NOTES FROM THE DISMAL SCIENCE

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What Have We Learned About Our Economy?

1. Keynesian stimuli don't work?

That assertion amounts to pure propaganda. The Congressional Budget Office estimated that the Obama stimulus created or saved from one to three million jobs. And many voices joined in. For example, the top economic model building company, Macroeconomic Advisers, estimated a gain of 2.6 million jobs. Even a top conservative economist, Robert Barro, regards the stimulus as effective in creating jobs. Some economists, including this one, believe further that Obama and Bernanke saved the country from falling into a deep depression spiral.

2. Austerity and the triple whammy.

Those who agree that stimuli can work, might also agree that it stimulates GDP and jobs because it increases spending. Sources of spending include the federal government, state governments, consumers, and investors. Investors notoriously refuse to invest, "we need to wait," they say, "until consumers start spending." So I don't count on them here.

Consumers got the biggest lesson of their financial lives in '08 and '09. Before the crisis they had acquired a large overhang of personal debt but felt secure because of their substantial wealth. Much of that wealth evaporated. Having learned that lesson, they are now saving to pay their debts down. Less spending.

Most states passed a Balanced Budget Amendment Law some time ago. You can bet that when these laws were up for a vote some politician boomed that “states should balance their budgets just like families do.” The truth seldom appears in such contexts. Who points out that families don’t balance their yearly budgets. They don’t pay cash for their houses, they buy appliances and cars on time, and when times get tough they use their credit card if they have one. These laws force states to cut spending when tax collections fall off, as happens during a recession. OK, so if one state cuts spending, so what? But if all 50 states do it?—Paul Krugman calls this situation “50 Hoovers.” Less spending.

When the world financial crisis loomed, both Europe and the U.S. caught the government debt hysteria. Although cooler heads advised that it is best, first, to stimulate growth, the austerity idea spread like a virus, even to countries that could ill afford the policy. I recognize, of course, that respectable people joined those who recommended deep, deep austerity. OU’s 2011 Alice Gorlin Lecture, hosted by the SBA and the Economics Department, featured Dr. Carmen Reinhart, a senior Fellow from the Peterson Institute. Professor Reinhart, a pleasant and competent representative of the austerity lobby, spoke of the huge, oppressive federal debt and its alarming rate of increase. The ratio of federal debt to GDP approaches 100 percent. What if our creditors lose faith in the U.S. economy and demand higher rates of interest? If we reached this tipping point we might spiral downward as the higher rates increased our debt burden. But again, cooler heads tell us that this is unlikely because the interest rates that the U.S. must pay its creditors remain extremely low. When Standard and Poors lowered the U.S. credit rating from AAA to AA+, the bond market responded by buying *more* U.S. bonds! We are a safe haven. Of course, the future is unknown to all of us. Professor Reinhart, too, humbly admitted that she hopes to look back on the economy in three or four years and find that she had been right to promote austerity.

Should we pay off our federal debt or should we grow out of it? Our last giant federal debt arose just after WWII; we never paid it off. From 1946 to 1970 the total dollars owed stayed about the same. By then nobody cared anymore. Postwar GDP grew so robustly that the debt came to seem trivial. Leading economists subscribe to this optimism: Paul Krugman, Christina Romer, Robert Reich, Joe Stiglitz, Brad DeLong . . . Nevertheless, the austerity promoters in Congress, Paul Ryan, Eric Cantor and others, have been winning out, and deep cuts in federal spending mean less spending nationally. Less spending.

Consumers, states and the federal budget have all turned up contractionary, each a predictor of a double dip recession. The triple whammy.

3. Why do economists often contradict themselves?

This indeed happens, and it happens most often in macroeconomics as opposed to microeconomics. During the Great Recession, Gary Becker and Robert Lucas of the University of Chicago said we should do nothing except foster a predictable and reliable government framework to develop business confidence. The Chicago School is dense with Noble Prize winners and can't be dismissed out of hand. But for many economists whose highly theoretical models are founded on market clearing, rational economics seems uncomfortably at odds with real-life economic behavior.

On the other side, economists such as Paul Krugman and Robert Reich have urged quick and strong fiscal stimuli. This stark contrast poses an embarrassment to economics, that at a critical time it couldn't scientifically dispense with one or the other of these views. Macro lacks the conditions for a decisive experiments. Like astrophysics all macro experiments are natural experiments. Altogether economics is more like biology, and human organisms don't follow precise laws. Still there is credible evidence to suggest that both monetary and fiscal stimuli work. A monetary squeeze in 1930 sent the economy deeply into depression. A premature austerity in 1936 sent the economy back into depression. In 1987, the Fed flooded the market with liquidity and the stock market crash had little effect.

4. Who won the debt ceiling debate?

Boehner grinned at the cameras and boasted that his team had won 98 percent of what they went in for. But astute observers noted that his team had failed to rein in the clueless Tea Party and had risked the well-being of the nation and world. The federal agenda they won was "austerity now and austerity in the future, too." This was an arguable political issue and should have been decided by voting on the issue, not by voting under a hostage-taking situation.

Pundits and citizens continue to discuss the morality of current party politics, particularly in the instance above. Gambling can be enjoyable; I played poker for several decades. But gambling is appropriately done with your own money, not with the health and well-being of the whole nation.

An interesting twist on the debt ceiling debate was offered by Yale law professor [name] writing in the *Minneapolis Star and Tribune* on August 3rd. As an expert on contract negotiations he noted that the greater power in negotiating adheres usually to the party that has the least to lose. Obama and Geithner credibly professed a strong concern for the population's well-being while the Tea Party couldn't care less (or perhaps simply didn't understand). The final list of budget cuts was less than earlier proposed in the negotiations and much less than the Yale professor expected. He suggested that this was a success for Obama.

5. Should I vote for Ron Paul?

I fancy myself as a different kind of libertarian, although I sympathize with Ron Paul on certain issues, namely: skepticism of government wars, a relaxed view of immigration, and a dismay with the war on drugs. But radical laissez faire makes no sense. Why aren't people free to vote in a government program to achieve some goal that they couldn't achieve otherwise? As a History of Economic Thought teacher I am annoyed when leaders on the Republican Right attribute radical laissez faire to Adam Smith. Smith was no radical, and it is important to remember that he also promoted some restraints on trade, encouraged public schooling and so on. Smith's great insight was the understanding that invisible hand solutions were possible in markets, and he clearly opposed mercantilist controls on international trade. What happened to Adam Smith over the years must have been like that kindergarten game where someone whispers a phrase in a child's ear and the kids whisper it around in the circle and then giggle at how different it all comes out. This is akin to how Emma Rothschild describes the historical popular distortion of Smith's views in her book, *Economic Sentiments: Adam Smith, Condorcet and the Enlightenment.*

The modern Austrians like Ron Paul consider Frederich Hayek as an intellectual hero. Yet it seems doubtful to me that they have ever read him outside of the notorious *Road to Serfdom.* The following are two quotes from Hayek's *The Constitution of Liberty,* speaking first of a New Deal program:

> Up to this point the justification for the whole apparatus of 'social security' can probably be accepted by the most consistent defenders of liberty. (286)

And of social health insurance he says:

> There is little doubt that the growth of health insurance is a desirable development.And perhaps there is also a case for making it compulsory since many who could thus provide for themselves might otherwise become a public charge. (298)

Sounds a bit like Obamacare. Note also that the little phrase, "become a public charge," implies Hayek's acceptance of our public responsibility to care for the destitute ill. Very unlike Ron Paul.

6. Do states make good laboratories for federal policy?

With several governors running for president, we have heard a great deal about the inspiring success of their states. This probably rates as a good thing since the 50 states in principle can serve federal policy as trial balloons. You would probably agree, however, that there also are risks. Texas, North Dakota and Alaska benefited greatly when the price of oil rose sharply, a feat that can be reproduced by few other states. Likewise, a peculiarity of the Southern states is warm weather, an attraction for population gains and thus employment gains. The employment gains in Texas distract observers from the misery of many Texans: poor schools, high poverty rate and very low levels of health insurance.

Journalists do well at explaining many of these drawbacks, but one issue stubbornly remains that neither journalists nor economists effectively explain to the public. Suppose that a state sets tax rates very low and succeeds in gaining an influx of people and industry. I doubt this works very well, but suppose it did. This policy is essentially a 'beggar thy neighbor' policy. Your governor can brag about it if he insists, but were he to become president and successfully persuade the 50 states to do the same, it would have perverse effects. Low tax rates would no longer attract, and the resulting low state revenues would starve the public infrastructure that state citizens need for their well-being. Economists call the faulty logic in this scenario 'the fallacy of composition,' the mistaken notion that what works for the individual may not work for the whole. A similar unexpected mishap occurs when states compete by giving tax discounts to movie companies and casinos. It takes a very confident mayor or governor to put a stop to this deleterious competition.

In contrast, Massachusetts set a good laboratory for the nation by their individual mandate for social health insurance. Admittedly, when they began they failed to include cost control features, but they quickly proved that it virtually provides universal coverage. I can understand that some people feel that these benefits aren't worth the cost. But as an economist I am annoyed when some critics claim to thoroughly analyze the Affordable Care Act without counting these benefits, mainly that it assures health insurance and thus insures health care for 40 million currently uninsured. In fact the Act it is monumental in doing this, a historic acceptance of the nation's responsibility to its poor and sick. Cost benefit analysis requires both costs and benefits.