In an Emerging New World, Choose Economic Freedom

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The world is on a hinge of history. The future is going to be different from the past in major ways.

At the end of the Second World War, people such as Dean Acheson, George Marshall, and Harry Truman sat atop another hinge of history, though they may not have realized it at the time—you can know something is important without knowing exactly what it is that you are dealing with. But when they looked around at the devastation that had been wrought across the globe, with tens of millions of lives lost and the economies of allies and adversaries alike in ruins, they saw how the United States could work with both to help. American economic resources could help to rebuild infrastructure and restart economies. American military resources could help protect those efforts from new conflicts. There wasn't a grandiose plan to do so, but bit by bit sectors and countries from across the world were drawn into a voluntary, shared framework—one in which the United States could do well for itself and that was also appealing to others around the world who could see their own success in it too. I think it's fair to say that when the Cold War came to an end, a security and economic commons had been built in the world, which everybody benefited from.

But that commons is now eroding—and it should be clear that new challenges are coming at us. New communications technologies make speech and information available to anyone, anywhere, simultaneously. This adds new dimensions to the old challenge of effectively governing over diversity. New forms of production, such as advanced automation or additive manufacturing (also known as 3-D printing), reduce the importance of labor costs and make it easier to produce goods closer to where they will be used; along with a shift toward services in advanced economies, this development could upend traditional trade relationships and industrialization patterns. Data science and machine learning promise to transform a host of industries, jobs, and products. That includes new weaponry and ways of warfighting that put destructive power in the hands of more and more actors around the world, with disruptive effects. Major changes in the global demographic picture have set the advanced economies, most of them (save the United States and other immigration countries) with shrinking workforces, on a completely separate path from that of the poorest emerging economies in Africa or South Asia, whose youth populations are set to explode, despite the poor governance and economic opportunities available to them. What happens in these parts of the world, long ignored, will impact us, too. And major technical and scientific challenges loom: the environment, energy, climate, pandemics, and health.

How should the United States respond to this complex, emerging new world?

The message I wish to convey is that when navigating these big changes—or even because of the scale of such changes at home and elsewhere—it becomes more important than ever to have common principles to work from so that you steer a good course. And though the institutions and techniques to deliver them may change, the core approaches today are no different from the ones that animated Acheson and Marshall and Truman after the war: personal liberty, ensured through a just and responsive government (and realized through good individual educational foundations), and the market price system, which is really just a way of enabling personal choice and initiative, within a feedback loop, for social benefit.

But history shows that when novel policy challenges arise, it's tempting for governments to abandon such principles in the name of "doing something." Consider the following piece of advice to the president of the United States:

Why are the old rules not working? . . . Much of our economic thinking and economic policy has not yet caught up with the changes that have taken place in the structure of our economy. We continue to rely on monetary and fiscal policies that worked reasonably well ten or twenty years ago, unmindful of the profound changes in our economic environment.

Such words echo today, but this is not a quote from a Senator Sanders stump speech. Rather, it is from a 1971 letter, marked "personal and confidential," from Fed chair Arthur Burns to President Richard Nixon—a letter that I recently stumbled upon from my own collections in the Hoover Archives. In it, Burns—the widely respected "pope of economics" himself, struggling to respond to public and political panic over inflation—is advocating for an economywide system of federally administered wage and price controls, one that would in fact be enacted just two months later. Burns's new approach was initially met with rapturous and bipartisan applause across the country—before leading to a decade of disastrous consequences. This experience instilled my own sense that, in the end, even wise people are fallible—and that, even in times of upheaval, it's good economics that leads to good policies, and to good results for the country.

We may think of market principles as defining of the American system, but the challenges we often hear voiced against them today are not novel. Members of the public, alongside intellectuals and political leaders in both parties, have often found cause to abandon them when convenient. In our recent book *Choose Economic Freedom*, John Taylor and I—alongside honorary co-author the late economist and Hoover fellow Milton Friedman, our friend and colleague who supplied many relevant words of wisdom during his lifetime—tell the story of what happens when these principles are abandoned and when they are once again heeded.[1] As we once again look to new policy challenges in this country, I'd like to remind people of those lessons, forged through the crucible of an earlier American age of "democratic distemper" (to borrow Hoover fellow Mo Fiorina's phrase), without having to relive the pain that proved it.[2]

Let's return to that chaotic era in American history by setting the scene.[3] In 1962, I was a faculty member at the University of Chicago. I had read the new and energetic Kennedy administration's President's Council of Economic Advisers annual report, which issued a set of soft guidelines for wage and price changes designed to set the sights of labor and management on wage and price changes in a way that would keep inflation under control.[4] They outlined voluntary, productivity-linked "guideposts" to stabilize wage and price setting in industries they said exercised market power. Their concerns about inflation were underlined by Lyndon Johnson's Vietnam War and Great Society spending.

I worried, though, that these guidelines might be the conceptual precursors of harder, government-directed wage and price controls. Such a move would paralyze the open-market economy that underlies American prosperity. So, in collaboration with my colleague Robert Aliber, we held a conference on the issue, and many heavy hitters attended—top-notch economists of all persuasions, including George Stigler, Allan Meltzer, then CEA chair Gardner Ackley, and future labor secretary John Dunlop. Milton Friedman gave an outstanding address against wage and price guidelines (or guideposts), pointing to the harms they cause—including that it is actually in the business's and the economy's interest to violate such government requests, thereby encouraging a sense of lawlessness—and showing that inflation is instead a "monetary phenomenon" caused by bad fiscal policy. In response, Robert Solow, who like Friedman would also later win a Nobel Prize, offered "The Case against the Case against the Guideposts"—in effect arguing for them, using a technical justification based upon the employment level and firms' market power. Although Friedman and Solow disagreed, the conference was a success; the issues were well identified. Aliber and I gathered together the papers and transcripts of the discussions and published them in a book.[5] So the subject was on my mind.

Not long afterward, I became secretary of labor. In this capacity, I was preoccupied with settling major strikes, fighting against discrimination in the workplace, and managing on the president's behalf the desegregation of schools in seven Southern states, sixteen years after the *Brown v. Board of Education* decision of 1954.

By July 1970, however, I became the first director of the Office of Management and Budget (OMB). I sensed, after a time, that wage and price controls were, indeed, in the air, so I gave a speech making the case that we had the budget under control and, with a reasonable monetary policy, inflation would be brought under control. All we needed was the patience to see these orthodox policies through, so the title of my speech was "Steady as You Go." I argued:

A portion of the battle against inflation is now over; time and the guts to take the time, not additional medicine, are required for the sickness to disappear. We should now follow a noninflationary path back to full employment.[6]

Instead, the pace toward controls picked up. In August 1970, Congress gave the president the authority to impose them. In effect, Congress said, "We have given you the tools; now it's up to you to do the job." Meanwhile, the accelerating growth of dollars in foreign hands posed the threat of a run on the bank (Fort Knox), with inflationary implications.

This was about the time that Burns, as chairman of the Federal Reserve at the time, wrote to President Nixon. In his private letter, dated June 22, 1971, Burns argued that structural changes in the economy made it difficult to control inflation, that sound monetary and fiscal policies—classical policies—would not work as in the past, and that a new approach was needed. He advocated a six-month wage and price freeze. Obviously, he thought that government-directed controls would work, giving the Fed a major assist in taming inflation. He was an expert in the business cycle, with many years conducting research at the National Bureau of Economic Research, so this was a surprising change in his thinking. Burns argued:

In my judgment, some of us are continuing to interpret the economic world on the model of the 1940s and 1950s. In fact, the structure of the economy has changed profoundly since then.

There was a time when the onset of a business recession was typically followed in a few months by a decline in the price level and in wage rates, or at least by a moderation of the rise. That is no longer the case. The business cycle is still alive, indeed

too much so; but its inner response mechanism, which has never stood still, is now very different from what it was even ten or twenty years ago.

Failure to perceive this may be responsible for some shortcomings in our national economic policy. I doubt if we will bring inflation under control, or even get a satisfactory expansion going, without a major shift in economic policy.[7]

I resisted—even making my case at a dramatic, last-moment weekend retreat with the president at Camp David. But the decisions had already been made, and I had lost. On Sunday, August 15, 1971, the president announced a ninety-day wage and price freeze, to be followed by more elaborate controls and a surcharge of 10 percent on imported goods and services. On three television networks, he said, "The time has come for a new economic policy for the United States." Nixon's "shock" was a radical departure from the free-market price system of personal decision making and responsibility upon which our American system was based.

Disaster had struck, I thought. But it didn't look that way. The stock market logged its largest ever one-day increase. In fact, the freeze was hugely popular—with the public, with most businesses (especially given the new tariffs that went along with it), and among politicians from both parties—so much so that I was frightened, as the natural flow and feedback of economic variables in the economy was being stifled. This enthusiastic endorsement of the freeze from Richard Reynolds Jr., president of the Reynolds Metals Company, was typical:

A very good and forceful move at a critical time. . . . The President's program is going to help the economy generally and basic industries, including aluminum, in particular. His action was certainly warranted by the condition of the economy. We don't have the demand. . . . It is quite clear that the President deserves praise for the scope of this action.[8]

I did have some help. A number of economists, published in the *Wall Street Journal* and in *Newsweek*, argued against the freeze. And Milton Friedman was quoted in *Newsweek* as saying: "[President Nixon] has a tiger by the tail. Reluctant as he was to grasp it, he will find it hard to let go."[9]

At first, the wage-price freeze seemed to work, as it came at a time when inflation was already in the process of declining and commodity prices were soft in the world markets. The "temporary" freeze was inevitably followed up by explicit, compulsory wage and price controls, which turned out to be very intrusive on the economy. People were unable to change wages and prices without the consent of the so-called Price Commission or Pay Board. The seven-member Price Commission and the fifteen-member Pay Board were established with members from labor, business, and the public. The controls were administered with enthusiasm by a Cost of Living Council, headed by John Connally, secretary of the Treasury.

At the conclusion of the ninety-day freeze period, the council enacted Phase II of the controls, which would stay in place through the 1972 election. Under Phase II, corporations were allowed to pass increased costs through to prices but were slowed down by prenotification and profit margin limitation requirements; for example, companies with sales exceeding $100 million had to register price increases thirty days in advance, which could then go ahead, barring rejection from the Price Commission. Price growth was targeted at 2.5 percent. Wages were to be limited to 5.5 percent annual growth. Burns, who had earlier turned down a seat on the Cost of Living Council, was appointed to head the Committee on Interest and Dividends, which stated that corporate dividend growth should be limited to just 4 percent. Burns described the committee as "a new instrument for jawboning." The complexity of administering the controls grew.

In the short term, the consumer price index (CPI), which measures inflation, declined and real GDP rose. All this led to the landslide reelection of President Nixon. But trouble lay ahead. The economy sputtered, and prices were a problem. The Cost of Living Council, the bureaucracy responsible for administering the controls, was intrusive. No wage or price change could take place without approval by the Pay Board or the Price Commission, so the gears of the economy ceased working in the normal and natural ways that produce an efficient system.

On June 12, 1972, I moved from OMB to become Treasury secretary, and the Cost of Living Council control system, now headed by Don Rumsfeld and Dick Cheney, reported to me. Working with Rumsfeld and Cheney, and with the president's support, we designed an effort to ease away from the rigidity of Phase II. On January 11, 1973, the president announced Phase III of the wage and price controls. The idea was to scale back the institutional complexity of the program and to rely more on voluntary cooperation in the private sector. We knew that an initial burst of suppressed inflation was likely to show its head, but following that, we expected a more settled period (at the time, the CPI was growing at an annual rate of 3.6 percent). So the Price Commission and the Pay Board were abolished in favor of "self-administration" by obligated parties: Firms with sales exceeding $250 million had to report quarterly profits and price changes to the council, but advance clearances were no

longer required. Annual price growth targets were still set, but firms could petition for exceptions. The complexity in relating all of this today shows just how hard it is to unwind the idea that a centralized command-and-control system is somehow simpler than the natural workings of the market.

One humorous sideline to all this was a discussion in which Herb Stein, chairman of the Council of Economic Advisers, said to the president, referring to the popularity of the earlier wage-price freeze: "Mr. President, you can't walk on water twice," to which President Nixon replied, "You can if it's frozen." It was clear then where policy was once again headed.

When that expected inflation uptick came, Nixon decided to reimpose controls. A new sixty-day price freeze was implemented in June 1973, beginning phase IV of the program—despite the president simultaneously warning the American public against becoming "addicted" to the tool. By that point, I had to say to the president, "This is your call, but it's directly opposed to my advice, and I think you are making a mistake. Under the circumstances, you need to find a new secretary of the Treasury."

Meanwhile, the controls went on. Under Phase IV, the Cost of Living Council's administrative focus was on trying to induce supply expansion despite the price freeze and limits on exports, especially for food items. Wholesale agricultural goods were exempted in a bid to encourage production, while retail food prices were controlled, resulting in shortages. I recall a colleague in my office exclaiming about Washington-area supermarkets: "We've got great prices posted on the shelves for meat—but we've got no meat!" The wholesale price of oil was similarly capped, at $4.25 per barrel, and scheduled to gradually rise over six months toward the world price (a plan disrupted by the Arab oil boycott, which sent up global prices faster than the US domestic oil prices were rising to meet them).

Faced with these disruptions, and poor public reaction, this second freeze was ended early by the president, after just thirty-five days. Further price controls were gradually scaled back, from covering 44 percent of all CPI basket prices in August 1973 down to 12 percent of CPI basket prices in April 1974.

But the controls—or the threat of their reimposition—never really stopped. Not six months after allowing the Cost of Living Council to dissolve in the spring of 1974, Congress reversed itself in August by granting a request from President Ford to establish a Council on Wage and Price Stability, which lasted until President Reagan took office. Everyone remembers President Carter's gas lines, as price controls in the oil sector led to shortages during the 1979 Iranian Revolution. What you control, you get less of. As Milton Friedman (himself invoking Edmund Burke) said of wage and price controls, "That is one of those 'very plausible schemes . . . with very pleasing commencements [that] have often shameful and lamentable conclusions.'"[10]

So what can we draw from this history of radical public policy? Above all, the main lesson is that orthodox policies, and the accountability of the free-market price system, work well and that selectively deviating from them can lead to trouble.

President Nixon, it might be said, did us a great favor by demonstrating that heavy-handed and open-ended interventions, as exemplified by the wage and price controls, generally do not work. He imposed them on the economy with broad political support and arranged to have them administered by talented people such as John Connally, John Dunlop, Don Rumsfeld, and Dick Cheney, among others. So he gave the country a lesson that, even with high talent at the helm and the wind at your back, this approach doesn't work. He also showed that, in thick of it, political affiliation does not guarantee a principled defense in this realm.

We also must be careful about the argument, as in the Arthur Burns letter, that the economy is a mess and doesn't work right anymore, so classical methods won't work. When you reach that stage of the argument, you almost inevitably reach for a different and untested lever—in this case, wage and price controls.

As is likely to be the case should it happen again, Burns's and others' prescriptions of drastic policy change proved to be wrong. It took years before Paul Volcker, in his own role as chair of the Federal Reserve, would return to classical but effective monetary policies alongside the freedom of decision making among businesses, workers, and consumers across the broader economy that Burns said would not work.

They did work. It took a while for inflation to come under control, but once it did, the economy took off. By the end of 1982, inflation was substantially reduced and stabilized, and everyone could see it was going to stay that way. The last remnants of the controls were killed off. And this lesson goes well beyond avoiding wage and price guideposts or controls. The same lessons apply to the other market-oriented reforms that began in the 1980s, including tax and regulatory policies. The marginal rate of income taxation, for example, having been reduced by Presidents Kennedy and Johnson from 90 percent to 70 percent,

was brought down to 50 percent by President Reagan. Meanwhile, the regulatory burden across a number of sectors of the economy was also lightened. And in 1983, the economy took off like a bird.

So remember, markets generally work (even, or perhaps particularly so, in times of uncertainty), and excessive interventions by government in the operations of the economy or in personal decision making can cause problems, sometimes severe. Watch out for charges that the world has changed, or society has changed, or the economy has changed, as justifications for suddenly abandoning your principles. Arguments to break with "the old rules" will always come; countering those is a continuous process—one that should aim to address new challenges and new public concerns. We do face major changes coming over this hinge of history. So we should observe these new trends, acknowledge them and learn to understand them, and then develop a credible, long-term strategy to confront them—before the urgency of an exigent crisis throws the door open to poor options and poor political choices. By owning up to the face of an emerging new world today, we will be in a better position to succeed in it by building from our shared American principles of individual liberty and prosperity.

Endnotes

[1] George P. Shultz and John B. Taylor, *Choose Economic Freedom: Enduring Policy Lessons from the 1970s and 1980s* (Stanford, CA: Hoover Institution Press, 2020)

[2] Morris Fiorina, "The Democratic Distemper," Project on Governance in an Emerging World, Hoover Institution, May 2019, https://www.hoover.org/research/democratic-distemper.

[3] The following text recalling this era is excerpted and adapted from two previous tellings: as published in Shultz and Taylor, *Choose Economic Freedom*, described here, and previously in a September 2017 speech I delivered to a meeting of the Economic History Association in San Jose, titled "Dreams Can Be Nightmares."

[4] White House, Council of Economic Advisers, *Economic Report of the President* (Washington, DC: US Government Printing Office, 1962).

[5] George P. Shultz and Robert Aliber, *Guidelines, Informal Controls, and the Market Place: Policy Choices in a Full Employment Economy* (Chicago: University of Chicago Press, 1966).

[6] George P. Shultz, "Prescription for Economic Policy: 'Steady As You Go'" (speech, meeting of the Economic Club of Chicago, Chicago, April 22, 1971).

[7] An original copy of the letter appears in the George P. Shultz collections of the Hoover Instruction Archives. It is reprinted in Shultz and Taylor, *Choose Economic Freedom*.

[8] Quoted in Walter Stovall, "Banks, Firms Laud Nixon Move," *Associated Press*, August 17, 1971.

[9] Milton Friedman, "Why the Freeze Is a Mistake," *Newsweek*, August 30, 1971.

[10] Friedman, "Why the Freeze Is a Mistake."

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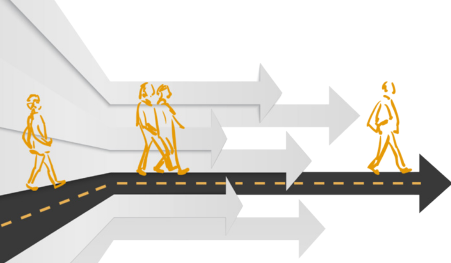

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