EFFECTIVE ECONOMIC POLICY: SOME KEY REQUIREMENTS

a lecture by

MARK H. WILLES
President
Federal Reserve Bank of Minneapolis

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Introduction

I am delighted to be here today, although knowing a little about what I'm going to say, I am nervous about being introduced as having been a professor. It reminds me of the essay a child once wrote about Socrates: "Socrates was a famous Greek teacher who went around giving people advice. They poisoned him."

In spite of that risk, I appreciate very much the opportunity to be on this distinguished campus to share with you some observations on what is required in order for the United States to have effective national economic policies. There are two reasons why I am particularly pleased to be here today. First, I enjoy the environment of a major university campus. The intellectual sophistication of faculty, and the vitality of students, provide a climate and a challenge that I find stimulating.

Second, I appreciate the "neutral" forum of a university that should make it possible to discuss some difficult and sensitive issues with more objectivity and less emotion than might be possible in other places. With that in mind, I intend to venture out into some treacherous territory. My purpose is not to criticize or put down anyone else's point of view, but rather to engage in and encourage debate on some key issues which in my judgment have far-reaching implications for the social and political as well as the economic health of this nation.

Let me begin by acknowledging that the views that I express today are my own, and do not necessarily reflect the official views of the Federal Reserve System.

Second, let me state, since you will figure it out for yourselves anyway, that my remarks may well reflect my own personal biases. Within the realm of public policy, there is no such thing as an unbiased book, article, or speech. All of us who are actively involved in this arena allow our personal tastes and predilections to sway our thinking and our communicating. This was confirmed when a wise professor of mine was asked by a fellow Ph.D. student how to write an unbiased book. His response was: "You can't, and neither can anyone else. The important thing is to have access to an unbiased library." I think that is the key for each of us -- to make sure that we are exposed to alternative points of view so that we can carefully and thoughtfully come closer to that thing called "truth."

Unfortunately, in my judgment, public discussion of economic policy is often lopsided, if not one-sided, and people who hold opposing points of view are either not heard from or are not carefully considered. In this part of the country, for example, the "farm problem" is often treated as a sacred cow. In other places such things as business profits or labor wages, are treated in such a presumptive way that understanding and policy decisions are negatively affected.

So I would like to express some views today, some of which go against the grain of some strongly held opinions of some very able people. I do that to add a little more balance to the library of public opinion, and with the hope that the ensuing dialogue will help improve public understanding and thereby public policy.

A Few Requirements for Effective Policy

The conditions which must be satisfied in order to have effective economic policy are large in number and complex in nature. We only have time today to discuss a few of these conditions, but they are, in my judgment, fundamental to the whole business of public policy. Simply put, what I want to suggest is that in order to have effective economic policy we must

(1) Have a good knowledge of how the economy works,

(2) Use appropriate tools (policy instruments) to influence the economy,

(3) Have the consent of the public -- i.e., general agreement that the policies that are being followed are appropriate.

That may sound like a deceptively simple list, but I would like to suggest that we are a long way from satisfying any of those conditions, and we will not have the kind of economic policy we all want, until we have made a great deal of progress in each of these three areas.

Consent of the Public

Since this is a "public lecture," let me begin by discussing the third area: the need for public consent.

In a democracy like we have in the United States, it is clear that the economic policies that are followed must have the support of the majority of the citizens. No matter how "correct" a particular economic policy may be from a theoretical point of view, if it does not have the general support of the people, it will not work. For people will either find a way to work around a policy they don't support, and thereby undermine its effectiveness, or they will use the political process to have the policy nullified.

If the public is to support the thrust of economic policy, it must understand policy and then agree that it is right. Having said that, several problems are immediately apparent.

First, as a public we are often unwilling or unable to work as hard as we must to understand the complex and difficult economic decisions that must be made. We seem to want easy answers to complex problems. And unfortunately, some bureaucrats and politicians have spent decades telling us that very difficult problems can indeed be solved if we will just spend a little more money, or provide a little more governmental help or protection to someone or some group in need. But all of our wishing, hoping, good intentions, and money have not brought the hoped for solutions.

It is no wonder that people today have a large distrust of government. That distrust reflects more than Watergate, corruption, or other immoral personal acts on the part of government officials. It reflects a history of unfilled promises -- not because government didn't try, but because it was beyond government's capacity to deliver on the commitments that it made. Government can't eliminate all economic risk for its citizens. It can't negate the inevitable short-run trade-offs that arise from the many environmental, health, energy, income support, and other policies that are being pressed today.

Unfortunately, we are currently in the midst of a stream of policy actions and proposals that seem simple, make great promises, and, in my judgment, will be counterproductive in their results. Public frustration will increase accordingly. Let me just cite two examples (of the many that are all too close at hand).

First, the President recently signed into law, with great fanfare, a law which increases the minimum wage by over 44 percent for the next four years. The premise upon which this legislation was based was that it would raise the income of our most lowly paid workers so that they can earn a "decent" living. In fact, however, the bitter result will be that while some low-income workers will have an enlarged income, a significant number of other workers (perhaps 200,000 -- primarily young and black), will find that they have been priced out of the labor market. Their earned income, instead of going up, will go down to zero, because at the higher wage it will not be profitable for employers to employ them. The promise of a high paying job, but with no job to be had, is the stuff from which frustration -- and even riots in the streets -- are made.

A second example is that the federal government is earnestly making plans to "guarantee" public jobs for those who can't get them in the private sector. The purpose is to reduce unemployment to a more acceptable level (unemployment caused in part by the minimum wage legislation I just mentioned). Once again the promise is well-intentioned, but the results are likely to be negative. If the government sets a low wage for its public service jobs, few will sign up. After all, why should someone settle for a low wage when government policies have told him or her repeatedly that they deserve a high wage. They will just take their leisure, and unemployment insurance or government assistance payments, and wait for a better paying job to come along.

On the other hand, if the government sets a sufficiently high wage for public service jobs, then some previously unemployed workers will become employed in the public sector, although whether such employment will be of long-range benefit to the employee is not clear. But some low paid workers in the private sector will be induced to leave their jobs and take better paying government jobs. And such a switch is precisely what we should not want. It is in the private sector, not a public sector offering "temporary" jobs, where life-time career opportunities are to be found. Moreover, as is clear from what I have just said, any increase in government employment is not a net increase in total employment. The increase has to be offset by the decrease in private sector employment.

There is a further point to be made about any public service job program that offers jobs at a sufficiently attractive wage. It is inflationary. Some proponents have suggested that employment can be increased, but in contrast to government spending programs, without generating inflationary pressures. That, I submit, is wrong. For one thing, an attractive public service wage will force public sector employers to increase their wages. There is nothing magical about such a program: A public service jobs program, if it works, will be inflationary.

As a matter of equity, I should also add that some businesspeople, labor leaders, and even academics do their share in adding to public confusion and distrust. Businesspeople who extol the virtues of profits and incentives, the virtues of private enterprise and market-oriented solutions to economic problems, have a hollow ring when they quickly turn to government for aid in times of stress. Business requests for government loans to bankrupt firms, for protection against imports from abroad or competition at home, make the public very skeptical about the entire system. Businesspeople will not succeed very well in convincing the public that adequate profits are needed to reward them for taking risks as long as the public sees some of them first in line at the public trough when those risks actually produce undesirable results.

The current alliance of business and labor leaders in the steel industry, clamoring for protection from imports, is a classic example of that which bodes ill for economic understanding and the economy.

Even the academic community doesn't do, in my judgment, the job it has the potential to do in helping the public to understand the economic problems we face and the alternative solutions that are available. Because it is hard work to communicate clearly, in terms the general public can understand, far too many academicians are content to talk among themselves in terms only they can understand (if the truth were out, I guess we would have to say that they often don't even understand each other). As a result, except for people like Walter Heller, who is as articulate as anyone I know, the public doesn't have sufficient benefit from what should be one of its best sources of economic understanding.

Of course there are conspicuous exceptions to everything I have said so far, but in my judgment the point remains that if we are to have effective economic policy, we must have the consent of the public. And that consent will not be strong and enduring if it is based on ignorance or charisma. It will only be truly effective if it is based on a knowledge of what is going on, and a trust in the officials who are carrying out policy. This in turn requires more articulate communication of economic issues and ideas. It also implies, and I can't emphasize this too strongly, a scaling down of rhetoric, of public promises, of expectations, so that public officials and policy are believable and therefore worthy of support.

Knowledge of How the Economy Works

One of the reasons why it is necessary to limit what we say we can accomplish with economic policy is because we really don't know very well how the economy works. I don't want to overstate this. We do know some things -- I think. We know (I think) how to prevent major depressions such as was experienced in the 1930s. And we know how to prevent the run-away inflation that we saw in Germany after the war. But we don't know how to fine tune the economy to produce steady growth -- with no ups and downs. We don't really know how to get stable prices and low unemployment at the same time. Some of us do think we know how to accomplish these things, but a large degree of uncertainty must be attached to any pronouncements that are made.

It is of course primarily to the academic community and other research groups that we look for the theories, the empirical tests, and the insights that will allow us to improve our understanding of how the economy works. Clearly much excellent work is being done. Unfortunately, scholars sometimes show that they are human like the rest of us. Some of them allow their disinterest in the "real world" to send them off on intellectual pursuits that are not only arcane but irrelevant to the pressing problems of the day. More unfortunately, they sometimes develop such a vested interest in their own views of the world that they are unwilling or unable to seriously and openly consider different theories and ideas. As a result, academic debates often generate more heat than light, and the public is the loser.

Consequently, if we are to have effective economic policy, we must have a coherent theory of how the economy works; one which has been tested against and supported by real-world facts and events. And let me say that our needs in this regard are urgent. Keynes, that great economist of earlier years, once said that, "Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slave of some defunct economist." Unfortunately, many "practical men" are now slaves of the ideas of Keynes himself. Policies based on his theories cannot deal effectively with today's economic conditions. Somehow the monetarist view of Milton Friedman doesn't seem completely convincing either. Perhaps the rational expectationists here at the University of Minnesota have the ultimate answer. At this point only Heaven, Neil Wallace, and Tom Sargent* know for sure. I must say I am very impressed with their work; they have made a substantial -- and stimulating -- contribution to research being done at the Minneapolis Fed. I only hope that it receives the benefit of open and genuine debate so that it is either confirmed and extended or is replaced by something better.

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* Neil Wallace and Thomas J. Sargent are professors of economics at the University of Minnesota, advisers to the Federal Reserve Bank of Minneapolis, and leading theorists of the rational expectations viewpoint.

Appropriate Policy Instruments

The final area I want to discuss briefly today is the need to use appropriate tools in the conduct of economic policy, and to use them in ways that are appropriate to the results that are to be achieved.

A large variety of tools are available to policymakers today. There are general tools of policy. One of these is monetary policy, i.e., that policy which makes its influence felt through what it does to the availability of money and money's costs (interest rates). The second is fiscal policy, which is that policy that determines the general level of government spending and taxation. In addition to these two general policies, there is a whole host of more specific policies which can nevertheless have a significant impact on the general level of unemployment, prices, economic growth, and so on. This category would include things like selective credit controls, trade policies, income support programs, specific tax provisions, government regulations and controls -- an almost endless list.

One of the difficulties we have today is that we often attempt to use the wrong policy tool to solve a particular economic problem. For example, we try to overcome unemployment caused by structural problems in the economy (e.g., minimum wages, barriers to entry, lack of training), by increasing aggregate demand: The result is that we pay a high inflationary cost for little or no reduction in unemployment. In fact, many people are currently pressing the Federal Reserve to stimulate the economy in order to reduce unemployment. Yet a large proportion of today's unemployment is caused by structural problems or by the uncertainties and distortions caused by past economic problems, including economic mismanagement. If I understand what an increasing number of businesspeople are telling me, a more expansive monetary policy, instead of reducing unemployment, would have just the opposite effect. An increase in the rate of growth of money would further agitate expectations of inflation, in which case businesspeople have told me they would reduce their capital spending, for its expected profitability would be called into question. Consumers, faced with additional inflation and the uncertainty it creates, might well reduce their spending, to conserve for a rainy day. The effect of these actions by businesspeople and consumers would be to increase, rather than reduce, the level of unemployment. Consequently, a more stimulative monetary policy could well aggravate the problem it was intended to solve.

Let me cite another example of where we often use, in my judgment, inappropriate tools to solve economic problems, and where the results are more costly than they need to be.

As I mentioned earlier in my remarks, the farm problem is considered by many to be a sacred cow. Because of that, I'm afraid that it is not always analyzed as rigorously as it should be. The result is that when a problem arises, as has happened during the last couple of years, we often prescribe a cure that turns out to be an overdose. Like all powerful drugs, the side effects can be awful.

To show you what I mean, let's look at a few facts. It is clear that the prices that farmers receive for their produce have dropped sharply. They have had to borrow heavily to meet operating and capital costs. They have had a real cash flow problem. So far, so good (in terms of agreeing on the facts). Based on these facts, the government has rushed in to provide, at great expense, support payments to farmers. The result will be higher government spending and more inflation than is really necessary to solve the farm problem. The reason is that there are some additional facts that have been overlooked, that change the nature of the policy that should be followed. One of these facts is that a large proportion of farmers, even without income support payments, hold economic assets that make them economically well off by any reasonable standard. The reason, of course, is that their land has appreciated so much in value.

Some will argue that farmers should not have to borrow against their land in order to live. But what a strange argument that is. If I owned a million dollars worth of stocks, but I had no income, I doubt very much that anyone would vote for a government program to give me and people like me additional income. Yet many farmers have substantial assets in land, and somehow, because the assets are land rather than stocks, we feel obliged to help out.

It should be noted that the debt/equity ratio for American agriculture is around 20 percent. And this in spite of the massive farm borrowing of the last couple of years. In fact, in many cases, that borrowing demonstrates how our financial markets have made it possible for farmers to take some of the increased value of their land and turn it into a liquid form to be spent as needed.

Now clearly not all farmers are well-off. New farmers, who have had to buy or lease their land at high prices, are in real trouble. But if, as a matter of national policy, we want to help those who are really in need, we could do so with specific help aimed directly at those people. This would cost far less, require much less government interference, and would have a much smaller inflationary impact than does using the pervasive policy of general price supports. Why use a cannon ball, when a rifle bullet would do?

I have singled out the farm program because it is particularly germane to this part of the country. I could cite many other examples as well. The main point is that we need to do a much better job of analyzing our economic problems and then using the tools that can most effectively deal with them. Otherwise, we may be worse off as a nation than if we had done nothing at all.

Conclusion

As I said in the beginning, I have treaded out into treacherous territory. The risk to many friendships is great. And yet, in my judgment, the stakes are also great. We do have difficult economic problems. In order to solve them, we must know more about how our economy works. We must make more judicious use of the policy tools available to us. And we must reduce frustration and conflict among peoples and groups by being more realistic in our promises and our expectations. For only in that way can we expect the consent of the people which is probably the most fundamental policy need of all.

As my remarks have suggested, I think we have a very long way to go before we satisfy the conditions necessary for effective economic policy. But I am optimistic that if we are honest with ourselves and others, we can make great progress. I just hope we do better than another optimist, General Custer, who said at the Little Big Horn, "Now men, let's not take any prisoners." Let's begin now to avoid his fate.