

NATIONAL AFFAIRS

The Cycle of Rules and Discretion in Economic Policy

John B. Taylor

ON DECEMBER 28, 1948, the famed financier Winthrop Aldrich—who was then serving as president of the nation’s largest bank, Chase National—addressed the first joint luncheon of the American Economic Association and the American Finance Association. The two groups—and, with them, the larger community of American economists—were struggling to find a way out of the seemingly endless economic state of emergency America had experienced in the prior two decades, and to shape a post-war approach to macroeconomic policy. In his remarks, Aldrich took up a theme that would reverberate throughout the post-war era: the question of whether monetary policy should be guided by the goal of long-term price stability or yield to short-term pressures to keep interest rates low.

Aldrich blamed the Federal Reserve’s easy-money policies of the 1920s for helping to cause the Great Depression. In the late ’40s, he was concerned that the Fed would monetize the enormous World War II debt, printing money to buy up Treasury bonds and thereby increasing the risk of inflation. “The goal of the monetary authorities,” he said, should instead be to “modify the policy of maintaining rigid support levels for government bonds and to regain their freedom” to combat long-term inflation.

The following year, the groups’ second joint luncheon address was given by Paul Douglas, the University of Chicago economist who had just been elected to the U.S. Senate from Illinois. Douglas’s themes were similar

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to Aldrich's, though he focused on fiscal policy. He knew the Keynesian arguments for short-term deficit spending but was concerned about the national debt: "[T]he problem of balancing the budget and of adopting a sound fiscal policy is not merely economic," Douglas argued. "It is to an even greater degree a moral issue. We shall need a proper sense of values and a high degree of ethical self-restraint if we are to reach our goal."

The question that concerned Aldrich and Douglas more than 60 years ago—the question of the basic ends and means of American fiscal and monetary policy—has been hotly disputed ever since. That dispute has often centered on the merits of *rules-based* policymaking versus those of *discretionary* policymaking. Of course, fiscal and monetary policies always involve some combination of rules and discretion: Policymakers never simply employ one approach or another by itself. But they do, at different times and in response to different pressures, tend to emphasize one over the other.

When policymakers lean in the direction of rules, they pursue less interventionist, more predictable, and more systematic policies. In monetary policy, the Federal Reserve adheres to a steady and predictable strategy for adjusting interest rates or the money supply. In fiscal policy, legislators and executive-branch officials set long-term debt, spending, and revenue policies and rely on "automatic stabilizers"—such as unemployment benefits and other transfer programs that are sensitive to changes in the business cycle—to counteract booms or busts.

When policymakers lean toward discretion, by contrast, they pursue less predictable, more interventionist policies with a focus on short-term fine-tuning. In monetary policy, the Federal Reserve seeks to influence or respond to momentary fluctuations in unemployment and inflation without a long-term strategy. Fiscal policy comes to involve targeted and temporary spending and tax changes, the goals of which are usually to produce a short-term stimulus.

Economic policy during the post-war period has consisted of three major oscillations between rules-based and discretionary policy. The first swing moved toward more discretionary policies in the 1960s and '70s; then came a shift toward more rules-based policies in the 1980s and '90s. In the past decade, there has been a return to discretion. Remarkably, the same oscillations occurred simultaneously in both monetary and fiscal policy. Each of these swings has had enormous consequences for the American economy. Taken together, they make for

a historical proving ground in which to study the effects of rules-based and discretionary policies on the economy.

So what, then, might we learn from this evidence about the effects of these policies on unemployment, inflation, economic stability, the frequency and depths of recessions, the length and strength of recoveries, and periods of economic growth? What does history suggest about the question that concerned Aldrich and Douglas, and that has consumed countless economic thinkers since? When it comes to fostering prosperity, which is better—sticking to clear rules, or granting policymakers broad discretion?

THREE SWINGS

In the decades following World War II, Keynesian ideas about countercyclical fiscal policy became increasingly popular among academic economists. This developing consensus received an official imprimatur when the 1962 *Economic Report of the President*—the annual publication produced by the President’s Council of Economic Advisers—made an explicit case for significant discretion in economic policy. “The task of economic stabilization cannot be left entirely to built-in stabilizers,” the report warned. “Discretionary budget policy, e.g., changes in tax rates or expenditure programs, is indispensable—sometimes to reinforce, sometimes to offset, the effects of the stabilizers.” The council further argued that the government should have broad leeway to make such changes frequently, in response to evolving conditions: “In order to promote economic stability, the Government should be able to change quickly tax rates or expenditure programs, and equally able to reverse its actions as circumstances change,” the report noted. According to the council, a similar logic must prevail in monetary policy—where “[d]iscretionary policy is essential, sometimes to reinforce, sometimes to mitigate or overcome, the monetary consequences of short-run fluctuations of economic activity.”

These general principles soon started to be expressed in policy—and they continued to be throughout the 1960s and ’70s, under administrations from both parties. By and large, they took the form of stimulus packages and other targeted spending or temporary tax changes intended to drive demand or otherwise manipulate the economy. They included the investment tax credit of 1962, and tax surcharge of 1968, and the tax rebate of 1975. As late as 1977, the Carter administration successfully enacted discretionary stimulus packages, including sizable grants to the states for infrastructure.

The epitome of interventionist economic policy, though, was the imposition of wage and price controls by the Nixon administration in 1971 to combat inflation, which had climbed above 6% the previous year. The original 90-day freeze on nearly all wage and price increases expanded into a three-year experiment in discretionary inflation control—an experiment that ultimately failed. (In 1974, the average inflation rate was above 11%.)

These interventionist measures had the support of that era's most prominent voices in monetary policy. Indeed, in 1972, Federal Reserve chairman Arthur Burns defended the administration's efforts; the reason, he explained to another joint luncheon of the American Economic Association and the American Finance Association, was that "wage rates and prices no longer respond as they once did to the play of market forces." Burns applied the same interventionist approach to his role at the Fed, and the late 1960s and '70s saw a series of discretionary adjustments of the money supply and interest rates. No one, it seems, was heeding Milton Friedman's counsel—offered in his own American Economic Association address in 1967—that the Federal Reserve should go about "setting itself a steady course and keeping to it."

A great deal of subsequent research has shown that the Fed's responses to inflation were highly unstable over this period of discretion. Those responses can be divided into several distinct boom-bust periods, each of which saw the Fed ease and then sharply tighten the money supply. These measures induced contractions in economic activity, but the Fed then failed to sustain its tighter policy long enough to yield a lasting decline in inflation. Again and again, short-term thinking led to uneven and irregular monetary decisions.

This dynamic began to change as the 1980s dawned. Some prominent analyses of the effects of discretionary fiscal stimulus—perhaps most notably that of economist Edward Gramlich in his 1979 study of the Carter stimulus packages—undermined the support for such policies among academic economists. On the practical side, the Reagan administration eschewed highly discretionary approaches in favor of greater reliance on fundamental (and permanent, rather than temporary) tax reforms.

This reliance on automatic stabilizers (rather than discretionary policies) in responding to the ups and downs of the business cycle continued through the 1990s, with very few—and very modest—exceptions. A very small stimulus was proposed by President Bush in 1992, but even this failed to pass in Congress. Another small stimulus was proposed by

President Clinton in 1993, but it too failed to pass. By 1997, Northwestern University economist Martin Eichenbaum could write of the “widespread agreement that countercyclical discretionary fiscal policy is neither desirable nor politically feasible.”

A similar shift occurred in monetary policy, beginning with the Federal Reserve’s decision — starting in 1979 under the leadership of Paul Volcker — to focus its efforts on reining in inflation. This marked a dramatic change from most of the 1970s, when the Fed repeatedly switched emphasis from unemployment to inflation and back again. In his 1983 address before that year’s AEA-AFA luncheon, Volcker noted that the Fed had “gone a long way toward changing the trends of the past decade and more.” His successor, Alan Greenspan, maintained this commitment to price stability through the 1980s and ’90s.

The Fed also showed a greater appreciation for the importance of predictability and transparency in its decisions. In the 1970s, decisions about interest rates were hidden within the Fed’s announcements about its borrowed reserves. By the early 1990s, however, the Fed was announcing its interest-rate decisions immediately after making them, and was even publicly explaining its expectations and intentions for the future. The transcripts of meetings of the Federal Open Market Committee — the Federal Reserve body that makes decisions about interest rates and the money supply — throughout the 1990s include numerous references to policy rules.

The empirical evidence, too, plainly demonstrates that monetary policy corresponded far more closely to simple policy rules in the 1980s and ’90s than it had in the previous two decades — as shown, for example, in a 1995 study by John Judd and Bharat Trehan of the Federal Reserve Bank of San Francisco.

But this commitment to rules-based economic policy has waned in the last decade. Perhaps an early sign of the change was the Bush administration’s decision to respond to the economic downturn it confronted in 2001 with a one-time “tax rebate” (in which \$300 checks were sent to about two-thirds of American taxpayers) intended to stimulate demand. Though one could say this was a down payment on the more permanent 2001 tax cuts that followed, the administration’s move led Milton Friedman to pronounce with regret that “Keynesianism has risen from the dead.”

Clearer signs, however, could be found in monetary policy. Between 2003 and 2005, the Federal Reserve held interest rates far below the levels that would have been suggested by the monetary-policy rules that

had guided its actions in the previous two decades. The deviation was large—on the order of magnitude seen in the unstable decade of the 1970s. The Fed’s public statements during that time—which asserted that interest rates would be low for a “considerable period” and would rise at a “measured” pace—are evidence that this was an intentional departure from the policies of the 1980s and ’90s.

Ostensibly, that departure was intended to help ward off a perceived risk of deflation, but the extremely low interest rates during these years contributed to the development of the housing bubble that played a central role in the economic crisis from which we are still recovering. The Bush administration then responded to the downturn that began in December 2007 with another round of exceptionally discretionary fiscal policy. First came a \$152 billion stimulus package enacted in February 2008 (that again included checks to taxpayers). The following month began a series of on-again-off-again bailouts of the creditors of financial firms—on for the creditors of Bear Stearns, off for those of Lehman Brothers, on for those of AIG, and then off again while the Troubled Asset Relief Program was rolled out. During the ensuing panic in the fall of 2008, the government intervened to help the commercial-paper market and money-market mutual funds.

The next year, the Obama administration advanced an \$862 billion fiscal stimulus (which included temporary rebates and credits, as well as grants to state and local governments) and the Cash for Clunkers program. The Fed then stepped in with more discretionary policy of its own, most notably its massive quantitative-easing policy in 2009 (which included the purchase of \$1.25 trillion in mortgage-backed securities and \$300 billion in long-term Treasury bonds). The Fed’s second round of quantitative easing—which is popularly known as “QE2” and will continue into this year—is set to involve the purchase of another \$600 billion in long-term Treasury bonds. All told, there can be little doubt that the rules-based economic policies of the 1980s and ’90s are over.

DISCRETION, RULES, AND CONSEQUENCES

What effect did this policy cycle have on the economy? What happened to America’s economic performance—measured through employment, inflation, stability, the nature of recessions and recoveries, and economic growth—as the pendulum swung back and forth between policies governed by rules and those based on discretion?

The three periods in question clearly coincided with dramatically different levels of economic performance. The first swing, toward discretionary policies, aligned with a period of frequent recessions, high unemployment, and high inflation from the late 1960s to the early 1980s. In fact, inflation, unemployment, and interest rates all reached into double digits in this period, and by the late 1970s there was a palpable sense in America that our economy was out of control, and perhaps headed for an enduring decline.

The second swing, toward more rules-based policies, coincided with a remarkably stable period, frequently called the Great Moderation, from the mid-1980s until the early to mid-2000s. Both the levels and the volatility of inflation and interest rates were markedly lower than they had been in the 1970s. The volatility of real gross domestic product, in fact, was reduced by half. Economic expansions in this period were longer and stronger, while recessions were shorter and shallower than they had been in the previous two decades.

Finally, the swing back toward discretion in recent years has coincided with the financial crisis and a recession much deeper than those of the Great Moderation period. The recovery, meanwhile, has been much slower than the one we saw after the recession of the early 1980s.

The economic history of the past 60 years thus suggests a connection between rules-based policy and good economic performance. But correlation — even an amazing six-decade-long correlation — does not prove causation, so we must investigate further.

First, we must consider the possibility that the correlation reflects a cause-and-effect relationship in the opposite direction — that is, that poor economic performance brought about more intervention, and good economic performance permitted less intervention, so that the swings were caused *by* changing economic performance rather than serving as the cause *of* it. The basic timeline laid out above, however, is completely inconsistent with such an explanation. The popularity of discretionary Keynesian fiscal policy in the 1960s could not have been a response to the deep recessions of the 1970s, after all. Similarly, the inflationary monetary policy that began in the late 1960s could not have been caused by the inflation of the 1970s. And it obviously strains credibility to argue that the Federal Reserve's move to reduce inflation and restore economic stability in the late '70s was caused by the low inflation and stable economy of the 1980s and '90s.

Perhaps one could more plausibly argue that the shift back to discretion in recent years was provoked by the severe financial panic of 2008. But much of that shift toward discretion began *before* the panic of the fall of 2008: Low interest rates were maintained from 2003 through 2005; the Bush administration's stimulus package was enacted in February 2008; the Fed's discretionary bailouts began in March 2008. Moreover, if the emergency of the panic were the reason for the move toward discretion, one would expect to see a return to rules-based policies now that the height of that panic is more than two years in the past. Instead, another large discretionary action—the Fed's so-called QE2—has been undertaken, rationalized on the quintessentially discretionary grounds that the economic recovery is slowing and that even a monetary policy with interest rates near zero has not been easy enough to combat deflation.

The more straightforward conclusion—that rules-based policy was an important *cause* of the improved performance of the 1980s and '90s, and that discretionary policy has been harmful to the economy—aligns much better with the historical timeline. It is also amply supported by economic theory. Any dynamic model in which people are forward-looking and take time to adjust their behavior to circumstances implies that monetary and fiscal policy work best when formulated as rules. Government's adherence to known rules allows people to have a clearer sense of what is coming, and therefore to make more informed decisions and long-range plans.

The so-called “time consistency” argument developed by economists Finn Kydland and Edward Prescott—for which they won the Nobel Prize in economics in 2004—further buttresses this view. In a 1977 article in the *Journal of Political Economy*, Kydland and Prescott argued that discretionary policies produce suboptimal results because they deny people the benefits of “policy commitments.” Such commitments—which give the public the sense that the basic rules of the game are steady and reliable—are essential to the proper functioning of a market economy. Kydland and Prescott's argument suggests that a commitment to a reasonably sound rule—even if it is very far from a perfect rule—is preferable to discretionary policies, however well intentioned or managed. Moreover, almost by definition, highly discretionary policy limits the ability of market players to plan, and so tends to distort market behavior, driving it toward inefficient short-term responses and choices.

The so-called “Lucas Critique,” named for economist Robert Lucas (who won the Nobel Prize in economics in 1995), suggests that consistent

rules are crucial for conducting and evaluating economic policy. First published in 1976, the Lucas Critique argues that, since people's expectations are heavily dependent on particular public policies, economic models that try to evaluate policy based entirely on extrapolating historical trends are bound to fail because they do not take policy changes into account. The same principle suggests that economic models will break down if policymakers do not follow relatively consistent rules—and therefore that rules have an essential role to play in guiding policymakers toward sound decisions, and in helping them assess the effects of their decisions. Over time, discretionary policy will inevitably make for bad policy.

Some observers have argued that the crisis of the past few years shows that economic models that assume rational forward-looking agents have failed—and that we should therefore discount this case for rules, which is based on such models. But the evidence of the past few years does not support such a view. It suggests instead that the models and theories were right, and that the policies pursued by policymakers in Washington were wrong—that the failure to adhere to rules-based policies contributed to the crisis. As Princeton economist Avinash Dixit put it recently, “economic theory came out of this rather better than policy practice did.”

I have spent a good part of the past three years studying the implications of the past decade's turn to discretionary policies. My research shows that the low interest rates set by the Federal Reserve from 2003 to 2005 added fuel to the housing boom and led to risk-taking and eventually a sharp increase in delinquencies and foreclosures and in the toxic assets held by financial institutions. A more rules-based federal funds rate—particularly one that held to the general approach that characterized Fed decisions throughout the 1980s and '90s—would have prevented much of the boom and the bust that followed.

Other economists have found much the same. In a paper published last year by the Federal Reserve Bank of Kansas City, economist George Kahn observed that, were it not for the Fed's deviation from its general rule of the 1980s and '90s, the housing bubble would have been significantly less severe. “When the [policy rule] deviations are excluded from the forecasting equation,” he wrote, “the bubble in housing prices looks more like a bump.” Last year, Charles Bean and his colleagues at the Bank of England argued that the Fed's deviation from its earlier policy rule caused 26% of the increase in U.S. housing prices during the period of the boom—no small portion, given that housing prices have

fallen by only about 30% from their peak. It seems clear that the Federal Reserve's discretionary measures played a significant role in setting up the severe recession from which we are still recovering.

On the fiscal-policy front, I have found that the tax rebates and one-time stimulus payments in 2008 and 2009 did little overall to jumpstart consumption and thereby jumpstart the economy, which their proponents insisted they would. Aggregate disposable personal income increased when the stimulus checks were sent out in the spring of 2008, but aggregate personal *consumption* did not increase. Similarly, the stimulus-induced temporary increase in disposable personal income in the spring of 2009 did not have a noticeable effect on aggregate consumption. Thus the evidence shows that, in the aggregate, neither stimulus package had *any* noticeable effect on consumption.

My Stanford colleague John Cogan and I have also found that the parts of the 2009 stimulus aimed at boosting government purchases were similarly ineffective. Data from the Bureau of Economic Analysis show that government infrastructure spending at the federal level increased by only 0.04% of GDP due to the stimulus. And the grants sent to state and local governments also did not actually result in an increase in government purchases of goods and services (perhaps in part because many states and localities merely used them to plug holes in their budgets).

To be sure, the Fed's interventions in the commercial-paper market and money-market funds during the panic in the fall of 2008—measures intended to provide liquidity to those markets—were helpful in rebuilding confidence. So not every discretionary intervention in recent years has been harmful, but those more effective interventions would not have been necessary had the earlier interventions been avoided.

On the whole, the past few years leave little doubt about the dangers of discretionary economic policy. And the evidence left in the wake of the policy cycles of the past six decades strongly suggests that rules-based policymaking is a far superior approach.

POLICY RULES AND ECONOMIC FREEDOM

The case for rules over discretion is not only an economic case. As Friedrich Hayek put it in *The Road to Serfdom* in 1944,

Nothing distinguishes more clearly conditions in a free country from those in a country under arbitrary government than the

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observance in the former of the great principles known as the Rule of Law. Stripped of all technicalities, this means that government in all its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one’s individual affairs on the basis of this knowledge. . . . the discretion left to the executive organs wielding coercive power should be reduced as much as possible.

It is no coincidence that the same approach that best serves the interests of freedom and the rule of law also makes for good economics in practice. In both cases, setting out a rule and sticking to it helps policy-makers resist interest-group pressure and avoid overreacting to short-term blips. It allows citizens to exercise their freedom and their judgment, and enables both the people and their leaders to keep their eyes on long-term needs and goals.

As former Treasury secretary George Shultz put it to yet another joint luncheon of the American Economic Association and the American Finance Association (this one in 1973), “economists have a particular responsibility to relate policy decisions to the maintenance of freedom, so that, when that combination of special-interest groups, bureaucratic pressures, and congressional appetites calls for still one more increment of government intervention, we can calculate the cost in these terms . . . [and so] may have an impact on policy that extends beyond the most current crisis and reflects the best traditions of this discipline.”

The best traditions of economics today demand an engagement with the facts of the past 60 years, informed by the theories built up in that time. Those facts and those theories argue against the recent reversion to Keynesian discretionary interventionism, and for a revival of the kinds of rules-based fiscal and monetary policies that have yielded unmatched stability and economic growth.