Rethinking Macro-Economic Policy

Abstract

The current macro-economic policy debate focuses on what may be called policy mechanics, i.e., specific policy actions. This essay argues that these actions are not nearly as important as the signals they and the accompanying rhetoric convey to consumers and businesses. The perceived signals may create responses by the private sectors that are contrary to the goals of the policy actions. Very often policy purveyors ignore the effects of these signals.

The goal of macro-economic policy is to alter human behavior in such a manner as to alleviate economic ills such as unemployment, inflation or slow economic growth. There is little or no progress on those goals if in the process of debating and implementing the policy the resultant signals convey how catastrophic current economic conditions are. Rational actors will react accordingly and retrench their spending plans. Individuals, businesses and financial institutions end up holding unusually large amounts of cash waiting for the economic fog to clear before pursuing future projects.

Successful policy requires actions that are perceived as new (or different) and permanent (or indefinite in length). Limiting Federal Reserve responsibility to what it can clearly and unequivocally accomplish and pursuing a fiscal policy, including meaningful tax reform, that relentlessly seeks a balanced federal budget may be the best that macro-economic policy can do.

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Appropriate fiscal and monetary policy has been the source of much recent debate with little consensus in sight. Unfortunately, the debate has focused on the mechanics of economic policy, e.g., increased spending, lowering tax rates, and something called Qualitative Easing, aka, monetizing the debt. Current economic policy primarily consists of errant quests to find the Holy Grail of economic policy that will right all wrongs.

With respect to monetary policy The FED is not in an enviable position as it does not possess the capacity to do all that it is charged to do, i.e., achieve and maintain high levels of employment, stable prices, economic growth and exchange rate stability. The FED possesses direct influence only over Reserves that, after a lag, will affect the money supply and hence prices. The FED may also influence interest rates through moral suasion and manipulating Reserves. It possesses little capability to affect short-term employment and economic growth. That is, the FED has the ability to affect nominal variables and has little or no affect on real variables such as productivity. Forcing the FED to try anyway increases the likelihood of future inflation. The Humphrey-Hawkins Act needs to be amended to reflect this economic realty.

Policy mechanics though important are simply means to an end. The end is altering human perceptions, expectations and, thus, behavior. Since 1936 Keynesians have assumed that government could modify human conduct using the same economic policy measures over and over again to achieve the desired results. Keynesians initially ignored the fact that most people most of the time behave rationally. All the people will not be fooled all the time. If tax cuts spur additional spending thereby inducing higher incomes and prices, people learn that tax hikes are not far behind and respond accordingly. The same applies for spending increases.

Equally or more important than policy mechanics are the signals that leaders of all political ilk emit by their policy actions. Policy makers scurrying around The Beltway claiming that the current economic climate is the worst since the Great Depression all the while advocating policy actions such as TARP, the ‘Stimulus’, and a myriad of other spending options sends a very loud message that conditions are not just bad they are calamitous. Individuals and businesses react rationally by cancelling or postponing major expenditure plans. Supplementing that message are announced intensions by the FED to monetize the debt an action normally reserved for the so-called “Banana Republics”.

What rational person or business wants to borrow/loan in such a climate? These signals lead to near perfect offsets to the simulative actions taken by policy makers. The net result on the economy is near zero. This finding coincides with Milton Friedman’s dictum that one more dollar spent by government is one less dollar the private sector has to spend. There is a strong intuitive argument that, in the main, the private sector can spend the dollars more productively. Indeed, excessive government spending may be defined as dollars spent by the government that could have been more productively spent by the private sector.

Policy measures often fail because policy makers fail to incorporate two very important axioms of successful policy actions: The actions must be perceived as permanent (or at least indefinite) and they must be new (or at least different). Actions lacking in these criteria are doomed to failure despite how meritorious they otherwise may be.

Enter the drive to eliminate the deficit and lower the debt. Actions, not words, to pursue these goals send an important signal. Serious inroads in the accomplishment of these goals (no matter the accompanying rhetoric) provide relief from the frenetic debate over mechanics. Eliminating the deficit and lowering the debt are simple: reduce government spending or raise government revenues. People and businesses can choose sides and follow the debate blow-by-blow. People understand the necessity of living within their means and have no difficulty, rightly or wrongly, extending that reasoning to government (Recall state and local governments already do this). Serious efforts to balance the federal budget would be interpreted both as new and permanent.

Are serious efforts to balance the federal budget at an appropriate level the best that government can do to help the economy? Probably. The best the FED can do is to provide an environment with near zero inflationary expectations. The best government fiscal policy can do is send signals that policy actions will provide an environment that encourages private investment and does little or nothing to detract from the creation of wealth. Meaningful tax reform is the best way to make the collection of government revenues more efficient, that is, garner additional government revenues while at the same time provide the private sector with a greater incentive to invest. Policy makers need only refer to the successes of serious and significant tax reform efforts in sixteen eastern European countries including Russia for their inspiration.

It is worth noting that whatever else the redistribution of incomes does it does not lead to the creation of additional wealth. Efforts to rationalize as ‘stimulus’ enhanced redistributive programs such as 99-week unemployment benefits, food stamps, housing subsidies, etc. are doomed to fail (in a fiscal sense) because they simply take dollars out of some people’s pockets and put them in other people’s pockets without generating or stimulating any net new economic product. Income redistribution by borrowing is just another form of government expenditure.

Attempts to alter human behavior come in many forms but they are best served by providing positive incentives; reducing impediments to productive behavior; establishing logical and clear rules of the game; and the reasonable enforcement of those rules. The idea is to instill in the populace confidence and certainty in its future. Uncertainty is the economy’s (and the public welfare’s) worse enemy.

To the public’s chagrin there is not much political leaders can do, other than get out of the way, to enhance short term economic performance but there is much they can do to make it worse. As in medicine the first rule of economic policy should be to do no harm. The public needs to resist calls for the government to do something every time things do not seem to go its way. All too often the enacted policies consist of economic blood letting (government spending) and if the patient fails to improve then some will argue that not enough blood was let.