

Selected Papers . No. 48

National Economic Policy in the 1970's

By **JOHN P. GOULD**



**GRADUATE SCHOOL OF BUSINESS
UNIVERSITY OF CHICAGO**

JOHN P. GOULD is Professor of Business Economics at The University of Chicago's Graduate School of Business. He earned the S.B. degree (with Highest Distinction) from Northwestern University in 1960, and the Ph.D. degree from Chicago in 1966. He joined the faculty of the Graduate School of Business in 1965 as an instructor, became an assistant professor in 1966, an associate professor in 1969, and a full professor in 1974. In 1969-70 he served as Special Assistant for Economic Affairs to the Secretary of Labor, and in 1970 was Consultant for Economic Affairs to the Director of the U.S. Office of Management and Budget. He has written and lectured widely on a broad range of economic topics, with special emphasis on the determinants of investment, economic policy, monetary policy, and the economics of information. He has authored a number of articles in scholarly journals and is the author (with C. E. Ferguson) of *Microeconomic Theory* (4th edition), Richard D. Irwin, Inc., (March, 1975). On May 11, 1976 Professor Gould delivered the Woodward Court Lecture at The University of Chicago; that lecture is reproduced herein.

National Economic Policy in the 1970's

THE EVALUATION and characterization of economic policy in the 1970's is facilitated by a brief review of the history of economic theory and its relation to economic policy. Economic considerations obviously have played a key role in the life of man even when human society was in its earliest and most rudimentary forms. It was not until about 200 years ago, with the publication of Adam Smith's magnificent work, *An Inquiry Into the Nature and Causes of the Wealth of Nations*, that economics emerged as a subject of formal intellectual investigation and we began our efforts to understand how economic systems worked. The progress made along these lines in the 19th and 20th centuries was truly impressive. It included the work of many distinguished thinkers such as Ricardo, Mill, Say, Edgeworth, Walras, Fisher, Jevons, Wicksell, and Marshall, to name but a few.

There is no way to accurately summarize this body of work so I shall adopt the usual method in historical commentary and provide an inaccurate summary. The first characterization in my inaccurate summary is that classical economic thought was essentially positive or descriptive in its objectives. That is, the economic system was viewed as one might view the solar system or the weather, with the economist in the passive role of an astronomer or a meteorologist trying to make sense of what he saw.

An essential part of this perception was that the economy contained self-stabilizing forces that assured levels of output and employment consistent with what the society desired. Evidence of this view can be found in one of the

major American economics texts of the 1920's, authored by Fred M. Taylor, who clearly asserts the validity of Say's Law that the supply of goods constitutes the demand for goods so that unemployment can not arise from a deficiency of demand. This conception of the economy did not ignore the possibility that the economic system could be in a state of disequilibrium part of the time or even much of the time. A suggestive physical analogy might be a pendulum which can be thrown out of equilibrium by some external force, but will ultimately return to equilibrium by natural forces in the absence of any further external disruptions. Thus, the classical view of the economy was essentially a logically tight description of a system that was self-stabilizing in the long-run.

THE ROLE of the government in the classical view was necessarily interstitial. The government had important functions such as the provision of defense and other public goods, and it also played an essential part in the creation and enforcement of property rights which make it possible for a market economy to work. Government taxation and expenditure policies had a reasonably well-defined role consistent with the tasks the government was to perform. Creation of money (that is, the medium of exchange) has usually been seen as the unique province of the government, but in the classical view changes in the quantity of money affected only the general level of prices, not relative prices or the level of real employment and output.

To say that in the classical view the government operated interstitially is not to imply that government policies were seen as economically inconsequential. Taxes clearly have incentive effects, both in terms of how individuals decide to allocate their time between productive employment and leisure and in

terms of the kinds of economic activities they engage in when they work. A tax on alcoholic beverages reduces the amount of gin produced and consumed but increases the production and consumption of untaxed goods. Similarly, an increase in government purchases of tanks or missiles increases employment in these industries but reduces employment in other industries. In this view the government has relatively little influence on the size of the economic pie, but it may have an important influence on how it is divided.

It is appropriate to reemphasize that this is an admittedly inaccurate description of the classical economic model. Surely classical economists were not oblivious to the severe and often persistent periods of unemployment that various countries experienced in the 19th and 20th centuries. Indeed, there were early writers who specifically rejected what I have called the classical view and saw excessive thrift as a cause of unemployment. In the 18th century Mandeville's *Fable of the Bees* argued that prosperity was increased by expenditure rather than thrift and Malthus also asserted that excessive saving would destroy the motive to production. In the 19th century Hobson and Mummery argued that underconsumption could lead to overproduction. These arguments were generally repudiated by writers such as Ricardo and Mill, but by the early 20th century many economists acknowledged that Say's Law could be violated in the short-run so that demand for goods could be less than the production of goods. Moreover, the "short-run" could in fact be a long period of time, chronologically speaking.

Whatever the state of the art in economic theory may have been up to the early part of the 20th century, it seems to have had, at most, a relatively minor impact on the pragmatic policy decisions of politicians-or for that matter on the advice that economists gave

to political leaders with regard to such decisions. While it is perhaps common to view the Hoover administration as passive in the face of the catastrophic economic depression that started in 1929, it is surely not a very accurate description of what actually took place. Hoover clearly believed that the government had an important role to play during recessions and depressions. This role included government expenditures on public works programs to reduce unemployment and efforts to prevent wages from dropping.

Both policies were inconsistent with, if not directly contradictory to, classical economic theory as I have sketched it. This is not to say that economists in the 1920's objected to the policy positions of the government. For example, in Taylor's *of Economics* text, which I cited earlier, it was stated that when Say's Law failed to keep demand in balance with supply a large-scale public policy of roadmaking or building construction would mean a considerable increase in total demand and thus lead to an increase in general prosperity. This position fairly reflected the standard orthodoxy among many, if not most, professional economists in the early part of this century despite its essentially ad hoc relationship to the then extant theoretical framework.

HAVING NOW COVERED two hundred or so years of economic thought in a wholly cavalier fashion, I have no remaining qualms about jumping quickly from 1930 to 1970 with equal disregard for subtlety and qualification. What transpired in those 40 years has been called a fiscal revolution by Herbert Stein in his book of that title. The essence of that revolution, as Professor Stein sees it, is that the fiscal policy of today is based on the principle of compensatory finance, which says first that an increase in government spending coupled with a reduction in taxes will stimulate economic

activity in an underemployed economy. The second aspect of the doctrine of compensatory finance is that in some situations expenditure increases and tax reductions are the *only* way to solve the problem of unemployment.

At this point I would very much like to quarrel with Stein's interpretation of history and argue that what has occurred in the last 40 years (or more specifically the last 10 years) has not in fact been a revolution, but an evolution. Unfortunately for the rhetorical force of my point, Stein says exactly that on the first page of the Introduction of his book. I am left with a quibble about the choice of title for this book, but I can see no reason to establish higher standards in truth in advertising for Stein and the editors of the University of Chicago Press than a reasonable person would apply to a manufacturer of breakfast cereal.

RETURNING to my main line of discussion, I think it is interesting to consider in more detail the second aspect of the principle of compensatory finance, namely that in some situations increased government expenditures and tax reductions are essential if the problem of underemployment in an economy is to be solved. Now, if government expenditures are to be increased and taxes reduced, either the government deficit must increase or the government must create and issue more money. This is a matter of arithmetic, not economics, since the government cannot finance expenditures unless it either sells bonds or prints money.

Early glimmerings of the idea of accepting deficits to stimulate the economy can be seen in the policy discussions of the Hoover administration and in the advice given by economists at that time. But this idea was based largely on intuition and, using the economic theory of the 1920's, it is understandable that one would feel uncertain about just what such

a policy would do. After all, if one reasoned by analogy and used a household or a business as the analog, the concept of a deficit spelled further disaster, not recovery.

It is in respect to this point that the impact of John Maynard Keynes, in his 1936 book, *The General Theory of Employment, Interest and Money*, is most apparent. What this book did was to direct economic thinking to a logical system within which the principle of compensatory finance could not only be rationalized, but in the extreme case justified as the only policy tool that would solve the problem. Keynes saw this as a *general* theory because it did not replace classical theory but expanded it. In his words,

“Our criticism of the accepted classical theory of economics has consisted not so much in finding logical flaws in its analysis as in pointing out that its tacit assumptions are seldom or never satisfied with the result that it cannot solve the economic problems of the actual world. But if our central controls succeed in establishing an aggregate volume of output corresponding to full employment as nearly as practicable, the classical theory comes into its own again from this point onwards.”

What are the controls that Keynes refers to? Once again in his words,

“The State will have to exercise a guiding influence on the propensity to consume partly through its scheme of taxation, partly by fixing the rate of interest, and partly, perhaps, in other ways. Furthermore, it seems unlikely that the influence of banking policy on the rate of interest will be sufficient by itself to determine the optimum rate of investment. I conceive, therefore, that a somewhat comprehensive socialization of investment will prove the only

means of securing an approximation to full employment, though this need not exclude all manner of compromises and of devices by which public authority will cooperate with private initiative.”

I THINK that this history (which turns out not to be as brief as I had hoped) conveys a reasonable though rough approximation to the thinking guiding national economic policy in the 1970's. That thinking is now so widespread that most Americans take it for granted that the state of the economy is the direct responsibility of our political leaders, and that that responsibility is to be discharged through conscious and active use of tax and expenditure policy, as well as through the monetary and credit policies of the Federal Reserve System. Indeed, the Employment Act of 1946 which established the Council of Economic Advisers specifically gives a mandate to the President to develop and administer a national policy directed toward the goal of economic stabilization.

I now turn to an assessment of what kind of track record this new economic policy has had and what its consequences for the future seem to be.

PERHAPS the biggest change as far as economists are concerned is that much of economic analysis is now prescriptive rather than descriptive. Instead of seeing the economy as a self-stabilizing system it is now generally assumed by many economists that the economy must be guided and controlled if the perils of recession and inflation are to be avoided.

As I noted earlier, Keynes said the problem with the classical view was that its tacit assumptions are seldom or never met, so that it cannot solve the practical problems of the actual world. Most scientists would regard this as an empirical statement and ask to see the

evidence. Unfortunately, Keynes' book contains virtually no empirical or statistical evidence to support the assertion. This is not really Keynes' fault since in 1936 there was virtually no empirical evidence available that was appropriate to check the kinds of claims being made, and neither was there any well-developed theory of economic statistics or econometrics to use in this regard.

Since that time, enormous advances have been made both in the accumulation of data and in the development of statistical methods and techniques needed to test the basic models and propositions. The empirical work that has been done has led to major modifications in Keynesian macroeconomic theory, but even now—some 40 years after the general theory and some 50 years after the initial movement toward fiscal activism—we remain uncertain about the answers to the fundamental questions. What I mean by that is that an economist who asserted today that compensatory finance has no effect on the level of economic activity could provide statistical evidence of a non-trivial nature in support of his position. But so could an economist who asserted the contrary.

ON SOMEWHAT LESS sophisticated grounds, one might argue that compensatory finance has worked by pointing out that the U.S. recovered from the depression of 1929-1933 and has experienced no decline of similar magnitude in the postwar era. The problem with this argument is that a depression like 1929-1933 is a relatively rare event and, moreover, Milton Friedman and Anna Schwartz have provided important empirical evidence to the effect that much of the 1929-1933 collapse can be explained by monetary mismanagement, not fiscal policy.

Full use of compensatory finance as a tool of economic stabilization did not really oc-

cur until sometime in the mid-1960's. But it would be hard to argue that there has been any great improvement in economic stability since then. Between 1970 and 1976 the economy experienced two recessions, the second one being the most severe that the U.S. has experienced in the postwar era. Similarly, the government's increase in fiscal activism has not been accompanied by any notable improvement in the unemployment rate. Indeed, if anything, the unemployment picture has gotten worse. From 1950 to 1959 the unemployment rate averaged 4.5 percent; from 1960 to 1969 (the decade when the principle of compensatory finance was fully acknowledged and implemented) the unemployment rate averaged 4.8 percent; and from 1970 to 1975 the average had risen to 5.9 percent, and last year it was over 8 percent.

Of course no economist who embraces the principle of compensatory finance would be prepared to abandon his belief on the basis of this dismal track record, but I think it is fair to say that the lack of convincing evidence suggests that the origin of this belief is more philosophical than scientific.

IF IT IS TRUE that what many hailed as the dawning of a new day turned out to be a rainy afternoon, then it is natural to ask why fiscal activism and compensatory finance are now such firmly entrenched parts of both political and economic orthodoxy. I think the answer to this puzzle is to be found not in economic theory but in the political marketplace. It is not hard to understand that a politician sees great political advantages in spending more and taxing less. It is equally easy to see that if an economist wants to give advice to politicians, he will find that advice is most readily accepted and acted upon if it turns out to be what politicians want to hear. This is a point made quite effectively by Professor George

Stigler in a recent article entitled, "Do Economists Matter?"

To say that economists give advice that politicians want to hear is not to say that such economists are necessarily intellectual prostitutes. An economist can have an honest intellectual belief in the principle of compensatory finance and not find anything hostile to this position in the existing empirical evidence because of its ambiguity. On the other hand, if a politician thinks that his constituents want more spending and less taxes, he will be greatly interested in knowing about economic reasoning that supports their position and less receptive to reasoning that contradicts what he feels he must do anyway.

The law of supply and demand applies in the market for economic theory with the same force that it applies in the markets for wheat or bologna. An interesting illustration of this point can be seen in the case of the Davis-Bacon Act, which was passed in 1931 to support wages in the construction industry. I have examined the effects of this Act in some detail and the evidence points overwhelmingly to the conclusion that the economic costs far outweigh any conceivable benefits. By raising construction wages above the market level the Act also negates other government programs such as the production of low and moderate-income housing. The evidence is so clear in this case that I know of no economist who has looked at it and has come to any other conclusion. The General Accounting Office has filed numerous reports with the Congress, all pointing to essentially the same result, namely that the Act has been administered in a way so as to raise construction costs on federal projects far above anything justified by the enabling legislation.

It would be hard to find a situation where both economic theory and statistical evidence were less ambiguous in their conclusions.

Moreover, as far as I can tell, economic advisors to all presidential administrations in the last 15 or so years have made at least some effort to have this Act modified or repealed. Not only have these efforts failed completely but the Davis-Bacon Act provisions have been added to an increasing number of other laws and bills. The reason is not hard to find—organized labor wants this Act and is a significant political force.

When political objectives do not square easily with economic evidence and advice, the economic advice seldom survives, if ever. The Davis-Bacon Act is not an isolated example. In the last 25 years direct government regulation of industry and other parts of the economy has grown substantially. A large number of economic studies have been made of these regulatory activities and have generally found that the effect has been to impose enormous costs through the creation of economic inefficiency, even though the ostensible objective of the regulation is just the reverse. Despite the economic evidence, the trend has been to more regulation, not less. Currently there is some effort in Washington to reduce regulation in certain cases—a notable one being the airline industry. But the airline industry does not want to be deregulated and I will be very surprised if the economic arguments prevail even in this case.

IF THE GENERAL principle of compensatory finance is indeed firmly entrenched despite the ambiguity of its economic rationale, what are the likely consequences of this policy for the future? One rather clear implication is that the government will become an increasingly large component of the economy. This is because of an essential asymmetry in the principle of compensatory finance; namely that the government should spend more and tax less when the economy is thought to be underem-

ployed, while in periods of full employment the economy is treated as self-sufficient in the classical sense. Combine this asymmetry with political motivation to see potential recessionary forces at every turn and the reluctance of politicians to cut government spending, and the drift toward larger and larger government is virtually assured.

I think these forces go far to explain the substantial growth of the government sector in the last 40 or 50 years. In 1929 government expenditures were about 12 percent of national income; by 1950 that share had grown to about 26 percent; in 1960 it was around 33 percent; and in 1975 it was 43 percent.

I note that a big part of this growth occurred during the Nixon and Ford administrations despite their claims that the government sector should be reduced. It is also worth noting that there is nothing in the principle of compensatory finance that requires the increased government expenditures to be directed to socially desirable goals. A trip for 25 Congressmen to England to pick up a copy of the Magna Carta for our Bicentennial celebration presumably has the same justification in stimulating economic activity as would greater expenditures on public services, and more justification than an equivalent cut in taxes. I suspect I am not alone in the feeling that the increased share of income going to the government has not been matched by anything like a proportional increase in the value of the services provided by the government.

ANOTHER important aspect of this new economic policy is its consequences for the future productive capacity of the nation. If compensatory finance is used at a time when the conditions outlined by its proponents are not fulfilled, the effect will be to divert savings away from investment and toward current consumption. This means that the stock of pro-

ductive capital is reduced and consequently that the economy will not be able to produce as much in the future.

The ability of economists to forecast the future or even to assess the current economic environment is not terribly impressive. Remember that when President Ford took office he called a summit meeting of the nation's best economists. The great concern of that group was the threat of further inflation and its major tangible achievement was the production of WIN buttons to be worn by concerned citizens. Within three months of that meeting, it became apparent that the nation was slipping into a serious recession.

The situation is very much like that of a physician who does not know what is really the matter with a patient but nonetheless proceeds to prescribe strong medication that has a good chance of producing serious side effects. The difference is that in the case of compensatory finance the side effects are most likely to be felt by future generations. This is not likely to alter the commitment to the policy since future generations do not vote for current politicians (although in Chicago there have been cases where members of past generations voted).

A THIRD RESULT of the policy is a much greater likelihood of inflation. I noted earlier that increased expenditures and reduced taxes necessarily mean that the government must either print more money or issue more debt in the form of government bonds. If it borrows it displaces current capital accumulation and raises the implicit tax burden for the future. Concern about this is often expressed in the political area by clamoring for a balanced budget or other means. Thus, the government is pushed toward financing at least some of the deficit through direct creation of money—in effect by running the printing presses faster.

But an increased rate of growth of the money supply generally means an increased rate of inflation.

Once again this pattern stands out quite prominently in the historical data. Between 1950 and 1965 the money supply rose at an average rate of about 2.8 percent and the price level rose at an average rate of less than 2 percent. Since 1965 the money supply rose at an average rate of over 5 percent and so did the price level.

Unfortunately, the government reaction to inflation is not always to see this as a negative aspect of compensatory finance, but to blame someone else. As a result, we are likely to see greater and more frequent use of wage and price controls than we did between 1971 and 1973. Such wage and price controls do not address the basic problem since the government's money-printing presses keep running. These controls do increase the government's involvement in the economy and the effect of that involvement is usually quite disruptive, leading as it does to severe shortages of needed goods and services and other costly economic dislocations.

ECONOMICS has been called the dismal science and as an economist I have to keep my credentials in order by being appropriately gloomy and pessimistic. This is harder to do sometimes than you might think, but my batting average for this talk hasn't been at all bad. After all, I have been able to suggest that the government is going to get larger and more dominant, that our stock of productive capital is likely to be seriously attenuated, that inflation is here to stay, that wage and price controls will be increasingly common, and that the economic policy that leads to all this has benefits that are highly ambiguous and possibly nonexistent.

In concluding my formal remarks, I should

tell you that economists are not always so pessimistic. In a futuristic essay in 1930, John Maynard Keynes happily foresaw the end of the economic problem by the year 2000. In concluding his essay he said, "If economists could manage to get themselves thought of as humble, competent people, on a level with dentists, that would be splendid!" I don't believe economists have much chance of ever making it to the level of dentists, but with another 20 or 30 more years of hard work it should be possible to catch up with the witch doctors.