The Lamppost Theory of Economic Policy[1]

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You can observe a lot just by watching.
—Yogi Berra

This talk is based on what I call the *Lamppost Theory of Economic Policy*—namely, that politicians use economics the way a drunk uses a lamppost, for *support*, not for *illumination*. I'll flesh out the argument in three steps. First, I will detail why I see economists and politicos as belonging to two distinct *civilizations*—it's not too strong a word—that don't communicate very well with one another. Second, I will summarize the four-ring circus by which policy *ideas* either do or do not get turned into actual *policies*. In this context, I will suggest that economists come close to guaranteeing their irrelevance by participating almost exclusively in only one of those four rings—the policy *substance* ring. Third, I will use this analysis to examine the three major impediments to sound policy that I call *The Three* I's: ignorance, ideology, and interest groups. Once all this is done, I'll conclude with a short case study of tax policy, which illustrates the three aforementioned steps.

The Two Civilizations

George Bernard Shaw is widely credited with observing that the English and the Americans are two peoples separated by a common language. In the case of economists and politicos, the separation goes way beyond language. But let's start there, with how members of the two civilizations think and speak.

We economists try to stick to logic as it is taught in colleges and universities—replete with syllogisms, deductive reasoning, algebra, and all that—even at the risk of being dry and boring. Facts, even if under dispute, and logical arguments, even if complicated and "academic," dominate economic discourse. And when it comes to doing

1 Read 8 November 2018.

calculations, we follow the standard rules of arithmetic or, when calculations are more complex, of algebra and calculus.

Politicians and their spinmeisters do all of this differently. They cannot afford to be boring—they have to hold their audiences. But they can afford to be somewhat illogical and/or to play fast and loose with the facts. They are, after all, answering to the voters, not to academic referees. Before I went to Washington, I used to think that politics was fundamentally illogical—somewhat crazy, even. But I learned there that skilled practitioners have their own form of logic, which I call *political logic*. Political logic follows rules that Aristotle, Boole, and Quine would not recognize. But it is far from random; there is a coherence to it. I will offer several examples of political logic in what follows. But one particular example is worth stating right at the outset. In economics, when we add up 2 + 2, we always get 4. In politics, when you add things up, you must weight them by political influence. So some 2 + 2's count as only 2 while others add up to 8.

The Darwinian selection principles for success also differ starkly between the two civilizations. Economists who are engaged in the policy process succeed or fail based on their "smarts" and the quality and creativity of their ideas. Their incentive system pushes them toward clever policy proposals designed to maximize social welfare.

A high IQ is an asset in politics, too, but only up to a point. Wise politicians don't want to get too far ahead of their voters, and certainly don't want their voters to think they are. (Contrast that with academia, where one-upmanship is a central part of the culture.) A variety of people skills that are more or less irrelevant—and, one might argue, rare—in the academy are far more critical to success in politics than is IQ. Politicians' incentives, of course, are to maximize their electoral prospects, not to maximize anything as amorphous as social welfare, whatever that is.

Naturally, then, the central foci of policy-oriented economists and politicians differ sharply. We dote on *economic efficiency*—a concept that ordinary people neither understand nor, I'd guess, would think terribly important if they understood it. Politicians focus instead on *fairness*—or rather, the *appearance of fairness*—because they know that matters more to voters. Economists worry, pretty much exclusively, about which policies *are good* for the commonweal. Politicians worry more about which policies *sound good* to the common man and woman. Sadly, the two criteria often do not correspond (e.g., using trade protection to "save" jobs). Finally, economists rank policy options by how well they serve the broad *national interest*. Politicians, more often than not, rank them on how well they serve narrow, *special interests*.

And then there is the matter of time horizons. It is a commonplace to say that politicians have short time horizons—lasting only until the next election. That time frame is, at most, two years long; usually, it's far shorter. But for many, probably most, economic policies, even a two-time horizon year is too short. Policy options must be appraised over longer time frames. Economists are very good at doing that—too good, I'd argue. For example, if opening up some market to freer international trade will cause serious disruptions for two or three years, but everything will be fine in a decade or two, that's a "short run" problem that policymakers should not ignore. Economists often do; politicians don't.

The central message of this talk is that each civilization could learn some things from the other—and that some mutual learning could take the hard edge off the Lamppost Theory. No one in this room will be surprised to hear an economist explain how and why politicos should learn more from us. The surprising part, coming from me, is the parallel claim that economists could learn some valuable lessons from politicos. So I'll dwell on that more.

The Four-Ring Circus of Policymaking

The aphorism that you never want to see laws or sausages being made is often attributed—rightly or wrongly—to Bismarck. I'll ignore sausages and stick to the laws governing economic policy. In most cases, such economic policies are made in a four-ring circus consisting of substance, politics, message, and process—all interacting at the same time in a mind-boggling display of apparent disorder. As I've indicated, economists mostly confine themselves to the first ring: the substance of the matter—which is the "illumination" part of the Lamppost Theory. But with so much action going on simultaneously in the other three rings, that self-imposed limitation often leaves economists with little influence on the end result.[2] Let's take up the rings one at a time.

Politics

It is hardly a revelation that politics matters a lot for economic policy, even if economists disdain politics and are clumsy and/or naïve at it. We do, after all, live in a democracy in which top officials are either elected by the voters or appointed by politicians who, in turn, have

2 In fairness to my colleagues, we are sometimes barred from the political and message rings by politicos who view our presence there as practicing politics without a license.

faced the voters—as I was, twice, by Bill Clinton.[3] In the political "ring," fairness almost always trumps efficiency, time horizons are short, and parochial interests routinely defeat the commonweal—all of which I mentioned earlier.

But there is another point, which often goes unnoticed. Economics teaches us to look for clean "best" or perhaps "second best" solutions—subject to constraints, of course, for constrained optimization is the bread and butter of economics. Policy wonks seek to develop comprehensive policies that are internally coherent, held together by guiding principles, and based on evidence. This is not foolish. If the pieces don't fit together, the infamous law of unintended consequence may take over and overwhelm all the good you are trying to do.

One of my favorite examples is called *optimal tax theory*.[4] It's a beautiful piece of economic analysis that treats the entire tax system as a unified whole, and instructs us on how to find the optimal tax rate to apply to every economic activity. The formulae generated by optimal tax theory allow for the possibility that, for example, the tax rate on interest might interact with the tax rate on cigarettes. As I said, it's a beautiful theory; and in the domain of substance, it gets things basically right. But optimal tax theory has exactly nothing to do with how tax policies are made in the real world, where politicians seek the *politically optimal* tax code, not the *economically optimal* one. Politicos have their own form of logic, which involves campaign contributions, lobbying forces, the geography of costs and benefits, and superficial appeal (or lack thereof) to voters, among other things. It does not involve, say, the elasticities of demand and deadweight loss calculations that form the core of optimal tax theory.

This is just one example, but the point is general: Intellectual purity doesn't travel far in the political processes that generate economic policies. Almost all workable *political* solutions involve compromises, often unprincipled compromises, rather than the intellectually coherent plans that economists prize and reflexively seek. While we economists try to design a beautiful gazelle, political compromises are more likely to produce an ungainly monster with the head of a horse, the body of an elephant, and the tail of a monkey. Part of the art of real-world policymaking is learning to love—or at least to tolerate—such

3 I served as a member of the Council of Economic Advisers, 1993–1994, and as Vice Chairman of the Board of Governors of the Federal Reserve System, 1994–1996. Not incidentally, I was also an economic adviser to the presidential campaigns of Bill Clinton, Al Gore, and Hillary Clinton.

4 Literally hundreds of references could be given. One good one is Joel Slemrod, "Optimal Taxation and Optimal Tax Systems," *Journal of Economic Perspectives* 4, no. 1 (Winter 1990): 157–78.

creatures. "My monstrosity is better than your monstrosity" is the right attitude.

The matter of time horizons was broached earlier. Let me bring it up again here, and sharpen it, in a slightly different context. We economists dote on *equilibrium* states. You probably remember from Economics 101 the importance attached to the point where the supply and demand curves cross. Your instructor no doubt highlighted that *equilibrium* point as the key spot on the diagram. If you were sharp or annoying enough to ask what happens *out of* equilibrium, you probably got some story about the forces that return the market *to* equilibrium. Not quite an answer. We economists are an equilibrium-oriented bunch.

But ordinary people, and therefore the politicians who serve them, are not. For people don't live in equilibrium states. Rather, they live in *transitions* almost all the time. At some epistemological level, economists understand that simple point. Understand it, but reflexively ignore it. We tend to belittle the adjustment costs imposed on people as *transition costs* that won't last forever (which is true) and therefore can be ignored (which is terribly wrong).

Trade agreements offer politically salient examples. Every such agreement changes the constellation of goods and services produced and consumed in the countries involved. That's what they are supposed to do. In the process of moving from Equilibrium A, where the country starts, to Equilibrium B, where it winds up, new jobs are created in some industries and old jobs disappear in others. It is often demonstrable, under certain assumptions, that B is superior to A. In fact, empirical economists who specialize in international trade offer quantitative estimates of *by how much* B is better than A.[5] So, economists almost always support trade-opening agreements. After all, they improve social welfare.

But now think about those pesky transition costs that economists are wont to ignore. As the economy makes its *transition* from Equilibrium A to Equilibrium B, some people will lose their jobs. Their incomes will drop sharply. They may have to move to find new jobs—which some of them won't be able to do because of their spouse's job, a sick family member, or something else. In some cases the job loser may *never* find another job that pays as well. Think, for example, of a 55-year-old steelworker who loses his job when a steel mill in Ohio closes. Should we dismiss these "transition costs" as relatively

5 As an example for the ill-fated TPP, see United States International Trade Commission, *Trans-Pacific Partnership Agreement: Likely Impact on the U.S. Economy and on Specific Industry Sectors*, TPA-105-001, 4607, May 19, 2016, usitc.gov/publications/332/pub4607.pdf.

unimportant details—which economists often do, but politicians don't? If you do, you've assured your irrelevance in the political arena.

Message

I'll be much briefer on message, at which the typical economist is woefully inept and about which the typical economist is reflexively disdainful. (Would you want your son or daughter to grow up to be a spinmeister?) But here's the bad news for those of us who like to live on the high horse: In the American form of democracy, policies need to be *sold*. Elites can't force them down the throats of an unwilling body politic. That's why we live with endless campaigns.

It would be nice if nature had arranged economic life so that good policies *sounded* good to ordinary people while bad policies *sounded* bad. But it hasn't. Rather, as I noted earlier, some economic policies that sound good are actually bad for the nation while other policies, which sound bad, are actually good for the nation. An example of the former was mentioned earlier: "saving American jobs" through trade protection. As an example of the latter, think about a carbon tax to combat global climate change. (Oh, no, there's the dreaded T-word!) When policies that *sound* bad but *are* good compete for support in the political arena with policies that *sound* good but *are* bad, the former are at a severe disadvantage. It's hard for them to win when battles are fought with bumper-sticker slogans, sound bites, and 20-second TV ads.

Complexity sells poorly in the message ring of the policy circus. Unfortunately, appropriate economic policies are often complicated. Just think, for example, of reforming the tax code, or financial regulation, or anti-trust policy. The details matter. Economists and other would-be policymakers must somehow strike a balance between necessary complexity and the KISS principle ("Keep it simple, stupid") because the latter will matter greatly in the political world. As in my horse-elephant-monkey metaphor, economists must learn to live with—even advocate—simpler policy options than they would like.

Process

If academics disdain message (which they do), they absolutely *hate* process. For proof, try to remember your last faculty meeting—if you attended it. With the single exception of co-authorships—which rarely involve more than three or four people—academic economics (like many other disciplines) is a solitary occupation. (I'm writing this sitting

alone at my computer.) People get their work done by themselves; they rarely need either cooperation with or permission from anyone else.

Policy development is not like that. "Process" is a key element in policy formulation because it is exactly about getting *organized* to get things done. Who will (and will not) be at the meetings? Which agency will perform which tasks? What deadlines are either forced upon us or appropriate to work toward? And so on. The list goes on and on, and it's not particularly exciting stuff. But it's absolutely necessary if a policy process is to reach a reasonable conclusion, or any conclusion at all.

Among the many reasons why process is so important is *path dependence*. That means, simply, that where you wind up depends on the path you travel to get there. In a word, history matters. At first blush, you might think that history *always* matters. But that's not so. Think back to the supply and demand example. The equilibrium of the system is always at the point where the supply curve and the demand curve cross, irrespective of the path traversed to get there. There is no path dependence; all roads lead to Rome. Or take a well-known example from physics. The resting point of a pendulum (the "equilibrium") is always at the bottom of the arc—regardless of whether you set the pendulum in motion by pushing it left or right, softly or hard, multiple times or just once. Again, there is no path dependence.

Most economist models are like that. (Remember, we're *equilibrium* theorists.) I'm often skeptical of that methodological approach, but never mind that. My point here is that policymaking, unlike, say, supply and demand analysis, almost always displays path dependence. Depending on how you start, you may wind up in Rome, Italy, or in Rome, New York. There are many reasons, but I'll mention just one: The *order* in which legislative issues get taken up exerts a profound, sometimes even dispositive, influence on what gets passed and what gets left on the cutting room floor.

Examples abound. Consider the economic agenda of the new Trump administration in January 2017. There were three main items, listed here in the order in which the administration brought them to Congress: healthcare (which basically meant repealing Obamacare), tax cuts (misleadingly labeled as tax "reform"), and infrastructure. As you know, healthcare failed, tax cuts passed without a single Democratic vote in either the House or the Senate, and we are still waiting for an infrastructure proposal.

Now imagine that the order was reversed. It seems a good bet that an infrastructure package could have passed both chambers easily, perhaps after some cross-party compromises, thereby creating some good will for the new Trump administration instead of the political

rancor that followed the bitterly fought battles over healthcare. That good will might then have carried over to move a few Democratic votes into the "yes" column on the tax cut proposals, especially if it fostered a little bipartisan compromise rather than the highly partisan bill we got. Maybe. But in any case, the political atmosphere would almost certainly have been less poisonous, and the president's legislative record more impressive, by the time healthcare arrived on the House and Senate floors. The legislative history of the early Trump administration, in a word, might have been quite different.

Notice an obvious point here. Healthcare reform, tax cuts, and infrastructure spending have relatively little to do with one another in terms of pure economic *substance*. Had these three unrelated decisions been made by votes of the American Economic Association, rather than by members of Congress, the order of the votes would not have mattered. But once you add politics, message, and process to the brew, path dependence rules the roost.

Impediments to Sound Policy: The Three *I*'s

Partly because of the clash of civilizations, the pathways to sound economic policy are often blocked by one or more of what I call *The Three* I*'s*: *ignorance*, *ideology*, and the power of *interest groups*. I take them up in turn.

Ignorance

Where economics is concerned, ignorance is astonishingly widespread in the population at large. Ordinary Americans understand basic physics well enough to know that a proposal for a major irrigation project that purports to make water run uphill *without the use of power* is snake oil. But the economic equivalents of water running uphill are routinely accepted by many Americans. Snake oil not only can be, but is, regularly sold in the political marketplace. Just think about how many times "supply side economics" has bounced back into the debate over tax cuts.[6]

And the ignorance problem goes deeper. As I mentioned earlier, even smart politicians who know some economics have no incentive to show off their knowledge. They understand that getting too far out in front of their voters can lead to electoral disaster; better to feign

6 In 2017, Secretary of the Treasury Stephen Mnuchin even claimed that the Trump tax cut proposal would pay for itself. See, for example, Damian Paletta and Max Ehrenfreund, "Trump's Treasury Secretary: The Tax Cut 'Will Pay for Itself,'" *Washington Post*, April 20, 2017.

ignorance and go with the politically expedient flow. So, for example, simple T-shirt (or, these days, baseball cap) slogans like "Tariffs save American jobs" sell better in the political marketplace than complex realities that require more than 20 seconds to explain. Bad policy ideas can flourish in an atmosphere of ignorance.

Can we economists correct, or at least ameliorate, this ignorance? I wish we could, but I believe we can't. Our audiences are trivially small. It's the President of the United States, and perhaps only he, who has the big audience. As in other contexts, the presidential bully pulpit can be used either for good or for ill. A president can educate or mislead, and I think you all know which one this president is doing.

Ideology

Ideology is the second of The Three *I*'s, and it dies hard. Examples abound, from both the left and the right. Let me offer just one example of each.

Politicians of the right continue to insist, despite much evidence to the contrary, that lowering the income tax rate paid by top taxpayers is the key to faster economic growth. They cling to that belief even though study after scholarly study contradicts it, and even though neither the Reagan tax cuts of 1981–1984 nor the Bush tax cuts of 2001–2003 raised the growth rate.

Here's a picture that should be worth a thousand words. It's a scatter plot of the top personal income tax rate from 1929 through 2010, measured horizontally, against the average growth rate of real GDP over the subsequent five years (to allow enough time for tax changes to influence the economy), measured vertically (Figure 1). Supply-side economics asserts a strong *negative* relationship between the two: Higher taxes should lead to slower growth. But there is no such relationship in the data; the actual correlation is close to zero. Nonetheless, true believers keep believing.

On the left, a number of critics continue to pin a meaningful share of the blame for the financial crisis of 2007–2009 on the repeal, in 1999, of the Glass-Steagall barrier that used to separate banking from the securities business—a repeal they never liked.[7] But as I have explained at some length elsewhere, mergers between banks and investment banks had approximately nothing to do with the multiple problems that gave rise to the financial crisis.[8] There was a lot of bad

7 See, for example, Jim Zarroli, "Fact Check: Did Glass-Steagall Cause the 2008 Financial Crisis?" *NPR*, October 14, 2015, https://www.npr.org/sections/thetwo-way/2015/10/14/448685233/fact-check-did-glass-steagall-cause-the-2008-financial-crisis.

8 See Alan S. Blinder, *After the Music Stopped: The Financial Crisis, the Response, and*

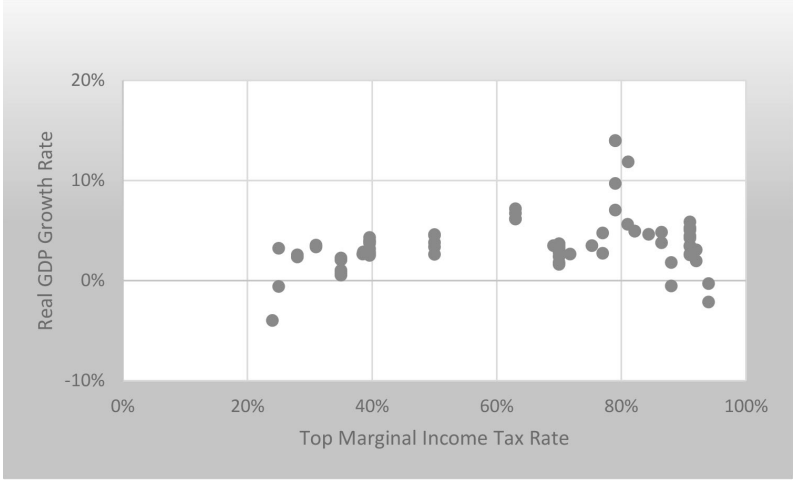

FIGURE 1. Real GDP growth rate over next five years vs. top marginal income tax rate, 1929–2010.

banking by pure banks like Wachovia, Washington Mutual, and many others. There was a lot of bad investment banking by pure investment banks like Bear Stearns, Lehman Brothers, and others. There was even an insurance company (AIG) that allowed a crazily irresponsible hedge fund to operate in its midst. But virtually none of the rampant financial malpractice took place within a company that resulted from merging banking and investment banking.[9] And essentially none of it would have been stopped by the old Glass-Steagall barriers.

Interest Groups

Politically effective interest groups are often the most powerful enemies of the common good. Let me illustrate how with an example that harkens back to the two kinds of arithmetic I mentioned earlier.

Imagine a policy change that will increase 10 people's annual incomes by $1 millon each, but will cost 10 million people $2 per year. The economic calculus is simple: With $10 million in gains and $20 million in losses, the policy is almost certainly a bad idea, and almost all economists will draw that conclusion.

Now look at that same policy change through political lenses. The 10 million losers will probably not notice their tiny losses. Even if some of them do, they may not attribute the losses to the policy change. And

the Work Ahead (New York: Penguin Press, 2013): 266ff.

9 Citigroup is often offered as a counterexample. It may be the only one. But does anyone believe Citi would have avoided trouble if it had never merged with Travelers?

even if they do that, a loss of $2/year will not be nearly enough to move them to political action. By contrast, the 10 big winners will certainly notice their ample gains and be duly grateful to the politicians who dole them out. They will almost certainly thank these politicians with support, and probably also with campaign contributions. So this "bad" policy is a clear winner under political calculus.

The numbers in this little example may appear kindergarten-ish. But the example is indicative of the costs and benefits inherent in many special tax breaks and highly specific trade preferences. Most of these feather a small number of nests generously, while the broad public loses.

Case Study: The Elusiveness of Tax Reform

Finally, let me apply some of these ideas to a domain of policymaking that has bedeviled politicians and frustrated economist for decades: tax reform. If there ever was an area of economic policy in which politicians welcomed support but shunned illumination, this is it.

Seemingly everyone—Democrats, Republicans, and Independents alike—agrees that our tax code is a national disgrace. The status quo seems to have no defenders. Yet it endures. The 2017 tax bill, for example, was heavy on tax *cuts*, but light on tax *reform*. The last thoroughgoing tax reform in the United States was signed into law in 1986! Why is tax reform so hard?

To start on an answer, remember that the present tax code did not result from acts of nature like earthquakes, meteor showers, or forest fires. It's entirely manmade, not by economists, and not by a series of accidents. Rather, everything that's in the tax code was put there purposefully by politicians—*for good political reasons*. That means that any suggested reform of the code that would eliminate some egregious tax loophole must confront an opposing political force that will defend that loophole. Economically, tax reform looks like an inviting orchard full of delicious low-hanging fruit. Politically, it's a briar patch.

Here's a thought experiment for you to take away. Imagine that Congress assigned the job of rewriting the tax code to a bunch of non-political technocrats—mainly economists, lawyers, and accountants. These technocrats would get broad marching orders from Congress on the big issues. Should we tax mainly income or mainly consumption? How progressive or regressive should the tax burden be? Should there be an estate tax or not? This imaginary bunch of technocrats would then be instructed to devise a tax code that meets these requirements and bring it back to Congress for a straight up-or-down

vote. If the vote is "down," Congress would include a statement of what it wants changed, and the technocrats would try again.

If this hypothetical process reminds you of fast-track procedures for trade agreements, at least in their idealized form, it should. Notice, also, that it gives the hypothetical tax writing experts far less independence that the Federal Reserve's experts have over monetary policy.

I finish with three quick questions:

First, what are the chances that this procedure would give us a better tax code than we have now? Approximately 100 percent.

Second, what are the chances that this would ever happen? Approximately zero.

Third, don't those two contrasting answers make you think we'd be better off if we could escape the clutches of the Lamppost Theory?