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The Strategy of Economic Policy and Income Distribution

By Hyman P. Minsky

Abstract: In a capitalist economy, income distribution is compounded out of the distribution of capital income, the distribution of labor income and the shares of capital and labor in total income. As capital inequality is much greater than income inequality, a decrease in capital's share would decrease income inequality. Keynes held that euthanasia of the rentier—that is, a decrease in capital's share of total income—would result from the investment that takes place during sustained full employment. Tolerably full employment has been sustained ever since World War II, but capital's share of income has not fallen. Full employment over the postwar period has been the result of policy which conformed to a private investment strategy. This strategy operates by sustaining and increasing the returns on capital and also carries threats of financial instability and inflation. An alternative public employment strategy for full employment policy is available. This strategy would probably lead to a partial euthanasia of the rentier and would tend to diminish the likelihood of financial instability and inflation. Highly stylized examples show that the effects of a partial euthanasia of the rentier, when combined with mildly equalitarian taxes, transfers and government services, can lead to a substantial decrease in income inequality.

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In the first paragraph of the last chapter of *The General Theory of Employment, Interest and Money,* Keynes announced that there were two lessons to be learned from his theory:

> The outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes. The bearing of the foregoing theory on the first of these is obvious. But there are also two important respects in which it is relevant to the second.[1]

The first lesson has become part of accepted wisdom. As a result of policy measures that owe their legitimacy to *The General Theory,* a closer sustained approximation to full employment has been achieved during the period since World War II than in any previous era. On the other hand, Keynes's belief that his theory would enable us to ameliorate the "arbitrary and inequitable distribution of wealth and incomes" has not been realized. Over the postwar period no significant progress has been made towards improving distributional equity.

Introduction

The two lessons have enjoyed such disparate theoretical, and practical, success because the standard interpretation of Keynes which has guided economic policy has ignored those aspects of the theory which make income distribution dependent upon the mode of operation of the economy. In an age of active economic policy, income distribution is inevitably affected by the policy strategy that is adopted.

To recapture some lost features of Keynes's theory and its implications for income distribution policy, a financial instability hypothesis which integrates the neglected features of his theory will be advanced. Of course, the important issue is not whether this alternative view is an accurate reproduction of Keynes's theory; the main issue is whether the alternative is a better theory for the class of economies with which we are dealing—advanced capitalist economies with sophisticated financial systems.

Keynes gives two reasons why his theory applies to income distribution policy: (1) it refutes the defense of inequality that rests on the need to release resources from consumption activities to investment outputs; (2) more importantly, his theory points towards the imminent euthanasia of the rentier. Since capital income is more unequally distributed than labor income, decreasing the weight of capital income in total income would tend to decrease inequality.

The euthanasia of the rentier is one of Keynes's concepts which has been lost. It points to the power of policy to affect income distribution by affecting the share of capital in total income. To point up the power and relevance of this idea, I will consider some highly stylized material on income and wealth distribution in the United States.

Two policy strategies for full employment are distinguished.[2] The first, which dominates the policy thrust in the United States since World War II, emphasizes private investment. This strategy reflects an effort to achieve both full employment and accelerated growth. A side effect of this strategy is an intensified tendency towards financial instability, as well as increased income inequality. The second policy strategy, which largely characterized recovery policy in the years just prior to World

1. J. M. Keynes, *The General Theory of Employment, Interest and Money* (New York: Harcourt, Brace, World, 1936), p. 372.

2. A policy strategy is the broad structure and thrust of the measures adopted. A particular strategy can be affected by various mixes of policy measures.

War II, emphasizes public employment. My argument is that this strategy, appropriately implemented, can decrease inequality by decreasing capital's share of income. A public employment strategy also decreases the likelihood that serious financial stringency will occur.

The operation of the economy generates initial income shares compounded out of the distribution of capital income, the distribution of labor income and the relative weights of capital and labor incomes in total income.[3] Income distribution policy can ignore the way in which the initial distribution of income is obtained and operate to alter the initial distribution by means of tax, transfer and government services in the effort to achieve a desired distribution. The various negative income tax, or guaranteed income, proposals which had a run of academic, but not of public, acceptance in the recent past embodied this approach to income distribution policy.[4] Policy designed to expedite the euthanasia of the rentier modifies the initial distribution by decreasing capital's share. For the United States, a significant decrease in inequality can be achieved by combining a partial euthanasia of the rentier with a rather modest equalitarian bias in taxation, transfer payments and government service programs.

THE FINANCIAL INSTABILITY HYPOTHESIS

The financial instability hypothesis underlies this paper.[5] This interpretation of Keynes's *The General Theory* ties aggregate demand to the financing and speculative pricing of assets.

A key proposition in this hypothesis is that full employment is itself destabilizing—that is, it is a disequilibrium state, because sustained full employment induces speculation which transforms otherwise stable growth into an euphoric investment boom. In such a boom the cash payment commitments of firms and financial institutions increase more rapidly than cash receipts from participation in income production. A sustained investment boom requires two things: (1) that investing units commit ever greater cash flows to debtors; and (2) that an ever larger, and more closely articulated, set of financial markets function properly. These developments increase the likelihood that financial distress will occur. Such distress or crisis triggers a falling away from full employment.

As a result of these interactions, income in a capitalist economy moves in a cyclical fashion. The economy transits among various system states: full employment, investment boom, financial crisis, debt-deflation, recession, depression, stagnation and recovery. These various states need neither occur nor be of the same intensity in every business cycle. Each system state is a disequilibrium state, which carries the seeds of its own destruction. The transit among system states is an endogenous phenomenon.

The path of income, employment and debts after a financial crisis, as well as the likelihood and severity of the crisis, is sensitive to the behavior of the Federal Reserve System and the fiscal posture of the federal government.

3. This initial distribution is conditioned by institutional and fiscal features of the economy.

4. For the taxation and transfer approach, see Christopher Green, *Negative Taxes and the Poverty Problem* (Washington, D.C.: The Brookings Institution, 1967).

5. See H. P. Minsky, "Financial Instability Revisited: The Economics of Disaster," in *Reappraisal of the Federal Revenue Discount Mechanism*, Board of Governors of the Federal Reserve System (Washington, D.C.: June 1972), vol. 3, pp. 95–136.

Prompt intervention by the Federal Reserve System can abort the more serious financial consequences, such as those which have often followed a crisis. Large government expenditures, combined with consumption supporting transfer schemes, set a high floor to income and introduce safe government debt into portfolios. Thus, the postwar combination of federal reserve sophistication, large government expenditures and substantial transfer payments has succeeded in changing the shape, but not in eliminating, the business cycle.

As decisions to invest and hold assets are based upon uncertain expectations, the market price of equities—common stocks—and prices of real assets are not precisely determined by the technical characteristics of capital assets in production. Investment, capital holding and liability structure decisions are based upon speculative considerations which dominate productivity. These speculative considerations take the form of conjectures about: (1) the cash flows that capital assets generate when used in production, (2) the cash payments required by liabilities, (3) the market price of capital assets and (4) the market conditions for the liabilities of the asset holders. As the subjective estimates are based upon flimsy evidence, events can trigger rapid changes in the decision determinants, thus, in investment and desired asset holdings.

In a world with cyclical expectations and experience, the ratio of employed to available capital and labor services has been, and is expected to be, variable. As a result, the distribution of income between, and within, capital and labor is not determined by production function characteristics. In standard economic theory, the initial, pretax, distribution of income between capital and labor and the size distribution within labor are determined by endowments and production function characteristics. In the financial instability view, production relations do not dominate in determining income distribution. In particular, profit expectations induce investment, and the pace of investment determines the share of profits in income. Thus, policy is not restricted to the use of tax, transfer and government services to modify some technologically determined distribution of income. Policy can affect the within labor distribution of income and the weights of labor and capital incomes in total income, as it affects the structure of demand.

THE EUTHANASIA OF THE RENTIER

In the cited passage, Keynes writes that there are "two important respects" in which his theory is relevant to the goal of a just and logical distribution of income. One is that inequality is unnecessary in generating the savings required for investment and growth. The other is that accumulation during sustained full employment eases the chronic and oppressive shortage of capital, resulting in a decrease of scarcity rent which capital commands.

Logically, these two grounds are quite different. The savings and investment argument points out that a barrier which was believed to exist, in fact, does not exist. Nevertheless, it remains a policy decision whether this opening will be used. On the other hand, the euthanasia of the rentier argument represents a positive view about the economy. It presumes that a sustained approximation of full employment, relieved of the waste of war, will soon lead to full investment—that is, a regime in which the scarcity rent of capital is drastically reduced.

Keynes's distributional optimism was based upon a belief that: "The demand

for capital is strictly limited. . . . it would not be difficult to increase the stock of capital up to a point where its marginal efficiency had fallen to a very low figure."[6] Rentier income disappears once capital ". . . ceases to be scarce, so that the functionless investor will no longer receive a bonus."[7] Keynes held that the investment which would take place under full employment and without war and excessive population growth would lead to ". . . the euthanasia of the cumulative oppressive power of the capitalist to exploit the scarcity-value of capital."[8]

Since World War II, a generation has passed without a major war or a serious depression. Nevertheless, the euthanasia of the rentier remains as remote as ever; if anything, the share of capital in total income may have increased over this period. Military expenditures and the increase in population explain part of the continued scarcity of capital, but the enormous rate of accumulation necessitates a deeper explanation.

Keynes approached the question of the ultimate required capital stock with a view that human wants, for those items that use economic resources, are satiable:

> Now it is true that the needs of human beings may seem to be insatiable. But they fall into two classes—those needs which are absolute in the sense that we feel them whatever the situation of our fellow human beings may be, and those which are relative in the sense that we feel them only if their satisfaction lifts us above, makes us feel superior to, our fellows. Needs of the second class, those which satisfy the desire for superiority, may indeed be insatiable; for the higher the general level, the higher still are they. But this is not so true of the absolute needs—a point may soon be reached, much sooner perhaps than we are all of us aware of, when these needs are satisfied in the sense that we prefer to devote our further energies to non-economic purposes."[9]

Experience has not validated Keynes's view about the satiation of human needs. The universal satisfaction of the absolute needs lies within the capacity of the affluent countries, such as the United States, Western Europe and Japan; this objective was within the technical capacity of the affluent economies when Keynes wrote.

Nevertheless, capital continues to be scarce and commands a substantial positive return. Relative needs have grown, and these needs are so structured as to induce demand for capital. The apparently insatiable demand is what it is because income distribution enables the rich and near rich to consume capital absorbing goods at an ever expanding tempo. Via demonstration effects and the course of social prestige, demand for such goods trickles down from the few to the many. The result is a demand for capital assets that sustains the shortage of capital. Consequently, growth and affluence—instead of bringing satisfaction—requires the cultivation of dissatisfaction.

SCHEMATIZED VIEW OF INCOME DISTRIBUTION

Conditioned by the impact of monopoly, trade unions and government, the economy generates an initial distribution of income. Taxes, transfer payments and government services transform an initial distribution of income into a final one. In a capitalist economy, the initial distribution is compounded out of three factors: the distribution of labor income, the allocation of capital income and the relative weight of capital income to total income. Net worth—and, by inference, capital income—is much more concentrated than total income; whereas the top fifth receives 40 percent of income, the top fifth owns 80 percent of net worth.[10]

As the distribution of net worth is more concentrated than that of income, any increase in capital's share of total income reenforces inequality. If we assume that our distribution of income is the result of capital receiving 30 percent of the total income, by making quite heroic assumptions that the distribution of capital and labor income completely overlaps the distribution of income with capital's share, 20 and 10 percent of total income can be computed. These computations indicate that if the data which show that the top fifth receive 40 percent of income are the result of capital receiving 30 percent of income, then a decrease of capital's share to 20 percent would lower the top fifth to 35 percent of total income. A decrease of capital's share to 10 percent would lower the top fifth to 29 percent of total income. The income of the bottom fifth in the income distribution would increase from 6 percent, to 7 percent and finally to 8 percent as the share of capital income in total income decreases from 30 percent, to 20 percent and finally to 10 percent. The ratio of the top fifth's total income to the bottom fifth's total income would fall from 6.7, to 5.0, to 3.6 as the weight of capital income would decrease.

It is evident that an improvement in distribution can be effected if capital's share decreases. It is also evident that a partial euthanasia of the rentier—that is, the reduction of capital's share to 20 percent or 10 percent of total income—would have to be supplemented by tax and transfer measures, if a more substantial increase in the income of the very lowest income groups is the objective. Euthanasia of the rentier is more effective in cutting the income of the very top income groups than it is in raising the income of the very lowest groups.

THE DISTRIBUTIONAL IMPACT OF STRATEGIES FOR FULL EMPLOYMENT

For full employment, the gap between consumption and full employment output must be filled by a combination of private investment and government demand. During the recovery period of the 1930s a public employment strategy was prominent. However, on the whole, policy since World War II has emphasized a private investment strategy.

Private investment strategy

Underlying the emphasis upon private investment as the preferred way to achieve full employment is the view that economic growth is desirable, and that the growth rate is determined by the pace of private investment. Furthermore, permeating standard economics is the preconception that the distributive shares are determined by technical conditions; hence, it is believed that the only effective way to improve the absolute lot of the poor is to increase total income.

The cash flow—gross profit—expected from owning capital assets is the proximate determinant of private investment.

6. J. M. Keynes, *General Theory,* p. 375.
7. Ibid., p. 376. The elimination of rentier income does not mean that entrepreneurial income will disappear.
8. Ibid., p. 376.
9. J. M. Keynes, "Economic Possibilities for Our Grandchildren," in his *Essays in Persuasion* (New York: W. W. Norton, 1930), p. 326.
10. U.S., Congress, Joint Economic Committee, *The American Distribution of Income: A Structural Problem,* prepared by L. C. Thurow and R. E. B. Lucas (Washington, D.C.: Government Printing Office, 1972).

If the aim is to increase investment, measures to increase the size and certainty of capital income are required. Included are tax devices which give capital income favored treatment—that is, accelerated depreciation and investment tax credits and spending programs that take the form of contracts with guaranteed profits, such as defense and space procurement, highway construction, housing subsidies and research. The tax breaks directly increase inequality. Contract spending, especially on sophisticated defense and space systems, tends to generate demand for short-lived and high gross profit outputs. Furthermore, the associated labor demand is for skilled, high wage labor, which increases the intralabor inequality of income.

High capital incomes lead to opulent consumption by the rich which induces imitative consumption by the less affluent, high paid workers. The rising consumption demand, which is a product of inequality, in turn sustains the shortage and income of capital.

Capital yields two kinds of returns: profits and interest, which are the result of participation in income production, and capital gains, which are the result of the revaluation of asset prices. An investment strategy sustains income earned in production by capital assets. An enlargement of capital income increases the value of capital assets, in particular, stock exchange equities. An increase in the surety of profits raises the rate at which income is capitalized. Thus, sooner or later, an investment strategy results in capital gains. Widespread realization and anticipation of capital gains fosters an increase in speculative debt financing of ownership of capital assets and of investment. A private investment strategy contributes to a speculative, debt-financed investment boom. The ratio of contractual cash payments in debts to cash receipts from normal income related services is increased.

The greater the ratio of debt payments to income receipts, the more fragile the financial structure. Inevitably, monetary policy is handcuffed by an awareness that monetary restraint may ignite a debt deflation process, difficult to control. Monetary and fiscal policy must then maneuver ever more delicately to prevent unemployment. Furthermore, each success in avoiding a debt deflation makes subsequent policy more difficult to execute.

A private investment dependence is fraught with inflationary contingencies. The rising desire to consume which is induced by capital gains during booms makes it likely that the growth in aggregate demand will outpace aggregate supply. This generates a demand-pull inflation. In addition, the investment strategy can impel a special type of cost-push inflation, if, as is true for the United States, some trade unions have relatively greater market power than other trade unions.

For example, the combination of an investment strategy and uneven trade union power in construction can force a rise in construction wages relative to other wages and, thus, in the price of the building trade output relative to other output. This, in turn, increases the cash flows that must be realized if investment is to be sustained. For this to happen, it is necessary that the price of output rise to a level that is consistent with construction wages. An investment strategy breeds a likelihood that both inflationary pressures in investment production and a need to generalize this inflation—in order to service the debt used in financing investment—will exist. Furthermore, as construction workers' income is high relative to other workers' income, the private investment strategy, within the context of the greater relative power of trade unions in the building trades, tends to advance high wage incomes relative to low wage workers. The private investment strategy, as it works in the United States, tends to sharpen intralabor inequality.[11]

Thus, the private investment strategy has four flaws:

—it breeds fragile financial relations that threaten full employment and financial stability;
—it evokes inflationary pressures;
—it enlarges capital income in total income;
—it fosters inequality in labor income.

Public employment strategy

The basic ingredients for a public employment strategy are to be found in the Works Projects Administration, National Youth Administration and Civilian Conservation Corps of the 1930s. The philosophy underlying this strategy takes the unemployed as they are and fits public jobs to their capabilities.[12] Such public employment for adult workers would be at the national minimum wage; part time work to supplement social security and child maintenance allowances would be available; youth wages could be at some discount from the legislated minimum wage. This is analogous to farm price supports: the legislated minimum wage is replaced by a wage floor set by an always available alternative. Jobs will be available to all; there would be no means test for participation.

The employment available would be in labor intensive services that lead to readily visible public benefits, such as cleaner, safer cities, more and better-maintained parks and recreational facilities. As there will be a continuing minimum amount of public employment, certain services of public concern might well have a permanent cadre of such workers—that is, in hospitals, schools and on police forces. The income received, while presumably more than adequate for the absolute needs of which Keynes spoke, would not generate opulent incomes for any, not even for administrators of the programs.

An employment strategy is consistent with constraints upon private speculative finance. Speculative finance not being required, developing liability structures would not jeopardize the success of this strategy. Tax policy need not be conditioned by the necessity to induce private investment and to sustain the cash flows required to service debts born of speculative finance.

A public employment strategy imparts a strong underpinning to demand. As it does allow technical progress to induce investment and does not foster speculative booms, this strategy can underwrite a steady pace of investment. The tax schedule could be devised to balance the budget whenever public employment is consistent with what would now be a 4.5 percent measured unemployment rate. Whenever the pace of private investment increased to force public employment below this level, the budget would quickly move to a surplus; whenever private employment decreased, the budget would move to a deficit. As a fiscal device, an automatic public employment policy could be an effective stabilizer. As capital shortages and large capital rents are

11. H. P. Minsky, "Effects of Shifts of Aggregate Demand Upon Income Distribution," *American Journal of Agricultural Economics* (May 1968).

12. H. P. Minsky, *Labor and the War Against Poverty* (Berkeley, Calif.: Institute of Industrial Relations, Center for Labor Research and Education, 1965).

superfluous for this program—and because the emphasis in policy shifts from more to better use of existing capabilities—a rather quick partial euthanasia of the rentier should occur once this strategy is adopted.

With a public employment strategy there is no need to stimulate investment by allowing large intergenerational inheritance transfers. Thus, truly progressive and effective death duties can be instituted. Furthermore, corporate income taxes—especially the definition of nontaxable corporate income—no longer need be determined by a need to sustain corporate cash flows. Capital gains for rentiers would not be a necessary driving force, and the need for the protective treatment of such income would vanish. For example, as construction would be removed from the arena of privileged output, the power of construction unions to force inflation and inequality would be attenuated. Since it is more sustainable and less inflationary, a public employment strategy may be preferable to a private investment strategy. In addition, it holds out the promise that by a partial euthanasia of the rentier it will ease the burden of income inequality.

CONCLUSION

A partial euthanasia of the rentier, which would accompany a shift to public employment strategy, can contribute to equalizing income. A reduction of capital's share of total income from 30 percent to 20 percent will lower the ratio of total income in the top fifth to total income in the bottom fifth from 6.7 to 5. Further reductions in inequality could be accomplished by quite modest tax, transfer and service programs. In the examples that follow, a partial euthanasia that lowers capital's share from 30 percent to 20 percent is assumed.

Let us call a fair shares program one in which there is a proportionate tax on income and an equal per capita distribution of benefits. If the total collected in this manner is 10 percent of total income, then the ratio of the top fifth's total income to that of the bottom fifth's will drop to 3.7.

In a mildly progressive scheme, 10 percent of total income is collected by tax rates that range from 13 percent in the highest fifth to 3 percent for the lowest fifth, and transfers and services are distributed so that the top fifth receives 10 percent of the total—50 percent of their fair share—and the lowest fifth receives 30 percent—150 percent of their fare share. This scheme combined with a partial euthanasia will lead to a top fifth to bottom fifth ratio of 3 to 1.

Substantial progress towards a more just and equitable distribution of income can be achieved by a modest partial euthanasia combined with either fair shares or mildly progressive tax, transfer and service programs. To effect such a transformation it is necessary to design policy with these specific objectives in mind. A public employment strategy is consistent with the goal of distributional equity—a private investment strategy is not.

A public employment strategy directly affects the distribution of income by setting an effective floor to wage income. In addition, the services produced by public employment will be distributed at least on a fair share basis and, more than likely, on a progressive basis. The areas, neighborhoods and population groups with the highest unemployment would naturally receive a larger portion of the useful output produced by such employment.

A public employment strategy implies a significant reordering of priorities. A private investment strategy promises pie in the sky—that is, skimp today for tomorrow's abundance. A public employment strategy aims at a better application of current capabilities and a more equitable distribution of current output. A public employment strategy also removes constraints upon tax policy: it is not necessary to compromise justice and equity because of an overriding need to induce investment.

A final note: the private investment strategy was fully institutionalized during the Kennedy regime with its emphasis upon growth. The liberal economists of that administration apparently did not realize that the measures they pressed to increase growth had the additional effect of increasing inequality. The current financial instability—first evidenced by the crunch of 1966, repeated in the liquidity-squeeze, Penn Central crisis, of 1970 and succeeded by the dollar crises in 1971 and 1973—indicates that the private investment strategy to maintain full employment is running out of steam. The question that we may soon have to face is not whether there will be increased public spending, but what kind of public spending will be selected. The big choice will be between public contractual spending—for defense, highways and so on—and public employment.