according to such a definition, income from *all*

sources is the sum of an individual's consumption and change in net worth[19]. Thus an individual's income would include capital gains, gratuitous receipts such as transfer payments, gifts, and inheritances. Simons' tax reform agenda, further developed in his *Federal Tax Reform* (1950), was based on this broad definition of income.

Using Simons' definition of income, as well as recognizing that special provisions such as 'tax expenditures' and other loopholes lead to a considerable loss of government revenue, Pechman showed that the tax base could be widened in a number of ways[20]. His unique contribution was to demonstrate that this new CIT would be progressive and raise additional revenues so as to lower the budget deficit.

Together, the above arguments show that over the long run welfare expenditures can rise and be accompanied by a rising social savings rate. The key is to design an innovative taxation policy, such as Pechman's CIT. In other words, social policy and the logic of accumulation do not necessarily have to be contradictory.

If our analysis with regard to the role of retained earnings and the social savings rate is correct, the question we seek to pose is the following. Given the historical pattern of the variation in the social wage, could the long-run increase in profitability (see Figure 5) in the post-Reagan era have arisen via a less retrogressive social wage policy?

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19 This idea is captured in the social accounting matrix (SAM) framework in Godley (1999) and Moudud (1999) in which households' aggregate total income from all sources less consumption expenditures equals their net asset accumulation.

20 Some of these tax shelters are quite remarkable. Pechman mentions two examples. One was the so-called 'Mayer amendment' enacted in 1951. The purpose was to provide capital gains benefits for a lump sum distribution to Louis B. Mayer after he retired from the movie industry. Since the amendment could not mention him by name, it was worded so as to apply to a movie executive who (a) had been employed for twenty years, (b) had held rights to future profits for twelve years and (c) was entitled to receive a share of profits for life or for at least five years after the termination of his employment. The other example was an amendment submitted by Congressman James Burke of Massachusetts which was to provide a 7 percent tax credit for the purchase of garden implements so as 'to encourage private production of food'. Fortunately, the garden tools amendment was removed though it is not clear what the fate of the 'Mayer amendment' was.

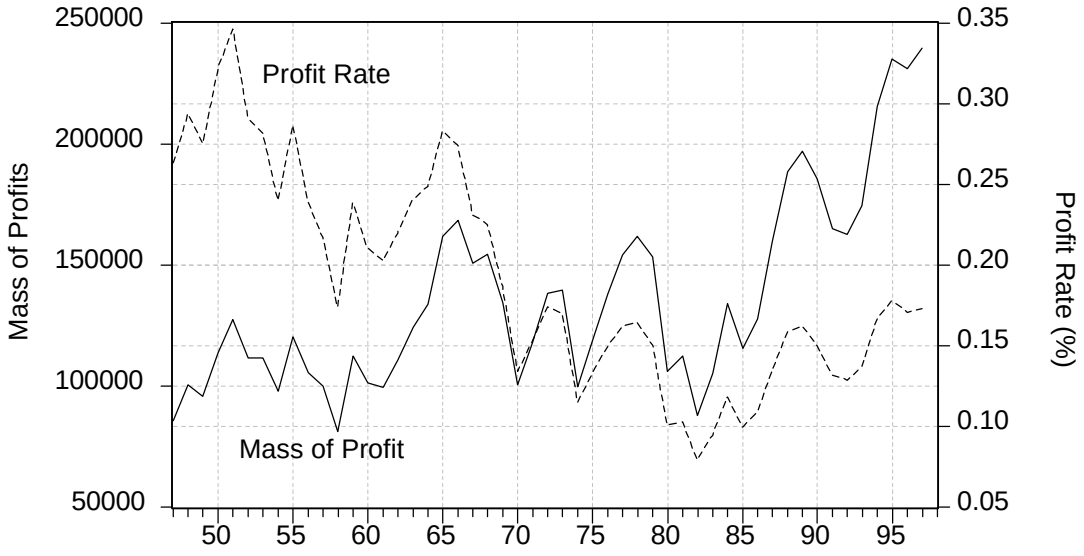

Fig. 5. Manufacturing Sector's Rate and Mass of Profits
(Source: BEA)

In other words, could the long wave upturn that began in the early 1980s have taken place via the intra-capitalist class tax transfer policies suggested above? Certainly, the standpoint of the classical-Harrodian perspective provides good theoretical reasons for such policies. Note that this long wave upturn in profitability arose principally via corporate downsizing and the squeezing of wages. We do not deny the central importance of this mechanism: in fact in the classical view this *is* the way by which the long-run rate of profit is raised. Our question is, did this mechanism need to be accompanied by the particularly vicious cutbacks in social welfare that this period in U.S. history has witnessed? In other words, what would have been the implication for accumulation if social wage policy in the U.S. had been more progressive? Finally, what are the implications of restrictive social policies for the future when the current boom runs out of steam?

The first issue that we should deal with straight away is whether or not the growth of the welfare state has been a drain on the total savings in the economy. Figure 6 plots government

savings, business retained earnings, personal savings, and the aggregate national savings as shares of GDP.

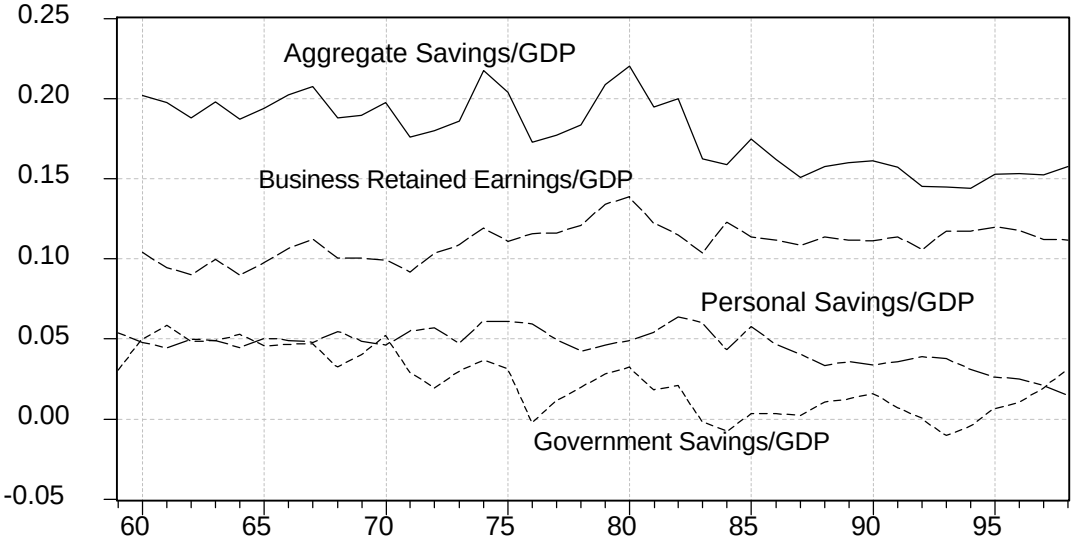

Fig. 6. Savings Ratios
(Source: CITIBASE)

What is remarkable about the aggregate national savings - to - GDP ratio is that it remained remarkably stable for the period 1959-80, in the first half of which there was quite a substantial rise in welfare programs such as Johnson's War on Poverty in the 1960s. And yet, national savings as a share of GDP *fell* in the Reagan-Bush-Clinton eras *precisely when the welfare state came under attack*. Of course, to a large extent this was due to the quite dramatic increase in the budget deficit in the Reagan years as well as the fall in the personal savings caused by the sharp rise in household debt (Godley, 1999). Nonetheless the figure raises questions about the orthodox view that the welfare state has been absorbing national savings.

The historical pattern of aggregate savings raises yet another question about the orthodox viewpoint. Given that the welfare state in the 1950s and 1960s was relatively large and growing with a taxation system that was more progressive (Pechman, 1985, 1989), how is one to explain the higher aggregate savings rate compared to 1980s and 1990s? Surely, if neoclassical policies are to be believed, one would have expected a higher aggregate savings rate in the Reagan-Bush-

Clinton era?

In a couple of important papers Shaikh and Tonak (1987,1999) have developed a new methodology for calculating the *net social wage* earned by workers. This variable is a measure of the total benefits received by the working class from the government (Federal, state, and local) net of all the taxes paid.[21]. Their purpose was to investigate the extent to which the country's surplus product is transferred to the working class. Figure 7 shows the benefits received by the working population as calculated by Shaikh and Tonak as shares of GDP and total government spending:

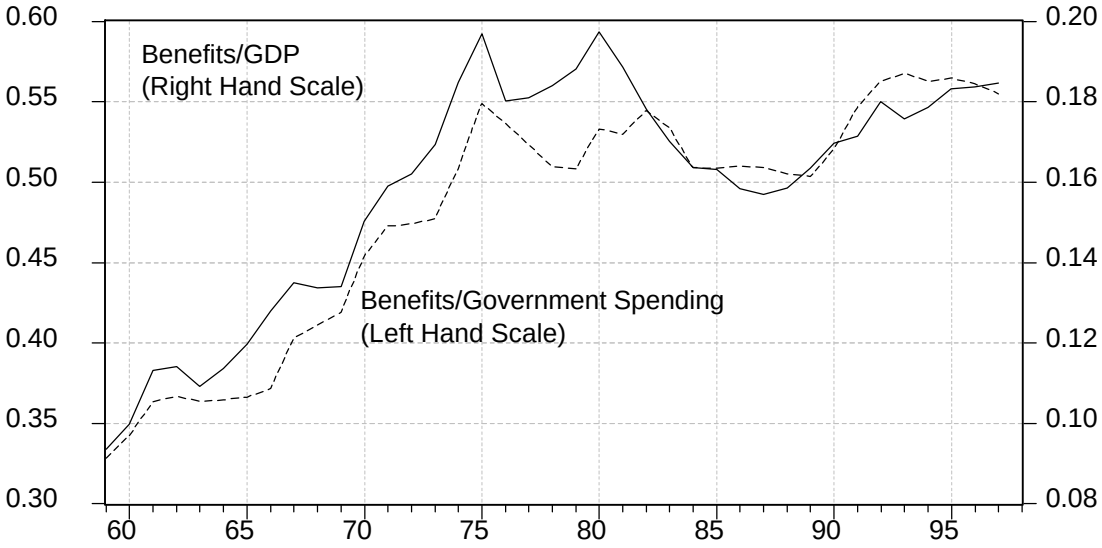

Fig. 7. Benefits Shares Received by Working Population
(Source: Shaikh and Tonak, 1999)

A comparison of figures 6 and 7 yields yet another apparent paradox from the orthodox standpoint. The period which witnessed the most rapid increase in the rise of the benefits share (from the 1950s to around 1971) did not correspond to an equally dramatic fall in either the aggregate savings/GDP or government savings/GDP ratio; the former ratio remained roughly stable to around 1979 and the latter started to fall from the late 1960s and stabilized to a lower

[21] The working class is defined as that section of the population "not having ownership of capital as a principal source of income" (ibid., p. 5).

level until the 1990s. On the other hand, both benefit ratios were relatively steady (with sharp drops in the mid 1980s) after the early 1970s. In other words, cuts in welfare benefits did not raise either government or aggregate savings.

In fact there is no paradox at all. Shaikh and Tonak (1999) find that "over much of the postwar period there has been a net transfer from workers to the state: the so-called social wage is largely a social subsidy of capital," (ibid. p. 3). They find that for the period 1952-1997 the average net social wage ratio (net social wage as a fraction of employee compensation) has been roughly zero. See Figure 8.

Fig. 8. Social Wage as a Share of Employee Compensation

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iller (1992) finds the methodology of Shaikh and Tonak robust and, in fact, by using two additional measures of the social wage he finds that it is more negative. Thus we can conclude that the welfare state was *not* a net absorber of the social surplus product.

Figures 5 through 8 have a troubling implication for the orthodox view on the relationship between the welfare state, aggregate savings, and long-run growth. To summarize our argument, beneficiaries of the American welfare state were not net absorbers of aggregate savings and could not have contributed to a lowering of long-run growth. Instead the higher savings in the 1950s and 1960s corresponded to the boom phase of a long wave with higher rates

of profit and, until about 1967-68, a continuous growth in the mass of profits (Shaikh, 1987, 1992). It was this boom phase in the long wave that produced higher aggregate savings. Finally, it was the phase change in accumulation in the late 1960s that brought about the subsequent economic slowdown. The welfare state "rode the tide", so to speak, of the boom phase and came under attack when Keynesian policies in general came under attack in the growth cycle downturn of the 1970s.

In the above discussion, we emphasize the role of savings as this is a key variable in both the classical and neoclassical perspectives. On the other hand, could the evolution of the welfare state have affected the long-run rate of profit? From the classical-Harrodian perspective, this is the other variable that determines the long-run growth rate. Authors invoking the so-called profit-squeeze hypothesis (Glyn and Sutcliffe, 1972; Bowles and Gintis, 1982a, 1982b; Gordon, Weisskopf, and Bowles,1987) have argued that the collapse of profitability that began in the late 1960s took place because of the dramatic rise in the citizen's wage in that decade in which labor and general domestic militancy effectively transferred growing proportions of profits away from corporations to society. We will not enter into a critique of this theory as that has been adequately done elsewhere (Shaikh, 1978, 1983, 1994). Note that this kind of an argument is hard to sustain given that the social wage was negative throughout this period as the findings of Shaikh and Tonak and Miller show.

We would argue however that, as part of a wider political and economic program of attacks against labor, cutbacks in the welfare state in the post-Reagan era had the effect of squeezing wages and thereby raising the rate of profit. This long wave upturn was accomplished not by freeing up more savings but by reducing business costs. Thus, from our perspective, the impact of the welfare state on the long-run rate of profit is *asymmetric*. The collapse of the rate of profit in the late 1960s did not take place via a profit squeeze but because of technological change (Shaikh, 1992). On the other hand, the recovery of the rate of profit from the early 1980s did take place via a squeeze on wages which was in part accomplished by rolling back the welfare state so as to weaken the political position of labor.

We would however question whether this was the only way by which the rate of profit could have recovered. Following the empirical literature that finds complementarities between public and private investment (Erenburg, 1993) and that public investment lowers business costs

(Dalenberg and Eberts, 1992; Morrison and Schwartz, 1992; Nadiri and Mamuneas, 1991), Moudud (1999) shows that within the context of the classical-Harrodian model a change in the composition of government spending would raise the long-run growth rate by lowering costs. Along with measures that would raise the social savings rate, this type of fiscal policy could have supported welfare expenditure, allow a greater degree of public sector investment over time, and partially contribute to raising the long-run growth rate. In other words, while we recognize that downsizing and lay offs by firms constitute a fundamental mechanism by which profitability is raised, we see no economic reason why these measures need to be accompanied by social cutbacks. In the event of a growth cycle downturn, deficit reduction will do more harm in the short run without remedying the long-run structural causes of the downturn. They will deepen the recession by slashing demand, and cuts in public investment may reduce future private investment and thereby lower long-run growth. Since it is the rate of profit which is the well-spring of the mass of profits, a narrow policy of balanced budgets may be totally off the mark if the system is in the midst of a long wave decline characterized by a decline in profitability (van Duijn, 1983; Sterman,1986; Kleinknecht, Mandel, and Wallerstein, 1992; Duménil and Lévy, 1993; Freeman, 1996). Cutting the budget deficit will not raise the long-run rate of profit which regulates the warranted growth rate. These arguments imply that indiscriminate budget deficit cutting may exacerbate poverty and inequality in both the short and the long run.

CONCLUSIONS

In contrast to marginalist rationales for the existence of the welfare state, a historical and institutional analysis shows that the rise of the welfare state was principally caused by pressure from below as Piven and Cloward (1997) argue, although this was a process that was subject to the push and pull of several different political forces. Neither the rise in the welfare state nor the attacks against it since the last twenty years can be explained by insurance market failures. Instead one has to understand these trends by considering the concrete political struggles that took place in various phases of accumulation. As in Britain, the state in the U.S. over the last twenty years has pursued a deliberately interventionist policy to increase job insecurity and raise the cost of job loss (Schor, 1987) by attacking the social safety net. The consequence of *this*

particular type of state intervention has been a long wave upturn with low inflation and stagnant wages. One could argue that in the two Anglo-Saxon countries, capital has been the most successful in harnessing the power of the state to discipline labor. And yet, as we argue below, state intervention could have been of a different type in this period.

Perhaps the main lacuna in the debate between Keynesians and neoclassicals about fiscal policy in general, and welfare spending in particular, is that each side emphasizes the importance of one arm of the process of accumulation. For the Keynesians, short-run or cyclical demand factors are crucial whereas for the neoclassicals supply-side factors along the long-run are of central importance; in fact, the analytical framework of the rational expectations school rules out endogenous disequilibrium dynamics. Thus Keynesians emphasize the negative demand effects of welfare cutbacks whereas neoclassicals emphasize the positive effects on growth via the increase in savings.

Our endogenous cyclical growth perspective recognizes the importance of *both* demand- and supply-related factors. Thus, as Minsky (1986) emphasized, demand injections via government spending play a crucial role in providing a "floor" to recessions. On the other hand, along the trend growth rate when excess demand is zero and capacity utilization fluctuates around the normal level, the social savings rate is of central importance. We would argue that welfare policy needs to deal with both of these poles of the accumulation process.

Our view of the long-run, however, differs from the neoclassical perspective in three fundamental ways. First, savings to finance investment do not arise from household consumption decisions but principally from business retained earnings. That is, for the classical-Harrodian perspective the focus of analysis is the business firm. As in Marx's schemes of reproduction, if the rate of profit and costs are given then higher growth rates of output can only be obtained by increasing firms' retained earnings. This importance of *internal finance* for the long-run was also formally demonstrated in Shaikh's (1989) growth model. As shown in Moudud (1998b, 1999b), it raises the possibility of using appropriate taxation policies to raise business retained earnings to both increase growth and allow a greater degree of government spending.

The key policy is to increase the social savings rate. Pechman's (1989) comprehensive income tax proposals along with Shaikh and Tonak's (1994) analytical framework on the distribution of the surplus product provide the inspiration for policies to stabilize or increase the

social savings rate. Our point is that this variable can be kept constant or increased by appropriate higher taxes on upper income households, certain financial market transactions and closing tax loopholes. Such measures would also allow government spending to rise with higher taxation revenues and/or with a growing rate of business retained earnings. At an analytical level, we would argue that intelligent taxation policy should be introduced so as to effect an indirect transfer of surplus value from both the circuit of revenue (wealthy households) and certain sections of the circuit of finance capital to the circuit of industrial capital where the surplus value is actually produced.

Alternatively, periodic increases in the *level* of government spending rather than its *share* would provide the required demand stimulus, and leave both the social savings rate and the long-run growth path unchanged. It is quite surprising that this distinction is not made by neoclassical authors who use the endogenous growth perspective. And yet, with unchanged taxation policy, such periodic injections of government spending would provide all the positive Keynesian benefits without any of the negative long-run neoclassical effects.

Second, the long-run path of accumulation is itself regulated by the rate of profit which is determined by income distribution and technology as Sraffa (1960) demonstrated. It is the normal rate of profit which is the ultimate source of finance for new investment since it determines the growth of the mass of profits. This suggests that efforts to squeeze out savings by fiscal austerity measures are misplaced since these measures by *themselves* will not raise the rate of profit.

Third, the long-run path of accumulation at normal capacity utilization is consistent in the classical tradition with unemployment as Goodwin (1967) showed formally in his famous growth and cycles model. Thus provided wage growth does not exceed productivity growth, the long-run growth rate in the classical-Harrodian model can be increased without any inflationary consequences.

Given this analytical framework and the empirical finding by Shaikh and Tonak (1999) that over the entire postwar period there was not a net transfer of the surplus product to the working class by the state, what are we to make of the welfare reform and government policies that started during Reagan's tenure? At an empirical level, the combination of fiscal stimulus, business tax cuts, measures to support a large wage squeeze, and defense-related expenditures

provided a powerful growth cycle boost which raised the long-run rate of profit. Military expenditures had a dual effect. On the one hand they increased unproductive expenditures but, on the other, they provided an important stimulus to the telecommunications and computer industries as well as other sectors that benefitted from large subsidies from DARPA (Defense Advanced Research Projects Agency), the Pentagon and other government agencies.

But our analysis suggests that such *supply-side Keynesian* policies could have been of a different kind. Instead of military spending and cutbacks in social policy, the higher government spending could have been used to provide both an adequate social safety net, increase public sector investment (both direct and infrastructure investment), and support R&D. As Shaikh (1996) argues, the key to is to apply policies to raise productivity which would allow unit labor costs to fall without squeezing wages. In fact such industrial policy strategies could have allowed for an increase in wages as well as the rise in the long-run growth rate.[22]

The above discussion suggests that from the classical-Harrodian perspective, welfare policy needs to be analyzed within the context of the phase of long wave accumulation. Both demand and supply-side measures need to be applied so as to allow room for progressive social policies to operate. Although we disagree with his theoretical framework, we concur with Block (1987) who criticizes the mainstream view according to which there is a trade-off between social policy and the logic of accumulation. Our view is that while the economy has *dominant tendencies* (Shaikh,1983) which endow it with laws of motion, there is room for social policy and that, within limits, a wide variety of policies might be conducive to helping the accumulation process itself.

We are critical of the welfare reform measures enacted in the 1990s under Clinton, especially the Personal Responsibility and Work Opportunity Act. The long boom of the U.S. economy does not provide any economic justification for the social retrenchment measures enacted in this period. Budget surpluses should be used to finance public sector investment projects, increased public education and a national health care program. While government

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[22] Other authors such as Shapiro and Taylor (19xx), Amsden (1989) have also emphasized the crucial importance of industrial policy and public investment. Hudson (1988) discusses a variety of government policies that could stimulate the supply-side and improve firm performance.

spending on welfare do constitute a deduction from the annual surplus product, public policy should take advantage of the current boom and budget surplus to help unemployed and underemployed people develop genuine and advanced skills and help them find good jobs in the private or public sectors. Instead of the draconian measures employed currently, such alternative policies to "get people off welfare" would lead to greater social equity. But equally important, if such labor market policies are accompanied by industrial policies to stimulate productive[23] investment in *both* the private and public sectors, then there will also be long-run macroeconomic gains.

Instead in the current political climate the single-minded pursuit of budget surpluses is seen as an end in itself. According to conventional wisdom this policy is an example of national probity and thriftiness. Along with moral stipulations to "encourage" work effort, such government policies remind us of those in the pre-New Deal era. If we bear in mind that long wave fluctuations are recurrent, then the next growth cycle depression will confront rigid fiscal policies because of the Balanced Budget Amendment. The consequences for American society will be grave. We are tempted to speculate that the social chaos might be as severe as that during the Great Depression of the 1930s.

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[23] We use the word "productive" in the sense that it is used in classical economics (Shaikh and Tonak, 1994), i.e. it describes all those activities that generate a surplus.

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