Looking Out for the National Interest: The Principles of the Council of Economic Advisers

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The year 1996 marked the 50th anniversary of what has turned out to be an enormously successful institutional innovation: the Council of Economic Advisers (CEA). It was neither obvious nor inevitable that the CEA would enjoy the success it has had. Who would have thought that a group of academics, typically with little or no experience with politics or realpolitik, would not only survive in the rough-and-tumble of Washington, but also thrive and have some influence over policy? To be sure, the CEA's influence has fluctuated and has had to be established anew with each administration. But the durability of the institution, despite repeated reexaminations, is a testimony to the contribution that it has made in both Democratic and Republican administrations.

I. The Challenge to the CEA

My appointment as Chairman of the Council coincided with one of these reexaminations. Indeed, virtually on the day my appointment was announced, the House Appropriations Subcommittee announced that the CEA budget was being zeroed out. Lacking any sense of paranoia, I did not take this personally. Instead, I used the opportunity provided by this challenge to make the case for the CEA both to the Congress and to a more general audience. The outpouring of support, not just from past CEA chairs, but also from economists throughout the country, for this obscure agency with a staff of 35 and a budget of under $3.5 million was heartening. There was also television and media interest and widespread editorial support from, among others, the *New York Times*, the *Washington Post*, the *Washington Times*, and the *Chicago Tribune*.

The reason for the attack on the Council was simple: in an era of budget stringency, every agency needed to be reexamined. There was perhaps a desire for a trophy: an agency that could be eliminated entirely. Commerce or Energy would have been bigger trophies, but as the saying goes, a bird in the hand is worth two in the bush, and the CEA looked like easy prey.

As I met with members of Congress and responded to press and television interviews, I made a few simple points. I welcomed the scrutiny: that was Congress's responsibility. And I felt confident that we would pass any cost-benefit test: the money saved from just one of the many bad projects the CEA had helped stop (such as the supersonic transport [SST] and high-definition television [HDTV]) would have been enough to provide us with a permanent endowment. Furthermore, ideas that the CEA had been pushing for years, such as tradable permits (which were discussed in the *Economic Report of the President* as early as 1971) and spectrum auctions, were finally being put into practice and proving their worth.

Although the outpouring of support defended our importance, it gave rise to another question: if we were so important, why were we so obscure? I pointed out that, in some sense, we *should* be obscure: we were meant to be advisers to the President, not media stars. We are most effective as inside players. Indeed, some Council chairs had gone so far as to refuse to testify before Congress. We are not, and should not be, the Administration's public mouthpiece on economic matters. Being such would, in almost any administration, put the Council chair in the compromising position of trying to defend an important economic decision with which he or she might disagree, forcing the unpleasant dilemma of either compromising the CEA's reputation for

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professional integrity or damaging the CEA's internal effectiveness by failing to be a "team player."

II. Incentives: The Central Message

Of all the arguments that I raised about the value of the CEA, the most convincing, both to me and to others, concerned incentives. The story of the CEA is the story of incentives. There are two different ways in which this is true.

First, the CEA brings to the rest of government the simple message that incentives matter. Although incentives are probably the most important *economic* consideration in determining policy, many other considerations, chiefly political, come into play in the policy process. But there will always be plenty of people who bring these other considerations to the table; economists are a rarer and more fragile breed in Washington. (As an aside, there is an important piece of advice I would give to future CEA chairs: focus on giving economic rather than political advice. Economists bring something unique to policy discussions: an absolute and comparative advantage in economics. Those economists in government who have tried to play a political role, with few exceptions, have confirmed two of my prejudices: political forecasting is even more difficult than economic forecasting, and there are gains from specialization.)

There are many examples of cases in which incentives can have first-order effects, but while these may be obvious to us, they are sometimes contentious to others. Incentives play a central role in a variety of questions. What are the consequences of a legal system that imposes full (joint and several) liability for the cleanup of toxic waste or groundwater pollution on any purchaser of a property? What are the incentives to import and use enriched uranium from Russia for the peaceful purpose of producing energy if the exclusive right to import the material is given to a private firm controlling 80 percent of the U.S. market and 40 percent of the world market, and whose (subsidized, or even unsubsidized) marginal cost of production is lower than the agreed-upon import price? What are the incentives for the utilization of home health-care services by the aged if no charge is imposed? What are the incentives to move from welfare to work if the available job is in a distant town and if, in moving, one loses large housing subsidies?

Second, the CEA does not just have an important message concerning the relevance of incentives in designing policies; the CEA as an institution owes its success to its incentive structure. It is composed of a group of economists who are in the government for a relatively short term, "citizen-bureaucrats" as I refer to them, paralleling the "citizen-legislators" highlighted in the term-limits debate. Although each of us has a short-term incentive to be a member of the team (and I do not want to underemphasize the strength of these peer-group pressures), we also have a long-term incentive to maintain our professional reputations. Almost without fail, the long-term incentives have dominated, and this has served the CEA, successive administrations, and our nation well.

It is imperative that the President (and, more broadly, the Administration) be given honest advice. Often, the message we bring as economists is not a welcome one. We wish there were a free lunch—but there is not. There is always the fear that the messenger bringing bad news will be blamed for the message; institutional incentives of the kind embedded in the CEA are necessary to mitigate one of the consequences of this fear, the tendency to avoid bringing the unwanted message.

The CEA's influence no longer derives from its monopoly power in economic ideas: many government agencies today have first-rate economists. Instead, it is these institutional incentives that set us apart. Although the CEA has continued to attract some of the nation's best economists, even they often lack the detailed knowledge necessary to be active players in the policy debate. Although this knowledge is the forte of agency economists, their incentive to maintain a certain amount of loyalty to their agency inevitably puts them in a role quite different from that of members of the CEA. The CEA can be most effective when it forms an alliance with these economists, in a joint effort to move the agency position. While staff economists work effectively within the bureaucracy, the CEA chair and the members work on the Secretaries and Deputy Secretaries.

III. The National Interest

The CEA brings to the table more than just an economist's concern for incentives; it brings a different, and broader, perspective. This was brought home to me forcefully early in the Administration. We were trying to reach agreement on criteria for deciding priorities for trade policies, an admittedly academic exercise in a world in which decisions are made in the haphazard way of politics. We were proceeding along the lines we would recommend in a course on public policy. It became apparent, however, that the analysis was leading toward choices that would hurt the programs and constituencies of some departments while helping those of others. People who were usually reasonable and intelligent argued against the exercise; one economist-policymaker went so far as to question the very notion of trade-offs. In a reflective moment after these special interests forced an abandonment of the exercise, one thoughtful policymaker, a former political-science professor, commented to me: "You at the CEA represent just another special interest. Your special interest is the national interest." That was right. The CEA has the distinctive charge of looking at matters not from the perspective of labor, commerce, energy, or agriculture, but from the national perspective. It tries to balance competing claims by quantitative assessment of the impacts on various groups, a process that often results in outcomes different from the aggregation of political interests that emerges from the policy process. In this assessment, the CEA incorporates the interests of some groups—notably consumers—that often do not even have a seat at the table.

IV. Other Microeconomic Messages

While incentives are the CEA's central and most important message, there are other economic messages as well. John Maynard Keynes wrote that policymakers are often the slaves of long-dead economic scribblers. Time evidently moves faster today. I was pleased to see that issues of adverse selection and moral hazard, notions that I and others had written about only 10–15 years earlier, have already entered the decision-making discourse. (I should mention that the emphasis on adverse selection over moral hazard makes me worry about the extent to which analytic concerns are really the driving force.) I was also surprised that some aspects of *incidence*, often nonobvious, were incorporated into discussions, though not always in a consistent manner. For example, despite the recognition that workers bore most of the burden of rising health-care costs, some continued to argue that these costs were hurting America's competitiveness.

V. The CEA's Macroeconomic Role

The CEA was created by the Employment Act of 1946 in order to focus on the countercylical aspects of macroeconomic policy, smoothing business cycles with well-timed fiscal policy and easing inflationary pressures (called promoting purchasing power back then). In recent years, however, countercyclical policy has been conducted largely by the Federal Reserve, while budget stringency has reduced the scope for discretionary fiscal policy. Partly in response to these changes, the CEA has come to focus more on the kinds of microeconomic issues I discussed earlier. Macroeconomics, however, remains an important part of the CEA's portfolio, although the emphasis is increasingly on the trend rather than the cycle.

One of the CEA's primary responsibilities is the production and dissemination of information and analysis of the economy. The direct consumers of our information are the President and the White House senior staff. In ascertaining the overall direction of economic policy, the President and Administration need to be apprised of the state of the economy; assessing that state remains a prime responsibility of the CEA. The executive branch is not the only consumer of this information, however, the CEA also plays an important role in explaining and interpreting the economy to the media, the business community, and the public. Although our knowledge and power are sometimes exaggerated—we do not have dials in our offices which we can use to change exchange rates, inflation, or the number of jobs —we do have a great deal of information, some of which is not publicly available, and we have given considerable thought to the condition of the economy. We may be able to affect, if ever so slightly, the mood in the economy—and as Keynes argued, these ''spirits'' can have real effects.

Our informational role is not restricted to analysis of the short-term outlook for the economy. We play an important part in framing public discourse on macroeconomic policy. We have pointed out, for example, that expansions do not die of old age, and fluctuations are better described by a Poisson process than by a regular business cycle. Also, we have shown evidence that the nonaccelerating inflationary rate of unemployment (NAIRU) has decreased, that there is no precipice, and that, even if inflation increases, it does not accelerate out of control. This is important not just as an academic exercise: in a world in which bond traders and others believe in the NAIRU, influencing the popular understanding of its level can affect interest rates and inflationary expectations, and perhaps inflation itself.

Increasingly, the CEA's analysis has been geared toward long-run issues, particularly understanding and advocating policies to promote growth. Increasing saving and investment is certainly an important part of any growth agenda. More capital alone, however, will do little to reverse the slowdown in multifactor productivity growth. This will require policies that promote research and development and education.

The business cycle still plays an important role, but an emphasis on designing appropriate structures makes more sense than focusing on the stance of policy at any point in time. For example, the proposed balanced-budget amendment would seriously reduce the scope for automatic stabilizers, which is one reason why we have been so strongly opposed to it.

Finally, the CEA is the lead agency in producing the economic assumptions used for planning the budget. It is essential for the credibility of the Administration, as well as for ensuring that deficit reduction continues on course, that these forecasts be as accurate as possible. In forming our estimates, the ''loss function'' we have adopted has led to consistently conservative estimates.

VI. The CEA's Marginal Product

It is always difficult to ascertain marginal products, particularly in the context of team production and administrative activity. Some years ago, I wrote (with Raaj Sah) a series of papers on the architecture of organizations, focusing in particular on structuring decision-making. The analysis was based on the premise of human fallibility. One of our (not surprising) conclusions was that more important decisions should involve larger groups in the decision-making process. This would limit the influence of any individual's mistakes on the group's decision. After four years in Washington, I have not changed my views about either the underlying premise or the conclusions we drew then, although I would alter much of the analysis.

It is difficult to tell the ways in which decisions were influenced by the CEA without the benefit of a controlled experiment, but I firmly believe that we do make a difference. Sometimes, I think we make a difference simply because we are at the table—even before we say anything. One of my colleagues at another agency suggested that the CEA was less effective than it might be, because we were so consistent: we were almost always in favor of competition, we always talked about incentives, and we always promoted markets and quasi-market mechanisms like auctions and options. I took this as a compliment. Because others knew that we would be there with our arsenal of analysis and evidence, they shaped their proposals to avoid, or at least minimize, our criticisms.

Before accepting the offer to serve on the CEA I talked to a number of former members, Republican and Democrat. They emphasized the role of the CEA in stopping bad ideas—not only the big ones, like HDTV and SST, which I referred to earlier, but also smaller ones. Bad ideas (proposals with negative expected value) are almost costless to produce; consequently, the CEA is kept busy as a bastion against rent-seeking, whether it takes the form of a new protectionist measure or a new corporate subsidy. We have been largely, but not entirely, successful in this endeavor.

But we have also taken a positive, creative role. To be sure, our success has hinged on enlisting others in our causes; the mutual reinforcement helps to push the initiatives, often against strong forces in the opposing direction. In a few cases, such as pension simplification and indexed bonds, we have seen our initiatives reach fruition. Other proposals before Congress or in preparation represent advances in the policy debate. These include corporatization of the air-traffic control system, reforms in our housing programs, and a comprehensive approach to natural-disaster policy.

Perhaps our most important and constructive role is in helping to shape policy more broadly. For example, a decision had to be made concerning how actively to pursue NAFTA, and a whole series of ongoing decisions had to be made concerning the emphasis to be placed on deficit reduction and the balanced-budget amendment. In these central issues of economic policy it is often difficult to identify the special role played by each agency, especially in an administration marked by cooperative efforts to reach common views.

In more narrow, microeconomic initiatives, the CEA has tended to play a more dominant role. Much of the CEA's most effective work will never be recognized except by aficionados of the arcane. Examples include designing regulations concerning the market for tradable permits in pollutants in a way that makes it more likely that the market will work; designing regulations concerning dumping so that it is less likely that dumping laws will be used as protectionist devices; helping to write a more effective executive order on cost--benefit analysis and writing guidelines for its implementation so as to incorporate appropriate ways of handling risk, discounting, and impacts on lives; changing the support price for sugar or the level of its imports; restricting and targeting the use of export enhancement programs; and raising the possibility of introducing auction mechanisms there and elsewhere. In each of these cases, there was little or no expertise in government outside the administering agency.

As Senator Everett Dirksen once said, "A billion here, a billion there ... pretty soon you're talking real money." But more than just money is at stake: it is the nature of our democratic government. The question is whether government is simply an arena for bargaining by special interests, or whether government can rise above that to represent the will of all.

VII. Personal Notes

I will end on two personal notes. When I went to Washington, I thought that I would be using up my human capital. I had spent a great deal of time thinking about the economics of the public sector. Here was my opportunity to use that capital. And I did expect some depreciation in that capital over time. I found, however, that the job was far more intellectually challenging than I had anticipated. Academic economists had made important contributions by providing intellectual frameworks: as I noted, ideas like adverse selection, moral hazard, and incidence were part of everyday debate, even if not always under those names. But academic economists had failed to do the hard work: for instance, was there an alternative to joint and several liability for Superfund which would lead to faster cleanups and lower transactions costs?

The second comment concerns a remark that my good friend and colleague John Taylor made in an interview with the *New York Times* shortly after I was appointed. He suggested that a stint in Washington would make me more skeptical of the role that government should play in our economy. Although I am leaving after four years with an increased awareness of the influence of special interests, John's prediction has not fully come true. I have continuing confidence that government can be a vital force in improving the life of our nation, in correcting market failures and enhancing economic opportunity. But regardless of one's view about the role that government *should* play in our society, the fact of the matter is that it *will* play a central role. And in the process of defining that role, our little agency, the Council of Economic Advisers, plays a vital part in looking out for that little-represented special interest known as the national interest.