Slouching Towards Utopia?: An Economic History of the Long Twentieth Century

XVII. Social Democracy: High Tide and Ebb

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17.1. Really-Existing Social Democracy

17.1.1. Successes at Regulation and Provision

In 1891, meeting in Erfurt, the German socialists set out their program. Isreform part called for: universal adult (including female) suffrage, the separation of church and state, the secularization of education, the eight-hour day, government regulation of health and safety in the workplace, the right to unionize, unemployment insurance paid by the state and administered by the workers, popular referenda to control parliaments and bureaucracies, and the election of judges.

In the United States today, social democracy includes the interstate highway system, airport construction, air traffic control, the Coast Guard, the National Parks, government support for direct research and development through agencies like the National Institute of Standards and Technology, the National Oceanic and Atmospheric Administration, and the National Institutes of Health. It includes the antitrust lawyers of the Department of Justice and the Federal Trade Commission, the financial regulators in the Securities and Exchange Commission, the Office of the Comptroller of the Currency, the Federal Reserve, and the Pension Benefit Guarantee Corporation. It includes the promise by the federal government to insure small bank depositors against bank failures, and big bankers—systemically important financial institutions—against collapse. It includes Social Security and all of its means-tested and non-means-tested cousins—Supplemental Security Income, Food Stamps, Head Start, and the Earned Income Tax Credit. None of these programs would be seen as a proper use of the government by even the weakest-tea sympathizer with libertarianism. None of them fit under the definition of the "night watchman" state. And America's version of social democracy is distinctly anemic relative to those found elsewhere in the Global North.

These government programs and their analogues in other advanced industrial countries have been remarkably politically successful: Voters distrust politicians who seek to cut back on the major programs of the social insurance state. Voters find taxes earmarked to support social insurance programs less distasteful than taxes that flow into general revenues. Outside of the United States, right-of-center parties have never made any attempt to make a stand against social democracy. And in their heyday of the thirty glorious years, these programs were part of an economically successful institutional configuration: growth was faster than ever before, unemployment was low, incomes were not too unequally distributed—at least if you were a native-born white guy—and the business cycle was very moderate.

17.1.2. Social Insurance and Income Distribution

Much of social democracy was not aimed at the high socialist goal of removing commodities from the market—of making them free, or at least publicly provided, and thus entitlements of citizenship or rather comradeship instead of things that had to be earned by the sweat of one's brow. Social democracy, instead, focused on providing income supports and progressive taxes to redistribute income in a more egalitarian direction. Why bother with public provision—often inefficient—when with an egalitarian distribution of income those who wanted goods and services could simply buy them? This would avoid the waste of provision to those who did not want. And it would harness the magical efficiencies of the market to societal goals. Redistribution and then dollar votes in the market place rather than public provision seemed the smart road to social democracy.

The growth of Keynesian doctrines meant that the government was to spend a fortune to stimulate the economy and avoid depression. But shouldn't it at least spend this fortune efficiently, and in a way that enhanced the general welfare. On this strong role for social insurance nearly all could agree. Centrists feared that abandonment of social insurance would lead to abandonment of the Keynesian stabilization mission, and a return of the Great Depression. Left-wingers and unions saw in an expanded role of the government a way to eliminate, or at least to reduce, the evils of laissez-faire. Right-wingers and industrialists hoped that the "cooperative" social and production climate could be continued, and saw the social insurance state as offering the possibility of doing so at a low price in terms of taxes levied to finance the programs.

Under social democracy, people chose out that ballot box how much income and wealth inequality they wanted to see. They could vote for more or less progressive taxes. They could expand and contract the set of public and semi-public goods and of benefits offered to all citizens. And they could expand and contract the set of means-tested benefits offered t the poor.

The standard way of thinking technocratically about how a social democracy should manage its income distribution became Arthur Okun's proposed metaphor of the "leaky bucket." After a while, increases in redistribution from rich to poor might begin to create incentive problems that would reduce the benefit to the poor from a policy that would cut the income of the rich. How leaky could the bucket get before redistribution had reached an optimal level?

Social democrats took the middle ground: redistribution was fine—was a good thing, because ex-ante behind a veil of ignorance all citizens would have wanted to be insured against the risk of poverty. But incentives for maximizing production were fine too. How leaky the bucket could be allowed to get was a matter of judgement and politics: social democracy should strive for programs that were buckets with small leaks and avoid programs that corresponded to buckets with large leaks. And all the while they should aim at the utilitarian greatest good of the greatest number.

17.1.3. Moochers and Takers

But there was a problem.

Humans see their society as a network of reciprocal gift-exchange relationships. We are all interdependent, and we all do much better if we do things for one another rather than requiring that everyone do everything for him or herself. In these relationships, we do not always want to be the receiver: it makes us feel small and inadequate. In these relationships, we do not always want to be the giver: that makes us feel exploited and grifted. And we altruistically disapprove whenever we see a situation in which somebody else seems to be following a life-strategy of always trying to be the receiver.

Moreover, what it means to be a "giver" or a "receiver" is contested. When the moneylender agrees to forgive part of the interest you owe and add it in to the principal and so put you deeper in debt, has he done you a favor in not exacting his contractual full count of flesh, or has he cheated you by having originally exercised his bargaining power to the full to set the interest rate so unreasonably and unconscionably high? When the local Frankish warrior who has just moved in to the Roman Empire allows you to become his serf—to work for him for three days a week in return for his protection against other Frankish warriors who have just moved in—are you a receiver of a boon from this particular Frankish warrior, or have the Franks as a tribe and as a nascent feudal aristocratic class stolen half of your labor time from you? Are mothers raising children without a partner our benefactors, as they are performing the hard and incredibly valuable work of raising the next generation whose Social Security taxes will fund our Social Security checks? Or are they "welfare queens", popping out children because then lazing about, probably buying fried chicken, watermelon, and drugs with the AFDC welfare check, is an easier life than getting and holding a job?

The logic of social democracy is that we are all equals as citizens, and equals should not be treated unequally without very good cause—and, in a market economy, the good cause is that we want to incentivize economic growth by rewarding skill, industry, and foresight, and doing so inevitably involves a good deal of the rewarding of good luck as well. But what if some citizens think that they are more equal than others—the others who, for one reason or another, are not full members of an ethno-national community? And what of those who, in the case of means-tested programs, seem to be always receiving not because they have bad luck but simply because they never contribute?

These issues, too, could be papered over as long as employment stayed high and growth stayed strong. When growth slowed, and employment became less certain, the fear that the "moochers" were taking advantage was one powerful thing that prompted the neoliberal turn.

16.2. Failures of Social Democracy

16.2.1. The Commanding Heights

In the age of social democracy, all over the industrialized and developing parts of the world, governments—even the most anti-Communist of governments—

somehow got it into their heads that they should run and operate businesses. Public control and operation of the "commanding heights" of the economy was seen as a proper goal.

Consider the case of Britain's Attlee government. In the late 1940s the Attlee government nationalized the Bank of England, the railways that became British Rail, airlines, telephones, coal mining, electric power generation, long-distance trucking, iron and steel, and natural gas provision. Officially, management policy did not change once industries were nationalized: commercial profitability remained the official objective (although pursued with less vigor, especially as far as possible plant closings were concerned). Coal workers and railroad workers hoped that the public sector would be more benevolent and higher-wage employer than the private sector. They were apparently mistaken.

Donald Sassoon quotes from official histories that "Very little thought had been given to the organization of the nationalized industries either in the Labour movement or in Whitehall," and asks the natural question: "Why was there such a wide extension of public control if Labour did not know what to do with it?" He answers his question by pointing to "the traditional left-wing bias against private ownership…. The extension of state ownership was good in itself, because it brought the 'end-state' of socialism that much nearer."

In retrospect this is puzzling: the social-democratic insistence on government provision of goods and services—not government demand, not government distribution, not government price and quality regulation, but government *production*. All over the world the belief that large chunks of productive industry ought to be publicly-owned and managed dominated the mid-twentieth century. There are still immense state-owned and state-managed enterprises: railroads, hospitals, schools, power generating facilities, steel works, chemical factories, coal mines, and others.

This is puzzling because governments' core competence has never been in running a hospital, or a steel mill, or a railroad. Such organizations ought to be run with an eye on efficiency: getting the most produced with the resources available. But governments' logic of operation is very different: it is a logic of the political adjustment of conflicting interests. As a result, government-managed enterprises—whether the coal mines of Britain or the telecommunications monopolies of western Europe or the oil-production monopolies of developing nations—are likely to be inefficient and wasteful.

For a social-democratic political movement to choose government ownership and management of industry as the hill to die ones rarely good policy, and is unlikely to be good durable politics. And indeed it was not. When Margaret Thatcher's conservatives took office in the late 1970s, it was behind the slogan of "Britain isn't working"—which meant both that unemployment was high, and that state-owned enterprises were inefficient, provided poor service, and had payrolls amply padded for political reasons.

Now there are times and places when you do not want "efficiency"—at least not in the sense of maximizing the total amount of measured output given the available resources. There are times when you want "soft" rather than "hard" incentives: a health clinic that is paid by insurance companies should not be replacing antibiotic solutions with colored water in order to decrease its costs. A company running an electricity distribution network should not skimp on maintenance of the system as a whole in order to boost its current profits.

But the cases in which "soft" incentives are desirable are not that many. Ultimate consumers must be poor judges of quality, or must be unable to vote-with-their-feet by switching to alternative suppliers, or there must be no alternative suppliers to switch to before one reaches the stage where one would rather rely solely on the professionalism and the pride of accomplishment and usefulness of the producers. Elsewhere, the hard material incentives for efficient performance provided to the for-profit enterprise in market context are very valuable. And quality (and price!) regulation is often a much more attractive alternative than is public ownership and management of the enterprise.

As best as I can judge, the sources of demand for public ownership of the "commanding heights" of the economy had three sources:

- First, an inordinate fear of monopoly: a belief that economies of scale would ultimately lead to the domination of one single firm in most industries, and that that one single firm would exploit the public unmercifully if it were not state-owned.
- Second, a fear that the monopoly bosses would own the government: that regulation would be ineffective because the monopoly bosses would simply buy off the regulators, and that only public ownership that destroyed the monopoly bosses could avoid this problem.
- Third, the echoes of the classical Marxist belief that the market was inherently corrupted by exploitation—and that such exploitation could be avoided by eliminating the private ownership of the means of production.

All of these sources seem naïve to us now. If the market is inherently corrupted by exploitation, what do we think of bureaucratic hierarchies? Yes, monopoly is to be feared. Yes, there are grave problems in a world in which much economic life is increasing-returns-to-scale of controlling monopoly. But a publicly-managed monopoly lis a monopoly still.

But, in terms of its effect on its political support, inefficiency in operating the "commanding heights" was small beer compared to the failure of social democracy to deliver a semi-stable price level

16.2.2. Sparking the Inflation of the 1970s

16.2.2.1. Raising the Anchor of the Price Level

Time passed after World War II, and the memory of the Great Depression dimmed. Between 1954 and 1969—between the Korean War and the height of the Vietnam War—it looked as though the U.S. economy was sliding back and forth along a stable inflation-unemployment "Phillips Curve." Democratic-Party governments tended to spend more time at the left end of the curve, with relatively low unemployment. Republican governments tended to spend more time at the right end, with relatively low inflation and higher unemployment. But by absolute and by historical standards, both inflation and unemployment were low.

The first sign that something had changed came during Richard Nixon's first term as president. He attempted to move the economy from the left to the right side of the 1954-69 curve, and found that it would not go. 1970-1973 saw unemployment and inflation both at high levels relative to the previous post-World War II experience (although still at low levels absolutely).

After some thought, a consensus was reached: tight monetary policy and attempts to fight inflation by marginally increasing unemployment no longer worked because no one believed that such efforts would be continued very far. Auto workers, say, believed that the government would not allow widespread unemployment in the automobile industry—that the government would pump up nominal demand to give people enough liquidity to buy cars if ever the industry's sales began to drop. This left the United Auto Workers, therefore, with no incentive to moderate its wage demands-it was not risking serious unemployment on the part of its members if it did so. And this left the automobile manufacturers with no incentive to resist demands for higher wages: they could simply pass them on in higher prices. And so the economy had grown "used to" steady inflation at five percent per year.

How to deal with this dilemma? One possibility was that the government should create a truly massive recession: should make it painfully obvious that if inflation rose too high and if wages agreed on by workers and firms rose too rapidly, the government would not accommodate, would not expand nominal demand, but would instead inflict unemployment and keep unemployment high until inflation came down. No president wanted to think about this possibility. It was, in the end, the road the United States took, but largely by accident and after many stopgaps. And taking this road led to the end of the most successful economic order the industrial world had seen.

Back in the 1930s, Chicago-school economist Jacob Viner had reviewed Keynes's *General Theory.* He had snarked that:

> In a world organized in accordance with Keynes' specifications, there would be a constant race between the printing press and the business agents of the trade unions, with the problem of unemployment largely solved if the printing press could maintain a constant lead...

And he gloomily called the *General Theory* a "book which is likely to have more influence than it deserves."

The Great Depression—and other deep depressions before—were not fluctuations around but rather shortfalls below an economy in macroeconomic balance. Recall the crude model of the business cycle that John Stuart Mill had constructed: an excess demand for money (often caused by panic or lack of "confidence") is the cause of an excess supply of all other commodities—a general glut, and high unemployment relative to normal—while an excess supply of money (relative to fluctuating demand) is a source of unexpected inflation relative to normal.

16.2.2.2. Driving for Full Employment

But what, for an economy, is "normal"? What is "full employment"?

The business cycles of the 1950s and 1960s were much more fluctuations around than shortfalls below some "full employment" benchmark. But many at the time did not see them as such. For one thing, the "full employment" unemployment rate was so damn high. There was "frictional" unemployment—workers looking for jobs and jobs looking for workers before the appropriate matches had been made—

which served as a kind of "inventory" of labor for the economy. There could be "structural" unemployment— people with low skills in isolated regions where it was not worth any firm's while to employ them at wages they would accept—and such problems could not be solved by Keynesian depression-fighting tools. And then there was "cyclical" unemployment: a smaller case of the same disease as the unemployment of the Great Depression, which could presumably be cured by the standard expansionary policy means that economists' believed would have cured the Great Depression if they had been tried at the time.

In the 1960s in the United States, the economists of the Johnson administration diagnosed that a good chunk of the 5% or so unemployment rate that they saw in the American economy was "cyclical" unemployment. "Structural" unemployment was a narrow, regional problem—largely in Appalachia and the Deep South. And given that most people changed jobs without going through a spell of unemployment, to suppose that a normal economy had nearly one in twenty of those who wanted to work out of work for "frictional" reasons seemed much too high. Johnson economic advisor Walter Heller, who said that opinion now took it "for granted that the government must step in to provide the essential stability [of the economy] at high levels of employment and growth that the market mechanism, left alone, cannot deliver." Not avoid depressions: but attain *high levels* of employment—and growth.

Was a 4% unemployment rate one that was consistent with their being not an excess supply of but balance of supply and demand for money? And thus could an unemployment rate of four percent or below be maintained without accelerating inflation? By 1969 the answer was reasonably clear: no. Average nonfarm nominal wage growth in America had fluctuated around or below four percent per year between the end of the Korean War and the mid-1960s. It had jumped to more than six percent during calendar 1968. Moreover, a half-decade of slowly rising inflation had led people to begin to focus on what was going on. People form their expectations of what the price level will be next year, and decide how much to demand, in terms of cash to hold and also of prices and wages to charge, based on those expectations. An excess supply of money than causes *unexpected* inflation. But if people look back and there has been an excess supply of money in each of the past half-decade, they will expect inflation, and so that *unexpected* inflation will be an extra layer on top: the price level will jump in part as expected, and in part as unexpected. And the total inflation rate—expected plus unexpected—will accelerate upwards.

The economists advising the Johnson administration, as well as others, had not expected this. As economist Robert Gordon reminisced, looking back, the analytical framework they were using:

> collapsed with amazing speed after 1967. My graduate school classmates and I were acutely aware of the timing of this turn of the tide, as we began our first teaching jobs and almost immediately found our graduate school education incapable of explaining the evolution of the economy…

Kennedy and Johnson economic advisors had argued that a substantial reduction in unemployment could be achieved with only a moderate increase in the *level* of inflation. But expectations of inflation became "unanchored": the normal relative to which prices and wages were set became not price stability or a slow upward creep in inflation, but rather to look to last year's inflation and suppose that this year's inflation would be the same. Over 1965-1969 the Johnson-era Federal Reserve accommodated the president's desire to reduce unemployment by expanding the money supply to keep interest rates low, then Vietnam War spending unbalanced by higher taxes overheated the economy further, and then the rate of labor productivity growth began to drop, reducing the cushion between the rate of growth of wages and the price inflation rate. The 4% per year nominal wage growth of the early 1960s had fit with a 2% price inflation rate. The 6% per year nominal wage growth of 1969 fit with a 5% price inflation rate. The U.S. was now not a 2% but a 5% per year inflation economy.

16.2.2.3. Richard Nixon Agonistes

Starting in 1969 the economists of the newly-elected Republican administration of Richard Nixon—initially backed by Nixon—hoped to attain a cooling off of inflation at the cost of only a small increase in unemployment by reducing government spending and encouraging the Federal Reserve to raise interest rates. Their policies only half-worked: Unemployment did indeed rise from 3.5% to almost 6% from 1969 to 1971. But inflation barely budged.

Richard Nixon was, in some ways, a semi-Trumpian figure.

Nixon had strong and deep beliefs and great knowledge about foreign policy: He wanted to win the Cold War, and thought that he could win the Cold War by recognizing that China had no interests and not even ideological sympathy with Russia, and so could turn both into status-quo powers that would abandon global revolutionary aspirations and settle into being normal bureaucratic despotisms if he could judiciously play one off against another. Thus the centerpiece of his administration was "only Nixon can go to China"—in large part because he had spent the previous generation making it politically impossible for any other American politician to negotiate with Mao.

Otherwise? Nixon wanted to appear strong. He wanted to be a leader. And he liked to surprise people. Was pollution rising as a problem in the press? Then Nixon would work with Democrats in Congress to establish an Environmental Protection Agency. Had Daniel Patrick Moynihan dropped by for drinks in the evening a few times? Propose national health insurance and a universal basic income—and claim victory if they proved overwhelmingly popular in the legislature, and confuse the Democratic Party if they did not. Hear rumors that Senator Teddy Kennedy's aides were, wittingly or unwittingly, too close to agents of Cuban Communist Fidel Castro? Demand that the FBI investigate. And if the FBI dragged its feet, assemble a motley team of misfit CIA and ex-CIA agents and send them in to bug and burgle the Democratic Party headquarters in Washington's Watergate Hotel: "if the president does it, it is not illegal". Much more disciplined, much more intelligent, not suffering from cognitive decline at all, much less racist—viewing immigrants and their children and grandchildren as hard-working entrepreneurial natural Republicans, and strongly believing that the Republican Party had a duty to uplift the Negro (if also an opportunity to win elections by pandering to white racism). But, in many ways—Trumpian. In the end Nixon resigned under the threat of imminent impeachment. Was the different reaction of the Republican legislators of the 1970s to Nixon's High Crimes and Misdemeanors because he was viewed as smart, disciplined, and non-demented—and hence more dangerous? Or was it because back then Republican Party legislators loved their country, and its institutions and norms, more?

Confronted with an unemployment rate of 6%, an inflation rate of 5%, and a loud chorus of complaints that he had mismanaged the economy, Nixon faced a problem. Arthur Burns, Nixon's ex-counsellor newly installed as Chair of the Federal Reserve, gloomily believed that it would take a large recession to reduce inflationary expectations via market mechanisms, and that Congress would overwhelmingly vote to fire a Federal Reserve Chair who created such a large recession. Nixon recalled how in 1960 he and then-Eisenhower aide Arthur Burns had gone to President Eisenhower, begged Eisenhower not to let unemployment rise during the 1960 election year, and how Eisenhower had then turned them down. Nixon had then lost the 1960 election to John F. Kennedy, very narrowly.

Nixon decided on a version of "shock therapy": suspend the operation of the Bretton Woods pegged-but-flexible exchange-rate system (the suspension would be permanent), impose wage and price controls to reduce inflation, and make sure that Arthur Burns, Nixon's ex-counsellor newly installed as Chair of the Federal Reserve, understood that unemployment needed to be lower and declining as the election of 1972 approached.

So the supply of money greatly outran demand, and as Nixon's price controls were lifted inflation accelerated upward still more.

16.2.3. Disinflation as a Viable and Visible Choice

That upward burst in inflation, however, was not only due to Nixon's (and Burns's) political calculations. You had economists like Johnson's ex-chief economist Walter Heller telling Congress in July 1972 that the Nixon administration's policies were not nearly stimulative and inflationary enough:

> As I say, now that we are again on the [economic] move the voice of overcautious conservatism is raised again at the other [White House] end of Pennsylvania Avenue. Reach for the [monetary] brakes, slash the [fiscal] budget, seek an end to wage-price restraints…

Could inflation in the United States have been reduced to a "normal" of 2% or so, or at least contained at less than 5% a year or so, at the end of the 1960s? At a technical level, of course it could have. Consider inflation in the five largest industrial economies. Before the breakdown of the Bretton Woods exchange-rate system, the price levels in these five countries were linked by their quasi-fixed exchange rates. But starting in the 1970s domestic political economy predominates as the determinant of inflation.

West Germany was the first economy to undertake a "disinflation." The peak of German inflation in the 1970s came in 1971: thereafter the Bundesbank pursued policies that accomodated little of supply shocks or other upward pressures on inflation. The mid-1970s cyclical peak in inflation was lower than the 1970-71 peak. The early-1980s cyclical peak in West German inflation is invisible.

Japan began its disinflation in the mid-1970s, in spite of the enormous impact of the 1973 oil price rise on the balance-of-payments and the domestic economy of that oil import-dependent country.

Britain and France waited until later to begin their disinflations. France's last year of double-digit inflation was 1980. Britain's last year of double-digit inflation was 1981.

Certainly there were no "technical" obstacles to making the burst of moderate inflation the U.S. experienced in the late 1960s a quickly-reversed anomaly. But Arthur Burns did not dare.

Federal Reserve Chair Arthur Burns had no confidence that he could reduce inflation at a price in terms of higher unemployment that the economy was willing to pay. In 1959 Arthur Burns had given his presidential address to the American Economic Association. His presidential address was called, "Progress toward Economic Stability." Burns spent the bulk of his time detailing how automatic stabilizers and monetary policy based on a better sense of the workings of the banking system had made episodes like the Great Depression of the past extremely unlikely. Toward the end of his speech, Burns spoke of an unresolved problem created by the progress toward economic stability that he saw: "a future of secular inflation":

> During the postwar recessions the average level of prices in wholesale and consumer markets has declined little or not at all. The advances in prices that customarily occur during periods of business expansion have therefore become cumulative. It is true that in the last few years the federal government has made some progress in dealing with inflation. Nevertheless, wages and prices rose appreciably even during the recent recession, the general public has been speculating on a larger scale in common stocks, long-term interest rates have risen very sharply since mid-1958, and the yield on stocks relative to bonds has become abnormally low. All these appear to be symptoms of a continuation of inflationary expectations or pressures…

16.2.4. Oil Shocks

Then, after 1972, came the oil shocks: The tripling of world oil prices in the Yom Kippur Arab-Israeli War of 1973, and the again tripling in the Iranian Revolution of 1979, as the Organization of Petroleum Exporting Countries—OPEC—realized how much market power it had.

It is possible that the tripling of world oil prices was an intended result of U.S. foreign policy. Nixon's chief foreign policy advisor, Henry Kissinger, wanted to strengthen the shah of Iran as a possible counterweight to Soviet influence in the middle east. Certainly this was what Nixon's Treasury Secretary William Simon believed had happened inside the West Wing's corridors of power.

With the oil price tripled, the shah was indeed immensely strengthened-at the price of enormous economic damage to the industrial west and to the rest of the developing world, which saw its oil bill multiplied manyfold. It is certain that the economic repercussions of the oil price rise came as a surprise to the Nixon administration-Kissinger always thought economic matters were boring and unimportant in spite of the fact that the military and diplomatic strength of the United States depended on and should have been used to safeguard the liberty and prosperity of the United States. It is most likely that the oil price rise struck the administration as not worth its concern, and certainly as not worth trying to roll back—it did, after all, strengthen the shah, few had any conception of the economic damage it might do, and those few were not listened to by the U.S. government.

With oil the key energy input in the world economy, these price increases fed through the system. And in a world in which expectations of inflation had lost their anchor, they led to the world of double-digit annual inflation of the late 1970s.

Somewhat paradoxically, the rational-expectations school of economics that would have given advance warning of the breakdown of the Phillips Curve, and had as a result become dominant among economists, believed that these two tripling of world oil prices was macroeconomically irrelevant: The oil price would rise, other prices would fall, and the overall price level would be unaffected. Why? because the general price level was determined by the money supply, and not by decisions of producers of individual commodities to raise prices. Yet the tripling of oil prices sent the world economy into one of the deepest recessions of the post-World War II period, and left the economy with the legacy of high inflation that would in its turn lead to the 1980-82 recession, the deepest of the post-World War II era. And one of the striking features of the inflation of the 1970s was that—as any view that market expectations are rational would reject—the increases in inflation of the decade were almost always unanticipated. In every single year in the 1970s, the consensus forecast made late in the previous year sharply understated the actual value of inflation would be. And, of course, the reverse would be the case in the 2010s.

16.2.5. Inflation in the Late 1970s

Each surge in inflation was quickly followed by—or in the case of the mid-1970s oil shock inflation cycle roughly coincident with—an increase in unemployment.

Once again, each cycle in the late 1960s and 1970s was larger than the one before: unemployment peaked at around 6 percent in 1971, at about 8.5 percent in 1975, and at nearly 10 percent in 1982-83.

The recession of 1974-1975 made it politically dangerous to be an advocate of restrictive monetary policy to reduce inflation. Near the trough of the recession, Hubert Humphrey and Augustus Hawkins sought to require that the government reduce unemployment to 3 percent within four years after passage, that it offer employment to all who wished at the same “prevailing wage” that Davis-Bacon mandated be paid on government construction projects, and (in its House version) that individuals have the right to sue in federal court for their Humphrey-Hawkins jobs if the federal government had not provided them. In early 1976 the National Journal assessed its chances of passage as quite good-though principally as veto bait to create an issue for Democrats to campaign against Gerald Ford, rather than as a desirable policy. Arthur Burns had tried to avoid getting sucked into what he saw as a no-win situation:

> Humphrey-Hawkins... continues the old game of setting a target for the unemployment rate. You set one figure. I set another figure. If your figure is low, you are a friend of mankind; if mine is high, I am a servant of Wall Street.... I think that is not a profitable game... (Wells (1994))

The Humphrey-Hawkins bill was watered down, and watered down, and watered down again to be a set of declarations that the Federal Reserve should try to do good things—declarations with numerical targets attached—but no teeth as far as shaping actual policy was concerned. But it did make it difficult in the late 1970s to propose policies to reduce inflation, because all such involved at least a temporary rise in unemployment.

By the end of the 1970s average nominal wage growth was some eight percent per year rather than six percent per year, and the wedge between nominal wage and nominal price growth had more than vanished: it had become negative, as a result of a productivity slowdown and of the oil price shocks.

16.2.6. Why Did It Matter for the Stability of Social Democracy?

From an economist’s perspective, an inflationary episode like that of the United States in the 1970s—in which inflation bounces around between 5% per year and 10% per year for a decade—cannot, does not, will not matter (much). Prices go up.

But wages and profits go up as well. Perhaps there are some somewhat-damaging economic distortions introduced by the tax treatment of nominal interest payments, and by the failure to rebase basis values for the purposes of capital gains taxes. Certainly those who have borrowed in fixed sums of nominal dollars or at fixed nominal interest rates win. Certainly those who have loaned in fixed sums of nominal dollars or at fixed interest rates lose. But there is already an awful lot of luck and chance in incomes and payments. Inflation is a zero-sum redistribution. Some lose, but others gain as much. With no strong reason to think that the losers are in any sense more deserving than the gainers, why care (much)? Why should anyone care (much)?

This is wrong. Return to John Maynard Keynes's assessment of the consequences of inflation during and after World War I:

> Lenin is said to have declared that the best way to destroy the capitalist system was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some. The sight of this arbitrary rearrangement of riches strikes not only at security but [also] at confidence in the equity of the existing distribution of wealth. Those to whom the system brings windfalls, beyond their deserts and even beyond their expectations or desires, become "profiteers," who are the object of the hatred of the bourgeoisie, whom the inflationism has impoverished, not less than of the proletariat. As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.
>
> Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose…

Keynes was speaking of high inflation: enough to take "all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism" and make them "utterly disordered". That inflicts real harm on the division of labor and the functioning of the economy. But woven through this passage is another effect: One can usually pretend that there is a logic to the distribution of wealth—that somebody's hard work and skill lies behind prosperity, either the possessor of wealth's hard work and skill, or that of some ancestor, or that of those that the possessor was far-sighted enough to hire. Inflation—even moderate inflation—strips the mask. It is then, obviously, "windfalls" to "profiteers", the result of a "degenerate[d]… gamble and a lottery".

And a government that generates such an inflation is, obviously, not competent at what it is doing. Thus in the late 1970s all critics of social democracy had to do was to point at the inflation, and say: Would a well-functioning political-economic system have produced this? We need to think again, and reform. We need to make what became the neoliberal turn.