A History of Macroeconomic Policy in the United States

John H. Wood

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A History of Macroeconomic Policy in the United States

Keynes asked whether his ‘visionary’ ideas would overcome the interests opposed to change. However, an examination of the histories of monetary and fiscal policies suggests that this is a false distinction. The interests and ideas associated with government policies are seldom opposed. The suspicion that the latter more often follows than confronts the former is supported by the experiences documented in this book.

Professor Wood’s new title examines the controlling influences that drive macroeconomic policies in the United States. The book addresses the history of the interests, ideas, and practices of monetary and fiscal policies in the United States, although it also examines macro-policies in other countries, particularly the United Kingdom. Professor Wood argues that economic policies in the United States have been relatively predictable and stable historically, through a detailed examination of conflicts over taxes and monetary policy such as the whiskey rebellion, Magna Carta, the Stamp Act, the Banks of the United States, and the Federal Reserve. Issues covered also include property, economists’ theories of stabilization, taxes, deficits, and monetary policy.

This book will be of interest to monetary and fiscal economists, both in the United States and the United Kingdom. It is also relevant to postgraduate and advanced undergraduate economics students.

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But though thus largely directed by practical needs, economics avoids as far as possible the discussion of those exigencies of party organization, and those diplomacies of home and foreign politics of which the statesman is bound to take account in deciding what measures that he can propose will bring him nearest to the end that he desires to secure for his country. It aims indeed at helping him to determine not only what that end should be, but also what are the best methods of a broad policy devoted to that end. But it shuns many political issues, which the practical man cannot ignore: and it is therefore a science, pure and applied, rather than a science and an art. And it is better described by the broad term 'Economics' than by the narrower term 'Political Economy'.

(Marshall 1920: 36)

It is universally acknowledged that there is a great uniformity among the actions of men in all nations and ages, and that human nature remains still the same in its principles and operations. The same motives always produce the same actions; the same events follow from the same causes.... Would you know the sentiments, inclinations, and course of life of the Greeks and Romans? Study well the temper and actions of the French and English: you cannot be much mistaken in transferring to the former most of the observations which you have made with regard to the latter. Mankind are so much the same in all times and places that history informs us of nothing new or strange in this particular.... Nor are the earth, water, and other elements examined by Aristotle and Hippocrates more like to those which at present lie under our observation than the men described by Polybius and Tacitus are to those who now govern the world.

(David Hume 1748: 92–3)

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I have observed and tried to learn how macroeconomic policies are made since my days as a fellowship student at the Federal Reserve Bank of Chicago many decades ago, and have accumulated intellectual debts along the way to a great many officials, teachers (they were all my teachers), colleagues, and students, including George Mitchell, Andrew Brimmer, Lyle Gramley, George Horwich, Ernest Baughman, Bill Poole, Mike Grove, Ed Feige, George Kaufman, John Hughes, Rollin Thomas, Pat Hendershott, Dale Osborne, Frank de Leeuw, Dan Brill, Steve Taylor, Jack Guttentag, Terence Hutchison, Alan Walters, Uli Schlieper, Duane Harris, Mark Willes, Lee Hoskins, Ira Kaminow, Irwin Friend, John Boyd, Joe Lucia, Doug Vickers, Stuart Greenbaum, Gerry O'Driscoll, Ed Kane, Larry White, Cara Lown, Maureen O'Hara, Ed Prescott, Joe Burns, Tony Elavia, John Crihfield, Mike Lawlor, Jac Heckelman, Dan Hammond, Michael Bordo, Anna Schwartz, Bob Hetzel, Marc Quintyn, Donato Masciandaro, and Andreas Freytag, none of whom agree with everything in this book. I am also thankful for the facilities of Clare Hall, Cambridge, and the American Institute of Economic Research, Great Barrington, Massachusetts.

1 Introduction

> There is a naïve view among economists that ‘we need to change this or that policy in order to improve economic welfare’. [T]his is impossible. The current values of policies reflect a delicate political equilibrium that balances all of society’s conflicting interests. The current negative views of economists on the policy have already been embodied in its equilibrium. The policy is endogenous and is outside the control of any group, including the politicians. They are merely the agents balancing all of the conflicting interests. . . .
>
> (Magee *et al.* 1989: xvi)

This book attempts a partial answer to the complex question: What determines monetary and fiscal policies? The answer prevalent among economists is clear and simple: economic theory. ‘Academic thinking about monetary economics – as well as macroeconomics more generally – has altered drastically since 1971–73 and so has the practice of monetary policy’, a prominent economist wrote in 2002. ‘The former has passed through the rational expectations and real-business-cycle revolutions into today’s “new neoclassical synthesis,” leading the latter “into an era of low inflation that emphasizes the concepts of central bank independence, transparency, and accountability”’ (McCallum 2002). The fluctuating inflations since World War II, a team of leading economists wrote, resulted from the applications of ‘a crude but fundamentally sensible model of how the economy worked in the 1950s to more formal but faulty models in the 1960s and 1970s to a model that was both sensible and sophisticated in the 1980s and 1990s’ (Romer and Romer 2002).

Economists were just as confident of their influence four decades ago. A former chairman of the president’s Council of Economic Advisors and advocate of Keynesian interventions, wrote:

> Economics has come of age in the 1960s. Two Presidents have recognized and drawn on modern economics as a source of national strength and Presidential power. Their willingness to use, for the first time, the full range of modern economic tools underlies the unbroken U.S. expansion since early 1961. [W]e have at last unleashed fiscal and monetary policy for the aggressive pursuit of those objectives.
>
> (Heller 1966: 1–2)

'By about 1980', however, after another revolution in economic theory, another Keynesian economist observed that 'it was hard to find an American academic macroeconomist under the age of 40 who professed to be a Keynesian' (Blinder 1988). The president elected that year seemed to share the next new policy view of economists when he said: 'Government is the problem' (Reagan, Inaugural Address: 20 January 1981).

Changing policies are often thought to be examples of the much quoted conclusion to J.M. Keynes's *The General Theory of Employment, Interest and Money* (1936: 383–4). After asking whether the application of his theory was more than 'a visionary hope', he answered that

> the ideas of economists and political philosophers … are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. [S]oon or late, it is ideas, not vested interests, which are dangerous for good or evil.

These claims rest on weak foundations. Interests are more stubborn than Keynes assumed. The vanity of his hopes, and of theorists in general, is the thesis of this book. The interests – or incentives, to which we might expect economists to ascribe more influence – that govern the world have persevered. This alternative explanation of policy is supported by the record of actions of the monetary and fiscal authorities which form the substance of the pages that follow. Existing policies may not be 'delicate equilibria' as suggested in the opening quotation, but they are certainly endogenous and not easily manipulated by economists or politicians.

The case can be made more generally, but it is limited in this book to the United States, where it is shown that the direction of influence between economic theory and practice is primarily from the latter to the former. Notwithstanding their claims for innovation, economists have rationalized more than influenced policy. Ideas not supporting interests have been ignored in practice.

The lights of theory playing on public policies have oscillated – for example, from *Classical* to *Keynesian* to *New Classical* and *New Keynesian* – but the policies themselves have been more persistent than is generally recognized. Policymakers and policies have been more conservative than they have been given credit (or blamed) for. My purpose is neither to criticize nor defend the dominance of interests, but to record it in the hope of better understanding policy. In the process, we cannot help but find the opening epigraph by David Hume more helpful than Keynes's belief in the fragility and malleability of human thought and behavior.

The next six chapters explore the interests, ideas, and practices of fiscal and monetary policies. The general conclusions are quickly summarized. Economists dismiss the public's disapproval of the national debt as *Deficit Hysteria* (Benavie 1998) which fails to comprehend scientific explanations that public debts are like private debts, they arise from spending that promotes stabilization and growth, and the government's net worth is positive, anyway (Samuelson 1958: 350–62; Eisner 1986).

Opposed to this view of government budgets as applications of economic theory – instruments of macroeconomic policy – is the experience of tax conflicts that is virtually the history of the development of democratic government. Taxes have been about wealth and power, about government, in fact. We should be surprised if the powers for which interests have fought so long and so hard were given away to experts 'who have never won a precinct'. 'When you have decided upon your budget procedure you have decided on the form of government you will have as a *matter of fact*' (Fitzpatrick 1918). The pessimistic implications of the story told in Chapter 2 for the practice of discretionary stabilization policy are clear, and are shown in Chapter 4 to be realized.

The story of monetary policy is similar, although knowledge plays a greater part in its telling. Interests cannot be separated from knowledge. Central bankers, who function in the environment of the financial markets and have inherited with their banker cousins the belief that sound money is good for themselves and necessary to economic stability, resist the temptations of more removed and ambitious goals. They follow their interests, as they feel and understand them, as much as the congressmen who tax and spend. The money-market myopia of central bankers that is vilified by economists finds no place in monetary theory but explains their behavior. Fluctuating inflations have been due to governments wanting cheap finance – sometimes rationalized by equally fluctuating economic theories – rather than to instability in the knowledge or preferences of central bankers.

It is worth emphasizing that interests and customs are not the only impediments to the application of theory. The communication of knowledge is also fraught with difficulties. Even the understanding of a new theory – before its application can be considered – requires the breach of difficult, although sometimes invisible because they are in the mind, obstacles. The dissemination of theory among intellectuals might be thought a low hurdle, but it is seldom accomplished. Rhetoric is easy ('We are all Keynesians now.'), but intellectuals are as liable as practitioners to mold ideas in their own interests. Economists' rejection of Keynes's difficult general (including disequilibrium) theory of an uncertain money economy, preferring the familiar certainty-equivalent equilibrium of a costless real economy, is the subject of Chapter 3. The 'Keynesian revolution' is a case study of the difficulties of communication between groups in the policy chain.

Making the next step, although the purportedly Keynesian economists accepted (many had anticipated) Keynes's interventionist policy proposals, they had little influence on political minds. Applications even of the severely modified form that economists found tractable would have had to survive a complicated and itself uncertain political process that depends on the attitudes and energies of voters and their representatives attempting to manipulate viscous institutions.

The fundamental attitudes of policymakers – politicians and central bankers – have been distant from economic theory, and resistant to the volatile intellectual efforts to change them. The improvement in monetary policy the last three decades in fact has consisted of the government's subordination to the more persistent preferences of central bankers. Theory followed the Fed more than the other way around.

Chapters 5–7 do for monetary policy what Chapters 2–4 did for fiscal policy, giving a history of monetary policy that is another study in the stability of behavior, the mainly sensory determinants of that behavior, and an account of the persistent beliefs and conduct of the Federal Reserve.

Interests are probably sufficient barriers to the application of theories but the barriers are raised by the difficulties of communication – of the transmission of ideas between minds molded by divergent backgrounds, environments, and interests. Theorists and 'practical men' possess fundamentally different – closed vs. open, certain vs. uncertain – visions. The British empiricist philosophers and American pragmatists help explain a good part of the intellectual gap in terms of sensory differences arising from different experiences and environments which generate distinct ideas as well as interests. There are good reasons for the significant and enduring resistance of policy to theory. This book is not an argument that macro-policies ought to be conservative but rather a discussion of the forces that make them so.

Not all economists have believed that policies are straightforward applications of theory. Alfred Marshall distinguished 'economics' and 'political economy', the former being a science available to all regardless of ethical or political views. He believed that the coupling of 'political' with 'economics' wrongly implied 'political interests' that 'the practical man [distinct from the economist/scientist] cannot ignore' (Marshall 1920: 36; Marshall and Marshall 1879: 2; Cannan 1922: 43).

Marshall's interventionist successors have been unable to resist the mixture. Theories are explanations of economic relations that abstract from political, institutional, and cultural complications. However, the temptation to project theories onto actual economies has been irresistible. The distinctions between 'positive' and 'normative' economics, that is, between simplified general explanations and their applications to specific problems are often discussed but seldom taken seriously.

The field of 'public choice' is available to help qualify the exaggerated trust in the practical power of theory, but 'most economists have chosen to ignore the interaction between economic policy and politics' (Laffont 2000: 5). This book does not try to overcome these great problems by modeling the interactions. I only record that the practical influences of theory are small. Interests dominate policies, and largely mold the theories that rationalize them.

This does not mean that economic theory is uninteresting or useless. On the contrary, it provides considerable insights into economic relations. An example is its demonstration of the benefits of free trade, about which, probably more than any other issue, economists agree. So why don't we have free trade? The usual answer is in terms of interests realized through the political process (Riezman and Wilson 1995). Shouldn't this apply to other – fiscal and monetary – theories, as well?

Part I

Fiscal policy

2 Interests

A history of tax conflicts

> When a fellow says it hain't the money but the principle o' the thing, it's th' money.
>
> (Hubbard 1920)

> *Politics*, n. A strife of interests masquerading as a contest of principles.
>
> (Bierce 1911)

This chapter is a history of tax conflicts in England and the United States. I do not consider the efficiency of taxes directly but examine the interests affecting their adoption and collection. The history of taxes is also the history of the development of democracy. Property rights are personal rights. In his second *Treatise of Civil Government*, the ideas of which 'the principles of the American Revolution were in large part an acknowledged adoption' (Carpenter 1924: 180), John Locke wrote: 'The great and chief end … of men uniting into commonwealths, and putting themselves under government, is the preservation of their property' (1690b: 180).

The political and social relations between groups of various locations and endowments have played important parts in tax struggles. The purpose of a tax may have been broadly national or imperial but its effectiveness was molded by the detailed political and social fabric of the nation or empire – of the English counties, the colonies, and in the new republic, the conflicting interests of enterprise and geography.

The keen, even violent, interests in government budgets belie those who would dismiss them as 'symbolic' or instruments of control. Governors and governed understood that wealth and power were at stake (Savage 1988: 7).

> it has long been recognized that the history of taxation is the history of 'the English constitution expressed in economic terms', and that 'the English constitution was developed by the necessaries of taxation'.
>
> (Dietz 1928)

The most famous as well as the most important episodes in the eternal conflict – the only certainties are death and taxes – are summarized in mostly chronological order. I am interested primarily in modern American fiscal policy, but since

American law and experience have grown out of the English, it is useful to begin with the Great Charter of 1215, before moving to the contest over Ship Money that led to the Civil War of the 1640s, the struggle over control of the public purse that was decided by the Glorious Revolution of 1688, and the Stamp Act and other differences between Great Britain and its American colonies leading to the War of Independence. These were followed by tax conflicts in the new republic when citizens sought to apply the principles of the Declaration of Independence from Great Britain to themselves vis-à-vis their state and federal governments. The most enduring tax conflict in the United States has been over tariffs. The continuing debate over defense spending and its finance is close behind. Disputes over both arose in the 1790s, and continue. Taxpayers do not always oppose taxes, such as during the 'missile gap' of the 1950s, when Congress complained that the president was not asking enough for defense.

These are not all the important tax conflicts, but I hope they will be sufficient to show why the economic implications of Keynesian stabilization theory were not accepted, or even considered by politicians or taxpayers, as opposed to intellectual activists. Even if the theory had been accepted, too much was at stake for economic and political interests to yield control.

The Magna Carta

> If any earl, baron, or other person that holds lands directly of the Crown, for military service, shall die, and at his death his heir shall be of full age and owe a 'relief', the heir shall have his inheritance on payment of the ancient scale of 'relief'. That is to say, the heir or heirs of an earl shall pay £100 for the entire earl's barony, the heir or heirs of a knight at most £5 for the entire knight's fee, and any man that owes less shall pay less, in accordance with the ancient usage of 'fees'.

Thus runs a translation of the second clause of the Great Charter that King John was compelled to accept by the nobles assembled at Runnymede, outside London, in 1215. John's imagination and ruthlessness in finding and collecting taxes, primarily for military efforts to retain his lands in France, had aroused dissension among the nobles, and his failures, especially the loss of Normandy, had reduced his status and opened the way to successful resistance.

The clauses are not numbered in the charter, but of the 63 issues that are usually identified, most are restrictions on the king's authority to command resources (Jennings 1965: 44–7). Prominent are limits on regular taxes, such as the inheritance fees noted above, and special levies for the king's military ventures. Procedures for assessing taxes are also specified, as in clause 12:

> No 'scutage' [payment in lieu of military service] or 'aid' may be levied in our kingdom without general consent, unless it is for the ransom of our person, to make our eldest son a knight, and (once) to marry our eldest daughter. For these purposes only a reasonable 'aid' may be levied.

Clauses on the administration of justice sought to secure property from arbitrary seizure. Court fines were limited to amounts 'in proportion to the degree of the offence', in the judgment of 'reputable men of the neighbourhood' (clause 20), and 'ordinary lawsuits shall not follow the royal court around, but shall be held in a fixed place' (clause 17). Further protections of property prohibited the king from seizing goods without payment, limited his ability to claim lands as his private forests, and protected towns and persons from being 'forced to build bridges over rivers except those with an ancient obligation to do so' (clause 23).

Clauses 48–62 promised to abandon or reverse several of the king's practices during recent hostilities between the king's men and his adversaries, such as the release of hostages, removal of foreign troops, return of forests and castles, and pardoning of opponents, the fulfillment of which was guaranteed by the provision that 'The barons shall elect twenty-five of their number to keep, and cause to be observed with all their might, the peace and liberties granted and confirmed to them by this charter.'

The document was evidently written in haste by many hands in the midst of bargaining. Most of its clauses dealt with particular grievances rather than general principles of law. It was an 'intensely practical document', F.W. Maitland (1902) wrote, 'the fit prologue for those intensely practical statutes which English Parliaments will publish in age after age'.

> It is worthy of its place just because it is no philosophical or oratorical declaration of the rights of man.... [I]t is a grand compromise, and a fit prologue for all those thousands of compromises in which the practical wisdom of the English race will always be expressing itself. Its very form is a compromise – in part that of a free grant of liberties made by the king, in part that of a treaty between him and his subjects.... And then in its detailed clauses it must do something for all those sorts and conditions of men who have united to resist John's tyranny – for the bishop, the clerk, the baron, the knight, the burgess, the merchant – and there must be some give and take between these classes, for not all their interests are harmonious.

This '*practicability*', according to William McKechnie (1914: 121–2),

> is an English characteristic, and strikes the key-note of almost every great movement for reform which has succeeded in English history.... While democratic enthusiasts in France and America have often sought to found their liberties on a lofty but unstable basis of philosophical theory embodied in Declarations of Rights, Englishmen have occupied lower but surer ground, aiming at practical remedies for actual wrongs.

We will see that the English have not been free of the urge to try to collect taxes in the face of popular opposition.

Magna Carta was not the beginning of limited government in England. 'The traditional view' is that Magna Carta was a direct descendant of Henry II's