Tobin on macroeconomic policy: A review essay

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Tobin on Macroeconomic Policy

A Review Essay

by

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1. Introduction

Professor Tobin's scientific contributions to macroeconomics, monetary theory, portfolio theory, the theory of economic growth, and other topics place him among the leaders of our profession. So many of his contributions are well known, and highly regarded, that it seems superfluous to praise them further. Like many others who were attracted to economics from the 1920s through the 1950s, Tobin sees economics as more than a set of abstractions, more than a collection of theorems and empirical regularities, and more than a branch of applied mathematics. Whatever its other pretensions, for Tobin as for me, economics is a policy science. We study economics, not least, to order the facts about the world and to learn how welfare can be increased. To encourage policy changes, Tobin lectures on economic policy not only to his students, but to the Congress, the administration, and the general public. He writes in scholarly journals but also in journals of opinion, in the public press, in Congressional hearings and wherever social and economic issues are discussed.

Tobin's most recent volume of collected essays on policy *Policies for Prosperity: Essays in a Keynesian Mode*, edited by P.M. Jackson (M.I.T. Press, Cambridge, MA, 1987), reprints 43 papers with Tobin's personal and professional views. The essays bring out that there are two James Tobins. One is a careful, skilled economist. The other, a polemicist, is less careful and more provocative. The first Tobin writes and presents thoughtful policy papers to academic audiences. The second Tobin denounces monetarists, supply siders, new classical economists, the policies of Reagan and Thatcher, and Paul Volcker's 'unrelenting' attack on inflation for readers of the *New York Times*, the *New York Review of Books* and the *New Republic*. The two Tobins often discuss the same topics, but they do so in different ways.

*Helpful comments were received from Alberto Alesina, Karl Brunner, and Bennett McCallum.
Policies for Prosperity has six subsections, each containing five to ten papers and an introduction to the section summarizing the main ideas. Most of the papers were written in the 1980s, but some are from the 1970s. The papers vary in length, and they cover topics as diverse as energy crises, income redistribution, race, and the efficiency of the financial system. These are apart from the main themes. Most of the papers concentrate on macroeconomic policy issues, particularly inflation, disinflation, unemployment, fiscal, monetary, and incomes policies. Tobin recognizes that there is considerable redundancy. This is not a modest disclaimer. I lost count of the number of calls for an incomes policy and would gladly have traded two or three such calls for one clear analysis of the failures of past efforts in the U.S., the U.K., or elsewhere.

2. What is a Keynesian?

The book sets out a Keynesian view (p. xiii). Part 1 has six papers several of which help to clarify what Tobin means by the term Keynesian. The section closes with a review of Lester Thurow’s Dangerous Currents—policy proposals that are ‘hazardous to public policy today and tomorrow and to the health of the profession itself’ (p. 55). Tobin endorses the main message of Thurow’s book which he describes as skepticism about the ‘Invisible Hand ideology (sic.) so prevalent today in various guises’ (p. 57). The section has criticisms of new classical economics for neglecting aggregation, for assuming linearity, flexible prices and constant relative risk aversion (pp. 18–19) but, perhaps most important of all, for treating any current rate of unemployment as the natural rate. Tobin believes that unemployment is too high at the natural rate at which the economy reaches equilibrium (p. 26). ‘Unemployment is a waste of productive resources’ (p. 21). The solution, in part 1 and elsewhere, is to use some type of income policy. Monetarists reject this solution and pursue anti-inflation policies relentlessly (a word that recurs just about every time the subject comes up). Even Thurow is criticized for dismissing income policies. Part 1 concludes that Keynesian economics is ‘back in the center of the arena’ (p. 60). This idea is repeated several times, typically after Tobin has

1 This remarkable assertion is offered without qualification. Keynes is more careful. He recognizes what would now be called job search as a source of transitional, frictional, and seasonal unemployment.

2 This part also contains the very odd statement: ‘[I]n given circumstances...there is nothing more or less inflationary in monetary expansion than in equivalent fiscal stimulus’ (p. 31). Equivalent must mean the same shift in aggregate demand produced by a debt-financed fiscal policy. Tobin excepts the effects on the exchange rate, but he neglects the different effects on the capital stock and the relative price of assets arising from financing by debt and money. He also neglects the effect on the equilibrium price level arising from the differences in the effect of financing by issuing money and bonds. See Brunner and Meltzer (1972,1976).
argued that monetarism, supply side economics and rational expectations have failed. Here is a sample.

'The stock of supply-side economics has plummeted as rapidly as it rose. Monetarism having brought the United States and world economies to the brink of disaster in 1982, until to almost universal relief the Federal Reserve suspended its monetarist targets, has also waned in professional and public popularity. Well-advertised, relentless monetary disinflation turned out to be much more painful... than rational expectations theory implied.' (p. 60)

This does not establish that Keynesian ideas are correct or 'back in the center' (wherever that is). I believe a more accurate conclusion would be that many of the public (and many economists) have become skeptical of economists' ability to manage government policy so as to control short-term changes in unemployment, prices and other variables of interest.

What are the Keynesian ideas to which Tobin would like to return? Keynes's concern about real economic outcomes, 'to which he subordinated nominal and financial variables' (p. 7), is one of the most important. He advocated 'redistribution through the fisc in favor of poorer citizens with higher consumption propensities' (p. 8). And, Keynes favored lowering interest rates to maintain mature investment booms.

This is a misreading of Keynes. While it is true that Keynes expressed concerns about unemployment and real growth, these concerns were not unique to Keynes, and he did not 'subordinate' concerns about inflation. He believed that output could be increased without sustained inflation by increasing investment and by reducing risk premiums in interest rates. Nor was Keynes typically a proponent of redistribution to increase consumption. He favored policies to increase investment. He was, at most, ambivalent about redistribution and, generally, opposed policies to stimulate consumption [Meltzer (1988)].

Tobin lists four Keynesian principles: (1) dedication of policy instruments to reach real economic goals, (2) activist demand management with attention to projections, or forecasts, of future demand, (3) coordination of fiscal and monetary policy actions to manage demand, and (4) a wage–price policy. The last, he recognizes, is a problem. 'Until Keynesians design the instrument missing from their kit of tools, we cannot press with the full conviction and confidence merited by theory and history the superiority of Keynesian policies to the anti-Keynesian policies of recent experience' (p. 12). Unfortunately, Tobin does not usually warn his readers about this problem or develop its relevance for his proposals to use incomes policies to shift the Phillips curve.
3. Reaganomics

Many of the themes from part 1 carry over to part 2 on Reaganomics. Tobin’s introduction to this section compares the achievements of the Reagan and Kennedy–Johnson administrations. Charts show measures such as real GNP, unemployment, inflation, interest rates, and investment. Tobin describes January 1961 and January 1981 as ‘similar in several respects’ (p. 64). The reader is left to draw his own conclusion, but the obvious implication — which Tobin suggests in several essays — is that the Kennedy–Johnson administrations had better results because they followed Keynesian policies. A perceptive reader may notice that when the two administrations took office, the measured inflation rates in Tobin’s chart were far from ‘similar’ — about 2% in 1961 and 12% in 1981. When the charts end after six years, Tobin’s measure shows inflation at about 1% in 1987 and nearly 4% in 1967. Since one of Tobin’s main topics is the high cost of reducing inflation, a more balanced presentation might recognize both the importance of initial conditions inherited from the preceding administration and the conditions left to the succeeding administration. Recent empirical work finds that Republican administrations in the postwar years inherited inflation from Democratic administrations. To reduce inflation, the Republicans took actions which produced recessions. Democratic administrations typically took advantage of reduced inflation to seek temporary gains in employment. [See Alesina and Sachs (1988).]

Conditions in the rest of the world are ignored. This biases the comparison. The world economy expanded rapidly in the 1960s, but not in the 1980s. World expansion affects the demand for U.S. goods differently in the two periods in ways that do not depend entirely on the policies of the different U.S. administrations. Further, the 1960s are part of the early postwar stability under the Pax Americana with declining tariffs, development and expansion of the European Common Market, and a measure of world political stability before Vietnam. The 1980s follow a period of heightened uncertainty after the U.S. defeat in Vietnam and the two oil shocks. A balanced assessment of the two periods would not neglect these differences.

In 1981, Tobin criticized the 1981 tax cuts and the policy of disinflation for the readers of the New Republic. The program was ‘irrelevant to stagflation’ (p. 100). ‘Wealth and power are to be redistributed to the wealthy and powerful’ (idem.). Tax reduction is a ‘give away’ (p. 104). (Tobin does not explain what was given away.) At about the same time, however, readers of the Economic Review of the Federal Reserve Bank of San Francisco found a moderate Tobin, who described the fiscal program as ‘more or less innocuous in its macroeconomic impact’ (p. 113). He objected to the fiscal package on macroeconomic and distributional grounds, and he criticized the administration for failing to use tax reduction as part of an incomes policy. Tobin remained skeptical about the prospects for disinflation ‘without a clear and
credible threat' (p. 117). His reasons are familiar. Each group of wage earners will fear the loss of relative income and, therefore, will insist on inflationary wage increases. By December Tobin, in the New York Review of Books, was more alarmist. He was concerned that the Employment Act of 1946 had been reversed (p. 95). The administration's program was costly; the Federal Reserve, pushed by the administration, was pursuing an anti-inflation policy. Tobin remained skeptical about the administration's prospects for achieving its aims. 'What it is sure to do is to redistribute wealth, power and opportunity to the wealthy and powerful and their heirs' (p. 98).

By 1984, recovery was in full swing. Fiscal policy was no longer innocuous. It was now, according to Tobin, a triumph for Keynesian policy. 'The stimulative fiscal measures came into full effect just at the right time...Of course, this was Keynesian demand-side policy with a vengeance, not the supply-side renaissance intended' (p. 138). Now, the budget was 'over-stimulative', the recovery 'unexpectedly rapid' (p. 164). The turn came when, to use Tobin's frequent description, Paul Volcker relented in the fall of 1982. Tobin's complaint about innocuous fiscal policy vanished with the recovery. Later he describes the 'patent success of fiscal stimulus in promoting recovery' (p. 266).

Tobin concludes that 'Reaganomics was a fraud from the beginning' (p. 88). He calls tax reform 'a political miracle' (p. 82), but the administration gets criticism, not credit, for the miracle. Tobin grants that the 1986 tax act improves horizontal equity and economic efficiency, but the 'regressive tax cuts are a high political price for these improvements' (p. 83). Further, the public sector has been 'crippled' (p. 84), as a result of the 'supine surrender' (ibid.) by Congress to the President.

There is more, but the tone and flavor are clear. One would never guess that, judged by aggregate measures, average tax rates remained between 18 and 19% of GNP, as they have during all administrations since the 1950s, or that the Reagan administration is near the upper end of the range. Nor, would one guess that changes in effective tax rates were relatively modest for almost all taxpayers with much of the reduction of progressivity for low-income tax payers a result of the increase in social security taxes [Congressional Budget Office (1987)]. Nor would one suspect that the Reagan administration not only did not 'cripple' the public sector, but transfer payments and other social spending rose as a share of GNP. Further, Tobin's complaints about the budget deficit never address such economic issues as the intertemporal alloc-

At times, Tobin has a curious presentation of 'facts'. 'In 1989, defense and interest will take 8.7 percent of GNP, leaving income taxes of only 2.0 percent for other activities' (p. 85). Did Tobin expect all nonincome taxes to be repealed and the budget balanced? What is the point of the comparison? Would it not have been less polemical and more informative to point out that outlays for major transfer and entitlement programs (other than social security) rose from 6.1% of GNP in 1979 to 7.4% in 1989, based on Congressional Budget Office projections? Included as transfers and other social spending are: community and regional development, education, training and employment, health, medicare, and income security.
ation of the costs and benefits of a one-time increase in defense spending or the proper measurement of the deficit.

4. Fiscal policy

In part 3, Tobin reprints six papers on issues in fiscal policy. These papers comment on contemporary events, but the tone is very different from part 2. Most of the material is directed at students or professionals, and it is written with the skill and clarity that characterize Tobin's academic writings.

Much of the discussion elaborates or draws conclusion from standard textbook IS-LM analysis. Tobin is alarmed by concerns over the deficit that fail to distinguish between deficits resulting from recession and deficits at full employment. At full employment, deficits crowd out other spending but, at less than full employment, they do not. Tobin is also at pains, in this section, to distinguish between structural deficits and actual deficits, and between primary deficits and interest payments. He comments on the reversal of the ratio of debt to GNP after 1981 and expresses concern that capital will be crowded out. The fact that much of the decline in the debt ratio from 1946 to 1981 was consequence of inflation is not mentioned. Let the rentier beware, even if it is a pension fund.

Chapter 20 states Tobin's case against balanced budget and tax limitation amendments. The problem is that these amendments, if approved, would remove the opportunity to use fiscal policy to stabilize the economy. Despite his complaints about Reagan administration policies, Tobin assumes that fiscal policies are used for stabilization. He does not discuss whether a constitutional limitation on spending would provide a public good by reducing log rolling, enhancing the efficiency of public spending and perhaps making more resources available for investment, the latter an end that Tobin typically favors when he discusses the mix of monetary and fiscal policy.

5. Monetarists and monetary policy

Part 4 has five papers on monetary policy, monetarism, and financial structure. Few will be surprised to learn that Tobin opposes the use of targets based on monetary aggregates. Regrettably, Tobin does not use his lecture on monetary policy at the Bank of Japan (Chapter 22) to discuss experience with such targets. Since the mid-seventies, the Bank of Japan has announced 'projections' for a monetary aggregate. The projections were reduced gradually so that, over an eight-year period, inflation declined from 8% to about zero, while real growth remained between 3 and 5%. Fiscal policy aimed at reducing the budget deficit without raising taxes. There was no attempt to achieve the type of policy mix that Tobin favors, and there we no explicit guideposts or
wage-price policies. Tobin does not discuss the outcome. The policy was relatively successful; it is one of the few examples, perhaps the only one, in which an entrenched inflation was reduced without a recession.

Tobin takes a cautious approach to financial deregulation. There are efficiency gains to be had, but there are risks in a deregulated system. He proposes deposits with 100% reserves to be used as a store of value with government paying interest on the reserves to create a public good. He favors, also, the issuance of indexed saving certificates, but the index should be free of indirect taxes and changes in the terms of trade.

A short essay, written in 1974, makes the point that interest rates were high because of restrictive monetary policy; whereas the rise was misinterpreted by others as the (Fisher) effect of fully anticipated inflation. Tobin argued that the Fisherian interpretation was inconsistent with the fall in stock prices at about the same time. His argument, unlike many others at the time, recognized the effect of inflation on tax rates and the resulting overstatement of taxable earnings. He neglects this point, however, when he argues that inflation should leave the relative price of assets unchanged (p. 278).

What I take to be the main complaint against monetarism arises from the monetarists' support for rules and opposition to discretion. In 'Monetarism: An Ebbing Tide?,' Tobin argues against rules, but the argument is temperate. As usual, he overstates the influence of monetarism on the Federal Reserve. However, he recognizes central banks' duty to restrict inflation and to oppose pressures for inflation, but he argues this can be done without excluding countercyclical demand management policies.

Tobin prefers 'discretion' but not unlimited discretion. His preferred monetary policy (in 1983) would aim at real, not just nominal, magnitudes. He gives two reasons. First, prices adjust slowly, so monetary policy can influence the path along which the economy adjusts. The path is important; steady states are not independent of the path by which they are reached. Second is a political argument; central banks cannot stand aloof.

In 'Monetary Policy in an Uncertain World,' Tobin recognizes that information is incomplete; activist policymakers can misjudge the type of shock they face or perhaps make incorrect forecasts. His proposal is to weigh the costs of unemployment and lost production against the risks and costs of accelerating inflation. The weights are given by the estimated tradeoff between the two objectives.

The stability or reliability of the estimated tradeoff is not discussed. Several countries that attempted in the past to manage the tradeoff have deemphasized the tradeoff strategy and adopted policy rules in the form of medium-term

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Footnote: At one point, Tobin describes the Japanese (and Germans) as firm monetarists (p. 74). Elsewhere, he attributes Japan's success to weak unions and a bonus system. Would the unions have remained weak and wages noninflationary if Japan followed Tobin's preferred policies? Or would inflation have remained at 8%, as in the early seventies.
strategies. Tobin dismisses such decisions as mistakes. 'There is no substitute for stochastic dynamic models of the economy linking policy instruments to contemporaneous and future outcomes' (p. 245). Never mind that these models, whether judgmental, econometric, or autoregressive have quarterly or annual forecast errors that are a large fraction of the average rate of change. If Tobin has seen or heard these criticisms, he has chosen to disregard them. His only concession is to recognize that the central bank may be uncertain about the type of shock that has occurred. Shocks to aggregate real demand and to portfolios (IS and LM shocks) call for different responses. He argues that action should not be delayed during the period of uncertainty. The central bank should use the probability of each type of shock as a weight to determine its action. Once the type of shock is identified, the weights should be disregarded. Tobin does not discuss the monetary response to real supply shocks in this, his most explicit, statement about monetary policy. Nor does he consider effects on anticipations, or that inaction or an activist rule may be more efficient, or other objections to his policy that are in the literature.

Tobin proposes that the longer-term objectives of the central bank should be expressed in a hierarchical structure. Long-term goals should include both real and nominal variables. The intermediate goal or (annual) target should be an objective for nominal GNP growth and, for shorter periods (up to two quarters), the central bank should announce targets for money, reserves, and interest rates. The target ranges 'would remain constant for the period' (p. 246). I interpret this to mean that each quarter the central bank would (or could) revise its medium and longer-term objectives. The targets would be coordinated with the fiscal authority and with the principal noncommunist countries.

What incentives would drive the central bank to do more than give lip service to its long-term goals? What incentive would induce coordination? Tobin acknowledges some of the difficulties and moves on.

6. Inflation

The longest section of the book, part 5, contains ten papers on 'Inflation, Stagflation, Unemployment and Incomes Policies' written between 1974 and 1984. The main message is repeated many times. Price stability and full employment are incompatible. Incomes policy can make them more closely compatible. The benefits of an incomes policy, therefore, outweigh the efficiency loss resulting from its use.

Chapter 27, written for an encyclopedia, is a careful restatement of mainstream views with some notable statements. 'Inflation is by definition a monetary phenomenon' (p. 302; see also p. 324). Money prices rise. Inflation (or deflation) is recognized as a cost that society pays for the efficiency that 'monetary institutions contribute in trade and division of labor' (p. 305).
Tobin typically treats inflation as socially costless – just redistribution within a group. Here, he recognizes that fluctuations can be so violent that they reduce the social gain from using money.

In the presence of rigid prices – contracts, zero interest on reserves and currency, fixed rates on loans, mortgages, and other instruments – anticipated inflation is not neutral. Set against the social costs resulting from sluggish price adjustment is the social gain from holding an increased capital stock.

Unanticipated inflation produces gains and losses that are offsetting. Tobin recognizes, however, that inflation may make foreign debt more costly to service or change the real value of foreign assets.

The other Tobin reappears; none of the qualifications is mentioned for the readers of The New York Times. 'It is simply vulgar nonsense... to say that an internal self-contained inflation causes per se a loss of economic welfare in aggregate' (p. 322). Is the reader of the Times so much more sophisticated than the reader of the encyclopedia that he can guess that Tobin has, by assumption, eliminated foreign debts and assets and made the inflation fully anticipated and constant? And both readers would have to go to another source\(^5\) to learn that there are excess burdens from an inflation that is not fully indexed, from the uncertainty that cannot be hedged fully unless someone is willing to offer indexed assets, and possibly from the heightened variability of relative prices reported for periods of high inflation in Cukierman (1984).

While inflation is a monetary phenomenon, it has many causes. The quantity theory, with money causal, is a rough approximation for earlier periods but is incomplete as an explanation of inflation in modern economies. High money growth is necessary, not sufficient, for inflation. Tobin emphasizes by repetition that money may accommodate price increases that occur for other reasons. Governments may choose to mobilize resources for war or other purposes, or governments may regard anti-inflationary policies as too costly. Tobin describes three main sources of inflation: (1) excess aggregate demand, often brought about by high rates of money growth; (2) inertial, brought on by sluggish adjustment of prices and wages, by the inflationary bias in modern economies, and by supply shocks and other accidents; and (3) conflict, arising from competing claims to income that are resolved by increasing money growth to raise money income. This discussion, like many others, breaks down in a discussion of the motives for money growth and fails to distinguish between one-time price changes and sustained rates of price change (inflation). Failure to make this distinction is one main reason that economists disagree about the cause of 'inflation'.

Tobin dismisses vulgar forms of cost-push inflation where relative price changes cause changes in the general price level. The problem is that wages

\(^5\)A good starting place would be Fischer (1981). There is one partial exception. Tobin mentions that prices are costly to change, so relative prices may be distorted (p. 333).
and prices are not fully flexible. Workers look at the wage increases in other industries and firms and at the cost of living index also. They try to maintain their relative income or their position in the real wage distribution. Prices are based on costs of production, so wage increases in excess of productivity induce price increases, additional wage increases, and a wage-price-wage spiral. The monetary authority is forced to choose between accommodation of external shocks (or inertial processes) and a monetary contraction that will cause, first, recession and unemployment and, only later, disinflation. The losses from unemployment fall on a small segment of the population.  

Tobin’s solution is incomes policy to supplement policies of reducing aggregate demand. He favors some system of rewards and penalties such as taxes on excessive increases or tax reduction for wage and price restraint. He recognizes that there are costs of controls but, he points out, there are also benefits. He has no doubt about the balance. Tobin does not explain why the wage-price policies of the Nixon and Carter administrations, in the U.K., in France, and in many other countries did not achieve price stability or maintain substantially lower inflation. If the cost-benefit calculus is favorable, why are the benefits of past attempts not apparent? Why must Tobin rely on a few questionable claims about the success of guideposts in 1961 to 1965, a period in which inflation (GNP deflator) rose from 1.0 to 2.7 percent?  

Tobin’s discussion fails to distinguish carefully between one-time price level changes and maintained inflation. What reason is there to accommodate an oil shock that raises prices and reduces employment? If money growth remains on its path, real balances and aggregate demand fall, but real wages also fall. The fall in real wages helps to maintain employment following the shock. Monetary accommodation cannot be expected to permanently change the relative price of oil, but it can distort the signals that the economy receives, slowing (or temporarily reversing) the reduction in real wages and the changes in relative prices that are required for a return to a new full equilibrium.

Tobin’s argument about inertial inflation or the inflationary bias strikes me as partial and incomplete. Expectations are not mentioned and appear to be fixed (inert) independently of the type of policy. Policies of accommodation strengthen the belief that efforts to control inflation will not be sustained, while an accommodative policy reinforces the belief that there is a bias toward inflation. A credible commitment to noninflationary and nonaccommodative policy, that prevents inflation on average, can lower the cost of maintaining

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6 It is interesting to contrast two statements. The first is from the discussion of inflation. ‘One can see little change in the size distributions of income and wealth, or in the shares of labor and property. They have remained much the same throughout the postwar period…’ (p. 334). The second pair comes from the discussion of Reaganomics. ‘Wealth and power are to be redistributed to the wealthy and powerful’ (p. 100). ‘During the Reagan years poverty and inequality have increased in the United States’ (p. 81). The first was published in 1982, the second pair in 1981 and 1984.
that average and persuade price setters (including unions) that one-time price changes are not likely to be followed by persistent price increases.

In my view, it is not happenstance that countries that are committed to low inflation – e.g., Switzerland and Japan – have more flexible wages or prices. One need only contrast the rate of wage increase in Japan during the years of inflation with wage increases in the years of credible disinflation. And, one does not have to go to Japan. In 1966, few believed that the U.S. would experience persistent inflation. A few months of monetary deceleration in the U.S. brought the average rate of increase in the consumer price index from 4% in January 1966 to 1.4% in January 1967.7

Tobin ignores this episode. He blames the inflation of the late 1960s entirely on President Johnson’s unwillingness to choose between guns and butter. His account is selective. Omitted is the 1966 experience just mentioned and the change in policy mix following the 1968 tax surcharge. Keynesian economists, responsible for policy at the time, were so concerned about the consequences of a ‘tight’ (or tighter) fiscal policy that they persuaded the Federal Reserve to adopt an ‘easier’ monetary policy. The Federal funds rate was lowered and money growth increased. By 1969, the rate of change of producer prices had increased from 1.5% to about 5%.

Tobin avoids discussion of this failure to choose the right mix. On his logic, if President Johnson insisted on an easy fiscal policy before the 1968 surtax, the Keynesians responsible for policy should have called for a tighter monetary policy. I don’t recall Keynesian demands for slower money growth to control inflation, and Tobin does not suggest such a policy in his papers or in retrospect.

Much is written about the costs of a nonaccommodative policy and even more about the costs of disinflation. Yet, the two costs are not brought together and linked, as they should be, to expectations. Tobin either does not see, or he refuses to address, the relation between policy and expectations. He does not remove the issue by dismissing new classical economics. Rational expectations makes a correct point, even if new classical economics overstates it by neglecting costs of learning and acquiring information. People learn; they behave differently under accommodative and nonaccommodative policies. Accommodation encourages sluggish adjustment by reinforcing the belief that, on average, the rate of price change is positive and may be rising. By the late 1960s people were aware that many attempts to disinflate were reversed when unemployment rose. Anticipations about the long-term path shifted.

The issue is not, in Tobin’s terms, whether we are always at the natural rate or subject to large social costs of disinflation. It is, again in Tobin’s terms,

7 Data are for a six-month average. Corresponding data for the producer price index are 4.6% and minus 1.8%. The unemployment rate declined from 4% to 3.9%. Keynesians were very critical of the disinflation policy. Tobin now believes that Chairman Martin was right to raise the discount rate in December 1965 (p. 435).
whether the results of the cost–benefit calculation are independent of the policies pursued, whether the belief that others will not reduce their claims is reinforced by evidence that the government does not persist in policy actions that induce temporary increases in unemployment. To fail to address these issues is to fail to join the argument and respond to the critics of discretionary policy.

7. Miscellany

Part 6, Political Economy, collects seven unrelated papers on policies and policy issues. A paper on energy policy, written in 1974 for the National Academy of Sciences, dismisses exaggerated claims about the effects on ‘life styles’ and criticisms of America’s profligate use of world energy resources. There is a review of Thomas Sowell’s book, Race and Economics. A commentary on the Catholic Bishop’s letter on the economy and poverty gives Tobin an opportunity to comment on some of the major policy failures of our time – our inability to find constructive solutions for the crime, violence, drugs, illiteracy and other, all too common, features of urban centers. In ‘The Political Economy of the 1960s’ Tobin reflects on his experience in government and, more broadly, on the role of government in our society. This paper ends, poignantly, with a comment on the loss of social consensus, the growing fractiousness after Vietnam and Watergate, and the importance of trust and social consensus for reaching agreement on policies to deal with the collective problems of the environment, defense and income redistribution. If Tobin believes that government coercion has contributed to a weakening of the social consensus, he neglects to say so.

8. Why we disagree

Although economists differ about models, they often differ much more about policy. This review is not an exception. A frequent explanation is that the differences reflect value judgments or are doctrinal and ideological. Tobin seems to accept this interpretation when he refers to the ‘increasing doctrinal and, yes, ideological polarization of the economics profession in recent years. It is a shame, and it should stop.’ (p. 227)

While it is regrettable that Tobin chooses at times not to follow his own strictures, as this review has suggested, I believe it would be wrong to conclude that differences are solely or even mainly differences about values or beliefs. It is not only too easy, it is incorrect to conclude that the differences in interpretation of events or proposals for policy represent mainly different weights in private utility functions.

For this reader of Policies for Prosperity at least four reasons for disagreement about policy seem more important than differences about beliefs and
values. First, there is a difference about the model. Much of Tobin’s analysis relies on an IS-LM framework combined with a stable Phillips curve. Second, there are differences about the sources of variability, the treatment of information, uncertainty, and the value of forecasts. Third, there are issues about facts or interpretation of facts. Fourth is the role of the public, as voters, in the policy process. The remainder of this review discusses these points in turn.

Advances in economics that are neither Keynesian nor anti-Keynesian have moved macro theory beyond the IS-LM model with a stable Phillips curve. The more complete analysis of stocks, to which Tobin made major contributions, and the development of expectations are two such developments. Policies for Prosperity does not draw on these developments. Tobin does not insist on a permanent tradeoff between inflation and unemployment, but his papers take a reliable tradeoff as a starting point. Even when Tobin appears to accept the natural rate hypothesis (p. 316), he combines the natural rate with a stable short-run Phillips curve. And his many calls for incomes policy suggest that he thinks the Phillips curve can be shifted in a reliable and predictable way.

Tobin presumes that the forecast errors from available models using current techniques are sufficiently low that policymakers can remove more variability than they introduce and that they have incentives to do so. He presumes also that policymakers can adjust the fiscal–monetary mix and the guidepost for wages to achieve a better outcome. I am skeptical and, more importantly, I believe the evidence shows that even the lowest forecast errors for prices, output, and other variables of interest are, on average, large relative to the average quarterly or annual change. There is no evidence that government or private forecasts can be used to lower variability on average. Further, Tobin is far from even-handed. He points frequently to the instability and poor predictability of velocity in the 1980s, but he relies on the presumed stability of the Phillips curve and Okun’s law. In fact, neither velocity nor the Phillips curve can be used to steer the economy from quarter to quarter or year to year if the goal is to reduce variability and lower social costs. I am persuaded by evidence that, under conditions of uncertainty, the best we can do on average is to choose adaptive policy rules that use relevant current information but do not rely on forecasts. Tobin does not address issues of this kind, and he does not consider costs of acquiring information by policymakers or the risk that policies based on incomplete or inaccurate information about the structure of the economy increase variability and uncertainty. Tobin is more willing than the proponents of rules (including adaptive or contingent rules) to bet that activist policy reduces social cost, but he provides little evidence to support his view.

One of the main issues that Tobin addresses is the incompatibility of inflation and full employment. He offers no evidence of long-term incompatibility. Further, his discussion of the short-term adjustment ignores anticipa-
tions and the role of policy in changing beliefs about future inflation. Also missing is discussion of policymakers' commitments to forego using discretionary monetary policy to gain electoral advantage, to pursue redistributive policies to aid housing, debtors, or other groups. Such policies often increase inflation and strengthen beliefs about the persistence of inflation. Thus, they raise the costs of disinflation and contribute to what Tobin calls incompatibility.

Voters, and politicians acting as politicians and as voters' agents, generally have no role. A clear lesson of the past twenty years is that voters do not like either rising inflation or rising unemployment. The inflation they have experienced and appear to dislike is not the constant, indexed inflation that necessitates a few extra trips to the bank. It is variable inflation that, while lowering real indebtedness, often raises taxes and increases uncertainty about the real value of accumulated savings and pensions. Perhaps voters see, also, that the gains in employment and consumption achieved by raising the inflation rate are temporary, that their lifetime real incomes are not higher and, to the extent that inflation raises taxes, the additional taxes finance expenditures and transfers that, on the margin, they prefer not to make. An economist may try to persuade them, as Tobin often does, that they should change their views. A politician is likely to be persuaded more by the reelection of governments that substantially reduced inflation. A stable adaptive rule or medium-term strategy may be beneficial politically as well as economically.

If voters choose to pay and receive welfare benefits that are high relative to the real wage offered by employers, as they appear to do in parts of Europe, should governments use demand expansion to reduce the real value of nominal transfers so as to increase employment? Tobin does not analyze the effect of the welfare state on the equilibrium rate of measured unemployment. His denial that all unemployment is voluntary does not establish that all unemployment is Keynesian. Real after-tax wages received and real employment costs (including taxes) paid receive too little attention in this book. The same is true of evidence to support Tobin's presumption about the achievements of policies to vary the fiscal–monetary mix. Tobin seems unwilling to use his outstanding analytic abilities to see the unemployment problem as more than a bad choice of position on the Phillips curve.

There are a few exceptions; p. 317 is one of the few.

Tobin is very critical of the Thatcher government in the U.K. A plurality of voters preferred that government to its alternative. Now that we have a longer record, their choice of a government that offered a medium-term strategy (rule) does not seem unwise. Unemployment, though high by past standards, is below the European average. So is the current inflation rate. Real income, which rose at a rate 40% slower than the Common Market average from 1960 to 1980, rose at a rate nearly 40% above the Common Market average for the five years ending in 1987.
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