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Lessons from Living with Economic Policy

All my writing and speaking these days consists of reminiscences. I have a lot to reminisce about: I have practiced Washington economics—observing and participating in the making of federal economic policy—for over fifty-six years. That is longer than any other economist in the history of the republic.

The recent death of Richard Nixon prompts me to recall my experience as one of his economic advisers. That experience illustrates two general points about economic policy: the lack of strategic thinking about economic policy and the limited consequences of policy mistakes. These points are supported by the whole history of the past fifty years; I use the Nixon experience only because I know it best.

Lack of Strategic Thinking

There is little strategic thinking about economic policy: that is, having clear and consistent goals, having plans for achieving them, and having a plan or policy for adapting when the plans are not working. This latter feature is almost always missing. Presidential administrations come into office with many goals, and with plans for achieving them, but often the world turns out different from what was assumed in the plans and the administration founders in an effort to deal with conditions it had not foreseen, even as possibilities.

Although I could say some positive things about what we did or tried to do in economic policy during the Nixon years, what stands out is the big gap between what was expected at the beginning and what turned out at the end. Two examples of this discrepancy come to mind.

At the time of Nixon's first inauguration in 1969, a dominant feature of his economics appeared to be a phobia about unemployment. At my first meeting with him, in December 1968, he asked me what I thought our main economic problem was. I said it was inflation, and he said, "Yes, but you must worry about unemployment."

A second dominant feature of Nixon's economics at the beginning of his term was opposition to price and wage controls. This was, for Nixon, more than conventional Republican paternoster or standard classical economics: it was a strong personal conviction. His brief tenure as a lawyer in the Office of Price Administration at the beginning of World War II had been a frustrating experience.

But the unemployment rate that had been 3.4 percent when we came into office was 9 percent in May 1975. That was nine months after Mr. Nixon's premature departure from office, but it would have been no lower if he had stayed. Insofar as the unemployment rate is ever the president's, that 9 percent rate was Nixon's.

And in August 1971, Mr. Nixon, the great enemy of price controls, inaugurated the only comprehensive, mandatory price and wage controls in America's peacetime history. These controls remained more or less in effect for two and a half years.

I could list a great many reasons for this big gap between our promises and expectations and the outcomes. We inherited what at the time seemed a high inflation rate. No one knew how much slowdown of the economy would be required to curb that inflation or what monetary policy would be necessary to bring about the disinflation. In any case, the administration did not control monetary policy. The course of the economy in 1970 was disturbed by a major strike at General Motors. The Nixon administration had to deal with a Democratic Congress that was much less averse to price controls than the administration was and, moreover, wanted to embarrass the administration for its reluctance to use controls. Later, in 1972 and 1973, there were major disruptions of the world supply situation—Soviet crop failures, the departure of the anchovies from the Pacific coast of South America, and, most severe, the oil shock.

These conditions and developments ensured that the course of economic policy during the Nixon administration would not run smoothly, no matter what we did. But my point is that in our decisions and statements we did not take much account of these possible obstacles and uncertainties. Some of these conditions—such as the presence of a Democratic Congress—were obvious from the outset, but the possible consequences of that fact were not explored and given adequate attention. Some of these developments—such as the oil embargo—were probably not foreseeable, but the possibility of some kind of external shock, even if not that particular one, could have been recognized. The implications of that possibility were not given attention either.

We had a view of what we called the optimum feasible path of the economy. It would bring us to 1972 with low inflation, without price controls, and after having passed through a brief period of only moderately high unemployment. We also had a view of the combination of fiscal and monetary measures that would make the economy move along that path. Every few months, when we recognized that we were off the path, we would revise the path and the necessary policy, always to reach the same goals. But we never prepared ourselves or the public for the very likely possibility that reality would turn out to be as far from the new path as it had been from the old one.

As a result, we were constantly revising our policy to catch up with events, and the public was continuously losing confidence in our policy and our forecasts. That made it impossible finally to convince the country that gradualism would end inflation and that price controls were unnecessary, even dangerous. The condition of the economy at the time we imposed the controls was not terribly bad by any standard except one: the standard of our own promises. Both inflation and unemployment were higher than we had been promising for two years. We could no longer convince people, probably including the president, that our policy of avoiding price controls was working. If we had recognized and insisted on the inevitable uncertainties from the outset, we would have been in a better position to argue for patience.

Moreover, our own conception of the bad consequences of price controls was abstract and academic. If we had been more conscious of the way price controls might work out, we might have been even more reluctant than we were to impose them and more successful in explaining to the public why we did not want to use them.

As I look back to that weekend some twenty years ago when we decided to impose the ninety-day freeze on prices and wages, I am amazed to recall how unconcerned and ignorant we were about what would happen next. We had a vague idea that after ninety days we would get down to a system of essentially voluntary exhortation to large businesses and unions about their price and wage behavior. We did not foresee that the public would love the ninety-day freeze so much that we could not retreat from it very quickly. We did not foresee that we would be living with the system for two and a half years. We did not foresee that the initial apparent success of the controls would seduce us into excessively expansionary fiscal and monetary policy. We did not count on the possibility of shocks to the world food and energy supplies that would end the system in an explosion of inflation followed by the worst recession of the postwar period up to that time.

If we had visualized that course of events, not as most probable but as possible, we might have resisted the imposition of the controls more and have explained more successfully to the public why we did that. We suffered from a tendency to regard the most probable scenario as the only possible scenario and to neglect the implications of the uncertainties of our condition.

This deficiency, of course, was not peculiar to the administration in which I served. The Kennedy-Johnson administration failed to recognize the possible consequences of its policy of fine-tuning fiscal measures combined with arm-twisting businesses and unions to prevent inflation. Members of the Reagan team had various assumptions of what the consequences of the initial big tax cut would be and found themselves struggling for seven years with the fact that none of these assumptions turned out to be true. The Bush administration found itself seriously embarrassed for having failed to recognize and prepare for the possibility that its pledge of no new taxes might be inconsistent with its pledge to balance the budget in five years.

Consequences of Policy Mistakes

This history illustrates my first point, which is the common lack of strategic thinking. My second point is more comforting: like hurricanes in Hartford, Hereford, and Hampshire, terrible things hardly ever happen, at least as a result of mistakes of economic policy. The story of the follies of economic policy is the story of irony, of the gap between pretensions and outcomes, not a story of tragedy.

Most people would probably agree that the imposition of price controls in 1971 was one of the great mistakes of economic policy of the postwar period. Some generally sensible observers thought that the American economy would never be the same and that we would never get back to free markets. But that did not turn out to be the case. We did go through some foolish experiences, like the drowning of baby chicks allegedly because of the price controls, and having to wait in line for gasoline. We did end up with a recession, but recessions are a common part of our economic history. The 1974–1975 recession was not much worse than our average. And we did have an exceptional rise of output and employment in 1972, which we might not have had without the controls.

Many people would agree that the deficits of the Reagan and Bush administrations were a major mistake of economic policy. But it is hard now to point to any substantial damage they did. Economists will say that the deficits depressed private investment and slowed down long-term growth, but when we try to estimate the size of this effect, it seems to be quite small.

How do we explain this apparent fact that we can have so much folly with so little resulting damage? I will suggest an explanation by referring to three quotations.

Adam Smith, the fount of all wisdom, said, "There is a great deal of ruin in a nation." He meant, I believe, that a nation is a sturdy, flexible institution, reflecting the private decisions of millions of individuals, and that the follies of government do not much disturb the national condition unless the follies are exceptionally great.

A second quotation is less elegant but more pointed: "Economic policy is random with respect to the performance of the American economy, but thank God there isn't much of it." That revelation did not come from the fount of all wisdom but from me; it suddenly came to me ten years ago as a summary of my experience in forty-six years of Washington economics. The fact is that most of the things that we regard as big issues are really small relative to the size of the American economy.

The third quotation is, to me, the most interesting. Axel Oxenstiern, chancellor of Sweden 350 years ago, said: "Behold, my son, with how little wisdom the world is governed." For a long time, I thought he was saying that the world is governed badly because it is governed with so little wisdom. I now believe that he may have been saying that even a little wisdom is sufficient to govern the world—that the world can be well governed without much wisdom.

That idea should be familiar to economists. Thanks to Adam Smith, we believe that good performance of the economy does not depend on the wisdom of the individual actors in the economy. We have an institution, the market, that produces good results even though the individuals may not be very wise. The institution winnows out the follies of the participants. That, we suppose, is what Adam Smith meant by reference to the Invisible Hand, although since he put the initials of those words in capital letters he may also have been speaking of God.

But we generally reject, or at least overlook, the possibility that an Invisible Hand controls government to prevent the follies of our governors from resulting in tragedy. I recently read the First Inaugural Address of George Washington and was surprised to find him saying this: "No people can be bound to acknowledge and adore the Invisible Hand which conducts the affairs of men more than those of the United States."

I do not know whether George Washington ever read *The Wealth of Nations.* Alexander Hamilton, who helped Washington as a speech writer, may have done so, and that may be the connection between Smith's Invisible Hand and Washington's. Clearly, Washington was referring to God, as Smith probably was also. But Washington like Smith was probably also referring to institutional arrangements that yielded good results without great demands on either the wisdom or the virtue of individuals. In Smith's case, the institution was the free market. In Washington's case, it may have been the structure of government, starting with the Constitution in which he and his contemporaries placed so much faith. The Invisible Hand may have been the guidance and limitation placed on the policies of government by the division of functions among the federal government, the states, and the citizens; the balance of powers among the branches of the federal government; the room left for the play of diverse factions and interests; and the assurance of freedom of discussion and the competition of ideas. This may be the Invisible Hand that despite the lack of strategic thinking about which I have complained saves us from extreme and persistent errors of government. *(June 1994)*