"What Can An Economic Adviser Do When the President Adopts Bad Economic Policies?"

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Summary:

What would you do if you were appointed Chair of the Council of Economic Advisers under a president who was committed to one or more specific policies that you considered to be inconsistent with good economics? A look at the experiences of your predecessors over the last 40 years might help illustrate your alternative options. The lecture will review the history. It will then go on to suggest that such conflicts should be particularly acute in the current Administration. The reason is that Republican presidents have increasingly adopted policies-- with regard particularly to budget deficits, trade, the size of government, and inflation -- that deviate from the principles of good economics, and that used to be considered the weaknesses of Democratic presidents.

It is a great honor to be giving the Pierson lecture.[1]

I must confess that I never had Frank Pierson for a course. But he was the senior eminence of the Economics Department when I attended Swarthmore in the early 1970s, having already been associated with the department more than 40 years. In that time, Frank Pierson was known as one of the last professors who still regularly held his honors seminars at his house, with an impressive series of desserts, including make-your-own sundaes, and Irish coffee.

The early 1970s were a volatile time of course, with the War in Viet Nam still on.[2] In 1972 the big split on campus was between those of us working for McGovern on the left, and the

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[1] The author wishes to acknowledge help from Peter Jaquette, Arnold Kling, Jeff Miron, Stephen O'Connell, Francis Bator, Michael Boskin, David Cutler, Jason Furman, Gilbert Heebner, William Gale, Jeff Liebman, Peter Orszag, Roger Porter, Charles Schultze, Phillip Swagel, Laura Tyson, Murray Weidenbaum, Marina Whitman, and Janet Yellen.

[2] The wife of my junior-year roommate, who has always been conservative by Swarthmore standards, asked me what the other students thought of him then (Alberto Mora, who is today the chief counsel of the navy -- my roommates and classmates seem to have become lawyers much more than economists: including also Aleinikoff, Edley, Zoellick). My response was to recall what was the political split on campus in 1972.

radicals on the *far* left, which at Swarthmore meant the inexplicably numerous followers of Lyndon LaRouche. One of my friends remembers being impressed that Frank Pierson, despite having one of the most outspoken LaRouchians in the class, kept his cool and a twinkle in his eye.

Bernie Saffran

The man who *was* my professor then, and lifelong mentor, was Bernie Saffran, whose recent passing has been very much on my mind. Bringing him to the College in 1967 was one of Frank Pierson's most brilliant decisions. I hope you will forgive me for usurping this occasion slightly to make a few brief reminiscences about Bernie.

Perhaps what I most remember is the language of friendly debate that we imbibed from him. Such signature phrases as "Let me make a counterargument," or "I'm perfectly willing to be wrong" showed how much he relished intellectual argument and how little need there is for it be argumentative.

There was a session in Bernie's honor at the AEA meetings in Philadelphia 3 months ago; Mark Kuperberg commented there that Bernie's economic policy beliefs had actually always been "quite neoclassical," by which he may have meant any of several things. First, he may have meant the free-market policies that were called liberal in the 19th century. Or, second, we all agree it is important to clarify that neoclassical economics does not preclude responding to market failures by putting a big weight on such goals as environmental protection (externalities), anti-trust policy (competition), and equity (income distribution). Or, third, he may have meant "conservative" in the sense usually understood in the US. But I will argue later in my talk that today, as well, "conservatives" in one sense are not those that practice good neoclassical economics, but something closer to the opposite).

Anyway Bernie taught us all to think like economists, which includes applying the economists' approach – basically the logic of constrained maximization -- to all kinds of problems that most people considered none of our business (at least back then). In many universities, freshmen's first reaction to this is that it is right wing Gordon Gecko ism. But that never occurred to us in Bernie's classes. And Mark had part of the answer, that Bernie had such a warm humanist personality, that it would never occur to us that economics lacked humanity.

As I told the Swarthmore *Phoenix* for their initial story on Bernie's passing, I had earnestly sought his advice when deciding what to do after graduation, and proceeded to do the same with virtually every major decision in my life, up to and including a job decision just a couple of years ago, at age 50. I think I always took the advice and it was always right. But the important point is how large was the role that he played in the lives of his students. Some of you have probably heard this many times from many people - any of you who were at the memorial services in January. So I won't go on any longer.[3]

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[3] But one story from this time. By the spring of 1979, honors economics was so popular at Swarthmore, in part due to Bernie, that orals honors exams for Ec Theory had to be scheduled from first thing in the morning until late in the day, and the department had to ask a too-young former student, me, to be the outside examiner. When the first examinee and I arrived early in the morning at the front door of Trotter Hall to begin, we found it locked. But I remembered from my student days 5 years earlier the secret of how to get in through a certain unlocked window. I was able to do it quickly and to begin the exam on time. After that I felt I had earned my keep.

What To Do When You Disagree with the President.

I wrote the first version of "What Can an Economic Adviser Do When He Disagrees with the President?" two years ago.[4] It was phrased as a letter of advice to my Harvard colleague Greg Mankiw, who had just been appointed Chairman of the CEA under George W. Bush. Now Ben Bernanke has just been appointed as the latest CEA Chair, to take effect this summer. Ben was with me in graduate school at MIT. The same ideas would do just as well as advice addressed to him today.

Ben may need some advice: a historical perspective, in particular, on what an adviser can do when official White House policy goes contrary to his convictions as a professional economist. It would be a remarkable coincidence if any president accepted every position that his economic advisers had taken on every issue. But there are likely to be especially large divergences between this president and good economics in such areas as budget deficits, steel tariffs, subsidies to agriculture and other special interests, and expansionary monetary policy.

In this administration, the Treasury Secretaries have already been asked to sell a shift toward budget deficits that are inconsistent with their past views. But it is possible for a Treasury Secretary or OMB director to toe the party line while in office, and then confess later that this did not entirely correspond to his true beliefs. A professor of economics like Mankiw or Bernanke , who plans to return to Harvard after his service as a White House advisor, cannot engage in such inconsistencies, without risking losing some of the professional credibility that is so important to an academic career. Indeed, this truth-telling constraint may be the most valuable advantage of having a Council of Economic Advisers.

It might help to know the variety of strategies tried by past economic advisers, when they have found themselves disagreeing with the president, often over these same issues. I will cite examples from each of the last four decades.

- In 1966, President Johnson initially rejected, on political grounds, the advice of Gardner Ackley that if he wanted to pursue the War in Vietnam simultaneously with his domestic spending programs, he was going to have to pay for it by raising taxes. The resulting budget deficits led to two decades of inflation, and to an immediate acceleration of the trend toward US balance of payments deficits that eventually brought down the Bretton Woods monetary system. I hope the parallels with today are obvious.

In 1971, President Nixon's Council of Economic Advisers argued strenuously against wage-price controls as a response to that same inflation. Paul McCracken, the CEA chair, considered controls "sinful." Herb Stein was the macro member of the Council and ultimately the next Chairman, and someone Bernie Saffran very much admired. Stein termed wage price controls "wicked." But the Treasury Department, other cabinet members, and White House aide Bob Haldeman had come to a view supporting controls. Nixon decided to impose a freeze on wages and prices on September 15, 1971. The CEA tried to help make it work the best it could.

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[4] Challenge, May/June 2003, 46, no. 3, pp. 29-52 (also condensed in an op-ed in the *Financial Times*.)

But, as the advisers had warned, the controls were a bureaucratic nightmare, and the suppression of inflation turned out to be very temporary.

Incidentally, I believe that Frank Pierson served on various War Labor Boards in the 1940s, essentially part of the comprehensive system of wage-price controls. They worked well in wartime but would be anathema to most economists in normal times, certainly today.[5]

And, also incidentally, Bernie Saffran was a Senior Staff Economist at the CEA in the Nixon Administration, taking a year off in 1971-72, my sophomore year. He, and a few of his fellow staff members, came back to the campus to give a few talks about what was going on in Washington. We were all very excited to hear these, but I am afraid we were too naïve to ask the right questions about what really were some dreadful economic policies.

- In 1983-84, Martin Feldstein, President Reagan's CEA chair, gave speeches and testimony predicting years of record budget and trade deficits. This went over badly among White House aides, even though the predictions turned out to be accurate – or perhaps precisely because they turned out to be accurate. (Incidentally I did the senior staff economist job in the first Reagan Administration, working for Feldstein on precisely these issues.)

For some reason, CEA chairs in the Clinton administration had a slightly easier time of it. Not that their advice was always taken.

- In 1993, Laura Tyson expressed doubts about President Clinton's health care plan in meetings with him. But after the internal policy process reached a decision, she managed to avoid having to sell the ill-fated proposal. In particular, she refused to participate in a White House press briefing in support of the contention that employer mandates would have a positive effect on employment by increasing demand for health care, which she did not believe to be true.
- In 1997, the Clinton Administration negotiated the Kyoto Protocol on Global Climate Change, even though standard economic models predicted large economic costs if the U.S. had to implement the specified emission cuts domestically. His adviser Janet Yellen *was* expected to sell the policy afterwards – Congress demanded that she testify regarding the economic rationale for Kyoto. Many in the administration wanted her to testify that technological progress would allow the goals of Kyoto to be met even without politically unpopular incentives in the form of a higher price for carbon-intensive energy, something that she did not believe. But she was able to testify that the economic models did predict only modest costs if the U.S. was allowed to pay for cheap emission reductions in other countries, through a system of international trading of emission permits. Not only was this statement truthful, but it had the substantial advantage of cementing the Administration's position that the treaty would not be submitted to the Senate for ratification unless and until developing countries agreed to meaningful participation and the European countries agreed to a system of international trading of emission permits

[5] "Arbitrator, Nat. War Labor Board, 1941-42, Director of Wage Stabilization 1942-43, Vice Harir, 3rd Reg. War Labor Board 1943-44. Also Natl Wage Stabilzatn Board 1950-51."

- Not all advisers have been so fortunate. Bernanke will want to avoid the fate of Michael Boskin, who was CEA chair under his new boss's father. In 1990 and 1991, Boskin tried to warn George H.W. Bush about a weak economy, contrary to the happy talk that was being written into the president's speeches, with little success. Later, as employment stagnated, the press widely reported a perception that the White House had neglected the economy, precisely what Boskin had feared, and Bush sank sharply in the polls. Three weeks before the 1992 election, as a desperate campaign move to demonstrate that the president "got it," the White House in effect tried to blame the economic troubles on Boskin and the other advisers, by announcing that if re-elected he would not reappoint them.

- A similar absence of loyalty to the economic team was displayed by Bush the Second, in December 2002, in the unceremonious manner in which the press secretary announced the departures of Treasury Secretary O'Neill and National Economic Adviser Lindsey. So watch out.

Do economic advisers ever "do the honorable thing," and quit in protest over a policy disagreement? Although there is less historical precedent in the United States for resigning over an issue of policy than in the United Kingdom, it happens occasionally.

1. McCracken considered leaving when Nixon rejected his advice on wage-price controls, but postponed the resignation four months to minimize negative publicity.

2. Ten years later, President Reagan's first CEA chair, Murray Weidenbaum did the same thing. The president was forever giving speeches about the need to cut government spending and yet, when faced with actual hard budget decisions, repeatedly declined the aggressive option, even in areas of spending that the CEA chair considered wasteful (military as well as domestic). Finally, in late 1982, Weidenbaum decided to leave his position early, due to his frustration over this issue and the knowledge that he could not defend the coming budget deficits. But, out of loyalty, he did not publicly resign in protest, nor has he revealed the story since.

It would be wrong to draw the lesson from this history of disagreements that the economic advisers are always overruled. It would be even more wrong to draw the lesson that the Ph.D. economists as a general rule are smarter or know better than others in the government. There are at least three reasons.

1. This speech has deliberately singled out a set of relatively rare episodes -- those where "good economics," as represented by a heavy majority of economists or by leading textbooks, gives some relatively unambiguous answers to major controversial policy questions of the day, and where subsequent history has vindicated these answers fairly clearly.
2. In most of these examples, the Council of Economic Advisers was not alone in making its points. Other major players also told Johnson he would have to raise taxes to pay for the war, opposed price controls in the Nixon Administration, worried about rising budget deficits in the Reagan Administration, feared the recession that damaged the first Bush

presidency, and had doubts about Clinton's plans for health care policy and the Kyoto Protocol.

Many top government aides show truly extraordinary levels of intelligence, hard work, and effectiveness. Sometimes this characterization even describes the president himself. I know from firsthand experience that it described Bill Clinton, and I have no grounds for doubting those who say that it also described Lyndon Johnson and Richard Nixon, whatever their other faults. In any case,

3. the third point is the most important: any president has to weigh in many factors besides what economic theory says, including many political factors. That is their job, in a democracy. A system in which the CEA gives advice that is a few steps farther removed from political reality than the rest of the White House, and in which the president then does something different from that advice because he sees a larger picture, is a system in which everybody is doing his or her job properly.

But the public, Congress, and the media should "do their jobs properly" as well. This includes putting members of the CEA on the spot, when White House policy appears to deviate from good economics.

- Bernanke has one major factor working in his favor: in these situations, the press seldom asks persistent or sophisticated questions, or at least (whey the do) seldom finds the responses worth printing. So one can usually formulate a careful sentence that appears to be consistent with the White House line and yet is not literally false, and get away with it. Bush's first CEA chairman, Glenn Hubbard, crafted the White House statement "Interest rates don't move in lockstep with budget deficits." He, like Mankiw, has a textbook with the standard model linking interest rates to budget deficit. But because the sentence is true as written, Hubbard had nothing to fear from his colleagues when he returned to university life. The press did not ask the obvious follow-up questions. ("OK, we understand that budget deficits are not the only factor that determine interest rates. But, in your view, doesn't a budget deficit cause interest rates to be higher than they otherwise would be? And regardless whether that increase is small, doesn't the deficit crowd out investment?")

The Parties Have Switched Places

I have said that I would expect economic advisers in the current Administration to suffer from these conflicts more than those in an average administration. And I would say the economic advisers in the Reagan and Nixon administrations faced similar conflicts. But why should that be? Aren't Republicans presidents supposed to be the ones who recognize the truths of good neoclassical economics: laissez faire, monetary and fiscal discipline, and so on? Why should their advisers have to face such large conflicts between loyalty to their presidents and loyalty to good economics?

There was certainly a time when Democrats stood for a strong push in the direction of microeconomic interventionism and macroconomic expansion, policies many of which in recent decades have been found inconsistent with good economics.

I think Franklin Roosevelt was a Great Leader in a time that sorely needed it. But, if the truth be known, many economists today would say that his economics were not the best. I would prefer to say that the confident leadership he projected, and some of his policies, were appropriate for such extreme circumstances as the Great Depression and World War II, but some of the reforms he put in place were no longer been appropriate half a century later. It's not so much the Keynesian fiscal policies or taking the currency off gold as the microeconomic policies – such discretionary macro policies were a "plus" until abused 25 years later. It is more the institutional innovations that deliberately made the economy less competitive, discouraging competition in both goods and labor market (e.g., by suspending anti-trust proceedings), enacting agricultural subsidies, those war time wage-price controls, and so on. And of course the argument in favor of expanding the safety net for the elderly, disabled, jobless and destitute was far stronger at a time when the safety net of the status quo was almost non-existent than today, a time when most retirees are better off than most workers.

As recently as the 1960s, one would still say that the Democratic policy stood for big government, budget deficits, expansionary monetary policy, while the Republicans carried the torch representing macroeconomic discipline and laissez faire. But my thesis is that ***Republican and Democrat Presidents Have Switched Economic Policies.***[6] This is a surprising secret, though it has long been in plain sight. When it comes to White House economic policy, the Republican and Democratic parties have switched places since the 1960s.

By now the pattern is sufficiently well established that the generalization can no longer be denied: The Republicans have become the party of fiscal irresponsibility, trade restriction, big government, and bad microeconomics. Surprisingly, Democratic presidents have – relatively speaking -- become the agents of fiscal responsibility, free trade, competitive markets, and good neoclassical microeconomics. This characterization sounds wrong on the face of it. Certainly it is not to be found in the two parties' rhetoric. But just compare the actual records of Presidents Carter and Clinton versus Nixon, Reagan, and Bush II. Such a comparison is facilitated by reading what those who participated in the last two decades of White House economic policy-making have to say about the specific decisions made.

A simple look at the federal budget statistics shows an uncanny tendency for the deficit to rise precisely during Republican presidencies. There is no mistaking the link between the Reagan and Bush tax cuts legislated in 1981 and 2001, respectively, and the dramatic shift in the long-term budget outlook that each engendered. In between the two, record surpluses were achieved by the end of the Clinton Administration. Although many factors determine the overall budget, two deliberate steps were key to this achievement:

- first, Clinton's 1993 budget package, which established new trends for spending and tax revenues such that the two paths converged later in the decade; and,

[6] An abridged version of this article appeared as "Trading Places," in the *Financial Times*, Sept. 13, 2002. An expanded version appeared in *Milken Institute Review*, 1st Quarter, 2003.

- second, his 1998 “Save Social Security first” strategy, which successfully blocked Congressional desires either to cut taxes (Republicans) or raise spending (Democrats) and thus preserved the new surpluses. The history is clear in a 2002 book containing recollections by such Clintonite figures as Rubin, Summers, Tyson, Barshefsky, Sperling, and Reich, together with Republican counterparts and neutral observers (*Amer.Ec.Pol. in 1990s*).

Almost overnight, the Bush Administration threw away long-sought and hard-fought budget balance. The projected cumulated 10-year budget was a surplus over $5 trillion in January 2001, and is now – if done at all honestly – a deficit of over $5 trillion.

[see BD chart]

How did the Republican Party, long associated with fiscal conservatism, come to preside over so large a deviation from good economic policy?

The list of examples over the last quarter century extends well beyond the budget.

- Republicans are supposed to place more emphasis on fighting inflation. But, in practice,
    - Arthur Burns notoriously collaborated with the White House to get Nixon reelected in 1972 by producing a monetary policy that ultimately re-ignited inflation. Similarly (as reported in Bob Woodward’s *Maestro*),
    - Presidents Reagan and Bush I pressured the Fed to ease up on monetary policy, while
    - Clinton deliberately and unprecedentedly let Alan Greenspan do his job
    - I suspect that the current White House may secretly have put similar pressure on Greenspan (even though no hints of this have been reported anywhere); this would explain the extraordinarily low interest rates of the last four years, and the otherwise-puzzling comments of Greenspan that have been perceived as supporting the Bush tax cuts.

- Republicans are supposed to support small government, but
    - federal employment rose under Presidents Nixon, Reagan and Bush,
    - and shrank under Clinton.
- Republican presidents have been big on free trade rhetoric. But their actions have in fact been protectionist, judged not just by some politics-free ideal, but as compared to the record of Clinton. Highlights include
    - The 1971 “Nixon shock”, in which he imposed a 10% surcharge on imports and embargoed essential foodstuffs to Japan. (This was part of the same New Economic Policy announced in September 1971 that included the wage price controls and the abandonment of the Bretton Woods monetary system.)
    - Ronald Reagan’s “voluntary” export restraints on autos.
    - George W. Bush’s tariffs on steel
- the trend toward deregulation that most imagine began in the Reagan Administration?
    - It actually began in the Carter Administration – in airlines, trucking, natural gas, and banking.

    - Reagan at best continued the trend.
- These characterizations are shared by economists from across the political spectrum, as is clear in both the 1990s *AEP* book, and in the earlier 1980s book on which it was modeled. The current administration's support of large subsidies to agriculture and to exploitation of natural resources takes the pattern to further heights.

This is not to say, of course, that Democratic presidents have done everything right, nor Republican presidents everything wrong.

- Jimmy Carter's initial energy policy and Bill Clinton's initial health care policy were misguided.
- Ronald Reagan's firing of the air traffic controllers, who were striking in violation of their contracts, was much admired by economists.
- George H. W. Bush's 1990 decision to revoke his "no new taxes" campaign pledge was a brave step, which ranks of equal importance with Clinton's two measures, in establishing a path toward eventual budget balance.

Nevertheless, it is striking how many examples go the other direction, and how seldom expressed is that assessment.

If Republican and Democratic presidencies have indeed reversed roles, what is the explanation? I am not sure. After all, the Democrats in Congress, on average, are still less supportive of free trade and small government than the Republicans. Perhaps an explanation stems precisely from the fact that Democrats remain saddled with the image of big government. For that reason wary voters would never elect a Democrat president in the first place, unless he had specifically exhibited the will and ability to grapple effectively with the problems of government's role in the economy. The public seems willing, however, to accept Republican presidents who believe that it is enough to adopt the rhetoric of small government, even while their actions have the opposite effect.

It is easy to fall into the trap of thinking that governing is easy. Governing is not easy; it is very difficult. If a presidential candidate believes that everything is a simple question of good versus evil, then he is not prepared for the painstaking work of acquiring detailed information, making logical analysis of tradeoffs, and confronting difficult political interest groups. But that is what intelligent economic policy decisions in Washington require.

If a president takes office thinking that good policymaking is a simple matter of declaring his desire to oppose evil-doers, favor small government and eliminate "waste, fraud and abuse," he is ill-prepared for the complexities of the job. Excessive size and interventionism of big government come about, not primarily because of moral failings of Washington politicians and bureaucrats, but rather because we, the citizens, each want something from the government. Most farmers truly believe that they oppose big government, but that "farm supports are different." The same is true of loggers, steelworkers, energy executives, and every other interest group. Resisting the appeals of such specific interests well enough to safeguard the welfare of the whole requires more than that the president give small-government speeches. It even requires more than that he sincerely believe that he favors small efficient government. It requires hard work, knowledge, ability to absorb and synthesize facts, analysis, ability to communicate, and willingness to trade off issues when constraints make it appropriate while taking unpopular stands when required.