The economics profession should devote more attention to genuine policy analysis, at least in its spare time (not necessarily in the journal publications by which we judge our academic careers). Most academic economists remain in their ivory towers, and proud of it. We sometimes act as if the necessity of meeting the test of the market place – of supply responding to demand – applies to everyone but us. Joe Stiglitz is immune from this charge -- impressive in his record of moving back and forth between academia and participating in public policy.

In discussing US economic policy, I will refer to Joe’s very readable new book, *The Roaring Nineties*. But I want also to mention a recent book that I co-edited, *American Economic Policy in the 1990s*. A number of the people in this room participated. The 14 chapters each dealt with areas of economic policy: monetary policy, trade, tax policy, labor, medicare policy, etc. One of the questions we have been assigned to address in this session on US Economic Policy is “what are likely to be the important issue areas in the future?” If I tried to guess what the 14 chapters of a retrospective on the current decade will look like, my guess is that they will not be very different. After all, the list of chapters in our book was very similar to that in Martin Feldstein’s analogous book on the 1980s of ten years earlier. Crises in financial markets were important in the 1990s, but the topic was already there in the 1980s. We added a chapter on IT policy, and also something on Tobacco policy; my guess is those two will be gone next time. We dropped Exchange Rate Policy, and added Energy and
the Environment. My forecast would be that that choice of priorities will also be appropriate ten years from now. I think the international dimensions of energy and the environment will be increasingly central. We didn’t have a chapter on Corporate Governance, and that would be necessary next time.

I am going to offer a broad idea for a direction in which policy research perhaps should move in the future. But, first, I will attempt some gross generalizations about economic policy in the Clinton Administration, which come out of the chapters of the book on the 1990s, as I see them.

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*Policy areas where intelligent intervention is appropriate*

In the public arena, the problem is of course the opposite from that of the ivory tower. What passes for debate is phrased in oversimplified terms and polarizing slogans. An example is the ubiquitous paradigm of “big government” versus “free market,” which is too oversimplified for my taste. Economists know that government should intervene when there is a market failure, and only then, and in an appropriately designed way. Joe himself has taught us a lot about this.

Many of the chapters of the book can be used to illustrate an important generalization, the principle that good economics does not mean leaving everything to the market. There are sources of market failure—externalities, imperfect competition, income distribution issues, imperfect information—that do call for some kind of government response, some kind of intervention, interventions, it is hoped, that are well targeted to address the particular failure in question. Five policy areas are particularly relevant:

- **International financial crises:** We are not quite sure why the world financial system does not operate quite as well as the textbooks say. It is true that countries can derive lots of advantages from borrowing and lending. Thinking of the crises that hit Mexico in December 1994, East Asia in 1997-8, Russia, Brazil, Turkey and Argentina, however, more of us now think that the markets are not working the way they should. Moral hazard created by the IMF cannot be the main explanation, contrary to many critics’ claims. Some kind of government participation in managing these crises is called for.

- **Industrial organization:** Anti-trust policy is one of several areas of regulation where the Clinton Administration was more aggressive than the Reagan or Bush Administrations that had come before. Joe’s book, like ours, mentions Microsoft and the lysene cartel. In the current decade, we began to talk a lot about corporate governance. Many of the problems we have seen—Enron, etc.—developed during the 1990s, and then came to light when the stock markets went down sharply during the Administration of George II. The Clinton White House did not do enough, but at least it wanted to move in the right direction. The head of the Securities and Exchange Commission, Arthur Levitt, whom Clinton appointed, took up questions such as whether accounting firms were subject to conflict of interest and needed to be regulated. But he was blocked by the Congress—both Republicans and Democrats.
The Chairman of the Securities and Exchange Commission who was appointed by George II in 2001 came from the accounting industry and was initially much more in favor of letting the accounting firms do what they wanted.

One could get the impression from Joe’s book, *The Roaring Nineties*, that President Clinton and the Treasury hyped the stock market, and trumpeted its boom as evidence of the wisdom of their policies. I believe that almost any other president and Treasury Secretary would have done this, but in my clear recollection, Bill Clinton and Bob Rubin emphatically did not. The Treasury was even careful not to build the upward trend into their budget projections. The Bush Administration, by contrast, has repeatedly made more optimistic forecasts even though the feared bust materialized in the interim. (I do agree with Joe’s book, however, that Alan Greenspan should have raised margin requirements as an effort to take some air out of the stock market bubble.)

- Energy and the Environment: Pollution is the quintessential market failure, an externality requiring a proper government response. The Clinton Administration tried a BTU tax early on, an economist’s dream policy if there every was one, but political opposition was fierce. The fallback position was a gasoline tax. (By my accounting, a gasoline tax is a rare opportunity to hit seven target/birds with a single policy instrument/stone: pollution, global warming, congestion, accidents, budget deficit, trade deficit, and national security constraints arising from dependence on mideastern oil.) But we ended up with a mere 5-cent gasoline tax. By the time I got to the Council of Economic Advisers in 1996, it was taboo even to discuss energy taxes. One environmental policy where the Clinton Administration was aggressive was the Kyoto Protocol on Global Climate Change, which happens to be something on which we at CEA spent a lot of time working, beginning with the period of Joe’s term as Chairman. If you want a policy area that will be with us for the remainder of this century, climate change is your issue. I am prepared to defend the Clinton-Gore version of the Kyoto Protocol. Overall, I view it as quite an adverse comment on the political acumen of the Green Party that in the 2000 election it purported not to be able to tell the difference between Clinton-Gore and Bush on environmental policy.

- Education: The Clinton Administration created various tax credits and deductions to allow lower income people, who otherwise may not be able to go to college at all, to do so, for example to go to junior college for two years. This was a successful policy. One drawback is that having too many special breaks like that makes the tax code even more complicated than it had been. Many of us would like to have a simpler tax code if that is possible.

**Policy areas where the Clinton Administration appropriately moved toward market discipline**

Those were areas that illustrate the principle of good mainstream economics that when there is a market failure the government should try to do something about it, if it can be effective. But there are other areas where good economics says to leave it to the market. Even though the Clinton Administration was a Democratic Administration—and the Democrats are traditionally associated with big government and intervention—to
my way of thinking, the Clinton Administration was more in tune with what the economic textbooks say is good economics, more in tune with moving towards the market when it comes to microeconomics and enforcing macroeconomic discipline when it comes to macroeconomics, than recent Republican Administrations have been. Many would find this claim surprising. But Democratic and Republican presidents have switched places over the last 25 years. In the 1960s, the Democrats stood for big government, protectionism and deficits, and the Republicans stood for macroeconomic discipline, free trade, and small government. But since then—I am just speaking of the President, the White House, not the Congress—they have switched places. For example, deregulation actually started under Carter, in the late 1970s, not under Reagan. Clinton was the responsible grown-up, and Reagan and George W. Bush, contrary to their rhetoric, have practiced the slogan, “if it feels good, do it.”

Let us go through some of these areas where the Clinton Administration moved in the direction of market discipline, and where I think this was the right thing to do. These, too, correspond to chapters in my book *American Economic Policy in the 1990s*.

- **Monetary Policy:** There are many who would give the credit for the good economic performance in the 1990s to Greenspan rather than to Clinton or to other historical forces. I think Greenspan does deserve a lot of the credit. The Administration’s important contribution was to leave monetary policy to the Federal Reserve Board. But this was a more radical change than may be evident at first, because previous Presidents had never been able to resist the temptation to pressure the Central Bank for easier monetary policy. Nixon did it, Reagan did it, George the First did it. A book by Bob Woodward documents pretty clearly that Reagan tried to appoint easy money people to the Federal Reserve Board, and that the first Bush White House leaned quite hard on Paul Volcker, making such demands on him that he asked not to be reappointed in 1987.

  The Clinton Administration got lower interest rates by leaving the Fed alone than we would have if we had pressured them to lower interest rates.

- **Fiscal policy:** The elimination of the US budget deficit in the late 1990s was a dramatic accomplishment (and constituted the other half, along with monetary policy, of the successful strategy to bring down interest rates). I do not think anybody at the beginning of the decade thought that we could eliminate the huge budget deficits altogether, but we did. It was not all due to Clinton, of course. Strong growth and a booming stock market was part of it, because it generated tax revenue in the form of capital gains. However, three policy steps that were taken were key in my view. First, to give Bush Senior credit, in 1990 he bravely reversed himself on the ‘no new taxes’ pledge. An historic meeting with the Congress put some long-range caps on spending, and raised taxes. That was one major step.

  The second key policy step was Clinton’s first budget, in 1993, which decided not to increase spending and raised some taxes (while cutting others). Those steps, together with strong growth, did succeed in reducing deficits. By 1998 we could see that we were going to have surpluses—and record surpluses, at that. There was a great temptation to spend the new surpluses. The Democrats in Congress (and plenty of
Republicans too) wanted to spend on their pet programs—build highways, whatever. The Republicans wanted, especially, to have tax cuts. The third key policy step: In the State of the Union Address in 1998, Clinton declared a strategy best expressed in the slogan, ‘Save Social Security first,’ The baby boom will start retiring at the end of this decade. We have a current surplus in social security, but not enough to pay all the pension benefits to those who will be retiring. Hence the idea, ‘let us first save the surplus for social security.’ If and when we think we have succeeded in putting social security on a firm footing -- and also Medicare, the healthcare equivalent -- only if we have those on firm footings should we start thinking about goodies like tax cuts or other kinds of spending. It was a pretty attractive political mechanism— and was effective in preventing Congress from either cutting taxes or raising spending. Thus it preserved the new surpluses. In retrospect it worked for only two years, until the end of the Administration. (I thought it would have lasted longer than that, but when George II came in, everything changed.) But it was the continuation of a ten-year regime “if you want to increase spending somewhere or cut taxes, you have to pay for it somewhere else.” Some of our Republican friends claim that a regime of record deficits -- as in the early 1980s and again today -- is a useful political device to limit the growth of wasteful government spending; but that is demonstrably false, if the alternative is the regime of the 1990s.

- Trade policy: When we were in the government, we, like all CEAs, spent a lot of time in lonely battles over trade issues. I give the Clinton Administration a lot more credit in retrospect than I did at the time. Look at some of the things the current Administration has done—steel tariffs, tariffs on softwood lumber, agricultural subsidies. Compared to that, and compared to the Reagan Administration, we did relatively well by free trade principles. Two big successes were NAFTA (North American Free Trade Area) which was passed in the beginning of the Administration, and the accession of China into the WTO, which came at the end.

- Information Technology: One of the distinguishing characteristics of the 1990s — perhaps the distinguishing characteristic in many people’s minds—was the Internet revolution, the electronics revolution. It took place mostly in the private sector, of course. People who favor government intervention always remind us that the Internet was actually invented by DARPA, i.e., was originally a creature of the government. Nevertheless, as it prospered it was taken over by the private sector. There were some key decisions, such as whether domain names should be handed out by the government or by a private agency. The Clinton Administration largely turned it over to the private sector. And that was probably the right decision—contrary to those who thought that the Democrats would be unable to resist the temptation to regulate a new sector.

- Income distribution: This is an obvious area for government intervention. Why do I class it with areas where I believe the Clinton Administration moved appropriately in the direction of the market? We expanded the “Earned Income Tax Credit,” thereby reducing the marginal tax rate on lower-income workers. Then there is welfare reform. Although the welfare system is the major safety net for low-income people in the United States, by the beginning of the 1990s there was a rough consensus that
welfare needed to be reformed. When Clinton supported welfare reform, it got many people on the Left very upset. But in retrospect it worked surprisingly well.

Everyone likes tax cuts. But keeping marginal tax rates low for low-income people, it seems to me, should have higher priority than keeping them low for rich people. By contrast, the current administration has been cutting taxes for the rich at every opportunity and in every way that it can. The guiding principle behind such brainstorms as the 2010 abolition of the estate tax seems to be “do as much damage to the objectives of equal income distribution, long-run fiscal solvency, and simplicity of tax planning as you can, with as little stimulus to demand or improvement in supply incentives as possible.” The position of the administration is that letting heirs get every penny of a $100 million dollar estate promotes the work-and-save incentives of the wealthy bequeather while he is still alive. I submit that it does little, that the bequeather may even be concerned that his children will inherit more than is good for them. If we took that same lost revenue, and spread it over 10,000 lower-income workers, e.g., by cutting payroll taxes, we could make sure that they keep every penny of the returns to going to college and getting a better job. Surely increasing incentives at this end of the income ladder has a higher payoff.

I do not wish to claim 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 and ill-fated. Ronald Reagan’s firing of the air traffic controllers, who were striking in violation of their contracts and the law, was a much admired stand on principle and the demonstration effect may have helped a bit to break the back of inflation. George H. W. Bush’s 1990 decision to revoke his “no new taxes” campaign pledge was a brave step, as I have said, which ranks of equal importance with Clinton’s two measures, in establishing the 1990s path toward eventual budget balance. Nevertheless, it is striking how many examples go the other direction -- good textbook economics from the Democrats, the opposite (except rhetorically) from the Republicans -- and more striking still how seldom expressed is that assessment.

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A point about political economy

Those of us academic economists who have the opportunity to enter government often make mistakes there before we get the hang of it. One of the things that we sometimes do wrong is to refuse to answer the questions that our employers ask of us. We typically want to answer some other question instead. In any other profession or sector of the economy, if the technician’s general approach was to refuse to help the employer figure out how to accomplish his objective, but instead to suggest an alternative objective, we economists would say the technician should be fired. But we reserve the right, for ourselves, to tell the politician that he is asking the wrong question.

Of course, to a large extent, speaking up for what economic theory says is in the interest of Americans in the aggregate – out of the set of relevant policy options -- is precisely our job. At least it is the job of the Council of Economic Advisers, if not of other economists in the government.
At the same time, I wish someone outside of government would more often do what we tried to do in the book for the case of the 1990s, but -- to be honest -- did not entirely succeed in. That is to consider the policy issues of the day, including the actual specific feasible options, weigh all the pros and cons of each, and then rendering an overall judgment. In the case of retrospective analysis, it should include the political economy that underlay the option that policy-makers ultimately chose, and how it played out subsequently. Most academic economists usually think that the job of getting your hands this dirty with policy detail belongs to others. But to whom? If we are talking about contemporary events, the newspapers don’t do it: the formula for op-eds is to consider only the arguments on one side, while the formula for news coverage is to avoid an overall judgment. The historians don’t do it: some time ago they were taken over by a philosophy that powerful leaders have already received a disproportionate share of attention, and shouldn’t get any more until the person in the street has received his or her fair share on a per capita basis. It seems to me that nobody does it.

In one sense the purity of theory is an ally of political expediency, rather than an ally of what most of us would consider good economics. The common scholarly paradigm, let us say, in trade theory, is that economists can only take positions on policies that result in pareto-improvements. If a policy change increases the size of the pie, but also changes the distribution, then we can’t pass judgment on it. That is society’s call, we say, not ours. But this is an astoundingly limiting rule for us to impose on ourselves. As soon as one gets into the policy arena, one quickly discovers that every issue has winners and losers. Even if you think that free trade benefits most people, including most poor people, you know there will always be somebody that is adversely affected. The anti-globalizers often play on this. They point out that globalization leaves behind somebody somewhere; and that is supposed to be an argument for calling a halt in the process of international integration, as if a non-globalization strategy wouldn’t also leave behind lots of people in lots of places. If we economists let the criterion of strict Pareto-improvement stop us from offering a judgment on what is the best policy, then we will never have anything to say.

Now, economists who are interested in policy generally don’t let Pareto stop them. When we are in the policy arena we usually do something like maximize an objective function that includes both aggregate real GDP and a measure of income dispersion, or of the number of people in poverty. But this strategy is more often implicit than explicit. I propose that research ought more often to make the issue explicit.

Meanwhile, the political process does something quite different. Of course certain interest groups have influence -- on the issue of particular interest to them -- that is vastly disproportionate to the population they represent. (Often the interest groups I am talking about are corporations or their wealthy owners; but I would also include many groups as disparate as farmers on agricultural subsidies, the textile industry on textiles, the NRA on guns, trial lawyers on the law, teachers’ unions on education, Cuban émigrés on Cuba, Jewish groups and evangelicals on Israel, and so on and on). But this isn’t the point I wish to raise. The role of lobbying and donations by interest groups is already well-known. If anything, the phrase “special interest group” is used far too often, since everyone uses the phrase to complain about interest groups other than their own.
Moreover, this issue already receives some of the academic attention it deserves, including from economists, who are not generally shy about usurping territory that others might have thought belonged to the political scientists. Furthermore, I see it as inevitable that the votes of groups that feel strongly about an issue and are willing to invest time and energy and organization will count more heavily than the votes of others [and it is not even clear to me that this tendency is per se necessarily wrong].

What I have in mind is something else. It is something that is so obvious in the policy arena that most of us academics miss it. It is that the benchmark, relative to which the political process evaluates changes in the welfare of individuals or groups when considering policy changes, is the status quo. A Milton Friedman or von Hayek or other libertarian would consider the relevant benchmark to be a hypothetical state of nature with no government intervention; only if a policy would represent large gains for most with small losses for a few, relative to laissez faire, is that intervention justified. A utilitarian would have no particular interest in the laissez faire benchmark. He would designate as the sole criterion of maximizing the total pie, perhaps also with a large weight on minimizing the dispersion of income if he or she is an egalitarian sort of utilitarian. A Rawlsian would approve a policy change if and only if it raises the lot of the worst-off individual.

But the benchmark that is relevant for policy is none of those. Rather it is the status quo. The threat point or default option is whatever policies are already in place. A policy of making Western farmers pay the true cost of water would not be controversial, if it were the status quo. A policy of taxing fossil fuels and using the proceeds to subsidize public transportation or other good causes would not be controversial if it were the status quo, as it is in Europe (for reasons of historical accident more than any difference in values vis-à-vis Americans), whereas it is considered politically impossible in the United States. We would be infinitely less likely to use tariffs or quotas to protect textile production if those textile jobs and capital did not already exist. And so on. The importance at every point in time of the status quo gives a path-dependence to political economy that I think is missing from most models of politics.

Part of the reason that we economists have, relatively speaking, neglected the tyranny of the status quo in our models of policy is the option of glibly invoking lump-sum transfers. Trying to compensate losers with transfers is indeed a good idea and should be done more often, in order to get good policies adopted. Nevertheless, true lump-sum transfers are all but non-existent in reality. A transfer precedent almost always changes somebody’s incentives for the future. There is an inability to commit. Joe gave us the good example of the Freedom to Farm Act, where the farmers took the side payments but then subsequently did not accept the phase-out of their subsidies, and indeed were able to win even larger subsidies from the current administration.

Now you might think that a change relative to the status quo would be acceptable if the gains of the gainers were far greater than the losses of the losers. And to some extent this is true. After all, not all policy changes are successfully blocked by holdouts. Since I have already said that virtually all changes have at least some losers, those that get through must be those where the weighted interests of the gainers dominate (where
the weights include votes, contributions, capacity for mobilization, etc.). But the concentrated losses of a few losers count far more than the thinly distributed gains of many gainers. This familiar (Mancur Olsonian) theorem of political economy holds more strongly than most people realize. One of the things I learned in Washington is that if a change from the policy status quo does nothing worse than move forward by a few years the disappearance of a thousand existing jobs, those displaced workers may still carry enough weight to prevail over the arrayed interests of, not just all consumers, but important industrial constituencies and important national security interests. I will name two esoteric examples from the period when Joe and I were at the Council: imports of broom-corn broom from Mexico, and the terms under the privatization of the US Enrichment Corporation regarding two uranium-processing plants in Kentucky and Ohio. Perhaps there is some de minimus threshold, but in those cases, a few hundred or a few thousand jobs was enough to influence the outcome.

The general point is that the set of policy options that are politically feasible from the viewpoint of a president is likely to be highly constrained, for example, those that do not impose large losses on any important constituencies relative to the status quo. And yet, the set of options is not so constrained as to rule out any room for maneuver altogether, or to make the question of the economic optimum an intellectually trivial one. Determining the optimum subject to such constraints is the challenge to the practicing economist.

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1. WW Norton, 2003
6. For example, a typical trade issue has a dozen arguments or interest groups on various sides, and the White House runs an inter-agency process to try to decide how best to weigh them up. What is our contribution? To emphasize the importance of an interest group that isn’t even at the table, and never will be, because they don’t know better, that is, consumers.
7. Arnold Schwarzenegger illustrated this within 24 hours of announcing that he would not take money for his campaign from special interest groups.
8. By the way, in my view just the fact that issues like those two are so obscure, even among specialized policy-interested economists, is in itself a problem. I doubt if there was a single attempt by any private economist anywhere to weigh up the pros and cons of those issues (except a thesis on USEC by Peter Orszag, who it happens was also my co-editor on the book on the 1990s). Of course such issues are far too narrow to merit consideration in leading journals. But such issues are also too small to merit the attention of the op-ed writers or the Washington think tanks or the historians or those who write cases at the Kennedy School or the business schools. When we suggested that Paul Joskow include USEC in his chapter on energy policy in the 1990s volume, his view was that it merited no more than one sentence, out of 70 pages. And he may well have been right. There are hundreds of such issues, and an op-ed or a think
tank or a survey chapter can’t be expected to go into enough detail to cover most of them. But my point is that somebody somewhere within the economics profession should. The marginal social product of the second paper on USEC exceeds the marginal social product of the thousandth paper on how models of exchange rate determination don’t work.