

Comments on Daniel Benjamin and David Laibson:
“Good Policies For Bad Governments: Behavioral Political Economy”

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The authors make two main arguments in this paper: that behavioral economics rationalizes a wide array of welfare-improving interventions; and that economists should refrain from recommending policies that go beyond benign paternalism because policymakers are subject to the same behavioral biases that afflict individuals or, worse, may be self-interested, not benevolent. I agree that behavioral economics rationalizes activist policy. I agree too that policies sometimes do more harm than good. But I see a stronger rationale for at least some policies that go beyond benign paternalism.

I would like to react to some of the particular macroeconomic policies espoused by the authors. But first, I want to make explicit my view that behavioral economics provides a solid and much needed intellectual underpinning for Keynesian economics and the macroeconomic goal of stabilization policy. This point is implicit in the Benjamin/Laibson paper but it deserves emphasis. Keynesian economics, and its conclusion, that absent active policy, market economies may exhibit pronounced cyclical fluctuations in output and employment, has been under attack for decades from theorists who regard its microfoundations—particularly the assumption of sluggish wage and price adjustment—as both ad hoc and implausible. A major contribution of behavioral economics is to demonstrate that “money wage stickiness” is a sensible description of how labor markets actually work, reflecting deep aspects of the human psyche, not implausible adhocery. It is striking that the authors describe these ideas about wage determination as now the “consensus views in the profession.”

I am uncertain whether the authors consider the active use of monetary and fiscal policy to stabilize the economy an example of benign paternalism or not. There is certainly a large literature, dating at least back to Milton Friedman, questioning both the competence and

motivation of policymakers to improve macroeconomic performance. This literature urges that policy be governed by rules rather than discretion. I see far greater cause for concern about the use of fiscal than monetary policy to stabilize the economy. If individuals suffer from present bias, elected politicians do so in the extreme, as our present fiscal policy shows. However, developed countries have devised very effective institutional arrangements for the conduct of monetary policy that work well to overcome these biases. Theoretical arguments concerning time inconsistency in monetary policy notwithstanding, independent Central Banks, such as the Federal Reserve, have demonstrated both the ability to take the long view and the technical competence to implement monetary policy in a way that improves macroeconomic performance.

Several of the authors' recommendations tackle head on how monetary and fiscal policy should be conducted. I agree with many of their concrete policy suggestions, particularly recommendations #1 and #2 concerning methods to encourage saving and regulate asset allocation, and also recommendation #4, which provides an excellent summary of behavioral lessons relating to the design of stimulatory fiscal policy. The demonstration that individual saving behavior is so sensitive to the "defaults" in 401K and retirement arrangements is a truly striking finding of the behavioral literature with huge practical implications for the design of tax/retirement policy. The paper does not address the potential relevance of behavioral economics to the stock market. However, behavioral economics offers interesting insights into factors, such as herding and overconfidence, that may foster asset bubbles. The question of how to react to possible bubbles is a key issue for monetary policy. Since tightening monetary policy is a costly approach, I wonder if there might be benign policy interventions affecting trading, akin to those directed at saving and asset choices, that could mitigate the tendency to irrational

exuberance.

In my remaining time, I would like to comment in greater depth on two of the authors' policy recommendations: the proposal to target low, positive inflation, with which I strongly agree, and the proposal to privatize Social Security to increase national saving, with which I strongly disagree

Behavioral Economics and the Phillips Curve. Behavioral economics has important implications for the Phillips curve and macroeconomic policy. In particular, it points to the possibility that the long run Phillips curve may not be vertical at low inflation rates when productivity growth is low. This means that an inflation target that is too low could result in higher long-term unemployment. There are at least two different behavioral models that produce this result. In the first model, which the authors discuss, the key behavior giving rise to a tradeoff is the unwillingness of workers to accept, or firms to impose, money wage cuts. Inflation then serves to grease the wheels of the labor market when productivity growth is sufficiently low that a significant fraction of firms find that they need to cut real wages. Here, a policy that targets low, as opposed to zero inflation, can erase the effects of downward rigidity of money wages by relieving the constraint against real wage cuts resulting from workers' negative reactions to reductions in their money wages.

A paper by Akerlof, Dickens and Perry¹ explores another set of behavioral factors that may give rise to a tradeoff between inflation and unemployment at low inflation rates. The idea is that inflation only really matters to nominal wage bargains on a point-for-point basis once it has

¹ George A. Akerlof, George L. Perry, and William T. Dickens, "Near Rationality and the Long-Run Phillips Curve," *Brookings Papers on Economic Activity*. 2000:1.

become salient. Psychological studies suggest that decision-makers often edit or ignore information that is potentially relevant to a decision to concentrate on a few factors deemed most important. In fascinating surveys, Robert Shiller² also finds that employees fail to see the connection between wage and price changes. They systematically underestimate the tendency of inflation to boost their own nominal wages. Thus, they view money wage increases favorably, as the reward for good job performance, and inflation a separate negative factor impacting well-being. Such attitudes are consistent with Truman Bewley's finding that "workers do not expect pay increases to equal the rate of inflation plus what they would obtain if there were no inflation." The consequence of such views is that it takes smaller real wage increases to maintain the same level of morale as inflation increases. Akerlof, Dickens and Perry (ADP) explore the intriguing possibility that money illusion could actually be welfare enhancing because it creates the opportunity for policy to drive unemployment below "NAIRU". In the ADP model, the Phillips curve possesses a "leftward bulge": namely, a negative slope at negative and very low positive inflation rates, and increasingly positive slopes as inflation rises, becoming ever more salient. At sufficiently high inflation, the Phillips curve turns vertical at "NAIRU." In a world of perfect competition in both labor and product markets, NAIRU is socially optimal. But in modern macroeconomic models, monopolistically competitive markets are taken as the norm, so that output and employment fall short of their Pareto optimal levels when the economy operates at NAIRU. The implication is that exploitation of the Phillips curve tradeoff present at low inflation rates due to money illusion is welfare-improving. The judicious choice of an inflation target may

² Robert Shiller, "Why Do People Dislike Inflation?", in *Reducing Inflation: Motivation and Strategy*, edited by Christina D. Romer and David H. Romer. Chicago: University of Chicago Press: 1997.

make workers happier with lower real wage increases, allowing an expansion of the economy that erodes the underutilization of resources due to monopolistic competition.

I believe that behavioral economics also sheds light on why the Phillips curve appeared to shift in a favorable direction in the 1990s. Research by Larry Ball³ and others suggests that, for behavioral reasons, productivity growth is an important variable in the Phillips curve. Changes in the pace of productivity growth may have a prolonged impact on NAIRU if the real wage aspirations of workers are sticky. In this case, shifts in productivity growth, by making it easier or more difficult for firms to meet historically-rooted real wage norms, have implications for the inflation-safe unemployment rate. During the 1990s, faster productivity growth enabled firms to more easily meet norms for real wage growth that were depressed by the post-1973 productivity decline. Sluggish upward adjustment of those norms enabled unemployment to fall to 40-year lows without igniting inflation. In contrast, the poor experience of the 1970s reflected the collision of inherited norms for rapid real wage growth with the unpleasant reality of a sharp productivity slowdown.

Privatizing Social Security. I would like to conclude my discussion with some comments on the one policy proposal advanced by the authors with which I strongly disagree, namely their proposal to privatize Social Security. In fairness, the authors recognize that their proposal has drawbacks. First, I consider Social Security a successfully paternalistic intervention that goes well beyond benign: a large fraction of participants are forced to save more than they would choose on their own. They are also required to realize their retirement income in the form of an indexed annuity. As a result of

³ Laurence Ball and Robert Moffitt, "Productivity Growth and the Phillips Curve," in Alan B. Krueger and Robert Solow, eds., *The Roaring Nineties, Can Full Employment Be Sustained?* Russell Sage Foundation and Century Foundation, 2001.

Social Security, the elderly have at least a base level of real income in old age. I think the system has successfully offset the “present bias” that led so many elderly households into poverty as a result of undersaving. The elderly poverty rate has declined from 35 percent in 1959 to 11 percent in 1996. The system enjoys broad public support. There are many good reasons not to switch the system from defined benefit to defined contribution: such a shift would expose individuals to greater risk and higher administrative costs, even if asset choices are restricted as the authors suggest.

The authors’ main argument for privatization, however, is to increase national saving. The case is not as airtight as commonly assumed, but I agree that higher national saving is what the United States probably needs now to address its impending demographic crunch.⁴ Higher national saving following privatization will only occur, however, if the shift of the (currently) large (off-budget) Social Security surpluses from government to private accounts really changes the public’s understanding of the plight of the Federal budget and then voters, knowing the true state of affairs, force their elected representatives to impose higher taxes and/or cut Federal spending in response. These are behavioral hypotheses and, in both cases, I have my doubts about their validity.

I agree with the authors’ argument that inclusion of the Social Security surplus in the unified “deficit”, the measure that receives the bulk of public attention, impedes public understanding of the Federal government’s true fiscal position. The sum is nontrivial, amounting to \$2.5 trillion over the ten-year budget horizon. Actually, Social Security is the mere tip of the

⁴ Advocates sometimes overstate their case: prefunding on the scale that some economists call for could push down the return to capital substantially; moreover, slowing population growth is likely to depress marginal returns and reduce the demand for capital because with a smaller flow of new workers, the amount of capital needed to equip those workers will be lower (see Douglas W. Elmendorf and Louise M. Sheiner 2000. “Should America Save for Its Old Age? Fiscal Policy, Population Aging, and National Saving” *Journal of Economic Perspectives*, 14(3): 57-74.)

iceberg when it comes to deceptive Federal budget accounting practices. Overstatements of revenue relating to surpluses in the “on-budget” Medicare Trust Fund, sunsets in the tax code, and “phantom” AMT revenues, coupled with lowballing of spending, probably adds an additional \$3 trillion or so to estimates of the unified Federal surplus over the ten-year budget window.

Although existing deficit measures are “flawed,” the “on budget” deficit is not an adequate summary of the state of the Federal budget either. The on-budget surplus fails to capture the huge problems that will appear at the end of the ten-year budget window as the baby boomers retire. By 2030, Social Security, Medicare and Medicaid are projected to double from 8 to 16% as a share of GDP. The best single measure is the “fiscal gap”—the amount by which taxes, as a share of GDP, would have to rise (or spending contract) to stabilize the ratio of debt to GDP at its present level, around 35%. Estimates made prior to the recent tax cut placed the fiscal gap in the range of 4-8% of GDP. In other words, long-term budget balance would require a permanent increase in federal revenues of about 20-38%, a comparable decline in spending, or a combination of the two. Privatization of Social Security strikes me as a high price to pay for what is only a “slightly improved” measure of the Federal government’s fiscal plight.

I think the public does understand that the country faces major problems associated with the funding of its retirement programs, even though deficit measures are imperfect. Polls suggest that the majority of Americans are aware of the large actuarial imbalance in Social Security, did not attach high priority to tax cuts, and favor paying down debt. The now-defunct plan to place off-budget surpluses in a lockbox to pay down debt and shore up Social Security commanded broadbased public support. This understanding is not, however, driving voting behavior.

Whether national saving rises following privatization depends entirely on how the transition costs involved in privatization are handled. Privatization could easily turn into a shell game in which future workers are permitted to invest their payroll tax contributions but the benefits of current workers are maintained and financed through larger deficits, as in the Chilean privatization. A litmus test of the seriousness of any privatization plan is whether it imposes pain: higher national saving requires higher taxes and/or reduced government spending. Because such changes are unpopular, responsible plans to privatize Social Security, such as the plan proposed by the National Commission on Retirement Policy, have been unenthusiastically received. I suspect that in the decades ahead, however, greater discipline over national saving may emerge not from voters, but rather from financial markets as market participants come to appreciate the long-term implications of current fiscal policy.