RESEARCH REPORTS

Volume LXXXI

February 2020

published by
AMERICAN INSTITUTE *for* ECONOMIC RESEARCH

Research Reports

AIER publishes as many as 100 articles per month that are distributed in digital form. Research Reports contains Business Conditions Monthly plus 11 of the most representative, chosen here for popularity, variety, and relevance. These articles are often reprinted in venues around the web, including *Seeking Alpha*, *Intellectual Takeout*, *Mises Brasil*, and dozens of other outlets. To read all of them, go to **www.aier.org**

February, 2020

Business Conditions Monthly

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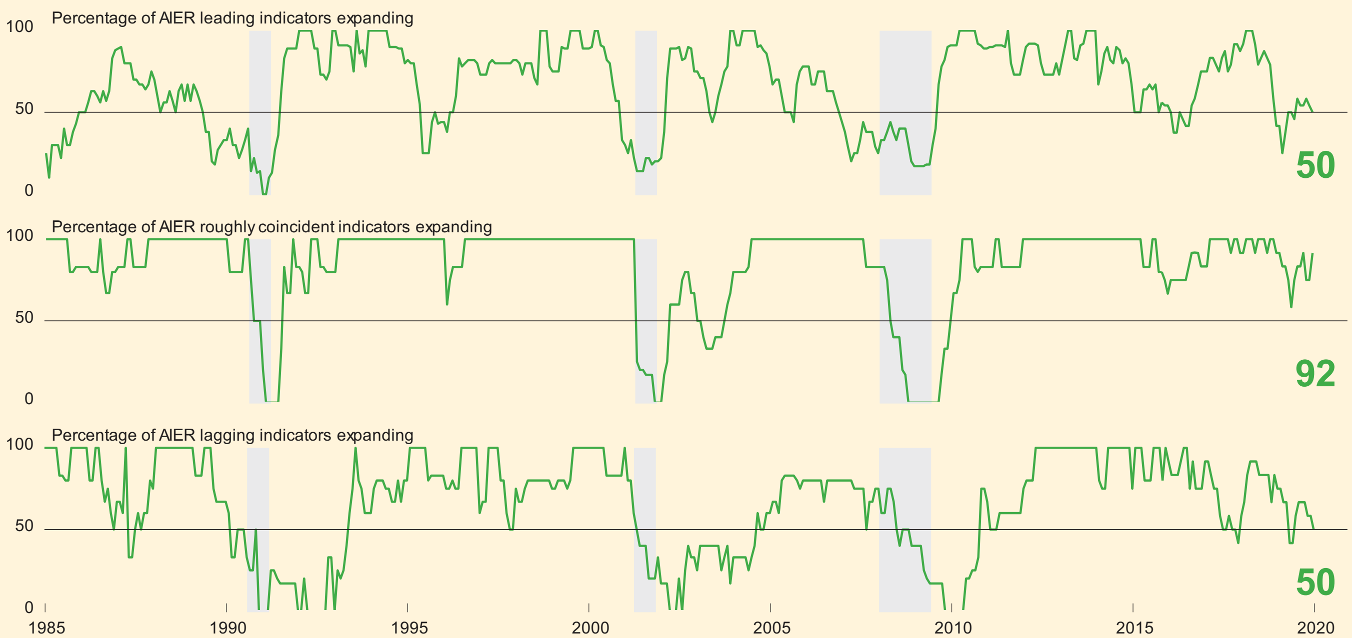
A decline for the AIER Leading Indicators index leaves the index at a neutral 50 for January.

AIER's Business Cycle Conditions Leading Indicators index fell another 4 points in January, falling to a neutral 50 reading. The latest result was the lowest reading since July 2019. The Roughly Coincident Indicators index rose to 92 from 75 in December while the Lagging Indicators index fell 8 points to 50 (see chart).

The neutral reading for the Leading Indicators Index reflects the varied strength among the major sectors and overall slow pace of growth for the economy. Fourth quarter real gross domestic product rose at a 2.1 percent annual rate, matching the third quarter performance. The modest growth in real gross domestic product in the fourth quarter was driven by a slower pace of growth in real private domestic demand (consumer spending, business fixed investment, and residential investment) combined with a small positive contribution from exports, a large positive contribution from a sharp drop in imports (which are used in the calculation of real gross domestic product) and an increase in government spending. Partially offsetting these was a sharp slowdown in inventory accumulation.

Politics and policy uncertainty continue to represent risks to consumer and business confidence, and given the modest pace of economic expansion, it would not take much to reduce growth to zero. The recent outbreak of the coronavirus is also disrupting economic activity globally. It's too early to gauge the magnitude of the impact, but the outbreak is another risk to global economic expansion. Overall, the U.S. economy continues to expand but remains vulnerable to erratic policies, political partisanship, and global economic risks.

Indicators at a glance



Note: Shaded areas denote recessions. A score above 50 indicates expansion.
Source: AIER.

The AIER Leading Indicators index came in at a neutral 50 reading with the 12 indicators evenly split between positive and negative trends.

The AIER Leading Indicators index declined by 4 points for the second month in a row, coming in at a neutral 50 in January. The index has been range bound between 45 and 58 for 9 consecutive months and hasn't been above 60 since November 2018. The extended period of close-to-neutral results are consistent with the overall mixed performance of the various sectors of the economy. The results suggest continued economic expansion albeit at a moderate pace and with a heightened degree of uncertainty. Overall, the 12 indicators were evenly split with six positives and six negatives; no indicators were neutral.

Three of the 12 leading indicators changed direction in January with two moving to negative trends and one indicator improving to a positive trend. Real new orders for core capital goods and the 10-year–1-year Treasury yield spread moved to negative trends from neutral trends in December. Total heavy-truck unit sales, the ratio of manufacturing and trade sales to inventory, the average workweek in manufacturing, and debit balances in customers' margin accounts maintained unfavorable trends.

The University of Michigan index of consumer expectations improved in January, turning to a positive trend in December. Positive trends were maintained by initial claims for unemployment insurance, real retail sales and food services, real new orders for consumer goods, housing permits, and real stock prices.

Overall, the Leading Indicators index came in right at the neutral 50 level, continuing a run of very modest readings. The extended run of close-to-neutral results combined with other mixed data and policy uncertainty suggest a high degree of caution remains warranted.

The Roughly Coincident Indicators index rose to 92 in January from 75 in December. Two indicators improved in January with industrial production moving to a neutral trend and The Conference Board index of consumer confidence for the present situation moving to a positive trend. Overall, five of the six roughly coincident indicators were trending favorably while one was neutral, and none were trending unfavorably.

Historically, this index frequently posts readings of 100 late in economic expansions but hasn't seen a perfect score since December 2018. Over the last 13 months, since the last 100 reading, the index has registered 92 four times but also fallen as low as 58. The average over that period is just 81. The less-than-robust results confirm the mixed performance of the economy.

AIER's Lagging Indicators index fell to 50 in January, the lowest reading since June 2019. One indicator, commercial and industrial loans, worsened in January, falling to a negative trend. Overall, three of the six lagging indicators were trending higher, three were trending lower, and none were in a neutral trend.

Real gross domestic product grew at the slowest pace since 2013

Real gross domestic product rose at a 2.1 percent annualized rate in the fourth quarter, the same pace as in the third quarter, according to the Bureau of Economic Analysis. Measured from fourth quarter 2018 to fourth quarter 2019, real gross domestic product increased 2.3 percent versus 2.5 percent for the four quarters of 2018. For calendar year 2019, real gross domestic product grew 2.3 percent, the slowest pace since 2013.

Domestic demand components were even weaker

Real final sales to private domestic purchasers, a key measure of private domestic demand, rose at a meager 1.4 percent annualized rate in the fourth quarter, down from a 2.3 percent pace in the third quarter. The fourth-quarter gain was the slowest pace since 2015. Over the last four quarters, the pace of growth was 2.2 percent, matching the third quarter pace and the slowest since 2013. Among the major components, real consumer spending rose but at a slower pace, business fixed investment fell, but residential investment posted its third quarterly gain.

Consumers remain the engine of growth

Real consumer spending decelerated in the fourth quarter, rising at a 1.8 percent annualized pace following robust gains of 3.2 percent and 4.6 percent in the third and second quarters, respectively. The deceleration was broad-based with durable-goods spending up 2.1 percent versus 8.1 percent in the third quarter, nondurable-goods spending up 0.8 percent versus 3.9 percent, and services gaining 2.0 percent versus 2.2 percent previously. Real consumer spending contributed 1.2 percentage points of the 2.1 percent real-gross domestic product growth rate.

Monthly retail sales and food services rose 0.3 percent in December, following a 0.3 percent rise in November. Over the past year, they are up 5.8 percent. Core retail sales, which excludes motor vehicles and gasoline, rose 0.5 percent in December following a 0.2 percent decline in November. From a year ago, core retail sales are up 5.7 percent. Unit-auto sales fell 2.3 percent in December, selling at a 16.7 million annualized pace. Unit sales have been in the 16 to 18 million range since 2014. Sales are dominated by the light-truck segment including sport utility vehicles and pick-up trucks, which sold at a 12.2 million pace while car sales came in at a 4.5 million pace. That puts the light-truck share at 72.8 percent in December, down from 73.8 percent in November but up from 70.2 percent in December 2018 and well above the less-than-50 percent share in 2000.

New orders for consumer goods rose 0.9 percent in December following an 0.8 percent gain in November. For all of 2019, new orders posted a meager 0.5 percent gain versus 2018. Among the major components, orders for consumer durable goods fell 1.1 percent in December following a 0.3 percent rise in the prior month. Nondurable consumer-goods orders increased 1.4 percent for the month of December following a 0.9 percent increase. For the full year, consumer durable-goods orders were up 1.9 percent while consumer nondurable-goods orders gained just 0.1 percent.

Business investment declined again

Business fixed investment fell at a 1.5 percent annualized rate in the fourth quarter, the third quarterly decline in a row. At annualized rates, the decline was led by a 10.1 percent fall in spending on structures while spending on equipment declined at a 2.9 percent annual pace, the third drop in the last four quarters. Investment in intellectual property rose 5.9 percent following a 4.7 percent pace in the third quarter; the gain extends to 12, the number of consecutive quarterly increases in investment in intellectual property products. Overall, real business investment subtracted 0.20 percentage points from real gross domestic product growth versus a 0.31 percentage-point reduction in the third quarter.

New orders for capital goods jumped 5.9 percent in December, rebounding from a 10.9 percent plunge in November. Nondefense capital goods orders excluding aircraft, a proxy for business capital equipment expenditures, fell 0.8 percent in December after no change in November. Businesses appear to be taking a cautious approach to capital investment.

Inventory accumulation by businesses continued in the fourth quarter but at a sharply slower pace compared to the third quarter, subtracting 1.09 percentage points from fourth-quarter growth.

Housing investment rises but so do inventories

Residential investment, or housing, rose at a 5.8 percent pace in the fourth quarter compared to a 4.6 percent pace in the prior quarter. Housing has risen for two consecutive quarters following declines over the prior six quarters and eight of the last nine quarters. Residential investment added 0.21 percentage points to real gross domestic product growth in the fourth quarter.

Housing permits, an indicator of future construction activity, fell 3.9 percent in December. The fall was led by an 11.1 percent plunge in multifamily (5+ units) permits while the single-family category, which accounts for about two-thirds of total permits, fell 0.5 percent for the month.

Sales of new single-family homes fell 0.4 percent in December. Sales came in at 694,000, down from 697,000 in November. Despite the drop, sales are still up 23.0 percent from a year ago. Total inventory of new single-family homes for sale rose 1.6 percent to 327,000 in December, pushing the months' supply (inventory divided by the annual selling rate times 12) to 5.7, up from 5.5 months in November. For new single-family homes, months' supply has been holding above five, a somewhat elevated level, since December 2017.

Plunge in imports impacts GDP calculation

Net trade had a large positive impact on the calculation of real gross domestic product growth in the fourth quarter, adding 1.48 percentage points. Real exports rose at a 1.4 percent pace, adding 0.17 percentage points to overall growth while real imports plunged at an 8.7 percent rate, adding a whopping 1.32 percentage points in the calculation of real gross domestic product. Trade patterns are likely being distorted by disruptions to trade policy, current and threatened, suggesting the significant contribution from declining imports is unlikely to be repeated. The outbreak of the coronavirus is also an unknown for the outlook for global growth.

Government spending and deficits still rising

Government spending rose at a 2.7 percent annualized rate in the fourth quarter compared to a 1.7 percent increase in the third quarter, contributing 0.47 percentage points to growth versus a 0.30 percentage-point contribution in the prior quarter. Federal defense spending rose 4.9 percent while federal nondefense spending rose 1.6 percent. The Federal deficit continues to expand at an unprecedented pace given the record-long economic expansion. Exploding federal deficits remain one of the most significant risks to the medium- and long-term outlook for the economy.

CAPITAL MARKET PERFORMANCE

(Percent change)

	January	Latest 3M	Latest 12M	Calendar Year 2019	2018	2017	Annualized 3-year	5-year	10-year
Equity Markets									
S&P 1500	-0.4	5.8	18.2	28.3	-6.8	18.8	11.7	9.8	11.6
S&P 500 - total return	0.0	6.7	21.7	31.5	-4.4	21.8	14.5	12.4	14.0
S&P 500 - price only	-0.2	6.2	19.3	28.9	-6.2	19.4	12.3	10.1	11.6
S&P 400	-2.7	2.7	9.4	24.1	-12.5	14.5	6.0	6.9	11.1
Russell 2000	-3.3	3.3	7.7	23.7	-12.2	13.1	5.8	6.7	10.4
Dow Jones Global Large-Cap Index	-1.1	4.6	14.1	23.8	-10.4	42.9	16.2	6.5	6.8
Dow Jones Global Large-Cap ex-U.S. Index	-2.7	2.1	7.3	18.2	-15.7	41.0	11.0	2.3	2.5
STOXX Europe 600 Index	-1.2	3.5	14.5	23.2	-13.2	7.7	4.5	2.3	5.2
Bond Markets									
iShares 20-plus Year Treasury Bond ETF	7.7	3.3	19.6	11.5	-4.2	6.5	6.7	1.1	4.7
IiShares AAA - A Corporate Bond Fund	2.2	1.8	8.9	9.1	-5.2	2.9	2.8	1.0	NA
Commodity Markets									
Gold	4.4	5.1	20.0	18.7	-1.7	12.6	9.4	4.5	3.9
Silver	-0.9	-0.9	11.3	16.7	-8.3	3.8	1.1	1.1	0.9
CRB all commodities	0.6	3.8	-2.1	-1.9	-5.4	2.2	-2.3	-0.9	-0.3

Sources: Barrons, Commodity Research Bureau, Dow Jones, Frank Russell, iShares, Standard & Poor's, STOXX Europe 600, Refinitiv.

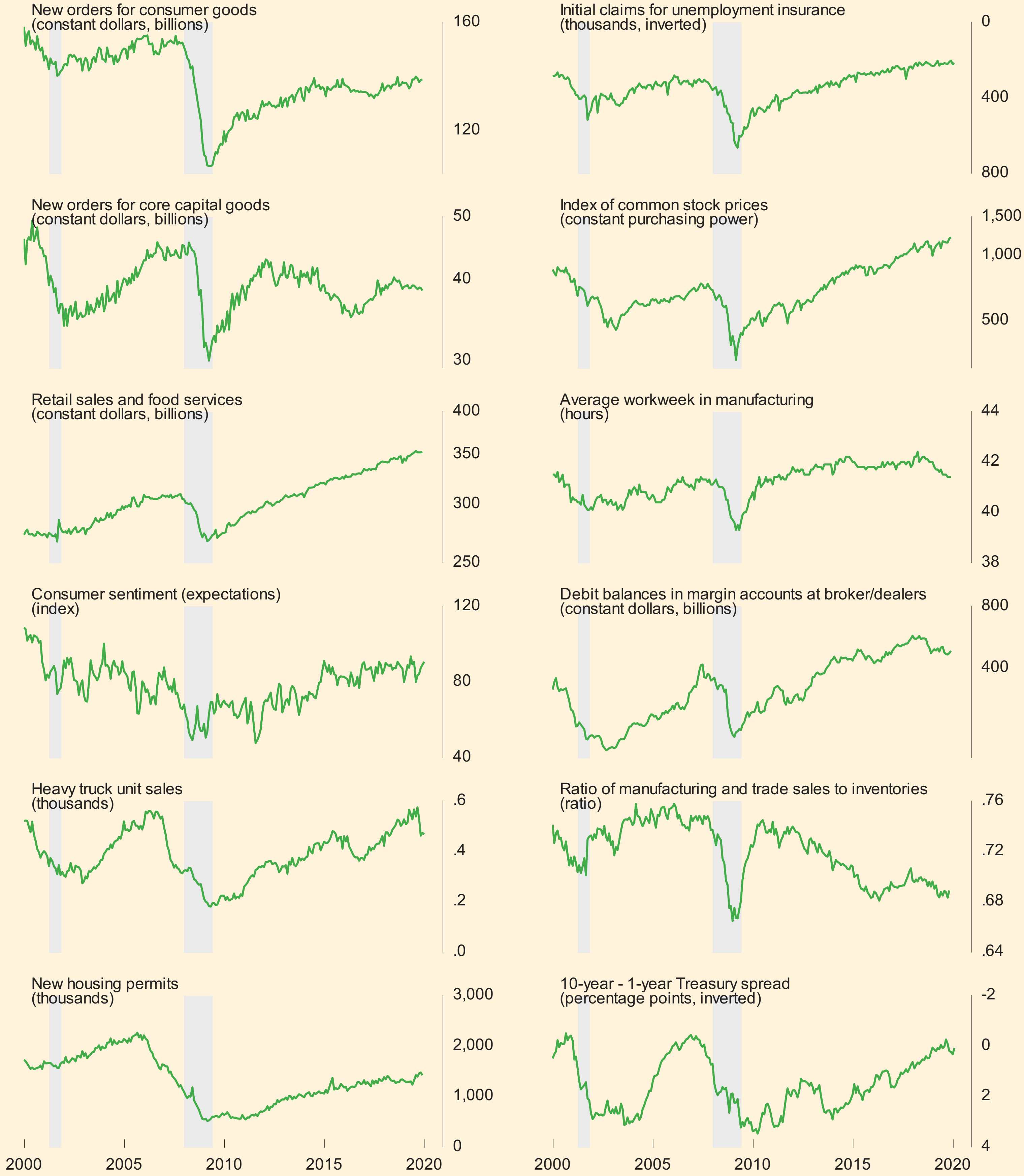
CONSUMER FINANCE RATES

(Percent)

	January	Latest 3M	Latest 12M	Average for Year 2019	2018	2017	Average over Period 3-year	5-year	10-year
30-yr. fixed mortgage	3.7	3.7	3.9	3.9	3.7	3.9	4.2	4.0	4.1
15-yr. fixed mortgage	3.2	3.2	3.4	3.4	2.9	3.1	3.6	3.3	3.4
5-yr. adjustable mortgage	3.4	3.4	3.6	3.6	2.9	2.9	3.5	3.3	3.2
48-month new car loan	NA	5.5	5.4	5.4	4.3	4.2	5.0	4.7	4.9

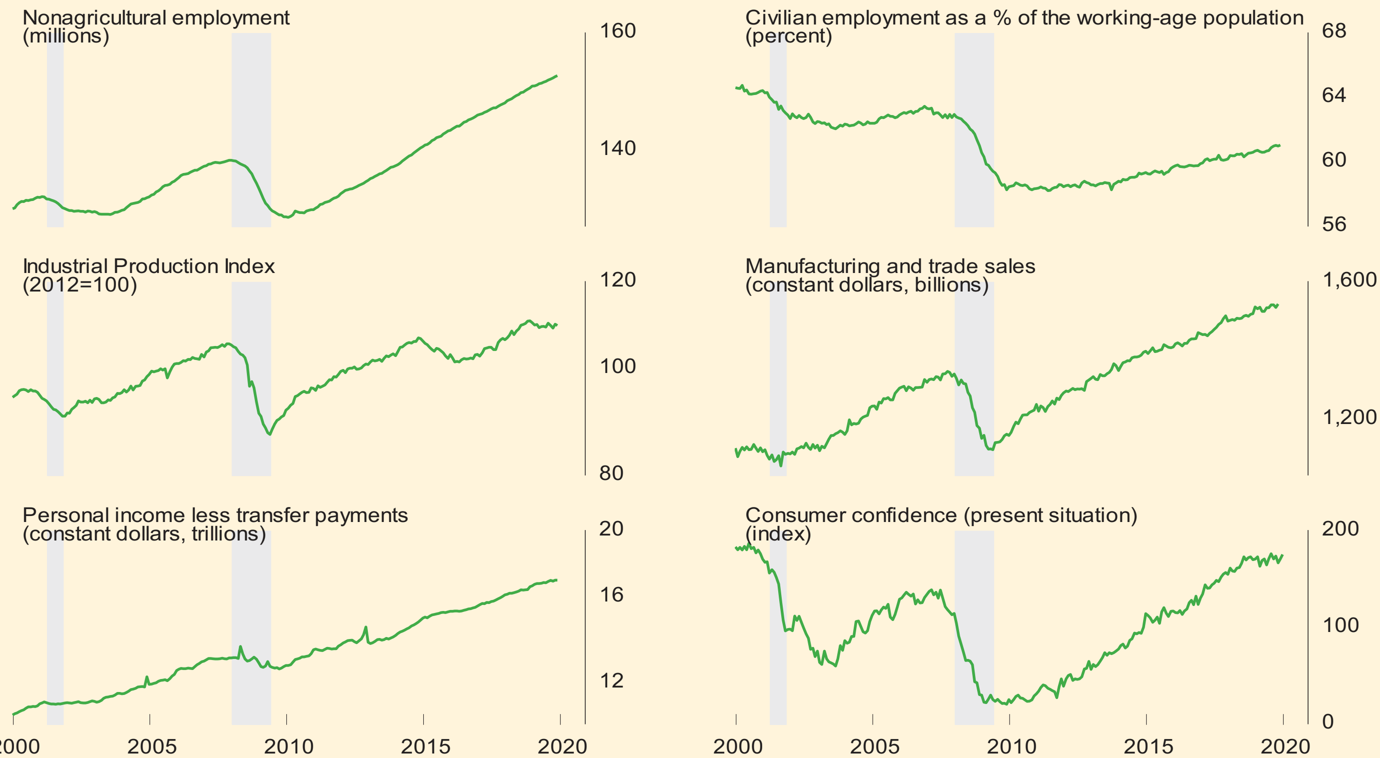
Sources: Bankrate, Federal Reserve.

LEADING INDICATORS (2000-2020)



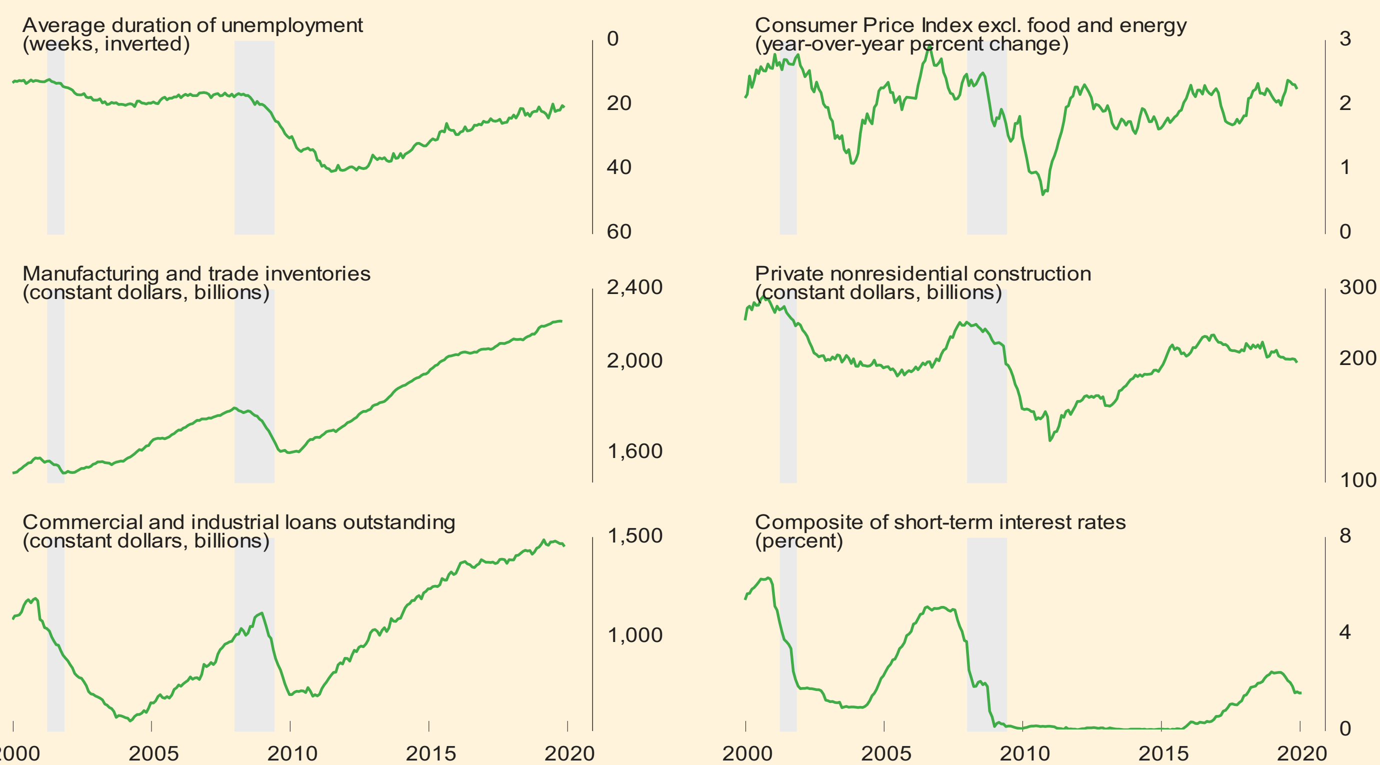
Note: Shaded areas denote recessions.
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve (Refinitiv).

ROUGHLY COINCIDENT INDICATORS (2000-2020)



Note: Shaded areas denote recessions.
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve (Refinitiv).

LAGGING INDICATORS (2000-2020)



Note: Shaded areas denote recessions.
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, The Conference Board, Federal Reserve (Refinitiv).

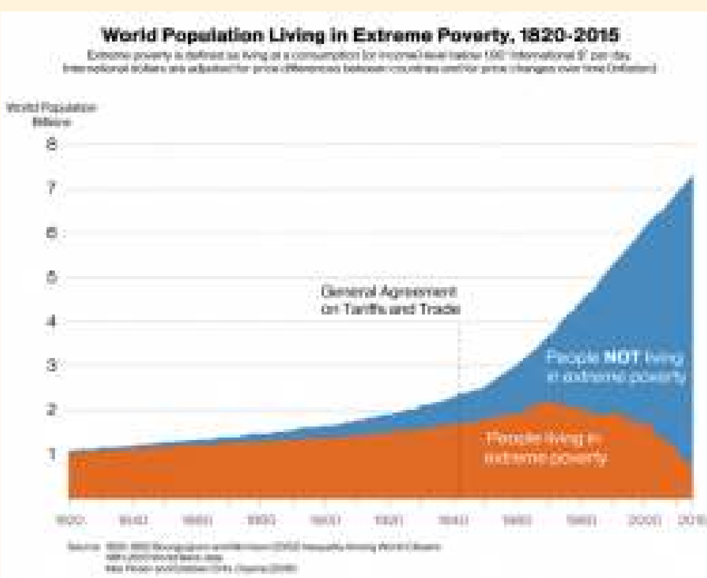
The Dangers to Prosperity All Around Us

Colin Lloyd
Contributor

Looking back at the 20th century there were great social, political and economic challenges. Technological advances accelerated and mass communication shrank the planet. In the process we embarked on two catastrophic world wars, whilst in peacetime economic booms and busts ensured human progress was as uneven as it was cathartic.

The first two decades of the new century saw a continuation, though thankfully without too many widespread military conflicts. At a global level, diseases have been eradicated, life expectancy extended, quality of life improved.

Of course, progress has remained uneven and there have been inevitable winners and losers. Overall, however, we are moving in the right direction and, during the last half-century, the number of people who remain in extreme poverty has fallen faster than at any time in human history. According to the World Data Lab, even during the last four years the number in absolute poverty has fallen from 652mln to 588mln. The chart below shows the dramatic decline since 1970:—



At the heart of this triumph of humanity is freedom to trade. The incredible work of the World Trade Organisation (WTO) is not to be understated. Nonetheless, the WTO is not without their critics and other institutions have fallen behind in their efforts to drive improvements in the lot of mankind. Additionally, despite this impressive evidence in favour of free trade, it remains under constant political threat. After all, free trade is not the solution to all the ills of humanity; some always benefit far more than others. There has been a backlash, but place trade in fetters and productivity suffers; when productivity declines human progress slows.

Protectionist policies benefit minorities and lower the trend rate of economic growth. Nonetheless, during the last decade populist protectionist policies have garnered support in many developed countries. Global supply chains have shortened and a global depression has been averted only by the aggressive interventions of developed nation central banks.

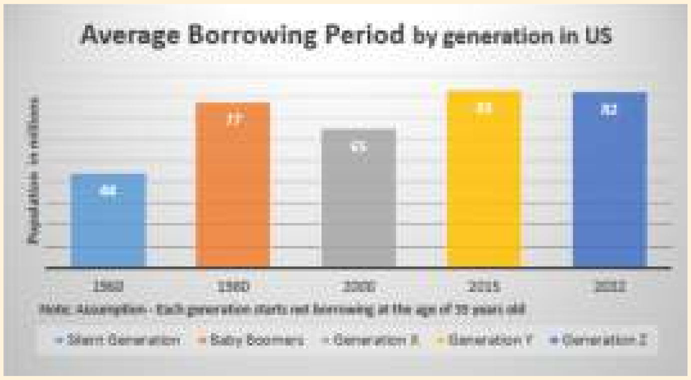
In the decade ahead, historically low interest rates should prompt governments to embark on long-term investment in infrastructure. They should borrow while they can, and the demographic forces which have driven inflation lower during the past two decades will lessen. The table below shows how Generation Y has started borrowing since 2015, reversing a decline in train since 2000. It will be the middle of the 2020's before Generation X retirees begin to partially offset that impetus by their increased saving:

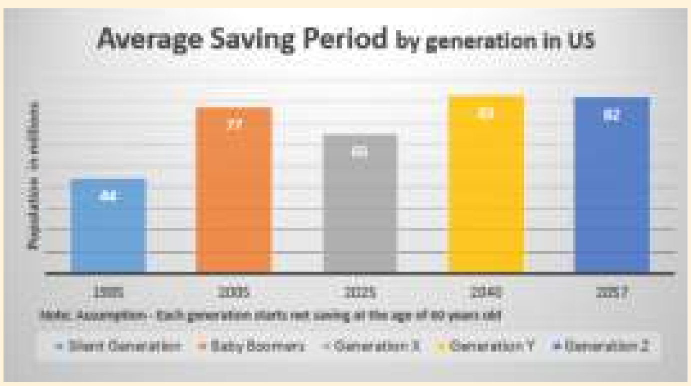
Generation's definition

(US populations born between)

Silent Generation	(1925–1942)
Baby Boomer	(1945–1965)
Generation X	(1965–1980)
Generation Y	(1980–1997)
Generation Z	(1997–2017)

Note: Generations are analytical constructs, it is not easy to develop precise boundaries that demarcate one generation from another.





Source: US Census Bureau

With this Gen Y increase in borrowing, in order to consume, will come a rebound in inflation and, with it, the need for higher interest rates. I do not anticipate the beginning of a bond bear market; the outstanding debt overhang will insure over-leveraged economies stall rapidly in response to tighter monetary conditions. This in turn may prompt central banks to ease monetary policy despite inflation, or for government regulation, especially in relation to bank capital requirements, to be relaxed. Over the next decade both bond and stock markets may be stuck within a broad range, although the risks are on the downside.

90 years of the US Stock Market

The benefit of viewing financial markets over multiple decades is that one can observe the long-run trends absent the short-run noise. Here is the S&P 500 since 1929:

Source: Marcotrends.net

There have been just two decades since 1930 when the S&P 500 ended the period lower; the 10 years to 1940 and 2000 through 2010. It is worth mentioning, however, that the inflationary 1960's and 1970's were decades which saw very limited stock price appreciation: and in inflation-adjusted terms these decades delivered scant succour to equity investors. Bondholders fared even worse.

The recent stock market strength since the financial crisis may appear unjustified when compared to the anemic economic growth of the last decade, but, as the chart below shows, the earnings per share (brown line) combined with historically low interest rates, help to justify these inflated valuations:

Source: Marcotrends.net

It is worth remembering the difference between company earnings and earnings per share. The latter can be inflated simply by reducing the number of shares in issue. As interest rates have collapsed, debt financing has become more cost effective than equity financing. Firms have embraced debt to finance new projects but also to redeem shares, thereby magically increasing their earnings per share. Assuming corporate leverage has its limits, during the next decade there will be less opportunity to grow earnings per share through such financial sleight of hand.

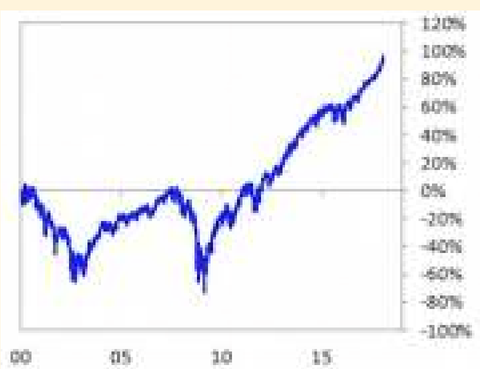
If the principal driver of stock market returns over the last decade has been the steady lowering of interest rates and an increase in corporate leverage, then the next decade will require substantially more leverage or a marked increase in economic growth in order to maintain the upward momentum in prices. There are, of course, smaller international markets where interest rates remain elevated and corporate leverage subdued, but these are exceptions to the broader rule. The US has more latitude to cut interest rates than Europe or Japan but the US stock market has led the way during the current bull market and global stock markets are historically highly correlated.

Where should investors look for returns?
The chart below compares bonds versus stocks.

Bonds and Stocks Since 2000

10yr Bond Cumulative Excess Return

S&P Cumulative Excess Return



Sources: S&P, Barclays

What are the alternatives? To begin here is a table showing the long-term return from a balanced stock and bond portfolio:

Historical Risk/Return (1926–2016)	
Average annual return	7.8%
Best year (1933)	27.9%
Worst year (1931)	–18.4%
Years with a loss	16 of 91

Historical Risk/Return (1926–2016)	
Average annual return	8.3%
Best year (1933)	32.3%
Worst year (1931)	–22.5%
Years with a loss	17 of 91

Historical Risk/Return (1926–2016)	
Average annual return	8.7%
Best year (1933)	36.7%
Worst year (1931)	–26.6%
Years with a loss	21 of 91

Source: Vanguard

The classic mix of 60% stocks and 40% bonds has delivered 8.7% over the 91 years to 2016. Investors incurred losses in 21 of those years.

A more aggressive portfolio, with a higher stock weighting, combined with a money market investment, might be a solution:

Historical Risk/Return (1926–2016)	
Average annual return	9.1%
Best year (1933)	41.1%
Worst year (1931)	–30.7%
Years with a loss	22 of 91

Historical Risk/Return (1926–2016)	
Average annual return	9.5%
Best year (1933)	45.4%
Worst year (1931)	–34.9%
Years with a loss	23 of 91

Historical Risk/Return (1926–2016)	
Average annual return	10.2%
Best year (1933)	54.2%
Worst year (1931)	–43.1%
Years with a loss	25 of 91

Source: Vanguard

Other alternatives to a stock and bond portfolio include Real Estate and Infrastructure, but these sectors remain sensitive to interest rates and are therefore quite highly correlated to fixed income. Their enticing returns are also a function of their lack of transparency and liquidity. To succeed in such assets a much longer-term investment horizon is required. These assets are difficult to evaluate and price discovery is often challenging.

Another alternative or addition to a portfolio is Commodities. As an asset class they are far less homogenous, making investment a more nuanced affair. Gold may rise as copper falls, wheat and corn may rise together, then diverge for years. Additionally, in the long run, real, inflation adjusted, commodity prices almost always fall: in asset management parlance, they have a negative expected real-return. This is a function of human endeavour. We raise more from an acre of land through technological progress, we drill and frack more efficiently, our geological survey techniques improve. The triumphs of human ingenuity are endless.

Finally, commodities offer no yield, no dividend, no coupon. These are trading assets; by all means follow their trends but do not forget, trends always end.

Looking ahead to 2030, active, tactical asset allocation may appear beguiling, but trading asset markets is a zero-sum game. For every winner there must be a loser. I would, nonetheless, commend two consistent strategies which have proved their worth over the long-run, Value and Trend Following. Tread carefully, however, as Lord Keynes famously observed, 'Markets can remain irrational longer than I can remain solvent.' Value has underperformed for the last decade, even though it has delivered excellent results over a longer time horizon. Periods of trend-less-ness can last for years and price patterns seldom repeat though they may well rhyme.

Aside from financial markets, there are many other economic factors to consider between now and 2030. After successive tax cuts, the room for the US government to go further without also curbing spending is limited, yet politicians, left and right, continue to promise more. A rude awakening cannot be ruled out during the next decade and this may sow the seeds for another great recession. However, lightning seldom strikes twice in the same manner and I fear that reckoning will be postponed by more pork barrel spending funded by long-term borrowing at the lowest interest rates in history. Financial leverage is a game of the greater fool, but when a government issues debt in its own medium of exchange, especially if that medium remains the world reserve currency of choice, it has little to fear in the short run. Every dollar of government debt is deferred taxation for the purposes of immediate consumption. For the political classes, paying back the loan will be someone else's problem.

Financial leverage, even when wielded by the minter of money, possesses a dark side. As an individual, corporation or government becomes more leveraged so they become more sensitive to even a small change in interest rates. Whilst independent central banks continue to provide support by the manipulation of interest rates, all is well, but at some point the markets may lose faith in their omnipotence.

Whilst my Austrian economic inclinations favour sound money and an unwinding of decades of excess, the fabric of society could be rent asunder by the collapse of the current financial system. I believe central bankers are cognisant of the risk, but to force a normalisation of interest rates is not their mandate. Even the recent quantitative tightening pursued by the Federal Reserve was short-lived and limited by comparison with the monetary easing and balance sheet expansion that preceded it.

For the next decade I envisage more extreme experiments with monetary policy, combined with a return to fiscal largesse, all of it aimed at maintaining the status quo. Eventually the experiments will fail but by that point new leaders will be in office. I do not envy their task.

January 2, 2020

The Effect of Data Lags on Monetary Policy

William J. Luther
Director, Sound Money Project

Advanced, money-using economies occasionally encounter temporary periods of underproduction, where resources are not sufficiently utilized and some workers are rendered unemployed. Since 1980, the United States has experienced five recessions, ranging from 6 to 18 months in duration. The average recession over the period lasted just under a year.

Periods of underproduction are costly in two ways. First, they mean we get fewer goods and services than we would like, given our constraints. Second, since workers gain and maintain skills while working, their temporary unemployment makes them less productive in the future. In other words, we produce less than we are capable of today and we are less capable of producing than we would have been capable of in the future. For these reasons, and perhaps others, we would like to prevent periods of underproduction when possible.

Monetary policy has the potential to reduce the depth and duration of recessions, when they are driven by nominal disturbances. But it takes time to formulate and implement an appropriate monetary policy response. And the monetary authority cannot even begin this task until it realizes there is a problem. Alas, the lags in data collection make it very unlikely that the monetary authority will be able to remedy all but the most long-lasting recessions.

Consider a relatively straightforward question: are we in a recession? I am not asking, *What caused the recession?* or *How severe is the recession?* or *How long will the recession last?*—all of which would be useful to know when formulating an appropriate monetary policy response. No, I am merely asking whether we are currently experiencing a recession. As it turns out, we struggle to answer even this relatively straightforward question in a timely manner.

In the United States, the National Bureau of Economic Research's Business Cycle Dating Committee is widely viewed by economists as the authority for determining when the economy is in a recession. A list of expansions and contractions, beginning in December 1854, is maintained here. The site also includes the announcement dates for peaks (when a recession begins) and troughs (when a recession ends) since 1980. In the following table, I reproduce the data since 1980 and include calculations for the (1) duration of each recession and (2) the number of months between the start of the recession, as identified by the committee, and the announcement of that recession by the committee.

Peak	Trough	Announcement	Duration of Contraction (Months)	Announcement Lag (Months)
Jan-80	Jul-80	3-Jun-80	6	4.6
Jul-81	Nov-82	6-Jan-82	16	5.8
Jul-90	Mar-91	25-Apr-91	8	9.3
Mar-01	Nov-01	26-Nov-01	8	8.4
Dec-07	Jun-09	1-Dec-08	18	11.6
		Average:	11.2	7.9

The typical announcement lag—that is, the time between the start of a recession and when the Business Cycle Dating Committee announces the start of a recession—is just under 8 months. That's a huge lag. The typical recession lasts a mere 3.3 months after the announcement. And, for the recessions beginning in 1990 and 2001, the contraction had ended before the announcement of the contraction's start had been made!

One cannot expect the monetary authority to formulate and implement an appropriate monetary policy response if it does not know the economy is in recession until that recession is over. But, even when it knows, it often has very little time to do much about it.

There are two caveats in order here. First, the Business Cycle Dating Committee does not intend to announce recessions in a timely manner in order to facilitate the successful conduct of monetary policy. Rather, it intends to provide the most accurate assessment of when a recession begins and ends for historical classification. That almost certainly means it is more conservative in announcing recession dates—waiting until it is absolutely sure—than it would be if it were trying to facilitate monetary policy. The Federal Reserve relies on a host of indicators and constructs elaborate forecasts to make its own assessment of the state of the economy. It does not wait around for the NBER to certify that a recession has begun.

Second, it might be argued that the successful conduct of monetary policy explains why the typical recession has been so short since the 1980s. Perhaps recessions would have been longer and deeper if the Fed were not engaged in countercyclical policy.

Despite these two caveats, however, the point remains: it takes time to collect and analyze data. While it might not take as long to collect sufficient evidence for policy as it does to provide an authoritative statement for the historical record, the known time for the latter gives us a good reason to be concerned about the unknown time for the former. After all, any policy conducted on the evidence available prior to when the Business Cycle Dating Committee feels confident enough to state that a recession has begun is necessarily conducted on a less certain assessment of the state of the economy.

Likewise, the recognition that monetary policy may have reduced the duration of recessions in no way invalidates the claim that there remains a considerable amount of underproduction that the monetary authority is unable to do much about. If monetary policy is conducted based on historical data, occasional periods of underproduction, while perhaps short in duration, are inevitable.

It is difficult to conduct monetary policy effectively. It takes time to formulate and implement an appropriate monetary policy response. That task is made all the more difficult by the lags of data collection. Recognizing the existence of these lags does not imply that the Fed is incapable of reducing the depth and duration of recessions. However, it should instill a sense of humility in those of us considering what the Fed might accomplish in practice.

January 14, 2020

When Perfect Correlations Dissolve Into Dust

Joakim Book
Visiting Scholar

Time is a faulty correlation's worst enemy. Time separates universal and plausibly causal relationships from those that merely happened to correlate. We call the latter *spurious* correlations: variables that statistically moved together but are not related, either directly or indirectly.

By way of example, Tracy Alloway at *Bloomberg* has long monitored the price movements of Mexican Hass avocados and the dollar price of bitcoin, noticing that they track one another remarkably well. Nobody believes that bitcoin is involved in the pricing of avocados or that Mexican avocado traders are running the world bitcoin market. Statistically, the two lines follow each other closely enough that somebody could invent a plausible story for how avocados rule the crypto world—watch out for that one!

There are countless such laughable correlations around—like the per capita consumption of margarine and the divorce rate in Maine or non-commercial space launches and U.S. sociology PhDs. Correlation is not causation, and to hone in on causal mechanisms in economics or social sciences generally, there is a lot more statistical nitpicking involved. Letting time run its course, however, is usually a simple way to debunk some alleged statistical relationship.

One example on Tyler Vigen's amusing website *Spurious Correlations* is the number of lawyers in South Dakota and the number of pedestrians killed by car, pickup truck, or van—yes, the Centers for Disease Control and Prevention, the government agency that tracks *Underlying Cause of Death*, is oddly specific. Between 1999 and 2010, Vigen reports, this correlation was almost perfectly inverse (-0.94). For every additional lawyer in South Dakota, pedestrian deaths across the United States fell by over four people.

Because this instance is so absurd, nobody would read anything into this relation beyond suggesting that perhaps they are both caused by some common factor—say, economic growth protecting pedestrians as well as generating needs for lawyers in South Dakota. For a decade, these two numbers just happened to align and gave us a jolly good laugh.

Adding in the next seven years of records shows the spurious nature of the correlation: running the stats between 2008 and 2017 (last available CDC data) returns an insignificant correlation of -0.17, an R-square—a statistic measure of fit—of 3 percent. Relationship gone.

The problem with most closely correlated observations is that we intuitively interpret them as meaningful signals even when we shouldn't. Expanding time periods or comparing the variables involved on a different dataset, time period, or institutional setting is a valuable way of calling BS on fishy statistics.

In finance, we do these *out of sample* tests all the time. If a model derived and developed on one dataset in a certain country or time period also holds up in different settings, we are more confident that we've uncovered something real. While relationships that fail an out-of-sample test may still be correct, the failure suggests that the relation might be random, only selectively relevant, and at least weaker than we initially thought.

Take the size effect as an example. In finance, the size effect reflects the tendency for stocks of smaller firms to outperform stocks of larger firms even after controlling for market betas (return sensitivity with respect to the average stock market). After it was first discovered by Rolf Banz in the 1980s and replicated by Fama and French in their foundational cross-sectional paper in 1992, the effect became common knowledge. Everybody knew that small firms overperformed, and it was believed to be a universal feature of financial markets; asset-management firms went to town, and money poured into small-cap funds. As I was looking at stock market returns in 19th- and early 20th-century Britain—a much less liquid and informationally sophisticated market than today's—I too found a size effect for stock returns, in a setting well before asset-pricing theories had developed.

Then, in the late 1990s and the first decade of the 2000s, the size effect disappeared. Suddenly, no matter how hard financial economists tried, they couldn't find it—until it emerged alive and well in a paper by David Aharon and Mahmoud Qadan late last year.

My point is not to weigh in on whether the size effect is real—much more competent financial economists are already investigating that—but to remind us that statistics applied to the best of our abilities may still lead us astray. Statistics may mistakenly attribute signals to what is nothing but noise.

The Year of the Yield Curve

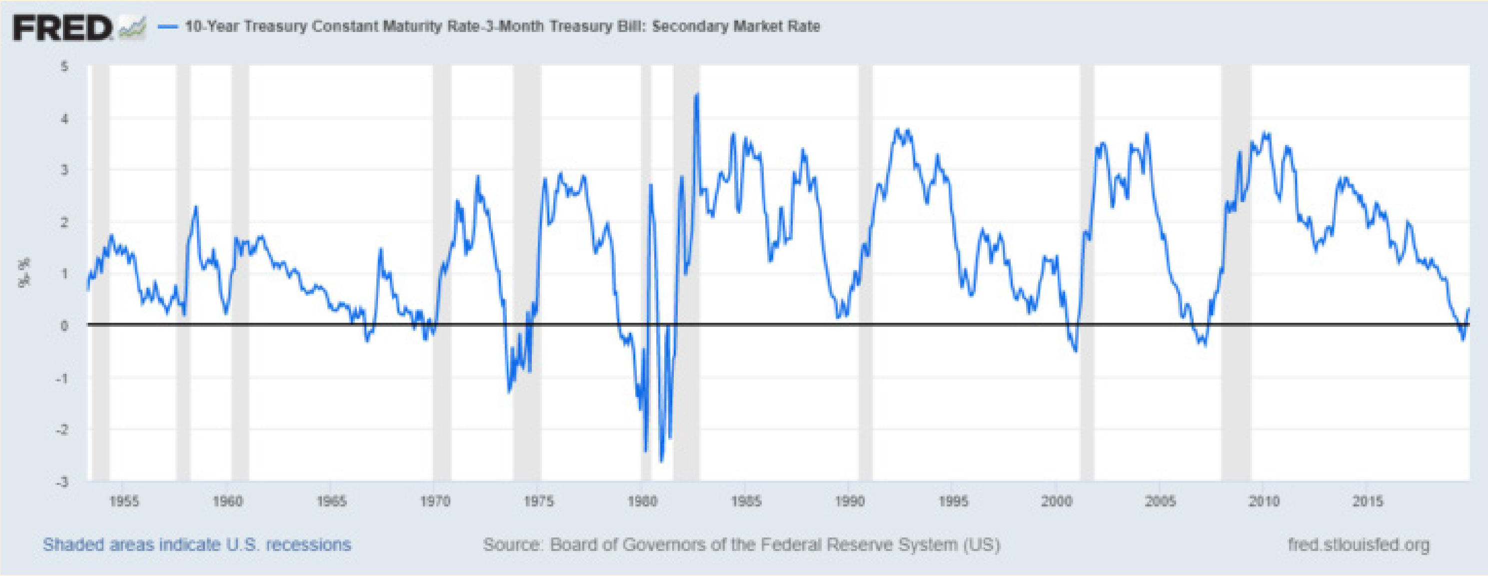
2019 became the year when the *yield curve* entered the public's vocabulary. Why? Well, the yield curve *inverted*, which means that the return on long-dated government debt fell below the return on short-dated government debt. Over the course of 2019, economists and commentators increasingly voiced their concerns since yield curve inversions, going back to the 1960s, have *reliably predicted all seven U.S. recessions*.

The underlying research about yield curve inversions comes from the Duke economist Campbell Harvey, a prolific, well-regarded financial economist who served as the president of the American Finance Association in 2016. During his doctoral work in the 1980s and in subsequent publications, Harvey found that an inverted yield curve—specifically the yield on 10-year bonds falling below the yield on 3-month Treasuries—indicated a recession 7–19 months down the line. Notably, the signal had no false positives (it only flashed when a recession was actually coming) and it has correctly predicted all three recessions since.

For the full seven-recession sample, the average time between yield curve inversion and the beginning of a recession is 14 months, which puts our next recession in the summer of 2020—specifically August, if we're counting from when Harvey sounded the alarm last year.

Since we're all afraid of doom and gloom, news media more than anybody else, surefire predictions by reputable economists about an oncoming recession warrant lots of attention—particularly so in August, September, and October of 2019, when outlets from *Fortune* to *CNBC* and *Financial Times* widely publicized the infallible prediction.

The relevant St. Louis Fed graph is reproduced below, reaching back three recessions before the beginning of Harvey's research. Expanding the time period covered reduces the seven-out-of-seven record that's currently voiced. Using this specification (10y-3m), the yield curve just avoided turning negative before the 1990 recession; the yield curves of two recessions (1957–58 and 1960–61) prior to Harvey's core period don't invert; and there is even a false positive in 1966.



Now What?

Since the U.S. yield curve inverted last year, the Fed has cut its federal funds target on three occasions and yields on longer-dated bonds recovered somewhat. The yield curve, while still very flat, has resumed its regular upward-sloping shape. This led observers at the *Economist*, Matt Phillips of the *New York Times*, and Gillian Tett of the *Financial Times* to consider whether we could abandon the *inversion-watching chatter* and return to normal. Phillips correctly observed that the resumption of normality might still be too late: *Once the yield curve has predicted a recession,* he wrote, *one usually follows even if that signal changes later.* This is in line with Harvey's original research. He maintains that the recession threat is still with us.

Of course, we will have to wait another 6 to 12 months to see if the model will grace us with another correctly predicted recession.

Even if it doesn't, Harvey and his yield curve followers —like all creators of failed predictions past and present— can add some post hoc justification for why the metric misfired. A simple way of doing this is to extend the time coverage of their prediction as recessions have been a recurring phenomenon in the long history of capitalism; extend your prediction long enough and you'll be right by chance alone. Considering that the current economic expansion is the longest on U.S. record, you might say that the economy is already overdue for a recession.

In general, prediction quacks and pushers of spurious statistics take great care in including open-ended time frames or being as vague as humanly possible—an age-old way of ensuring predictive success. Harvey's yield curve story is merely the most sophisticated of these: If there is a recession in 2020, even if it is caused by something entirely different, Harvey can claim victory and add another observation to his yield curve story. If there is no recession, Harvey can claim that this time is different—say, large-scale asset purchases or liquidity and capital requirements have altered the underlying relation and blurred the signal.

To his credit, Harvey has specifically rejected that avenue, responding to his critics that this time *isn't* different and that Fed bond-market intervention ought to have had a greater impact in the 1960s and 1970s than now, at a time when his predictive model seemed to have worked. This year, in other words, is shaping up to be a great yield curve showdown for inversion watchers.

Regardless of whether signals from the bond market accurately forecast recession, it's unclear what an investor ought to do. Last summer, Fama and French ran the returns for various stock-and-bond portfolios following a yield curve inversion and came up way short; it almost certainly doesn't pay to alter one's investment strategy on a yield curve inversion.

The bigger statistical story here is the predictive power of carefully selected variables. Commenting on the yield curve scare in December, Michael Gayed of the *Lead-Lag Report* wrote that *there certainly hasn't been enough data points to consider [yield curve inversions] statistically relevant, and many other things have to happen (or not happen) after inversion for a recession to hit.* While Harvey's story has been remarkably prescient in the U.S. postwar period, we're still talking about a signal with a sample size of seven. Few statisticians would trust that.

Statistical relations can be tenuous, and statistics can be fishy. Perhaps with time, Harvey's yield curve relation will go the way of pedestrians and South Dakota lawyers—a near-perfect correlation dissolving into dust.

January 22, 2020

The Four Pillars of Economic Understanding

Peter Boettke
Senior Fellow

It is no exaggeration to say that learning economics changed my life. In fact, I would go as far as saying the two most pivotal moments of my young adulthood were meeting my future wife at 17 and being exposed to economics at 19. Not only pivotal, but responsible for the good fortune and happiness I have had in the intervening years.

Earlier this month I turned 60. I became an economics major 40 years ago after the powerful messages I learned from my teacher Dr. Hans Sennholz and the economists and ideas he alerted me to. It was simply the way he taught that excited my imagination, and my journey since that time has only fueled my curiosity and imagination since.

I find *everything* about economics fascinating—its history, its sociology, its underlying philosophical debates, and most of all its ability in the hands of a real master to render the world in all its complexity intelligible. As James Buchanan taught us, economic theory is able to lift an ordinary individual to the heights of observational genius, while a genius unarmed with economic theory will often be reduced to very ordinary if not worse in their observations of how the world works.

Earlier this fall, I was part of a panel at the Southern Economic Association on Paul Rubin's *The Capitalism Paradox*, along with Steve Horwitz and Sanford Ikeda. I have known of Ikeda since I was 19 because he was the star graduating economic student when I was first learning economics from Dr. Sennholz back at Grove City College. So, it was not surprising to me when Sandy in his comments summed up what he thought were the key ideas for teachers of economics to stress to excite the imaginations of subsequent generations of students. It was these ideas that changed my life.

Rubin's book is highly recommended because he offers a useful corrective by stressing the importance of social cooperation among distant and disparate people, rather than the ruthless competitive nature of market society. Yes, market competition is unrelenting and valuable. But the by-product isn't just the delivery of goods and services at least cost, but also the network of social relationships and bonds of cooperation that are formed even among strangers. Steve Horwitz recently gave a great talk on this in Greece, and was discussed at Coordination Problem. So our panel was united in its praise for Rubin's work.

But, when Ikeda had his chance to summarize he placed the teaching of economics into 4 categories: Truth and Light; Beauty and Awe; Hope; and Compassion. My mind rushed back over the years to all the great teachers I have had in economics from Sennholz to Don Lavoie and Karen Vaughn, from Kenneth Boulding to James Buchanan and Gordon Tullock, and from colleagues such as Israel Kirzner and Mario Rizzo at NYU to Don Boudreaux, Tyler Cowen, Chris Coyne, Peter Leeson, Russ Roberts, Vernon Smith and Virgil Storr. They all hit these different categories in their teaching and writing with different levels of emphasis and all with great effect. A few hit all four constantly and they stand out above the crowd.

Truth and Light

Economics begins with the recognition of scarcity. There is certain shock value when you first are taught this idea and the notion that in our world we are constantly confronted with trade-offs, and as such notions of optimality are a function of the skill with which we as human decision-makers negotiate these trade-offs.

Learning economics to a considerable extent is learning about all the implications of scarcity, and thus the persistent and consistent application of opportunity cost reasoning to all human affairs. Tullock (along with Richard McKenzie) achieve this with their *The New World of Economics*, which was originally published during the 1970s and which I read as an undergraduate economics student at Grove City College.

Economics brings truth and the light to the darkness, and pierces through the fog to make sense of all human endeavors, whether in pursuit of the highest ideals or the basis of crass motives. If you are being taught economics by Gordon Tullock, or for that matter Pete Leeson (*The Invisible Hook* and more recently *WTF*), be prepared to be shocked out of your comfortable complacency and instead learn about the logic and underlying governing dynamics of the world around you.

Beauty and Awe

Adam Smith sought to excite the imagination of his readers of *The Wealth of Nations* with two striking examples early on in the first book. We are asked to contemplate our situation in the world. We depend for our very survival on the cooperation of a great multitude of individuals, yet in our lifetime we have the occasion to make only a few close friends. Smith informs us, therefore, that we cannot rely on their benevolence to help us in our daily struggle for existence. We must appeal to their own self-love. It is not, as he says, from the benevolence of the butcher, the baker and the brewer that we can procure our dinner, but with regard to their self-love.

Let that sink in; we require institutions that will enable us to engage in productive specialization, realize mutual gains from exchange, and achieve peaceful social cooperation among distant and disparate people. Smith hammers this point home with his example of the common woolen coat that exists on the back of the day laborer. He traces out the great multitude of individuals involved in this complex division of labor that must coordinate their activity with one another in order to produce even this simple product. Leonard Read and Milton Friedman would later use the story of a pencil to similar effect.

And how is that achieved? Friedrich Hayek's great contribution was to show how the price system through the knowledge generating, utilization and communication functions can produce this complex web of interdependent relationships among economic actors near and far. Hayek even used the phrase *marvel* to shake his professional colleagues out of their complacency about the beauty and awe of the complex coordination of a free market economy.

The scientific imagination is piqued either through a sense of awe or a sense of urgency. Economics is capable of both, and we do a disservice to our students when we don't expose them to both. My colleague Chris Coyne's work in the field of post-war reconstruction (*After War*) as well as humanitarian aid (*Doing Bad By Doing Good*) demonstrates to his readers that getting the economics right is really a matter of life and death in the real-world. But this understanding of the urgency is based on a sense of awe at the power of the price system.

This is reflected in important ways in Russ Roberts' trilogy, *The Choice, The Invisible Heart* and *The Price of Everything*. Recently I made a post about the beautiful patterns of nature and the analogy to the market that Alfred Marshall draws in his *Principles of Economics*, and I think watching the rhythmic movement of the pendulum and the pattern produced is helpful to economics students to think about the complex pattern of economic relationships formed through the guidance of the price system.

Prices guide us, profits lure us, and losses discipline us in our decisions, and property rights provide the institutional infrastructure required for all of this to take place. James Buchanan taught us that the number one job of the economics teacher was to develop an appreciation in their students of the spontaneous order of the market so that our students could become informed participants in the democratic process of collective decision-making. In developing that appreciation, it helps to teach them about the mystery of the mundane.

Hope

But, learning economics and economic history teaches us even more; it teaches us about the *Great Escape* as Angus Deaton has dubbed it, as through the expansion of trade, refinements in the division of labor, technological innovations, and adoption of rules of the economic game that cultivate these developments rather than hinder them, humanity was able to get beyond the Malthusian struggle and the oppression of crushing poverty. Economics teaches us hope in the betterment of the human condition.

Entrepreneurs in the private sector act on price signals to constantly seek out deals by buying low and selling high, and in doing so bring mutual gains from trade. But these entrepreneurs are also constantly on the lookout for cost saving technologies in production or improvements in the delivery mechanism to consumers of their goods and services. And, don't ever forget the innovations they introduce and the discovery of new products and new services that better satisfy the demands of consumers. Hope in the form of improved living conditions is born out of individuals being able to bet on ideas and bring those bets to life.

Hope is also a function of finding changes in the rules that will ease the costs of transacting and encourage the discovery of new opportunities for mutual gains from trade. Thus, public entrepreneurs can, and have, made tremendous improvements in the lives of millions (billions) by introducing changes in policy and more importantly in the legal and political structure that unleashes the creative powers of a free civilization as Hayek talks about in *The Constitution of Liberty*.

In recent years, perhaps nobody has documented this message of hope from economics better than Deirdre McCloskey in her Bourgeois trilogy. These are advanced texts, but the basic message is accessible to everyone. And, I would argue that as economic teachers, it is imperative that you communicate. Tyler Cowen in his recent Arrow Lecture asks whether Economic Growth is a Moral Imperative; he answers in the affirmative. It would be valuable to have your students watch this discussion.

Compassion

And, finally, economic teaching should stress how economic progress doesn't result in gains only for the wealthy, but lifts the least advantaged from their previous precarious situation through material betterment. As Milton Friedman used to say, all ships rise in a rising tide. But it goes deeper than this empirical observation.

Economics as a tool of social criticism—perhaps its second most important role—is a rational method for assessing alternative policies and even economic systems. The strict adherence to value freedom in the analysis means that the economist takes the ends of the advocate as given, and limits their critical analysis to the effectiveness of the chosen means by the advocate to the achievement of the stated ends of the advocate for the policy or system.

If the goal is to help the least advantaged get affordable housing, and the means chosen is rent control, then the economists examines the logic of choice, and the situational logic of that means/ends relationship. We study the structure of incentives and the flow of information embodied in those structures and the ability of the system to produce the desired results. This has been the economist's way from the classical political economists to the modern textbook economics.

The much maligned Econ 101 is actually couched in these terms for anyone who wants to read closely, rather than assume that economists are engaged in normative theorizing parading as positive analysis.

The great economists from Adam Smith to Vernon Smith were all passionately concerned with the status of the least advantaged among us. Economics teaches with great compassion about the less fortunate, and focuses energy on the institutional remedies that will open up opportunities and eradicate barriers.

As Lionel Robbins persuasively argued to my mind in *The Theory of Economic Policy*, the great British Classical Political Economists developed their theories in a manner that co-evolved with the development of British institutions of liberalism—private property, freedom of contract, rule of law. What must not be forgotten in all of this is that these liberal political economists, again reflected strongly in Hayek's *The Constitution of Liberty* as well as in various writings of James Buchanan, sought a system of government that exhibited neither discrimination nor domination. It is a system designed to eliminate privileges, and to recognize the rights of all as dignified equals before the law.

I honestly think that this message of economics—truth and light; beauty and awe; hope; and compassion—can excite the imagination of every generation to explore the intricacies of economic theory, and study in detail both the history of this fascinating discipline and the practical history of economies throughout the world.

We have to bring our students the truth and the light, but we also must instill in them a sense of beauty and awe at the complex coordination of the market, communicate the message of hope in our quest to improve the human condition, and speak to concerns and express our compassion for the least advantaged in our common cause of living in a society that grants freedom and dignity to all. As my colleague Virgil Storr (and Ginny Choi) establish in their recent book, *Does the Market Corrupt Our Morals?*, the answer is NO, it doesn't. In fact, commercial society provides the foundation for our moral learning and improvement in our social relationships with one another.

With the increasing attacks on Econ 101, it is time for a renewed commitment by teachers to communicating to this generation the best of what is to be learned from economics.

January 24, 2020

The Surreal Logic of Trump's Trade Deal

Max Gulker
Senior Research Fellow

President Donald Trump's tariffs-first trade policy against China has unequivocally harmed the majority of people and businesses in both countries since its inception just under two years ago.

There's the estimated $46 billion in new taxes directly paid by American businesses importing Chinese products, despite the president's Twitter admonitions that the Chinese were paying the bill. Factor in massive retaliatory tariffs from China, and the indirect effects of taking money out of businesses' and ultimately consumers' pockets and it's no wonder that even in the muddy waters of macroeconomics, most observers believe the trade war has significantly slowed the global economy.

What about the stated goal of keeping domestic industries healthy—the idea that gives protectionism its name? Before the president firmly trained his gaze across the Pacific, the American steel industry was supposed to be the marquee beneficiary of nascent policy. It never happened. After a promising first month or two, neither steel prices nor export volume rose.

Like the child repeatedly touching a hot stove, the lesson to the president that even his own brand of rough-and-tumble boardroom central planning wasn't the way to address deep structural issues should have been clear.

It wasn't.

As the administration ramped up tariffs on Chinese goods in the summer of 2018, the president along with his trade advisor and economic snake-oil salesman Peter Navarro retreated to the final hill they could plausibly defend. Of course tariffs were costing the American people, and perhaps they weren't saving jobs, but this was really a war of attrition designed to outlast and out-tough the Chinese into acquiescing to better IP protection and fewer subsidies to national-champion firms.

It's clear that the president's past as a boardroom brawler greatly impacted his identity and belief in his unique power to restore the nation to greatness—perhaps this was his plan all along.

Phase One of the U.S./China deal was announced January 15, and it doesn't look likely that any publishers are going to be knocking on the president's door for an epilogue to his 1980s corporate-alpha-male classic *The Art of the Deal*. To be fair, global financial markets did respond well to the news, though that only indicates just how damaging the last two years had been.

The truly strange aspect of the initial deal is the additional $200 billion in U.S. goods and services that the Chinese have *pledged* to buy over the course of two years, likely through private firms, state-owned firms, and the state itself. The money, spread in a detailed manner across U.S. industries, smacks of the president adopting the far more planned approach of his Chinese counterparts. That may be pragmatism designed to produce a deal more palatable to the Chinese, who eye-openingly sent their vice premier with a note from the head honcho to meet with Trump. But why after being rewarded for decades for being the opposite of pragmatic would he change now?

As Jeffrey Tucker has written, this president seems to have a strange fixation with trade surpluses and deficits, which most economists don't believe even matter. Assuming this is the president's logic, he's narrowed the deficit and can now begin interviewing sculptors for his spot on Mount Rushmore. But this is not a healthy export sector. A healthy export sector revolves around individual firms creating items for a low enough cost such that a consumer is willing to buy them.

Without that transfer of information inherent in a price system fueled by value creation, what's to say the U.S. has any idea what industries these purchases should come from, or how the Chinese government would order businesses of varying degrees of privatization to absorb the new purchases? Finally, after two years of U.S. capacity expansion necessary to meet this contrived demand, the agreement will be done, and U.S. manufacturing might be left right where it started or worse.

In fact, there are rumblings that the Chinese simply won't be able to make this level of purchases, as well as remarks regarding U.S. farm products from the Chinese vice premier that purchasing decisions would be made considering *market forces*. Suddenly this looks less like President Trump embracing central planning and more like a deal that's an absolute non-event.

The non-event aspect of this spectacle is underscored by the many outstanding questions left for later phases of the deal, such as the matter of Chinese IP piracy, which whether a major problem or not was frequently discussed in the run-up to the trade war. And then there are the tariffs themselves, the majority of which are still in place.

The president still has his leverage in place, the American people still have their higher tax bill, and we're all left wondering what on earth actually happened in the past few days and weeks.

It's often said that nobody wins a trade war, but the events of the past week lead us to a strange philosophical question. If the leader who almost single-handedly launched the trade war is never willing to concede defeat, and is able to remind crowd after crowd during this election year what a wonderful job he did of staring his Chinese counterparts down across the table, wasn't there one winner after all?

And wasn't that really the whole point from the beginning?

January 17, 2020

The Adverse Impact of Government Bureaucracy on Private Employment

Daniel J. Mitchell
Contributor

When I did this video *https://danieljmitchell.wordpress.com/2010/06/01/taxpayers-vs-bureaucrats-the-video-version/* about public-sector compensation almost 10 years ago, I focused on why it is unfair that bureaucrats get much higher levels of compensation than people working in the private sector.

Today, let's consider the economic consequences of excessive bureaucracy.

And what will make this column particularly interesting is that I'll be citing some research from economists at the International Monetary Fund (a bureaucracy which is definitely not an outpost of libertarian thinking).

The two authors, Alberto Behar and Junghwan Mok, investigated whether nations lowered unemployment rates by employing more bureaucrats.

The contribution of this paper is to investigate the effects of public hiring of workers on labor market outcomes, specifically unemployment and private employment. In particular, does public hiring increase ("crowd in") private employment or decrease ("crowd out") private employment? . . . It is arguably the case that a private-sector job is more desirable than a public-sector job from a public policy point of view. . . there is evidence that a large government share in economic activity can be negative for long-term growth because of the distortionary effects of taxation, inefficient government spending due in part to rent-seeking or lower worker productivity, and the crowding out of private investment. …Crowding out could occur through a number of channels. Derived labor demand can be affected through crowding out of the product market, possibly via higher taxes, higher interest rates, and competition from state-owned enterprises. It can occur through the labor market, where higher wages, more job security, or a higher probability of finding a public-sector job can make an individual more likely to seek or wait for public-sector employment rather than search for or accept a job in the private sector… Finally, it can occur in the education market, where individuals seek qualifications appropriate for entering the public sector rather than skills needed for productive employment.

As you can see, the authors sensibly consider both the direct and indirect effects of public employment.

Yes, hiring someone to be a bureaucrat obviously means that person is employed, but it also means that resources are being diverted to government.

And that imposes costs on the economy's productive sector.

So the real question is the net impact.

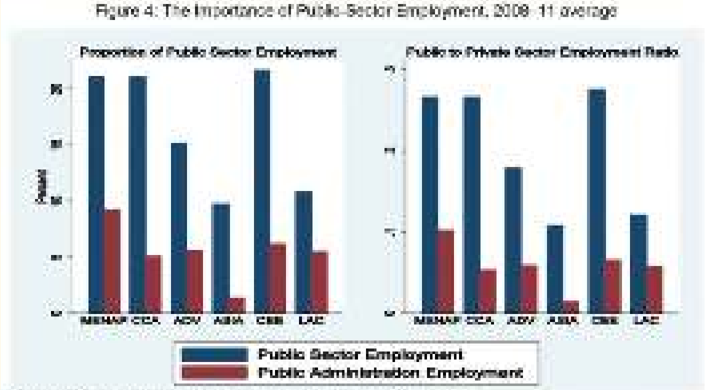
In their study for the IMF, the authors cite other academic research suggesting that government employment crowds out (i.e., reduces) private employment.

…there is prior evidence that crowding-out effects are sufficiently large to increase unemployment in a number of advanced countries. However, there has hitherto not been a thorough investigation of how public employment affects labor market outcomes in developing countries. We fill this gap in the literature by investigating the effects of public employment on both private employment and on unemployment. An important part of our contribution lies in the assembly of the dataset to expand the number of non-OECD countries… The most related and relevant work to this paper is by Algan et al. (2002), who explore the consequences of public-sector employment for labor market performance. Using pooled cross-section and annual time-series data for 17 OECD countries from 1960 to 2000, they run regressions of the unemployment rate and/or the private-sector employment rate on the public-sector employment rate. Empirical evidence from the employment equation suggests that the creation of 100 public jobs crowds out 150 private-sector jobs.

In the study, the authors look at two main measures of public sector employment.

And, as you can see in Figure 4, they look at data for nations in different regions.

Figure 4: The Importance of Public-Sector Employment, 2008–11 average



Sources: Country authorities; and International Labor Organization.

They wisely utilize the broader measure of public employment, which includes the people employed by state-owned enterprises.

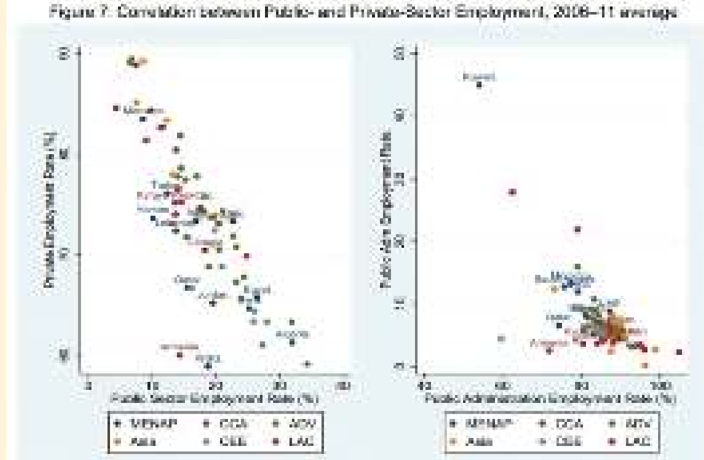
We have collected data for up to 194 countries over the period 1988–2011. . . .Our contribution to the literature includes the assembly of data on public and private employment and other indicators for a wide range of developing and advanced countries. . . . Definitions of "public sector" are different across countries and organizations, so we choose two definitions and generate corresponding public employment datasets, namely a "narrow" measure also referred to as "public administration" and a "broad" measure. …This dataset includes not only governmental agencies but also state-owned enterprises (SOEs). We call this the 'broad' measure of public employment, preserving the term 'public sector'.

In Figure 7, they use a scatter diagram to show some of the data.

The diagram on the left is most relevant since it shows that private employment (vertical axis) declines as government jobs (horizontal axis) increase.

And when they do the statistical analysis, we get confirmation that government jobs displace employment in the economy's productive sector.

Figure 7: Correlation between Public- and Private-Sector Employment, 2008–11 average



Sources: Country authorities; and International Labor Organization.

. . . all coefficients indicate a very strong negative relationship between public- and private-sector employment rates. For example, 100 new public jobs crowd out 98 private jobs. . . Taken together with the unemployment results, public employment just about fully crowds out private-sector employment regardless of the definition, such that a rise in government hiring would be offset by decreases in private employment. . . Regressions of unemployment on public employment and of private employment on public employment, each of which is based on two definitions of public employment, find robust evidence that public employment crowds out private employment. . . Public-sector hiring: (i) does not reduce unemployment, (ii) increases the fiscal burden, and (iii) inhibits long-term growth through reductions in private-sector employment. Together, this would imply that public hiring is detrimental to long term fiscal sustainability.

The final part of the above excerpt is critical.

In addition to not increasing overall employment, government jobs also increase the fiscal burden of government and undermine long-run growth.

So the long-term damage is even greater than the short-run damage.

P.S. The IMF isn't the only international bureaucracy to conclude that government employment is bad for overall prosperity. A few years ago, I shared research from the European Central Bank which also showed negative macroeconomic consequences from costly bureaucracy.

P.P.S. While I'm usually critical of the IMF because it has a statist policy agenda, it's not uncommon for the professional economists who work there to produce good research. In the past, I've highlighted some very good IMF studies on topics such as spending caps, the size of government, taxes and business vitality, fiscal decentralization, the Laffer Curve, and class-warfare taxation.

January 21, 2020

The Soviet Economy Was Not Growing; It Was Dying

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For much of the twentieth century, leading figures of the American academy looked upon the Soviet Union's economic performance with what may be legitimately described as a sense of credulous envy. Although the Soviet economy was smaller than the United States', the Soviets' official numbers consistently projected a growth rate that would soon overtake their Cold War rival's and, in doing so, validate the claimed inevitability of the socialist economic system on which it was built. Even as American economists rejected the Marxist philosophy behind Soviet planning, they settled into a curious postwar habit of disseminating economic projections that depicted the Soviet economy overtaking the United States in the near future.

Beginning with the 1961 edition of his bestselling economics textbook, Paul Samuelson included a graphic displaying the comparative growth rates of the American and Soviet economies. Per this forecast, the Soviet gross national product would overtake the United States at some point between twenty-three and thirty-six years in the future. Curiously, by the 1980 edition of the textbook this same graph had shifted forward by two decades so that the point of projected intersection would still take place between twenty-two and thirty-two years in the future. Similar claims appeared in competing textbooks from the time and generally transferred over into the specialist literature on the Soviet economy as well.[1]

At the midcentury mark, economist G. Warren Nutter (1923–79) provided one of the lone dissenting voices to challenge what had become a matter of conventional wisdom among Sovietologists. Whereas others perceived vibrancy and vitality in the socialist society's industrial growth, Nutter recognized its long-term economic decline concealed behind a politically crafted veneer of propaganda about socialist industrial prowess.

From 1956 onward, he labored on providing a statistical corrective that painted a picture of a society gradually succumbing to the weight of its own central planning and the wasteful accretions of a graft-riddled and politically repressive bureaucracy.[2] The early reception of Nutter's work expressed doubt about its accuracy compared to more optimistic portrayals from the textbooks and accompanying Sovietology literature, yet history proved him right. Nutter had scooped the field and accurately identified an economy with deep structural problems—most of them directly traceable to its destruction of a functional price mechanism through the tools of state management.

Nutter's assessment was no abstraction, but rather the result of years of close study of the relationship between state policy and industrial concentration in the United States—the subject of his dissertation at the University of Chicago. But he also possessed an uncommonly keen eye for extracting observations from his surroundings. He deployed the latter during a twenty-eight-day visit to the Soviet Union in 1956 as a self-described *tourist* researcher, which he contrasted with other American experts whose longer visits occurred under the heavy scrutiny and management of handlers from the Soviet government. [3]

Whereas others largely picked up on what the Soviets wanted them to see and incorporated curated factory tours and contrived statistical claims into their assessments, Nutter apparently had a knack for looking beneath the surface through everyday observations of his surroundings—simply by keeping an eye on the types of goods in the shop window, the patterns of workers entering the factory in the background, and the way that the people he encountered described even the most mundane economic transactions of their daily lives.[4]

He had no formal training in Russian and does not appear to have claimed fluency, describing his tour as having taken place *under the severe handicap of not knowing the language*.[5] Yet Nutter was also something of a linguistic autodidact—an ability he realized in the US Army during the liberation of Europe a little over a decade prior. In reading his travelogue, one gathers that he may have gleaned more from observing the surrounding conversations than he let on—more than, importantly, his Soviet guides realized at the time.

Born in Topeka, Kansas, to a Jewish mother who was widowed around the time of his birth, Nutter grew up in tight economic circumstances. His small family migrated around the Depression-era rural Midwest in search of stable income, eventually settling in Iowa. A promising student, he received a break to attend the University of Chicago, where he came under the mentorship of the economist Henry Simons as an undergraduate.

Nutter's wartime service took him to the front lines of the European theater. He fought in the infantry during the invasion of Germany, directly witnessing the horrifying revelations that came with the liberation of the Nazi concentration camps. He returned to Chicago after the war with the intention of completing his graduate studies under Simons, but the latter's untimely death and an existing acquaintance with law professor Aaron Director brought him under the guidance of a newly hired economics professor by the name of Milton Friedman. Graduating in 1949, he became Friedman's first doctoral student to enter into academic life. After a brief stint on the economics faculty at Yale, he eventually settled at the University of Virginia, where he cofounded the Thomas Jefferson Center for the Study of Political Economy with his old Chicago classmate James M. Buchanan.

The dissolution of the Soviet Union, membership in a star-studded faculty that included two future Nobel Prize winners (Buchanan and Ronald Coase), and an untimely death from cancer in 1979 have somewhat overshadowed Nutter's own substantial resume as a scholar. Curiously, as we mark thirty years since the fall of the Berlin Wall, political calls for socialism have regained fashionability on the far left. Rehabilitated by academics and activists who present themselves as *democratic* expositors of centralized planning, practitioners of the modern euphemized version are all too eager to dissociate their brand from its notorious and deadly twentieth-century iterations.

Thus the recent anniversary of Karl Marx's two-hundredth birthday was met with an outpouring of editorials and academic commentaries celebrating the claimed relevance of the discredited philosopher's theories for *solving* income inequality, climate change, and a slew of similar progressive political causes in the present day. The human toll imposed by his followers received comparatively little attention, as did the connection between this recurring pattern and the socialist philosophy that undergirds it.

Yet this year marks another anniversary that may, in part, provide a needed intellectual corrective to the misguided fancies of the ongoing socialist rehabilitation. Whereas Nutter's earlier work on the Soviet Union consisted of detailed industrial analysis and number crunching suited for academic discussions among economists, in 1969 he turned his attention to the more practical matter of daily life under a socialist system of government.

The result was *The Strange World of Ivan Ivanov*, a short yet hard-hitting indictment of the economic and political repression that so often follows from attempts to structure a society around Marxist ideology and centralized economic planning.

Nutter began his work on *Ivan Ivanov* in 1967 as part of a debate with the Marxist historian Herbert Aptheker at the University of Western Ontario. As was a common theme at the time, Aptheker enlisted the history of racial segregation in the United States to build a sweeping indictment of *capitalism* as an economic system, including assigning it blame for inculcating racial and other forms of discrimination. Nutter's rejoinder *I Choose Capitalism* is published here as an accompanying text to the book for the first time.

The counterargument did not shy from confronting the problem of racism in the United States. Yet as Nutter explained, discrimination appeared to be a persistent curse of the human condition. Far from solving this problem, the socialist approach of the Soviets had actually systematized it into the instruments of the state.

Noting that state action carries with it a far greater degree of coercive power, Nutter reframed the question of discrimination by asking his audience to judge a society on whether it availed the individual of a means to escape the very same instruments. In the Soviet Union, state policy had become a means of carrying out anti-Semitic and other ethnic persecutions under the guise of economic redistribution, property appropriation, and even genocidal persecutions and famines. Though Nutter avoided implicating his opponent by name, Aptheker himself had weathered the Stalin years as something of an apologist for the Soviet state's most notorious atrocities.

The cheerful depictions of life under socialism that the Marxist intellectual presented amounted to a political sleight of hand. They entailed a false comparison between an idealized form of egalitarian socioeconomic organization, as proposed on the far left but never realized, and the observed faults of Western capitalism as it existed. Aptheker was comparing a constructed socialist fantasy to a disliked capitalist reality and declaring that fantasy the victor on account of its unrealized promises. Yet as Nutter stressed, the reality of life under socialism often reduced society to abject impoverishment and immiseration.

Far from being *solved* by socialism's promises, discrimination on ethnic and religious lines, along with deeply inegalitarian political distributions of resources and power, were endemic features of the Soviet system. Even as these features also manifested in the West through private and state-sanctioned discrimination, capitalism itself was an escape mechanism to the very same problems that the Soviet state, through its absolute and uncontested control of social life, denied. A socialist economy is inescapably dependent upon political mechanisms to allocate scarce resources, whereas a capitalist society offers an escape from politics through voluntary market exchange.

Shortly after the debate, Nutter shared a written transcript of his comments with William F. Buckley, indicating he would likely *toss them in the wastebasket* if the conservative editor of *National Review* could find no use for them.[6] Nutter's papers contain few clues as to why he changed his heart, but within a year's time he had expanded the transcript into a series of lectures on how the Soviet government treated its ordinary citizens. He delivered one version the following year at a conference for the American Bar Association.[7] At some point shortly thereafter, David Appel, a features editor at the *Philadelphia Inquirer*, approached the economist about developing the lectures into a multipart series on daily life in the Soviet Union. Nutter composed ten articles for the paper, drawing on the previous two decades of his research and developing its implications for Ivan Ivanov, a generic Soviet counterpart to the American John Doe. After the series ran in March 1968, he compiled its contents and edited them into the present manuscript.

The book's publication came shortly after Nutter accepted an appointment as assistant secretary for international security affairs in the Department of Defense. In part, the government appointment proved to be his own exit strategy from a devolving political climate at the University of Virginia. A few years prior, an increasingly hostile university administration began the systematic dismantling of the economics department after faculty in other departments deemed it overly *conservative*. Coase had been chased away to the University of Chicago by a hostile dean who denigrated his academic work and impeded his promotion through the department. Buchanan left in protest the previous year after the university blocked the promotion of their widely published colleague Gordon Tullock. Nutter simply took a leave from his academic post and would return to the department after his service concluded, although the department was only a shadow of its most vibrant years in the late 1950s and early 1960s.

In a sense, *Ivan Ivanov* provided something of a final capstone for the broader scholarly project that emerged from the Thomas Jefferson Center during its heyday. In addition to the aforementioned faculty affiliates, this unique academic convergence had cultivated a generation of new scholars steeped in price theory, birthed the public choice subfield, and produced dozens of seminal works on economic theory and its political dimensions—Nutter's empirical analysis of the Soviet economy among them.

Though generally well-received in the Cold War environment of its publication, *Ivan Ivanov*, unfortunately, drifted from memory along with its own Soviet subject matter. In this new edition, we aim to make this text accessible again—both as a record of the daily personal hardships experienced under an actual Marxian-socialist state and a warning for a time when socialism's reputation has become detached from its own track record. The poverty, fear, and coerced subordination of Ivan Ivanov's life were not aberrations of a socialist revolution gone astray—they were the entirely predictable results of that same socialist system. And as its human toll stretches from the Eastern Bloc to China to Cuba to Venezuela, they continue to repeat with alarming certainty whenever and wherever socialism is attempted.

January 10, 2020

[1] *Levy, David M., and Peart, Sandra J. "Soviet growth and American textbooks: An endogenous past." Journal of Economic Behavior & Organization 78.1-2 (2011): 110-125.*

[2] *Nutter, G. Warren. "Some observations on Soviet industrial growth." The American Economic Review 47.2 (1957): 618-630; Nutter, G. Warren, Israel Borenstein, and Adam Kaufman. "Growth of industrial production in the Soviet Union." NBER Books (1962).*

[3] *Levy, David M., and Peart, Sandra J. "G. Warren Nutter's "Traveler's tale of the Soviet economy": A witness to the actual world." The Review of Austrian Economics 28.4 (2015): 397-404.*

[4] Ibid

[5] *Nutter, G. Warren. "A Traveler's Tale of the Soviet Economy." September 1956. Manuscript located at the Dwight D. Eisenhower Presidential library. Acknowledgement and thanks to David M. Levy, who provided me with a copy.*

[6] *Nutter to Buckley, May 3, 1967. William F. Buckley Papers, Yale University.*

[7] *Nutter, G. Warren. 1969. "Economic Aspects of Freedom," in Liberty under Law, Anarchy, Totalitarianism. American Bar Association, Standing Committee on Education About Communism.*

If Libertarianism Hollowed Out, Why?

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Editorial Director

It's always an iffy proposition to characterize the public status of a movement, but economist Tyler Cowen is used to making bold moves. In this now-famous statement, he characterizes libertarianism as hollowed out.

Here is his take.

Having tracked the libertarian "movement" for much of my life, I believe it is now pretty much hollowed out, at least in terms of flow. One branch split off into Ron Paul-ism and less savory alt right directions, and another, more establishment branch remains out there in force but not really commanding new adherents. For one thing, it doesn't seem that old-style libertarianism can solve or even very well address a number of major problems, most significantly climate change. For another, smart people are on the internet, and the internet seems to encourage synthetic and eclectic views, at least among the smart and curious. Unlike the mass culture of the 1970s, it does not tend to breed "capital L Libertarianism." On top of all that, the out-migration from narrowly libertarian views has been severe, most of all from educated women.

My first reaction is to fight back and refute. There are some contrary data points, and what he characterizes as hollowing out might actually be a sign of maturation and mainstreaming. Who, for example, generally trusts government to do the right thing? About 1 in 10 of us. That's a huge difference from decades ago. Politically, the Democrats have failed to gain much traction from attacks on markets and Republican calls for more protectionism are always failing to resonate.

As for eclecticism, that's an inevitable aspect of public opinion but the general theme of distrust of government pervades nearly all groups. That's a hugely significant trend, one that undergirds the reality that libertarian impulses are more alive than ever, not only in the U.S. but also around the rest of the developed world. Look at the protests around the world against governments left, right, and center. It's a growing revolt that knows no bounds.

That said, there is truth in what he says about a shift in organized libertarianism, at least as regards the delusion that there was somehow building a nationwide movement made up around libertarian postulates embodied in online memes.

The data-point decline in organized libertarianism (talk about an oxymoron) since the early part of the last decade has been precipitous. Ten years ago, conferences were packed, huge venues were filling up to hear Ron Paul denounce government and the Fed, money was flowing to new libertarian nonprofits, activist organizations, and podcasts were starting by the day. YouTube accounts of indy producers were booming. Big media was paying attention. I even began a new venture designed entirely to facilitate libertarian publishing and discussion.

Even at the time, I suspected that it was a bubble. It was as early as 2008 when I first saw a YouTube of some rally of political activists claiming to be libertarian. The message was all about taking the red pill, screamed from podiums. The ethos was populist anger—a purely negative message about who we hate and why. There was something about the aesthetic that bugged me: the rationality, calm, and social feeling that Ludwig von Mises said must characterize the liberal movement was all but absent. It didn't feel right. I was glad not to be part of it. But I wondered what this hot mess would become over time, after their savior failed to gain power.

A few years later, I recall going to events and talking to people just casually and periodically being shocked at the views told to me in passing. Mostly I encountered extreme rightist thought that could at best be characterized as illiberal, the stuff you can see today at 4chan and 8chan. And I wondered, why do these people assume that I could share their views in this otherwise libertarian environment? Outside my own purview, there was another push in the lefty direction, toward a more welfarist/warfarist rendering of libertarian thought.

After a while, I came to a new realization of the malleability of words, particularly in a political context. There seemed to be many things sailing under the label libertarian. My libertarianism I believed to be the embrace of peace and prosperity through universal human emancipation via the disempowerment of statism at all levels of society, with the purpose of enabling human flourishing.

But there was another view becoming entrenched: libertarianism is nothing more than a demand that the ruling state establishment die the death because it is preventing some people from having the kind of power they want. The power to do what? Maybe you don't want to know.

The movement I recall from that period was becoming brutal and entirely too tolerant of hoary and ill-educated belligerence from speakers' platforms and podcasts. The message seemed to be that if you were mad enough about something, you were a libertarian. And this much I saw coming and predicated: After their guy did not become president (it's amazing anyone believed it was possible), they moved on to other things. They were still political but things got weird really fast.

From that point to the present, the change has been dramatic. In every area, the decline is obvious. Conferences are a fraction as big, and they are reaching out ever less. The ones that survive have moved on past economic education and rational discussion toward far-flung concerns over eccentric lifestyles, parenting, eccentric conspiracy theories, and various spiritual longings. Alienation and personal redemption became the theme. To be sure, all of these longings are consistent with the idea of liberty; however, they do not embody the whole of it. Audiences seemed ever more bored by mundane concerns about trade and tax policy, economic logic, or the history of ideas.

Ten years after the heights of libertarian activism, we see a very different world. What had been built on ebullient political longings was clearly unsustainable. I knew it at the time. There were three general problems that had developed at the time.

First, political campaigns, whether they intend it or not, even if the candidate is completely earnest, invariably seem to promise a magic bullet to realize one's aspirations. Want liberty? Just vote for this white knight, he'll get power, use the executive office, and make the world a better place. No need for slow cultural change through influence or education. No need for the gradualist approach. It's too late for that. We need executive action now to beat back the enemies of what I believe.

Political campaigns can't raise money usually without leading people to believe there is a prospect for success. That's understandable but it creates a bad habit of mind, the expectation that one's hopes for life are best realized through screaming, giving money, agitating, and voting. It's a matter of outsourcing your ideology to an agent of power. When it doesn't work, what's next? Often, it is despair and nihilism stemming from anger that your hopes didn't pan out. It was for the reason that I fully expected that an ideological recession or depression for libertarians would be next.

Second, another feature of politics is its reductionist character. That doesn't really work well for the slow task of restraining the state in every way possible. Libertarianism is not a slogan or a meme or a handful of chants screamed by mobs. It is not even a worldview much less a religion or a tribal creed. It is an intellectual conviction that society, and especially in its commercial realm can manage itself better without overarching authoritarian structures. Therefore it believes in diversity, religious liberty, human rights, cooperation over violence, justice, innovation, and universal freedom.

Third, the movement lost touch with its history, if the activists even knew there was one. The postwar roots of the term libertarian are indisputable: it was a synonym for a word that had been stolen from that generation by the New Dealers. That word was liberalism; libertarianism as a term was a regrettable substitute, or so believed the 1950s-era architects of the term. Liberalism has a 500-year history that built a gradual conviction that society was best left alone to manage itself without kings, princes, popes, and presidents planning the way society should look. It became a generalized preference for freedom over power, peace over violence, private ownership over collective action, and individual human rights over tribal identity.

Establishing liberalism as an idea in action—which required extreme limits on state power—was exceedingly difficult to bring about. Reestablishing liberty after a century of statism is also very hard work, not only politically speaking but intellectually speaking. There is no fast-tracking either the education part or the realization part.

The result of this quick-fix reductionism and historical amnesia amounted to shaving off much of the depth and complications of libertarian theory: its roots, its past achievements, its social aesthetic, its universal applicability, its philosophical richness, and its multifarious implications for an operational liberty in real life. Instead what we got was simple, tweetable slogans that were barren of historical and philosophical understanding. The moment that a person's newfound ideology bumps into intellectual or political barriers, there is a tendency to bail and find something else more enticing.

This is precisely what happened. That required those of us who have been involved much longer to dig in, soldier on, work harder, and find new ways to be part of the conversation. However, we had to do it without mobs of paying customers and screaming partisans. I consider this a good thing. It seems to me that we are back on track, without the distractions of short-term thinking and the toxic environment of political campaigns to distract us.

None of this I would call hollowing out. I would call it the failure of a paradigm whose demise was baked into the strategy. What is replacing it is a more serious effort devoted to historical, philosophical, theoretical, and practical work at all levels. In a sense, this is all to the good. This work is necessary to keep the traditional liberal agenda from veering right and left for purposes of political or strategic expediency. Our guides now are what they have always been, the millions of brilliant thoughts and ideas of the masters (John Locke, Adam Smith, Thomas Paine, Frederic Bastiat, Ludwig von Mises, F.A. Hayek, among thousands of great thinkers) as well as the sweep of history that proves again and again that liberty works better than state control. This is the liberal tradition; there is no substitute for learning it and living it.

Some people date the decline and fall of sloganized libertarianism to events following the end of the Cold War, when some libertarians, I among them, imagined that they could form a coalition with aspects of the American conservative movement. It was not an entirely implausible plan at the time. The warfarism of the American right was bound up with anti-Sovietism from 1948 onward; perhaps this would die out and make way for a more consistent anti-statism in the new times. It seemed promising at first. This idea, however, gradually morphed in a few years into something different, mainly because the conservatives (the *paleoconservatives*) with whom the libertarians linked up were themselves against market economics. As much as they hated welfare and warfare, they had no affection for modernity or appreciation for commercial society—or even much affection for the idea of individualism and human rights.

Gradually, over the course of a few years, the direction of influence shifted from the libertarians bringing the conservatives around to a pro-market position to the reverse. It was a strange thing to watch taking place. The effort began in 1990; five years later, the promise had turned to dust. Murray Rothbard himself had lost interest in the idea by the time he died in 1995. But ideas have an amazing life that extends far beyond their promoters' intentions. Twenty years hence, the *paleo coalition* had morphed again into apologias for what became a rightist form of collectivism and too great a tolerance for populist agitation, culminating of course in nationalism, authoritarianism, and worse.

That entire history is enormously confusing and complex to unravel but the lesson should be clear. There is never advantage to be gained by attempting to game the ideological debate through compromises, odd coalitions, political expediency, and gnostic strategies of influence peddling. In the past, liberalism won the day through arguments made with integrity, truth, conviction, research, patience, and the boldness to say what is true—plus the humility to admit that no ideological package has everything precisely right. Any other path proves unsustainable over time.

There is nothing hollow about the idea that people should be free, that people should expect to live good lives without having their volition and property invaded by public officials who know much less about real life than the people actually living it. It is for this reason that society should be left alone to take its own course of evolution. This is the path to peace, prosperity, and progress. This is the real libertarian position. It's a broad conviction that has more presence in today's world than any point in the last century.

Becoming a libertarian doesn't mean leaving your humanity behind; on the contrary, it means embracing it fully and believing that the potential of a free life on earth is far from fully realized.

January 8, 2020

State Capacity, Economic Growth, and Reverse Causality?

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A few days ago, Tyler Cowen sparked a debate on *state capacity* and classical liberalism. Simply put, Cowen contends that state capacity (broadly, the government's ability to accomplish its intended policy goals) is not inimical to liberty and development. In essence, a strong state can protect property rights and provide important public goods, which may support and even extend markets, so long as it is appropriately constrained. Thus, a strong and capable state promotes liberty and economic growth simultaneously.

Many have jumped to criticize Cowen for his proposition that libertarians should embrace what he terms *state capacity libertarianism*. Without engaging on the issue of ideology, we believe that there is a crucial nuance missing from the discussion of state capacity. Cowen points out *rapid increases in state capacity can be very dangerous (earlier Japan, Germany), but high levels of state capacity are not inherently tyrannical.* Cowen also points that this capacity, when constrained, is beneficial to growth. Implicit in both statements is that the relationship goes from *increases in constrained state capacity* to *greater development*.

In a forthcoming article in the *Journal of Economic Behaviour & Organization*, this is exactly what we contest. If anything, the relationship runs backward—greater development invites greater state capacity.

Why question the relationship between state capacity and generalized prosperity? To start, the concept itself does not make sense as a social-scientific mechanism. It is difficult to see how state capacity, as used by Cowen and others, could be a causal explanation of growth. When we assess national well-being, whether in the form of high living standards or some other welfare metric, we must answer two questions: what *incentives* did agents on the ground have to promote those outcomes?

And from where did they get the *information* that enabled them to do so? These are inherently institutional questions, but those questions cannot be answered with recourse to mere institutional structure. State capacity may be a useful concept in economic history, but in terms of its explanatory capability, it is little more than institutional morphology.

Pointing out that governance institutions became centralized and hierarchical cannot explain why those governance institutions were used to *good* ends. To explain the role of states in e.g. fostering economic development, we need to invoke *something else* to explain why political elites in control of the state found it incentive- and information-compatible to promote the general welfare, rather than their own welfare narrowly. This *something else* has to be a deeper institutional property than state capacity.

But while it doesn't make much sense to claim state capacity causes development, it makes much more sense to claim development causes state capacity. There are many poor countries whose governments have limited capacities and many rich countries with strong capacities. Countries in those categories easily come to mind. We can also come up with countries with strong capacities and low development, such as the USSR and Cuba. However, no one can come up with examples of rich countries with weak states. Why? There are many historical cases of weak states. They are often cited in the literature on the economics of anarchy and statelessness. They rarely persist for any extended length of time. They tend to meet their end either in conquest and subjugation or they build up strong states to resist conquest and subjugation.

The fact that we fail to see such examples of anarchy survive is highly informative of the direction of causality. A rich country with a weak state invites the predation from other countries. The inability to defend a certain stock of appropriable wealth is a lure for the rulers to subjugate the weak-state-capacity country. The weak state-capacity country has two choices. The first is to be conquered and absorbed by the strong-state-capacity country. The second is to invest in state capacity (i.e. a centralized-hierarchical fiscal bureaucracy that can harness resources for the purposes of producing national defense and/or others).

Either way, the *weak-state capacity* scenario has to end. It is an unstable equilibrium. It is unstable because growth generates an externality in the form of heightened attention from potential predators. In fact, as soon as there is a coherently organized state, it is hard to imagine how rich societies with more decentralized governance institutions could survive. As such, state capacity is not causing growth. It is a product of growth.

In terms of empirical research, this argument for reverse causality is rife with implications.

The first implication is that empirical studies of state capacity and its impact on growth suffer from selection bias. Only the societies that successfully built up state capacity end up in the sample of countries' national economic performance. Those that failed simply disappeared or were absorbed. This means that to assess the effects of state capacity on growth, a better empirical approach would be to find a *low-state-capacity/high development* society that was absorbed into a *high-state-capacity* one and create a counterfactual. That counterfactual, which could be constructed with econometric methods like differences-in-differences or synthetic control, would tell us how much better or worse off that country would have been had it remained *low-state capacity*.

The second implication is more important. The whole state capacity literature starts from a clear, and undebatable, claim: that rulers build up state capacity because (and when) it is in their interest. Rulers have an *encompassing interest* in productivity. Thus, strong states promote economic growth by protecting property rights, resolving legal disputes, enforcing contracts, eliminating internal trade barriers, prosecuting crime, regulating weights and measures, and providing transportation infrastructure and public education.

However, if the capacity is built to plunder or resist plunder, then any positive outcome on growth is an accident and not the intent of rulers. Thus, we are still left with an important question unanswered: what institutions are amenable to human development? In this light, the state capacity literature only provides us with answers as to why certain states are better than others. It doesn't do much to tell us what kind of governance is best.

We are not necessarily hostile to the views advanced by Tyler Cowen. In fact, we are quite amenable to them. We heartily endorse, for example, the call to focus not just on smaller government, but effective government. The problem is that, from a research perspective, there are important reasons to keep off the state capacity bandwagon, even if doing so would be ideologically congenial.

January 14, 2020

The Academic Truce Has Crumbled

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In the late 1960s academia, and particularly the humanities, began to embrace a variety of political causes and incorporate them more overtly into their scholarship. This shift coincided with curricular and intellectual developments that re-envisioned the educator as an activist and tasked him with the pursuit of normative scholarship, typically in service of progressive causes or the ubiquitous concept of *social justice*.

While such emphases fell within the traditional protections and safeguards of academic freedom, they also provoked an intense backlash from conservatives who questioned the propriety of using publicly financed and operated institutions to advance radical political activism.

At its peak in the late 1960s, contentious events such as the firing of communist philosopher Angela Davis from UCLA under the pressure of then-governor Ronald Reagan suggested an imminent collision between faculty political beliefs and the public source of their finances, which were ultimately susceptible to public oversight.

Davis, who possessed only a slim body of scholarly work but was well known for radical Marxist activism, was fired, reinstated, and fired a second time by the university's board of regents over speech that primarily arose from her political agitation.

For its own part, the political left in the academy responded to the conservatives' backlash by rallying behind academic freedom and free speech. UCLA received numerous public censures for insufficiently safeguarding the academic freedom of a faculty member.

Interestingly, both contestants had intellectually consistent and defensible claims behind their positions—up to a point.

Academic freedom is a bulwark of unimpeded inquiry among faculty, yet as institutions drawing public support, universities also operate under the legitimate purview of public scrutiny and must exercise stewardship over the funds they receive.

We may see this tension in place by way of a thought experiment, using an extreme example. Suppose a specific department at a public university began offering a curriculum that espoused a noxious and discredited viewpoint such as eugenic racial theory, or Holocaust denial, and suppose the faculty members who designed it invoked the protections of academic freedom to pursue this viewpoint, even as it elicited a deserved condemnation from students, other scholars, and the public in general.

Depending on the circumstances, tenure might protect the continued employment of the culprit faculty. But would a state legislature be obliged to fund this program with public resources, knowing that it catered primarily to bigots and hate groups?

How about a somewhat related case where a biology department or medical school began spreading pseudoscientific misinformation that carried tangible threats to public health. Anti-vaccination conspiracy theories come to mind. Would the public be obliged to continue financing this program, knowing that it was instructing students with false information that exposed innocent people to dangerous diseases?

Both hypothetical episodes would necessarily invoke the question of the university's uses of tax dollars, in addition to the concerning content provided in their respective courses. Protections for faculty speech and the constraints of tenure may limit what a university could do in terms of the employment contracts of the individuals involved.

At the same time though, a tax dollar-funded university—as a steward of public resources—would appear to have both a cause and a reasonable expectation to pull the plug on these particular offerings.

Most collisions between problematic content and the public nature of university finance are not as clear cut, and yet it is the murkier cases that test the reach of this tension. Economist James M. Buchanan explained as much in a little-studied essay on the public finance of higher education, written some four decades ago in the wake of the 1960s controversies.

Universities, Buchanan noted, turned heavily toward a public finance model of operation in the mid-20th century that persists to the present day. Wherever one might stand on the optimal level and extent of public funding for higher education, it cannot be denied that their extension invites public oversight into the many uses of the same appropriations—including asking the question of whether a university's offerings are serving public priorities as expressed through democratically elected bodies.

Indeed, a major premise of publicly funded universities arises from their expected future returns to positive scientific knowledge, innovation, and general education. These scientific and social contributions ostensibly benefit society at large through both tangible advances in knowledge and a more learned populace—or so it is claimed.

Yet as Buchanan notes, these promises become murkier as the university's offerings shift away from the hard sciences and into the liberal arts and humanities, where knowledge-generation and instruction often takes on deeply normative characteristics. In the areas where activist scholarship has taken root, he continues, it is not uncommon for faculty to behave as though the taxpaying public has *some sacred obligation to throw increasing amounts of revenues over the universities' ivied walls without so much as a right to inquire what went on behind those walls.*

If left unattended, Buchanan anticipated an *emergent clash between 'academic freedom,' as this is defined by scholars behind the ivied walls, and 'public finance'* of their institutions. If taken to its conclusion, the public legitimately might decide that tax-supported universities *are not fulfilling the objectives for which they are presumably funded* and vote to withdraw funding.

As a result of forcing the question, only two real options emerge. Universities could choose to forgo further public support, allowing *the precepts of academic freedom to be strictly observed* free from any expectation of a return on their previous stewardship of such funds. This would obviously yield a much smaller and less-well-funded university system, but one free from any obligations to voter expectations, whether we deem those expectations warranted or not. Alternatively, the academy could admit that greater public oversight is an unavoidable tradeoff of taking public appropriations.

Buchanan did not endorse either position, save to note that they were the logical ends of the tension between academic freedom and public finance if the two competing aims continued to be pressed against each other.

We are fortunate that the university funding and content disputes of the late 1960s deescalated over the next few decades. The paths they followed were not without fault and exceptions pitting the two objectives against each other continued to plague the debate, but in the 1970s and 1980s the tension largely gave way to something of an informal truce between its main political contestants.

The academic left acknowledged that the unimpeded content freedom it desired for itself also applied to the minority of faculty hailing from other perspectives, including conservatives and libertarians. And the political right largely backed off the strategy of pressuring trustees to rein in the activist excesses of their institutions and curriculum, lest universities face stricter oversight tied to appropriations. The university system settled into a relatively stable distribution of political content. A clear plurality of the faculty leaned left, to be sure, and openly identified as such in surveys. But faculty from the center and right sides of the spectrum also carved out stable minority stakes in most disciplines.

There are many signs today, however, that the truce is crumbling.

Right-leaning faculty (and libertarians are usually lumped into this category for counting, despite its imperfect description) have all but disappeared from the faculty ranks, dwindling to a mere 12% in the latest surveys. Faculty on the left now constitute a clear majority of some 60% of the university system, and much of this growth was driven by an explosion of professors who identify on the far left. The entirety of this observed shift took place after the early 2000s.

It is more difficult to measure the parallel degradation of the political climate on campus, a subject that will have to wait for another day. But suffice it to say that observations to this effect have intensified in the last few years.

Many faculty on the far left no longer extend the academic freedom norms of a few decades ago to their dwindling counterparts on the right, or really any other part of the political spectrum. They impose ideological litmus tests on new faculty hiring, with significant shares of faculty in several disciplines openly admitting to discriminating against candidates with non-left perspectives. They engage in petition campaigns to have disfavored articles withdrawn from publication. Faculty with disliked and minority political perspectives are impeded from hiring and promotion at elite institutions, even when they have comparable or stronger credentials and research records than their counterparts on the left.

Students with non-left political beliefs routinely report feeling pressures to censor their own beliefs on campus. And far-left faculty now routinely launch political crusades against disliked funding sources, aiming to block or control their non-leftist colleagues from even accessing money that is necessary to conduct research, support programs, attract students, or hire new faculty to their departments. Instead, conservatives, libertarians, and really any faculty who hail from outside perspectives are often depicted as intruders on the academic domain who got there through *illegitimate* means and must be blocked or purged from academic life. The paranoid style has come full circle and taken refuge in the illiberal corners of the academic far-left.

Part of this purge mentality is also a response to the glutted academic job market in these same fields, which breeds a way of thinking about faculty jobs as a zero-sum game: if new faculty jobs are scarce relative to the number of job seekers, then we—as humanities faculty of the left—must proactively ensure that they all go to our fellow ideological travelers first.

In short, a growing subset of the academic left has effectively replaced traditional viewpoint liberalism—a perspective that valued free exchange and a diversity of perspectives, even as it maintained its own pluralities—with an echo chamber of hardline progressivism and the academically fashionable realm of Critical Theory.

Not to be outdone, the political right in the United States appears to be responding by turning against higher education itself. Its motives and causes vary, including a growing perception of bias against or persecution of non-left voices on campus. Some of this agitation has taken on a conspiratorial flavor, whereas other dimensions do seem to be grounded in empirical realities. But its cumulative effect is a resumption of pressures to take a closer look at the university's purse strings.

So far this process has amounted to more talk than action, but we recently saw signs of it at the University of Alaska, which drastically cut back on its funding and degree offerings (although political compromise later softened their severity). Other proposals aim to tie funding restrictions to on-campus free speech policies, or to steer more students into STEM programs, which tend to exhibit a greater political balance among their faculty—or steer away from political content and activism as primary features of their instruction.

It is not my aim to endorse or oppose any of these propositions. Some faculty on the left have responded to them in furious rage, whereas an alarming number of conservative populists seem to relish in dismantling university funding even if done haphazardly and for reasons of ideological retribution. Rather, my point is to note that each response is a predictable reaction to the erosion of the previous truce between a diverse conception of academic freedom and the extension of public funding.

If faculty wish to forestall and reverse budgetary backlash against public investments in higher education, they should not scoff at concerns over the changing and increasingly one-sided ideological climate on campus. Neither should they dismiss the more responsible voices who raise concerns about exclusionary practices and epistemic closure in the most afflicted disciplines.

Forestalling these trends requires a proactive commitment to reestablishing the academic freedom truce of previous decades, as the alternative is a collision between the one-sided political activism of the faculty ranks and the public's willingness to continue subsidizing careers in the same. Should that collision resume, both sides will likely emerge worse off.

Sources Referenced: Buchanan, James M. Public Finance and Academic Freedom. What Should Economists Do (1979).

January 21, 2020

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