

Structuralist Economics: Challenge to the Mainstream

Interview with Lance Taylor

In a new textbook, economist Lance Taylor makes his case for what he calls structuralist economics. It directly challenges mainstream economics' reliance on assumptions about how consumers and businesses act, and tries to ground economic theory in everyday reality. We discuss his theories, based on years of work, and how they apply to the real world.

Q The new macroeconomic textbook you have published is a reflection of your view of the state of economic theory today, and clearly of its limits. It reflects many years of work. What is its central objective?

A. What I have tried to do over the years is set up a framework for macroeconomics that relates to the institutional structure of an economy and the genuinely perceived behavioral patterns of consumers, business people, and so on. This approach stands in contrast to trying to derive everything a priori from assumptions about the profit maximization of business and the utility maximization of consumers. That latter has been the trend in economics since World War

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II. It seems to me that focusing on optimization or maximization really misses the point of how people behave in the real economy.

Q Let us try to explain that a little more clearly. The basic assumption of mainstream economics—should we call it neoclassical economics?—is that businesses and consumers act rationally to maximize in one case their own profits and in the other case their own welfare.

A. Well, the headline is that people make decisions pretty rationally or even thoroughly rationally. The underlying hypothesis is that, given all this rationality, the economy is more or less rapidly going to tend toward full employment and the optimal allocation of resources—the allocation of resources that optimizes welfare. This is the mainstream interpretation of Adam Smith, if you like. It was originally micro-theory but got taken over into macroeconomics in a series of steps after World War II.

Q. Who led the charge after World War II in taking over and reviving neoclassical economics?

A. Let me step back, if I can. I would like to discuss the work of John Maynard Keynes, most notably, and also the Polish economist Michal Kalecki, as well as a few other people. Basically, what they did was set up a system that referred to macroeconomic aggregates of individual behavior, including specifically consumption, government spending, and business investment. Keynes, Kalecki, and other people created modern macroeconomics by reasoning explicitly in terms of those aggregates. There was an accounting logic underlying all this. For example, household income has to equal consumption, plus taxes, savings, and several other factors. By making assumptions about aggregate behavior and imposing these accounting conditions, you can draw useful conclusions.

Q What were some of the outcomes that then emerged?

A. The most important outcome is that the level of economic activ-

ity is determined by effective demand. There are so-called demand injections like investment and government spending, and then there are demand leakages like imports, taxes, and saving. The interactions of injections and leakages give rise to the level of output. But the output the economy attains through this process is not necessarily at full employment.

Q. So we can have a kind of equilibrium that is not at full employment. And this was more or less a direct refutation of nineteenth-century liberal economics?

A. Yes, Keynes at least thought that way. It was a direct challenge to mainstream economics, or neoclassical economics, which is the label that emerged in the last half of the 1800s. His work comes out of the Great Depression, remember. Keynes was theorizing about an economy that was in depression. It was perfectly reasonable to say that there is not going to be a tendency toward full employment.

Q. But after World War II we had come out of that depression, needless to say, and the views remained.

A. I think you can explain the ending of the depression on Keynesian reasoning. There was a consumption boom after World War II. People were almost immediately spending the savings bonds that they had bought up during the war. There was also military Keynesianism. There was a felt need for a U.S. military presence in the world. This required government spending, which stimulates aggregate demand. So you can see why the economy—from a Keynesian perspective—tended toward full employment. I do not think it ever really got there, but it certainly got closer.

Q. Then what happened? There was a reversion, so to speak, to try to synthesize Keynesianism with nineteenth-century classical economics.

A. It went through several stages, but in effect, what happened is that by, say, the 1970s and certainly the 1980s, mainstream macroeconomics had reverted to nineteenth-century economics. The major figure in late-nineteenth–early-twentieth-century economics was Knut Wicksell from Sweden, and basically what has come out in recent decades is a less interesting version of his work.

Q. Who led the charge in the 1950s?

A. It went through several stages. There was a professor in Cambridge, England, named Arthur Pigou, who was Keynes's *bête noire*. Keynes had argued strongly that wage cutting would be ineffective, and Pigou came up with a counterargument. That was the first step.

Q What was the basis for saying that wage cutting would be ineffective?

A. Keynes and Kalecki argued that prices are formed as a markup on wages. When wages go up, prices go up. If you are going to change demand, you have to change the real wage, which is the nominal wage adjusted for the price level. But if you cut money wages, prices will also fall, given markup pricing. In other words, prices will just come down proportionately, so the real wage will not change, and nothing will happen to demand.

Q. Pigou was the author of the “real balance” notion?

A. Yes. Pigou came up with an argument against Keynes and Kalecki, which came to be known as the Pigou effect and, ultimately, the real-balance effect.

Q. And the upshot of that was what?

A. The upshot was, suppose you cut wages, then prices go down. Then the real value of the money you are holding as an asset (the real balance) will go up. That is supposed to simulate demand. You will spend more because, in real terms, you have more wealth.

Q. This was consonant with neoclassical economics, then, and even some version of monetarism.

A. It is a version of monetarism, in effect. It says that aggregate demand is basically being determined by real balances—money supply (m) divided by the price level (p)—and that is surely consistent with the monetarist approach, although it was not labeled that in Pigou's days.

Q. What did people like Paul Samuelson—or the Samuelson-led group, I should say—contribute to this synthesis?

A. They came up with something they called the neoclassical synthesis, which was pretty close to Keynes, though it allowed some role for the real-balance effect. It also emphasized the need to get prices right—a key foundation of neoclassical economics—to get rid of distortions from tariffs and wage subsidies and so on. In my view, it was an uneasy mixture of smoothed-over Keynes with a belief in the power of the price system in terms of allocative efficiency.

Q. Was one of the consequences of that to reinstate the usefulness of monetary policy?

A. There were various consequences. Several papers came out not long after Keynes. There was the Pigou paper, which later turned into a series of more elaborate analyses by another economist, Don Patinkin, which was turned into a well-known book. There was also a famous 1944 paper by Franco Modigliani, which adopts the real-balance effect. It essentially says that one reason you might not have full employment is that the money wage is too high relative to the stock of money; therefore, you should cut wages. The fact that he did not put it the other way—that the stock of money is too low relative to the wage, and maybe you should pursue expansionary monetary policy—is a good example of mainstream preconceptions. So Modigliani is already refuting Keynes in the article written in 1944, which is only eight years after Keynes's major work, *The General Theory of Employment, Interest and Money*, was published. Modigliani's was, in a way, the seminal paper.

Q. How did monetarism fit into this and, in particular, into Chicago school monetarism?

A. Chicago had always had a monetarist tradition, which tended to tie the money supply more closely to the price level while postulating full employment. (If I can give you one equation, $m \times v$ is equal to $p \times x$, where m is a money supply, p is the price level, x is output, and v is some kind of constant called velocity, written by the finger of God. Needless to say, many do not believe velocity is a constant or even very stable, but it was a cornerstone of Friedman's contention.) To finish the thought, what Pigou did, in effect, was to say that real balances are proportional to output (x , or output, is proportional to

m over p). But what Friedman said—and the monetarists and successors endlessly repeated—is that there are strong tendencies for x , or output, to be at a full employment level anyway.

Q So output is high enough to generate full employment anyway . . .

A. . . . and, therefore, what is happening with the money supply is that it does not drive real output but rather prices.

Q. The money supply drives the price level but does not affect real incomes.

A. Right, as opposed to, in the Pigou story, the money supply will drive the real level of output. These stories all are really just themes and variations around the same equation, and that equation is central to all of them.

Q. Friedman did postulate there was some real effect, but it dissipated over time.

A. Yes. In another major paper written by Friedman, in 1968, he postulated that there were lags and frictions and that sort of thing, so you could be away from full employment for a while. But if that happened, prices would adjust in such a way that the real-balance effect would kick in and bring you back to full employment.

Q One of the things I like about your new textbook is that it cannot get itself away from the history of macroeconomic thought.

A. I do not see how you can in any serious way.

Q. Very few textbooks deal with history of economic thought.

A. That is true, and it reflects the bias of current economics—or let us call it the envy that economists have for physics.

Q. That there are immutable laws . . .

A. There are immutable laws, they claim, and they get stated and understood better and better all the time. Therefore, history is not necessary, as in the teaching of medicine, for example.

Q. So, your book is a direct attack on that notion, it seems to me—the immutability of economic laws?

A. Yes. I grew up as a development economist. I have seen lots of different things in lots of different countries. There is nothing immutable in economics.

Q. So, what does structuralist economics precisely mean? It is in the title of your book?

A. I borrowed the name from a school of economists who developed in Latin America around 1945–60. They were Latins and were probably influenced by the French structuralist schools in anthropology and philosophy. But what it means basically is that you look at the economy as it is rather than how you conceptualize it in theoretical terms. And you organize your thinking in aggregate-macro terms.

Q. Let us talk a little bit about the economy as it is versus the economy as mainstream economists think it is. What are some of the key assertions in your thinking?

A. On the whole, a main difference is our contention that output is going to be determined on the demand side, particularly in an economy like ours in the United States. In developing countries, it may be different. You can have various kinds of supply constraints, like food supply. But they are less relevant in the U.S. context. Distribution is important in terms of broad functional categories like profits versus wages and transactions between the home country, the rest of the world, and the government.

Q. Let us talk about the distribution income between profits and wages. This is basically what you mean when you are talking about distribution.

A. Right. But it could include other categories. If you were doing developing-country stuff, you would almost automatically worry about what is going on between agriculture and the rest of the economy. Or if you were doing Russia, the way the Russian economy is structured today, you have to worry about what is going on in the

energy sectors versus the rest of the economy. Wages and profits are a good place to start, but you do not necessarily have to end there—and should not end there.

Q. Let us go to that Russian example just to get a better beat on what you mean by this.

A. I am talking about distribution between the energy sector and the rest of the economy. If you have a dominant energy sector and an open economy, then, given the way that markets work, that tends to throw you in the direction of having a fairly strong exchange rate. If you have a fairly strong exchange rate, it is hard to industrialize because your exports are too expensive. That is, if you want to industrialize, it pays to have a weak exchange rate so you can sell your exports. So, Russia, in its current version, is driven very strongly in the direction of strong exchange rates and lagging industry or lagging nonenergy, and that, in turn, means that a lot of the technical progress that was achieved under the Soviet system is just disappearing, or has disappeared.

Q. What are some of the implications in your work for developing countries?

A. Take a look at the structure of the economy at hand and try to think through the implications. Take a country like India. A lot of things are going on in India macroeconomically, but certainly one important aspect is that if you get an upswing in economic activity outside agriculture, it tends to bid up the price of food because the food supply is limited. In fact, over the last ten years, the Indians have been pretty lucky with monsoons and have not run into a food constraint the way they did in the past, but that may not last. As it turns out, most poor people in India are net consumers of food (at their low income, they basically consume more food than anything else), so you get a direct negative impact on poverty in an economic upswing. Prices of food go up. We usually think of an upswing as being a good thing, on the whole, but in India it is definitely a mixed bag.

Q. If there are constraints on food supply?

A. Yes. As I have said, they have been lucky for the last few years.

Q. So this is a very good example of how economic laws are not

immutable. They depend on the structural, institutional, and social composition of a country?

A. Yes. In the Indian case, many of the poor are rural landless laborers, so they are hit by an upward shift in the agricultural terms of trade in the way I was discussing. In other places (eastern Anatolia in Turkey, for example), you have a peasantry in which a bigger share of the poor people are landed, and it may well go the other way.

Q. So, if India is in a boom, what does one have to worry about? It is not as if you do not want to boom.

A. Yes, you want to boom, but if you have a boom, then you try to do something about setting up mechanisms that channel resources toward the poor so they can buy food.

Q Let us take one or two examples of how this might affect the United States. Technological change and outsourcing can lead to growth, some claim. But obviously large groups of workers could be hurt.

A. Yes, they could, even though outsourcing in principle is desirable because it cuts costs. We should protect those workers' income levels and possibilities for mobility more aggressively. That will also keep up effective demand.

Q. You also argue that the distribution between wages and profits is important. Some nations grow by raising wages—wage-led growth—others by profit-led growth.

A. First, it is difficult to generalize from the econometric findings. But, right, developing nations seem to be wage-led; more advanced nations, profit-led. The empirical data suggest the United States is profit-led.

Q. That does not sound very Keynesian.

A. Well, it is non-left Keynesian. (I may be in trouble with some of my friends because of that.)

Q. What is the implication for policy?

A. Let me give you one example, but obviously there are many complicating factors. A big chunk of unit labor cost is made up of

health insurance premiums. If you were to cut the health insurance premiums and switch them to the government, that would have a direct effect on profitability and presumably help the economy. It would also guarantee wider coverage, if you structured it that way. Of course, then the government would have to pick up that fiscal burden, which it seems unwilling to do in this case.

Q Let me ask you a little bit about so-called new classical macroeconomics. How does your book address that? I heard the phrase “policy nihilism.”

A. I have never heard of it.

Q. Well, whatever the origin, I like it.

A. I do, too, actually. Certainly new classical economics contains many claims about the ineffectiveness of policy. But that really stems from the Friedman '68 model, if you like, where he is saying, suppose you try to print money to increase the level of aggregate demand. That may work for a while, but after a while prices will start to go up, and that will cut into effective demand through the real-balance effect, and so you will only get a short-term benefit. What new classical economics basically did . . .

Q. They take it a step or two farther.

A. Yes. They say it goes a lot faster. No lags, in effect. So you never really get away from full employment, and any attempt at policy that gets you away from full employment is going to be ineffective.

Q. How does your book take that on? One of your key assumptions is that we do not naturally get to full employment.

A. There is no real mechanism that is going to get you automatically to full employment.

Q. No natural mechanism?

A. No natural mechanisms. The story behind new classical economics is, again, that if there is a really well-working economy in the sense of having flexible prices and no distortions, the prices will adjust in such a way as to drive the system toward full utilization of resources. So that is the operative assumption behind new classical

economics. Now they throw in a bunch of pseudo thirty-year-old rocket science mathematics to try to make this look fancy, but basically they are assuming the answers that they want to get.

Q. What is wrong with that?

A. Economies do not automatically go to full employment.

Q. It is empirically not true?

A. It is empirically not true. Also, the assumptions are just impossible to swallow, particularly the way they are set up in the more recent models.

Q. Are some of those assumptions the rational-expectation assumptions?

A. Yes, rational-expectation assumptions, which means in this context that, to begin with, you live forever, and you have perfect foresight about what is going to happen in the future, and each one of us solves a fairly complicated maximization problem intuitively. There are some other technical conditions that are also implausible but have to be assumed to be true for the economy to get to full employment. People believe that!

Q. Does everybody really have to be a rational actor, or do only the people at the margin have to be rational actors?

A. It is everybody. One little guy at the margin being irrational is going to screw things up completely.

Q. Because that would always be the marginal guy, the irrational guy. I always think that everybody could be irrational, but you need a few rational people.

A. No, if you take the story seriously, everybody has to be fully rational.

Q. Last general question: The lack of a reality-based, mainstream economics—what consequences is it having these days?

A. Hard to say precisely. But let us say that Bush's economics is not reality based in the sense I am discussing, in the sense that it is

aware of institutions and the way people really behave. Now, does that matter? It matters insofar as large fiscal deficits used for the wrong purposes over an extended period of time are likely to be counterproductive, both in terms of productivity growth and certainly in terms of what most people would see as a just distribution of income. But Bush has been able to get away with this, and if he is reelected, he may be able to get away with it for a while longer. The point is that, ultimately, this lack of reality would tend to catch up with him or his successor . . .

Q. What would you have preferred?

A. Spending on infrastructure, transportation, education, and so on, which in turn can feed back into productivity growth and would be much better in the long run. . . . Let me just complete the thought about the 1990s in the sense that that was a very Keynesian period because savings levels were low, which Keynes would think was a good thing; investment levels were high; and there were no bear players in the stock market. So that was heaven as far as Keynes was concerned. What Keynes did not foresee, in some sense, was the sorts of distortions that tend to grow up from overspeculation, the bubble, and what happens when you actually get the economy pretty close to full employment. That shows that he did not have a truly general theory. But he had the ability to base a theory on the reality of the economy, and of that moment in time, and founded his ideas on just that reality.

Q. As it stood then?

A. As it stood then.