BARRO

Nothing Is Sacred

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Economic Ideas for the New Millennium

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Introduction

People often ask me why I became an economist. In college and before that, I tended toward mathematics and science. As a physics major at Caltech in the early 1960s, I was lucky to take the two-year sequence taught to freshmen and sophomores the one and only time by the great Richard Feynman. (To prove this, I have a signed and leather-bound copy of the notes from his course.) Feynman's approach was to skip the standard topics in physics and deal instead with frontier material. That was partly why many of the faculty and graduate students attended the course. It also meant that I learned early on what it would mean to be an actual physicist, and I decided pretty quickly that I would not be a great one. In retrospect, it was fortunate that I learned this so soon, rather than having to wait until my senior year or, perhaps, even to graduate school.

I had some exposure to economics from my brother, Steve, who was studying the subject in the 1960s in graduate school. This exposure motivated me to take my first course in economics as a junior at Caltech. Since Steve gets considerable teasing from his leftist friends about his right-wing brother, he may possibly regret this long-ago influence.

I find it amazing now that my first economics class, taught by Alan Sweezy, used John Maynard Keynes's *General Theory of Income and Employment* as the textbook. Although this book is one of the most influential works of the twentieth century, it makes a really lousy textbook. Moreover, since I now regard Keynes's analysis as seriously flawed, it is surprising that I enjoyed the course so much. As a student, I appreciated the simple way that the Keynesian model explained the workings and failings of the overall economy. Especially appealing were the clever policy remedies, such as increased government spending and tax cuts, that Keynes recommended to combat unemployment. Too bad that I discovered later that the model was theoretically and empirically deficient!

Bolstered by the Keynesian inspiration from my junior year course, I decided to make economics my career (although Caltech's rules at the time did not permit a major in economics). This switch in fields turned out to be one of the best decisions I have ever made. I also remember my time as an undergraduate at Caltech as the most academically challenging of my life. This description accords with Caltech's recognition as one of the nation's top undergraduate colleges. However, I have been greatly disappointed that Caltech never followed

MIT's lead by seeking to become as first rate in economics as it is in the "hard sciences."

I was attracted initially to economics because of its application of analytical methods to macroeconomic issues and policies. In fact, the emphasis on mathematics in economic research made it easy for me to make the transition from my undergraduate training in physics. My later periods as an economics Ph.D. student at Harvard and as a faculty member at various universities have been easy in comparison to my undergraduate experience. Perhaps I just had a greater aptitude for economics than for physics, because I do not believe that economics is intrinsically an easier subject.

I learned later that economic reasoning was not just mathematics and could be applied to a wide variety of social problems. Now, I think that no forms of social interaction—including religion, love, crime, and fertility choice—are immune from the power of economic reasoning. Hence, even widely held beliefs—for example, that beauty is an illegitimate credential of a worker or that democracy is important for economic growth—are not sacred truths and are subject to analysis. That is why the title of this book is *Nothing Is Sacred*. Intellectual pursuit in a free society such as ours is about reasoning and not about reaching forgone conclusions—at least not if one wants to obtain new economic ideas for the new millennium.

Early on in my career—at least through graduate school in economics at Harvard and into my stint as an assistant professor at Brown in the early 1970s—I was a standard twentieth-century liberal. Thus, my main approach to economic problems was to design clever government policies that could help to fix things.

Later, particularly influenced by my first experience at the University of Chicago from 1972 to 1975, I became more impressed by the efficiency of private markets and less enamored with the curative role of government. I would describe my underlying philosophy since that time as libertarian or classical liberal rather than conservative or Republican. As I said in the introduction to my book *Getting It Right,* "My views are more akin to the nineteenth-century liberal philosophy espoused by Milton Friedman, especially in his *Capitalism and Freedom.* In that work, he proposed many policies that are harmonious with free markets and are receiving serious attention in the United States and other countries. This list includes school choice, the flat-rate income tax, rules for monetary stability, privatized social security, and the elimination of affirmative-action programs."[1]

I also said in *Getting It Right,* "My view is not anarchic; I believe that government has some key functions, notably to define and protect property rights. This heading encompasses national and domestic security and the enactment and enforcement of a system of laws and contracts. . . . My belief in the appropriateness of this limited

1. Robert Barro, *Getting It Right* (Cambridge, Mass.: MIT Press, 1996), p. xiv.

range of public functions is consistent with the view that most governments have gone much too far in their expenditures, taxation, and regulations."

Larry Summers, my colleague at Harvard until 1991 (and later U.S. Treasury secretary and now president of Harvard and sort of my boss), had a view on my philosophy. He told me: "If I had your views on economics, I would find another profession." The point is, for Larry still (and for me when I was a student and junior professor), the main attraction of economics is its scope for designing policies that can improve private choices. If I was right that private markets usually function better without the government's intervention, then Larry thought that economics would be a pretty dull field. Thus, he would find something else to do. Naturally, I have to disagree, because I have found plenty of interesting things to analyze with economic tools even while maintaining my basic free-market approach. Some of this analysis even has interesting implications for government policy.

I have continued to focus my academic research on macroeconomics, perhaps because I started that way, going back to my first undergraduate course. However, I have used my writings in popular media—starting as a contributing editor of *The Wall Street Journal* in 1991 and continuing as a viewpoint columnist with *Business Week* since 1998—to explore the applications of economics more broadly. Many of these topics are discussed in this book.

I begin the book with biographical sketches of some noteworthy persons, mostly economists, whom I have known or read about. I discuss my former colleagues and leaders of the Chicago School of Economics, Milton Friedman, George Stigler, and Gary Becker. I learned a lot from them about the roles of markets and incentives, the wide applicability of economic reasoning, and the close interplay between economics and politics. Some of this work, notably Becker's, has been described as economic imperialism, but I think it is an excellent form of imperialism.

I include comments about the great classical precursors of the Chicago school, Adam Smith and David Ricardo. Smith is noted for extolling and explaining the virtues of markets and individual incentives. Ricardo is known for constructing a coherent macroeconomic framework, which can be used to study economic growth, taxes, public debt, and other matters.

I talk about Robert Mundell, who essentially invented international macroeconomics during a remarkably productive spurt at Chicago and the International Monetary Fund in the 1960s. I discuss Bob Lucas, a more recent pillar of Chicago, who taught me the implications of rational expectations for macroeconomic and other models.

I include a few thoughts about my Harvard colleague John Kenneth Galbraith, who was the hero of my leftist youth. Unfortunately, he later inspired me indirectly by convincing me that his big-government views were misguided. I also have thoughts on Larry Summers, whom I have already mentioned. Later I discuss Domingo Cavallo, who was a great hero for Argentina in 1991 but who failed in his second coming in 2001.

More surprisingly, I have a childhood remembrance of Joe DiMaggio and some commentary on Bono, the well-known rock star, amateur economist, and advocate for global justice. I also include in this section some remarks about Al Gore on environmental philosophy and George W. Bush on compassionate conservatism. No doubt these two political figures do not measure up intellectually to the others in this section (with the possible exception of DiMaggio but surely not Bono). But I guess politicians deserve some attention.

In a section on social issues, I consider the applications of economic thinking to some interesting social issues. I begin with a discussion of the economics of beauty. My politically incorrect position is that physical attractiveness and intelligence are essentially parallel as characteristics that are valued in the labor market (or elsewhere). Then I discuss a controversial study that links the expansion of abortion rights in the United States in the early 1970s to the reductions in crime that occurred a couple of decades later.

I also assess U.S. drug control policy in the context of policies toward Colombia, a country that has been driven apart by the drug problem. My central argument favors a movement toward legalization of drugs. When I wrote a column on this topic for *Business Week*, I expected wide attention—indeed, this column inspired more e-mails than any other I have written. However, I was surprised by the favorable tone of most of the readers.

I next investigate the popular argument that college admissions tests, including the SATs, have little predictive value for college grades. My findings are that these scores have substantial, though imperfect, predictive content, and not just for the freshman year.

I assess arguments for sustaining intellectual property rights through copyrights and patents by considering the cases of Napster and Prozac. The issues are not straightforward, but I am particularly concerned that abridgments of rights will sharply curtail the supply of new music, new pharmaceuticals, and other innovations.

I also look at the famous Microsoft antitrust case. My concern here is that U.S. antitrust policy tends to penalize success and innovation and has doubtful benefits for consumers.

Finally, I look at personal accounts for social security. I criticize the free-lunch arguments that have been offered about rates of return, but I nevertheless favor personal accounts because of their expansions of property rights and personal choice.

My recent work on macroeconomics has stressed long-term issues, including the determinants of long-run economic growth. From the standpoint of fighting world poverty, nothing is more important than figuring out which policies differentiate the fast-growing countries from the slow-growing ones. In this spirit, I focus the third section of the book on economic growth.

I first look at the regions of the former East and West Germany to understand issues of economic convergence. Particularly important in this case is the adverse consequence of the west's treating the east as a welfare client. I then look at the recent growth experiences in East Asia, stressing the role of the Asian financial crisis. I argue that the West may help by owning parts of the financial system and by providing the basis for widespread use of a strong foreign currency, such as the U.S. dollar. This monetary setup is often termed *dollarization,* although it can involve the use of the euro or another money rather than the dollar. However, I found that such suggestions led to charges of Yankee imperialism.

Next, I consider the interplay between inequality and growth and argue that the interactions are weak. Thus, I question the argument that equalization of incomes tends to foster better economic performance.

Other essays consider aspects of democracy or its absence, as observed in the new Congo, Chile, and Mexico. Throughout this discussion, I question the romantic focus of U.S. foreign policy on promoting democracy in all times and places. My cross-country research has convinced me that the rule of law and property rights are more important than democracy in the promotion of economic growth. Moreover, democracy—measured, say, by indexes of political rights or civil liberties—is not the same as the rule of law.

I look next at currency boards and currency unions. First, I discuss my Twilight Zone–like trip in August 1998 to Russia, where I unsuccessfully proposed the introduction of a currency board. Then I consider Ecuador's recent move to full use of the U.S. dollar. Finally, I discuss my experience with Davos's famous World Economic Forum, and I offer my views on the future of the International Monetary Fund.

The last section of the book deals with fiscal and monetary policies and other macroeconomic topics, primarily in a U.S. context. I discuss issues of U.S. budgets and tax cuts, and I relate the tendency of institutions to spend free cash, first, to the U.S. Congress and, later, to the American Economic Association. I also assess the likely economic consequences of the September 11 attacks and the resulting war on terrorism. Then I consider some general insights on budget policies that can be obtained from an international study of fiscal reforms.

Next, I carry out a quantitative evaluation of all the completed U.S. presidential administrations since Truman's second term. This evaluation is based on contributions to economic growth, unemployment, inflation, and interest rates. The best outcomes are for Reagan's first term and Clinton's second term. Of course, this sort of analysis does not isolate the effect of the president, and, in particular, it fails to distinguish luck from conscious policy.

I look at Chairman Alan Greenspan's tenure as chairman of the Federal Reserve, and I make an irreverent comparison between him and Chance the Gardener (the Peter Sellers character from the movie *Being There*). I am pleased that I feel I have finally achieved some understanding of how the Fed actually conducts monetary policy, but I am concerned that the policy became overly expansionary in 2001.

Another essay considers attempts by economists and political scientists to predict the outcomes of presidential elections, such as the one in 2000. Economic factors have substantial predictive content, but they did poorly in predicting outcomes during the 1990s. However, this analysis did well in predicting nearly a dead heat for the 2000 race.

The penultimate essay discusses oil and complains about the tendency of U.S. public officials to treat as friends countries that attempt to hold back supplies of oil. The final essay assesses the U.S. stock market and concludes that efficient-markets approaches are superior to analyses that purport to find irrationalities in one direction or the other.

This book covers a wide territory, and the unifying theme is less in the topics than in the underlying approach. Hence, my method for applying basic economic principles is similar whether I am studying standard economic problems, such as economic growth and monetary policy, or nonstandard ones, such as democracy, beauty, and abortion rights. The main thing I can promise readers is that I am trying to assess important questions in a logical and interesting way. It is not my fault if readers get upset by some of the logical conclusions.

For Rachel, to whom I owe the title of this book and many other things

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