A Nobel Tiger In The Tail

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This year's Nobel Prize winners in economics -- 60-year-old Norwegian Finn Kydland and 63-year-old American Edward Prescott -- earned the award for contributions on the "time-inconsistency problem" and "real business cycles." These terms may sound arcane, and, to some, irrelevant. They're not. In fact, the laureates' insights are crucial to current policy issues.

Take real business cycles. The Keynesian view, which had dominated from the late 1930s to the '70s, could not account for the combination of high inflation and low growth, "stagflation," that occurred in the early '70s. Virtually all of the action in the Keynesian model was on the demand side. But Kydland and Prescott pointed out that supply-side shocks, such as increases in oil prices to an oil-importing country, could slow growth and increase inflation and unemployment at the same time. Also, they noted, if technological change occurs unevenly -- which it does -- that could account for differences in growth rates over time. Indeed, their model showed that such "real changes," as opposed to demand-side changes emphasized by Keynesians, could account for 70% of the U.S. economy's postwar fluctuations in real output. Their work was one of the bigger nails in the Keynesian coffin. How about time inconsistency? A huge issue facing government policy makers is inflation, which is caused by government increasing the money supply too quickly. Because high inflation is bad, a government concerned about its citizens' well-being would avoid high inflation. But governments are tempted to increase inflation in the short run to drive down unemployment. This is the time-inconsistency problem. As people come to expect high inflation, governments find themselves driving inflation ever higher, as happened in the '60s and '70s. As early as 1959, Friedrich Hayek anticipated this problem and, later, called it having "a tiger by the tail."

What's the way out, assuming we don't abolish central banks? In 1985, economist Ken Rogoff, drawing on Kydland's and Prescott's work, called for an independent central bank, headed by someone highly averse to inflation who would resist the government's pressure to inflate. Just two years later, inflation hawk Alan Greenspan became chairman of the Fed. The result: in the last 17 years, U.S. inflation has averaged only 3%. And this overstates inflation by about one percentage point annually because the consumer price index fails to account adequately for quality increases and for the "Wal-Mart effect" of people purchasing lower-price items at big-box stores. Reforms that gave more independence to central banks in New Zealand, Sweden and the U.K. were explicitly based on Kydland's and Prescott's work.

One Kydland/Prescott example of time inconsistency relates to patent protection. Patents are legal monopolies for a fixed number of years that exist to encourage innovation. But once the innovation occurs, governments are tempted to let others violate intellectual property rights by imitating the invention. This brings the price down and helps current consumers. The future result will be less innovation and less consumer well-being. Canada's government does that with drugs: it threatens drug companies with its power to license generics even while the patent is in force, and uses this stick to negotiate lower drug prices. Future generations pay.

Take another example of time inconsistency: the Social Security nightmare in our future. In a November 2003 paper, Mr. Prescott shows that the reason the average American age 15 to 64 works 50% more hours than his counterpart in Germany or France is that marginal tax rates in those countries are about 60%, whereas in the U.S. they're more like 40%. Mr. Prescott points out that in the early '70s, when marginal tax rates between Western Europe and the U.S. were almost identical, so were working hours.

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How does this relate to Social Security? Many people anticipate keeping promises to the elderly by raising Social Security taxes dramatically in the next 10 to 20 years. But, writes Mr. Prescott, "The high labor supply elasticity [work hours fall as tax rates rise] does mean that . . . promises of payments to the current and future old cannot be financed by increasing tax rates." He has a solution. He writes, "These promises can be honored by reducing the effective marginal tax rate on labor and moving toward retirement systems with the property that benefits on margin increase proportionally to contributions."

In other words, privatize Social Security so that what otherwise would be taxes are in fact people's contributions to their own retirement. For that insight alone, every American under age 55 should thank Mr. Prescott. Here's mine.