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The Road to Recovery

As Hayek taught, freedom and the rule of law drive prosperity.

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Burdened by slow growth and high unemployment—especially long-term unemployment—the American economy faces an uncertain future. We have endured a painful financial crisis and recession, the recovery from which has been nearly nonexistent. Federal debt is exploding and threatening our children and grandchildren. In my view, the reason for this predicament is clear: we have deviated from the principles of economic freedom upon which America was founded.

Few thinkers of the past century understood the importance of economic freedom better than the Austrian economist Friedrich Hayek did. As we confront our current situation, Hayek's work has much to tell us, especially about policy rules, the rule of law, and the importance of predictability—topics that he discussed in his classic *The Road to Serfdom* (1944) and in greater detail in *The Constitution of Liberty* (1960). But his work in these areas goes beyond economics into fundamental issues of freedom and the role of government. That's why reading Hayek is more important than ever.

As Hayek would insist, we need to be careful about what we mean by economic freedom. The basic idea is that people are free to decide what to produce, what to buy, where to work, and how to help others. The American vision, as I explain in my book *First Principles*, held that people would make these choices within a policy framework that was predictable and based on the rule of law, with strong incentives emanating from a reliance on markets and a limited role for government. Historically, America adhered to these principles more than most countries did, a major reason why the nation prospered and so many people came to these shores.

But we haven't always followed the principles consistently. Leading up to the Great Depression, the Federal Reserve cut money growth sharply, deviating from a predictable policy framework. The federal government then worsened the Depression by raising tax rates and tariffs and by passing the National Industrial Recovery Act, which overrode market principles and went well beyond sensible limits on government. From the mid-1960s through the 1970s, federal policy again deviated from the principles of economic freedom: the era saw unpredictable short-term stimulus packages, discretionary "go-stop" monetary policies, and wage and price controls—the antithesis of an incentive-based market system. The results: double-digit unemployment, a severe slowdown in economic growth, and the Great Inflation. Well before that time, Hayek had rightly lamented such short-term approaches: "I cannot help regarding the increasing concentration on short-run effects . . . not only as a serious and dangerous intellectual error, but as a betrayal of the main duty of the economist and a grave menace to our civilization."

In the 1980s and 1990s, America moved back toward its first principles, a restoration that lasted until recently. Temporary stimulus programs were out; permanent tax reform was in. Steady-as-you-go monetary policy replaced go-stop monetary policy. We removed the last vestiges of price controls and reduced inappropriate regulations. The major federal welfare program devolved to the states. The results this time: declining unemployment, lower inflation, and eventually a revival of economic growth.

Now we have tragically gone off the path again. Leading up to the latest downturn, the Federal Reserve held interest rates too low for too long, deviating from the rules-based monetary policy that had worked so well in the 1980s and 1990s. Government regulators failed to enforce existing rules on banks and other financial institutions, including Fannie Mae and Freddie Mac. The resulting crisis prompted the Wall Street bailouts, which soon extended beyond their original mission. The auto-company bailouts resulted in arbitrary infringements on creditors' rights and interventions into business operations. Then came the return of the failed stimulus packages of the 1970s, the Fed's quantitative easing, and the regulatory uncertainty associated with the 2010 health-care legislation and the Dodd-Frank financial-reform law—which gives government the discretionary authority to take over any failing financial firm and rescue its creditors.

One sign of the increase in policy uncertainty is that over the past 12 years, the number of provisions of the tax code expiring annually has increased tenfold. Another is that the number of federal workers engaged in regulatory activities (excluding those in the Transportation Security Administration) has grown by 25 percent from 2007 to 2012. Most emblematic of the deviation from our basic principles is the self-inflicted fiscal cliff that we face at the end of this year, when virtually the entire tax code will change. And the Fed has effectively replaced the money market with itself, setting a zero-percent interest-rate policy through 2014.

Government policy has largely caused these problems. It follows that we can restore prosperity by changing the policy and implementing a plan based on our core economic principles. We should reduce federal spending, as a share of GDP, to what it was in 2007, which would let us balance the budget and stop the debt explosion with revenue-neutral, pro-growth tax reform. We should unwind our monetary excesses and normalize monetary policy, using a rules-based system of the kind that worked well in the 1980s and 1990s. We should halt the rapid expansion of the entitlement state, keeping entitlement spending growth close to GDP growth and doing it in a way that gives decision-making responsibility to people and states, rather than to the federal government. And we should replace most of Dodd-Frank with bankruptcy reform and simpler regulations, with the goal of ending government bailouts.

In implementing this new economic strategy, policymakers should be guided by Hayek, especially by his emphasis on the rule of law and the predictability of policy. As he wrote in *The Road to Serfdom*, "Nothing distinguishes more clearly conditions in a free country from those in a country under arbitrary government than the observance in the former of the great principles known as the Rule of Law. Stripped of all technicalities, this means that government in all its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one's individual affairs on the basis of this knowledge."

Rules-based policies produce more stable economies and stronger economic growth. When people make decisions, they look to the future. Prices that convey information and provide incentives reflect the future. So good decisions as well as the prices that guide them depend on the predictability of future policy—and thus on clear policy rules.

But Hayek emphasized that rules for government policy do something more. The rule of law protects freedom, as the title of Hayek's *The Constitution of Liberty* suggests. Hayek traced this idea through the ages—first to Aristotle, then to Cicero, about whom Hayek wrote: "No other author shows more clearly . . . that freedom is dependent upon certain attributes of the law, its generality and certainty, and the restrictions it places on the discretion of authority." Hayek also cited John Locke, who wrote that the purpose of the law was "not to abolish or restrain, but to preserve and enlarge freedom. . . . Where there is no law, there is no freedom." Finally, Hayek pointed to James Madison and other American statesmen who put these ideas into practice in a new nation. These thinkers distrusted government officials as protectors of freedom; the rule of law, they believed, was more reliable.

So rules have a dual purpose: encouraging economic growth and protecting freedom. The best way to understand the two advantages of rules is to examine what happens in their absence, as in the case of wage and price controls. Such controls are arbitrary: they require decisions by people at the top about virtually every price and wage; they distort economic signals and incentives; they create shortages and surpluses. These effects occur whether the price controls are imposed on the whole economy or on a particular sector, such as health care.

Many wonder how a system of rules can work in practice, with politicians and government officials continually pressured to "do something" about economic problems. Rules mean that you do nothing, say the skeptics, and that's impossible in today's charged political climate and hour-to-hour, even minute-to-minute, news cycle. My colleague George Shultz calls the problem "the urge to intervene."

Hayek had an answer to that challenge. In *The Road to Serfdom*, he pointed out the need to clear up a "confusion about the nature of this system" of formal rules: "the belief that its characteristic attitude is inaction of the state." Offering one example of a rules-based system, he noted that "the state controlling weights and measures (or preventing fraud or deception in any other way) is certainly acting." By contrast, a system in which the rule of law was flouted wasn't necessarily characterized by action: "The state permitting the use of violence, for example, by strike pickets, is inactive." Similarly, simple rules for monetary policy don't mean that the central bank, in response to events, takes no action at all with interest rates or the money supply. The bank might provide loans in the case of a bank run, for instance. But these actions can be taken in a predictable manner. For that matter, deviation from the rules sometimes results in inaction. A decision by government regulators not to act when financial institutions take on unreasonable risks, for example, constitutes both inaction and a violation of the rule of law.

Some argue that crises like the present one force policymakers to deviate from rules and the rule of law. But a crisis may be the *worst* time to do so. In a crisis, what is vital is increased strategic clarity, not increased unpredictability. That fact became clear following the first bailout of the recent crisis, the Bear Stearns intervention: few knew what to expect the next time a financial institution wanted help, since no strategy had been articulated. The crisis worsened. The sooner people can make decisions with knowledge of the rules, the sooner recovery will come about.

To get America back on track, we must choose leaders who believe in the principles of economic freedom and will implement them. But here, Hayek issued a warning. In a chapter in *The Road to Serfdom* called "Why the Worst Get on Top," he suggested that people with the ambition to become leaders, either by election or by appointment, are often interventionists, since their tendency is to do whatever it takes to succeed. Further, those who benefit directly from discretionary government interventions naturally support such officials. Industries and firms that benefit from bailouts will favor officials comfortable with bailouts, for example, and even academic research on economic policy will become biased toward interventionism. Perhaps the answer to Hayek's warning is to elect or appoint people regarded as *overly* committed to the principles of economic freedom. Then, after experiencing the heavy pressure pushing them toward intervention, they may emerge with a sensible balance. In the 1980s, Ronald Reagan took this tack, appointing many Ph.D.s from the University of Chicago's free-market school of economics to positions of leadership.

John Maynard Keynes took a different view. In a famous letter to Hayek about *The Road to Serfdom*, Keynes expressed his preference for more interventionist appointees—but he wanted only those whom he viewed as *beneficent* interventionists. "What we want is not no planning, or even less planning, indeed I should say we almost certainly want more," Keynes wrote. "But the planning should take place in a community in which as many people as possible, both leaders and followers, wholly share your own moral position." Milton Friedman later cited this letter to illustrate Keynesianism's defining characteristic: its focus on discretionary interventions taken by people in powerful government positions.

Even those who support the principles of economic freedom can sometimes get off track. One might argue that such deviations were needed in the fall of 2008; perhaps the actions taken then prevented a more serious panic. But that's no reason to embrace the discretionary policies that led to the mess in the first place. Such an argument is like saying that the person who set fire to a house should be exonerated because he then put out the fire and saved a few rooms.

Is today's departure from economic freedom any less serious than the assault on freedom that Hayek wrote about in *The Road to Serfdom*? Am I exaggerating when I say that the future of American prosperity—or even global prosperity—is at stake?

While central planning may not be the right term for it, consider the 2010 health-care law, which gave the federal government the power to mandate the terms of everyone's health-insurance package and which created an Independent Payment Advisory Board to determine the price, quantity, and quality of the medical services—from number of MRIs to the necessary accuracy of CT scans—that a medical professional provides. Is that so different from the way centrally planned economies determine the price, quantity, and quality of livestock, wheat, or steel that can be produced? Or consider monetary policy. A few years ago, I coined the term "mondustrial policy" to describe the Fed's practice of quantitative easing, which combined industrial policy (discretionary assistance to certain firms and industries) with monetary policy (printing money to finance that assistance). Since then, the Fed has purchased $1.25 trillion of mortgage-backed securities. In fiscal year 2011, it purchased 77 percent of the newly issued federal debt, long after panic conditions had subsided.

Hayek argued that inflationary monetary policy undermines economic freedom, in part because it hits the elderly and the poor particularly hard, rationalizing more discretionary interventions. Though the inflation problem is less severe now than in the 1970s—at least so far—the impact of the Fed's multiyear, zero-percent interest-rate policy resembles that of the Great Inflation era: it significantly cuts real incomes for those who have saved over a lifetime for retirement.

By moving away from the basic principles of economic freedom, government policy has caused our recent economic malaise. It should be no consolation that some of our friends in Europe are facing worse economic struggles, often because they moved even further away from those principles. The good news is that a change in government policy will alleviate the problems and help restore economic prosperity. Understanding Hayek's work, written during similar circumstances, will help us greatly as we undertake that difficult task.

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