Economics:

WHY ECONOMISTS DISAGREE

Only a few years ago, the United States seemed destined to enjoy endless good times. The 1950s were marred by two brief recessions, but unemployment averaged only 4.5 percent, inflation two percent. By 1965, the pace of annual economic growth had nearly doubled, climbing to 6.5 percent, and unemployment and inflation remained near their old levels. It seemed that Washington's economic sages had hit upon a magic formula to ensure growing prosperity for all. But within a decade, chronic stagflation had set in, exacerbated by the 1973–74 oil price "shocks," defying all predictions and cures. The high interest rates and severe recession of 1981–82 now stir new quarrels among economists. Here, James W. Dean tells what went wrong and what happened to the magic—if there ever really was any.

by James W. Dean

Economists have always disagreed among themselves, but until recently, no one much noticed.

Of course, history records exceptions. A dramatic example was the presidential campaign of 1896, when Democrat William Jennings Bryan immortalized the evils of tight money tied to a gold standard with the phrase "Cross of Gold." Today, ringing references to economic theory again fill the air, and last year the President even created a Gold Commission to contemplate resurrection of the Cross.

No presidential campaign since 1896 brought questions of economic theory so directly to public attention as did the 1980 Carter-Reagan contest. And the debate continues. When before has so academic a scandal as Doubting David Stockman's public confession about "supply-side" theory caused such a political uproar? When before did local newspapers lampoon the Federal Reserve? When before was the *New Yorker* inspired to run regular cartoon coverage of Keynesians and monetarists sparring

over family breakfast or in corner bars?

As an economist, I can no longer enjoy cocktail parties without being harassed by jazz dancers and interior decorators seeking a shepherd through the murky world of economic theory, of whose very existence they were, until recently, mercifully ignorant. What guidance can one offer the principled and sincere young dancer who contemplates, soon after the second television episode of *Free to Choose*, lifelong commitment to monetarism and Milton Friedman? And will her commitment falter after she reads Harvard's John Kenneth Galbraith, who is wittier but a Keynesian? Or when she discovers anti-monetarist letters to the *New York Times* by James Tobin of Yale, who is, like Friedman, a Nobel Laureate?

Welcome in Washington

Can there be truly serious theoretical disputes between *Nobel Laureates* in economic science? Or is the argument merely empirical? Or perhaps political?

Of course, it is all three. Empirical disagreements—arguments over facts and figures—are to be expected in any social science, where controlled experiments with indisputable outcomes are impossible. And political disagreements are predictable whenever policy choices must be made. It is harder to explain why economists today, more than 200 years after Adam Smith codified the principles of economics in *The Wealth of Nations* (1776), should find themselves in such deep disarray over theory.

The truth is that the postwar era up to the late 1960s was a time of unusual consensus among economists. With the exception of a few eccentrics from the University of Chicago and the Austrian school, economists considered themselves "neo-Keynesians." Confined to academia, none of this would have mattered very much. But after World War II, politicians vowed not to repeat the Great Depression, and they expanded the New Deal practice of bringing economists to Washington to serve as advisers. Of course, almost all these economists agreed that government could keep the economy healthy and foster steady growth by using neo-Keynesian "fiscal fine-tuning" techniques—continually adjusting government spending and taxes to keep aggregate demand steady, avoiding both inflation and recession..

This notion suited Congress and the White House. With the Employment Act of 1946, the federal government committed itself, at least on paper, to fiscal fine-tuning methods to contain

the jobless rate. Economists gained new prominence. The White House had acquired its first full-time economic adviser in 1939; seven years later, it added a three-member Council of Economic Advisers to counsel the President. Congress established its Joint Economic Committee in 1946 and added the Congressional Budget Office in 1974. By then, the number of economists on the government payroll had reached 4,300.

The New High Priests

The consensus that reigned among economists first took shape during the late 1940s, aided by the invention of electronic computers and the publication of Paul Samuelson's best-selling textbook, *Economics*, in 1948. Samuelson introduced the "neoclassical synthesis," which seemed to reconcile the thought of the neoclassical followers of Adam Smith with the economics of England's John Maynard Keynes. Smith believed that an economy, if left to itself, would be guided by an "invisible hand" toward a natural and widely beneficial equilibrium; Keynes, writing during the Depression, contended in his *General Theory of Employment, Interest and Money* (1936) that markets could seriously malfunction, leaving workers without jobs, consumers without income, and businesses without sales. As codified by Samuelson's textbook, neo-Keynesian conventional wisdom emphasized that markets could be relied upon to function much as neoclassical theory promised, as long as aggregate demand (i.e., spending by individuals, business, and government) was sustained. Unemployment, curse of the Depression years, could be reduced to some "hard-core" rate—for example, three percent—by stimulating the economy, chiefly through government spending or tax cuts.

Samuelson's textbook ended, at least temporarily, the great theoretical debate among economists. They turned to their new computers to engineer the application of neo-Keynesianism or to toy with elaborate mathematical models of the economy.

In 1958, a new twist—or rather, curve—was added to the economist's grab bag by Professor A. W. Phillips, a New Zealander then at the London School of Economics. According to

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"Good news! It's not a novel. It's economic theory."

the "Phillips curve," there is an inevitable tradeoff between inflation and employment: To get less of one, economies must suffer more of the other. For some reason, economists, unlike the rest of us, invariably welcome such Calvinistic reminders that the good things in life (low inflation) can only be obtained at great sacrifice and pain (unemployment). The Phillips curve quickly became a centerpiece of neo-Keynesian doctrine.

The aura of consensus was fostered by a period of benign prosperity. By the mid-1960s, not only had America reached a level of affluence unprecedented in human history, but also boom-and-bust business cycles seemed to be licked. Economists proclaimed themselves high priests of social engineering. Their success, and their methods, seemed beyond dispute. "It is possible to see at last," City University of New York economist Robert Lekachman wrote in 1966, "that Keynesian economics is not conservative, liberal, or radical. The techniques of economic stimulation and stabilization are simply neutral administrative tools." A few moral souls—Barbara Ward, Gunnar Myrdal, John Kenneth Galbraith—preached against the evils of income inequality, but by and large, the community of economists was

congenial, though something of a bore.

This is not to say there were no dissenters. In 1956, Milton Friedman, a prominent neoclassicist at the University of Chicago, published "The Quantity Theory of Money—A Restatement." The "Restatement" elegantly revived pre-Keynesian theory, laying the groundwork for a counterrevolution. Friedman challenged, head-on, Keynes's argument that if more money were put into circulation it might simply be hoarded, not spent. Instead, Friedman argued that "money *matters*." Like any other good, it decreases in value when plentiful and increases in value when scarce. Pumping too much money into the economy would spur inflation; reining in the money supply too rapidly would cause unemployment and recession.*

Then, in his 1959 *Program for Monetary Stability*, Friedman offered a prescription for government policy: the fixed monetary growth rule. The Federal Reserve Board, Friedman argued, should increase the money supply by a fixed rate of three to five percent annually to promote stable economic growth. His underlying idea harked back to Adam Smith: The private sector is self-stabilizing. Economic instability results primarily from government's fiscal, monetary, and regulatory actions. Keynes had suggested just the opposite.

JFK's Gamble

From Chicago and elsewhere poured reams of supporting evidence, forcing most economists to agree by the late 1960s that money is considerably more important than the Keynesians had first claimed. In 1968, the conservative Swiss-American economist Karl Brunner christened Friedman's Chicago-school economics "monetarism."

Meanwhile, back in the real world of 1968, postwar history seemed to have confirmed the success of neo-Keynesian fiscal fine-tuning. Granted, the 1950s had been prosperous without benefit of explicit Keynesian policies: President Dwight D. Eisenhower was a fiscal conservative who believed in balanced budgets. But that was the decade when America supplied a gradually reviving Western Europe with its exports, helping to sustain aggregate demand at home. Moreover, despite Ike's reluctance to fine-tune the economy, automatic stabilizers such as unemployment insurance (which buoyed demand when the economy turned sluggish) and progressive tax rates (which

*In his 1963 magnum opus, *A Monetary History of the United States*, co-authored with Anna Schwartz, Friedman argued that the Depression of the 1930s could have been avoided had the Federal Reserve Board pumped out enough money in time.

skimmed off excessive demand when it picked up) were already in place, along with federal public works programs.

John F. Kennedy was the first President to try deliberate neo-Keynesian policies. "In the early 1960s," Paul Samuelson later observed, "the United States government, for the first time in its history, *explicitly tried to add to a recession deficit in the interests of higher employment and growth*." Federal fiscal policy, particularly the famous $10 billion tax cut planned by Kennedy and enacted in 1964 under Johnson, was probably responsible for the sustained real growth (an average of 5.2 percent annually) and low unemployment of the Kennedy-Johnson years.

"Policy Nihilism"

Toward the end of the 1960s, however, things began to come unglued. Fearful of losing his Great Society social programs, Lyndon Johnson shied from putting the issue of financing the Vietnam War before Congress; he avoided raising taxes and refused to sell new Treasury bonds on the open market for fear of pushing up interest rates. Instead, he pressured the Federal Reserve to create new money to buy the bonds. The monetarists' warnings seemed to be confirmed: Inflation went from 1.7 percent in 1965 to 5.4 percent in 1969. In 1968, Johnson tried to combat inflation with a standard Keynesian tax tool—a 10 percent income-tax surcharge to lessen demand—and failed. Still worse, unemployment was rising too, contrary to the predictions of the Phillips curve. Events had outstripped theory. The neo-Keynesian orthodoxy was beginning to falter.

In a well-timed presidential address to the American Economics Association in 1967, Friedman unveiled a "new" Phillips curve (developed almost simultaneously by Edmund Phelps). There is, he contended, a "natural" rate of unemployment, unrelated to the rate of inflation. Furthermore, aggregate demand could be trimmed only by reducing monetary growth. Less money, therefore, would eliminate inflation without, in the long run, raising unemployment; more money would generate inflation without any long-run payoff in reduced unemployment.

Though the "new" Phillips curve did not necessarily imply that unemployment and inflation would rise simultaneously—giving us stagflation—it did seem to help explain it. Since employment in the long run was determined by supply alone, the swelling numbers of new workers during the late 1960s and '70s—the housewives and the maturing children of the Baby Boom entering the work force—had probably raised "natural" unemployment. Government policies—minimum wage laws

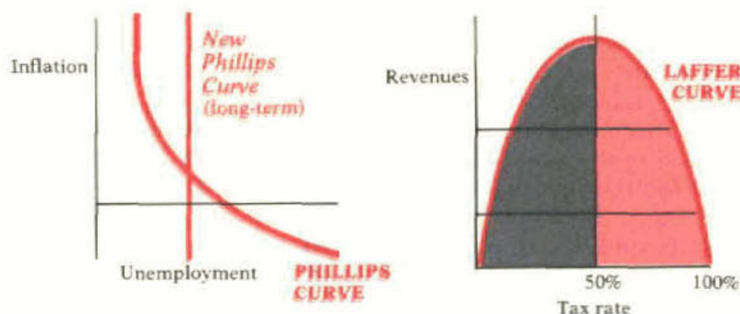
and unemployment insurance—that interfered with the natural workings of the market boosted the jobless rate higher, and "misguided" Keynesian pump-priming attempts to maintain unemployment at the old, lower rates simply added to inflation without permanently increasing the number of jobs.

What was so startling about Friedman's argument was that it denied the efficacy of the Keynesians' most basic policy prescription—stimulating demand to reduce unemployment. In his view, *no* form of demand stimulus could keep unemployment below its "natural" rate. Government could do little about unemployment and was best advised simply to provide stable monetary growth and to leave markets to function for themselves. An age of "policy nihilism" had begun.

Within 10 years, policy nihilism—passive government economic policy—was being seized upon by politicians, not all of them conservatives but all eager to avoid responsibility for stagflation. By the spring of 1978, even the Labour Prime Minister of Britain, James Callaghan, could be heard disclaiming his government's responsibility for unemployment.

At the August 1978 American Economic Association meetings, I asked 15 prominent economists whether unemployment, then at 5.9 percent (almost three points above the old "hard-core" rate) was at, above, or below its "natural" rate. A majority answered "at or below," implying that demand should be either left alone or geared down to avoid boosting inflation.

Economists from the depleted liberal ranks argue that their



At left, the unemployment-inflation tradeoff as seen by Keynesians (the Phillips Curve) and monetarists (the "new" Phillips Curve). Economists do not know where the two actually intersect. According to the Laffer Curve, either a high or low tax rate can yield the same revenue.

conservative colleagues, in their preoccupation with the natural rate of unemployment, have performed a serious social disservice. The "naturally" unemployed, they argue, are really victims of "structural" unemployment—a mismatch between job openings and the skills and aptitudes of job seekers. Their conservative counterparts prefer to think of unemployment as an extended but voluntary "search" for work.

At the bottom of this controversy is a philosophical question: What constitutes free choice? If the "naturally" unemployed were willing to change occupations or their location, or work for wages close to what they receive in welfare benefits or unemployment insurance, many could find jobs. But is such unemployment truly "voluntary"?

How to Work Wonders

The conservatives also argue that many of the "naturally" unemployed are mere youngsters who will find jobs once they grow up; others are wives who bring home "second" incomes. The implication is that we need not be deeply concerned about the fate of either group. But do youths or wives seek work with less zeal or compulsion than do their elders or their spouses?

There is little question that economists (with some notable exceptions) swung markedly to the right during the past decade. A generation of economists under 40—christened by *Newsweek* in 1978 "the new economists"—have explicitly rejected the Keynesian canons that stirred them during the 1960s. "We were good Keynesians once," declared University of Minnesota economist Thomas Sargent, "but we had to change our minds." Many in the older generation have also moved to the right. Most of the 15 doyens I interviewed in 1978 said they had retreated from fiscal activism, crediting their latter-day wisdom to a combination of old age, unhappy events inconsistent with Keynesian theory, and even the immutable advance of logic.

While the revised thinking on the tradeoff between unemployment and inflation is its most obvious manifestation, the intellectual retreat from neo-Keynesianism is far more fundamental. At the 1978 American Economic Association meetings, the prestigious Ely Lecture was delivered by Cornell's Alfred Kahn, who as chairman of the U.S. Civil Aeronautics Board had just dramatically deregulated the airlines. Kahn—something of a performer—was roundly applauded. To those I interviewed afterward, the lesson was clear: Sweeping deregulation throughout the U.S. economy would work wonders.

These days, economists' new love affair with "noninterven-

tionism" springs less from ideological commitment than from pragmatism. There is a growing recognition among economists that government often just cannot deliver on its promises, or can do so only by incurring unconscionable costs. For example, Murray Weidenbaum, now chairman of the Council of Economic Advisers, estimated in 1977 that it costs business $100 billion annually to comply with federal regulations—far more than the value of any benefits that might conceivably be reaped. Harvard's Martin Feldstein argued that the prospect of receiving Social Security benefits reduces incentives for younger families to save, thereby shrinking the pool of funds available for investment. And University of Southern California economist Arthur Laffer has become famous for his controversial "Laffer curve," which expresses the notion that rising tax rates discourage production by individuals and firms to such an extent that Washington has less to tax and reaps less revenue.

Thus, the 1970s saw the birth of "supply-side" economics. The supply-side credo is plain: Cut taxes and deregulate business to stimulate work effort, saving, investment, and productivity. The idea is to promote a greater *supply* of output, in contrast to the more indirect Keynesian strategy of stimulating *demand* to induce an expansion of output.

Out of the Closet

High taxes are not a necessary consequence of Keynesian theory, but in practice Keynesian economists often favor stimulating the economy by increasing government spending rather than cutting taxes. Also, the Keynesian "fine-tuning" mentality may have fostered a greater willingness in Congress and the White House to intervene in the economy. Keynesians thus got a good deal of the blame for what had gone wrong.

Supply-side economists found a home in Ronald Reagan's White House. Reagan, like Moses before him, held out to his people a Promised Land. It was to be a Promised Land of Low Taxes and Rapid Economic Growth. It was also to be a Promised Land Without Inflation so that monetarists, too, found a happy home with Reagan. But domestic disputes were inevitable. The monetarists advocated tight money. The supply-siders hoped for a quick stimulus; the more fervent and naive even expected tax revenues to rise, Laffer-like, soon after tax rates were cut.

But tax cuts coupled with tight money have produced precisely the opposite effect. Tax revenue has fallen below projections, and so has the growth of GNP. The federal deficit has ballooned, and so, consequently, has Washington's need to sell

bonds. With monetarists at the Federal Reserve keeping credit tight in order to fight inflation, interest rates can only skyrocket. As a result, business and consumer demand have been throttled. We are witnessing today the bizarre spectacle of demand-side *restriction* exacerbated by the attempt at supply-side *stimulus*. By fueling high interest rates, the most pro-business administration since Herbert Hoover's is crowding out private investment (albeit unintentionally) in favor of public spending.

Eventually—and this is the only point at which supply-side and monetarist policies can converge—a recession (or depression) will break not only *current inflation* (as it is beginning to do) but also *expectations of future inflation* (which it has not yet done). This will bring interest rates down, as lenders stop demanding high returns as insurance against future inflation. Then, investment may recover, and with it the economy.

Meanwhile, the rift between supply-siders and monetarists widened. President Reagan, in his monetarist incarnation, castigated Federal Reserve Board Chairman Paul Volcker for failing to dam the country's river of credit. But Representative Jack Kemp (R.-N.Y.), the consummate supply-side politician, called on Volcker to resign because his money policy was too restrictive. Thus, Congressman Kemp was exposed as a closet Keynesian. Suddenly, he wanted to stimulate not supply, but demand, by loosening the reigns on monetary policy. Keynes' message was that supply does not, in the *short* run, create its own demand. "In the *long* run," he wrote, "we're all dead."

That snippet from Keynes has been repeated so many times that it now seems trite, but it is a major clue to why economists disagree. Differences over short- and long-run perspectives are behind a surprising range of controversies among economists, cutting across issues of theory, "facts," and politics.

Guessing Games

The supply-side controversy, for example, was opened by Keynes 50 years ago when he questioned the validity in the short run of Say's Law. This proposition—first articulated by the French economist Jean-Baptiste Say in 1826—states that supply creates its own demand. An excess supply of goods or workers, for example, can never develop since prices and wages will always fall until they are all purchased or everyone gets a job.

Keynes observed that prices, and especially wages, do not fall rapidly in the short run, just because aggregate demand falls and unemployment rises. Similarly, as Congressman Kemp has divined, lowering taxes to stimulate the *supply* of goods and

services does no good unless the Federal Reserve fuels *demand*.

Short- versus long-run issues underlie the Keynesian-monetarist controversy, as well. Keynesians such as James Tobin favor the employment and output gains that come from stimulating demand, whereas monetarists such as Milton Friedman are convinced that such gains are only temporary and that stimulation only causes inflation in the long run.

Why such disagreement over the relative importance of the short and long runs? Increasingly over the last decade, economists have formulated theory in terms of *expectations*. The "new" Phillips curve, for example, suggests that high unemployment in the wake of monetary restriction is a result of workers' expectations that the respite in inflation is only temporary. They keep their wage demands high and employers, faced with lower revenues but steady costs, cut payrolls.

God, Khomeini, and the U.S. Economy

The stoic monetarist response calls for continued tight money—and thus continued high unemployment—to break inflationary expectations. It hinges on the faith that inflationary expectations can be broken before the economy, and perhaps society itself, cracks under the weight of the unemployed. Such cherubic faith was neatly parodied last fall by Bob Rae, then a member of the Canadian Parliament, who rewrote a passage from Peter Pan: "If we all get together and *really believe* that inflation will come down, that jobs will be created tomorrow, if we close our eyes and wish *ever so fervently*, then it will happen."

If inflationary expectations could be broken, the supply-siders' dream might come true, too. Interest rates would decline; investment would rise. It was faith that inflationary expectations would come down quickly that fostered an alliance between monetarists and supply-siders during President Reagan's first few months in office. And when it became clear that this would not happen quickly, the supply-siders called for a new Cross of Gold (gold standard) to do the job. The monetarists demurred, convinced that a steady tight money policy alone would eventually break inflationary expectations.

Why did economists seem so successful until the 1970s, and why have they seemed so unsuccessful since? Much of the answer has to do with the predictability of expectations.

Throughout the 1950s and '60s, the macroeconomic facts of life—inflation, unemployment, the growth of GNP—were remarkably stable. Economists did not need to be soothsayers. They could confidently create computer models of the economy

and base their projections of the future on extrapolations of what happened in the past. The long run could be expected to be more or less an extended version of the short run. Similarly, the effects of economic policies did not hinge nearly so much upon public expectations, since these stayed within a narrow range.

This benign world broke down with the Vietnam War deficits of the late 1960s. These not only overstimulated an economy already running near full capacity, but, because they were financed with new money, fueled inflation as well. Lyndon Johnson's 1968 tax surcharge failed to reduce inflation over the short run because the public (correctly) expected it to be a one-shot treatment, not a permanent curb on demand, and therefore kept buying (and pulling up prices) as before.

Johnson and Nixon kept the money supply and inflation at unprecedented levels well into the 1970s. A second layer of inflation was added with the drastic food, commodity, and oil price increases of 1973–74. By the mid-'70s, expectations that inflation would persist at high levels were deeply entrenched, reflected in wage demands and long-term interest rates.

What it will take to change these expectations is anybody's guess. In building computer models of the economy, economists must predict such things as how rapidly prices will change and how much business will invest. These predictions, in turn, depend on educated guesses about how rapidly people adjust their expectations to new conditions (e.g., will bankers ease long-term interest rates when inflation seems to decline?) and how optimistic (or pessimistic) businessmen are about future demand. Again, millions of individuals' expectations play a key role. Yet our ability to predict how these expectations will change is woefully inadequate.

What economists *can* do is provide orderly models of a relatively unchanging economy. As long as acts of God and the politicians are infrequent and relatively unimportant, such models can be used to test the effects of various policies and even to make rough predictions for the near future. But in a world reeling from the acts of Lyndon Johnson, Sheik Yamani, and the Ayatollah Khomeini, even this modest role becomes impossible. Economists find themselves reduced to diviners of the public psyche. Little wonder they disagree.