Introduction

While increasingly large segments of the economics profession cast themselves adrift in a sea of representative agents governed by the invisible hand, John Kenneth Galbraith has spent a lifetime studying and explaining the realities of the advanced industrial state. These realities are dominated by problems that stem from the accumulation and exercise of power by large corporations, and the obligation of government to counter this power in the public interest. This focus has made Galbraith a persistent critic of economic theories that give power and institutions at best a very minor role, and more usually none at all, in influencing economic performance. He finds this neglect of power and institutions, typical of mainstream economic theories, seriously diminishes their capacity to improve our understanding of the real world and its problems. In this chapter we find that recent radical changes in economic theory, initiated and propagated primarily by American economists, reaffirm Galbraith’s assessment. This shift has resulted in an entirely new formulation of macro theory, profoundly different from that associated with Keynes’s General Theory. We focus on how macroeconomic theories explain unemployment, because the treatment of unemployment is at the centre of this revolution in macroeconomic analysis and policy. By contrasting the core features of the original Keynesian macroeconomics with the new mainstream macroeconomics (hereafter referred to as Keynesian and New Keynesian macroeconomics respectively), we can more easily identify the shortcomings and misrepresentations that result when power and institutions are omitted from theory. These are essential determinants of macroeconomic outcomes, needed in order to understand why performance differs over time and among countries, and to design effective policies to remedy malfunction.

The second section contrasts macroeconomic developments in the two episodes comprising the period since World War II, the ‘Golden Age’ and what we designate the ‘Age of Decline’. The third section reviews the
changing mainstream schools of macroeconomics that prevailed over the same historical period. The fourth section summarizes in non-technical terms our extension of traditional Keynesian theory, in which power and institutions are integral elements determining macroeconomic function. In the fifth section these ideas are organized formally as a constrained optimization problem. This model is tested in the sixth section, which reports the results of an econometric model that includes measures of power and institutional characteristics as possible influences on unemployment performance in the OECD economies. The conclusions are contained in the final section.

**The stylized facts**

Table 8.1 records unemployment and inflation data for 18 developed capitalist economies from 1960 until the end of the century, the 1990s being the last short-run period for which comparable data are available. The countries fall into three groups: those with low rates of unemployment through the entire period (the low unemployment countries); those with relatively high rates of unemployment throughout the period (the high unemployment countries) and a third group in which low unemployment until the mid-1970s was followed by high unemployment thereafter (the low-high unemployment countries). The data show there were two lengthy episodes distinguished by their differing performance, the Golden Age of low unemployment, moderate inflation and rapid growth (not shown), followed by what we designate the Age of Decline, an episode of high unemployment, high rates of inflation and slow growth. Each episode covers a series of short-run business cycles, with turning points in GDP determined by the OECD and cited at the top of the columns.

The customary definition of full employment emphasizes the absence of involuntary unemployment after an adjustment for frictional or ‘job-search’ unemployment. Inspection of Table 8.1 shows an overall average unemployment rate of 2.3 per cent for the 18 developed capitalist economies during the Golden Age. During this episode 3 per cent was commonly accepted as the full employment rate of unemployment in the United States. We follow this custom, although choosing an overall average rate as high as 4.5 per cent would not alter the nature of our conclusions. Table 8.1 brings out clearly the exceptional unemployment and inflation records of all but four of the economies in the first episode; these form the high unemployment group. This was a period of expansion of the welfare state, especially outside of the United States, resulting in noticeable reductions in poverty rates and in the inequality of income distribution. It was clearly a Golden Age for most.

The period from the mid-1970s to the closing years of the century was one of economic decline. Accelerating inflation rates in the late 1960s and early