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MACROCONFUSION: THE DILEMMAS OF ECONOMIC POLICY

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Macroconfusion:

The Dilemmas of Economic Policy

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American macroeconomists are in disarray. Like a shellshocked army, barraged by criticism because of poor forecasts, wearied from fruitless battles with chronic inflation, confused because of divided intellectual leadership, they are unsure which way to retreat. Out of the ashes of defeat rises a new phalanx of competing theories, a ragtag collection of discarded ideas from the past as well as unproved fancies for the future.

In this period of reconstruction, the time has come to assert the superiority of the earlier, too-quickly discarded views. I believe that the intellectual consensus of the late 1960s was basically sound. The synthesis of Keynesian and neoclassical economics--the "neo-Keynesian synthesis" for short--although oversimplified, is the best way to understand the

puzzles of the economy as well as the dilemmas of policy. The neo-Keynesian synthesis is in critical condition today, not because it is flawed, but because it has too often been on the losing side of the battles against inflation and unemployment. The new phalanx of theories--monetarists, supply siders, rational expectations, defacists, goldbugs, and constitutionalists--have contributed little to resolving the dilemmas of economic policy. They only provide diversion from the real task of economic policymaking.

I sometimes wonder what Art Okun's view of the rise of the new army of macroeconomic theories would be. He remained a reconstructed Keynesian to the end. In his last paper, he criticized the rational expectations view as failing to explain many of the key features of the business cycle. His last book dismisses supply side economists with one sentence in a footnote on page 353: "Their position simply cannot be taken seriously." I suspect Art would have taken these theories increasingly seriously-- as political happenings. But his rigorous demand that theory be consistent with reality would, I am sure, have left him untouched by their fanciful prescriptions.

I. THE CENTRAL PROBLEMS FOR ECONOMIC POLICY

The central problems for macroeconomic policy in the 1980s, while changed in nuance, are those of the 1970s--slow productivity growth, chronic inflation, high unemployment, high vulnerability to volatile oil and foreign exchange markets remain the most important and durable issues. Contrary to much public discussion, we do not have a soaring budget deficit, public debt, or a runaway public sector. The task of macroeconomic theory is to understand the linkages between policy instruments and our major economic problems so that policymakers can steer the economy in sensible directions.

The major goals of macroeconomic policy are rapid growth in income, output and consumption; high employment; price stability or low inflation; and external balance. As is shown in Table 1, economic performance over the last decade has been depressing. In short, the key goals of an economy have been poorly attained in the United States, as elsewhere.

As can be seen in Table 1, the last few years have witnessed a deterioration in all the major indices of macroeconomic activity. Real growth of output, income and consumption declined from one-third to one-half. Unemployment rates rose 2 percentage points. The inflation rate tripled, and the terms of trade deteriorated considerably after more than a decade of stability.

Table 1.
KEY MEASURES OF ECONOMIC PERFORMANCE, UNITED STATES
1960-1980

	1960-73	1974-80
GROWTH RATE (a)		
Real GNP	4.2	2.4
Real consumption	4.2	2.8
Real national income	4.5	2.1
 UNEMPLOYMENT RATE (c)	 4.9	 6.8
INFLATION RATE (CPI) (a)	3.2	9.2
CHANGE IN THE TERMS OF TRADE (a,d)	- 0.1	- 4.1

Notes: (a) Growth rates are geometric averages,
percent per annum.
(b) National income deflated by the consumption
deflator.
(c) Annual averages.
(d) Ratio of implicit price of exports to
implicit price of imports, 1960=100.

Source: Economic Report on the President, 1981
and Economic Indicators, September 1981.

Having briefly suggested that the body economic is in critical condition-- which few today would contest-- I observe today little consensus about the diagnosis. There is deep division over the precise cause of our economic maladies. Was economic policy responsible for driving the economy off the road? I believe that the deterioration in economic performance did not arise mainly out of economic policy errors of the past.

Before discussing this point, it is useful to clarify what I mean by acquitting economic policy from responsibility for our current economic mess. It is not to deny, for example, that by ruthless anti-inflation policy we could have kept chronic inflation to a much lower level. Rather, given the economic costs of erasing chronic inflation, it would not have been sensible economic policy to do so. In technical language, an ex ante optimal macroeconomic policy is unlikely to have improved markedly a reasonable objective function when taking into account the actual constraints under which the economy was operating over the 1970s.

Two items can be used to illustrate the relative innocence of economic policy in our current economic mess, one concerning inflation, the other productivity growth.

An oft-repeated complaint about economic policy is that it has left the United States with a heritage of high inflation. In his recent study, *Core Inflation*, Otto

Eckstein decomposes inflation into core, demand, and shock components. He estimates the contribution each of these components made to the acceleration of inflation over the period 1960-79. Adding up all the demand shocks over this period, the total contribution to inflation is minus 0.7 percentage points. Given this result, it is hard to see how it could be concluded that excessively expansionary policies were responsible for the acceleration of inflation over the last two decades.

A second myth concerning economic policy is that the slow productivity growth in the United States and abroad has been due to successive bouts of self-inflicted wounds. The most prominently mentioned problem has been discouragement of capital formation. Thus, it is claimed that stop-go policies, high inflation, high taxes, loose money, tight money, and burdensome regulation have significantly weakened the incentive for investment.

It is possible to obtain evidence on the role of disincentives by examining international trends in investment behavior. The OECD has collected data on capital stocks and other determinants of productivity in major countries for the years 1960, 1973, and 1978. The results of this exercise are shown in Table 2.

Table 2.
CONTRIBUTION OF SLOWDOWN IN CAPITAL-LABOR RATIO
TO LABOR PRODUCTIVITY, 1960-73 TO 1973-78

	(1) Pretax Share of Profits in GDP(a)	(2) Change In: Annual Growth of K/L(b)	(3) Contribution Slowdown to Slowdown(c)	(4) Actual Slowdown (b,d)
Canada	.34	+0.5	+0.2	-2.1
France	.37	+1.0	+0.4	-1.7
Germany	.33	-0.4	-0.1	-1.0
Italy	.25	-2.4	-0.6	-4.3
Japan	.31	-3.4	-1.1	-5.6
U.K.	.29	-0.5	-0.1	-2.4
U.S.	.29	-0.6	-0.2	-1.9

Source: William Nordhaus, "Economic Policy in the Face
of Declining Productivity Growth," forthcoming
European Economic Review.

- a) Taken to be the elasticity of output with respect to capital.
- b) Annual growth rate 1973-78 less growth rate 1960-73, percent per annum.
- c) (3) = (1) x (2) .
- d) Output per employer, nonfarm business sectors.

The first column indicates the estimated share of pretax profits in GDP--conventionally taken as a good estimate of the elasticity of output with respect to capital services. The second column shows the acceleration or deceleration of the capital-labor ratio from the 1960-73 period to the 1973-78 period for each of our seven major industrial countries.

Multiplying columns (1) and (2) gives, in column (3), the growth-accounting estimate of the slowdown in labor productivity that should have come about because of the slowdown in the growth of the capital stock. This estimate is of the wrong sign or very small in five countries, and above the noise levels in Italy and Japan. But the major conclusion is clear: using the conventional analysis, in no country could the slowdown in investment and capital formation plausibly be a major part of the productivity slowdown. Indeed, in no country is the estimated contribution of capital more than one-fifth of the size of the productivity slowdown.

While crude, these calculations give the same qualitative answers as the more careful estimates for the United States. In a review of recent studies of productivity behavior, I concluded that a fraction, perhaps one-fifth, of the slowdown in productivity in the United States could be attributed to economic mismanagement. It is a puzzle, perhaps best left to the political scientists, how so small a factor can have become the major popular

explanation for the slowdown.

So I conclude that some of the claims about the failure of economic policy are groundless. This is not saying much. You don't get a medal for good driving by making it around the block without a crash, but at least you stay out of jail.

Of course, even if it is agreed that policy played a relatively unimportant part of the dismal performance of the 1970s, this provides little guidance about the appropriate role for policy in the 1980s. Appropriate policy will depend more on which of the shards of the fragmented consensus one examines. The next section reviews some of the key theories today, while the final section attempts to provide some prescriptions for economic policy.

II. THE FRAGMENTED CONSENSUS

The central paradigm of macroeconomics today is the neo-Keynesian synthesis. Therefore, I will first outline what its elements are, with particular attention to elements that are central to economic policy, then I will compare it with the major competing paradigms—monetarism, rational expectations, and supply side views.

The neo-Keynesian synthesis

It is obviously an act of hubris to attempt to summarize the complex body of neo-Keynesian thinking in a few pages. In what follows, I will concentrate on those aspects that relate most clearly to economic policy. These points are the distinction between as well as the determination of, actual and potential output; the role of monetary and fiscal policies in the determination of output; and the division of the growth of nominal output between prices and quantities.

The first central element in the neo-Keynesian synthesis is the distinction between actual and potential output. Actual output is whatever is produced in a given period. Potential output is what the economy could produce if resource utilization were at a high or benchmark level—today taken as a 5 percent unemployment rate for labor. It is not terribly oversimplified to think of actual output as "demand" and potential output as "supply"; and further to regard the forces determining supply and demand as quite

distinct, acting with quite different time lags. One of the central elements of the neo-Keynesian synthesis —clearly laid out in the 1962 Economic Report of the President, but since often forgotten by policymakers-- is that both the demand and supply sides of the economy require attention from economic policy. But the kinds of policies that affect the two are very different, and there is only a weak linkage between actual and potential output, particularly in the short run.

The need to keep an eye on improving the performance of both actual and potential output has proven a rigorous requirement. Central economic policy treatises of the 1970s-- the McCracken report, Okun's Prices and Quantities, most issues of the Economic Report of the President-- largely ignore the problem of increasing potential growth. If there is any justification for "supply-side" criticism, it lies in the tendency of Keynesian thinking in the 1970s to forget the lessons of growth theory of the 1960s.

It should be noted in passing that the intellectual foundation of the distinction between actual and potential output has never been well articulated from a theoretical point of view. Its roots lie in the "fixprice" view of the world, i.e., one in which prices and nominal wages are viewed as largely exogenous in the short run. The distinction would not make much sense in a "flexprice" world, where all markets are auction markets like corn or silver. In the flexprice world, the short run outcomes

closely approximate a competitive outcome and there is little reason to think output would be far from the level of output that would be produced by a competitive economy with auction markets ("ideal output", for short). In the fixprice world, in my view, output is often far from the ideal output and probably has a secular bias below the ideal output. In this case, if potential output is in the neighborhood of ideal output, then the gap between potential output is a measure of the deviation of actual from ideal output. (Because of asymmetries in fixprice markets, indeed, ideal output may even be considerably above potential output.) The infirm foundation of "fixprice" behavior has been pounced upon by critics from the rational expectations school and will be returned to below.

The second feature of the neo-Keynesian synthesis relates to the determination of potential output. In current thinking, potential output is determined in a way that is best described by neoclassical growth theory. That is, output is determined by a production function with inputs of labor, capital, energy, and other material inputs. This production function is often described as exhibiting constant or modestly increasing returns to scale, and with a variable rate of technological change.

Assuming that the rate of technological change is exogenously given, then potential output growth is determined by the growth of factor inputs. And the main way that policy affects potential output growth is by raising or

lowering the rate of formation of human or reproducible tangible capital.

It is interesting to note that this feature of the neo-Keynesian synthesis is not subject to much debate by the critics. It appears that--with the minor provisos to be discussed in part IV-- the view of the growth of potential just outlined is shared by all the major schools of thought reviewed here. Indeed, it appears that sometimes other paradigms accept the neoclassical growth model as applying to the short run as well as to the long run.

One of the major findings of empirical economic growth theory, however, is the very great difficulty of increasing the rate of growth of potential output by policy. (This is a corollary of the earlier proposition that policy has little to do with the productivity slowdown.) Thus Edward Denison found it plausible to increase real per capita growth of national income by only 0.3 percentage points per annum by increase national savings.

Given this very modest response of potential output to policy, it may be understandable that policymakers, particularly those with short time horizons, have generally ignored the goal of increased potential output and focussed instead on stabilization policy.

The short-run determination of actual output is the major difference between the new paradigms today. The differences arise from views of the determination of nominal GNP, and views about how nominal GNP is split between prices

and quantities.

The view of the neo-Keynesian synthesis of the determination of the level of actual output has changed little since the 1930s-- it has mainly been refined and given considerable empirical flesh. In this view, output is basically determined by aggregate spending, as in the Hicksian IS-LM curve. Of course, reality, and the embodiment of this vision of reality in large scale econometric models, are much more complicated than the simple IS-LM framework, but the increased realism of the 1000-plus equation econometric models mainly adds greater distinction between the impacts of different taxes or financial policies and better determination of the time lags. With the exception of the greater power currently given to money, there appear to be no major differences in the behavior of the large models today from the earliest econometric Keynesian models.

The best way of summarizing the beliefs of the neo-Keynesian synthesis is from examining simulations of the major models--the DRI, Wharton, Chase, and MPS models. From model simulations and comparisons, the major features of the neo-Keynesian synthesis models are the following: fiscal policy appears to have substantial impacts on actual output, at least in the short run, and the multipliers do not differ much among major models. Monetary policy also has substantial effects on output, but the money multipliers differ enormously among econometric models. Thus both money

and fiscal policy matter, but the uncertainty is much greater for the former than the latter.

The final important feature of the neo-Keynesian synthesis concerns the split of impulses to demand between output and prices. In other words, what is the view of aggregate price determination? No issue has produced more intellectual turmoil among macroeconomists than inflation theory; and the evolution of thinking from the 1930s to today is considerable.

It seems a reasonable approximation to say that some early Keynesian thinking held prices and wages to be approximately constant up to the point where the economy hit full employment. Today the view is quite different. Inflation is taken to be the sum of inertial, cyclical, and volatile or random forces. The inertial element is basically the inherited "underlying" rate of inflation, particularly from wages, that changes very slowly in response to experience and expectations. Cyclical elements include a very modest response of wage inflation to unemployment as well as some response of markups and material prices to the cycle. Volative forces include such elements as oil and food prices, as well as the effects of interest rates.

In the view of the neo-Keynesian synthesis, inertial or chronic inflation poses one of the most difficult dilemmas for economic policy. This dilemma arises because chronic inflation is extremely costly to erase, while the benefits

of lower inflation are subtle. According to Okun's calculations of the short-run tradeoff between unemployment and inflation, but using an up-to-date Okun's Law coefficient, it would cost two-thirds of one year's GNP to lower chronic inflation by 10 percentage points. The high cost of reducing inflation, or the stubbornness of the inertial element in inflation, arises because inflation is so firmly imbedded in our institutions in formal and informal contracts.

Put differently, a shock that lowers spending has its major short-run impact on output. Evidence indicates that around 90 percent of the first year response to a spending shock shows up in output, while 10 percent is in prices. As the time period lengthens, this split changes, moving more toward price response and less to output response. Although econometric evidence is obviously unavailable, it seems likely that after several decades all the response is in prices. These numbers are, it must be emphasized, not known with the certainty of the speed of light; nor are they independent of space, time or expectations. But the evidence for the United States is that the short-run division of nominal demand shocks between quantities and prices is closer to 90:10 than the 10:90 or 0:100 envisaged by the other paradigms.

III. ALTERNATIVE PARADIGMS

It will be useful to describe briefly the major alternative schools of thought that have had a significant impact upon thinking about economic policy in the United States. It should be emphasized that the summary below, as for the neo-Keynesian synthesis, cannot fairly represent the full richness of these theories. Moreover, I have emphasized only those aspects of the theories that relate to economic policy.

Monetarism

Monetarism is a venerable doctrine going back for centuries. It is, in my view, best interpreted as a special case of the neo-Keynesian synthesis. Monetarists accept the distinction between actual and potential output, as well as the view of the determination of potential output of the neo-Keynesian synthesis. The major difference of view lies in the view of output determination and the inflation process.

In the strict monetarists view, money velocity is interest inelastic so nominal GNP is determined by the money stock (although the definition of "the" money stock is quite volatile). In the standard Hicksian framework, such a proposition can be interpreted as a vertical LM curve. Fiscal policy affects the composition but not the level of nominal GNP. The money multiplier is large and stable, while the fiscal multipliers are zero. Today, most

monetarists have backed off from the extreme view of the insensitivity of velocity to monetary and fiscal policy of earlier periods. The fallback position is sometimes "constitutional monetarism" and sometimes the "new classical macroeconomics."

The second major aspect, perhaps less consensual among monetarists, is their view of the inflationary process. Along with all the other non-Keynesian paradigms adhering to the Walrasian conception of markets, monetarists believe that prices adjust relatively rapidly to demand or supply shocks. Thus any shock to aggregate demand ends up mainly in price shocks rather than output shocks.

While remaining optimistic relative to most neo-Keynesians, there is still wide divergence among monetarists about the costs of disinflation. In testimony before a British select committee on monetary policy, Milton Friedman stated that he thought there would be virtually no output loss from a program of monetary restraint, while David Laidler provided an estimate of the response of inflation to slack 10 times greater than that quoted above. On the other hand, work by Philip Cagan and Jerome Stein provides estimates that are from two to four times more optimistic.

Two basic propositions of monetarism -- interest inelastic demand for money and quick price adjustment-- have received scant empirical support in most careful structural statistical studies. Once an exogenous velocity is abandoned, however, it becomes virtually impossible to

distinguish the implications of monetarism from those of the neo-Keynesian synthesis.

New classical macroeconomics

A second major school of thought today is the rational expectations or new classical macroeconomics (NCM) view. This view has been developed by Robert Lucas, Thomas Sargent, and Neil Wallace over the last ten years.

The NCM school is based on two fundamental premises. The first, and less controversial, is that economic agents form expectations on the basis of all available information. This first premise has been extremely provocative as a tool for challenging established techniques for modeling expectations. It has led, for example, to much better understanding of why financial markets appear to behave perversely--why "good news" looks like "bad news". In addition, it has led to an understanding of why "unstable" structural equations are to be expected in, say, price and wage behavior.

The second and more controversial premise is that all markets clear in the very short run, that is to say prices are perfectly flexible. This second premise is more in the nature of an assumption than an empirical finding; moreover, it is at variance with considerable empirical work concerning actual price and wage behavior.

These two assumptions provide a very rich set of propositions concerning behavior and policy. An early

result--outdoing monetarist thinking-- was to suggest that the Phillips curve is vertical in the short-run as well as in the long run. A more general result was the "policy ineffectiveness theorem," which states that anticipated policies affect only prices and not real output.

One way of interpreting the NCM view is that it accepts the long-run but not the short-run half of the neo-Keynesian synthesis. That is, it views the economy as in neoclassical equilibrium, although subject to random shocks. Under this interpretation, the NCM view would share the presumptions concerning acceleration of the growth of potential output, but not those concerning short-run stabilization policy.

In this view, then, actual output never deviates from potential except for random shocks. The division of output between prices and quantities is at the extreme end of the spectrum, with 100 percent of anticipated changes in spending on nominal GNP going into prices. Given this view, disinflation is an easy and costless process, simply involving an announced and credible reduction in aggregate demand.

The professional verdict on the NCM is still out. Given the dubious nature of the fundamental flexible price assumption, many of the policy prescriptions of the NCM have been widely and correctly viewed as elegant but irrelevant. Thus while the NCM school has been extremely influential inside the economics profession, it has been adopted reluctantly by practitioners. Perhaps the idea that policy

cannot affect the real economy is as foreign to policymakers as random walk theories of stock prices are to stockbrokers.

Supply side economics

Conceived on a cocktail napkin, carried by an ambitious ex-quarterbacking Congressman, and mid-wifed by a skillful President, supply side economics burst upon the economic scene physically full-grown but intellectually dwarfed. In contrast to the other major paradigms, particularly the new classical macroeconomics school, supply side economics is fundamentally a political inspiration without serious scientific support. In this respect it resembles the Limits to Growth movement of a decade ago.

The major tenet of supply side economics is that economic activity responds quickly to relative prices, particularly to changes in tax rates, but that income effects are unimportant. Supply siders predicted that the reductions in the personal tax rates in the Laffer/Kemp/Roth proposal enacted in the 1981 Revenue Act would lead to greatly expanded labor and capital supplies, and thus rapid economic growth. Therefore, ignoring the pessimism that arises from work of Denison discussed above, supply siders appear to believe that the growth in potential output can be readily enhanced.

Aside from this central tenet of the supply side school, it is difficult to glean a comprehensive (or even comprehensible) view of economic policy. The major problem,

apparent even in the central proposition, is the failure to distinguish between actual and potential output. Thus, the supply siders favorite "proof" of their theories is to point to the Kennedy tax cuts of 1964 and 1965 as evidence of the validity of their views. Yet the Kennedy cuts were designed to increase actual output --and they clearly did so-- and were only incidentally aimed at potential output.

Does this indicate that supply siders are simply closet Keynesians, assuming a new mantle of respectability for revving up the economy? Not bloody likely. A more plausible interpretation is that the supply siders have failed to grasp the analytical distinction between aggregate supply and demand.

Given their lack of distinction between actual and potential output, it is easy to understand why the supply siders have difficulty articulating a consistent view of the inflationary process. If markets clear instantaneously, as the new classical macroeconomists believe, inflation can be quickly erased. If, on the other hand, inflation persists because wage and price behavior is sticky, then a notion of excess demand or supply is necessary to provide a mechanism by which inertial inflation accelerates or decelerates. Without either the market clearing or sticky behavior model, inflation appears in a completely ad hoc fashion. I have not seen any of the major supply-side enthusiasts outline a theory of inflation. Recently, this lack of theory has been compensated by a new bold proposal to lick inflation, return

to the gold standard.

IV. POLICY DILEMMAS

I now turn to a discussion of five key issues that must be faced by policymakers over the coming years. Almost all are issues that have been part of the internal dialogue of macroeconomics for decades. But given the economic turmoil of the 1970s, dilemmas have become more poignant and tradeoffs more intractable.

Economic Constitutionalism

A pervasive issue today concerns the movement imposing on economic decisionmakers stricter economic discipline, such as fixed monetary rules or constitutional amendments. I label this trend "economic constitutionalism". Examples of such a trend are legion. Perhaps the first was the Congressional resolution that required the Federal Reserve to announce monetary targets. More recent proposals are proposals for Constitutional Amendments on budget balance, expenditure limitation, and money growth, as well as a number of more informal operating rules for the fiscal and monetary authorities.

From an analytical point of view, there are two reasons for "economic constitutionalism". The first is the need for credibility. Assume that we accept the view that a credible disinflation policy would lead to little output loss. What we need to find is a cheap way of being credible. As Tom Shelling has shown, the best way to establish credibility of a decision is to put yourself in a position where to change

the policy would be extremely costly to the decisionmaker. Thus, by announcing, legislating, constitutionalizing policies--why not shoot inconsistent politicians?--we can enhance credibility.

If credibility is the key to better policies, however, why do we need to impose stricter discipline to be credible? I would generally expect optimal credible policies to be the same as optimal incredible policies (although counterexamples do exist). In this case, the worrisome element in economic policies would be, and this is the second point, that the optimal credible policy differs from likely actual policy.

Under this second interpretation, economic constitutionalism arises because political leaders are perceived as untrustworthy. This perception has many roots. One of the most general is the well-documented decline in respect for authority, particularly of political figures. This has spilled over into the economic debate in the form of distrust of discretionary political management of the economy. Another would be the failed promises of the "New Economics" of the 1960s, the impression that hard on the heels of the belated but short-lived Keynesian revolution in U. S. macroeconomic policy came the economic disasters of the 1970s. Perhaps a third source would be growing political conservatism, part of which grew out of a failure of earlier "liberal" programs to succeed.

Today, many of the most radical proposals for

management of the economy--particularly the monetarism and defecism discussed below-- can be interpreted as reflecting a profound mistrust in the institutions of American democracy. The movement for economic constitutionalism is sometimes rationalized as a retreat from "fine-tuning" the economy, but this is inaccurate. It is rather a desire to abjure all discretionary management of the economy.

In addition, recent economic theory has begun to incorporate explicitly some formal theory of the interaction between political and economic forces, as in the theory of the political business cycle. This line of thought suggests the possibility that elected policymakers will manipulate economic policy in ways that exacerbate business cycles.

The revulsion against democratic policymaking among economists has generally led them to suggest adding legal constraints to the policy process. Two of the most popular doctrines suggesting constraint are monetarism and defecism, discussed further below. These are attempts to substitute suboptimal but non-manipulable rules for manipulable but potentially optimal policies as a way of inserting backbone into spineless politicians.

Not to be outdone, the supply-siders have suggested a different economic rule that will discipline policymakers' return to the gold standard. The rationale for this is that by return to a "high quality money" inflation will automatically (and painlessly?) cease. Without the discipline of the convertibility of the dollar into gold, it

is argued, policymakers will be subject to the temptation to use inflation as a way of resolving political conflicts.

Not all procedural reforms are without intrinsic merit. There are other and more constructive uses of procedures to remove the defects of current institutions, particularly piecemeal decisionmaking. The 1974 Budget Act is a way of assuring that Congress acts on the budget as a whole rather than bidding up the total budget in small increments. A similar proposal has been suggested for regulation--the so-called regulatory budget.

What is the economist's judgment on constitutionalism? These approaches have both an economic and political component. From a pure economic point of view, however, it seems clear that use of general rules, like a fixed money growth or a balanced budget rule, is at best a second best solution to stabilizing the economy or promoting the appropriate balance between public and private sector. One academic defender has labeled strict monetary constraints as "the half-blind leading the blind." A more apt analogy is that economic constitutionalism represents the lame leading the sometimes wicked.

If indeed we accept the view that political management of the economy will be subject to impure motivation and incomplete knowledge, real dilemmas arise in the optimal design of economic policy institutions. Surely there are better institutional arrangements, however, than imposing rigid rules with little economic justification. Economic

constitutionalism also reflects a conservative view of the role of government, a view that much of government non-defense spending is wasteful. With roadblocks to slow government spending or prevent deficits, social programs are likely to wither on the vine. The acid test whether these programs are simply procedural or reflect an underlying conservative stance lies in their treatment of national defense: most proposals have an "escape clause" that exempts defense from their stringencies--a sure sign of the philosophical origin of the idea.

Deficicism

In 1863 a man from Las Vegas, New Mexico was found guilty of having murdered a witch who was supposed to have given him tuberculosis. In 1925 John Scopes was convicted of having illegally taught the theory of evolution. By 1980, 31 of the United States had passed resolutions calling for a constitutional convention to impose a balanced budget on the Federal government. What do these events have in common? They express the triumph of scientifically unsupported theories over the accumulated evidence.

Today, many economists and policymakers join together in calling for a balanced Federal budget as a cure for high interest rates, high inflation, and swollen government. The movement, which I label deficicism, is fundamentally flawed as an economic doctrine, for the Federal deficit has major shortcomings both as an accounting measure and as a device

for controlling the economy. The only serious intellectual support for deficism can be found in its use as an indirect constraint on the political process, as explained above in the section on constitutionalism. But it must be emphasized that it is highly defective as a constitutionalist constraint.

The first defect of deficism is its reliance on a highly imperfect instrument for controlling economic activity, this problem being similar to the reliance of monetarists on a endlessly evolving concept of the money supply. To illustrate the problems, we can examine the January 1981 estimates for the fiscal year 1981 Federal budget. The "official" budget deficit was estimated to be a frightening \$55 billion. However, this figure excluded two sets of programs: off-budget entities like TVA and interest subsidies on various loan programs. After correcting for these omitted programs, the deficit became \$105 billion.

However, the official deficit does not correct for two standard accounting concepts, investment and capital gains. The projection for 1981 was that \$143 billion of outlays would be investment-type activities, like filling the strategic petroleum reserve. In addition, capital gains on the debt (or, in accountants jargon, correction for real value of monetary assets) reduced outlays by \$78 billion. Thus with these four corrections the Federal government was estimated to run a surplus of \$116 billion for fiscal year 1981.

Of course, even this "corrected" Federal surplus is an inadequate measure. But the central point is that conventional measurement tools are highly imperfect, underestimating Federal deficits just as they are overestimating corporate profits. How can we seriously consider using as a control variable a tool whose conceptual and measurement uncertainty is in the order of 10 percent of GNP?

In addition, deficism suffers from an inadequate grounding in economic theory, for deficits and surpluses per se play no direct role in attaining any of our major economic goals. The Federal budget deficit itself does not enter into any of the major behavior equations of the economy-- into the determination of inflation, aggregate demand, potential output, or interest rates. Rather, the level and composition of spending and taxes, as well as other off-budget programs, are the major channels by which the budget affects economic activity, and the results affect economic activity. And even for these variables the route by which taxes and expenditures affect the economy is almost wholly through their influence on aggregate demand or potential output. Only when one enters into much more complicated general equilibrium models of financial markets can a separate influence of Federal debt and its growth be found, and even here the sign of the effect is ambiguous.

In sum, the current emphasis on bringing the Federal deficit under control can be considered misguided at best,

disingenuous at worst, but in the end irrational.

Monetarism

I discussed above briefly the monetarist economic philosophy. I will be extremely brief in an analysis of the monetarist policy solutions, mainly because there is nothing new to add. The pros and cons of monetarism have been discussed ad nauseum. Two of the most illuminating debates were that between Walter Heller and Milton Friedman in the early 1970s, and that between James Tobin and David Laidler in the *Economic Journal* in 1981.

The views put forth by monetarists lead to a distinctive stamp on their policy proposals. Clearly monetarists look mainly to the central bank for policy execution. Moreover, given that they estimate the output cost of reducing chronic inflation to be quite modest, monetarists are less reluctant to recommend slow money and output growth as effective and inexpensive cures for chronic inflation. Finally, monetarists in addition believe that the money demand function is stable; this reasoning leads to the conclusion that a stable path of money growth of 3 to 4 percent annually will lead quickly to stable noninflationary growth paths.

For an outsider, the most striking feature of the debate is that it continues to take place. Given the several glaring weaknesses of the monetarist doctrine--the evidence of interest-sensitivity of the demand for money;

the instability of the very definition of money; the highly unreliable nature of the relationship between interest rates and output--it is a puzzle to understand how the belief in the monetarist solution can survive and thrive.

The Productivity Slowdown

Over a period of a decade or more, the growth of potential output will be the principal determinant of real economic performance; and the growth of total factor productivity, along with labor force participation patterns, is the key to future growth in potential output. With some provisos to be mentioned presently, there is no major controversy among the major macroeconomic schools today about the appropriate policy to spur productivity. The main way that an economy can increase the growth in potential is by increasing the fraction of output devoted to human and tangible capital formation. Virtually all economists have called for one of an assortment of pro-saving or pro-investment policies from tax relief for investment to policies designed to spur personal savings to monetary policies that lower real interest rates.

The major dissenters from this consensus are the supply-siders and the neo-Malthusians. The supply-siders have extremely unrealistic notions about how easy it is to increase savings and investment. For example, supply-siders suggest that personal tax rate cuts will have a significant impact on productivity growth. A careful review of the

evidence indicates that there may well be a positive impact on productivity if the growth of actual output is accelerated; but this is clearly a "demand-side" impact and not a supply side impact. It is highly unlikely that personal tax cuts will have a positive impact on the growth of cyclically corrected output per person-hour employed; indeed, given the labor force responses of different demographic groups, the impact on potential productivity is likely to be negative rather than positive.

On the other side, the neo-Malthusians paint a pessimistic scenario in which economic growth will be constrained by limitations of resources or energy. One might predict that this view would land on fertile soil during the turbulent 1970s, but it appears to have received little serious attention either by economists or by policymakers.

Chronic inflation

The final policy dilemma I discuss is the enduring issue of chronic inflation. Art Okun devoted the last years of his professional life to diagnosis and cure of chronic inflation. Art had something to say about every economic issue; but he said everything worth saying about inflation theory and policy.

One of the ironies of economic history is that, while Keynesians have often been thought insouciant about inflation, most of the recent inquiry into the mechanics of

the inflation process and the dilemmas of policy have been undertaken in the framework of the neo-Keynesian synthesis. This apparent paradox is understandable given the views of the other major paradigms about price adjustment. Only when wage and price adjustment is slow relative to the pace of other economic forces, as in the neo-Keynesian synthesis, does it become interesting to study inflation. It is, in addition, in just this circumstance of slow price adjustment that policy faces the dilemma of the Phillips curve tradeoff in which inflation control both involve significant economic costs.

To understand the dilemmas of anti-inflation policy it is necessary to reiterate an earlier point: the orthodox way to slow chronic inflation is by inducing slack in product and labor markets; and such a cure is extremely costly. To repeat the calculation given above, to reduce an underlying inflation rate of 10 percent annually to 0 would require foregoing approximately two-thirds of a year's GNP, although it might be spread over an extended period of time. This embedded chronic inflation is akin to an external national debt of \$2.0 trillion--a debt that we must either live with in the form of high chronic inflation (with the "interest payments" being inefficiencies, misallocations, and shoe leather) or pay off in lower economic activity. The fact that on occasion, fortune allows actual inflation to drop quickly and painlessly, as it has over the last year, confuses markets about the causes and costs of

disinflation. An occasional run of good luck, in economic policy as in roulette, should not blind us to the fact that, substituting chance for a conscious anti-inflation policy leads to gamblers' or central bankers' ruin.

Given the high cost of reducing chronic inflation, inflation has become the major constraint on economic activity in the United States over the last decade. The main reason why policymakers have been unwilling to have higher targets for output and employment is simply that they were concerned about the risks higher targets would entail for inflation. It is difficult to guess how much higher output could have been in the absence of an inflation constraint; unemployment rates in the 2 to 3 percent range and output therefore 8 to 10 percent higher would surely have been much closer to the ideal output than was the outcome shown in Table 1 above.

Once inflation is accepted as the major constraint on high levels of utilization of labor and capital, economists will have to think about economic problems in a novel and paradoxical way. This was the topic of the last two chapters of Okun's Prices and Quantities. In such a world, the social cost of public or private sector activities is measured not only by their resource costs but also by their inflationary impacts. Thus, when considering alternative ways of cutting taxes, the differential impacts of taxes on the price level should enter into the cost-benefit calculation along with more Keynesian considerations of

aggregate demand or neoclassical strictures of resource allocation. Or in weighing alternative energy policies, it would be necessary to calculate the "energy price externality," the impact of different energy price trajectories on prices and thus on overall economic activity.

Given the view that inflation is the major constraint on economic activity in the short run, it is clear that much more thought should be given to devising "efficient" anti-inflation policies. An efficient policy is one that imposes lower economic costs than the orthodox anti-inflation policy of inducing economic slack.

Two classes of more efficient policies have been identified: incomes policies and cost-reducing policies. Cost-reducing policies consist of government actions, such as lowering indirect taxes or promoting productivity, that lower the normal costs of doing business. These provide one-shot reductions in the price level, but some fraction of these probably end up in a lower underlying inflation rate. There is little controversy about such measures, but the stock of cost-reducing actions is small and probably largely depleted.

The second kind of "efficient" anti-inflation policy is incomes policies, direct interventions in markets to moderate the pace of price and wage increases. A more modern version of incomes policies, relying on a market-like mechanism, is "tax-based incomes policy" or TIP. TIPs

continue to be the most promising of the "efficient" anti-inflation strategies.

Yet another efficient anti-inflation policy would be a monetary reform. Such an approach would revise all contracts and financial instruments (except currency) by reducing both future prices and nominal interest rates by a given amount, say 8 percent per annum from the present. Unlike other price-wage policies, a monetary reform would in principle reduce inflation painlessly, that is, without changing relative prices.

Thinking about the efficient allocation of resources in a macroeconomic framework where inflation is the major constraint on economic activity has proven an arduous task. Like physics after relativity theory, the world seems upside down when the short-run marginal cost of an action is its effect on dollar prices rather than its opportunity cost in diverting resources from other uses. The construction of a theory of value in which inflation impact is a central part of the cost of an economic event, along with detailed analysis of the kinds of policies that would efficiently reduce chronic inflation or prevent its accelerating inflation, were the tasks that Art Okun had undertaken before his untimely death. Much further work remains to synthesize Okun's theoretical and policy insights on the topic of chronic inflation into the body of modern macroeconomic thinking.