



Conversations with an Expert

Stanford University economist John B. Taylor was awarded the Kirby Distinguished Visiting Professorship in October 2016 by the Private Enterprise Research Center. During his visit to Texas A&M University, he was interviewed by PERC's Director, Dr. Thomas Saving.

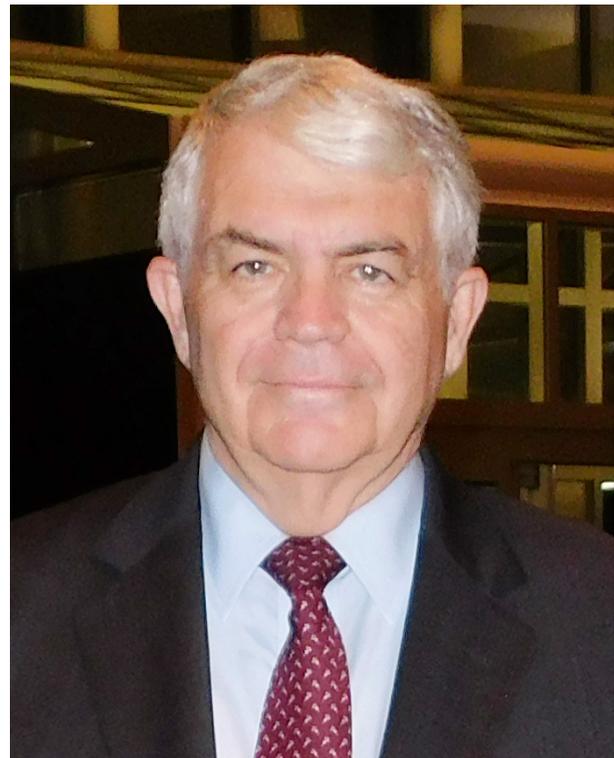
As early as in 2009, you cautioned in your book, *Getting off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis*, about government interventions that might impede recovery. Seven years later, recovery remains weak. What factors have contributed to the slow recovery we have seen?

The genesis for this book goes back to a presentation I gave at the Bank of Canada in November 2008. The occasion was a festschrift honoring the outgoing bank governor David Dodge.

I had been working on the things that ran up to the interest rate crisis; they had been too low for too long. When 2008 came I saw the combination of all these things and decided I should say what I thought. I was going to give the keynote address of the conference for Dodge and I was quite apprehensive to lay this out for the central bankers. So, I discussed my comments with my wife.

I said "You know what, I have this critique, and central bankers don't look too good in my critique. The interest rates were too low for too long—2003, 2004, 2005—and after that the policy that was implemented up until the crisis wasn't so good."

She said, "Well, if that's what you think, then tell them." She gave me a little pat on the back and I went up and gave the talk. The audience members were in



John B. Taylor spoke at Texas A&M University about getting the economy back on track. PERC hosted his lecture at the George Bush Library.

If people are forward-looking, and adjust their behavior to new circumstances, then economic policy works best when formulated as a rule. Government's adherence to known rules allows people to have a better sense of what is coming, and therefore to make more-informed decisions about long-range plans.

- *First Principles*, 23



a bit of a state of shock, but were still receptive to my comments.

That paper is what became the book [*Getting Off Track*], so much of its framework had been written before November 2008. That was in the middle of the crisis. Lehman Brothers' downfall was in September, and the TARP in October and leading up to that we had the bailout of Bear Stearns.

The early responses to what became the "Great Recession" were unsure, not only the Federal Reserve's, but other kinds of policies continued to be off-track. Overall, the Fed did a good job in November 2008 in its role as lender of last resort, but then when the liquidity operations were finished, and the immediate crisis was over, the Fed continued with quantitative easing one, two and three. The result was the massive increase in the Fed's balance sheet with its intervention in the mortgage market and its purchases in the treasury market. I have a lot of problems with these interventions, but that's actually subsequent to that book.

Can you explain the "five keys" in your 2012 book, *First Principles: Five Keys to Restoring America's Prosperity*?

The five keys are my way of summarizing good economic policy. Another way to think about them is that they are the five principles of economic

freedom.

The first key is a predictable policy framework so you know your tax and monetary policy. Importantly, the framework for monetary and fiscal policy should not be a lot of discretionary stimulus packages, but rather should be well defined automatic stabilizer rules known in advance.

The number two key is the rule of law. The rule of law is fundamental to a well-functioning market economy. It defends private property. If you do some work, you'll get rewarded by a particular amount, or if you invest in something the investments will not be taken away. That's the rule of law.

As economists we don't emphasize those first two principles enough. The Soviet Union fell because defensible property rights did not exist and there was no rule of law to speak of.

The third key is good incentives. Think about the economy running with good incentives where people invest in their schooling, they take on a job, and take care of their kids—all those things. What history has shown is the best way to get those incentives is to emphasize the market itself.

The fourth thing is that the market provides a way for price discovery and for prices to be determined. Those prices provide incentives for the most part, so the market system is the fourth key.

The fifth is a limited role for government. A limited

role for government means that your government does what cost-benefit analysis say government should do and they don't do what they shouldn't. It is just basic common sense cost-benefit analysis—how could you be against that? But it is not adhered to enough.

These are really five ways to summarize the principles of economic freedom. There are other ways to do it. This is kind of what I've been teaching students for many years and so it seems to be a good way to encapsulate what we need to do.

In your monetary policy research, you have consistently emphasized the importance of rules. Indeed, one of your main contributions to economics is dubbed “the Taylor Rule.” Why are rules so important in policy making?

Rules give you predictability about what the central bank or the fiscal authority will do. They take a lot of the surprise out of what these agencies are doing. They provide a framework by which the market economy can operate.

If you want the central bankers to know what to do, but if they come in and they don't know, the rule is the way to formulate whether it's a monetary base growth or an interest rate rule. That's what I've learned in this business to be so important. You have a new central bank governor in another country and they don't know what to do—this is a guideline for them. They don't have to wake up every morning and think about what's new to do.

A more recent popular argument for monetary rules is the “time inconsistency” argument. That is due to the pressure for it to adjust to a particular crisis. There is always going to be temptations to do something different. It may be that the promise of a low inflation or a high inflation is expected to stimulate the economy. Or the policy change could be related to politics. You want to get your side elected into power, so you stimulate the economy, not taking into account bad repercussions afterwards.

If you think about the economy—it is a dynamic

moving thing. There are shocks. They are dynamic. We don't know completely how the markets are operating. New businesses are forming. The notion that somehow, somebody at the top will go in and take some particular timed policy action and make a difference is so counter to the way the economy works.

Looking to the future, in order to reduce budget deficits, it is critical to contain the growth of entitlement spending. How should we go about controlling Social Security and Medicare spending?

First, the deficit problems are entitlements at this point. The other parts—government spending, purchases, military spending, education, security—are not exploding, and if anything, they are getting crowded out in the budget as the entitlement programs expand. That is also the case at the state and local level too.

I think people forget that the deficit problem is largely because of so-called, “mandatory” spending on entitlements—primarily Social Security, Medicare. A significant proportion of the health sector in addition to Medicare is also funded by government payers. So, number one is to address these programs.

It's such a glaring fact that we have to recognize. How do you address these programs? First, we cannot have entitlements growing faster than GDP. You cannot possibly have taxes rise so much that basically all your tax revenues are dedicated to entitlements. So it's critical that their growth is controlled. The growth should be roughly equal to GDP. That keeps the debt from increasing compared to GDP, which is important. Now how do you get there? Well, there are many suggestions, for example for reforming Social Security. It is not the fact that there are more people retiring—it is that each generation is getting more than the previous generations.

If you look at someone who is going to retire 10

The notion that somehow, somebody at the top will go in and take some particular timed policy action and make a difference is so counter to the way the economy works.

years from now, they are going to get more in real terms than a person who retires today, and so on. That has to be solved. One way to deal with that is to have your indexing not to wages, but to prices, and that will deal a lot with the fact that real benefits are increasing over time.

In terms of Medicare and the progress in health care technology and spending, it is more difficult. There are some in favor of decentralizing the program rather than continued centralized planning. Spending constraints adopted by Congress have been difficult to implement and enforce, but if the payments were decentralized, then the amount of funds distributed to the states could be controlled, and that would control the growth rate and provide the right incentives.

Those are some of the basics that you want to have with any reform deal, and they are all very difficult politically because you get critics saying “Oh, you are cutting my social security.” Well, no, we are just keeping the growth from getting out of hand.

The current recovery has been slow and at the same time inequality is rising. You once argued that it is the weak recovery that causes rising inequality and not the other way around. Can you explain this observation?

When the economy is growing slowly, it’s harder for people to get jobs. It gets discouraging at the work place. That’s part of the reason why a lot of people are not doing so well, and some people doing quite well. I am from Bay Area of California where unemployment is very low. But, if you go to the east, unemployment is twice as high. If you go north, it’s three times as high, in some areas. These communities are not thriving, the growth rate is low, so there is dispersion of income and income growth.

It’s not just fast economic growth, it’s where the economy is going. The incentive for firms to open up new franchises or to start new businesses is being constrained by a slow growth. It’s a combination of regulation and taxes that discourage business formation, hiring, and employee training. They are all very closely tied together.

Stronger growth would be good, but in a way it is the policies that are causing slow growth that are also causing income inequality. That’s due to the

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Research focus: modern
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Known for creating the
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1976 to 1977 - Senior staff
economist on the President’s
Council of Economic Advisers

1989 to 1991 - Member of the
Council of Economic Advisers
under President George H.W. Bush

1995 to 2001 - Member of the
Congressional Budget Office’s
Panel of Economic Advisers

2001 to 2005 - Served as
Under Secretary of Treasury for
International Affairs

2010 - Received the Bradley Prize
from the Bradley Foundation

2012 - Awarded the Hayek Prize
for his book *First Principles*

2016 - Received the Adam Smith
Award from the Association of
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regulations and tax policy. When we apply economic principles we want to be careful not to exclude people from enjoying economic freedom. Economic freedom must extend to all with policies that generate growth and help mitigate rising inequality.

Switching topics now: you've had a long career in teaching. Over the years we've seen that the internet have a huge impact on how we teach. This includes online classes. What's your experience been like with online learning?

Almost 20 years ago when I did my principles course I had it taped and put it on the internet. This was maybe 1998 or 1999. It was a long time ago so it wasn't the greatest quality and wasn't like what you can do now. Now I put my Economics One course online, and we offer online courses to Stanford students for credit.

It is still ideal to have students in the classroom. It's different being there. Students and professors can ask questions. But if you can go back and review the lecture online—go to a particular place in the lecture and compare the taped lecture to your notes—that's an advantage.

My mantra for the online courses is to have an online experience that is as good as you can get in the classroom. Comparing the student outcomes for those taking the online course to those taking the on-campus course, through questions, evaluations, and grades, the outcomes are comparable. I think that's promising in terms of the future. So, I am pretty optimistic about that. In many ways the internet is affecting the economy by making it more global. With everybody on the internet the potential is huge for many people to do better. They can see, they can learn, wherever they are in the world, and can improve their lives. But to benefit from that, you really have to implement these principles we have talked about. You have to give people the opportunity.

We take for granted these days whether you are searching for something that was written years ago, or what's in the foreign newspaper today. It reinforces the need for more decentralization of individuals' abilities to benefit from that technology. In a way it enhances freedom because people see are not controlled as much. Whether they live in

China or North Korea, they're eventually going to be able to see what is going on elsewhere. In terms of what we teach, it seems capital is more mobile, and eventually people become more mobile. You want to consider all the ramifications of that. Overall, I am optimistic about the potential of online learning to enhance opportunities and freedom. ■

Kirby Distinguished Visiting Professorship

First awarded in 1988, PERC's Kirby Distinguished Visiting Professorship brings internationally acclaimed scholars to Texas A&M University to interact with faculty and students. Other recipients have included Nobel Laureates Douglass North and James Buchanan, and most recently Robert Topel from the University of Chicago Booth School of Business.

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