My economic philippic

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1 person recommends this **Tags:** economics, military spending, military, federal spending, economy, obama, politics, conservatives, obama administration, barack obama, republicans, democrats, bush, iraq, iraq war, paul krugman, amity shales

The economics group at LLI occasionally engages in interesting email debates. I set one off last week when I sent them this. I put a lot of time into my latest response, so I thought I would post it. I think you can catch the drift of the conversation.

Harry et al

This is fun. Although, as a neophyte armature economist, I am a little uncomfortable arguing with people who probably know what they are talking about and it is taking me way too long to write this.

Harry - To say that the great depression was disappearing by 1936 is a bit of a stretch. While things had improved, unemployment was still north of 14% and the economy had a long way to go before full recovery. Amity Shales and Paul Krugman agree on almost nothing. But they both believe that it took World War II to get us out of the great depression. "F.D.R. did not, in fact, manage to engineer a full economic recovery during his first two terms. ... What saved the economy, and the New Deal, was the enormous public works project known as World War II". Mr. Krugman also believes it was a change in Roosevelt's fiscal policy, rather than the Fed that caused the 1936 recession.*

My opinion about economics is somewhere between Marty and Charles. Although there are truly economists who are zealots and true believers, I wouldn't call economics a religion, it is far from a quantitative science. You can take almost any position and find some economists who agree. Winston Churchill once said "If you put two economists in a room, you get two opinions, unless one of them is Lord Keynes, in which case you get three opinions." Harry is correct to call it a social science. But, as a psychology major, I don't put a lot of stock in the soft sciences.

Whether tax cuts or government spending is a more effective stimulus is open to debate. Advocates on both sides can site studies and statistics to support their positions. A while back I tried to conduct my own historical analysis of the economic impact of tax cuts and was unable to reach a conclusion. **I did find a fairly convincing relationship between capital gains tax rates and federal revenue from capital gains**.

Marty - It appears to me that the Regan deficits were a result of federal spending. Federal revenue increased when the Regan tax cuts went into effect.

I am a fan of the Laffer Curve. Sometimes raising (or lowering) taxes is a good thing, sometimes it is counterproductive. Unfortunately the real world is so complex that it is often difficult to tell where you are on the curve for any given tax.

I have been a deficit hawk for as long as I can remember. Most of our politicians are opposed to deficits only if they are run up by the other party. I particularly liked Peter Peterson's 2004 book, Running on Empty: How the Democratic and Republican Parties Are Bankrupting Our Future.

Under the previous administration, Republicans spent money like drunken sailors. Democrats decried the deficit, but only wanted to talk about tax cuts and the war in Iraq.** Now the Democrats are making that look like chump change.

I might buy into Keynesian solutions if I though governments were willing and able to follow them. Keynes said government spending should be countercyclical, increasing when the economy contracts and cutting back when times are good. Democracies are pretty good at the former and incapable of the latter.

In January of 2008, Larry Summers outlined three criteria for a fiscal stimulus

- "First, to be effective, fiscal stimulus must be timely. To be worth undertaking, it must be … based on changes in taxes and benefits that can be implemented almost immediately.
- Second, fiscal stimulus only works if it is spent so it must be targeted . Targeting should favour those with low incomes and those whose incomes have recently fallen for whom spending is most urgent.
- Third, fiscal stimulus, to be maximally effective, must be **clearly and credibly temporary – with no significant adverse impact on the deficit for more than a year or so after implementation**. Otherwise it risks being counterproductive by raising the spectre of enlarged future deficits pushing up longer-term interest rates and undermining confidence and longer-term growth prospects." *(emphasis mine)*

The Obama stimulus meets none of these criteria.

- It was not timely. So far we have only spent about 25%.
- It was not targeted, but was a grab bag of everything the Democrats have wanted for years.
- Most of all, it was not temporary. The Obama deficits go on forever.

In last week's Newsweek, Niall Ferguson had an interesting analysis of our projected deficits, saying that a rise in the real interest rate, which he feels is likely, would have a devastating impact on our debt service.

In 2003 a prominent economist published an op ed column entitled A Fiscal

Train Wreck.

“... last week I switched to a fixed-rate mortgage. It means higher monthly payments, but I'm terrified about what will happen to interest rates once financial markets wake up to the implications of skyrocketing budget deficits. … we're looking at a fiscal crisis that will drive interest rates sky-high. … When the government reduces saving by running a budget deficit, the interest rate rises. … But what's really scary … is the looming threat to the federal government's solvency. … my prediction is that politicians will eventually be tempted to resolve the crisis the way irresponsible governments usually do: by printing money… It won't happen right away. … But unless we slide into Japanese-style deflation, there are much higher interest rates in our future. I think that the main thing keeping long-term interest rates low right now is cognitive dissonance. Even though the business community is starting to get scared — the ultra-establishment Committee for Economic Development now warns that "a fiscal crisis threatens our future standard of living" — investors still can't believe that the leaders of the United States are acting like the rulers of a banana republic. But I've done the math, and reached my own conclusions — and I've locked in my rate. “

This was not from the CATO institute or the Heritage Foundation, but none other than the current champion of federal deficits, Paul Krugman.

*I mention this simply to point out how difficult (impossible?) it is to establish cause and effect in the real world of economics.

**It is interesting to note that defense spending as a percentage of total budget has been declining since the beginning of the Kennedy administration.

Comments: 3

Dorothy H. Dec 16, 2009, 9:49pm EST

That's why it's called voo-doo economics, I guess.

> Tanna Cauble Dec 17, 2009, 3:22am EST
>
> You got that right! And thanks for the post :)

Tim Nelson Dec 17, 2009, 9:04am EST

I have Arthur Laffer on my dead pool this year. Not for the desire of his demise, as much for the symbolic demise of his Laffer curve. His construct only works with a large middle class, with no corporate downsizing, mergers, wars, or bubbles caused by financial schemers.

Other than all that, it works great.

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