Viewpoint

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New Approaches to Economic Policy

IT WAS THE BEST of times. From 1900 to the 1970s there was unprecedented economic growth and unprecedented improvement in the living standards of the common man in advanced democratic countries. Real wages were increased three to five times, weekly hours of work were reduced by 25 to 35 percent, and life expectancy went up sharply. Average years spent in education grew substantially. These countries became welfare states offering a spectrum of public and private policies designed to protect workers, employees, and citizens from the risks of illness, retirement, accidents, disabilities, and involuntary idleness, and to facilitate access to housing, education, and training. Collective bargaining and worker participation in the decisions of the work place grew to major importance.

Then suddenly, in comparison, it seemed the worst of times. The advanced democratic societies confronted markedly higher energy costs, adverse impacts from the insistent aspirations of developing countries, conflicts and incongruities among their economic plans, slow growth, and continuing inflation and unemployment. In the eight years from 1970 to 1977 consumer prices in the United States rose at 6.5 percent per year and unemployment averaged 6.3 percent. The fact that real hourly earnings in the private sector had not recovered by 1977 to the 1973 levels created doubt that the economy or economic policy-makers could ever again produce a doubling of living standards every generation.

Perhaps the experience of the 1970s—this climacteric, watershed, or aberration as you like—has its roots in the premise that economic policy is somehow capable of determining and, by its own will, producing desirable results with regard to growth, unemployment, and inflation. In any event, the premises of government's role in economic policy require brief comment.

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Politics, Policy, and Government Penetration

A prime role of the political process is to articulate the common aspirations of the people. This function is not to be demeaned by technicians or administrators, but neither are the aspirations to be confused with reality or with the possible. In collective bargaining, the parties each develop their bargaining proposals or dream books, but in mature relations no one confuses demands with reality to the extent that politicians do in the economic arena.

Economic policy has been historically conceived in the main as concentrated upon fiscal and monetary measures. Economic growth, unemployment, and inflation have been assumed to be shaped through these classical policy instruments, while the rest of the economy has been assumed to be dominated by private decisions adapted to the general economic environment shaped by general government policies.

The economy of the 1970s, however, has been characterized by significant growth in direct government involvement in individual markets and in the decisions of enterprises and groups. The detailed involvement of public agencies in pricing (as in agriculture, in public utilities, and through incomes policies), the vast expansion of regulation in the areas of health, safety, pensions, environment, standards of service, and discrimination, the detailed negotiations of international trade arrangements, and the regulation of wages and working conditions now far exceed previous experience. Given this unparalleled expansion in the scope and detail of government penetration into private decisions, including collective bargaining, previous assumptions about government and economic policy are probably no longer valid.

At least two features of this new penetration, at any rate in the United States, deserve attention. First, there have come to be so many new political and legal centers of decision-making, uncoordinated by the market or by a central political force, that they have created vast uncertainties that private parties have been unable to comprehend or incorporate into viable plans. Consider the state of legislation, regulation, and litigation relating to energy or to the environment, and it becomes clear that the uncertainty of private decisions has been enormously increased. Second, the deep penetration of government regulation introduces a short-term perspective, reflecting the tendency for political considerations to change frequently and for government policy officials to have a short tenure in office.

Since government economic policies today (beyond general fiscal and monetary measures) include a host of specific measures and regulations, without central direction, the notion that government is a single or coordinated decision-maker defies reality, at least in the United States. The result is a new, strange, and often hostile economic environment for growth, employment, and price stability.

The traditional tools of macroeconomic analysis do not suit a world of pervasive and penetrating government. When product and labor markets already reflect governmental interventions, they do not readily respond to general fiscal and monetary policies. Indeed, the whole complex of internal and external governmental interventions so complicates analysis that prediction of the consequences of general policies becomes hazardous, and the general economist, whether attached to the Treasury, a central bank, or an economic planning agency, becomes less useful.

New Approaches to Economic Policy-making

The approach of the last generation has been dominated by aggregate technical economic concepts—among them the Phillips curve and Okun's law. But in the 1970s aggregate quantities and relationships have often proved misguided, if not treacherously misleading.

To put it briefly, economic policy-making would do well to adopt an approach characterized by five somewhat neglected elements. This approach should supplement, not displace, appropriate fiscal and monetary policy.*

(1) Analysis needs to be sectoral as well as aggregative. Agriculture, energy, housing, industrial goods, and health services, for instance, must be understood not only separately but in their reactions upon other sectors. The elements of wage and benefit setting, price determination in various sectors, and the consequences of direct governmental regulations and tax measures must be incorporated in the analysis.

(2) The approach must be institutional as well as analytical. To prescribe regarding wages without an understanding of collective bargaining and the policy-making processes of large nonunion enterprises and all small businesses is to invite wide errors, unreality, and unnecessary hostility.

(3) The approach must be political, to a degree, as well as economic—"political" in the sense of being grounded in the art of the possible, and particularly the possible consensus among large elements of the relevant groups. This is not to rule out an occasional good fight but to emphasize that the political process can tolerate relatively few serious contests.

(4) The approach must involve both domestic concerns and, as never before, an international perspective. Inflation in some major elements has been a worldwide phenomenon; economic growth in many countries is significantly affected by the domestic and trade policies of trading partners.

(5) There must be less resort to direction ("command and control") and regulation and more to consensus building and persuasion. Consensus building requires not merely broad general public support but participation and de facto acceptance by major interest groups —including large and small business, labor,

*As George P. Shultz has noted, "The great vice of wage and price controls is not so much that they work poorly or that they are an inappropriate response to inflation as it actually occurs in our economy, but rather that they induce government to relax monetary and fiscal policy" (in George P. Shultz and Kenneth W. Dam, *Economic Policy beyond the Headlines*).

and others. The politics of the electoral process (including television) may yield vote pluralities but only consensus building with major groups can produce the capacity to govern in the field of economic policy.

Policy and Program Areas

There is an enormous world of studies, reports, and pronouncements on the subject of growth, unemployment, and inflation in our times. My present purpose is to give a view on these issues which reflects my experience, without being unduly concerned as to the general acceptability of these judgments.

Inflation is not just a single malady with a single treatment. Each period of rising prices and wages in the postwar world has been quite distinctive. In 1946–48, there was a pent-up surfeit of liquid assets searching for scarce goods in the aftermath of war. In 1950–51, there was a sudden change of price expectations in world primary markets as a consequence of the sudden onset of the Korean War. In the late 1950s, there were cost pressures arising from large wage settlements that carried over to periods of soft demand and higher agricultural prices. In the late 1960s, there was insufficiently tight fiscal policy in the face of large expenditures associated with the Vietnam War. In 1972–73, there was a variety of factors including agricultural developments, monetary policy, the oil embargo, and the dollar devaluation. The basic point is that policy must recognize the special features of each period of inflation. A single prescription is not likely to be appropriate.

There are important structural respects in which the economy has now entered a period of greater inflationary pressures. It has been recognized for some years that money compensation always moves upward in the modern society, the social costs of downward adjustments being too great. But it has not so clearly been recognized that periodic bursts of inflation in agricultural prices, housing costs, and local taxes get more and more "baked in" with higher property values rather than being generally reversible. Lower rates of productivity (arising from a variety of factors including changes in the composition of the labor force), social charges for environmental and other concerns, higher energy prices, and low capital formation all contribute to compensation increases being translated into higher prices.

I agree that governments should regularly discuss basic issues (the course of prices and wages, unemployment, economic growth, and appropriate policies) with the organizations representing business and labor—though I have difficulty with the 1977 statement of the OECD committee of experts that links the discussions with a target or guideline for wages and prices, which I oppose. But whatever that maligned term "incomes policy" may mean in the United States, there appears little likelihood—in the absence of a genuine emergency—of policy agreement among labor, management, and government in the foreseeable future. Moreover, if incomes policies simply try to reduce wages or price increases, leaving everything else the same, little if anything can be accomplished. The successful voluntary programs are those that induce changes in the underlying factors, something that requires consensus.

In the United States, formal government controls with a tripartite board are a more likely course of development than the sort of structural changes that would be required in the national levels of labor and management organizations to make an incomes policy based on these organizations at all administrable. With nine years of experience administering wage and price controls in the United States, I am simply not an advocate.

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Rather, on the wage and benefit side, we should seek to bring about (1) reform in the structure of bargaining so as to reduce rivalries and "leapfrogging," (2) the elimination of outdated work rules, practices, and manning requirements, (3) reform in methods of wage payment, (4) the improving of productivity in other ways, (5) the recasting of fringe benefit packages and their financing, (6) improvements in labor supply and training, and (7) specialized agreements to meet the problems of particular branches or plants in an industry. Programs of this sort take time to develop and require cooperation and trust and personnel with detailed sectoral knowledge. They cannot be imposed by government jawboning or arm-twisting. They can be developed only by persuasion and by imaginative and patient leadership.

On the price side, the future course of prices can be affected by (1) giving early attention to capacity needs, as revealed by discussions of potential bottlenecks; (2) encouraging government programs that enhance rather than restrict supply; (3) stimulating investment and cost-reducing outlays; (4) attending to the "interface" areas where manufacturing, transportation, and finance meet; and, particularly, (5) attending to government activities and regulations which create uncertainty and increase costs unnecessarily.

Let me turn briefly to other areas. The last decade has certainly demonstrated that unemployment is not a simple target of policy. The labor force is susceptible to a variety of short-run and long-run influences that make prediction and policy prescription most difficult. No single aggregate unemployment figure is appropriate as a guide to economic policies. Instead, we will need to look at labor market conditions by age, skill, locality, industries, and degree of disadvantage. It is not the aggregate measures but the wealth of detail that is relevant to appraising potential shortages and inflationary pressures arising within the relatively few decisive markets.

The targeting of public programs on particular categories of the labor force may be appropriate policy, but greater involvement of the private sector in job creation is necessary if good, continuing jobs are to be developed. Existing public service programs are in the main unsatisfactory, save as a method of income maintenance. We need new forms of nongovernmental organizations to provide training and to encourage job creation for the hard-to-employ.

With respect to growth, the stagnation of the economy since 1973 reflects, no doubt, many short-term and structural factors. The two elements that appear most significant to me are uncertainty in government policies on a variety of fundamentals (including energy, the environment, and regulatory conditions) and the resulting tendency for low levels of investment in modern plant and for concentration of investment outlays on machinery and equipment rather than on longer-run plant and developmental expenditures. In this climate of uncertainty, government economic policies, including fiscal stimulus, cannot have the favorable effects on the economy they have been presumed to produce.

Finally, I would note the unusual amount of controversy over international trade policy in the United States, reflecting deep concern over, first, trade involving Asian and Communist countries (particularly with regard to shipping and advanced technology items with security implications) and, second, trade involving labor-intensive items which threaten to displace large groups of relatively low-paid workers. The U.S. labor force includes very large numbers of low-productivity workers who cannot easily be converted to more productive activity and who are not willing to settle for displacement pay in various forms. Economic policy in this area requires imaginative attention to work out problems with those affected, not to mention skillful negotiations with our trading partners abroad. I fear we do not well understand how explosive these issues are.

The Watershed

The 1970s, in my view, constituted a watershed of economic policy, the difference in the United States deriving from the new and pervasive role of government and its adverse effects on growth and inflation. While there was, no doubt, "an unusual bunching of unfortunate events unlikely to be repeated on the same scale" (in the words of the 1977 OECD report), my judgment is that the difficulties are more fundamental. They relate to (1) the methods of making economic policy and (2) the substance of the decisions derived from the political process and from its massive new penetration into all manner of heretofore private economic activities. Neither private businesses nor collective bargaining agents nor governments have yet adapted—together or separately—to this new state of affairs: they seem to believe it is still the "best of times." ■