

THE ECONOMIC SITUATION

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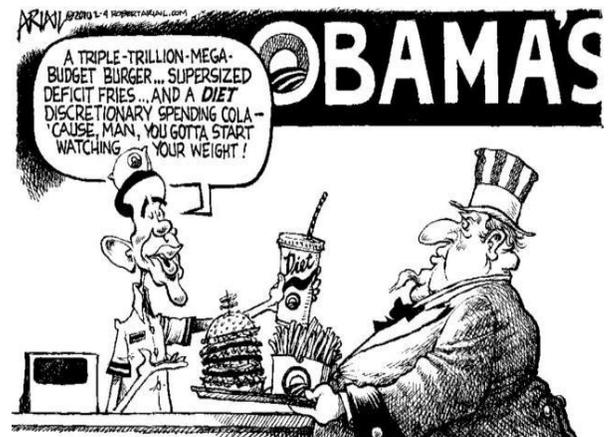
March 2010

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Democracy in Deficit

In 1977, Nobel Laureate James Buchanan and his colleague Richard Wagner picked up a clean slate and wrote what became a new chapter in macroeconomics, that subfield of economics that addresses central features of national economies, things such as fiscal and monetary policy, employment, unemployment and GDP growth.

Tossing aside the standard assumptions of Keynesian economics, Buchanan and Wagner explained the systematic tendency of democracies to run deficits, in the best and worst of times. They named their book *Democracy in Deficit*, a title that surely fits the U.S. in the 21st century. Incentives lie at the heart of their theory.



To keep their jobs, politicians, most of the time, want to bring home the bacon, which means increased spending is always preferred to spending reductions. And to get their jobs, politicians always promise not to raise taxes. Read my lips! Avoiding taxes and increasing spending form the fatal ingredients for the final deficit recipe. Whether Democrats with a big D, Republicans, Labor or Conservative, the tendencies are the same,

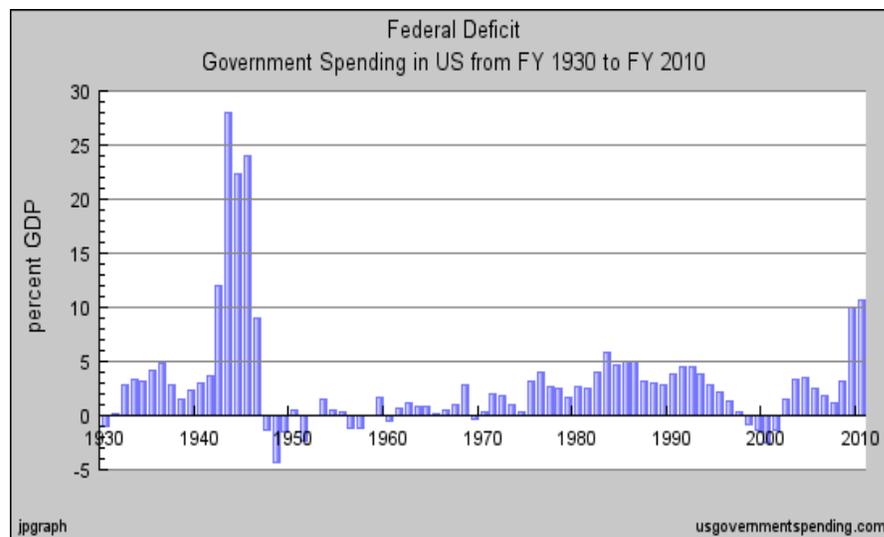
even though the speeches sound different. There are exceptions to the behavior, of course. But systematic deficits are the result, according to the persuasive Buchanan-Wagner story.

The deficit theory is assisted by supporting Bootlegger/Baptist stories. Instead of speaking of closing liquor stores on Sunday, the “Baptist” component takes the high ground and speaks of energy independence, hard times, necessary increases in welfare spending, failing firm rescues to assist failing states, war, defense, races to the moon, rapid rail, and the need to reduce crime and drain swamps, just to mention some of the public interest offerings. And the Bootleggers? They are not wiping their hands thinking of selling illicit booze on Sunday when the Baptists successfully have the legal sellers shut tight. These deficit loving political players see money making opportunities for ethanol in corn producing states, wind energy for the plains, rising land prices from bridges that may someday go somewhere, research dollars for favored universities, and Medicaid cost shifting, just to mention some of the treats.

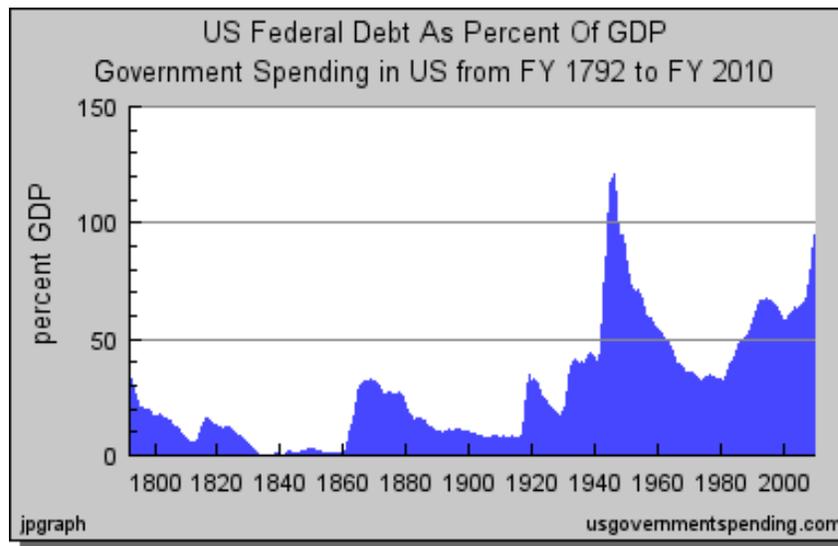
The political interaction is powerful. Eventually, almost all the public sector budget becomes untouchable. The “bootleggers and Baptists” see to it. Only a wee bit is seen as discretionary. As Robert Ariail’s cartoon suggests, putting a freeze on discretionary spending sounds good to the ear, but in fact makes just a small dent in the deficit-producing machine. A diet cola just won’t offset two biggie half-pounders and a large side-order of fries. But, the diet drink somehow makes you feel slimmer, if not a bit righteous.

How bad is it? And who will fund it?

Deficits can be measured in a number of ways. One way focuses on the annual operating budget. How much red ink are we generating on a year-to-year basis? The next chart, produced by usgovernment.com, shows the annual reckoning from 1930 to the current year. The Buchanan-Wagner point is evident in the data. It almost takes a magnifying glass to see the years when the budget was in surplus. (I leave to the reader to use the noted deficits and surpluses to identify the conservative Republican and liberal Democrat years.)



Of course, the current deficit, which is just a bit over 10% of GDP, looks pale when compared to those difficult World War II years. What is interesting, of course, is the belt tightening that followed the late 1940s. The cumulative effects of these deficits are shown in the next usgovernmentspending chart. This one gives a reading of public debt as a percent of GDP. From all indications, the current decade may set a record that exceeds World War II's high point.



The scare generated by Greece's threatened debt default put the spot light on democracy's profligate ways. With debt rising above 120% of GDP, the Hellenic people called for help. And with Greek debt on the balance sheets of major investment houses and central banks worldwide, there was plenty of lobbying for an EU bailout. Italy's situation was almost as bad, but Germany's 80% plus debt picture made that country look like the land of King Midas.

With EU help, the bullet was dodged, but the deficit gun is being quickly reloaded.

What about the U.S. deficit? What if China decides to bow out?

If the U.S. fiscal picture were a hurricane, we would probably call it "category 3," meaning devastating damage will occur..., unless the frightening winds are somehow calmed. With excuses galore, we continue to spend beyond our means, borrowing from all who will lend to us, and printing money to fill in the gaps. But so long as our situation is better than the rest, we can go our merry way..., at least for a while. As is said, a one-eyed man can be king in the region of the blind.

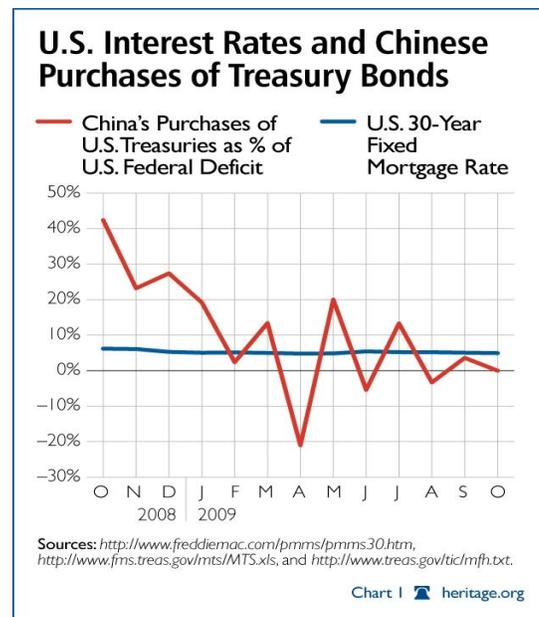
As indicated in the next chart, the American people are now saving a bit more than \$500 billion annually, close to 5% of national income and up from 1% just a few years ago. Hard times and plummeting asset values have a way of making us prudent.

Spending beyond our collective means is now confined to the public sector. All levels of government taken together are running a 2010 deficit of \$1.550 trillion. Private savings offsets one-third of this. No, the U.S. is not the last of the big spenders, but we are platinum club members. But after all, if China is willing to lend so that we can buy their goods, why not let the good times roll?



On this, Heritage Foundation economist Derek Scissors points out: “But it’s us, not China. We’re mortgaging our future because the President and Congress want a government hand in every aspect of business. We can finance our huge deficit without too much trouble, and in 10 years we’ll be very sorry that we could.”

The accompanying chart, produced by Scissors, shows the current picture for Chinese purchase of Treasury bonds. Of course, there are other U.S. debt instruments that China may be purchasing along with equities and land. The Chinese have to do something with the dollars they receive from our purchases of their goods. Since U.S. imports are down, the recycle challenge is not at large. If American lenders are willing to fund the debt so that we can maintain Social Security, fund wars, enhance health care, increase unemployment benefits, bail out failing firms, and help each other when we can no longer pay the mortgage payment, why not?



Lending to government comes at the cost of lending for other purposes. There is the inevitable trade-off. During hard times with little credit-worthy demand for investment funds to build schools, hospitals, and new factories, buying government debt is about the only game in town. But when better times arrive, and they will, competition for funds will raise interest rates and put the private sector on a starvation diet.

It is private action, not public, that creates wealth. Government may help build and maintain the fences, but the goose that lays the golden eggs is looking pretty slim these

days. As someone put it recently, “Due to recent budget cuts and the rising cost of electricity, gas and oil, as well as current market conditions, the Light at the End of the Tunnel has been turned off.” Ouch!!!

And there is one more lesson to remember. My father advised never to use a credit card for buying gasoline and groceries, things that would be consumed quickly leaving nothing but debt. If the nation is to run deficits, it should be to build long-lasting assets that generate a benefit stream worthy of the investment. Maybe Dad’s advice will prevail in better times. But then, there is the *Democracy in Deficit* story. The political incentives suggest otherwise.

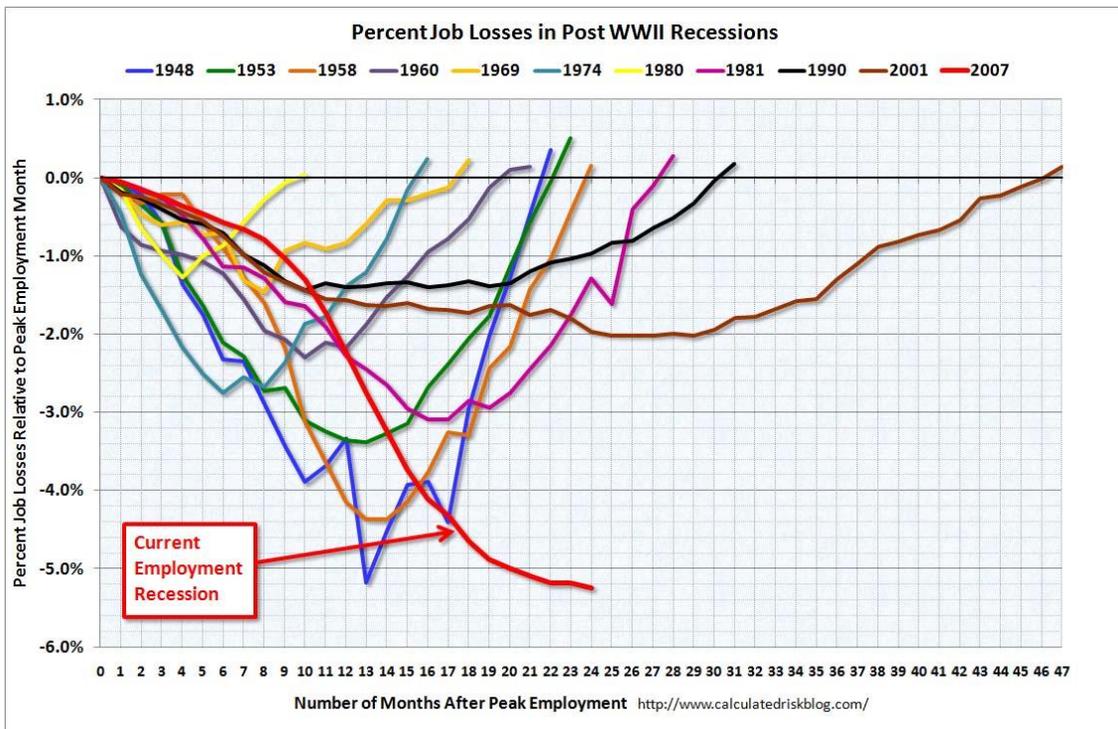
Given *Democracy in Deficit*, is there a way out of the trap? Something like BRAC, the 2005 Defense Base Closure and Realignment Commission, that brought major defense base closings nationwide by way of an up or down vote on a full action package, may be the answer. The prisoner’s dilemma problem is obvious here. Each congressman or senator is expected to do his or her best in bringing home the bacon. If one person leaves meat on the table, another will grab it. Binding the group together in an up or down vote can solve some of the political incentive dynamics.

Perhaps, this is what Mr. Obama hopes to accomplish with his new deficit reduction commission. But for it to work, Congress itself will have to buy into the deal.

Recovery Watch: What are the Ds saying?

Back before the credit market collapse and start of the Great Recession, I was tracking the four Ds in an attempt to determine when and if a recession might be headed our way. Memory refresher: The four Ds are Depth, Duration, Diffusion, and Despair.

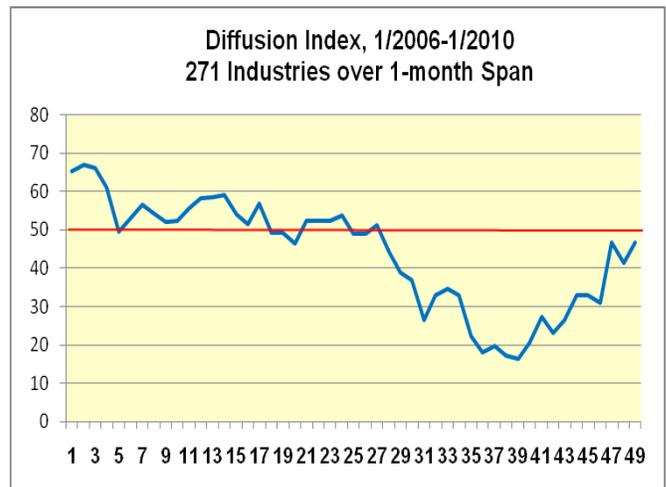
A quick glance at current data suggests it is time to reexamine the Ds to see what they may be saying about the recovery. The next chart, produced by CalculatedRisk.com, shows the pattern of all 11 recessions since World War II. Measured in terms of the share of jobs lost relative to the starting point, which is December 2007, the red line tells us that the properly named Great Recession will be deeper and perhaps longer in duration than any of the other 10. It is possible, of course, that the duration of the 2001 recession may out-do the current one.



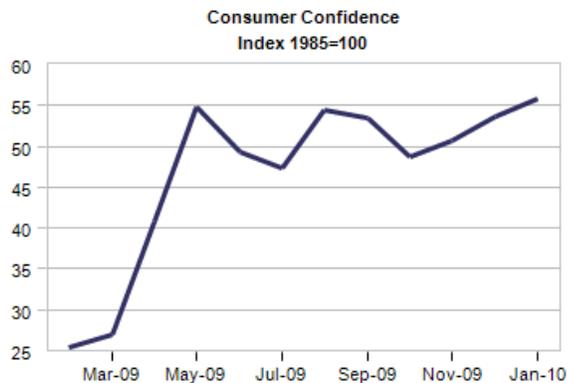
Just based on the symmetry of the sag, if nothing more, there appear to be at least 24 more months of job loss ahead of us. Depth and Duration signal the jobless recovery. As economist Larry Summers put it recently, we have a statistical recovery and a human recession.

A look at the Bureau of Labor Statistics manufacturing employment diffusion index shown in the next chart takes us to the next D. Recall that the magic value is 50; that is the reckoning point where manufacturing employment is neither growing nor shrinking.

Back in December 2007, when the great decline started, the diffusion index was right about 50; employment growth was dead in the water. As recently as January 2009, the number was just below 20, which means that 80% of the industries covered were losing workers. The January 2010 number is 46.8. We are getting close to the zero point. The trace formed by the index from March 2008 to the present gives another picture of the recession's fearsome shape.



What about Despair? We may use the Conference Board's confidence index as a way of getting a reading on what is going on inside the heads of American consumer/citizens. As shown here, there is a recovery of optimism. In spite of soaring unemployment, confidence is building. But the path can still become bumpy.

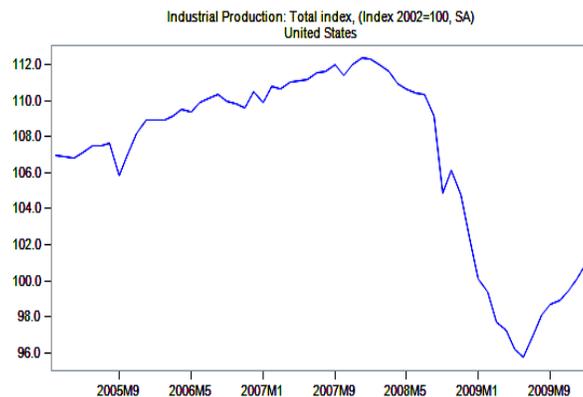


The four Ds are sending some interesting signals. We are moving across the trough of a deep and long recession, with little prospect of seeing meaningful employment numbers until 2012. In spite of this, recovery is emerging in the manufacturing sector; a good part of this is tied to inventory rebuilding and expanding exports.

At the same time, consumer confidence is recovering, but is still at a very low level. Low consumer confidence and high unemployment go with higher levels of savings. And high savings means low spending.

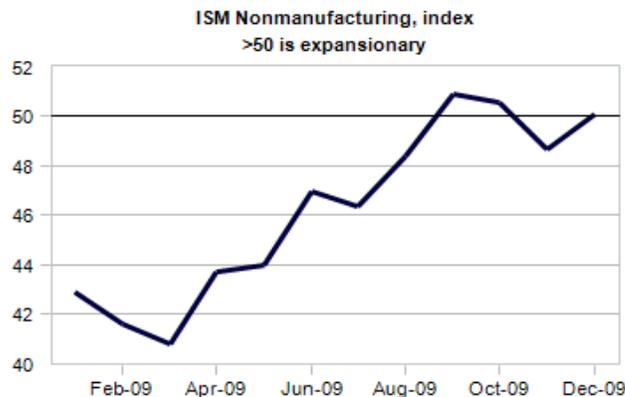
Taking a closer look at the “planets.” What are these signs saying?

First, let's consider the big picture—Industrial Production, which includes the output from all factories, mines, and electric utilities.

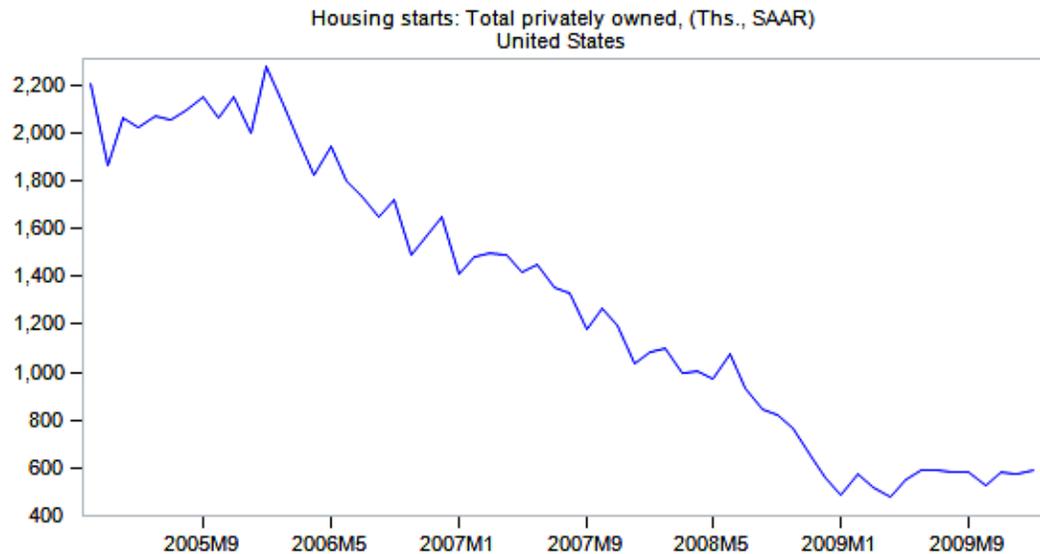
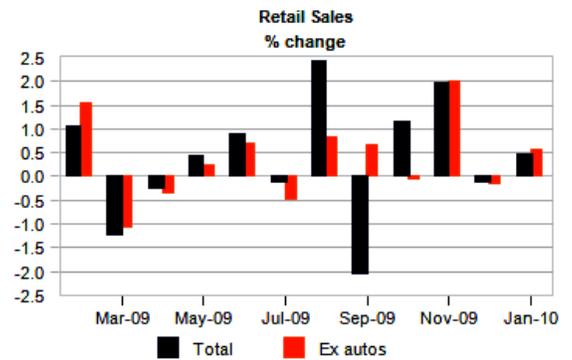
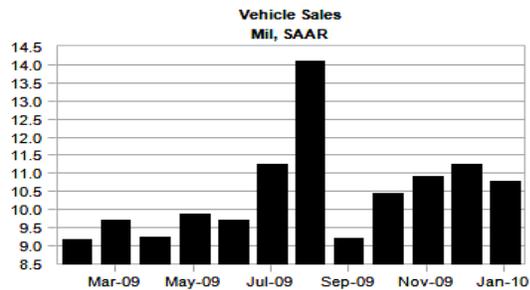


The signs are encouraging. We see about seven expanding months; the goods recovery is in place.

Then, consider the two Institute of Supply Chain Managements indexes—the manufacturing and nonmanufacturing (services) indexes. Here we see confirmation of industrial production. The manufacturing index is riding well above the magic 50 point. But services, which is the economy's larger component, is not looking quite so bright. Taken together, the two charts show a pale recovery taking place.



Finally, let's examine retail activity, vehicle sales, and housing starts in charts from economy.com. With savings up, retail sales are weak, but growing. And with Cash for Clunkers behind us, vehicle sales are moving up on their own. There is life in the marketplace. The housing start data suggest a bottom has formed.

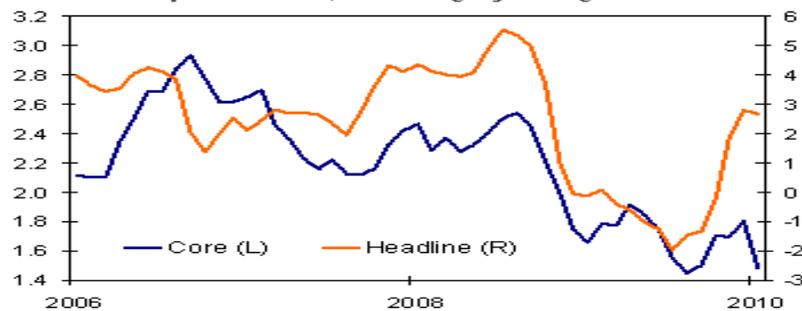


Do we need to worry about inflation?



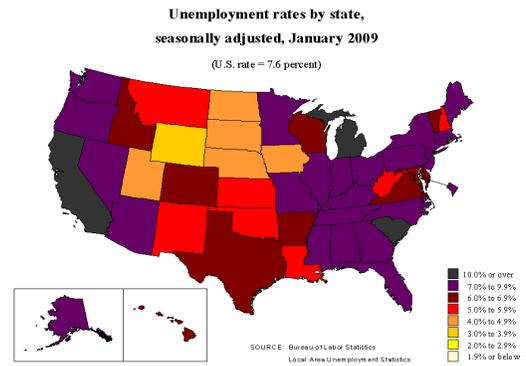
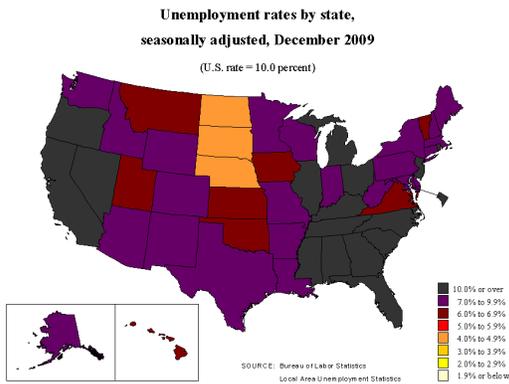
In a word, the answer is yes, but not quite yet. The most recent CPI data tell us that core inflation is tame. Put another way, if we take out the potential bubbles—energy and food prices—we eliminate the inflation concern. But, if we put them into the mix, we see a potential problem. Even so, with the world in recession, and the recovering economies riding the brakes, run-away inflation is still just a gleam in the eye. The Fed's recent decision on raising the discount rate, while mild in its effect, does signal that the night watchman is on duty.

The trend in core inflation continues to slow
Consumer price index, % change year ago

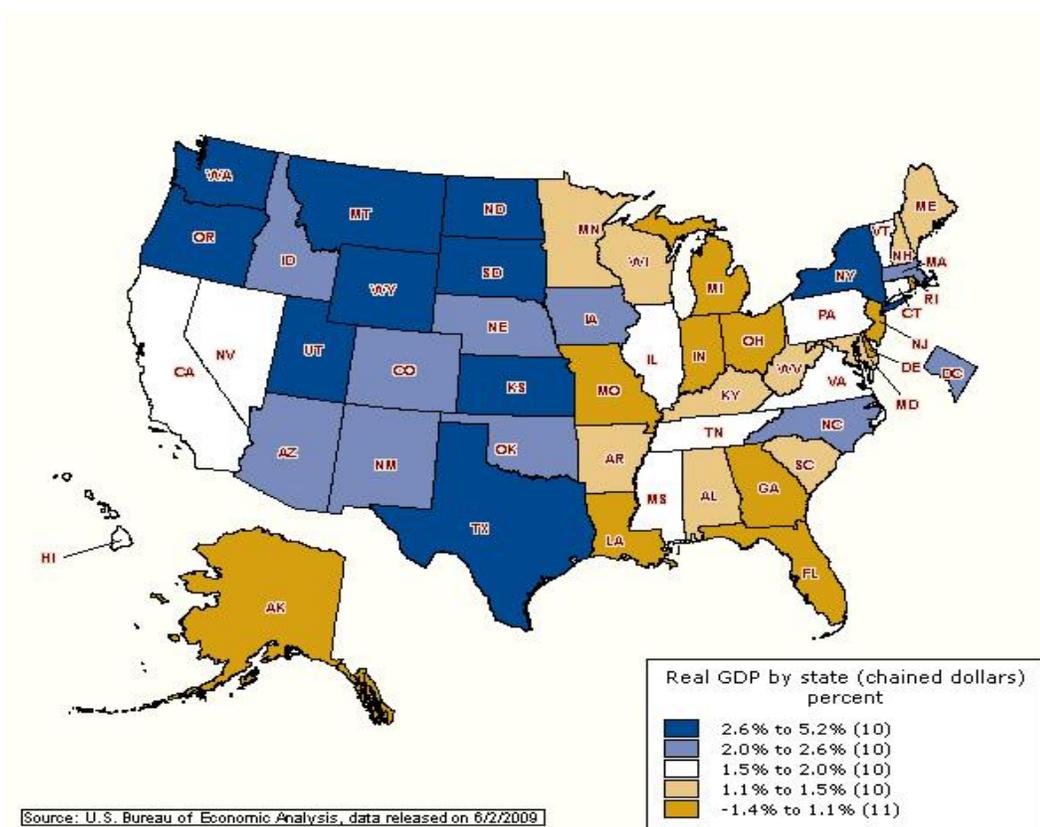


Where are the jobs?

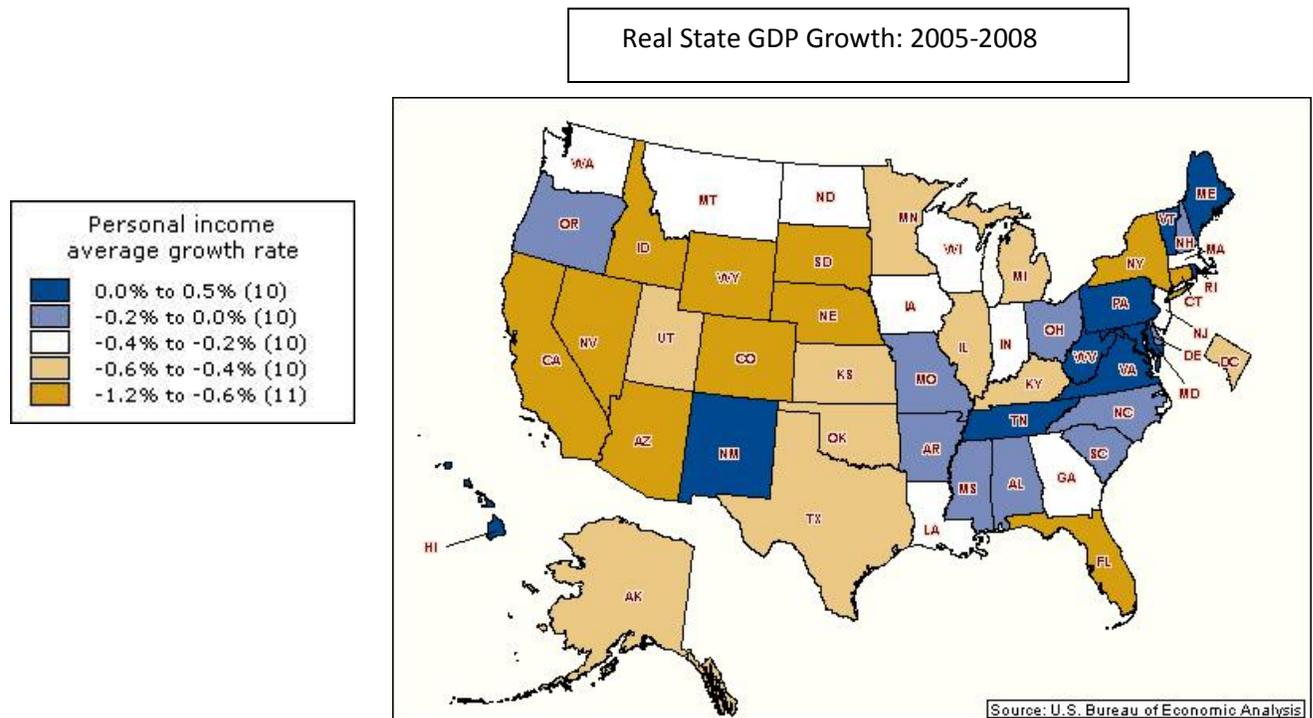
I provide below two unemployment outline maps of the United States, one for December 2009, the other for January 2009. This gives a glimpse of what has happened to employment opportunity during the year just passed. The darker the state, the higher the unemployment rate. The corn/ethanol producing states form the brighter parts of the employment economy.



The next two maps show growth in real GDP for the 50 states from 2005 to 2008 and Personal Income growth from 3Q2008 to 3Q2009. The real action in the first chart is primarily west of the Mississippi River. Put differently, real GDP growth is highest in the



nonmanufacturing states. Personal income growth for the most recent year gives a very different picture. First off, be aware that the only states showing positive growth are colored bright blue. Of the western states, only New Mexico shows positive growth. Put another way, the states that suffered most from the recession tend to be states that are showing the faster income growth.



With unemployment pain being felt in all directions, it is understandable that politicians would keep searching for and announcing new federal programs to lift the spirits. This was certainly the case in President Obama's State of Union address. Here are my comments on one small piece of his proposed programs.

Let there be silence: my thoughts on priming the small business pump (Reprinted from The Freeman, Feb. 9, 2009, www.thefreemanonline.org.)

The ears of small business America must have perked up the other night when President Obama spoke about that critically important sector in his State of the Union address. And mine did as well. Here's when it really got interesting: "I'm ... proposing a new small business tax credit -- one that will go to over one million small businesses who hire new workers or raise wages. While we're at it, let's also eliminate all capital gains taxes on small business investment, and provide a tax incentive for all large businesses and all small businesses to invest in new plants and equipment."

Later, the President explained that there would be a \$5,000 tax credit for employing an additional worker, forgiveness of the employer's 6.2 percent portion of Social Security payroll taxes for newly added salaries and other salary increases, an end to capital gains on investment, and continuation of rapid write-offs for new capital investment, all to be targeted to business with 50 or fewer workers.

Mr. Obama was right to be concerned about small businesses. According to ADP's latest report, firms with fewer than 50 workers employed some 48 million in December 2009; those hiring more than 50 had 60 million on the payroll. America's small businesses employ close to half the workers in the economy. But their hiring plans now are decidedly bleak.

On first hearing the President's message, and captured by the moment, I shouted out "Right on! Now we are getting somewhere." According to press reports, I was not alone in my enthusiastic reaction. John Arensmeyer, CEO of Small Business Majority, happily said "These tax credits are simple and straightforward, and will support small businesses to generate the jobs Americans so desperately need. And they'll start doing it now." My response must have come from a stored-up love for small businesses that goes back more than 40 years. But after settling back in my chair, I had other thoughts on the matter. Let me explain.

For some 15 years, starting when I was still a college student in 1952 to 1967, I was a part-owner of a small business enterprise, which in 1967 had about 50 employees. As corny as it may sound, I still remember what it takes to make a payroll on Friday night. I understand how hard it is to generate enough additional dependable business to add just one more employee. And I know how great it feels to bring one on and to introduce the new employee to the team members he or she will join. I also know how much it hurts everyone in the firm to cut back, to have to fire a good worker because business has fallen off. Because of the pain that goes with layoffs, I know how careful one will be before hiring another worker. In the case of small business, that person is likely to be a friend, former colleague or family member. Also, if the firm employs 10 people, which is common, adding one more amounts to a 10% increase in personnel. And that ain't hay, especially in a recession when you are not sure if the next month will be your last.

I hope that some of Mr. Obama's close advisors know these things as well, if not better than I. I am betting they do.

No one in his right mind wants to bring on a new employee only to face the plight of having to pass out more pink slips. Before hiring that one person, I would want to see a lot of black ink on the operating statement, not just one or two profitable months. Because of this, I don't think a \$5,000 tax credit will get the job done. What we need is some certainty.

This seemed to be a base concern when Susan Eckerly, VP of the National Federation of Independent Business, was asked about the Obama tax credit. She indicated that small businesses wouldn't start hiring until earnings improved. "An employer is unlikely to hire someone just to get a \$5,000 credit," she said. When I read Eckley's comments, I was reminded of a wise guy's response to tax incentives that allowed a firm to "to take it off your income tax." The response: "First off, I've got to have income."

Mr. Obama wants to see one million new employees added to the ranks of America's small businesses. I do as well. But adding just one new full-time hire when your toes can barely touch the bottom in a recession's deep end is risky business, and for one major reason. In February 2010, there is no way to know what really lies ahead; there is no way to distinguish between stimulus and the real economy. Too many policy boulders are being

dropped in the water. One can hardly determine the effects of one before another one is thrown in the pool..

There is stimulus one. Then,stimulus two. And now talk of stimulus three. There is TARP. Cash for Clunkers. Cash for Appliances. First home buyers tax credits. Healthcare revision. Copenhagen. Cap and trade. Jobs programs. Financial reform. Each announced in short succession. The effects of some of these programs are so large that they are readily seen in GDP and construction data. By some counts, about half of 2009's fourth quarter 5.7% GDP growth is explained by Cash for Clunkers, a program that came on like gang busters and then faded into oblivion.

Imagine yourself as owner of a small business with 20 employees. You are trying to decide if you should build up inventories again, hire one or two people, and lease another pickup truck. Would you make your decision on the basis of the fourth quarter GDP numbers? Would you base your plans on the explosion of existing home sales that followed the first home buyer stimulus? Most likely not. I'll bet you would wait so that you could get a better fix on the real economy.

Perhaps we need six months of political silence.

When I think about the situation and Mr. Obama's proposal, I wonder if it might be better to expand the noble elements of his idea to all businesses, small and large and do so permanently. Instead of having a complicated jobs-based tax system, why not just cut the marginal tax rate? And instead of allowing a temporary moratorium on capital gains taxes for small business, why not put an end to capital gains for all businesses. Doing this would put an end to trying to determine what is stimulus and what is real and what may change at the end of the year.

There is a supply side to the economy that wants to spring forward. A growing economy will produce more jobs and more tax revenue. This is the time to give a nudge and then stand back and let the real economy recover.

Final Thoughts

In a recent study of migration patterns for young-adult domestic and foreign movers, Tate Watkins and I identified variables that seemed to explain the crazy-quilt pattern formed across the 50 states during the years 2004-2008. We included in our statistical models indexes that account for economic and personal freedom, as well as knowledge economy opportunity. We also tested for other potential move influences such as income and a state "cool" index that measures life style attributes. There were astonishing differences between the factors that seem to influence international versus domestic movers. International movers are sensitive to personal and economic freedom; they move toward it. They also like the knowledge economy states. Domestic movers are insensitive to those variables, but are sensitive to the size of state welfare packages; they move toward them. Domestic movers like "cool" locations; international movers are not affected by them. Neither group is influenced by higher incomes, after accounting for the effects of the other variables.

What's the bottom line here? A new economy is forming in the U.S. International movers are part of it. They appear to be freedom lovers and seekers of economic opportunity. Capitalism seems to be alive and well.

If she only knew, the Statue of Liberty would be proud.

