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Prosperity, great compression and Reaganomics: lessons for economic policy

INTRODUCTION

Economic history delivered plenty of empirical data enabling policymakers to derive relevant conclusions and formulate generally applicable theoretical principles of a sound economic policy. Debates over the importance of state interventionism, equity and institutional development persist and take on huge praxeological value in light of the recent financial crisis.

Liberals and conservatives carry divergent views on the market mechanisms, institutions, income distribution and regulatory framework. In our opinion, the core of the disagreement resides in three fundamental dichotomic problems:

1. dirigisme versus ‘laissez-faire’ policy;
2. trickle-up versus trickle-down economics;
3. demand- versus supply-side economics.

The paper presents an opinion on these dilemmas based on positive analysis of three periods of economic history of the USA, i.e. Prosperity (1920–1929), Great Compression (1937–1947), and Reaganomics (1981–1989). Comparative analysis allows to derive conclusions on the effects of different policy measures on economic growth, social and institutional development.

The paper is structured as follows: firstly, we present an overview of the economic policy during the analyzed sub-periods of American history; next, we proceed with normative analysis and take a stance on the fundamental issues of economic policy basing on the results of positive analysis; the paper ends with a description of the current state of the US economy and its development prospects within the current policy paradigm.

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PROSPERITY IN USA: TECHNOLOGICAL PROGRESS
AND TRICKLE-DOWN ECONOMICS

The period of Roaring Twenties encompassing the presidencies of Warren Harding and Calvin Coolidge, is notorious for sustained productivity growth, steep technological transformations and conservative economic policy. Opinions diverge on social and institutional heritage of the Prosperity Era: Bernstein [1960] highlights the income imbalances disadvantaging the workers, while Hacker [1970] argues that the benefits of economic growth were largely shared by the entire population.

The Prosperity Era was undoubtedly a period of unparalleled productivity growth, which was largely shaped by technological advancements and growing trend of consumerism. Harrison and Weder [2009, p. 366] estimate that over the analyzed period output grew at the average rate of 3,55% yearly, while total factor productivity increased by 2,77% per year. These unprecedented figures were the result of the widening utilization of electricity, intensive use of natural resources, automatization of industrial processes, mass production of cars and electric appliances using the assembling line technologies, rapid penetration of radio and telephone, steadily growing urbanization accompanied with housing boom and considerable expenditure on transportation infrastructure and utilities, increased productivity in agriculture, as well as introduction of innovations into industrial organization and management. Labor productivity grew by 5,44% yearly, while capital productivity – by 4,21%, which was primarily stimulated by automatization and mechanization of industrial processes, increased flexibility and amelioration of working conditions [Devine, 1983].

Despite significant growth rates, real salaries were stagnating with the wages of the skilled and semi-skilled workforce rising by 4–7% [Historical Statistics of the United States, 1970] through the entire period.

Relatively favorable situation on the labor market induced a gradual degradation of the unionization movement, which was intensified during the wartime. Bernstein [1960] argues that Prosperity entailed a shift from unionization towards welfare capitalism with the domination of company-controlled unions, while overall the unionization rate fell below 12% signifying a defeat of the union movement.

The fiscal policy conducted by Harding's and Coolidge's administrations represents a classical example of supply-side economics. After the introduction of the federal income tax in 1913, the marginal tax rates increased from 7% in 1915 to 77% in 1918, while the share of tax revenue in the federal budget increased from less than 10% in 1914 to 70% in 1920 [Smiley and Keehn, 1995]. The Treasury Secretary Andrew Mellon argued that excessive tax rates aggravated the problem of tax avoidance. Democrats proposed to increase tax exemptions for the lowest brackets while maintaining highly progressive system for the top tax payers. However, Republican administration reduced the progressivity of the tax system by gradually diminishing the marginal tax rate from 77% to 58% in 1923, 46% in 1924 and 25%

in 1925. Tax cuts increased tax revenues and allowed the federal government to run budget surplus through the entire period [Smiley and Keehn, 1995]. However, income distribution approximated by the Gini coefficient shifted from around 42% in 1920 to 47% in 1929; the share of income of the top decile increased from 42% to 45% [Piketty & Saez, 2003]. The changes in income distribution was largely attributable to unprecedented capital gains accruing to the wealthiest decile. The degree of income inequality reached its maximum level before plunging in 1940s. Trickle-down economics clearly did not work with the salary levels stagnating and the benefits of economic growth largely reaped by the wealthiest.

Schumpeter [1946] postulates that the Great Depression, which ensued after a decade of growth, was primarily engendered by exuberant stock speculation and subsequent slump in aggregate demand caused by negative wealth effect, which was fueled by unrealized capital gains. The recession was aggravated by the crisis in the banking sector. Additionally, the economic downturn was amplified by the crisis in rural and urban mortgage, which was caused by lending malpractices. For example, farm mortgage foreclosure rate increased from 4% in 1920 to 18% in 1929 [Alston, 1983].

GREAT COMPRESSION: TOWARDS EQUITY, COHESION AND POLITICAL STABILITY

The term ‘Great Compression’ was first used by Goldin and Margo [1992] to denote a period of income convergence and steep decline in the overall inequality level in the aftermath of the WWII. The phenomenon was largely shaped by the dynamic processes on the labor market, progressive fiscal policy and destabilizing influence of the wartime.

The between- and within-group wage differentials dropped on average by 20%; premiums for education and experience showed a significant decline, while the unemployment rate remained consistently low. The shifts towards egalitarian income distribution may be partially explained by the New Deal initiatives and the wartime expenditure programs, i.e. The National Industrial Recovery Act (NIRA) as well as by the activities of the National War Labor Board, which controlled wage increases and smoothed geographical wage differentials. Additionally, increased demand for unskilled labor during the warfare coupled with a growing supply of educated labor created a downward pressure on wage differentials until 1970s. The Fair Labor Standards Act (1938), which established the minimum wage and induced its subsequent fourfold increase, may also partially explain the phenomenon [Goldin & Margo, 1992].

During 1940-1950s the income distribution went through a major change with the share of income of the top decile falling from 45% to 31%, which was attributable to the effects of taxation and slump in capital income [Piketty & Saez, 2003].

Vernon [1994] states that fiscal policy during the War period was the key to economic recovery after the Great Depression. It increased the output to its potential level and induced subsequent robust growth. To finance the increased expenditure, personal and corporate income taxes were increased along with excise taxes, taxes on capital gains and estate, which contributed towards leveling of the income distribution and allowed to boost the economy through a large-scale fiscal stimulus. Romer [1992] argues that the recovery was mostly attributable to the favorable impetus of the monetary policy with the increased bank reserves being the fuel of growth. The macroeconomic policy of 1940s represents a typical example of demand-side economics with a strong accent on aggregate expenditure as a source of growth. Throughout the decade the output kept growing at 2,34% yearly [Harisson & Weder, 2009, p. 366].

Great Compression was also a period of the most intensive union movement. The unionization rate grew to 35% in 1954 and started falling ever since. The gradual decline of unions may be partially explained by the shifts in the labor force structure, but was majorly due to the enactment of the Taft-Hartley amendment (1947), which considerably limited the rights of the unions and their access to the political battlefield, thereby virtually announcing the decay of the labor movement [Freeman et al., 1980]. Krugman [2007] describes Great Compression as a transition to the Society of Affluence. The post-war period was notorious for the surge of wide middle class benefiting from increased income and fair wealth distribution. Boom in tract housing, urbanization, development of public education, mass car ownership, health insurance and social security, retirement plans and agricultural subsidies substantially ameliorated the quality of life of manufacturing workers and farmers. The median income and purchasing power of blue-collar households doubled compared to 1929, real wages grew by 2,7% yearly. Active unions sustained compression of wage differentials and protected workers' rights in industrial disputes.

The post-war period was also marked by unprecedented political consensus and cohesion. McCarty et al. [2001] emphasize the decrease in political polarization during 1940-1960s; what is more, it was shown that political polarization was almost perfectly correlated with the degree of income inequality. The views on economic policy and welfare state were similar among the majority of representatives of the dominant parties, and voting in Congress did not have any pronounced ideological background.

REAGANOMICS: UNCONVENTIONAL ECONOMIC POLICY

Reaganomics was largely shaped by the historical recollection of the Roaring Twenties with a strong accent on supply-side incentives. Reagan administration proposed radical tax cuts and closure of tax loopholes, deregulation of business activity and government spending reduction [Magazzino, 2012]. The new policy

was the response to oil shocks, which entailed stagflation. Decreased individual taxes and tax reliefs for business were expected to trickle down and benefit the entire population. The outcomes of the applied policy measures raise controversy: during the decade total output was growing at 1,54% yearly while total factor production – by only 0,34% [Harisson & Weder, 2009, p. 366], tax cuts resulted in unparalleled rise of income inequality [Piketty & Saez, 2003], while the federal budget was run with an average deficit of 4,2% of GDP, which was two times higher than during Carter administration.

The primary focus of Reagan administration was the tax reform under Economic Recovery Tax Act (1981), which initially reduced marginal tax rates by 25% (eventually the marginal tax rate decreased from 70% to 28%) and provided corporate sector with a diversity of tax reliefs and exemptions. Despite the initial effort to decrease public spending, the expenditure part of the budget kept on increasing due to heavy defense investments, which resulted in skyrocketing public debt [Marshall & Arestis, 1989]. Overall, public expenditures were significantly higher than during previous administration, which may cast doubt on the supply-side focus of the Reaganomics [Magazzino, 2012]. By means of combining tax cuts with increased public expenditure, Reaganomics virtually combined Keynesianism with supply-side economics.

According to Magazzino [2012], despite successful implementation of the tax reform, Reaganomics brought about unprecedented budget deficits and negative balance of payments. Fall of unemployment coupled with reduced inflation may be considered the major accomplishments of the Reagan administration. At the same time, considerable reduction of tax progressivity, reduced tax burden on capital gains and cutting back on social programs entailed a long-lasting trend of rising income inequality and stagnating well-being of households. Reagan administration did not increase the minimum wages and suppressed union movement, thereby, contributing to the widening wage gaps and income differentiation. The share of income going to the top decile increased from 33% in 1981 to 39% in 1990, the share of the top 1% increased from 8% to 13% while the share of the top 0,1% quadrupled from 0,5% to 2% [Piketty & Saez, 2003].

INEQUALITY AND IMPERATIVE OF DIRIGISME

There are several domains where laissez-faire economic policy fails. The story of ‘tragedy of commons’ notably highlights that self-interest and ‘invisible hand’ may fail to create a long-lasting equilibrium and address the problem of social utility maximization.

The US history of the 20th century clearly demonstrates that economic policy plays a crucial role in shaping the wealth distribution, and that without proper government intervention negative trends tend to self-perpetuate, thereby, engen-

dering pathological socio-economic phenomena. Prosperity in US was a period of unparalleled productivity growth which did not trickle down to the manufacturing workers, resulting in the most unequal wealth distribution in a century. Progressive taxation, labor market transformations and wartime wage compression allowed for an evolution into a stable flourishing middle-class society with the least divided political field ever. Gradual return to ideological clichés of the Roaring Twenties accompanied with tax cuts and loopholes in regulatory framework resulted in extraordinary rise of inequality, which may have ruinous repercussions.

Piketty [2014] highlights the explosion of inequality during the last three decades with the share of income of the top decile in US growing to 47% and that of the top percentile to 20%. At the same time, the repartition of income has somewhat changed with the labor income outpacing the capital income. Piketty argues that this phenomenon is attributable to uncontrolled increase of remuneration of the top-managers, obviously disproportionate to their productivity dynamics. Combined with gradual withdrawal of progressive taxation and welfare programs, it entailed wealth concentration at the top of income distribution. With the return on capital outpacing the output growth, the concentration of wealth will self-reinforce creating a long-run trend of rising inequality, which according to Piketty, constitutes a threat to social order and may eventually result in a major bifurcation. Stiglitz [2012] commented that over the last two decades the median income in the US fell by 40%, which signifies a defeat of the trickle-down economics. Rising inequality entails limited bottom-up social mobility, gradual segregation of rich and poor, erosion of social capital and economic incentives, class warfare and general disillusionment. Lobby of the big capital coupled with social frustration cause dysfunctions of the political system, which may degenerate into clientelism and corruption.

Krugman [2007] argues that ideology plays a crucial role in shaping misperceptions regarding income inequality: several powerful right-wing think tanks constantly propagate a libertarian narrative with an accent on equal opportunities, market forces and economic incentives.

Based on analysis of data from OECD countries, Cingano [2014] concludes that income inequality slows down economic growth, while redistributive policies enhance growth opportunities. The adverse effect of inequality comes primarily from underinvestment in human capital at the bottom of income distribution, since poor families have limited access to education and other public services. Thereby, a sound economic policy should specifically target particular income groups in order to improve growth prospects of the entire economy. Special care should be taken in order to guarantee appropriate access to formal education for low-income families [Cingano, 2014]. Similar conclusions were derived by IMF [Dabla-Norris et al., 2015]: in unequal societies, benefits of economic growth do not trickle down; labor markets exhibit increased skill premium, thereby, reducing earning capacity of the poor, who do not have adequate access to professional training.

Atkinson [2015] proposes a set of policy measures, which may help alleviate the problem of inequality. Primarily, tax system should regain progressivity with the top-bracket marginal tax rate of at least 65%. Estate and inheritance taxes should be increased in order to prevent accumulation of patrimonial capital. Part of the proceeds should be directed towards social security and welfare programs in order to support the bottom of the income distribution.

DEMAND – VERSUS SUPPLY-SIDE ECONOMICS

Prosperity in US represented a consequential implementation of supply-side economics. Keller [1982] underlines that Coolidge's policy relied on the idea of 'constructive economy', which by means of tax cuts and government downsizing, attempted to unleash entrepreneurial initiative and enhance economic incentives. Tax cuts were covered by government expense reduction in order to maintain budget surplus. Defense expenditures decreased by 75%, while the marginal income tax rate plummeted to 25%, thereby, accommodating transition of the economy to the post-war balanced growth. Mellon's primary concern was the tax avoidance and large public debt, which were viewed as malaises of an oversized government sector. Unprecedented productivity growth did not trickle down as was expected by the Coolidge administration, however, robust economic growth allowed to alleviate social consequences of growing income inequality.

Reagan's administration revived the conservative Republican ideology and constantly alluded to the growth of the Roaring Twenties as a proof of effectiveness of supply-side economics. However, Reaganomics, based on supply-side tenets, diverged in several crucial aspects from the Coolidge-Mellon policy. Reagan emphasized the importance of tax cuts, but did not view balanced budget as a priority [Marshall & Arestis, 1989]. Throughout the Roaring Twenties inflation remained stably low, while under Carter's administration inflation became the principal source of concerns of the policymakers, which shifted the policy paradigm towards supply-side theories [Marshall & Arestis, 1989]. Tobin [1987] argued that a combination of restrictive monetary policy and expansionary supply-side stimulus would cure the stagflation, however, Volcker's policy was clearly threatening economic growth. Ailing economy could not reconcile elevated interest rates, supply-side stimulus and fiscal stability. Apart from growing public debt, the principal problem of the Reagan administration was the falling rate of national savings, which translated into increased capital inflows, dollar appreciation and negative trade balance [Cutler & Summers, 1988]. The fast growing economy of the Twenties was far better positioned to accommodate fiscal transition, than the economy of the 1980s experiencing stagflation and sluggish productivity growth, implying that sound economic environment is a vital prerequisite for success of the supply-side policy [Keller, 1982].

The experience of 1930–1950s demonstrated the merits of the demand-side Keynesian economics. In 2008 the US economy plunged into a crisis and reignited the debate over the possible remedies. Krugman [2009] stated that insufficient private spending was the core issue, which may be solved by means of credit expansion and public spending. The crucial idea proponent by Krugman [2012] is that resource underutilization caused by lack of aggregate demand is much worse than a temporary increase in budget deficits. Classical demand-side economics translated into quantitative easing and American Recovery and Reinvestment Act (2009), which proved to be an efficient tool of returning to economic growth. On the other hand, the supply-side response in the form of ‘confidence theory’ and austerity measures, applied in the EU countries, resulted in a prolonged stagnation and aggravated fiscal problems.

Recent financial crisis gave some additional arguments in favor of demand-side economics. Firstly, despite huge fiscal stimulus financed by unparalleled budget deficits, the interest rates remained at historical low, implying that the government spending was not crowding out private investment, as anticipated by the supply-side economics. Secondly, expansionary monetary policy in US did not result in surge of inflation, which puts the supply-side economics at odds with the monetarism.

TRICKLE-UP VERSUS TRICKLE-DOWN ECONOMICS

The trickle-down narrative was dominant in the political and economic discourse throughout the 20th century and remains among the key arguments of radical Republicans in US. Ideological conviction that ‘business knows best’ and that tax reliefs for capital gains create jobs, blemishes in the face of overwhelming evidence of growing income disparities. Data analysis reveals that neither during Prosperity nor during Reagan-Bush administration did tax reliefs for the top tax brackets translate into a more equitable income distribution [Piketty, 2014]. On the contrary, relaxation of tax progressivity always results in rising inequality with all respective economic, social and political consequences.

In 1970s the accents in development economics shifted from the problematic of economic growth to that of equitable income distribution, as it was clear that trickle-down paradigm proved to be wrong [Adelman et al., 1976].

Many neoclassical models [e.g. Aghion & Bolton, 1997] advocate trickle-down approach, arguing that even under conditions of capital market imperfections, capital accumulation leads to an equilibrium income distribution. At the initial phase, accumulation process contributes to growing income disparities, but eventually wealth trickles down and generates a steady state with considerably lower inequalities. Empirical evidence did not validate this pattern: in the last

30 years in African countries as well in advanced economies, including the US, dynamic productivity and output growth did not eliminate disparities and rather aggravated socio-political issues [Arndt, 1983].

The 'rising tide' narrative particularly gained in strength during Reagan's presidency. However, after analyzing the dynamics of Gini coefficient and average income, Michel [1991] concluded that between 1982 and 1987 the majority of post-tax incremental income was accruing to the top quintile of income distribution while the income of the bottom quintile (especially ethnic minorities) fell.

Even when the real per capita income is growing, increased inequality may reduce the household's overall well-being. Greenwood and Holt [2010] explore the phenomenon of negative trickle-down and the demand-supply disproportions on the housing market created by rising inequality, which considerably limited access of low-income families to real estate and caused housing debt accumulation in the low income brackets.

Oliver and Briscoe [2011] highlight that increased inequality is accompanied with limiting access to public education: the tuition fees rose significantly faster than average income, while government support of higher education was curtailed, entailing underinvestment in human capital. Education gradually loses its role of social mobility enhancement and inequality alleviation. Even more threatening processes are taking place in the healthcare, where income stratification left a significant part of population with no adequate medical coverage. The current political trends do not allow for any radical change and rather maintain an assault on the already existing social security network like Medicare and Medicaid [Krugman, 2007].

RENT SEEKING AND MORAL HAZARD

According to Stiglitz [2012] rent seeking has become a pervasive economic pathology, which substantially contributes to the increasing wealth inequality. It takes on multiple forms: government benefits and subsidies obtained by means of lobbying and corruption; abusive banking practices with credit cards; predatory mortgage lending resulting in skyrocketing foreclosure rates; bank bailouts which transfer the losses of the banks on the taxpayers and which obviously contain an element of moral hazard; unfair government procurement policy; transition from defined-benefit to defined-contribution pension plans, which transfer all the investment-related risks to the beneficiaries; reduced estate taxes and other tax loopholes, e.g. transfer pricing and tax avoidance through tax heavens; excessive executive remunerations irrespective of the stock performance record; excessive prices of prescription drugs due to lack of cost control; restricted access to private insurance due to problem of adverse selection, which deprives part of the population of adequate healthcare; excessive university tuition fees, which cause ex-

cessive student debts without possibility of declaring personal bankruptcy in case of unemployment after graduation; speculation on asset-backed securities with banks taking on excessive financial risks; monopoly power abuse; erosion of the social security network (employment benefit and Medicaid cuts) etc. Examples can be found in virtually all domains.

The market mechanism cannot cope with the problems of rent seeking and moral hazard, for they represent types of competitive behavior [Krueger, 1974]. The only remedy, same as in case of other market failures, is a relevant government regulations.

Notorious examples of regulatory failures came from the US banking sector, where rent-seeking behavior and moral hazard were major factors contributing to the systemic dysfunctions. Stiglitz [2010] argues that repeal of the Glass-Steagall Act, which started during Reagan administration, was partially the cause of predatory lending and excessive risk taking in the banking sector, which eventually resulted in the subprime mortgage crisis. Additionally, it contributed to the concentration in the banking industry and creation of the banks, which were ‘too big to fail’.

LABOR MARKET REGULATIONS

While the proponents of laissez-faire economics point to the allocative efficiency of perfectly competitive market and distortive influence of government interventions, institutionalists [Reardon, 2006] highlight logical inconsistencies of the neoclassical models and ability of a unionized labor market to achieve a Pareto-optimal allocation of resources. Conservatives postulate that cumbersome regulations and union bargains are detrimental to the flexibility of the labor market, engender unemployment and impede economic growth. On the other hand, analysis of the historical evolution of the union movement in USA reveals a correlation between labor movement dynamics and income inequality. After suppression in 1920s and gradual resurgence during the Great Compression, the labor movement remains in a constant decline, caused by regulatory action (administrations of Ronald Reagan and George W. Bush were particularly hostile towards unions) and to some extent demographic changes.

Jaumotte and Buitron [2015] analyzed relationship between the dynamics of the labor movement and equity of income distribution. Degradation of the unions was found to be concomitant to rising concentration of income at the top of distribution. It was also found to cause stagnation of the minimal wages and redistribution of wealth to the top. Weak unions were found to be the root reason of the uncontrolled rise of the incomes of managers and shareholders at the expense of the low- and middle-income employees.

There may exist many opinions on the possible modes of labor market regulations, however, progressive US officials will obviously have to look for alter-

natives to the existing status quo in order to curb inequality and remedy some of the most salient defects of the labor market. New Deal and the post-war period demonstrate that US economy can comfortably accommodate influential labor movement.

CONCLUSIONS

The paper presents a standpoint on the fundamental problems of economic policymaking basing on the positive analysis of three periods of economic history of the United States. We question the postulates of the ‘perfectly competitive market’ assumption, supply-side and trickle-down economics and formulate relevant recommendations for a sound economic policy. The paper underlines the imperative of radical institutional, political and social changes in order to curb the negative processes, which have been self-perpetuating in the American economy and which are largely attributable to regulatory failures and lack of political consensus.

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Summary

During the 20th century USA went through several radical swings of economic policy being the response to drastic societal, technological and ideological transformations. American economy endured several crises and experienced intensive sustained growth, which eventually transformed it into the world powerhouse. Basing on its historic record and with the benefit of hindsight, relevant lessons for economic policy can be derived. Three sub-periods of the American economic history, i.e. Prosperity (1920-1929), Great Compression (1937-1947), and Reaganomics (1981-1989), have been subject to positive analysis with the goal of suggesting answers to fundamental dilemmas of political economy. Particular attention is drawn towards evolution of institutional environment, income distribution policy and theoretical assumptions underlying policy making. We highlight the most prominent ideological pitfalls, which materialized in the American economic history, but which have not been properly addressed by the policymakers and engendered pathological processes in the political and social systems.

Keywords: economic policy, Prosperity, Great Compression, Reaganomics

Prosperity, ‘wielka kompresja’ i Reaganomika: wnioski dla polityki gospodarczej

Streszczenie

W XX wieku Stany Zjednoczone przeszły przez kilka radykalnych transformacji polityki gospodarczej będących odpowiedzią na zachodzące społeczne, technologiczne i ideologiczne zmiany. Amerykańska gospodarka przeżyła kilka kryzysów i doświadczyła intensywnego wzrostu, który uczynił ją światowym liderem. Bazując na tym historycznym doświadczeniu, możemy wyciągnąć ważne wnioski dla polityki gospodarczej. Trzy podokresy historii ekonomicznej Stanów Zjednoczonych – Prosperity (1920–1929), ‘wielka kompresja’ (1937–1947) oraz Reaganomika (1981–1989) – są poddane pozytywnej analizie w celu znalezienia odpowiedzi na fundamentalne dylematy polityki gospodarczej. Szczególną uwagę poświęcono zmianom instytucjonalnym, polityce redystrybucyjnej i teoretycznym założeniom kształtującym politykę ekonomiczną. Analizowane są ideologiczne złudzenia, które się zmaterializowały w amerykańskiej gospodarce i które nie zostały w odpowiedni sposób zaadresowane przez rządzących, powodując patologiczne zjawiska w polityce i społeczeństwie.

Słowa kluczowe: polityka gospodarcza, Prosperity, wielka kompresja, Reaganomika

JEL: H11, H21