WALTER WOLFGANG HELLER

ECONOMIC THEORY AT SERVICE OF ECONOMIC POLICY

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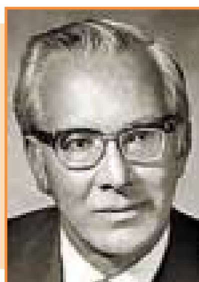
Walter W. Heller was a respected authority in the field of public finance who came to prominence as an exceptionally successful chairman of the Council of Economic Advisors under presidents John F. Kennedy and Lyndon B. Johnson (1961–1964). Heller's Council, which several American



economists have described as the most qualified since 1946, was incredibly active in shaping and pushing through a new form of macroeconomic policy, the "new economics". Heller's most important contribution was to bring the latest results of economic theory into economic policy.

Walter Heller (1915–1987) was born in Buffalo, New York State, and grew up in Seattle and Milwaukee. In 1935 he graduated from Oberlin College, and in 1941 he received his Ph.D. from the University of Wisconsin, where he taught economics from 1941 to 1942. From 1946 until the end of his life, he was based at the University of Minnesota in Minneapolis, first as a lecturer, then professor of economics. He also taught as a visiting professor at Washington State University (1966), University of Wisconsin (1969), and Harvard University (1978).

Walter Heller was always attracted by economic policy, an area in which he frequently served as an economic adviser. The first stop on this road came when he worked at the Treasury Department between 1942 and 1946. Then, in 1947 – 1948, he served as a tax advisor to the US Military Government in West Germany, where he played a major role in the designing the currency and fiscal reforms. In 1951 he served in the Marshall Plan mission in Germany, and in 1960 he became a tax adviser to Jordan's King Hussain and to Jordanian royal commission. Heller's "advisory" work culminated with the CEA chairmanship under presidents Kennedy and Johnson. There followed consultancy posts with the administration of presidents Johnson (1965–1969) and Ford (1974–1977) as well as with other institutions – for example, in 1966–1968 he chaired a group of fiscal experts at the OECD.

Many accolades and awards came Heller's way, including membership of the Phi Beta Kappa and Beta Gamma Sigma societies and the Ford Foundation, an executive directorship at the National Bureau of Economic Research (NBER), and several honorary doctorates. In 1974 he took up the prestigious post of president of the American Economic Association (AEA).

Heller himself evaluated his professional career in the following terms: "I am one of those fortunate individuals who has been able to realize his youthful professional ambitions, namely, a combined career of teaching, research and public service." It all began with teaching and research, mainly in the field of taxation and public finance.

New dimensions of political economy

Walter Heller named his most important publication "New Dimensions of Political Economy" (1966). He wrote in the introduction that these "new dimensions" are largely the consequence of the extensive use of modern economic theory in economic policy. This work came out at a time when the US economy was reaching the peak of a long-lasting period of prosperity, which Heller linked to the culmination of the Keynesian revolution. Economic success raised the prestige of professional economists, many of whom held high government positions and applied Keynesian policy in the form of the "new economics".

New dimensions reflect the wealth of experience that Heller acquired as chairman of the Council of Economic Advisors under presidents Kennedy and Johnson. The main question Heller asked himself was this: "What are the Presidential adviser's responsibilities to the President, to the public, to the profession, and to himself?" Although the president receives economic advice and information from many internal and external sources, the principal source, according to the Employment Act, should be the Council of Economic Advisors. The basic role of the Council is to "analyze, interpret, and forecast", and to make recommendations to the president. Heller, however, takes this to include the economic education of the president, members of Congress and the public. The Council often suggests alternatives and warns about conflicting objectives and political risks. However, if the president asks for the best solution, the Council must give an unambiguous answer. An economic adviser may not simply operate in the world of high abstractions divorced from economic reality; he must also explain complex economic matters in clear and engaging terms.

As regards the responsibility, Heller was clear that the Council must be in accordance with the general objectives of the president's policy. Were a Council member to disagree

with them, he should resign his position. When Kennedy's Council appeared before the Joint Economic Committee of the US Congress in 1961, it declared: "The Council has a responsibility to explain to the Congress and to the public the general economic strategy of the President's program, especially as it relates to the objectives of the Employment Act." Some economists say: "Explanation, yes; defence, no". But to draw a line between explaining and defending is almost impossible. An economic adviser should not in any case use his talent and reputation to defend the indefensible. It is true that some advisers may opt for a "tactic" of silence, in other words, they do not pass comment on contentious issues or simply say "I don't know". But any such tactic can only be temporary. An economist operating in the front line of economic policy has fewer options than the academic economist, since he must take decisions based not only on scientific knowledge but also on the limitations imposed by the political reality and the given time-limit. A "government" economist must take into consideration public opinion and institutional rigidities (for example, the length of the legislative process). Economic science stands on one side and economic policy on the other with each field having its own limitations. The role of an economic adviser should be to bring these fields closer together and to overcome any deficiencies in their mutual understanding.

In this regard, Heller's team notched some significant successes, with assistance from other members of the Kennedy administration and also from academic economists, such as Paul A. Samuelson, John K. Galbraith and Seymour Harris. The first Council chaired by Heller included James Tobin, a future Nobel Laureate in economics, and Kermit Gordon. President Kennedy, whose economic opinions were originally rather conservative and changed only under the influence of his economic advisers, attached great importance to the Council's informational and analytical activity and believed he should use it as a centre of scientific consultation. As for Kennedy's relations with the academic economists, an insight is given by the discourse he had with James Tobin when tapping him for membership of the Council: "I fear," said Tobin, "that I am an ivory tower economist." "That's all right," Kennedy replied, "I am what you might call an ivory tower president."

Heller's Council was characterized by two basic features. First, to a much greater extent than its predecessor it engaged in tackling current tasks of economic policy; secondly, it used modern methods to come up with fundamental concepts of economic policy, known as new economics. At the heart of this concept is the idea that the objective of economic policy should not be a balanced budget, but rather balanced growing economy.

The main characteristics of the new economics were as follows:

1. A short-term stabilization policy aimed at smoothing cyclical fluctuations was replaced by a long term policy aimed at achieving balanced growth with full employment.

2. Fiscal policy was "liberated" from orthodox principles, in the other words, released from the balanced-budget principle. A budget deficit was conceded until full employment was achieved.

3. Fiscal policy was to rely less on automatic stabilizers and more on discretionary measures responding to observed and forecast changes in the economy. Whereas the previous concepts mainly stressed changes in government spending, new economics focused on taxation as the principal instrument of economic policy.

4. The architects of new economics paid far less attention to monetary policy, saying it should comply with, and be supplementary to, fiscal policy.

Heller pointed out that "traditional thinking", which has a tendency to identify prosperity with a rising economy, often gives fiscal policy the wrong signals, requiring that stimulation of the economy be curbed long before full employment has been achieved. Advocates of new economics proceeded from another "philosophy". They demonstrated that a distinction should be drawn between the direction of economic development, which may be booming, and its level, which may be still far below the level of potential output. An expansionary policy, therefore should continue, while the production gap remains and the level of output does not achieve its potential. To maintain long-term balanced growth at the level of potential output is, however, an extremely complicated demanding task. It is a very narrow, trap-ridden road, even more so because the principal instrument is discretionary fiscal policy operating with various time lags.

It is clear from this short overview that new economics, which undoubtedly shed light on several new instruments and possibilities of fiscal policy, could not ensure long-term balanced growth with full employment. Its weaknesses, which included underestimating the danger of inflation and relegating monetary policy into a passive supplement of fiscal policy, appeared in the second half of the 1960s when the US economy suffered from overheating together with accelerating inflation.

Monetary versus fiscal policy

An interesting conclusion to the era of new economics was the dialogue that took place on 14 November 1968 at the Graduate School of Business Administration of New York University. The participants were two of the largest lights in economics, whose opinions on the key economic issues diverged substantially: Milton Friedman and Walter Heller. While Friedman analysed the role of monetary policy in stabilizing the economy, Heller on the other hand devoted himself to the stabilization task of fiscal policy. The name of Heller's paper, "Is Monetary Policy Being Oversold?" indicated his misgivings about the possibilities of the monetarist concept of monetary policy. The thesis often associated with monetarists is that "money matters", some Friedmanits even say, that only money matters. Heller

contended, however, that also new economics ascribed an important role not only to fiscal but also to monetary policy, in other words, it too recognized that "money matters". For him, the argument with monetarists lays elsewhere, namely, in the high importance that monetarists attach to the money supply. In this connection he posed the question: "Should money supply be the sole or primary guide to Federal Reserve policy?" Should not we take account of other variables? Should we rely on the monetary authority that it flexibly adjusts monetary policy to changing economic conditions, or should we instead not only enthrone money supply but encase it into a rigid formula that specifies its annual increase? Heller applied reductio ad absurdum to this principle. "In other words, should we accept the Friedman rule [steady growth of money supply – J. I.] and replace Bill Martin [then Chairman of the Federal Reserve – J. I.] with an exponential curve...?" According to Heller, there were two main questions: Should money be king? For what, if anything, is fiscal policy fit for?

It is true to say that there are other ambiguities related to money supply. The monetarists themselves differ which money supply indicator (M1, M2 or M3) is the best. When setting monetary policy, can it really suffice to consider only the money supply, or is it necessary to look also at demand for money and interest rates movements? Is it correct to assume the existence of a simple relationship between the money supply and nominal GDP? Should account not also be taken of changes in the time lag and velocity of money circulation? On the whole, it may be said that Friedman rule did not take account of the complex and changing conditions of the domestic and world economy, especially the potential for diverse shocks. On the contrary, it was formulated for ideal conditions (formula made in heaven) and could only function in such an environment.

Heller said he would feel more sympathetic to this doctrine were it not so lopsidedly focused on money supply as the only financial variable. We have noted already that one of the main weaknesses of monetarism is its neglect of the role played by interest rates, an endogenous variable whose behaviour is crucial to a correct interpretation of monetary development and in the execution of monetary policy. As for the dialogue between Friedman and Heller, it may be said that subsequent monetary development, insofar as it concerns the role of the money supply and the role of interest rates, has more borne out Heller's position. The fact is that interest rates, not money supply, have become the main instruments of monetary policy among leading central banks (including the Federal Reserve and European Central Bank).

The monetarist rule is sometimes compared with an automatic pilot reacting to changes in atmospheric conditions. This comparison is not apt though, since the monetarist rule does not adapt (and nor may it be adapted) to changing economic conditions – it cannot, for example, react to the turbulence of a recession (falls in employment, investment, profits, and so on). Heller said persuasively that good sense wins out "over the rigid and static rules that so ill befit an ever changing dynamic economy". In addressing this issue, Friedman pointed out that the price system, not the monetarist fixed rule, acted as an automatic pilot. At the same time, however, he admitted that the price system is "neither perfectly flexible, nor perfectly free". Friedman was, though, persuaded that the fixed rule of steady money-supply growth creates a stable monetary framework that provides for the reliable functioning of the market system. Critics of the monetarist rule are convinced that the opposite is the case. The rigid rule is, they say, more of destabilizing factor than a stabilizing one, and it complicates the functioning of the market mechanism. The modern economy includes various rigidities and a preponderance of imperfect competition, as a result of which the market may not always react adequately to economic disturbances. This is especially apparent with large disturbances, when active monetary or fiscal measures are essential.

The substantial difference in how the two economists approach the question "Rules or discretion?" is related to their understanding of economic forecasts. Friedman assumed that such forecasts – with regard to their quality – could not be a reliable instrument in the conduct of economic policy. Heller, by contrast, was convinced that forecasts were indispensable to high-quality economic policies: "We have to make the most reasonable forecast of the future and then be as nimble and flexible as possible in adjusting to unforeseen events and forces." Hindsight shows that the quality of economic forecasts has improved substantially since Heller's day.

At the end of his lecture, Heller acknowledged that monetarists had enriched economics in many ways, but he did not agree with their simple policy recommendations oriented on the money supply. Instead, he sought progress in economic policy through achieving the best possible combination of fiscal and monetary policies, as well as wage and price policies. This was to be supplemented with measures for accelerating productivity growth in order to achieve "sustainable, high employment and reasonable price stability".

What' s right with economics?

In the first half of the 1970s, several prominent economists came out critically against economics. Joan Robinson probably attracted the most attention when her Ely Lecture at the AEA in 1971 went under the name: "The Second Crisis of Economic Theory". Heller also addressed the evaluation of economics and, as the new AEA president, and gave his presidential address in 1974 entitled "What's right with economics?" As the title indicates, he took a different line from the critics. He wanted, "to offer a modest contribution to the immodest subject", in particular, to show what's right "with economics as a guide to economic policy". At the same time, he pointed out that disputes were part of the

healthy development of economics. The disagreements between economists should not obscure the fact that the area of consensus and agreement are much broader than those of divergence.

As regards the two basic fields of economics, the consensus in microeconomics is greater than in macroeconomics, but even in macroeconomics there is a coming together of certain standpoints, for example, on the relationship between budget deficits and inflation, the long-run effects of government debt, the role of tax cuts, and so on. Economists of various schools of economics also have a better understanding of the conflict between certain policy objectives that preclude them being achieved simulta-neously.

W. Heller reflected on the criteria for evaluating the results of economic science and came to the conclusion that economics, unfortunately, did not have at its disposal a conclusive, objective balance of "costs and benefits". It must therefore rely upon more subjective, sometimes not easy, quantifiable criteria, including: 1) the quality of inputs, in other words, the human capital and analytical instruments; 2) the demand for the services of "academic" economists, measurable by comparing their salaries with salaries in the corporate sector and state administration; 3) the involvement of economists and economic science into the policy – making process.

In evaluating the progress made by economics, Heller laid particular emphasis on the methodological revolution, and pointed out both the development in the analytical foundations of microeconomics and macroeconomics, and the results in the economics of human capital, cost–benefit analysis, the economics of risk and uncertainty, the analysis of transactions and information costs, as well as in other areas, including normative economics, social problems, and the study of economic behavior. At the same time, he noted that while the world was facing huge social and economic problems, a part of economic research was misdirected into arid puzzles, steril proofs, and "recreational" mathematics.

Most of Heller's presidential address was given over to public economics and inflation, which was at that time "enemy number one". As far as public economics was concerned, he stressed the contribution that the previous generation of economists had made to the analysis of decision-making for public spending (the theory of public goods, human capital and opportunity costs). He mentioned in this regard the historical importance of Samuelson's classic work "The Pure Theory of Public Expenditures", and appreciated the attempt to internalize external costs and to use market incentives and market analogies to improve the environment. Heller attached exceptional importance to the progress in theory of taxation, which at that time had helped to optimize the federal tax structure.

This being Heller's review there had to be a place for fiscal policy and the considerable contribution that "mathematical and econometric tools" had made to its development. By way of example, he mentioned the multiplier analysis and the study of the time lags of responses in the economy to fiscal policy changes (A. S. Blinder, R. M. Solow). He also returned to the evaluation of the effectiveness of the discretionary fiscal policy, which under certain conditions (especially when forecasts are sufficiently reliable) will be more effective that an automatic policy directed by fixed fiscal and monetary targets.

In the part entitled "The Economist and Inflation", Heller rejected the simplified view that Keynesian economists had caused the inflation, or stagflation, at the beginning of the 1970s. This opinion, expounded by Friedrich Hayek among others, was according to Heller "much like saying that the cause of forest fires is trees". On the other hand, Heller admitted that economists (not only Keynesians, but also those of a liberal orientation) had failed to foresee the "epidemic" inflation in 1973 – 1974 due to the absence of key supply and price parameters in their forecasting models. In this connection we must take in to accound that there was no articulated general theory of inflation as such. Macroeconomics had been helpless in the face of external shock inflation and it did not have a satisfactory explanation for the coexistence of inflation and recession, i.e. stagflation. Heller drew a comparison between inflation analysis and cancer research in that new pieces of knowledge also emerged only gradually.

The fact that a comprehensive theory of inflation seemed so remote in the 1970s was related to weaknesses in both the main schools, Keynesianism and monetarism. Heller reproached them for having marginalized inflation analysis. The Keynesians, according to him, were not able to explain how a given change in aggregate demand was divided between a change in real output and a change in prices. The monetarists likewise stood before the mystery of how the effect of money changes were divided between output and price movements.

More than thirty years have passed since Heller's presidential address, and during that time great progress have been made in economics and also in the analysis of inflation. The words with which Heller rounded off his inspirational look into the development of economic thought may be said to have been confirmed: " As economists, we have many sins, none deadly, to confess. But these are outweighed by the virtues, all quite lively, that we can legitimely profess."

The key economic works of Walter W. Heller

- State Income Tax Administration (1959, spoluautorka C. Penniman).
- New Dimensions of Political Economy (1966).
- Monetary vs. Fiscal Policy, a dialogue with Milton Friedman (1969).
- What's right with economics (1975).
- The Economy: Old Myths and New Realities (1976).
- Kennedy economics revisited (1982).