

**Mitchell's Musings**

**Daniel J.B. Mitchell**

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**Note: There is no Mitchell's Musings for January-March 2017 due to teaching obligations.**

## Mitchell's Musings 4-3-2017: Making Borderline Policy

Daniel J.B. Mitchell

*Note: We resume our weekly musings with this edition. Our practice is to omit the winter quarter due to teaching obligations.*

Much has happened since our last musing in late December. Some would say too much has happened. However, of particular note recently was the failure of Congressional Republicans to pass a “repeal and replace” bill for the Affordable Care Act. As numerous commentators have observed, the failure was due to an inability among House GOP members to decide on what should be the. That inability, combined with a seeming presidential indifference to the details of what the bill contained, doomed the effort. We can come back to the whys of that failure in a future musing. But, supposedly, the next big agenda item in Congress is to be tax “reform.” And, as in the case of health care, there seems to be no consensus among the Republic majority on what such reform should entail.

One version of reform, sometimes said to be under consideration and sometimes said to be off the table, is a so-called border adjustment tax. So let's look at what such a tax might entail. “Might” is the right word, since there is no explicit proposal. The idea seems to be that a tax (tariff) would be imposed on imports of, say, 20%, and a symmetrical subsidy would be given to exports at the same 20% rate.

Note first that this tariff-subsidy arrangement bears some similarity to the (Warren) Buffett voucher plan about which I have written in the past.<sup>1</sup> Under the Buffett plan (of the 1980s), exporters would be given a \$1 voucher for each dollar of exports. The voucher would entitle the bearer to import \$1 worth of goods and services. A voucher could be used directly by the recipient or sold in the open market. Under the Buffett plan, exports and imports would thus necessarily balance. The net effect on the combined actual exchange rate and market price of the voucher would be equivalent to the devaluation of the dollar needed to produce balanced trade.

Under the Buffett plan, the cost of the voucher to purchase imports is analogous to a tax (tariff) on imports and the value exporters obtain by selling the voucher is analogous to a subsidy of the same rate. Whether the border adjustment tax is being proposed – if it is – because of its similarity to the Buffett plan is unknown. But let's point to an obvious feature of the Buffett plan. Although the government distributes the vouchers given to exporters, there is no revenue for the government from the plan. Essentially, there is a direct monetary transfer from importers to exporters.

If the tax version were enacted rather than the voucher scheme, and if it led to a zero trade balance, there would also be no net revenue for the government because the tax collected from importers would go entirely to the subsidy collected by exporters. *If the purpose of a border adjustment tax is to improve the US trade balance and bring it to zero, the tax cannot be used to generate net revenue that would replace other taxes that the GOP wishes to eliminate or reduce.* More generally, the more the border adjustment tax improves the trade balance, the less revenue it produces.

Another way to put this point is that if the purpose of the border adjustment tax is to improve the trade balance and thus create more jobs – especially in manufacturing – it can't be a good revenue generator.

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<sup>1</sup><http://www.zocalopublicsquare.org/2017/01/09/cap-trade-solution-trade-dispute-china/ideas/nexus/>

If the purpose of the tax is to generate a lot of revenue to replace other taxes, then it can't be a good job creator. In effect, the two goals, jobs and revenue, are in opposition.<sup>2</sup>

There is a further wrinkle here. Some argue that if a border adjustment tax were imposed, it would actually not have any real effect because the dollar exchange rate would adjust to offset the impact. Such a conclusion might seem surprising. As noted, effectively what is being taxed NET is the trade imbalance. The tax only produces net revenue if the trade balance is negative (exports < imports). And we generally believe that if you tax something, you tend to get less of it. Getting less of the trade imbalance is a real effect, equivalent to the type of effect we associate with devaluations.

Currency devaluations "work" by changing (raising) the price of tradeable goods relative to non-tradeables. The ultimate non-tradeable is labor, so another way of looking at what is happening is that wage costs of production are lowered relative to world prices. The result is a greater incentive (due to greater profitability) for producing export goods and import-competing goods domestically. A border adjustment tax raises domestic import prices relative to labor costs due to the tariff effect. The domestic price of exportables rises relative to labor costs because exporters divert production toward world markets due to the subsidy.

So why would anyone think that a border adjustment tax would have no real effect? Note that in the case of a devaluation, there would be no real effect *if* domestic prices (including non-tradeables – essentially labor costs) rose to offset the devaluation effect. That is, if for every 1% the currency sank, domestic prices and wages rose by the same 1%, there would be no real effect. Those who argue that a border adjustment tax would have no real effect are assuming either that domestic prices rise to offset its devaluation-like effect or the currency rises in value in to offset the tax/subsidy impact. Were either of those offsets to occur, the trade imbalance would be unchanged and the tax would generate revenue without affecting (creating) jobs.

But why would someone think that there would be a total offset of the tax? The answer seems to be based on identities from the national income accounts. In the national income accounts, the trade balance (exports minus imports) equals by definition the gap between private and public saving and investment. So if the devaluation has no effect on saving behavior and no effect on investment behavior, then it can't affect the trade balance. But the very same analysis tells you that if saving rises relative to investment as a result of the devaluation (or as a result of the imposition of a border adjustment tax), the trade balance must improve.

There are two main reasons why we would expect saving to rise relative to investment, whether from devaluation or a border adjustment tax. The first is the general property of money illusion and wage stickiness. Wages are unlikely to move upward on Day 1 of the imposition to offset the price effect. Put another way, real wages will decline either way.

The second reason is that we have a central bank, the Federal Reserve, which has as part of its mandatory objective function the maintenance of price stability. So if domestic prices of tradeable goods rise by, say, 20%, it is unlikely that the Fed would accommodate an offsetting 20% rise in wages. It

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<sup>2</sup>Economists might note that this contradiction of objectives is a case of Tinbergen's law, which states that generally the number of policy instruments should match the number of policy goals. Here we have a case of one instrument and two goals.

would “tighten” monetary policy to prevent such a rise. Interest rates would rise, investment would be tamped down, and folks would consume less (save more). How smoothly such an adjustment would go would “depend.” But something like that scenario would occur, producing the real effect on the trade balance. Indeed, the less “smooth” the adjustment, the more likely you would see a quick improvement in the trade balance. There is nothing like a big recession to cause imports to drop relative to exports.

Of course, all of this analysis of a possible border adjustment tax is in the abstract. There may never be such a tax. It may never get beyond the talking stage. There is said to be an internal White House conflict between those who don’t want to monkey around with trade and those who do.<sup>3</sup> So whatever tax proposals come along may never include the border adjustment tax, precisely because those who don’t want to do anything on the trade side know the tax would have a real effect.

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<sup>3</sup><http://www.latimes.com/business/la-na-pol-trump-trade-conflict-20170328-story.html>

## Mitchell's Musings 4-10-2017: Klaatu Barada Nikto or This Time It's Different

**Daniel J.B. Mitchell**

Usually, the phrase "*this time it's different*" shows up when there are signs of irrational exuberance, as former Fed chair Alan Greenspan once put it, in the stock market. (We'll get to "*Klaatu barada nikto*" later.) Someone comes along and says that today's exuberance may seemingly look like past bubbles, but because of special explanation X, there is a rationale for the surge in market prices this time. There was a great deal of that type of thinking during the dot-com boom (which then proved to be a run-of-the-mill bubble when it burst). Similarly, the subsequent housing boom was rationalized as a new thing under the Sun until it disappeared into the Great Recession.

There usually is a market for both the rationalizing of excessive optimism and of gloom and doom. Basically, there is often money to be made out of both ends of the spectrum. There are folks ready to sell you on the latest investment fad. And there are folks ready to sell you gold and survivalist supplies to prepare for the supposed coming Dark Age. In either case, startling headlines sell. In contrast, there isn't a lot of money to be made by saying that we really don't know for sure what the future holds, but that past experience suggests that extreme predictions based on perceived current trends are generally wrong.

In downtown Los Angeles, you will find the Bradbury Building, said to be inspired when it was built in the early 1890s by the popular book, "Looking Backwards," a Rip Van Winkle-type story about someone who wakes up in 2000 and beholds a utopian future. Suffice it to say that such a utopia did not turn out to arrive by 2000. And the Bradbury Building looks like the latest thing of the 1890s.



*LA's Bradbury Building*

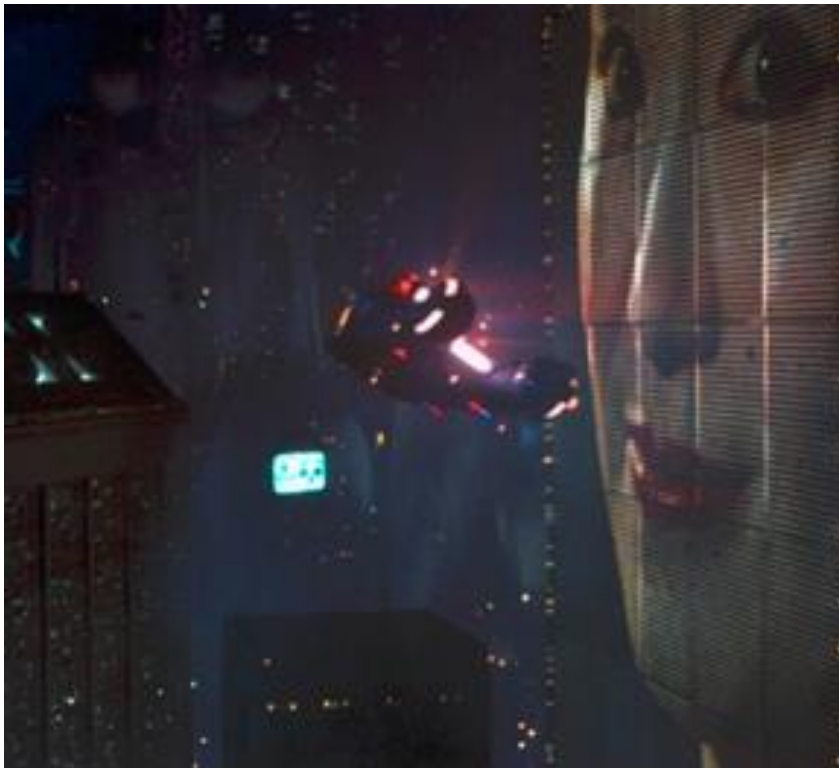
But we don't have to go back to the 1890s to find misguided predictions. In the 1930 film "Just Imagine" – a comic view of what the world would be like in fifty years - folks seem to get around in flying cars in distant 1980. The city in which they get around has skyscrapers that look remarkably like those being built in the 1920s and 1930s.

Flying cars seem also to be common in "Blade Runner," a film made in the early 1980s which takes place in the Los Angeles of 2019 (just two years from now). Folks in 2019 travel to distant planets and biotech

has advanced to the point where sentient biological beings are manufactured. On the other hand, no one in 2019 has a cellphone. About the only thing “Blade Runner” has right is that the Bradbury Building – where the film’s climax takes place - is still around. (I think we can safely predict at this point that since the Bradbury Building is still standing in 2017, it will be standing in 2019, particularly since the building has been seismically retrofitted.)



*Flying car in “Just Imagine”*



*Flying car in “Blade Runner”*



One could go on with such examples. In the film “2001,” made in the late 1960s, travel to the Moon on Pan Am seems to be routine. The manufactured sentient beings in the year 2001, however, are 1960s-style mainframe computers. But as in “Blade Runner,” there are no cellphones. When you want to make a call, you step into a phone booth and use the Bell System.



*Phone call in “2001”*

Despite this poor track record at technological forecasting, we are now being told that robots and computers are about to displace everyone. All jobs are at risk. No less than Bill Gates says we will need to figure out how to divvy up the income derived from a robot tax as we sit back and let robots do the work.<sup>4</sup> Or, if you don’t like that remedy, how about job quotas for humans so that some work that robots could do is nevertheless kept open for people.<sup>5</sup> We’ll need affirmative action for human beings.

Of course, the idea of scary robots has been around for a long time. The early 1950s film “The Day the Earth Stood Still” featured a robot named Gort who arrived in Washington, DC with a spaceman from another planet. Unless someone said the magic words *Klaatu barada nikto* to Gort, it would destroy the world. Luckily, Patricia Neal said them in the nick (nikto?) of time, thus saving the Earth.

The problem with the current robot panic is that we have been there before. In the 1950s, there was a similar “automation scare,” this one based on the entry of mainframe computers into the business world. And that scare, too, appeared in popular culture. The 1957 film “Desk Set” featured a room-size computer operated by Spencer Tracy – complete with tape drives, flashing lights, and printouts from an electric typewriter – that threatened to take the job of librarian Katharine Hepburn. Up to that point, automation had been thought of as something that only threatened blue collar types. But the 1950s automation scare suggested that white collar occupations were the next victims.

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<sup>4</sup><https://www.fastcompany.com/40400920/one-san-francisco-politician-is-exploring-a-tax-on-robots>

<sup>5</sup><https://www.theguardian.com/technology/2017/apr/04/innovation-in-ai-could-see-governments-introduce-human-quotas-study-says>



*Klaatu barada nikto*



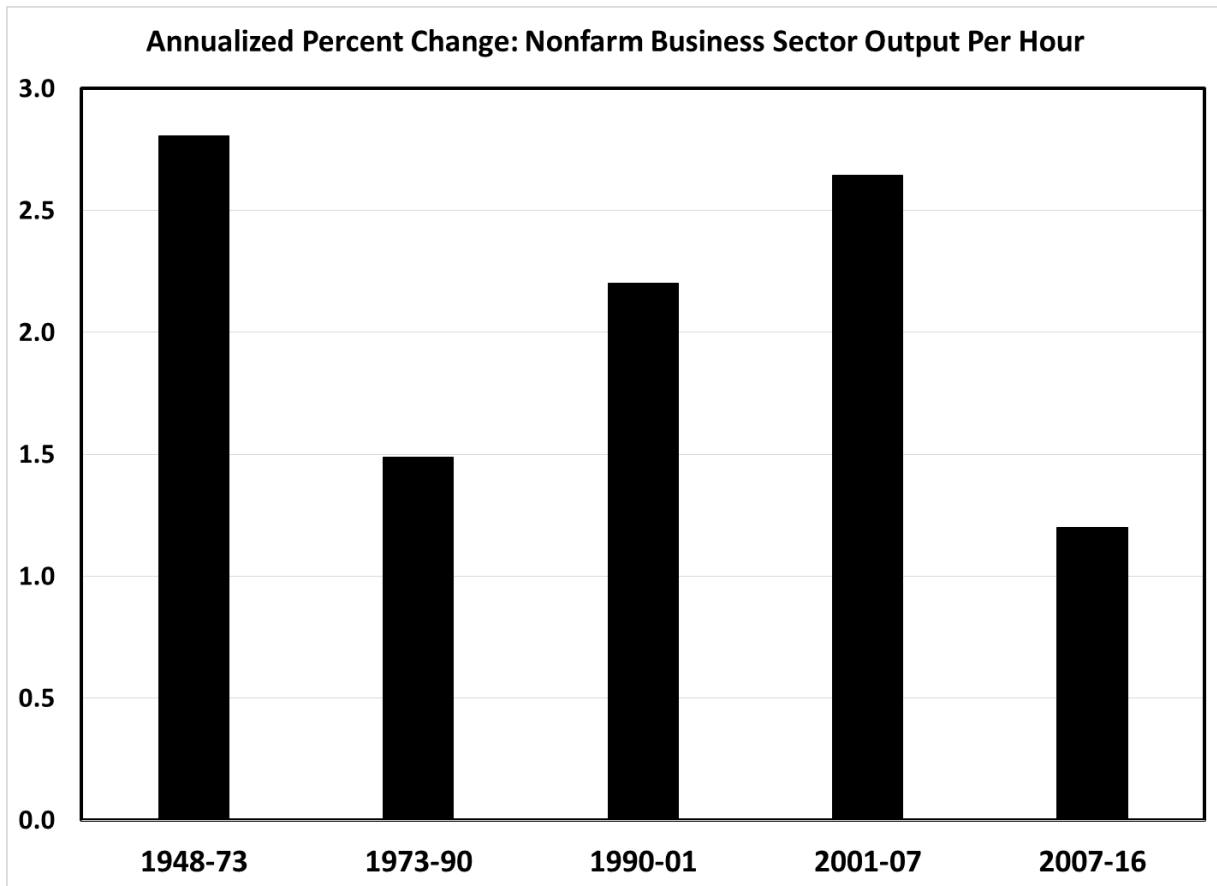
*The computers are coming!  
 "Desk Set"*

The problem with the current automation/robot scare is not that technology doesn't sometimes – even often – cause job displacement. The problem is the taking of a current perceived trend and projecting it to excess. And, moreover, there are various motivations at this time for doing so. The Trump election created a debate as to whether job loss in manufacturing was due to technological change or foreign



competition and globalism. (The answer seems to be that both factors were involved but that the technology story predominates.) However, if you are a free trader, you want to emphasize automation and robots to head off “protectionism.” No point in renegotiating NAFTA if it’s all robots.

Moreover, particularly among the chattering classes, cellphones, laptops, etc., are especially visible and are popularized as “disrupters.” So there is also a market for learned discussions and popular news items forecasting that everything is about to change – and soon. Disruption, disruption, disruption. Displacement, displacement, displacement. The fact that the latest unemployment rate is down to 4.5% is disregarded. Also neglected is the evidence from our measures of labor productivity which don’t show any recent uptick in output-per-hour.



Yes, I know. The productivity measures may be wrong. But when you look at the history of adjustments made to the output side of output-per-hour, the fact is that they get more and more aggressive over time. So if anything, when you look at current trends versus those recorded earlier, the relative growth in productivity is biased toward showing an uptick – and yet it doesn’t.

So let’s all calm down about disruption and displacement. And if a robot threatens, you know the magic words to say: *Klaatu barada nikto*.

## Mitchell's Musings 4-17-2017: Coal, Seriously

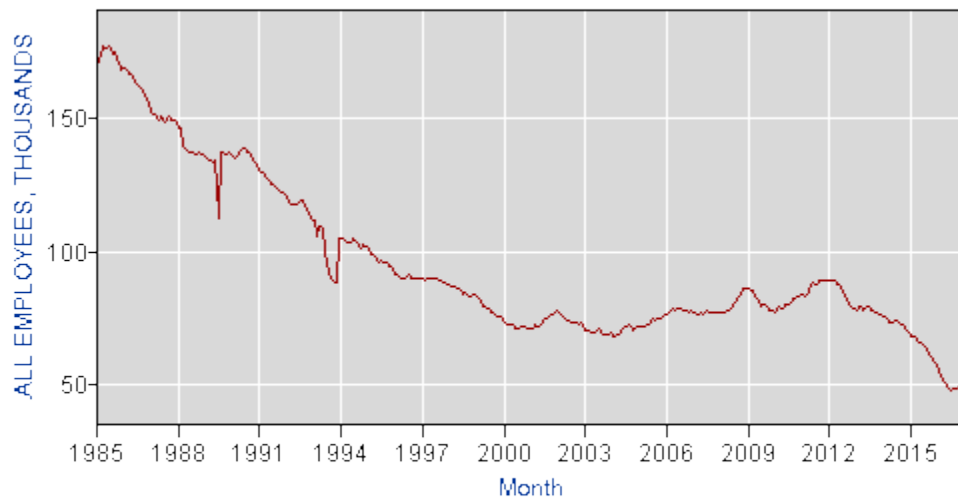
Daniel J.B. Mitchell

One byproduct of the 2016 presidential campaign was the attention paid to the plight of coal miners. During the campaign, then-candidate Trump promised to bring back employment in coal by lifting federal regulations, pulling out of agreements to limit greenhouse gas emissions, etc. So what are the prospects for bringing back jobs in coal, now that he is in office?

Below is a chart showing the trend in employment in the coal mining industry (NAICS 2121). The numbers include *all* jobs in that sector, not just coal miners, through March 2017. As can be seen, the trend over the long term is down, but with an interim period of stabilization or actual increase from about 2000 to 2012. After that point, jobs generally declined and now seem at a plateau of around 50,000 reached in 2016 and into 2017. U.S. coal production peaked at about 1.2 billion tons in 2008. It declined precipitously in recent years and was down to 739 million tons in 2016.

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### Coal Employment, 000s



Source: U.S. Bureau of Labor Statistics

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Of course, another well-known pledge of candidate Trump was to build a 2,000 mile wall along the US-Mexico border. Although no funds have been appropriated for such a wall, the federal government has solicited preliminary bids. In keeping with the spirit of wall building and solicitations, I made a humorous Modest Proposal on Twitter a couple of weeks ago that two objectives – bringing back coal mining jobs and building the wall - could be achieved *IF* the wall were to be built from coal.<sup>6</sup> Note additionally that even though the current administration doesn't care much about greenhouse gas, my proposal would

<sup>6</sup><https://twitter.com/CalPolicy/status/847229569916575745>

not involve burning the coal and thus emissions from the coal needed for the wall would be limited. The only emissions would be the indirect consequences of mining and transporting the coal.

As it turns out, however, my facetious proposal has a use. It is illustrative of why it would be difficult to produce a lot of new jobs in the coal mining industry. Let's do a little calculation. Apparently, the wall is supposed to be 30 feet high. So let's suppose we piled up coal in a triangular form on a 30-foot base. A cross section of the triangular coal pile would have a square area of 450 square feet ( $30 \times 30 / 2$ ). The wall is 2,000 miles long, so to convert its length into feet, we multiply 2,000 miles by 5,280 feet per mile and get 10,560,000 feet. When we multiply 10,560,000 feet by 450 square feet, we get a wall containing 4,752,000,000 cubic feet of coal.

Now we need to know how many cubic feet a ton of coal occupies. Coal varies in type and density. One number that seemed to repeat on the web, however, was that a ton of coal requires something like 40 cubic feet, so let's go with that estimate. Dividing 4,752,000,000 cubic feet by 40 gives us 118,800,000 tons of coal needed for the wall. Total U.S. production last year, as noted earlier, was 739,000,000 tons. So if we bought all the coal needed for the wall in one year, it would raise that year's coal demand by 16%. If coal jobs rose proportionately to output, we are talking about a *one-time* jump of 8,000 coal jobs.

OK. Let's make it clear that I am not advocating a wall of coal. But what I am doing is pointing to the fact that even a giant wall of coal running along the U.S.-Mexico border from the Pacific Ocean to the Gulf of Mexico wouldn't produce a lot of coal jobs. Coal employment fell from 2015 to 2016 by over 13,000 jobs. So the temporary boost of 8,000 coal jobs would be less than that one-year drop. In short, trends in coal prices (and of the prices of other energy commodities) and world demand are more likely to dictate what happens to coal employment than any change in federal policy.

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 Daniel J.B. Mitchell  
@CalPolicy

Interior secretary reopens federal coal mining  
[thehill.com/policy/energy-](http://thehill.com/policy/energy-...) ... Given the coal  
glut, why not build the wall of coal? Modest  
proposal



## Mitchell's Musings 4-24-2017: Lessons from Collective Bargaining for the North Korean Dispute

Daniel J.B. Mitchell

*Mike Pence's warning to North Korea: 'The sword stands ready'*<sup>7</sup>

Donald Trump was elected president in part due to a promise to negotiate better deals in areas such as international trade and foreign policy. For many years, less so now than in the past, union-management negotiations were very much in the public spotlight and served as a model of the bargaining process. The U.S. is currently engaged in *de facto* bargaining with North Korea. Is there anything that can be learned from collective bargaining that carries over into the North Korean situation?

Union-management negotiations are what economists call "repeat games." That is, unlike a buyer and a seller haggling over the terms of a one-time sale of a used car, the parties to a labor negotiation meet repeatedly over the years as one contract expires and a new one has to be negotiated. In the context of a repeat game, what either party does in a particular negotiation will have ramifications for what happens in subsequent contract negotiations. An added complication in the labor negotiation case is that the same union or the same employer may be negotiating other contracts with different parties at the same time. So what a party does in one situation may simultaneously influence the other negotiations.

One thing is clear from collective bargaining. In any negotiation, there are potential gains that can be obtained and costs that can be inflicted. Credibility is thus very important. Neither side can be 100% sure about what the other party is prepared to do in terms of making concessions or inflicting pain. But both sides can look for clues from past negotiations. What you say in any one negotiation and what you ultimately do is going to matter in other negotiations.

For example, if you threatened to do something in the past, or if you promised something, did you follow through? If you accepted a deal in the past containing terms that you previously had said you would never accept, that action suggests that any such a statement in the future has to be received with skepticism. If you offered something that you had previously said would never be on offer, such a statement in the future also has to be received skeptically. If you were a soft touch in the past, and now want to change to Mr. Tough-Guy, that shift could be costly. Your opposite number may assume you are bluffing when you aren't, and you both may stumble into a conflict as a result.

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<sup>7</sup><http://www.latimes.com/politics/washington/la-na-essential-washington-updates-mike-pence-s-warning-to-north-korea-1492605388-htmlstory.html>.

These considerations bring us to the current impasse, if that is what it is, with North Korea and its periodic testing of atomic bombs and missiles. A recent headline in the Los Angeles Times read:

*Pence warns North Korea not to 'test' Trump, says the 'era of strategic patience is over'*<sup>8</sup>

How seriously is North Korea likely to take such a warning? Presumably, the powers-that-be there (which may come down mainly to one man) are aware of President Trump's recent flip-flops on such matters as Chinese currency manipulation, the utility of NATO, the moving of the U.S. embassy to Jerusalem, etc. Even on domestic matters, the record of presidential backing down isn't likely to suggest to the North Koreans that "testing" Trump would lead to bad consequences.

There was going to be a repeal and replacement of Obamacare, for example, but it didn't happen after the president couldn't get a deal *within his own party*. He seems unable to obtain any party consensus on tax policy, let alone force a tax deal. If you think the North Koreans – because of their isolation – are unaware of these U.S. domestic matters, think again. Recall the Sony computer hacking in which the North Koreans were apparently up to date on who was who in Hollywood and on what could embarrass who in Hollywood.

What about recent U.S.-related military events in areas other than North Korea? What lessons might the North Koreans draw from those events? There was a U.S. missile attack on an airfield in Syria said to have been a target because of the use of chemical weapons by the Assad regime. The missile attack appeared to be aimed at differentiating the Trump administration from the Obama administration and the latter's infamous unenforced "red line" statement about the use of poison gas. And there was the "Mother of All Bombs" dropped on ISIS tunnels in Afghanistan.

But both U.S. attacks were delivered in ways in which there could be no shooting back from the enemy. So the attacks, while dramatic when shown on TV, posed little risk to Americans. As numerous pundits have pointed out, any U.S. attack on North Korea would, in contrast, involve considerable risks, particularly to civilians and U.S. military personnel in Seoul and elsewhere in South Korea.

When you look to the labor relations analogy, the missing ingredient in the U.S. position at this time is credibility. Flip flops in other spheres – foreign and domestic - and painless military attacks suggest the opposite of what is intended. They suggest that the president will back off when there might be real costs. If he doesn't intend to back off this time, that switch may not be evident to the North Koreans.

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<sup>8</sup><http://www.latimes.com/world/la-fg-south-korea-pence-20170417-story.html>.

One interpretation of Trump's fluidity with regard to domestic and foreign issues is that perhaps it could be an inadvertent test of President Nixon's so-called "Madman Theory."<sup>9</sup> That theory suggested that if the president acted unpredictably, uncertainty over what he might do would deter adversaries. In the Nixon era, the adversaries were North Vietnam and the Soviet Union.

There is some deterrent effect to uncertainty. Indeed, although I have no knowledge about where the Madman concept originated within the Nixon administration, it, too, has a labor relations analogy. There was a wave of strikes in the Nixon period. As a result, the president at one point toyed with idea of pushing legislation to allow dealing with major labor disputes through something called the "choice of procedures" approach. Nixon's secretary of labor, George P. Shultz, viewed choice of procedures positively, based on its use under a Massachusetts state law.<sup>10</sup> Choice of procedures can be seen as a cousin of the Madman idea.

Under the existing federal Taft-Hartley Act (covering most of the private sector) and the Railway Labor Act (railroads and airlines), the president can invoke a temporary injunction (cooling off period) to halt national emergency disputes for durations designated in the two laws. There was an argument that the parties to labor disputes that were likely to be considered as national emergencies would simply build the injunction delay into their strategic planning. However, if the president had several alternatives available (a choice of procedures rather than just the fixed-duration injunction), the resulting uncertainty would make such strategizing more difficult. The parties – not knowing for sure what the president would do - might be induced to settle their dispute on their own.

In a national emergency labor dispute, however, the president is acting as a third party. So the uncertainty in such disputes is about his intervention in someone else's conflict. In the North Korean situation, however, the U.S. is an active party to the dispute. If anything, China is the third party in the Korean case. And there is danger in the fact that so far, President Trump has conveyed an image of flip flopping on various issues and of unwillingness to risk pain militarily.

If his intent in North Korea is to deviate from his past record and now be tough and unyielding, there is – as noted earlier - an increased risk of stumbling into a confrontation. What reason do the North Koreans

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<sup>9</sup>[http://www.slate.com/articles/news\\_and\\_politics/war\\_stories/2017/04/trump\\_is\\_inadvertently\\_putting\\_nixon\\_s\\_madman\\_theory\\_to\\_the\\_test.html](http://www.slate.com/articles/news_and_politics/war_stories/2017/04/trump_is_inadvertently_putting_nixon_s_madman_theory_to_the_test.html).

<sup>10</sup>George P. Shultz, "The Massachusetts Choice of Procedures Approach to Emergency Disputes," *Industrial and Labor Relations Review*, Vol. 10, No. 3, April 1957, pp. 359-374.



have for believing that this time it's different? That's why in labor disputes, a good negotiator avoids saying "never" when the true position is "maybe."

The bottom line here is that if American policy toward North Korea has really shifted to a hard line, it will require something more than just saying so to convince the North Koreans of that fact. In a labor dispute, if the parties have misguided views of each other's true positions and responses, an unnecessary strike can result. The result is lost wages and profits and some public inconvenience. In the North Korean case, however, we are talking about the potential for mass casualties and even use of nuclear weapons as the consequences of blundering.

Let's hope we don't blunder into some catastrophe this time. Suppose at this point, the president – despite the no-more-mister-nice-guy rhetoric – ultimately lets China defuse the immediate conflict with some face-saving solution. At that point, the North Koreans will have learned that tough rhetoric from this president should not be taken literally; that the rhetoric is for domestic political consumption only. Should the president at some future date actually mean it when he issues a tough ultimatum, the declaration will likely lack credibility. And the next conflict will have a still higher risk of blundering into disaster. Too bad there is no one like George Shultz in the White House today who can inform the president of the escalating risks involved.

## Mitchell's Musings 5-1-2017: Currency Manipulation 101

**Daniel J.B. Mitchell**

Candidate Trump famously promised that - when elected president - he would declare China to be a currency manipulator. More recently, after meeting with president of China Xi Jinping (and apparently asking for his help on the North Korea problem), he declared that China no longer manipulates its currency. Some observers see this shift as a confirmation that the president tends to believe the last person who talks with him. Others see it as a sign of presidential learning that the world is more complicated than he had thought and that seemingly-unrelated problems (such as currency policy and North Korea) are in fact linked.

There is another issue beyond the varied analyses of presidential behavior. It's not clear what "currency manipulation" is supposed to be. In principle, it could mean that if a country's official monetary institution (Central Bank, Treasury) buys and sells its currency in the foreign exchange market to affect its market price, that country is manipulating its currency. Actually, many countries take *some* actions in foreign exchange markets to influence their exchange rates. For example, any country which has a fixed exchange rate with another country can only do so by offering to buy and sell its currency at the desired exchange rate in unlimited amounts. (The alternative is to abandon your domestic currency – as all the euro-zone countries have done – and use some other currency.) But there are many lesser forms of targeting or influencing the exchange rate.

**Exchange Rate Arrangements, 2008–16**  
(Percent of IMF members as of April 30)<sup>1</sup>

Exchange Rate Arrangement	2008 <sup>2</sup>	2009 <sup>3</sup>	2010 <sup>4</sup>	2011 <sup>5</sup>	2012 <sup>5</sup>	2013	2014	2015	2016 <sup>6</sup>
Hard peg	12.2	12.2	13.2	13.2	13.2	13.1	13.1	12.6	13.0
No separate legal tender	5.3	5.3	6.3	6.8	6.8	6.8	6.8	6.8	7.3
Currency board	6.9	6.9	6.9	6.3	6.3	6.3	6.3	5.8	5.7
Soft peg	39.9	34.6	39.7	43.2	39.5	42.9	43.5	47.1	39.6
Conventional peg	22.3	22.3	23.3	22.6	22.6	23.6	23.0	23.0	22.9
Stabilized arrangement	12.8	6.9	12.7	12.1	8.4	9.9	11.0	11.5	9.4
Crawling peg	2.7	2.7	1.6	1.6	1.6	1.0	1.0	1.6	1.6
Crawl-like arrangement	1.1	0.5	1.1	6.3	6.3	7.9	7.9	10.5	5.2
Pegged exchange rate within horizontal bands	1.1	2.1	1.1	0.5	0.5	0.5	0.5	0.5	0.5
Floating	39.9	42.0	36.0	34.7	34.7	34.0	34.0	35.1	37.0
Floating	20.2	24.5	20.1	18.9	18.4	18.3	18.8	19.4	20.8
Free floating	19.7	17.6	15.9	15.8	16.3	15.7	15.2	15.7	16.1
Residual									
Other managed arrangement	8.0	11.2	11.1	8.9	12.6	9.9	9.4	5.2	10.4

Source: AREAER database.

<sup>1</sup> Includes 189 member countries and three territories: Aruba, Curaçao, and Sint Maarten (all in the Kingdom of the Netherlands) and Hong Kong SAR (China).

<sup>2</sup> As retroactively classified February 2, 2009; does not include Kosovo, Tuvalu, and South Sudan, which became IMF members on June 29, 2009, June 24, 2010, and April 18, 2012, respectively.

<sup>3</sup> As published in the 2009 AREAER; does not include Kosovo, Tuvalu, and South Sudan, which became IMF members on June 29, 2009, June 24, 2010, and April 18, 2012, respectively.

<sup>4</sup> As published in the 2010 AREAER; does not include Tuvalu and South Sudan, which became IMF members on June 24, 2010, and April 18, 2012, respectively.

<sup>5</sup> As published in the 2011 and 2012 AREAER; does not include South Sudan, which became an IMF member on April 18, 2012.

<sup>6</sup> Includes Nauru, which became an IMF member on April 12, 2016.

The International Monetary Fund (IMF) maintains a database of different currency policies followed by its member countries, as can be seen on the table above.<sup>11</sup> The details of what the various categories mean are not important. What is important is that only those countries listed as having currencies that are “freely floating” are not engaged in some form of buying and selling of their currencies to influence their exchange rates. So if intervening in the exchange market is deemed to be “currency manipulation,” most countries do it.

China, in particular, is said by the IMF to follow policies such that its exchange rate’s “flexibility is limited vis-à-vis (a)... basket of currencies.” Its overall currency policy is classified under “other managed arrangements,” i.e., not freely floating. The IMF also reports a variety of Chinese controls on capital transactions.<sup>12</sup> In short, it is hard to make a case that China’s currency is not being “manipulated” *if* by that word you mean the following of various official policies aimed at influencing the exchange rate.

Of course, there are legalities involved in the definition of currency manipulation. The IMF has an Article VIII which contains rules about exchange rates and what countries are allowed to do about them. But not all member states accept those obligations. And there are relatively few restrictions with any teeth. As a practical matter, your view on whether currency manipulation is occurring depends heavily on what you want to see. It’s in the eye of the beholder.

However, the complaint by candidate Trump really didn’t directly deal with currency policy. The complaint was that China was running a large trade surplus with the U.S. (its exports to the U.S. exceeded its imports from the U.S.), and that this situation was displacing jobs in the U.S. manufacturing sector. Whether the trade imbalance resulted from currency manipulation by some definition or from something else didn’t much matter.

The fact is that a country can run a trade surplus or deficit with some other country or with the rest of the world as a whole, even if it has a totally *laissez-faire* policy towards its exchange rate. There is nothing inherent in a freely floating exchange rate policy that precludes trade imbalances, positive or negative. Put more strongly, the charge of currency manipulation was in some sense irrelevant to candidate Trump’s complaint about the manufacturing impact.

Economists like to point to an identity from the national income accounts as the ultimate insight into determination of trade imbalances. Under national income accounting, or at least a simplified version of it, national product = national income. That is, the value of what is produced is distributed ultimately as income to someone, essentially to labor (via wages and benefits) and to capital (via interest, dividends, etc.). In addition, some income is intercepted as tax receipts by the government. On the product side:

National Product = Consumption + Investment + Government Purchases + Exports – Imports

(Note that we subtract imports from the National Product since although they may be bought as domestic consumption, investment, or government goods and services, they are not produced domestically.)

On the income side:

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<sup>11</sup>[https://www.imf.org/~media/Files/Publications/AREAER/AREAER\\_2016\\_Overview.ashx](https://www.imf.org/~media/Files/Publications/AREAER/AREAER_2016_Overview.ashx).

<sup>12</sup>See page 58 of the IMF online publication listed in footnote [1].

National Income = Consumption + Private Saving + Taxes

That is, the recipients of income either spend it, or they save it (don't spend it), or they have it taxed away.

Since National Product = National Income, we end up with:

Private Saving + (Government Purchases – Taxes) = Exports – Imports

The term in parentheses, Government Purchases – Taxes, can be seen as the national public sector budget, i.e., public saving (which can be positive or negative). So ultimately:

**National Saving – Investment = Exports – Imports**

This equation, again, is an identity – it is always true because of the way we define national income and product. Because it is an identity, some folks mistakenly believe it shows that exchange rates have nothing to do with the trade balance. But that error is another story. What we do learn from this identity is that *any* policy that affects national saving (public or private) and/or affects national investment will have some effect on the trade balance. So, again, the presence or absence of a currency manipulation policy is really not the heart of the president's previous dispute with China.

Similarly, if the U.S. were to follow a policy to bring the trade balance to zero (exports = imports), it would necessarily have some impact on national saving and/or investment. There would be complicated effects on income distribution and welfare. There would be winners and losers. Ultimately, to be meaningful, the identity tells us that “currency manipulation” is best viewed as a portfolio of economic policies (which can include direct intervention in foreign exchange markets) that – in the Chinese case – produces a chronic and large trade surplus with the U.S.

As has been discussed in prior musings, you can argue that much of what happened in the long run to U.S. manufacturing involved technological change, not trade. “Much of,” however, is not the same as no trade effect at all. You can argue that even if addressing the trade issue taken by itself is worth doing, if China will resolve the North Korean problem, not addressing the trade imbalance is trade-off worth making.

In fact, China's perceived foreign policy interest with regard to North Korea has long been defusing, as opposed to resolving, the conflict. And its perceived economic interest is in not having the U.S. take unilateral action on trade. In the end, how is current trade policy with China any different that it was under Obama, Bush, and Clinton? Indeed, removing “currency manipulation” – whatever that might mean – from negotiations with China has created less leverage than possessed by the prior three presidents.

## Mitchell's Musings 5-8-2017: Your Final Exam Question

**Daniel J.B. Mitchell**

I recently placed online the PowerPoint slides (in pdf format) and other materials for courses I used to teach at UCLA in their final formats, i.e., as of 2008 when I retired.<sup>13</sup> One of them was an introductory course in international economics. From time to time in that course's final examination, I included a recent newspaper article that related to the course's topics and asked the students for a critique. As it happened, at about the time I was uploading the course files, an article appeared in the *Los Angeles Times* that would have been a good candidate for such an exam essay, were I still teaching the class.<sup>14</sup>

There are various themes in the article such as whether President Trump overestimates the bargaining leverage that running a trade deficit with a particular country gives him. But the article also goes into whether improving the trade deficit would create more jobs, particularly in manufacturing. In prior musings, we have noted that bringing the trade balance to zero would not come close to restoring the proportion of manufacturing workers in the labor force to what it was in the 1950s. But we also noted that given the current shrunken share of the workforce in manufacturing, about one in ten U.S. jobs, moving to balanced trade would have a significant impact on that sector.

If I had assigned the article as a final exam essay question, I would have hoped that the students would have directed their attention to the chart it contained below:

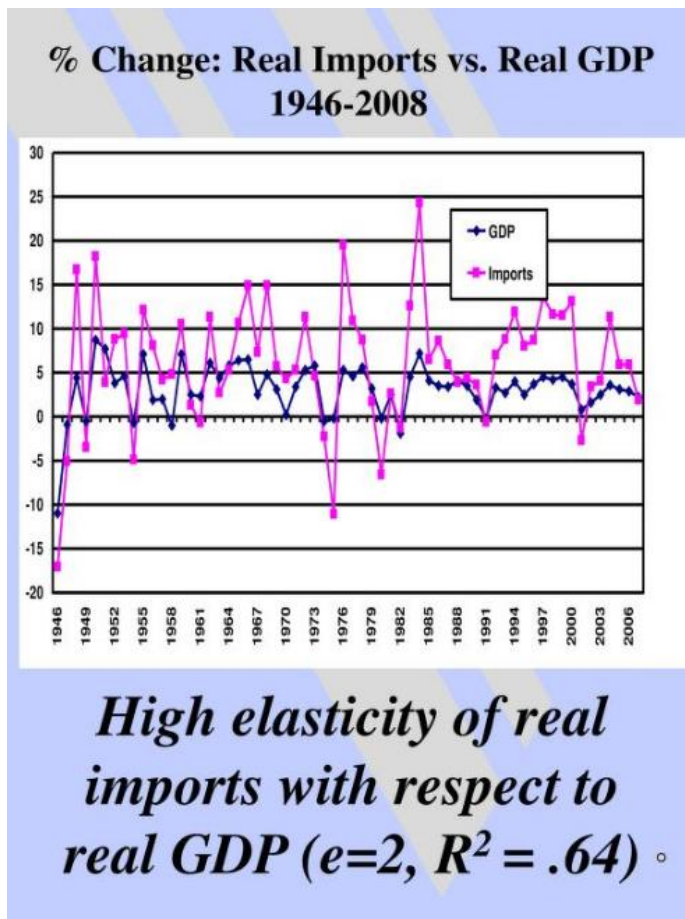
### Trade and jobs don't always track



<sup>13</sup>Management 205a - International Economics, available at <https://archive.org/details/week8-intl-2008>.

<sup>14</sup>"Why Trump's obsession with trade deficits is misguided," available at <http://www.latimes.com/business/la-fi-trade-deficit-trump-obsession-20170502-htlmstory.html>.

The chart represents an effort to show that changes in the trade balance don't correlate positively with changes in employment in manufacturing. But here's the problem. The trade balance as a time series tends to be *negatively* correlated with the business cycle. That is, during booms the trade balance tends to become more negative. During busts it improves. Manufacturing is highly cyclical, but in a positive direction. That is, other things equal, Good Times in the general economy tend to be Good Times in manufacturing (and for manufacturing jobs). Hard Times are especially hard in manufacturing. So in a time-series sense, an improvement in the trade balance is likely to be *negatively correlated with jobs in manufacturing*.



There is a simple explanation for this seeming paradox. Real imports are strongly correlated with real GDP. When times are good, there is more consumption, more investment, etc. Some of what is consumed and invested comes from abroad (the demand link). Some of what is produced domestically in the U.S. uses inputs, directly or indirectly, from abroad (components, fuel, etc.; the supply link). Indeed, a hypothetical student taking my final exam might have recalled the slide from the class above



showing that a one percent change in real GDP is associated with about a two percent change in real imports ( $e=2$  on the slide).<sup>15</sup>

Imports are only half the trade balance story. What about the export side? We can crudely think of imports as our demand for goods and services from them (the rest of the world). We can think of exports as their demand for goods and services from us. So, since our exports mainly reflect conditions abroad, they are going to be less associated with our business cycle than are imports. Put another way, the import side tends to dominate in determining the movement of our trade balance in response to our business cycle.<sup>16</sup>

The bottom line here is that the *Los Angeles Times* article's use of a time-series chart involving manufacturing jobs and the U.S. trade balance – while the numbers underlying the chart are correct – is highly misleading. The chart is dominated by the business cycle. Consider the two most recent recessions. You can see the trade balance improving during the dot-com bust of the early 2000s (and the simultaneous recession-induced fall in manufacturing jobs). The same effect is apparent from the chart during the Great Recession of 2008-09. All the chart really tells you is that manufacturing is hurt by recessions and helped by booms, and that the trade balance is helped (improved) by recessions and hurt by booms. The chart tells you nothing about the connection between improving the trade balance and adding more jobs in manufacturing.

You'll likely get an "A" on the final exam's essay if you knew that already.

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<sup>15</sup>I re-estimated the relationship for this musing, updating the data through 2016 and got the same  $e=2$  (not surprisingly since I was only adding a few years to a long time series). The course slide reproduced in the text is at <https://archive.org/stream/week8-intl-2008/week8-intl-2008correct#page/n44/mode/1up>.

<sup>16</sup>There is some positive correlation between our business cycle and the business cycle(s) abroad, partly because our imports are their exports. So you might expect real exports to show some positive correlation with real GDP through that channel and because they are a component of real GDP. But a similar estimation with regard to exports produces  $e<1$ . And since we start from the fact that imports > exports, the trade balance of the U.S. reflects the U.S. business cycle.

## Mitchell's Musings 5-15-2017: Stamping Out Hate

**Daniel J.B. Mitchell**

In 1966, "The Mad Show" opened off-Broadway. Among the songs in the show was the Hate Song, featuring the notion of "stamping out hate."<sup>17</sup> The lyrics involve progressively violent and grisly things the performers plan to do to "hate." So the song shows that the idea of intolerance on the left in the U.S. is not a new development, since it was being parodied six decades ago. But it was something that apparently was attracting attention back then. On the other hand, there is a long history of those on the left of American politics pushing for civil rights and against prejudice in the U.S. Tolerance was associated with left-liberal thinking.

Behavioral types nowadays tend to see the right vs. left division as a matter of some deep psychological leaning toward established order vs. openness to new things. Voting behavior regarding Trump in the U.S., Brexit in the U.K., or Le Pen in France is thus analyzed in that framework as determined by such attitudes, although where those attitudes originate is not so clear.<sup>18</sup> However, the behavioral view leaves out the ideological component, at least in an historical perspective.

Left and Marxism became intertwined in the 19<sup>th</sup> century. The connection was reinforced by the Russian revolution and the formation of the Soviet Union. In the Marxist view, human history was seen as class conflict which, by the 19<sup>th</sup> century, had evolved into workers versus capitalists. If that is your model of the underlying force in social development, other divisions in society are inherently downplayed. Divisions on the basis of race, ethnicity, religion, or anything else (other than whether you are a worker or a capitalist) are viewed as artificial. Indeed, prejudices based on anything else are seen as devices used by capitalists to divide workers and thus forestall revolution.

Since those on the left tended to face official repression, the idea of pushing for such things as civil liberties and free speech was natural. Ending segregation and discrimination more generally also was natural, since such practices were seen as capitalist devices that were aimed at dividing the working class. In short, tolerance and left-of-center politics became linked in the U.S. Left and liberal tended to go together, although sometimes in an uneasy alliance.

But by the mid-20<sup>th</sup> century, there were forces undermining old leftism and its worker-focused approach. The Soviet Union, particularly as Stalin's purges and gulags were revealed, could not be easily viewed as a contemporary workers' paradise or even something that was likely to evolve into one. In any event, Cold War politics repressed out-and-out communists (and others). While the Great Depression had tended to reinforce Marxist views about "contradictions" in capitalism, post-World War II prosperity worked in the opposite direction. Labor unions, which in the 1930s seemed to be part of the Marxist conflict model, by the late 1950s appeared to have become part of the "system."<sup>19</sup>

The New Left of the 1960s, often linked to college students rather than to blue collar workers, was less connected to traditional Marxism and was more into some kind of personal liberation. It didn't exactly

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<sup>17</sup><https://www.youtube.com/watch?v=Km3Y0J0CQRM>.

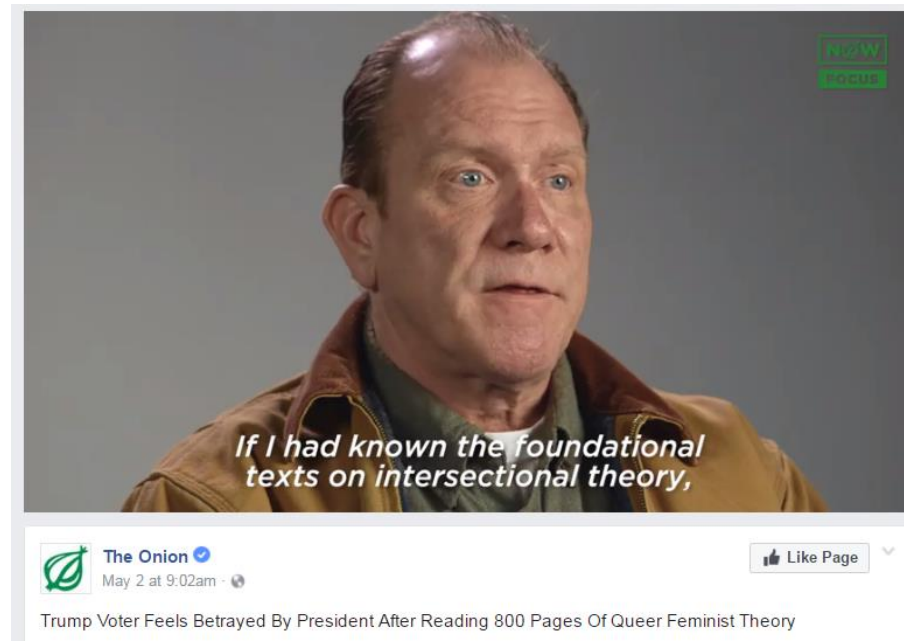
<sup>18</sup><https://theconversation.com/the-cultural-division-that-explains-global-political-shocks-from-brexit-to-le-pen-76962>.

<sup>19</sup>Richard A. Lester, *As Unions Mature: An Analysis of the Evolution of American Unionism* (Princeton University Press, 1958).

abandon the workers-versus-capitalists idea, but that kind of thinking became less and less central. College students don't conveniently fit into worker-versus-capitalist paradigm.<sup>20</sup> Black nationalism that became prominent in that era also didn't neatly fit into Marxist dualism. The fact that you had significant support for the Vietnam War among blue collar workers and "hardhats" added to the undermining of the Old Left with its worker orientation.

Fast forward to the present day. It's hard to see anything like the old Marxist model on the left. There is instead a collection of causes not centered on labor. Environmentalism is prominent. Some are preoccupied with "organic" foods and non-GMOs. The old connection to workers is not totally gone – you have support for such things as raising the minimum wage, for example. But particularly after the Trump election, there was a tendency to view the kind of workers around which the Old Left once revolved as part of the enemy.

A recent satirical video from *The Onion* depicts a fictional blue collar workers from a "steel town" lamenting he had voted for Trump before discovering the error of his ways after reading 800 pages of queer feminist theory.<sup>21</sup> Essentially, the video tells you that at least the academic left seems to have detached itself from its one-time concerns and now is speaking largely to itself.



The Old Left's interest in civil liberties and free speech did carry over into the New Left of the 1960s. But like the concerns of workers who became Trump supporters, civil liberties and free speech as issues seem to have been ceded to the right. In its milder form, the demand to be protected from speech has also been the target of an *Onion* parody, namely an article headlined "Berkeley Campus on Lockdown After Loose Pages from 'Wall Street Journal' Found on Park Bench."<sup>22</sup> Less amusing has been recent violence at some universities and dis-inviting of speakers, conduct which some on the left have

<sup>20</sup>You can hear the leader of the student revolt at Berkeley, Mario Savio, denounce the university, government, industry, and organized labor at <https://www.youtube.com/watch?v=0xR863v7E5c>.

<sup>21</sup><https://www.facebook.com/TheOnion/videos/10155397968279497/>.

<sup>22</sup><http://www.theonion.com/article/berkeley-campus-lockdown-after-loose-pages-wall-st-55815>.

rationalized in opaque writings.<sup>23</sup> And an over-concentration on what is called identity politics has become divisive.

Here's an example from the Santa Cruz Sentinel:

*UC Santa Cruz has agreed to the demands of the Afrikan Black Student Alliance after a three-day occupation of Kerr Hall, the primary administration building on campus.*

*...(D)uring the rally that preceded the occupation of Kerr Hall on Tuesday at Quarry Plaza, members of the Afrikan Black Student Alliance verbally attacked Jewish students, according to Santa Cruz Hillel Director Sarah Cohen Domont.*

*"Our students were, on three separate instances, subjected to protesters yelling, (expletives and anti-Semitic insults) and one of our Israeli flags was torn down," wrote Cohen Domont in a public statement...<sup>24</sup>*

Of course, those on the right have also exhibited fragmentation and division. There are libertarians vs. Chamber of Commerce Republicans vs. Trumpites and what were once called Reagan-Democrats. But in 2016, that alliance succeeded in electing a president. Those on the left could simply sit back in the hopes that the political pendulum will somehow swing back in some natural rhythm. They can assume that folks who, say, lose health insurance coverage will be angry in the midterm elections and start a process of reversing the 2016 electoral results. Maybe those things will happen. But odd and objectionable behavior on the left surely won't help. And maybe – in a back-to-the-future move - a bit more attention to those traditional labor concerns would help.

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<sup>23</sup><https://www.theatlantic.com/education/archive/2017/05/the-new-intellectuals/525660/>. Excerpt:

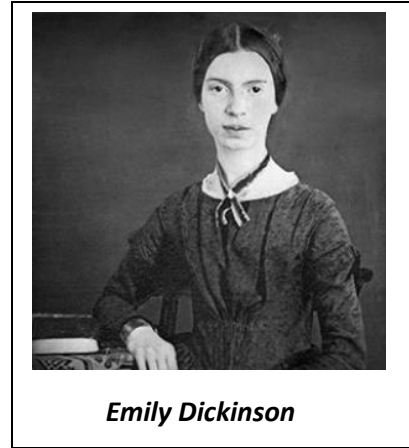
*"Representing campus protests under the heading of free speech helps to obscure the actual struggles occurring over the allocation of resources and the revision of curricula—struggles being led by students... To look at the situation differently, it might help to think alongside Antonio Gramsci, the Italian communist, political theorist, and educator who died in 1937, shortly after being released from prison..."*

<sup>24</sup><http://www.santacruzsentinel.com/social-affairs/20170504/uc-santa-cruz-agrees-to-demands-of-students-who-occupied-kerr-hall>.

## Mitchell's Musings 5-22-2017: Emily Dickinson & the Civics Lesson

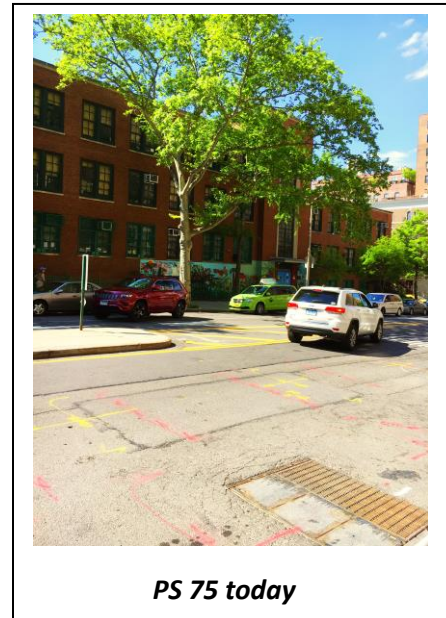
Daniel J.B. Mitchell

A recent movie, "A Quiet Passion," depicts the life of poet Emily Dickinson from childhood to death. Basically, the film's version of her life is of a household with tight rules of decorum and religion within which Emily rebels. But she nevertheless remains confined in the house and family of her birth and ultimately becomes a recluse – with most of her poetry discovered after her death.



As it happens, in 1950, as I entered the third grade, the powers-that-be in the New York City Board of Education built a new elementary school in the Manhattan district where I resided, PS 75, and named it the "Emily Dickinson School." As such things often happen, the building was actually not ready to open on time when classes began in the fall of 1950. So we first attended in an old school, and then transferred to the new structure when it was ready.

Exactly why the new school was named after Emily Dickinson was made never clear to the incoming students. She had no connection with New York City. However, PS 75 was new, not only in the sense of a new building, but also because it featured "progressive education." Perhaps the person or committee that named schools viewed Dickinson as progressive, since she was a female poet in an era when such things were generally not welcome in society. In any case, although I attended the third and fourth grades in the school, I cannot recall anyone in authority saying much about who Emily Dickinson was, or why the school was named after her.



I passed by the school recently on a visit to New York – see photo – and noted that there was no plaque with Dickinson's name on the outside wall. Her name did appear on a plastic banner attached to the playground fence, and the school's website does say it is the "Emily Dickinson School." But there is no explanation of the name's significance for the school on the website.<sup>25</sup>

For that matter, it was not clear back in 1950 that the teachers knew what progressive education was supposed to be or how it differed from traditional education except for two tangible changes. In the first and second grades, the schools I attended had the old screwed-to-the-floor rows of desks. But in the new school, the desks were moveable and modern looking. They could be arranged in patterns other than rows. And they did not contain the hole for an inkwell that the old desks had.<sup>26</sup>

<sup>25</sup><http://schools.nyc.gov/SchoolPortals/03/M075/default.htm>.

<sup>26</sup>By the time I entered the first grade, no one was using inkwells. We had fountain pens and carried bottles of ink around to fill them by the second grade. Since the pens tended to splatter, and there also were spills in filling them, I often had bluish fingers. (Ballpoint pens, according to web sources, were invented in Hungary in 1931. But they had not fallen to a price point by the early 1950s so that children would have them.)





**Playground banner**

The other tangible change in response to progressivism involved what you were to do – or not to do - when seated at your desk. In the old system, you were to keep your hands folded your desk. Indeed, teachers provided hand folding lessons to show you the correct way of doing it. But under progressivism, not only were you not required to keep your hands folded, *you were ordered not to do it*. Not doing it was a problem for us, however, since by then hands being folded when seated had become an entrenched habit. So it seemed that progressive education, like traditional education, had strict rules. It just had *different* strict rules.<sup>27</sup>

In any event, at some point during the school year, an official ceremony was arranged to inaugurate the new school’s opening. The ceremony was scheduled for an evening performance by students which their parents would attend. I can remember two musical elements in the ceremony. Some of it involved playing

excerpts over the loudspeaker from a phonograph record of “Manhattan Tower,” an especially soupy tribute to New York City.<sup>28</sup> The other musical piece that I can recall was the singing by students of an Emily Dickinson poem, “The Grass So Little Has to Do.” I’m not sure, however, that we were told anything about the poem’s meaning or why somebody would write one about grass.<sup>29</sup> We were just supposed to sing it.



**Manhattan Tower on two 78 rpm records**

Anyway, I wasn’t particularly concerned with grass, which obviously doesn’t have *anything* to do. What struck me at the time as THE important element of the ceremony was not the music but the fact that the mayor was schedule to come. Of course, in the third grade, you don’t know a lot about mayors, but you do know that they are important people.

Moreover, I knew from family discussions that the previous mayor – a man named William O’Dwyer – was a Bad Mayor and his replacement was, therefore, an improvement.

Googling O’Dwyer now reveals that he had doubled the subway fare from a nickel to a dime and that he had to step down in the midst of his second term due to some kind of scandal. (President Truman then conveniently appointed him ambassador to Mexico, thus getting him out of the city.) So it was the improved mayor – Vincent Impellitteri – that was due to

<sup>27</sup>The 1950 version of progressive education at PS 75 may not have accorded with what progressive education was supposed to be: <https://www.youtube.com/watch?v=opXKmwg8VQM>. However, all educational fads differ between theory and practice.

<sup>28</sup>The original (1946) version can be heard at [https://www.youtube.com/watch?v=NT\\_j3psJWHI](https://www.youtube.com/watch?v=NT_j3psJWHI). A later, longer version was recorded in 1956.

<sup>29</sup>There are various versions of this poem set to music on YouTube. None of these versions involve the musical piece that we used. I can still sing the music, so we must have rehearsed quite a bit. But despite utilizing various apps that purport to allow you to hum a tune and find it on the web, I cannot tell you what music was used. The apps failed to find it. The words of the poem are at <http://www.poetry.org/dickinson.htm>.



appear at the PS 75 inauguration. Again, as far as I was concerned, the fact that the mayor was coming was going to be the highlight of the event.

The day and then the evening of the great inauguration arrived. The audience dutifully assembled in the school auditorium. *But then at the ceremony, it was announced that Mayor Impellitteri was not going to appear after all and that he had sent some underling in his place.* Apparently, although the grass so little had to do, the mayor was too busy to show up.

Of course, there was a valuable civics lesson at the inauguration of the Emily Dickinson School in being stood up by Mayor Impellitteri. It's a lesson that many voters to this day seem never to have learned. *Elected officials do not always do what they promise.*

But there may be a more general lesson that goes beyond civic affairs. As you go through life, expecting too much can lead to disappointment. Ms. Dickinson said as much:

## ***Disenchantment***

*It dropped so low in my regard  
I heard it hit the ground,  
And go to pieces on the stones  
At bottom of my mind;  
Yet blamed the fate that fractured, less  
Than I reviled myself  
For entertaining plated wares  
Upon my silver shelf.*

## Mitchell's Musings 5-29-2017: Creative Accounting

### Daniel J.B. Mitchell

In June 2011, California governor Jerry Brown faced a problem. He had a budget crisis inherited from his predecessor, Arnold Schwarzenegger. Brown hoped to resolve the problem by extending certain temporary taxes that were due to expire. But he needed a few Republican legislative votes to put the tax issue on the ballot for voters to decide – a two-thirds vote of the legislature would have been required - and no Republicans would go along. However, the budget needed to be passed before the July 1, 2011 start of the new fiscal year, and budgetary rules required a “balanced” budget.<sup>30</sup> So eventually an extra \$4 billion in revenue was simply assumed, although it was not specified which tax or taxes would supply the extra revenue. With the assumption of the phantom \$4 billion, the proposed budget was balanced on paper and could be passed.

Readers will quickly discern that just assuming more revenue, while it solved an accounting problem, did not address the real problem, insufficient tax receipts. The revenue needed for the proposed budget to be in actual “balance” was not produced by just assuming it would appear, so the true problem was not resolved. If extra revenue is assumed that then doesn't appear, and if programs are continued absent that extra revenue, someone eventually must pay. In the California case, presumably that someone would be future taxpayers, since state debt will rise. Or perhaps some future programs that would otherwise be in later budgets won't be undertaken because of that debt.

Essentially, what an accounting trick does is to allow some course of action to go forward. But eventually there will be consequences.

That conclusion from this California anecdote is readily evident. And it can be applied more generally. From time to time, the idea of using a trick to deal with Social Security's long-term “underfunding” is suggested. Sometimes the trick involves giving recipients less in the future without making it apparent. Fiddling with the cost-of-living provision falls into that category. But sometimes the idea is to protect future recipients from cuts in the future, also without making that goal apparent.

A bit of history: Social Security, when it was enacted in 1935, was made to look like a private pension plan of the type that existed at the time in a few big firms. So it had a mix of employer and employee contributions, a trust fund, and a defined-benefit schedule. The trust fund was invested in U.S. Treasury securities. The fact that it was made to resemble a private pension plan was really for political purposes; such a structure made the plan – a radical innovation in its time – seem more normal. The trust fund was invested in Treasuries rather than in the stock market because in the midst of the Great Depression – which had begun with the market crash of 1929 – putting money into stocks would hardly have been reassuring.

In more recent history, however, the idea of putting some of the Social Security trust fund into the stock market has been raised on the grounds that stocks, over long periods, have earned more than Treasuries. So if you earn more on what is in the trust fund, there is less pressure to raise tax revenue for the program by increasing payroll taxes. But various objections have also been raised. In some cases, the stock market suggestion is combined with the idea of phasing out or diminishing the defined-benefit

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<sup>30</sup>We are putting aside here what “balanced” might mean. That matter is a separate issue we don't need to deal with here.

element of Social Security and substituting individual accounts, basically a variant on IRAs. Conservatives who don't like Social Security on ideological grounds favor that idea.

But liberals can see earning higher returns via the stock market as a way of preserving the program "as is" and its promised benefits. A recent paper makes just such a case.<sup>31</sup> The paper takes up various objections to diverting money to the stock market and puts them aside. For example, it raises the issue of whether Social Security purchases of stocks would "disrupt" the stock market (not clear what disrupt means) and finds that it wouldn't be a problem. But the paper misses the macro perspective. Social Security resembles a private pension plan. But as a near-universal federal program, it really isn't an ordinary pension.

There is a key problem facing Social Security as a system when it is seen as an ordinary pension plan. Viewed that way, it is underfunded. However, Social Security is basically a pay-as-you-go transfer arrangement (today's taxes pay current benefits). But it also has some savings built up – but not enough – for the demographic bulge created by the baby boom/baby bust. So the trust fund will go to zero before all the boomers have collected what current formulas suggest they will be owed.

Of course, the most obvious solution for preserving the system as it is would be to raise the associated employer and employee payroll taxes. But Washington gridlock prevents that step. So if earnings on the trust fund were raised sufficiently, those extra returns might get the system over the demographic hump.

Now, in theory, you could make those earnings go up by simply raising the interest rate paid on the Treasuries held by the system. In effect, Social Security would become solvent on paper and the national debt would rise to cover the added interest costs. The accounting trick would thus protect future boomer retirees and put the burden of paying for them on future taxpayers. However, the fact that it is a trick is too transparent for such a step to be undertaken. Why should the Treasury pay a higher interest rate to Social Security than to other lenders, folks would ask?

Diverting investment of the trust fund into stocks is a more subtle trick, but it is nonetheless a trick from a macro viewpoint. All that would really happen is that the identity of the holders of Treasury securities and stocks would shift. The trust fund would buy stocks. Those stocks would then not be available for institutions and individuals that otherwise would have bought them. On the other hand, more Treasury securities would have to be sold on the market since Social Security would not be buying them. So those institutions and people that would have bought stocks will end up buying Treasuries. There might be some second-order effects arising from this shuffling of portfolios, but in the end that's all it is: a portfolio shuffle.

In, say, the year 2040, when the boomer retirement will be at or near its peak, the then-existing GDP will be whatever it is and some of it will be consumed by retirees. The more they consume, the less will be available for anyone and anything else. That is the underlying macro significance of the baby boom demographic bulge. More for the elderly; less for others. Reshuffling the portfolio has no obvious impact on the total size of that future GDP. It doesn't, for example, raise national saving now which might –

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<sup>31</sup>Gary Burtless, Anqi Chen, Wenliang Hou, and Alicia H. Munnell, "What Are the Costs and Benefits of Social Security Investing in Equities?" (Boston College, Center for Retirement Research, May 2017), available at [http://crr.bc.edu/wp-content/uploads/2017/05/IB\\_17-10.pdf](http://crr.bc.edu/wp-content/uploads/2017/05/IB_17-10.pdf).

through more investment – lead to a higher GDP by 2040. So the trick entailed in diverting the trust fund into the stock market has only one effect. It tends to ensure that future retirees will be fully protected from cuts in promised benefits because the system will be “solvent.” The flip side of that solvency is that the incidence of paying for the demographic bulge will be borne by someone else.

Let’s do some simple examples. Imagine a society in which every year there is one birth at age 0 and everyone dies at their 80<sup>th</sup> birthday. Persons age 0-19 are “children-dependents.” From age 20 through age 59, they are active workers and parents. From age 60 until they die, they are retirees. Children-dependents are supported by intra-family transfers from parents, not the government. Retirees are supported by a government-operated, pay-as-you-go, tax-based Social Security system.

As we have set up this story, there will be a steady state in which at any time there will be twenty children (aged 0-19), 40 active workers-parents (aged 20-59), and 20 retirees (aged 60-79) in society. Let’s now suppose further that each active worker earns 1 dollar. So total GDP will be \$40. The 40 active workers, in producing that GDP, are supporting both their non-working children and non-working retirees. Forty workers, in other words, are supporting 80 people.

If every person receives an equal income, that income will be 50 cents. So the active worker-parents will, through intra-family transfers, divert \$10 of GDP to their 20 children (so each child will receive 50 cents). The twenty retirees are supported by Pay-Go Social Security, so \$10 will be taxed away from active workers and paid to the retirees (giving each retiree 50 cents). The 40 active workers thus will have \$20 left for themselves (50 cents per capita). This steady-state situation is shown on Appendix Figure A1.

Now let’s create a baby boom demographic bulge. Suppose in one year, there are 11 births (10 extra babies) instead of one. Thereafter, the birth rate goes back to one per year. There will be 30 children total in society until, after 20 years, the boomer-children become active worker-parents. Figure A2 show a typical year *before* the boomers age into the workforce. Let’s assume that parents want to maintain per capita consumption of children at 50 cents. They will have to divert \$15 of the \$40 GDP they are generating to their 30 kids. The number of retirees is still 20 so \$10 will still be taxed away from active workers to support the Pay-Go Social Security system and its promise of a retirement income of 50 cents/retiree. Active worker-parents will receive only 37.5 cents per capita for their consumption, assuming they want to sacrifice to keep their kids at 50 cents per capita.

When the boomers become workers, society faces two choices. It can continue Social Security on a Pay-Go basis, and not put anything away in a trust fund for the eventual retirement of the boomers. Or it can pre-fund the eventual increment of boomer-retirees. Figures A3 and A4, respectively, show the alternatives. In Figure A3, with the number of children back to 20 (baby bust), the intra-family transfer/diversion from the enlarged GDP of \$50 is back to \$10. There are still only 20 retirees so the tax diversion from the \$50 GDP is again only \$10. We now have 50 workers supporting 90 people which leaves more income for the active workers than when only 40 workers supported 90 (when the boomers were children) or when 40 workers supported 80 people (before the boomers were born). Boomer-workers have a per capita income of 60 cents if there is no pre-funding.

If there is full pre-funding of the *extra* boomers' retirement, we will need to put aside \$100 in the trust fund.<sup>32</sup> (The 10 extra boomers will be retired for 20 years and get 50 cents per year; we're assuming zero interest on the trust fund.) As Figure A4 shows, if we tax the 50 workers \$12.50 (instead of the previous \$10 with no pre-funding), over the 40 years before retirement of the boomers, the extra \$2.50/year will add up to \$100). Even so, the 50 active workers will do better than the steady-state and better than when the boomers were children. Their per capita income will be 55 cents.<sup>33</sup>

So what happens when the boomers become retirees? If the tax for Social Security is not raised, the \$10 tax taken from the \$40 GDP will produce only a per capita income for retirees of 33.3 cents (\$10/30), as shown on Figure A5. If, on the other hand, sufficient income in earlier years had been put aside to build the trust fund to \$100, as Figure A6, all groups – children, active workers, retirees – get their 50 cents per capita.<sup>34</sup>

What if there is no prefunding and also a decision is made to give the boomer-retirees their promised 50 cents per capita anyway? The money has to come from somewhere. As Figure A7 shows, if the incidence falls entirely on active workers, their per capita income falls to 37.5 cents, assuming they continue to give their children 50 cents per capita. It's worth noting that this result during boomer retirement is the same as what occurred when the boomers were children. But because no government agency was involved when the boomers were kids (the transfer was intra-family), we didn't call what occurred a "crisis." When a government agency is involved, however, we do. Go figure!

Let's get back to the proposal to put some Social Security funds into the stock market. Which of the various figures is most analogous to that proposal? Figure A7 is the closest analogy. As noted, putting the money in the stock market does not make GDP bigger. And more money has not been diverted from prior GDP to produce an actual reserve of resources. But putting funds in the stock market *does* make the Social Security system solvent on paper. Politically, the boomers are thus protected. Still, the incidence has to fall on someone other than retirees, as in Figure A7. That figure assumes the incidence falls on active workers by the mechanism of a higher tax. But it could fall on them through inflation.

The point is that if you have a \$40 GDP and 90 people to split it up, the average per capita income has to be less than when you have a \$40 GDP and 80 people to split it up. With a \$40 GDP and 90 people, you can't give everyone 50 cents per capita. It's no more complicated than that. Putting Social Security money in the stock market doesn't change that logic. It just rigs the game – assuming that stocks do earn more than Treasuries in the future - so that the boomers are not the ones who take a hit (because their system appears solvent). If they don't take a hit, the incidence has to be on active workers and/or their children.

There is another danger in resurrecting the stock market approach. As noted earlier, that idea has been more associated with dismantling the current structure of Social Security and turning it into individual IRA-type accounts. So re-introducing the dormant stock market argument risks destroying Social Security, not protecting it.

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<sup>32</sup>We are fully funding just the extra boomers, not all retirees.

<sup>33</sup>The gain is due to the baby bust. The 50 active worker-parents are supporting only 20 kids. In the steady state, we had 40 workers supporting 20 kids.

<sup>34</sup>Note that this result does not depend on earnings on trust fund monies, which are zero. At the macro level, what has happened is that in prior years real resources were diverted from GDP consumption, stored, and now paid out.

**Appendix**

**Figure A1: Typical Steady-State Year Before Baby Boom**

- *One birth per year*
- *One death per year at age 80*
- *Pay-Go Social Security system*

	Age 0-19 Children (Dependents)	Age 20-59 Active Workers (Parents)	Age 60-79 Retirees
Number	20	40	20
Income Generated	\$0	\$40	\$0
Income Taxed for Social Security	\$0	-\$10	\$0
Income Received from Social Security	\$0	\$0	+\$10
Intra- Family Transfer	+\$10	-\$10	\$0
Per capita Net Income	50¢*	50¢**	50¢***

\*\$10 transfer/20 children = 50¢.

\*\*\$40 income -\$10 tax -\$10 transfer to children = \$20 net income  
\$20 net income/40 active workers = 50¢.

\*\*\*\$10 from Social Security taxes/20 retirees = 50¢. Trust fund  
remains at \$20. The 50¢ per capita is in any case promised.

**Figure A2: Typical Year When Baby Boomers Are Children**

- *One year occurs in which there are 11 births  
Followed thereafter by one birth per year*
- *One death per year at age 80*
- *Pay-Go Social Security system*

	Age 0-19 Children (Dependents)	Age 20-59 Active Workers (Parents)	Age 60-79 Retirees
Number	30	40	20
Income Generated	\$0	\$40	\$0
Income Taxed for Social Security	\$0	-\$10	\$0
Income Received from Social Security	\$0	\$0	+\$10
Intra- Family Transfer	+\$15	-\$15	\$0
Per capita Net Income	50¢*	37.5¢**	50¢***

\*\$15 transfer/30 children = 50¢.

\*\*\$40 income -\$10 tax -\$15 transfer to children = \$15 net income.  
\$15 net income/40 active workers = 37.5¢.

\*\*\*\$10 from Social Security taxes/20 retirees = 50¢. The 50¢ per capita is in any case promised.



**Figure A3: Typical Year When Baby Boomers Are Active Workers With No Pre-Funding of Boomers' Social Security**

- One birth per year
- One death per year at age 80
- Pay-Go Social Security system

	Age 0-19 Children (Dependents)	Age 20-59 Active Workers	Age 60-79 Retirees
Number	20	50	20
Income Generated	\$0	\$50	\$0
Income Taxed for Social Security	\$0	-\$10	\$0
Income Received from Social Security	\$0	\$0	+\$10
Intra- Family Transfer	+\$10	-\$10	\$0
Per capita Net Income	50¢*	60¢**	50¢***

\*\$10 transfer/20 children = 50¢

\*\*\$50 income -\$10 tax -\$10 transfer to children = \$30 net income. \$30 net income/50 active workers = 60¢

\*\*\*\$10 from Social Security taxes/20 retirees = 50¢. The 50¢ per capita is in any case promised.

**Figure A4: Typical Year When Baby Boomers Are Active Workers With Full Pre-Funding of Boomers' Social Security**

- One birth per year
- One death per year at age 80
- Pay-Go Social Security system + \$2.50/year build-up of trust fund which rises over 40 years to \$100

	Age 0-19 Children (Dependents)	Age 20-59 Active Workers	Age 60-79 Retirees
Number	20	50	20
Income Generated	\$0	\$50	\$0
Income Taxed for Social Security	\$0	-\$12.50	\$0
Income Received from Social Security	\$0	\$0	+\$10
Intra- Family Transfer	+\$10	-\$10	\$0
Per capita Net Income	50¢*	55¢**	50¢***

\*\$10 transfer/20 children = 50¢.

\*\*\$50 income -\$12.50 tax -\$10 transfer to children = \$27.50 net income. \$27.50 net income/50 active workers = 55¢.

\*\*\*\$10 from Social Security taxes/20 retirees = 50¢. The 50¢ per capita is in any case promised.

**Figure A5: Typical Year When Baby Boomers Are Retirees With Social Security Crisis Absent Pre-Funding. Incidence of Crisis Falls on Retirees**

- One birth per year
- One death per year at age 80 except extra 10 deaths when boomers reach age 80

	Age 0-19 Children (Dependents)	Age 20-59 Active Workers (Parents)	Age 60-79 Retirees
Number	20	40	30
Income Generated	\$0	\$40	\$0
Income Taxed for Social Security	\$0	-\$10	\$0
Income Received from Social Security	\$0	\$0	+\$10
Intra- Family Transfer	+\$10	-\$10	\$0
Per capita Net Income	50¢*	50¢**	33.3¢***

\*\$10 transfer/20 children = 50¢

\*\*\$40 income -\$10 tax -\$15 transfer to children = \$15 net income.  
\$15 net income/40 active workers = 37.5¢

\*\*\*\$10 from Social Security taxes/30 retirees = 33.3¢. But 50¢ per capita was promised.

**Figure A6: Typical Year When Baby Boomers Are Retirees With Social Security Crisis Absent Boomers' Pre-Funding. Incidence of Crisis Falls on Active Workers**

- One birth per year
- One death per year at age 80 except extra 9 deaths when boomers reach age 80

	Age 0-19 Children (Dependents)	Age 20-59 Active Workers (Parents)	Age 60-79 Retirees
Number	20	40	30
Income Generated	\$0	\$40	\$0
Income Taxed for Social Security	\$0	-\$15	\$0
Income Received from Social Security	\$0	\$0	+\$15
Intra-Family Transfer	+\$10	-\$10	\$0
Per capita Net Income	50¢*	37.5¢**	50¢***

\*\$10 transfer/20 children = 50¢.

\*\*\$40 income -\$15 tax -\$10 transfer to children = \$15 net income.

\$15 net income/40 active workers = 37.5¢.

\*\*\*\$15 from Social Security taxes/30 retirees = 50¢.

**Figure A7: Typical Year When Baby Boomers Are Retirees With Social Security Crisis With Full Pre-Funding**

- One birth per year
- One death per year at age 80 except extra 9 deaths when boomers reach age 80
- \$100 trust fund is drawn down \$5/year for 20 years

	Age 0-19 Children (Dependents)	Age 20-59 Active Workers (Parents)	Age 60-79 Retirees
Number	20	40	30
Income Generated	\$0	\$40	\$0
Income Taxed for Social Security	\$0	-\$15	\$0
Draw down from Social Security Trust Fund	-	-	\$5
Income Received from Social Security	\$0	\$0	+\$15****
Intra-Family Transfer	+\$10	-\$10	\$0
Per capita Net Income	50¢*	37.5¢**	50¢***

\*\$10 transfer/20 children = 50¢.

\*\*\$40 income -\$10 tax -\$15 transfer to children = \$15 net income.

\$15 net income/40 active workers = 37.5¢.

\*\*\*\$15 from Social Security taxes and trust fund/30 retirees = 50¢.

\*\*\*\*\$10 from Social Security tax plus \$5 from trust fund drawdown.

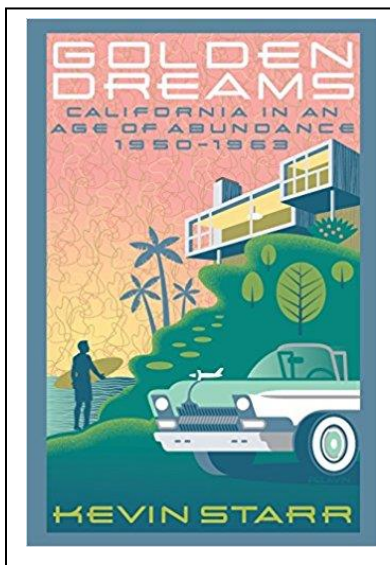
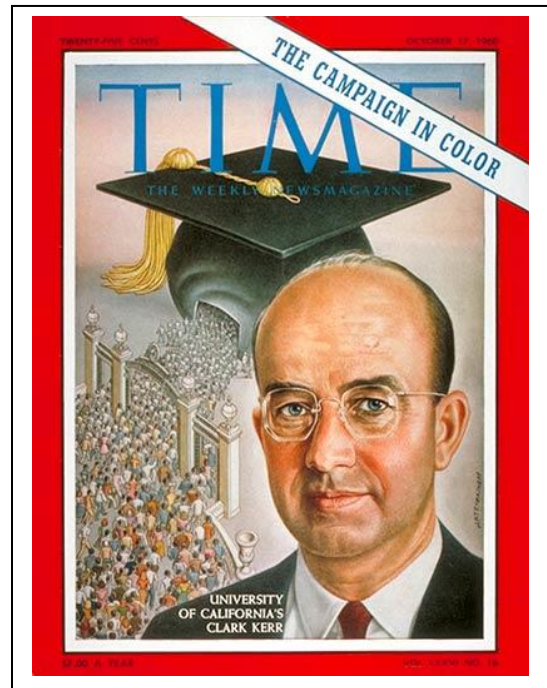
## Mitchell's Musings 6-5-17: What's the problem at UC?<sup>35</sup>

Daniel J.B. Mitchell

The University of California (UC) is a public university. As such, it competes for state funding with all other state programs. It has operated under a (gradually eroding) Master Plan for Higher Education that was put together in 1960 under the direction of the then-UC president, the legendary Clark Kerr, and shepherded into legislation by our current governor's dad, Pat Brown. Spoiler alert: UC's underlying economic problem is that the State has never fully adjusted to the end of the Cold War. Its underlying political problem is that doesn't have the leadership (despite the fact that it is headed by a former governor) that can make true long-term deal with the state.



*Clark Kerr hands Master Plan to Gov. Pat Brown.*



At the time of the original Master Plan (which actually expired in 1975, but somehow lives on), California was in what state historian Kevin Starr termed an age of "golden dreams." Not only was the state promising every college-age student a place somewhere in the higher ed system – virtually for free – but it was building new campuses to accommodate them, both at UC and in what was then called the state college system (now California State University – CSU). Even those students with marginal high school records could get into a community college and then transfer to a public 4-year institution after two years. Moreover, new freeways were being opened. And an ambitious state water project being planned.

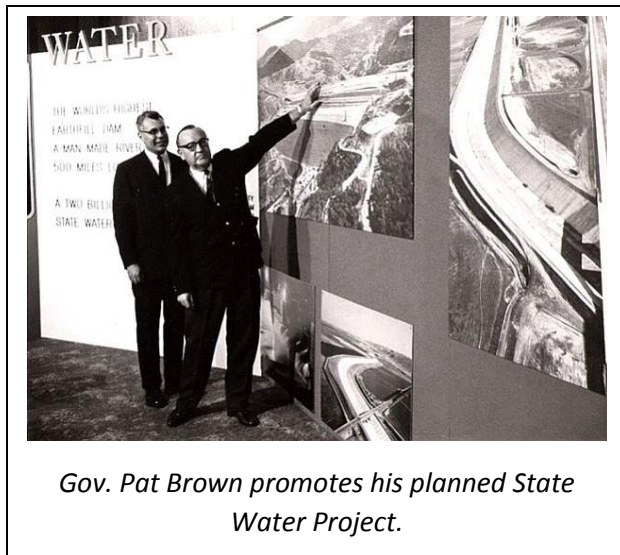
<sup>35</sup>Some thoughts for the June 4, 2017 panel in Anaheim, California on "Shifting Employment Relations in American Higher Education," Labor and Employment Relations Association.

How was it possible for a single state to be doing all of these things, given normal budget constraints? Part of the answer has to do with the fact that there was less competition for state funds back then. If you ask how much was the state spending on Medicaid (called Medi-Cal in California) when the Master Plan was adopted in 1960, the answer is zero. The program didn't exist at the time.

More importantly, there was an ongoing stimulus to the California economy (and thus indirectly to the state budget) that resulted from the military-related spending that was then going to the aerospace industry and related sectors. The stimulus was uneven – there were bumps in the road over time



*Gov. Pat Browns open a segment of the Santa Monica freeway in 1964.*



*Gov. Pat Brown promotes his planned State Water Project.*

depending on hot wars and Cold War confrontations. But when the Soviet Union dissolved, the state stopped growing faster than the U.S. A very mild recession in the early 1990s for the rest of the U.S. led to a years-long California state budgetary crisis and shaky fiscal conditions which persist. Even the dot-com boom of the late 1990s, and the housing/mortgage boom of the mid-2000s, were unable to put California back on its old growth path.

In the age of golden dreams, and beyond until 1990, although there was a budget constraint in California and an increase in claims by social welfare programs (such as Medi-Cal), it was easier to allocate funds out of the rapidly-expanding pie

than it is now. One dollar for X was not one dollar less for Y. In today's average-growth world for California, however, there is a more unpleasant trade-off. The average American state is used to being average and has adapted its expectations. California is not used to being average and resists adaptation.

I am telling an oversimplified story, of course. Fiscal aficionados of California would undoubtedly want me to say something about Prop 13 of 1978, for example, which drastically cut local property taxes and made the K-14 system heavily dependent on state support. Still, the underlying pressure resulting from

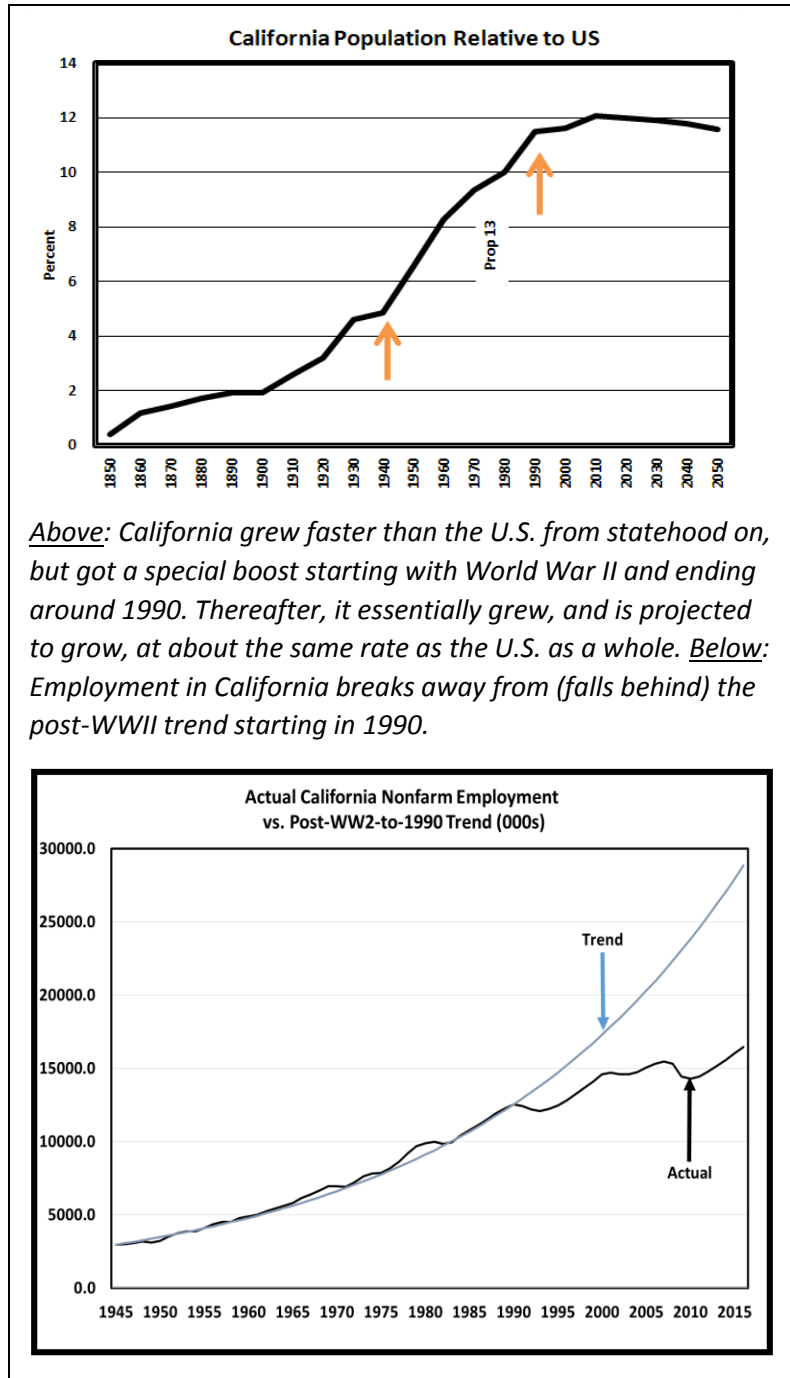


the switch from state super-fast growth to average growth is an important part of the tale of UC's dilemma.

One response of the state to being average has been to increase reliance on the income tax and, especially, the top brackets thereof. As a result, the state has a volatile tax base which depends heavily on the incomes of a relatively small group of high income taxpayers whose incomes often reflect the ups and downs of financial markets (capital gains), as well as the underlying real economy.

Almost half of income tax receipts are received from the top 1 percent of filers.<sup>36</sup> In the governor's proposed budget for fiscal year 2017-18, the income tax is projected to account for seven out of ten dollars received by the state general fund.<sup>37</sup> As an illustrative anecdote, back in February 2012, the Legislative Analyst's Office devoted a section of its report on the governor's initial budget proposal for 2012-13 to the impact of the Facebook IPO and how much the state could collect in capital gains from Mark Zuckerberg & Co.<sup>38</sup>

When there are economic downturns, UC is particularly vulnerable because state support for it is seen as discretionary. The legislature knows, moreover that reductions in tax support for UC can be made up by tuition increases that it doesn't have to approve. Indeed, it can blame the UC Regents for the increases, which is even better.



*Above: California grew faster than the U.S. from statehood on, but got a special boost starting with World War II and ending around 1990. Thereafter, it essentially grew, and is projected to grow, at about the same rate as the U.S. as a whole. Below: Employment in California breaks away from (falls behind) the post-WWII trend starting in 1990.*

<sup>36</sup><http://www.sacbee.com/news/politics-government/capitol-alert/article74271532.html>.

<sup>37</sup><http://www.ebudget.ca.gov/2017-18/pdf/Revised/BudgetSummary/SummaryCharts.pdf>.

<sup>38</sup><http://www.lao.ca.gov/analysis/2012/update/economic-revenue-update-022712.pdf>. See pp. 25-26.

That observation brings me now to the Regents. Under the state constitution, the Regents have “autonomy.” But the legislature can always condition funding on the Regents doing something or not doing something. So the meaning of constitutional autonomy has never been clear. The legislature *does* show some deference to the Regents, given the constitution, but less so now than in the past.

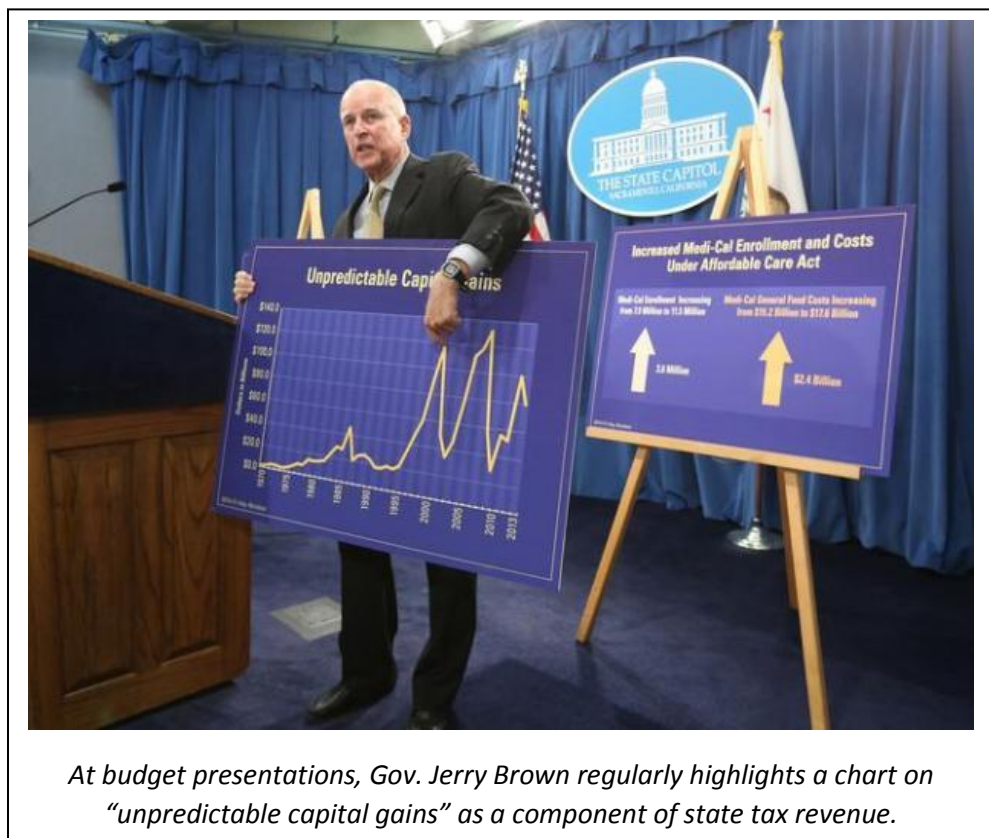
So let’s look at the political side to UC’s problem. Back in the day, before voters approved term limits for legislators (in that fateful year of 1990!), legislators tended to stay in office for long periods and specialize in particular fields (such as higher education). UC’s legislative representatives – some would say lobbyists – would form relationships with the key personalities in the legislature who controlled UC’s appropriations and cut deals when needed. But that ability eroded under term limits as the legislative personalities kept changing. Schmoozing with a few lawmakers just doesn’t work like it used to.

Moreover, UC’s president has typically been an academic and political skills did not always accompany academic credentials. So, for example, when Arnold Schwarzenegger became governor after a recall election in 2003, the then-UC president, physicist Robert Dynes, rushed to sign a “compact” with him dealing with university funding. Remarkably, Dynes seemed to think that his compact meant something. But as soon as the state budget went south under Schwarzenegger, neither the governor nor the legislature paid much attention to the compact.

The current governor, Jerry Brown, is actually in his second iteration in that office. He was first elected governor in 1974, reelected in 1978, and then went into political eclipse after an abortive run the for the U.S. senate in 1982.

During his first iteration as governor, Jerry Brown had a tense relation with UC. The governor is an *ex officio* member of

the Board of Regents and, in fact, is technically the “president” of the Board. But, as a matter of practice, most governors haven’t attended Regents meetings. Brown, however, took an interest in UC and does attend meetings. Why? He considers himself, if not the smartest guy in the room, then certainly the most profound questioner in the room. Brown was famous in his first iteration for promoting the idea



*At budget presentations, Gov. Jerry Brown regularly highlights a chart on “unpredictable capital gains” as a component of state tax revenue.*

that faculty should be content with their “psychic incomes” (as opposed to cash). There is still much of the old Brown in his attitude towards UC.

After emerging from his political eclipse, Brown was elected mayor of Oakland, then attorney general of the state, and finally governor in 2010 (reelected in 2014). As governor, as noted, he does show up at Regents meetings. At first, the Regents didn’t quite know how to handle him and generally played nice and went along with what he wanted. These things included more online education and a cut-rate pension plan for new hires, among others goals.

Eventually, however, the Regents seems to reach the conclusion that they were being outgunned politically, both by legislature and the governor. To change that dynamic, they decided to appoint a former governor – Janet Napolitano of

**UC Regents commit to audit recommendations, praise Napolitano**

Associated Press, KXTV 7:21 AM PDT May 30, 2017

The University of California has announced it will no longer pay for the meals of its governing board after a newspaper reported lavish spending on dinners.

The UC Board of Regents Chair Monica Lozano and UC President Janet Napolitano said in a statement that regents will “absorb their costs for board dinners” to avoid questions over how money is spent.

The San Francisco Chronicle reported Sunday that Napolitano’s office reimbursed regents for more than \$225,000 in dinner parties since 2012, including \$17,600 for a banquet held the night before the board voted to raise tuition.

*Firefighting the recent scandals.*

**Auditor says UC kept millions in secret fund**

By Melody Galanter Updated 9:48 am, Tuesday, April 25, 2017

**Regents throw parties at UC's expense**

By Melody Galanter and Noelle Andrew | May 18, 2017 | Updated: May 30, 2017 10:48 am

*The most recent scandals.*

Arizona – as president instead of a traditional academic. Surely, a former governor – a politician - could deal with the politics of UC.

Unfortunately, although Napolitano is more politically astute than many academic administrators, she doesn’t seem to have a sense of the underlying economic quandary facing UC that we noted at the outset. So she concedes what the governor and legislature want whenever they push hard enough or when there is a scandal. For example, the pension deal she cut with the governor has a real downside, but the governor pushed for it so she met with him in private (in what was termed the “Committee of Two”) and proclaimed the result to be a done deal.

UC admitted more out-of-state students during its most recent budget crisis (because they pay higher tuition), contributing to the popular notion that

the reason Johnny didn't get into Berkeley was because of these outsiders.<sup>39</sup> (The question of *why* there are more outsiders is not always asked – or is ignored.) So after the legislature fussed about out-of-state students, the UC president agreed to admit more in-state students and cap out-of-staters, although not with sufficient funding to pay for the extra admits and for the needed added facilities and services.

Most recently, there has been a clash with the California state auditor over UC's budget reserves and a brouhaha about super-expensive dinners for the Regents. As these problems arise and receive attention in the news media, Napolitano – as a politician – detects that something must be done in response to quiet the controversy. That's good. But it is basically a firefighting skill. And the lesson drawn is that if you want something from UC, you have to create enough of a controversy so that legislators start to threaten. UC agreed to do what the auditor said should be done about reserves. And UC ended the dinners. The pressures arising from the bad PR were sufficient to bring a swift result.

But consider another controversy involving outsourcing. UC-San Francisco, the medical campus,



outsourced various information technology jobs to India. Particularly in the age of Trump (in which issues of outsourcing and job displacement by foreigners have been highlighted), you might think that the UC president would quickly override the decision. But despite complaints delivered to the Regents and adverse publicity in the news media, the issue never got enough traction in the legislature for UC to change course. There was a fuss, but not a big enough fuss.

This reactive approach by UC doesn't get to the heart of things.

Given the fact that California is no longer in its one-time age of golden dreams, and that prospects for a renewed golden period are slim, what is needed now is a new Master Plan. Such a plan has to be far more than the useless "compact" UC had with Gov. Schwarzenegger. It can't be a hasty deal between the UC president and the governor, another Committee of Two arrangement. The legislature must be involved, the stakeholders within the university must be involved, and outside interest groups must also be involved. There has to be an encompassing political process.

The University of Michigan's arrangement with its state is sometimes referred to as the "Michigan Model." Essentially, the deal in Michigan is something like what happened to UC as state funding was restricted, i.e., tuition increases, expanding admissions of out-of-state students paying a premium to raise revenue, etc. But it was done in Michigan through a process that involved the key stakeholders

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<sup>39</sup>I focus the issue on UC-Berkeley because, as will be noted below, Gov. Jerry Brown (as an alumnus) has that focus.



including the outside interest groups. It might be noted that the University of Michigan was headed at the time by an academic economist, Harold Shapiro, who could see where the Michigan economy was going long term. In short, hiring a politician to run a university system gives you short-term political sensibilities, but not necessarily a strategic vision.

In any case, UC's problem is that it has stumbled into the Michigan Model (higher tuition; more out-of-state students) on an *ad hoc* basis without ever having a Michigan-type accord. Unfortunately, the *ad hoc* approach doesn't work very well. Eventually, the legislature, the public, the interest groups, and the internal stakeholders say they never agreed to it and the approach falters.

At one time, when politics in California were more balanced, there were such things as centrist Republicans in the state, business types who saw UC as contributing to the state economy. Thus, Jerry Brown's gubernatorial successor after his first iteration, Republican George Deukmejian, took pains despite the budget crisis Brown bequeathed to him in 1983, to substitute competitive pay for UC faculty in place of psychic income. His rationale was simply standard labor market analysis, an approach easily understood by business-type Republicans.

But now Republicans in California tend to be tea party types who don't like UC because it is seen as elite. And they are particularly turned off by misbehavior on the left: riots over guest speakers, demands for safe spaces, etc. There will be no George Deukmejian-type candidates in the next gubernatorial election (2018) to rescue UC, since there are no Deukmejian-style Republicans left in California who are capable of winning a statewide election. On the Democratic side, the candidate who is most prominent at the moment is the current lieutenant governor who is, like the governor, an *ex officio* member of the Regents. Nothing in his behavior on the Regents so far gives me reason to hope he will be a friend of UC should there be another budget crisis.

Now don't get me wrong. There is plenty the Regents could do, and UC administrators could do, to improve efficiency. Huge capital expenditures are routinely approved by the Regents without a capability for real review of plans or alternatives. The Regents are unpaid part-timers meeting once every two months and they have their day jobs to worry about. So their ability to oversee UC – now a vastly more complicated entity than when the Master Plan was developed - is more limited than they would like to admit. But the notion that if only “waste, fraud, and abuse” were vanquished, Johnny could get into Berkeley is simply wrong. You can complain that the Regents and/or UC top brass have “tin ears.” But even with the most acute ears on the part of UC's powers-that-be, Johnny's odds at getting into Berkeley won't materially improve.

Back when the Master Plan was enacted, there were about five and half million Californians under age 18, the potential seedbed of future college admissions. At the time of the 2010 Census, there were about 9.3 million in that age bracket, i.e., less than a doubling.<sup>40</sup> Even allowing for the fact that a larger fraction of high school graduates want to go to a 4-year undergraduate institution now than back in 1960, the fact is that the number of UC enrolled undergraduates who were California residents more

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<sup>40</sup><https://www.census.gov/prod/1/pop/p25-384.pdf>; <https://www.census.gov/prod/cen2010/briefs/c2010br-03.pdf>.

than quadrupled from around 40,000 to 176,000 over that interval.<sup>41</sup> But there is still only one Berkeley campus. There is no way they all could go to Berkeley.

The Master Plan of 1960 projected increased enrollments, *but dealt with them mainly by adding new campuses*. So, if anything, it is easier for Johnny to get into UC *somewhere* than it was in 1960, but *not* into Berkeley. Indeed, the state Legislative Analyst's Office (LAO) believes that the Master Plan target of UC offering admission to just the top 12.5 percent of high school graduates is currently being *exceeded*.<sup>42</sup>

Gov. Brown said at a Regents meeting that as far as Berkeley admissions is concerned *"you got your foreign students and you got your 4.0 folks, but just the kind of ordinary, normal students, you know, that got good grades but weren't at the top of the heap there – they're getting frozen out."*<sup>43</sup> And indeed they are. But that freezing has nothing to do with lavish Regents' dinners or sloppy accounting for reserves at UC headquarters.

What does it have to do with? Actually, although it's hard to find good historical data online, the Berkeley campus' undergraduate enrollment appears to have expanded significantly as the under-18 population in the state has expanded, although probably not proportionately.<sup>44</sup> But more high school graduates now want to go to college than in 1960. Cost-cutting pressures have encouraged more transfer students (who spend their first two years in community college), so getting in via good grades and scores as a freshman is now more constrained. There are pressures on the university from the legislature for diversity in admissions. So despite Prop 207, the 1996 voter initiative banning "affirmative action," admissions have become more "holistic," i.e., less focused on grades and scores. Finally, there is relative pricing.

Yes, UC tuition went up as state budget appropriations were squeezed. But for in-state students, tuition cuts two ways. On the negative side, it is a lot more expensive to go to Berkeley than it was in 1960. But Berkeley is cheaper than, say, Stanford or most other privates for many applicants. So if you want to get into Berkeley as a freshman via grades and scores, demand for slots is up for that route – but when it comes to supply, not so much.

Bottom line: Unless UC leadership sits down with state politicians and other stakeholders and interest groups concerned with the future of UC and develops an accord concerning the alternatives for funding, the long-run prospects are for continued firefighting. Quality erosion and decay could be the consequences. There are no guarantees that a better future can be produced by a deliberate and probably difficult political process to produce a new Master Plan. But the current approach of *ad hoc* adjustments to crisis and pressure, even with a former governor at UC's helm, is not working very well.

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<sup>41</sup><http://accountability.universityofcalifornia.edu/2011/index/1.1>. The 1960 data do not separate California residents from non-residents. So the 40,000 figure is an overstatement of Californians.

<sup>42</sup><http://www.lao.ca.gov/reports/2017/3532/uc-csu-enrollment-capacity-011917.pdf>.

<sup>43</sup><https://www.insidehighered.com/news/2015/01/23/gov-brown-says-normal-californians-cant-get-berkeley-problem-some-californians-blame>.

<sup>44</sup>Enrollment in 1960 was reported as a little over 15,000. See "Berkeley Campus Enrollment Rises," *Los Angeles Times*, September 16, 1960, p. A5. In 2010, it was about 25,000 of which around three fourths were California residents.

## **Mitchell's Musings 6-12-17: Trump on Trade: It's a Puzzlement (or Maybe It Isn't)**

**Daniel J.B. Mitchell**

In the musical "King and I," the King of Siam sings about learning of facts that don't fit into his frame of reference and declares them to be a "puzzlement."<sup>45</sup> During the 2016 presidential campaign, then-candidate Trump indicated that he would undertake various "protectionist" measures to protect the jobs of American factory workers. University of California-Irvine professor Peter Navarro – who had earlier denounced Chinese trade practices – became an official economic adviser. In the period before the inauguration, but after the election, Trump attracted substantial news media attention by ostensibly intervening personally with the management of various companies to preserve jobs and not outsource abroad.

All of these actions tended to go against establishment Republican pro-free trade beliefs. But Trump would sometimes point to President Ronald Reagan – now a god-like figure in conservative Republican circles – and Reagan's trade policy.<sup>46</sup> Reagan first came into office in 1981 at a time when the U.S. economy was entering a downturn. In fact, there were two back-to-back recessions that developed, the second of which was quite severe. Indeed, if measured by the unemployment rate, the severity of the Reagan recession was greater than the more recent Great Recession. (See below.)

So if Reagan followed a protectionist policy, and since Trump promised it citing Reagan, why hasn't he followed through? Even the veiled, and not-so-veiled, threats Trump made about what he would do if companies continued to outsource seem to have disappeared. It's a puzzlement.

It is even more puzzling when you consider the way Reagan went about his protection arrangements. Trump seems to prefer country-by-country "deals" over multilateral accords. And he believes himself to be a great dealmaker. Reagan didn't depict himself in that fashion, but his most high profile policy of protection – restricting Japanese car exports to the U.S. – was

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<sup>45</sup><https://www.youtube.com/watch?v=9u5iHzag120>.

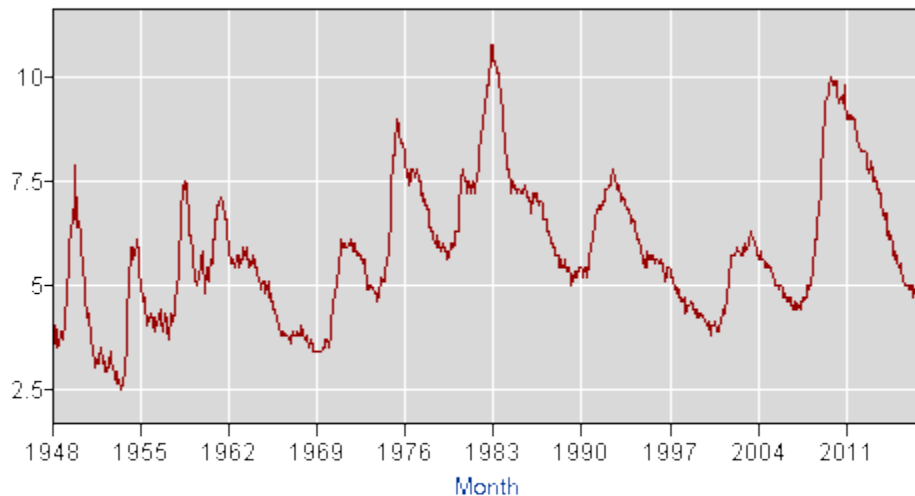
<sup>46</sup><http://money.cnn.com/2016/07/27/news/economy/donald-trump-ronald-reagan-trade-japan/index.html>.

precisely such a Trump-type deal. Reagan seemed to know about the Art of the Deal, even without having (ghost-) written a book by that title.

Of course, nowadays it's China, not Japan, playing the role of the chief U.S. trade villain. But the Chinese told Trump that currency manipulation was no longer occurring, and Trump accepted that story and even took credit for it.<sup>47</sup> The general view seems to be that Trump gave up pressuring China on trade in the hope that China will fix his North Korea problem – although it's not clear that anything like that is likely to occur.

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#### Civilian Unemployment Rate, seasonally adjusted



Source: U.S. Bureau of Labor Statistics. Note that the 1983 Reagan recession shows an unemployment peak higher than any other post-World War II recession, including the most-recent Great Recession.

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There is a possible explanation for the puzzlement, at least as far as China is concerned, which goes beyond the North Korea issue. Reagan made a deal with Japan for what were called “voluntary export restraints” (VER). There was no official American quota, which would have required Congressional action. Japan agreed “voluntarily” to limit its automobile exports to the

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<sup>47</sup><https://www.washingtonpost.com/news/fact-checker/wp/2017/05/16/president-trumps-evolving-claims-about-when-china-stopped-manipulating-its-currency/>.



U.S. The Japanese government then essentially distributed the quota among the various Japanese auto manufacturers.

One version of the Reagan story is that Japan agreed to the *de facto* quota system because of fears that if it didn't agree, Congress would enact something more restrictive. That lesser-of-two-evils motivation could have been part of the reason. But we know something else about the VER arrangement with Japan after the fact. When the Reagan administration later indicated that there was no need for continued voluntary quotas, the Japanese seemed reluctant to give them up. So why, if the threat was over, and if the threat had been the motivation, wouldn't the Japanese quickly terminate the quota arrangement?

Note that there are only a handful of major brand name Japanese auto manufacturers. They had been established in the U.S., and had developed a degree of brand recognition and loyalty, since the 1960s. In effect, the quota system, by restricting supply, raised the price of Japanese cars in the U.S. (which also benefited competing American brands). The quota system operated as a coordinated Japanese auto cartel, limiting supply *but raising the profit markup on each car sold*. From the point of view of Japan, reduced competition and higher markups were beneficial. But did the quota system provide a *net* benefit to Japan? Even if it didn't, it did provide Japanese auto companies at least an offset to the restriction on market share. And the fact that there was reluctance to give up the VER system when it was no longer required suggests that there may well have been a net benefit to Japan.

Could Trump have reached a comparable deal with China? The problem would have been that Chinese imports are not concentrated in a few brands or product lines that are highly recognizable to American consumers. What is the Toyota equivalent of China products? Maybe Lenovo computers? Imports from China more typically are outsourced arrangements with other, often American, firms. Apple's iPhone is an example. And there are lots of different products that constitute Chinese exports to the U.S. as opposed to a concentration (as in the Japanese case) on cars.

So a Chinese equivalent of a VER, even if Trump had requested one, seems unworkable. If, say, a VER-type quota was somehow imposed on iPhone imports, who would get the increased

markup? Apple or the Chinese manufacturer? Would there even be an increased markup, or would Apple just outsource to some other cheap-labor country?

In theory, China could agree to an export tariff (or some equivalent) on its sales to the U.S. Such an approach might capture some added revenue for China. But there are lots of other low-wage countries in the world that would pick up the slack, so the incentive for China to take such a step is small. Moreover, the idea that if China didn't impose a restriction on itself, Congress would enact something more restrictive seems far-fetched. There is no indication that the Republican Congress is itching to impose such a restriction.

Bottom line: There is a possible explanation of the puzzlement as to why Trump didn't make a trade deal with China: Without any leverage, he couldn't. You don't need to know much about the Art of the Deal to know that without leverage, there is no deal to be had.

## Mitchell's Musings 6-19-17: What If What We Know Ain't So?

Daniel J.B. Mitchell

The Fed keeps raising interest rates to counter inflation as the unemployment rate falls to a level (below 4½%) that someone thinks will cause price inflation to rise above the Fed's target of 2%/annum. Let's set aside the question of why 2% is the target. (Why not 2.5% or 1.5%? What price index is best?) The fact is that core inflation (excluding volatile food and energy prices), shows no trend toward acceleration:

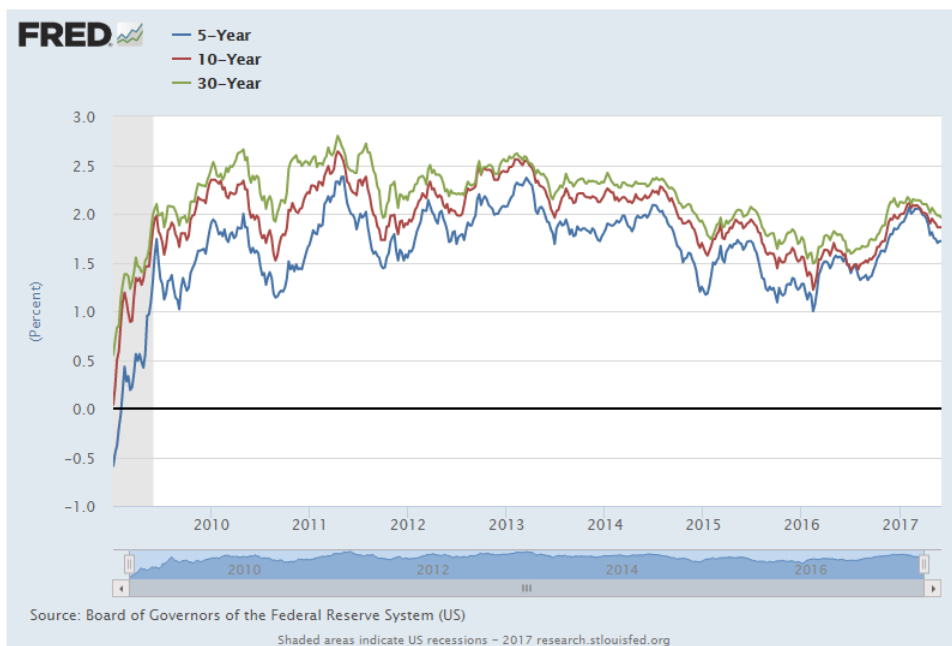
### Core Consumer Price Index: May of Year Shown: 12-Month Percent Change:

2008	2.3
2009	1.8
2010	0.9
2011	1.5
2012	2.3
2013	1.7
2014	2.0
2015	1.7
2016	2.2
2017	1.7

Nor is there any sign of inflation expectations accelerating above 2%:

### Inflation-Indexed Treasury Yield Spreads

Averages of Daily Figures



If we look at the labor market for signs of “wage-push,” we don’t see it. Presumably, wages would start to “push” the price level up if they rose faster than some long-term allowance for productivity. But there is no sign of such an outcome from current data:

**Employment Cost Index for Private Sector:  
12-Month Change, Total Compensation**

<b>Year</b>	<b>Qtr1</b>
<b>2007</b>	3.2
<b>2008</b>	3.2
<b>2009</b>	1.9
<b>2010</b>	1.6
<b>2011</b>	2.0
<b>2012</b>	2.1
<b>2013</b>	1.9
<b>2014</b>	1.7
<b>2015</b>	2.8
<b>2016</b>	1.8
<b>2017</b>	2.3

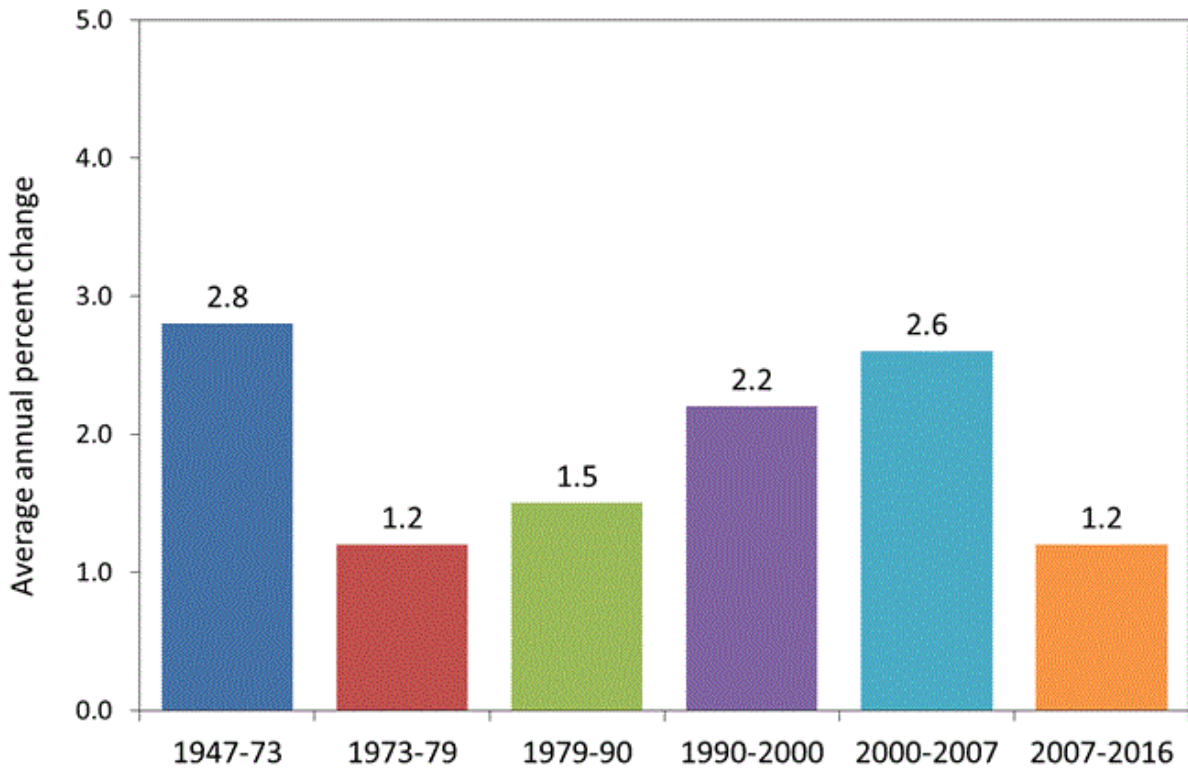
Even if you think there is something funny in the numbers above related to benefit costs, when we look at just wages (no benefits), it’s still hard to see any wage-push.

**Employment Cost Index for Private Sector:  
12-Month Change, Wages and Salaries**

<b>Year</b>	<b>Qtr1</b>
<b>2007</b>	3.6
<b>2008</b>	3.2
<b>2009</b>	2.0
<b>2010</b>	1.5
<b>2011</b>	1.6
<b>2012</b>	1.9
<b>2013</b>	1.7
<b>2014</b>	1.7
<b>2015</b>	2.8
<b>2016</b>	2.0
<b>2017</b>	2.6

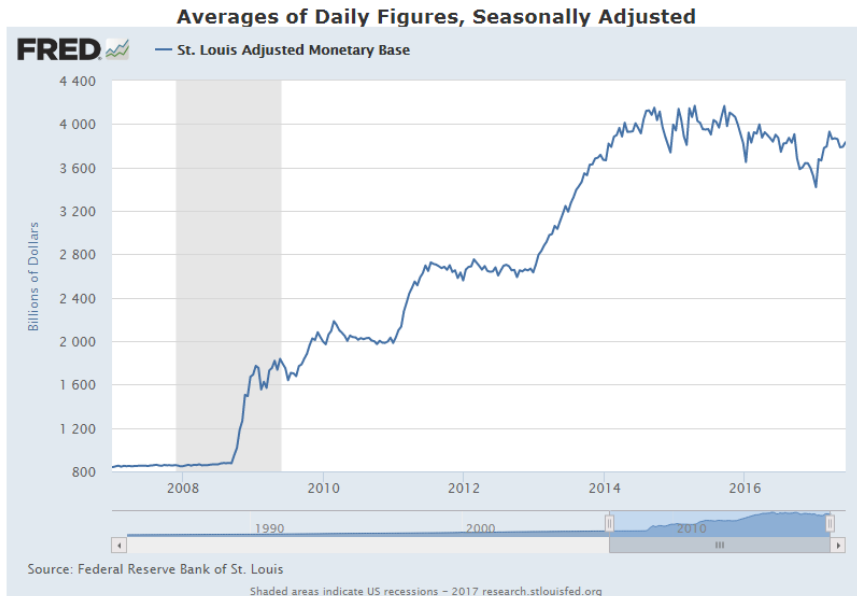
Those who argue we are in some kind of “new normal” of very modest productivity growth would surely allow at least a 1%/annum long-term increase in productivity:

## Productivity change in the nonfarm business sector, 1947-2016



Source: U.S. Bureau of Labor Statistics

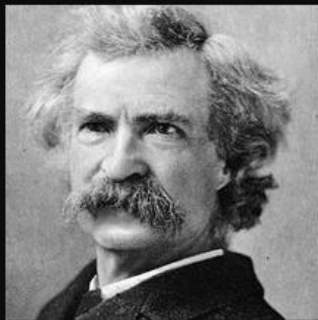
And then there is the question of what to do about the vast portfolio of assets the Fed accumulated in trying to offset the Great Recession. The flip side of the asset purchase was a big increase in the monetary base:



If you are a firm believer in some version of the quantity theory of money, you see great danger in the enlargement of the monetary base. Too much money chasing too few goods, etc. Inflation should rip any day now once “velocity” goes back to normal. Except it hasn’t happened, despite continued predictions by monetarists that inflation was imminent since the early days of the asset accumulation.

There appears also to be a group that thinks it is unseemly for a central bank to hold a big portfolio of assets, whether or not it poses an inflation danger. It’s not clear why because something is unusual, based on past history, it has to be reversed. If asset sales were purely cosmetic, at least there could be no harm in such worrying about appearances. The difficulty is that just as the original asset purchases were viewed as expansionary (or at least resisting the downward tug of the Great Recession), asset sales have to be seen as potentially contractionary. So why do them, if there is a risk?

The problem seems to be one of “everybody knows.” Everybody knows that very low interest rates are abnormal and Bad Things. Everybody knows that when unemployment is at current levels, inflation will inevitably accelerate. Everybody knows that the Fed has too large a portfolio of assets. Actually, at most what everybody knows is that models based on the past suggest such conclusions. But nobody knows whether – given the changes in financial and labor market institutions that have occurred – those models still hold. Why is it prudent to base monetary policy on models that don’t seem to be working? Wouldn’t prudence call for not changing policy until there is clearer evidence? Just asking.



It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.

~ Mark Twain

AZ QUOTES

## Mitchell's Musings 6-26-2017: It's the Russia-thing, stupid

Daniel J.B. Mitchell

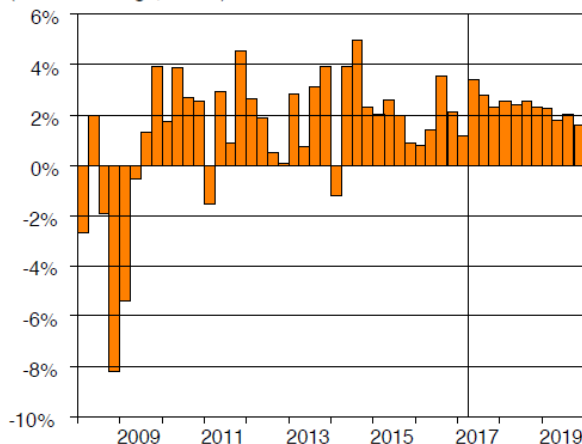
After the Democrats failed to win a highly-contested congressional seat in Georgia on June 20, the political wisdom seems to be that their strategy for the 2018 congressional elections should aim at economic issues rather than the ongoing Russia-thing investigations.<sup>48</sup> The Russia thing, after all, didn't flip the seat. And all the related and unrelated Trump/DC turmoil didn't flip the seat.

There is an ongoing literature on the effects of economic conditions on presidential elections. But 2018 is not a presidential year. My personal sense is that what is likely to drive election results in 2018 is whether things seem to be OK in the economy. There could be some seat gains for Democrats in 2018, since there is said to be some tendency for the party in control to lose some seats in midterm elections. But that is not the same thing as a political revolution. Congressional seats remain in the same GOP-favoring gerrymander that characterized them in 2016. Still, as a strategy for Democrats, there remains the Russia-thing.

I recently attended the UCLA Anderson economic forecast. So let's see what that forecast suggests for 2018. The two charts below basically tell the UCLA story:

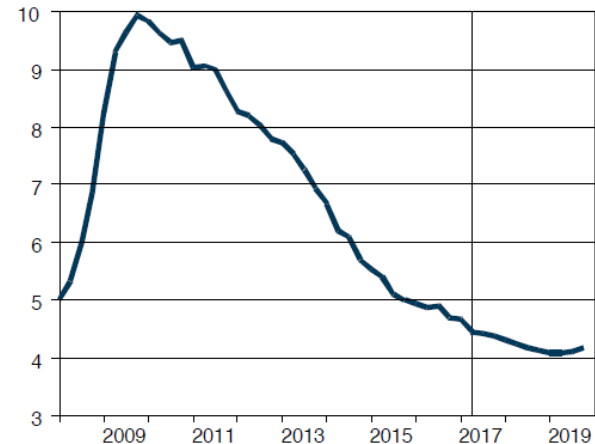
REAL GDP

(Percent Change, SAAR)



UNEMPLOYMENT RATE

(Rates)



The economy, as projected by UCLA, keeps growing at something like 2% per year measured by real GDP. That's a slower rate than the post-World War II average, and there is a debate as to whether 2% is a "new normal" or some kind of aberration. But note that if it is an aberration, the prospect would then be for *faster* growth, not slower. And given the assumptions that suggest 2% is a reasonable number, unemployment is projected to decline slightly and bottom out in 2019. Again, this economic story is not the stuff of political revolution. Democrats can complain about the economy, but the UCLA forecast suggests that issue will not be a plus for them.

Now you can always point to scenarios that could throw the economy into recession. But the time remaining for any such scenarios to develop before the November 2018 elections is diminishing. The

<sup>48</sup>Sen. Murphy on Dem's Georgia loss: Russia has been a distraction," 6-21-2017, *Politico*. Available at: <http://www.politico.com/story/2017/06/21/georgia-special-election-2017-democrats-lose-239798>.

forces that produce recessions take time to develop. So you could disagree with this or that assumption underlying the UCLA forecast and still come out with something like the above charts. The simple fact is that story on the charts is becoming more and more locked in for 2018. And that means the political ramifications of the story are also being locked in.

The argument for a focus by Democrats in 2018 on the economy seems to be embodied in the notion that the 2016 issues that might not have had sufficient resonance then will matter a lot a year from now:

*“Democrats have to be hyper-focused on an economic message that tells people that the Republican Party is all about economic growth for millionaires and billionaires and the Democratic Party is about economic growth for everybody,” [Senator Chris] Murphy (D-Conn.) told MSNBC’s “Morning Joe” on Tuesday. “The fact that we have spent so much time talking about Russia, you know, has been a distraction from what should be the clear contrast between Democrats and the Trump agenda, which is on economics.”<sup>49</sup>*

In this view, “economics” is not just real GDP growth and unemployment rates, but instead involves income distribution and fairness. Perhaps, if Republicans succeed in some version of repealing and replacing “Obamacare,” the economic fairness issue will have increased salience among voters. At this writing, however, it is unclear whether there will be a repeal and replace bill, or – if there is one – what it will contain.

There is the headline estimate of 20+ million people who will lose coverage in the House version of the Republican anti-Obamacare effort. But the problem is that such displacement is projected to occur *over time*, not immediately after repeal. Thus, if the GOP Senate leadership is smart – not a guarantee, of course – they could produce a bill that keeps the current health system going beyond the 2018 election cycle. The actual replacement could come later, yet still allow Republicans to say they did the repeal in 2017. That way, the losses of coverage occur later than November 2018 and perhaps become an issue for 2020. And note that if the Republicans *fail* to produce a bill, their failure will likely be due to Democrats’ efforts to block any repeal. In other words, the Democrats are committed to make every effort to *prevent* Republicans from doing something that could eventually hurt GOP prospects.

The fact is that the Russia-thing is the only lever the Democrats have. Maybe it isn’t a very effective lever. Maybe most people in the electorate are not political junkies who follow DC affairs closely. Maybe, to the extent that folks are aware of current White House turmoil and missteps, they tend to dismiss it as “just politics as usual,” even though the junkies and professionals know that it isn’t at all usual. But the Russia-thing is the only lever available to be pulled. After all, if you were driving a car and the regular brake failed, wouldn’t you yank as hard as you could on the available hand break, despite its limited effectiveness? What else could you do?

In any case, you can think of the options as playing the probabilities. The odds that the Russia-thing will produce a smoking gun that could tilt the 2018 election results are greater than the economic equivalent.

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<sup>49</sup>Ibid.