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**Economic Policies for a Market Economy**

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Five years ago, the wall that had divided West and East Germany for more than a quarter century came tumbling down. That event has served as an important symbol of the failure of an oppressive, authoritarian political system that stood for over 70 years. Equally important, the tearing down of the wall also marks the dismantling of misguided economic policies that dominated much of the 20th century.

In the 1990s, three major trends being observed around the world are deregulation, denationalization/privatization, and tax reform/reduction. The role of the state in economic affairs is being reassessed everywhere, not just in Eastern Europe and the former Soviet Republics. This appreciation for the superiority of markets would have undoubtedly warmed the hearts of Adam Smith and his contemporary scholars in the “Age of Enlightenment.” Perhaps history will treat the current period as an “Age of Re-enlightenment.”

In the summer of 1989, before the Berlin Wall came down, Milton Friedman visited China, where he met with the Minister responsible for the nation’s distribution of materials. The Minister said he planned to travel in the United States and wanted to meet our official in charge of distributing materials such as lumber, iron ore, grains, and so on. Friedman replied that the Minister should not go to Washington to meet such a person, but instead would need to stand in the balcony of the Chicago Mercantile Exchange and look down at the trading floor in order to see who controls the distribution of materials in the United States. Friedman reported that the Minister found it hard to believe that there was no single American who had such authority.

Clearly, people who spent decades behind an iron curtain have much to learn about a market economy. But we can also find lessons in the struggles of emerging nations to institute the necessary conditions to make markets function. A couple of years ago, the Prime Minister of the Czech Republic, Vaclav Klaus, and Milton Friedman were about to head off for a tennis match with a couple of other attendees at a conference. Rose Friedman said to Prime Minister Klaus, "I suppose as Prime Minister you won't have much time for playing tennis." Klaus replied, "Well certainly during the transition period I will be very busy, but once we have a market economy their won't be much for a Prime Minister to do except greet foreign dignitaries, so there should be plenty of time for tennis."

Like Friedman, Prime Minister Klaus clearly recognizes the inherent resiliency of a market-driven economy. In the spirit of his intellectual mentors, Austrian economists Ludwig von Mises and Friedrich von Hayek, Klaus believes that an economy based on private property and reliant on an unregulated price system to allocate resources to their best uses has a natural tendency to expand. Such an economy does not require artificial "pump priming" stimulus to aggregate demand to make it grow.

Regrettably, the views of Friedman, Klaus, and Adam Smith have not been the dominant ideas even in the most market-oriented western economies in the post-World War II period. Instead, economic policymaking for the past several decades has reflected the unfortunate legacy of the Great Depression of the 1930s, which gave rise to views that justified a massive increase in governmental intrusion into economic affairs. For firms and industries that were not nationalized, government agencies

told people what they could produce, where they could produce it, how much they could charge, how much they could pay their workers, and even what lines of business they could engage in.

The notion of “countercyclical stabilization policies” gave rise to a wide array of policies intended to “manage aggregate demand” and to counter perceived “market failures.” It was an era in which economic policymaking seemed more like social and political engineering than anything Adam Smith would have recognized. Indeed, even the language used by policymakers to describe their actions and the intended effects on the economy drew heavily on the physical sciences.

Maybe part of the reason that economists sounded more like engineers than social scientists is simply that many of us who obtained economics degrees in the 1950s and 1960s had started our freshman year in college as engineering or other physical sciences majors. Our quantitative skills were good, and we wanted to design or build things. Along the way we found that instead of designing and building bridges, we could use our facility with numbers and equations to build models that emulate the economy. In addition to John Maynard Keynes’ *General Theory*, we also could base our approach to the economy on Paul Samuelson’s appropriately titled *Foundations of Economic Analysis*, which emphasized mathematical terms, engineering nomenclature, and a strong emphasis on control. The next time you read about policymakers trying to bring about a “soft landing,” you will know the root of such terminology.

A much older (but for much of this century dormant) approach to market economies resembles a biological process more than an engineering

project. Adam Smith wrote about a “certain propensity in human nature...to truck, barter and exchange one thing for another.” Smith’s famous reference to an “invisible hand” clearly had in mind normal interactions of human beings as the driving forces in a market economy. Smith and his contemporaries would certainly have echoed Hayek’s characterization of 20th century economic policymaking as a “fatal conceit.”

What seems to have been forgotten, for a while at least, is that economics remains a social science. The actions and reactions of rational humans are still the core of the discipline. Consequently, mathematical models cannot tell us the effects of discretionary policy actions since they cannot predict the behavior of free people pursuing their self-interest in a market economy.

One of Friedman’s colleagues at the University of Chicago, George Shultz, has served in several departments of government, yet has maintained a healthy humility about the role of a policymaker. After serving as Treasury Secretary in the 1970s, he described the role of an economist as that of a helmsman tacking a sailboat. He said that telling a politician he was wrong about something was like telling the wind to blow in a different direction. Instead, he argued, the key to success was in learning how to use the prevailing winds to go in the direction you want to go--which often means tacking.

After serving as Secretary of State in the 1980s, Shultz was asked about his role as “architect of the post-Cold War era.” He replied that he preferred to think of himself as a gardener rather than an architect. Shultz obviously believes in what one of Adam Smith’s Scottish colleagues,

Andrew Ferguson, described as a process whereby “...nations stumble upon establishments which are indeed the result of human action but not the result of human design.”

One of Friedman’s fellow Nobel Laureates, James Buchanan, brought the *public choice* perspective to the role of policymaking. He contends that economists in Washington often behave like assistant coaches on the sideline whispering into the coach’s ear about which play to call next--or worse, begging to be put into the game to carry the ball themselves. In Buchanan’s view, economists have no comparative advantage in either handling the ball or calling plays for other players.

Instead, he describes the proper role of economists as being more like team owners and coaches meeting in the off-season to contemplate future rules for the game. Changes such as the height of the pitcher’s mound or the designated hitter rule in baseball, or the shot clock and three-point play in basketball, are the types of modifications that affect the comparative advantages of real players. The intent of such rule changes is to make each game a closer contest, in contrast to play-calling on the sideline, whose intent is to clobber the opponent.

### **Organizations, Rules, and Markets**

In this spirit, allow me to offer a few thoughts on the institutional arrangements and rules that enhance the workings of a market economy.

--Institutional arrangements affect economic performance:

If they improve markets, they enhance prosperity.

If they interfere with markets, they retard prosperity.

--Institutional arrangements come in two broad types: organizations and rules.

Governmental organizations include Cabinet Departments and all the various agencies created by governments.

International organizations include the International Monetary Fund, World Bank, United Nations, and the new World Trade Organization.

--Examples of prosperity-enhancing rules are:

Property rights.

Contract enforcement.

The Commerce Clause of the U.S. Constitution.

Standards for weights and measures.

--Examples of prosperity-retarding rules are:

Wage and price controls.

Interest-rate controls.

Credit allocation and industrial policy.

Controls on foreign exchange transactions and capital flows.

Trade restrictions, tariffs, quotas, subsidies.

--Unfortunately, policymakers often try to:

Help the already prosperous by restricting competition.

Help the less-prosperous through wealth redistribution rather than wealth creation.

Gain political support through policies that help in the short run, but hurt in the long run.



--Experience of the 20th century shows that successful policies are those that enhance the effectiveness of markets.

Central planning has failed; examples are dramatic:

Collapse of Soviet Union and Comecon.

Former West Germany is more prosperous than former East Germany.

South Korea is more prosperous than North Korea.

Taiwan is more prosperous than the Chinese mainland.

--Good policies are more important than possession of natural resources:

Resource-poor Japan and Switzerland are rich.

Resource-rich Brazil, Russia, and Africa are poor.

Resource-poor Hong Kong and Singapore are prospering.

--Good public policies attract productive resources; bad policies repel resources.

If resources are free to move, policymakers will have to compete for them through good policies.

### **Some Policy Rules**

Now, allow me to suggest some specific monetary and fiscal policy rules that will improve the operation of markets and thereby enhance prosperity.

--Clear rules that limit the use of discretion by monetary and fiscal policymakers can promote prosperity.

--Activist, discretionary, stop-and-go monetary and fiscal policies in past have done more harm than good.



--Clear rules mean households and businesses would face less uncertainty, and would make better decisions about consumption, saving, investment and production.

--Fewer short-sighted, politically motivated policies will then be imposed.

**RULE:** Monetary policy should pursue sound money;

**Objective:** Create conditions in which businesses and households make decisions about the future in expectation that the purchasing power of currency will be stable.

Sound money enhances prosperity in three ways:

1. It avoids capricious redistributions of wealth.
  - resources won't be used to avoid redistribution.
  - akin to a technological advance.
2. It encourages saving and investment.
  - inflation interacts with tax system to discourage saving and investment.
3. It facilitates planning of production, consumption, and saving.

Characterizing policymakers as either pro-growth or anti-inflation is a false dichotomy.

Hawks/doves characterization is contrived.

Only sustainable pro-growth, pro-employment policy is anti-inflation.

**RULE:** Congress should mandate that the central bank achieve price-level stability by a certain date and maintain it thereafter.

The mandate would increase the credibility of commitment to

maintain a stable purchasing power of money;

That credibility would facilitate achieving sound money -- and reduce the costs of transition.

**RULE:** Congress should mandate that monetary authorities have no objectives regarding short-run growth of output, employment, or other real magnitudes.

Sound money helps with all of these in long run.

Using monetary policy to pursue them directly in the short run sometimes impedes their achievement in the long run.

**Turn now to fiscal policy.**

**RULE:** Don't manipulate budget deficit for countercyclical purposes.

Changes in the levels of government expenditures or tax revenues have little lasting effect on total spending in the economy.

No balanced-budget multiplier.

No deficit-spending multiplier.

--few people believe deficit spending has any lasting stimulative effect on economic activity.

Any effect is transitory and quickly reversed.

**RULE:** Tax and spending proposals should be evaluated for their effects on incentives and resource allocation.

They can affect incentives to work, save, and invest.

They can shift resources between consumption and investment.

They can change the long-run growth path of output and thus affect our standards of living over time.

**RULE:** Governments should not impose taxes that discourage working, saving, investing, inventing, innovating, or owning and using productive resources.

To tax something is to discourage it.

The primary incidence of taxation should fall on consumed income.

A tax burden on individuals can't be avoided by levying taxes on businesses. Only individuals ultimately pay taxes.

Tax policies should be evaluated by considering whether individuals bear the tax in their roles as workers, consumers, or investors.

**RULE:** Policymakers and voters should not act on the myth that the burden of taxation is determined by the current level of tax revenues.

True tax burden is determined by the amount of government spending.

Ultimately, all government expenditures must be financed by:

--present or future explicit taxation;

--government money creation (inflation);

--unilateral transfers or gifts from foreign sources.

Actions that reduce current tax revenue without decreasing either present or future government expenditures do not constitute a reduction in actual tax burdens.

Conversely, decisions that reduce either the current level or the growth of government expenditures from what they otherwise would have been are a genuine reduction in tax burdens, even if current explicit tax revenue is not altered.

**RULE:** Deficit spending should not be thought of as an alternative to taxation.

It is a method of deferring explicit taxation.

It can encourage taxing through inflation.

Inflationary monetary policy can be viewed as an instrument of taxation.

**RULE:** Deficit spending should be financed with inflation-indexed bonds.

Indexing reduces the temptation for government to finance its expenditures through inflation.

**RULE:** Government should do only those few things that the market economy clearly cannot do well.

Because such a standard is difficult to apply, an alternative approach is to set a specific limit on government spending that can be altered only by constitutional amendment or supermajority of the legislature.

The limit could be expressed as a share of national income or as a rate of growth.

Part of the objective is to create an effective budget constraint on the government wherein opportunity cost cannot be ignored.

**TWO RULES** for retirement programs:

Government may choose to mandate them, but should not administer them.

They should be fully funded to avoid the negative effects on saving of redistributive pay-as-you-go schemes.

**Conclusion**

- Government programs do not cause growth to occur;
- Government programs do not create wealth;
- Government intrusions that interfere with function of markets lower our standards of living;
- Often, government regulations have reduced the natural discipline and regulating effects of market forces.

**Rules** that enhance the functioning of markets are much more essential to economic prosperity than are politically-created and controlled organizations, no matter how well-intentioned their missions.

Early in this century, the Italian dictator, Mussolini, said that “while the 19th century was the century of civil liberties, the 20th century would be the century of the state.” I think that we have to agree that for the most part he was right. However, as the century draws to a close, the dominant trend around the world is to roll-back the intrusion of the state in our lives, especially in economic affairs.

Looking ahead, the global trends of deregulation, denationalization/ privatization, and tax reform/tax reduction suggest that the 21st century will be the century of markets.