

## Macro Policy: Lessons from the Past and from Below

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There are various ways to gain insight into the macroeconomic challenges faced by the U.S. in the coming year or so. But much of the debate takes place in a silo-like format. Economists tend to use either forecasting models – models that are often not heavy in underlying theory – to evaluate scenarios or alternatives. Or they use theory – often to the exclusion of reality. This state of affairs is nothing new. I recall Bob Solow in a graduate course at MIT in the mid-1960s giving students a choice. He said we could talk about micro – which is beautiful. Or we could talk about macro – which is true. If that story makes you uncomfortable, you should probably stop reading now.

There is still another approach - which is more political than economic - and that approach ultimately centers on who wins the presidency in 2012. I have no special insights on that issue, but there are some lessons from the past suggesting that presidential reelection is possible even if economic goals are not achieved. The key actors are the general public composed largely of folks who have trouble distinguishing millions from billions, let alone trillions. Nonetheless, they have a sense that something has gone wrong, macro-wise, and that someone should do something about it. All they have to signal discontent is a toggle switch with two positions in a two-party system: incumbent and opposition.

In what follows, I will draw on history in particular episodes and recent experience – the latter not at the federal/national level where macro discussion generally focuses – but below. In particular, I will refer to fiscal and political events in my home state of California. California is often taken as a bellwether for things to come elsewhere in the U.S., often – especially in recent years – for things to come that will go wrong. Interestingly enough – as will be seen – California’s experience provides some insight into international issues as well. Six lessons from the current economic crisis will be drawn from the past and present.

### Public Attitudes: Now and Then

Let’s start with the views of the general public. Figure 1a highlights results from a California voter opinion poll taken shortly before the primary election in June 2010. Much of the media discussion of the poll was based on what it might predict about the various candidates and propositions then on the state ballot. But hidden in plain sight were the results shown on Figure 1a.

Polls are often taken issue by issue. That is, respondents are asked about, say, immigration, or abortion, or some other issue *de jour*. Naturally, when pressed on such issues, they express opinions. Missing from this piecemeal approach to polling is the intensity of concern. While the poll shown on Figure 1a

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was confined to California, I believe it can be generalized. What is striking about Figure 1a is not so much the ranking of issues but the intensity.

Over half of the respondents say that the most important issue was jobs and the economy. Issues such as immigration, education, and health care are not just ranked lower but are also distantly ranked. Note that health care and costs hardly register as a primary concern despite the fact that the Obama health proposal was much in the news for a year until passed. And the debate continued afterwards on just what was achieved. Figure 1b is a later poll – this one confined to respondents who said they had voted in the November 2010 general election. Although less detailed, it is in accord with the results of Figure 1a. Again, jobs and the economy matter much more than other issues.

What the two polls suggest is that addressing the Great Recession was what voters expected of their elected officials. It is clear to me that the measures that were taken in late 2008 and beyond, however imperfect in hindsight, averted another Great Depression. But the poll suggests that a year and a half after the financial crisis hit with full force, and more than two years after the recession officially began, voters were frustrated with lack of tangible improvement.

*Lesson #1: The President took a risk – calculated or not – in focusing on issues other than jobs and the economy. Voters may have been concerned about health care, global warming, Middle East negotiations, etc. But they were much less concerned about those issues than about jobs and the economy. The results of the 2010 midterm elections reflected the disconnect between voter expectations and political results.*

Many media commentators seemed surprised by the rise of Tea Party types and other fringe movements that have gained momentum in the last two years. Elsewhere, I have written about odd “pensionite” movements that arose in the 1930s during the Great Depression.<sup>1</sup> I won’t repeat that history here. But I will suggest that any American a-historical readers would benefit by Googling “Townsend Plan,” “Ham and Eggs,” “Silver Legion,” “Father Coughlin,” and “Huey Long.” Any Canadians reading this paper might also Google “Social Credit.”

Lest you think these Depression-era groups and individuals had no repercussions on the larger polity, you might be interested to know that the Townsendites played an inadvertent role in passing Social Security in 1935. They and other pensionite groups also played an important role in propelling Earl Warren into the governorship in California, ultimately producing the Warren U.S. Supreme Court. Social Credit ruled in the Province of Alberta for an extended period.

*Lesson #2: The longer high unemployment persists and the longer elected officials seem unable or unwilling to address it, the more credibility do fringe groups gain. They become a wild card on the political scene with unknown future effects.*

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<sup>1</sup> Daniel J.B. Mitchell, *Pensions, Politics, and the Elderly: Historic Social Movements and Their Lessons for Our Aging Society*, (Armonk, NY: M.E. Sharpe, 2000).

## Could Something Have Been Done to Improve the Economy?

Much ink has been devoted to analyzing the Great Depression and New Deal policy during the 1930s. Lack of historical background leads some researchers to plunge into the analysis without understanding that era. An important first thing to know is that the idea that the federal government had a role in responding to economic downturns was new back then. The word “macroeconomics” did not exist at the time. The government by and large did not even collect timely economic data. Why should it have done so, since it did not have a clear responsibility for responding to economic events?

### The Way It Was

The impression that the New Deal was somehow “Keynesian” is false. Keynes’ *General Theory* did not even appear until the mid-1930s, and relatively few in government at that time would have been influenced by his thinking. New Deal deficits were largely accidental, not deliberately planned. Indeed, there was much fretting about the deficit. When Social Security was enacted, a payroll tax was implemented in 1937 – contributing to the recession within the Depression of that year – to build up the trust fund and thus avoid creating a deficit-inducing program. Taxes were collected starting in 1937 even though no benefits were scheduled to be distributed until the 1940s.

Unemployment was not systematically surveyed until 1940. The nice time series of unemployment rates before 1940 you see nowadays for the Great Depression period are after-the-fact guestimates. National income accounts were embryonic in the 1930s. They were untimely and not readily available, particularly in real (inflation-adjusted) terms, until the 1940s. There was no President’s Council of Economic Advisors during the New Deal, just *ad hoc* advisors. The CEA was another 1940s innovation.

The Federal Reserve did exist prior to the Depression. But the notion that it should, or could, lean against the business cycle was not well developed. Indeed, a widespread 1920s view of the business cycle was that downturns were healthy; they were the way in which the economic system cleaned out its excesses. We are talking about an era in which learned journal papers were written attributing the business cycle to sunspots.

If you examine the introductory economics textbooks of that period, you will find that students learned little about the key problem of the day, unemployment.<sup>2</sup> They were more likely to find information in the textbooks about the legal differences between a corporation and a partnership than about anything even resembling macroeconomics. It is not surprising that left-wing politics and communism were in vogue on many college and university campuses. Marxism purported to explain economic crises – and presented a “solution.” In that respect, it was the opposite of what could be found in the standard textbook.

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<sup>2</sup> Daniel J.B. Mitchell, “Wages and Keynes: Lessons from the Past,” *Eastern Economic Journal*, July-September 1986, pp. 255-276.

## **The War on Unemployment**

Critics of the New Deal today often note that the Great Depression was not eradicated until World War II came along. That fact is hardly debatable. The official unemployment rate in 1940 – as noted, the first year in which modern surveys of unemployment began - was close to 15%. But what was World War II in economic terms but a massive public works project? Figures 2, 3, and 4 show the impact. At the peak, over 40% of the GDP was going to the military. Demand was so high that goods were rationed or – as in the case of new cars – not produced at all. Unemployment dropped to around 1%.

The U.S. officially entered the War towards the end of 1941 after the attack on Pearl Harbor on December 7. However, earlier during 1941, the draft was instituted and the lend-lease program was created. So it is interesting to look at the impact of War preparedness between 1940 and 1941, i.e., the period before military consumption became extreme. Essentially, military spending as a proportion of GDP rose by about 10% and the unemployment rate fell by about 5 percentage points. Over a million military “jobs” were created, including jobs for men who might not have wanted them.

I am sure the Obama folks would have liked to see the unemployment rate at its peak drop by 5 percentage points in a year, i.e., from 10% to 5%, or certainly by Election Day, November 2010. Despite all the differences in the structure of the contemporary U.S. economy relative to 1940-41, Figures 2, 3, and 4 make it clear that a sufficiently aggressive economic policies could have attained such a goal. That is the verdict of empirical history from the 1940s. But, of course, that is not what happened in 2009-2010.

*Lesson #3: It was technically possible to have implemented economic policies that would have substantially reduced the impact of the Great Recession. Whether such policies would have been politically feasible is another matter.*

## **Trickle Out**

The ARRA (stimulus) program in magnitude was roughly half of the military expansion between 1940 and 1941 as a percent of GDP. But ARRA was spread out over a period of years whereas the 1941 expenditures occurred in that year. Moreover, the focus of the Obama program on infrastructure was more like the New Deal in impact than it was like World War II.

Infrastructure projects inherently take time. Despite all the noise about “shovel-ready” projects, the only infrastructure projects that could be literally shovel ready were those that were likely to occur anyway; that’s why the shovel was ready. As I noted at last year’s meeting of the Brimmer Forum, a promise of possible federal subsidy to state and local infrastructure runs the risk of delaying projects. It is rational for local authorities to hold off starting projects to see if they might win the federal “lottery” and have someone else pay for them. I noted Ned Gramlich’s evidence for just that effect during the

stimulus efforts of the mid-1970s.<sup>3</sup> Someone needs to do detailed research on whether we experienced Gramlich effects in 2009-2010.

### **Owners or Sales?**

I also noted at last year's Brimmer Forum that if there was to be a bailout of General Motors to save jobs, the actual plan adopted – essentially government ownership – was not focused on the immediate problem. GM didn't lack owners; it lacked car sales. The government as GM's owner demanded what a commercial owner would. That is, absent sales, the thing to do is to close facilities and lay off workers. It is hard to obtain figures on GM employment. But it appears that something like a fifth of the GM workforce was downsized under government control.<sup>4</sup> (One might ask *why* it is hard to ascertain those figures, given the fact of government ownership and the trumpeting of the need for "transparency" in all things stimulative.)

### **Cars or Shovels?**

As I pointed out last year at the Brimmer Forum, an alternative plan to taking over GM could have been such measures as providing a police car for every police department in the country. New school buses? New transit buses? Other public vehicles? That kind of spending – immediate and with no shovel delay needed - would have been more like World War II in economic outcome. Put another way, if ARRA had been more generally focused on immediate purchases (including of labor), it would have had a greater impact. And, by the way, there could also have been a World War II-type political outcome. The fringe political movements of the 1930s noted above largely receded in the face of wartime, and then postwar, prosperity.

### **Focus: Then and Now**

Since Roosevelt had not rid the country of the Great Depression by the mid-1930s, why was he re-elected in 1936 (by a landslide)? Certainly, part of the answer was that voters perceived he was trying to deal with their number one concern – even if not succeeding to the degree they might have hoped for back in 1932. Communicating that effort was Roosevelt's strength. He persuaded voters that what they were worried about was what he was worried about – and was working on.

### **Then**

It is worth listening to Roosevelt's fireside chats to gain an understanding of the power of the new medium radio piping the President into homes on a regular basis.<sup>5</sup> (Radio broadcasting was one of the

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<sup>3</sup> Edward M. Gramlich, "State and Local Budgets the Day after it Rained: Why is the Surplus So High?," *Brookings Papers on Economic Activity*, number 1, 1978, pp. 191-216, especially pp. 208-209.

<sup>4</sup> The figures are distorted by GM's transitional purchase of a parts manufacturer that it had previously spun off.

<sup>5</sup> I have posted audios of Roosevelt's fireside chat on banking at [http://www.youtube.com/watch?v=kFvRL\\_nqx2c](http://www.youtube.com/watch?v=kFvRL_nqx2c) and <http://www.youtube.com/watch?v=hpbGmTSVZeM>

few industries to exhibit rapid job growth as the country slid into the Depression.) Just as folks in contemporary America tend to believe what they read on the Internet – today’s new medium – they were impressed by what they heard on the radio. (In 1938, many listeners panicked when Orson Welles told them on the radio that Martians were invading New Jersey – even though it was the Halloween broadcast.) Roosevelt entered American households regularly and reported convincingly on his efforts on the economy.

### **Now**

Of course, political communication does have to be convincing; you have to do more than say the magic words. When it fails on that score, the results are unfortunate. In the 2010 gubernatorial race for governor of California, Republican Meg Whitman – former eBay CEO - famously spent upwards of \$140 million of her own money (plus money from other sources) on a lengthy campaign against former governor Jerry Brown. Much of her TV advertising did reference jobs and job creation. So the words, at least, were on message.

Despite the edge Democrats have in California, polling indicated that as of September 2010, she was in a statistical tie with Brown. So the jobs approach was having effect. But yet, in the final vote, she lost by a wide margin: 54% to 41%. In fact, she received fewer votes than a ballot proposition to legalize marijuana – which also lost in November 2010. How could that happen?

What seemed to be Whitman’s downfall was her reported ill-treatment of a domestic employee – an illegal alien - and the remarks she made about firing the employee after the September poll was taken. While illegal immigration remains an issue in California, the end product of this episode was to paint Whitman as someone who didn’t care about ordinary people. That impression voided whatever attraction the jobs issue might have had for her candidacy. The big gap in favor of Brown opened up after “housekeeper-gate.”<sup>6</sup> If you don’t seem to care about ordinary people, it is hard to sustain the impression that you care a great deal about their job opportunities.

### **Policy Volatility**

Because there was at the time no clear consensus on what should or could be done about the economy during the Great Depression, Roosevelt explicitly promised to try different approaches and - if they didn’t work - to try others. This stance in retrospect produced programmatic volatility. The early New Deal suspended the antitrust laws and tried to cartelize industry under the National Industrial Recovery Act. The hope was that the new policy would foster stable corporate and government economic planning. But the later New Deal – after the Supreme Court had voided the NIRA - featured vigorous antitrust prosecution.

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<sup>6</sup> See the Field Poll at <http://field.com/fieldpollonline/subscribers/RIs2362.pdf>. The Brown-Whitman polling results went from 41%-41% in September 2010 to 49% to 39% in October (after housekeeper-gate).

As I noted in my presidential address to IBEFA in 2000, the Democratic Party had an ideological aversion to the international gold standard, going back to the free-silver movement of the 1890s.<sup>7</sup> Republicans, in contrast, were supporters of “sound money,” i.e., the traditional gold standard. Not surprisingly, when Roosevelt came to power, he effectively suspended American participation in the gold standard – which earlier had been abandoned by other major countries such as Britain.

### **Us (US) or Them**

Despite Roosevelt’s predilections on international monetary affairs, his predecessor – Herbert Hoover – had left him a legacy commitment, the 1933 London Gold Conference which was supposed to re-establish gold. Roosevelt did meet his obligation to send a delegation to London. But a cable from the President to the delegation was leaked (perhaps under the instigation of the President). It reminded the delegation that the President had been elected to deal with the problems afflicting the domestic U.S. economy and that they should agree to nothing in the international sphere that contradicted his policy. The outcry after the leak effectively ended the conference with no agreement reached, a result that was likely not a disappointment to Roosevelt.

I will return to the London conference example later. But the conference episode illustrates the relentless focus Roosevelt had on the one issue that got him elected. Even critics of his various policies did not deny that they were focused on the economy. They may have objected to the policies as either ineffective or harmful in their impact on the economy. But the *motivation* for the policies could not be denied. It was all about the economy and unemployment.

### **No Exception**

Even New Deal policies that seem off-topic from a modern perspective were not - once a closer look is taken. The 1935 Social Security Act might appear to be a parallel to Obama’s pursuit of a national health care plan in 2009. Both proposals were programs of social insurance. (Indeed, the early plans for Social Security included health insurance but that component was dropped from the final version due to doctor opposition.) However, the parallel is otherwise weak.

The Obama plan was not connected to job creation. It was billed as a longer-term approach to reducing the federal deficit. Tactically, the Obama plan might have been tied to an extension of COBRA rights (rights of those laid off to continue under their former employer’s health plan at their expense). That approach would have at least given the Obama plan an immediate job linkage – but it wasn’t taken.

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<sup>7</sup> Daniel J.B. Mitchell, “Dismantling the Cross of Gold: Economic Crises and U.S. Monetary Policy,” *North American Journal of Economics and Finance*, 11 (2000), pp. 77-104. Available at [http://www.anderson.ucla.edu/documents/areas/fac/hrob/mitchell\\_gold.pdf](http://www.anderson.ucla.edu/documents/areas/fac/hrob/mitchell_gold.pdf).

## **The Confidence = Jobs Theory**

What is often forgotten about the Social Security Act was that it created the contemporary federal-state unemployment insurance program.<sup>8</sup> So it was directly tied to jobs and job loss. The pension element of Social Security also had an economic motivation. As I have discussed elsewhere, “security” was a major theme of the New Deal. (*“The only thing we have to fear is fear itself,”* was an expression of economic theory – not just memorable inaugural rhetoric.)

There was an ongoing belief by Roosevelt that what the economy needed was more confidence (less fear). If consumers felt more secure, they would consume more. If businesses were more secure, they would invest more (hence, the early experiment with cartelization and planning). Insecurity, in contrast, was engendered by fears of job loss (which unemployment insurance addressed) and of not having resources in old age (which the pension addressed). “Welfare” – also created in modern form by the Social Security Act, was another safety net when all else failed – that would add to security (and consumption). Roosevelt was re-elected in 1936 – not because he had ended the Depression – but because he was working on it to the exclusion of almost everything else.

*Lesson #4: If jobs and the economy are seen clearly to be priority number 1, political rewards can be obtained even if – for whatever reason - the problem is not solved. But there must at least be perception of a 24/7 focus on the economy.*

## **Not Social**

To be fair to President Obama, Roosevelt did not inherit two ongoing wars and the large role now played by the U.S. in the world. And Obama also faced a collection of social issues that did not exist in 1933. No one had ever heard of a stem cell in the 1930s. Abortion and homosexuality were state-level issues and were illegal everywhere when Roosevelt took office. No one was thinking about changing those laws. No one then could have conceived of gay marriage or “don’t-ask/don’t-tell” as pressing federal matters about which the President should have views or be taking action. No one would have expected that some future Supreme Court would legalize abortion and produce the contemporary controversy surrounding that issue.

If there was a social issue of that era comparable to gay marriage and the like, it was prohibition – an issue which was quickly taken off the table by Roosevelt and the Congress a short time after his inauguration by amendment of the Volstead Act. (Later in 1933, a constitutional amendment ending prohibition more decisively was ratified.) From the perspective of contemporary hindsight, segregation would today be considered a major social issue of the 1930s. However, with the electoral vote lock the Democrats held at the time on the “solid South,” it was not an issue in an active political sense. Even anti-lynching laws could not pass Congress at the time.

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<sup>8</sup> Daniel J.B. Mitchell. (January 2010). “Homeland Security: Theme of the New Deal.” *Labor and Employment Research Association - Atlanta meetings*. January 2010. To appear in online proceedings. Available at <http://www.anderson.ucla.edu/documents/areas/fac/hrob/newDeal-LERA.pdf>.



Although tensions remained concerning the large population of immigrants in the U.S., large-scale immigration had been ended by legislation in the 1920s. Asians not born in the U.S. could not become citizens and restrictions on their entry were particularly tight. There was hardly a peep when folks of Mexican origin were deported in the 1930s *en masse*. Few later protested when the Japanese-origin population of the West Coast were rounded up and confined to internment camps soon after the U.S. entered World War II. In short, modern social sensibilities were not around to deflect Roosevelt from his economic predilection. But they were diversions for Obama.

### **Easier Said Than Done, But...**

In short, it is easier to prescribe a Roosevelt-style, single-minded focus on the economy for the Obama administration than it would have been to implement it. Perhaps the level of distraction for modern presidents is too high for a mono-focus. Nonetheless, my guess is that when the history of the Great Recession and its aftermath is written, and regardless of what may happen in the 2012 election, the verdict will be that the key issue that elected Obama – unemployment and the economy – was not adequately attended. The verdict will also be that major economic and political consequences flowed from inadequate attention. There will be debate about judgments made and about the proper allocation of the blame. But I predict that there won't be much debate about the basic conclusion.

### **Global Lessons: Then and Now**

One lesson of the recent past is that unsustainable trends – whether dot-com stock prices, or housing prices, or sliding standards for mortgage borrowing – eventually produce untoward macro results. What unsustainable trend remains evident? Some would say it is the federal deficit. But surely, the ongoing trade deficit and the attendant build up of U.S. debt to the world is a major candidate. Eventually, the unsustainable will not be sustained and the question is whether the current approach – essentially cajoling surplus countries to revalue their currencies – will lead anywhere.

As Figure 5 illustrates, a correction of our trade balance, given its magnitude relative to GDP, would be a substitute stimulus package. The net export deficit was about 6% of GDP at the top of the business cycle and is in the 3-4% range now – with the drop due to the economic slump. (If all you want to do is fix the trade balance, go for a double-dip recession – the bigger the better.) Note further that the current trade configuration drains stimulus money and impact from the U.S. I took advantage of the “cash-for-clunkers” plan and bought a Prius. Taking account of dealer markup, shipping costs from the dock, and state and local sales and other taxes, two thirds of my stimulus went to Japan.

### **Cajoling**

In the 1980s, we cajoled Japan about its trade imbalance with the U.S. without effect. Now we cajole the Chinese, Japan, and Germany without effect. For China and Japan, modern mercantilism – since that is what it is – has proved beneficial for the elites of those countries, even though a more consumption-oriented approach would benefit the larger population of both. So we get silly responses such as Chinese assertions that the yuan/dollar ratio is a domestic concern exclusively of China. (The

same logic suggests that its inverse – the dollar/yuan ratio – is purely a U.S. domestic matter!) For Germany and other euro-zone countries, the explanation of non-cajolability is more complex.

### **Eur-Only As Sovereign as Your Money**

Years ago, before the euro was implemented, I gave a talk at a meeting in Bologna in which I pointed out that states within the U.S. – which have no currencies and, hence, no monetary policies or exchange rates – also have little fiscal discretion. Lack of fiscal discretion is a consequence of lack of monetary discretion.<sup>9</sup> The states are subject to rough balanced-budget constraints, whether or not such a restriction is written into their constitutions. The financial markets from which they have to borrow are the disciplinarians.

I pointed at the time to the fiscal problems of California in the early 1990s as an example of the relative impotence of states in the U.S. dollar zone to deal with economic downturns. Back then, California was adversely affected by the comparatively mild U.S. recession much compounded by the loss of its aerospace industry as the Cold War ended. It struck me that the euro was understood by the incoming members of the euro-zone only as a device to ease cross-border transactions within the EU. The euro's macro impact was not widely appreciated.

### **Many Californias**

For better or worse, however, Germany, France, Italy, are now Californias – not to mention Ireland, Spain, Greece, and Portugal. But they are Californias with a big difference. States in the U.S. do not have fiscal military or social insurance obligations comparable to European nations. In short, it is no wonder that euro-zone countries are now eschewing fiscal stimulus, cutting public spending, and retreating from social obligations. Whatever public rationales they give for their actions, the hard fact is that they don't have much choice.<sup>10</sup> So cajoling them at international conferences won't have much effect on their behavior.

### **Select from the Buffett**

At the London Gold Conference of 1933, U.S. goals were not compatible with those of other nations and – as a result - the conference came to an abrupt end. In the U.S. case now, we also need to focus on the goal of ending the unsustainable trade imbalance. At the Brimmer Forum last year, I noted that financier Warren Buffett had suggested a solution to the U.S. trade problem back in the 1980s when

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<sup>9</sup> Reproduced in Daniel J.B. Mitchell. (1998). "Eur-Only as Sovereign as Your Money: California's Lessons for the European Union." *UCLA Anderson Forecast for the Nation and California*, June 1998. Available at [http://www.anderson.ucla.edu/documents/areas/fac/hrob/Mitchell\\_Eur-Only.pdf](http://www.anderson.ucla.edu/documents/areas/fac/hrob/Mitchell_Eur-Only.pdf).

<sup>10</sup> The British case is different since Britain did not adopt the euro. Basically, the new British Conservative coalition government had a pre-existing (pre-crisis) belief that the welfare state was too big and does not want to waste a crisis to shrink it. Similar developments will occur in the U.S. as the report of the "Deficit Commission" receives attention.

imbalance with Japan was the major concern.<sup>11</sup> The Buffett plan had the virtue, however, of not singling out Japan – or any other country – as a villain.

Buffett proposed a kind of cap-and-trade system. Essentially, any entity that exported a dollar's worth of goods and services from the U.S. would get a transferable voucher entitling it to import a dollar's worth of goods and services. Exporters could exercise their voucher rights directly, i.e., import. But there would also be a market for import vouchers. By definition, no matter who exercised them, exports would equal imports.

### **RIP, Reed and Willis**

Now I know that at this point, someone will want to scream protection and unearth (Reed) Smoot and (Willis) Hawley from their graves. (If their names are not familiar, consider them to be more Googling suggestions for a-historical readers.) Should you be a screamer, my advice is to let them sleep undisturbed and instead to do the math. The Buffett voucher system would produce a *de facto* exchange rate that is equivalent to the dollar exchange rate that would prevail with balanced U.S. trade. Moreover, no country is singled out for special treatment or punishment. But countries that practice mercantilism would go head to head with the rest of the world for access to the U.S. market. So the rest of the world would become the ones who pressure the mercantilists.

From the world perspective, retaliation against would be possible but collectively self defeating. Blocking a dollar of U.S. exports would automatically block a dollar of U.S. imports. My guess, however, is that mere announcement of a Buffett-type plan would produce what cajoling alone hasn't and can't; an international agreement to end modern mercantilism. It might even push the euro-zone countries to redo their economic and political institutions so that a measure of fiscal discretion was restored. Announcing a Buffett plan might well create a dynamic so that the plan never had to be implemented.

In any event, doing something quickly about the net export deficit would be a stimulus to the domestic economy. In contrast, doing something quickly about the other candidate for unsustainability – the federal deficit – would be a depressant. Let's focus on the former and take our time with the latter.

*Lesson #5: The U.S. has an unsustainable world trade position that needs correcting before unfortunate macro effects are felt. Cajoling other countries about their exchange rates is a failed policy. Fixing the trade imbalance would be a major stimulus. Something more dramatic that forces the trade issue is needed. If you have a better solution than the Buffett plan, what is it?*

### **All Politics is Local and Some Economics is, too.**

State and local government accounts for about an eighth of GDP and close to 15% of nonfarm payroll employment. Figure 6 shows the deviations in employment in the private nonfarm vs. the state and

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<sup>11</sup> Warren E. Buffett, "How to Solve Our Trade Mess Without Ruining Our Economy," *Washington Post*, May 3, 1987, p. B1.

local sectors from their December 2007 levels. (December 2007 is the official start of the recession declared by NBER.) As can be seen on Figure 6, most of the job-loss action in the Great Recession occurred in the private sector. State and local government employment kept expanding for a time, even as private sector jobs declined.

Some of the state and local lag was due to lagged revenue inherent in the tax system. Income taxes are due several months after the year closes, for example. Property taxes are based on past values. Some of the lag is due to sluggishness in the political process. When the state and local decline finally set in, it was modest compared to the private sector, even adjusting for the smaller size of state and local employment relative to private. Note that some of this modesty was due to stimulus and related funding from the federal government which came with maintenance-of-effort requirements. However, the stimulus funding is going away and, in the current political environment, is unlikely to be replaced.

State and local governments are good at smoothing out employment fluctuations in relatively mild recessions. Typically, state and local accounting methodology treats even the general (operating) fund of a jurisdiction as a revolving fund. That approach leads to cloudy data presentation where stocks and flows are mixed and even time frames are uncertain.

Political leaders in California still insist that in 2009, after an extended budget delay, they fixed what they called a “deficit” of about \$60 billion in a general fund budget that at its peak had expenditures of roughly \$100 billion.<sup>12</sup> If you take a deep breath and try and imagine how such a fix could even be attempted – assuming the word “deficit” had the common English meaning of the term – you will quickly see that something must be wrong with that claim. Indeed, I suspect that if you added up all the claimed deficit fixes that California political leaders said have been made in the state budget since it got into trouble (roughly starting with the 2006-07 fiscal year), the total probably would sum to more than the current budget. The problem is that in California, words such as “deficit” do not have common English meanings and California is not alone with this problem.

California used a combination of pushing expenditures into the future, raiding and borrowing the money of local governments and districts, using federal stimulus funding, implementing temporary tax increases, making actual expenditure cuts, and assuming phantom revenue. So far, the level of California nominal dollar state spending has been brought down from the \$100 billion range at the peak to something like \$93 billion in the 2010-11 fiscal year. The problem is that with the temporary tax increases expiring and push-back from voters regarding tax increases, fee increases, and local treasury raids, it appears that the pretending and delaying game is over.

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<sup>12</sup> On the 2009-10 California budget, see Daniel J.B. Mitchell. (2010). “Shades of Gray.” *California Policy Options 2010*. Available at [http://www.anderson.ucla.edu/documents/areas/fac/hrob/mitchell\\_gray.pdf](http://www.anderson.ucla.edu/documents/areas/fac/hrob/mitchell_gray.pdf). On the 2010-11 budget, see Daniel J.B. Mitchell, “Government by (Hot) Checks and (Im)Balances: California’s State Budget from the May 2009 Voter Rejection to the October 2010 Budget Deal,” *California Policy Options 2011*, forthcoming. Available at [http://www.anderson.ucla.edu/documents/areas/fac/hrob/mitchell\\_2011budgetchapter.pdf](http://www.anderson.ucla.edu/documents/areas/fac/hrob/mitchell_2011budgetchapter.pdf).

That is, there is a limit to the games that can be played with public accounts. Eventually, the problem I set forth earlier for the euro countries comes to state and local governments. Unlike the euro countries, my home state did not become a California; it already was California. Figure 7 shows projected general fund budget deficits for California absent a policy change for fiscal years beginning July 1, 2011. Year after year, they remain in the -\$20 billion range. That is a pretty big challenge when you start from a base level of expenditures in 2010-11 of \$93 billion and much of the gimmickry has been exhausted.

Not all states are in as dire a fiscal condition as California. Nonetheless, if you are looking for the next potential crisis, look to the state and local sector. As a technical matter, states cannot declare bankruptcy (although local governments can). On the other hand, states can take such steps as not pay bills when due. California has already gone through one episode during the current slump of issuing IOUs (known as registered warrants) to suppliers and taxpayers due refunds. Actual default on state debt service is improbable. But such defaults could happen at the local level, particularly since local government finances are intertwined to various degrees with state finances. The muni bond market is at risk if major defaults occur. Is the Fed ready for that event?

*Lesson #6. The state and local public sector could be an area of continued layoffs and there is risk to the muni bond market. The Federal Reserve has been creative during the current crisis with regard to other markets. Such creativity may be needed again.*

## **The Six**

The survey of past events, ranging from 1933 and the New Deal to World War II and to the November 2010 gubernatorial election in California, has suggested six lessons from history:

- Lesson #1: The President took a risk – calculated or not – in focusing on issues other than jobs and the economy. Voters may have been concerned about health care, global warming, Middle East negotiations, etc. But they were much less concerned about those issues than about jobs and the economy. The results of the 2010 midterm elections reflected the disconnect between voter expectations and political results.
- Lesson #2: The longer high unemployment persists and the longer elected officials seem unable or unwilling to address it, the more credibility do fringe groups gain. They become a wild card on the political scene with unknown future effects.
- Lesson #3: It was technically possible to have implemented economic policies that would have substantially reduced the impact of the Great Recession. Whether such policies would have been politically feasible is another matter.
- Lesson #4: If jobs and the economy are seen clearly to be priority number 1, political rewards can be obtained even if – for whatever reason - the problem is not solved. But there must at least be perception of a 24/7 focus on the economy.

- Lesson #5: The U.S. has an unsustainable world trade position that needs correcting before unfortunate macro effects are felt. Cajoling other countries about their exchange rates is a failed policy. Fixing the trade imbalance would be a major stimulus. Something more dramatic that forces the trade issue is needed. If you have a better solution than the Buffett plan, what is it?
- Lesson #6. The state and local public sector could be an area of continued layoffs and there is risk to the muni bond market. The Federal Reserve has been creative during the current crisis with regard to other markets. Such creativity may be needed again.

Of course, there are more issues related to the Great Recession than could be discussed here. The overhang of mortgage foreclosures and the housing stock is but one example. Nonetheless, if there is one overall lesson, it is to learn from history.

**Figure 1a: Public Attitudes Towards Various Issues in California: May 2010 PPIC Poll**

**“Thinking about the state as a whole, what do you think is the most important issue facing people in California today?”**

<i>Top five issues mentioned</i>	<b>All Adults</b>	<b>Party</b>			<b>Likely Voters</b>
		<b>Dem</b>	<b>Rep</b>	<b>Ind</b>	
<b>Jobs, economy</b>	53%	55%	42%	57%	51%
<b>State budget, deficit, taxes</b>	15	13	24	15	19
<b>Education, schools</b>	10	13	7	9	8
<b>Immigration, illegal immigration</b>	9	5	14	6	9
<b>Health care, health costs</b>	3	4	1	4	3

Note: Telephone (including cellphone) poll of 2,003 adults taken prior to the June 2010 California primary election.

Source: Public Policy Institute of California (PPIC), *Californians and Their Government*, May 2010, [http://www.ppic.org/content/pubs/survey/S\\_510MBS.pdf](http://www.ppic.org/content/pubs/survey/S_510MBS.pdf)

**Figure 1b: Public Attitudes Towards Various Issues in California: December 2010 PPIC Poll**

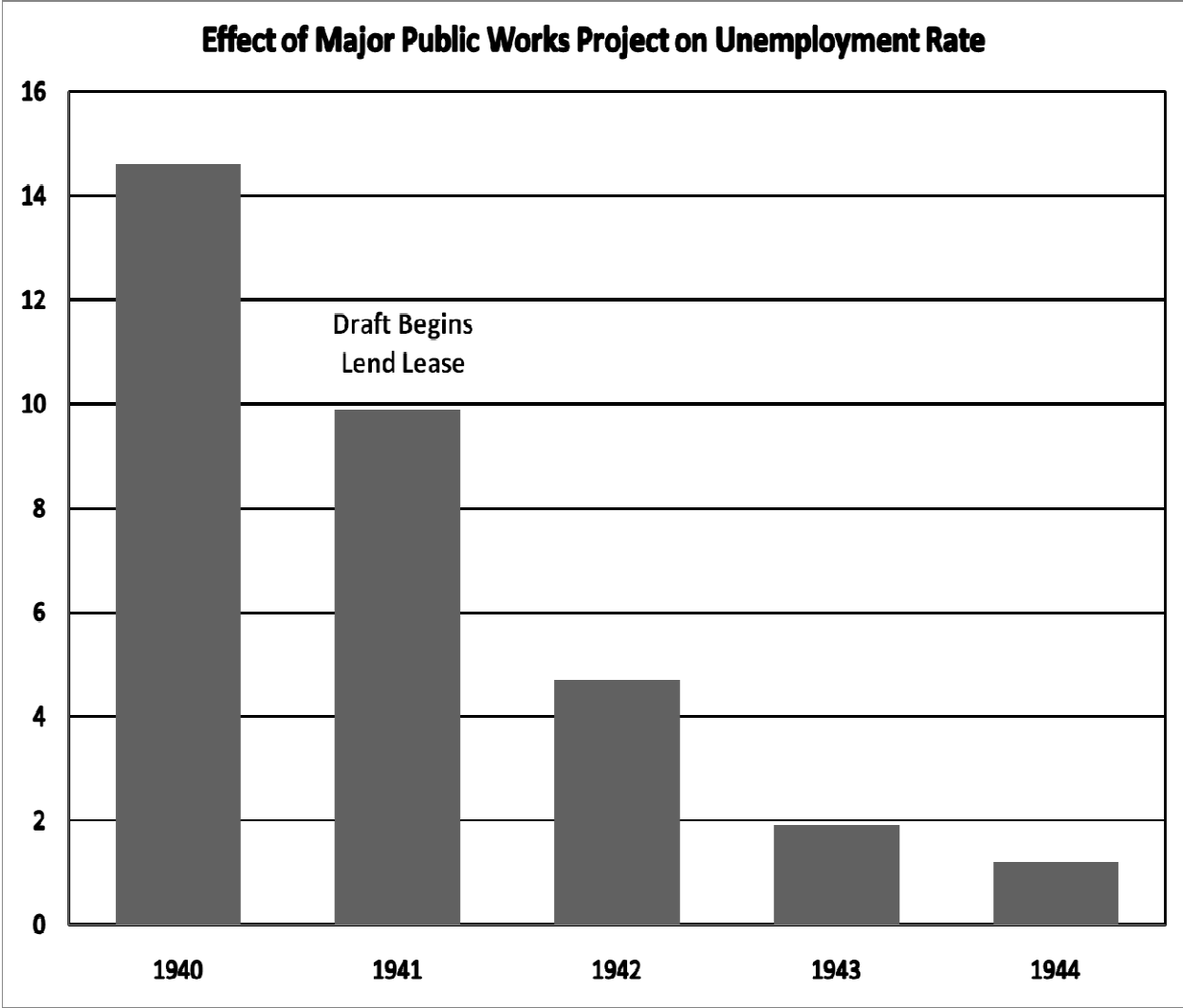
**“Thinking about the state as a whole, what do you think is the most important issue facing people in California today?”**

<i>Top three issues mentioned</i>		<b>Jobs, economy</b>	<b>State budget, deficit, taxes</b>	<b>Education, schools</b>
<b>General Election Voters</b>		64%	13%	4%
<b>Party</b>	<b>Democrats</b>	68	10	6
	<b>Republicans</b>	62	15	2
	<b>Independents</b>	59	15	4
<b>Region</b>	<b>Central Valley</b>	69	13	2
	<b>San Francisco Bay Area</b>	60	13	6
	<b>Los Angeles</b>	65	10	4
	<b>Other Southern California</b>	63	14	5

Note: Telephone (including cellphone) poll of 2,003 adults who reported taking part in the November 2010 election.

Source: Public Policy Institute of California (PPIC), *Californians and Their Government*, December 2010, [http://www.ppic.org/content/pubs/survey/S\\_1210MBS.pdf](http://www.ppic.org/content/pubs/survey/S_1210MBS.pdf)

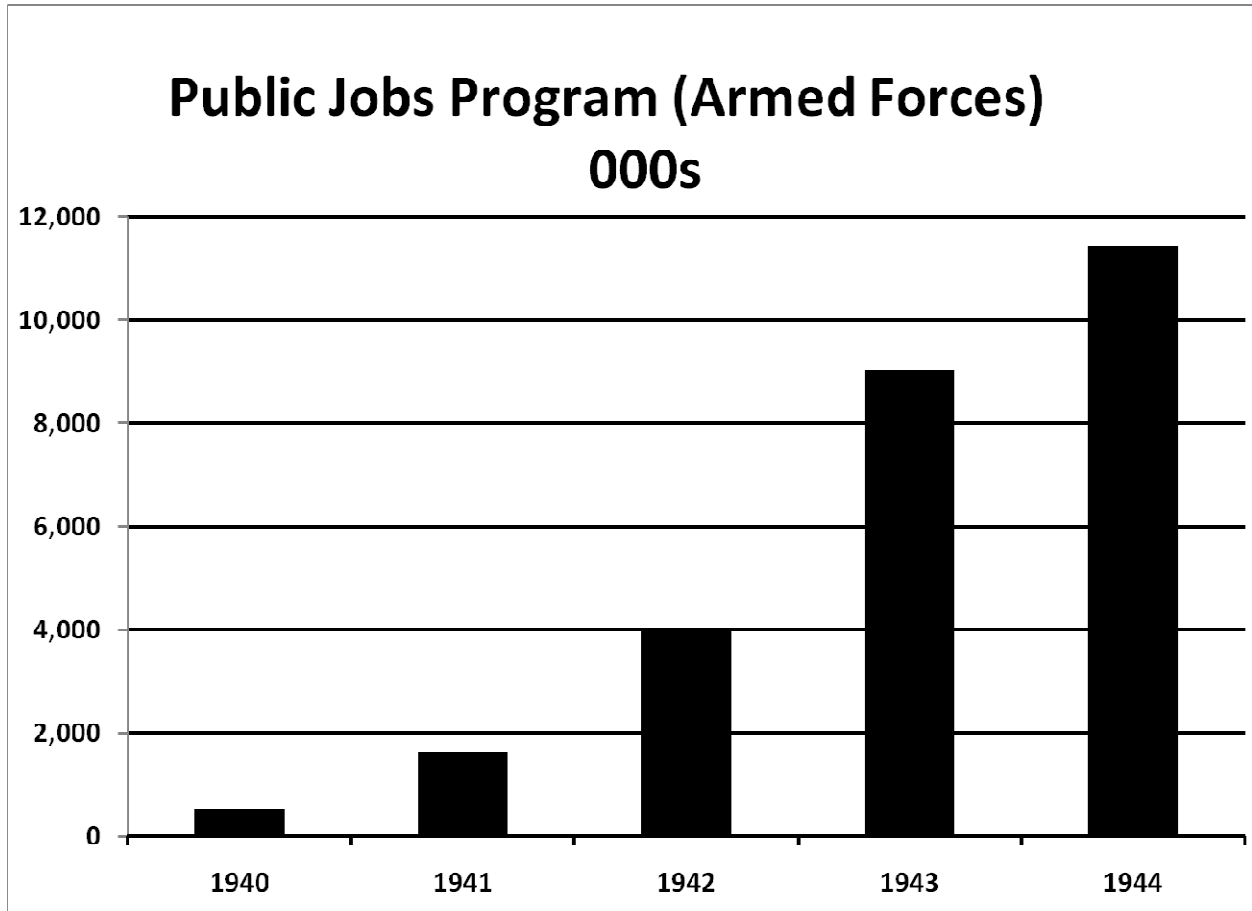
Figure 2: Unemployment Rates in the Period Leading to, and During, World War II



Source: U.S. Bureau of Labor Statistics

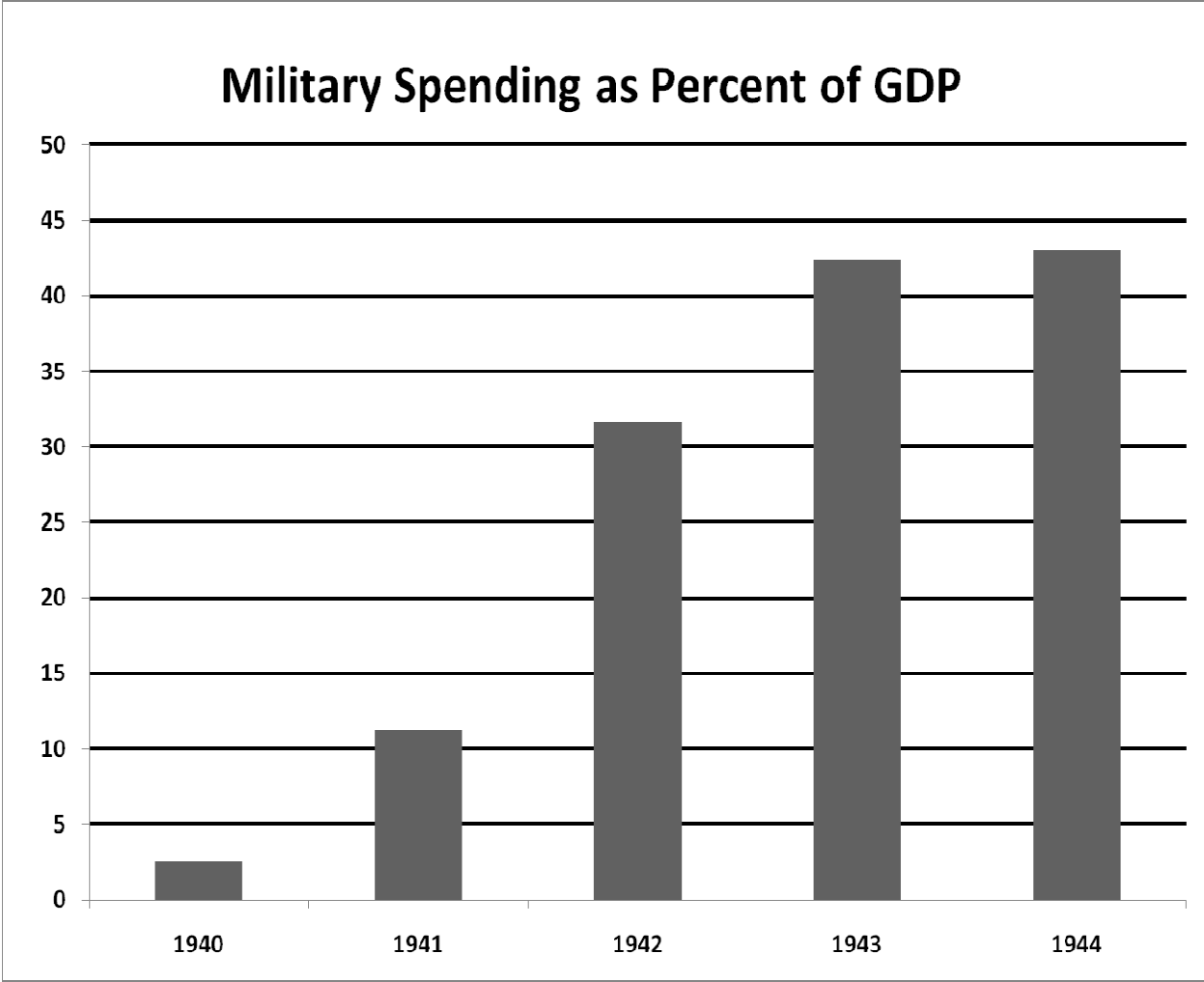


Figure 3: Military Employment in the Period Leading to, and During, World War II



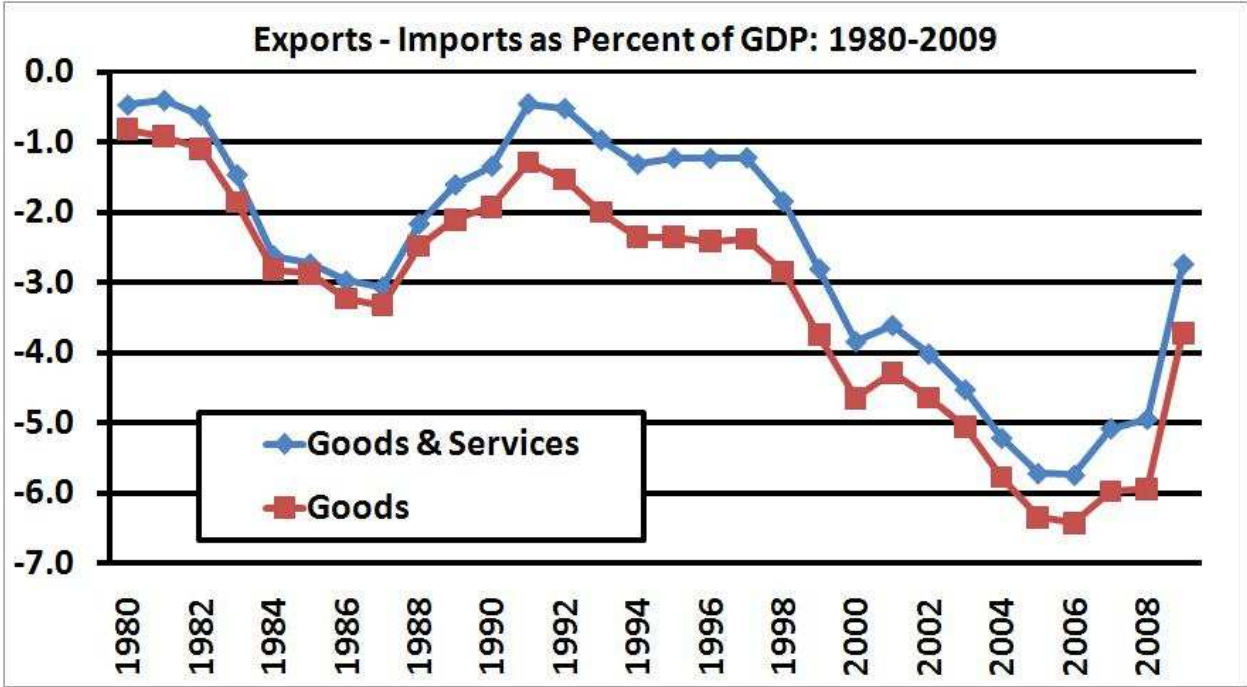
Source: U.S. Bureau of the Census, *Historical Statistics of the United States*,  
<http://www2.census.gov/prod2/statcomp/documents/CT1970p1-05.pdf>

Figure 4: World War II Fiscal Impact



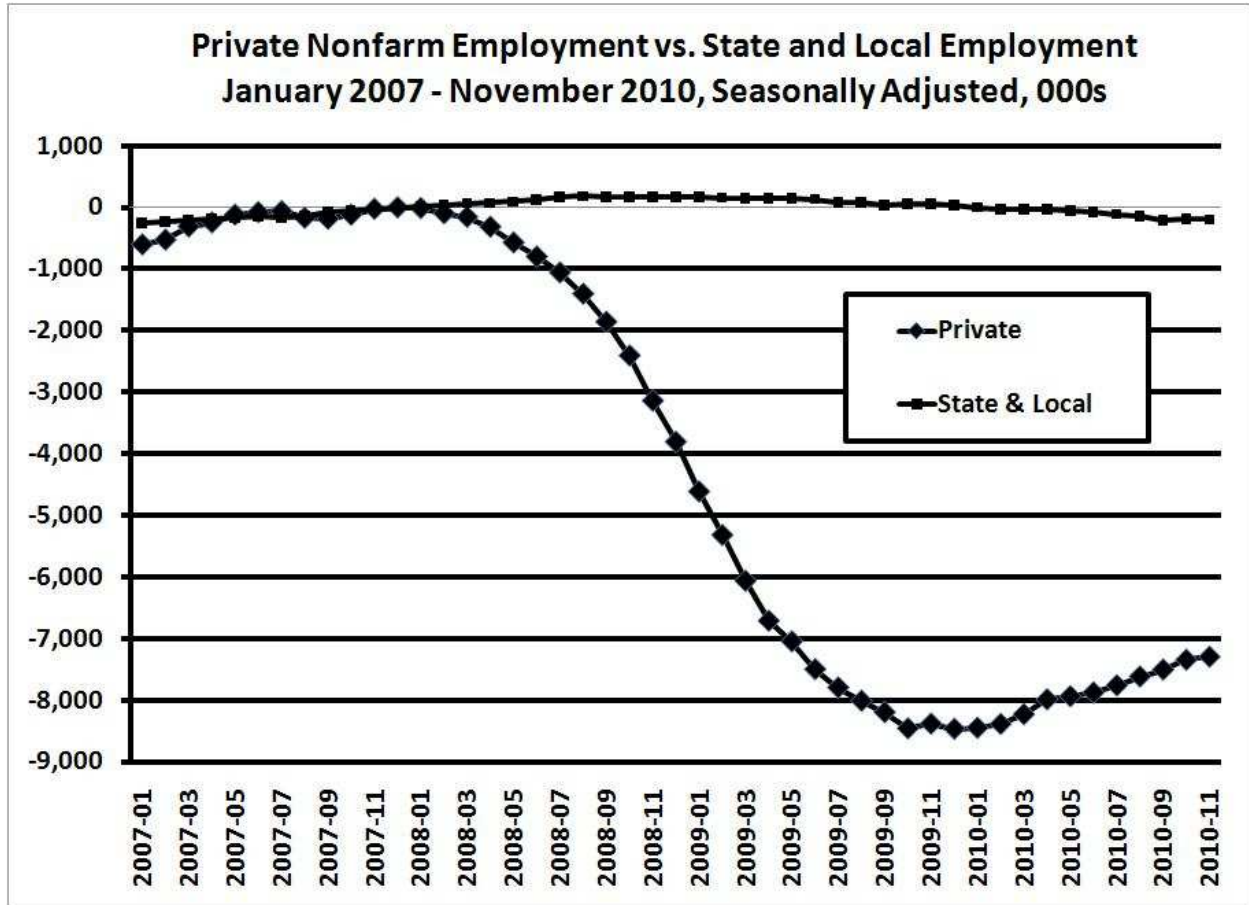
Source: National Income Accounts

Figure 5: U.S. Net Export Imbalance



Source: National Income Accounts

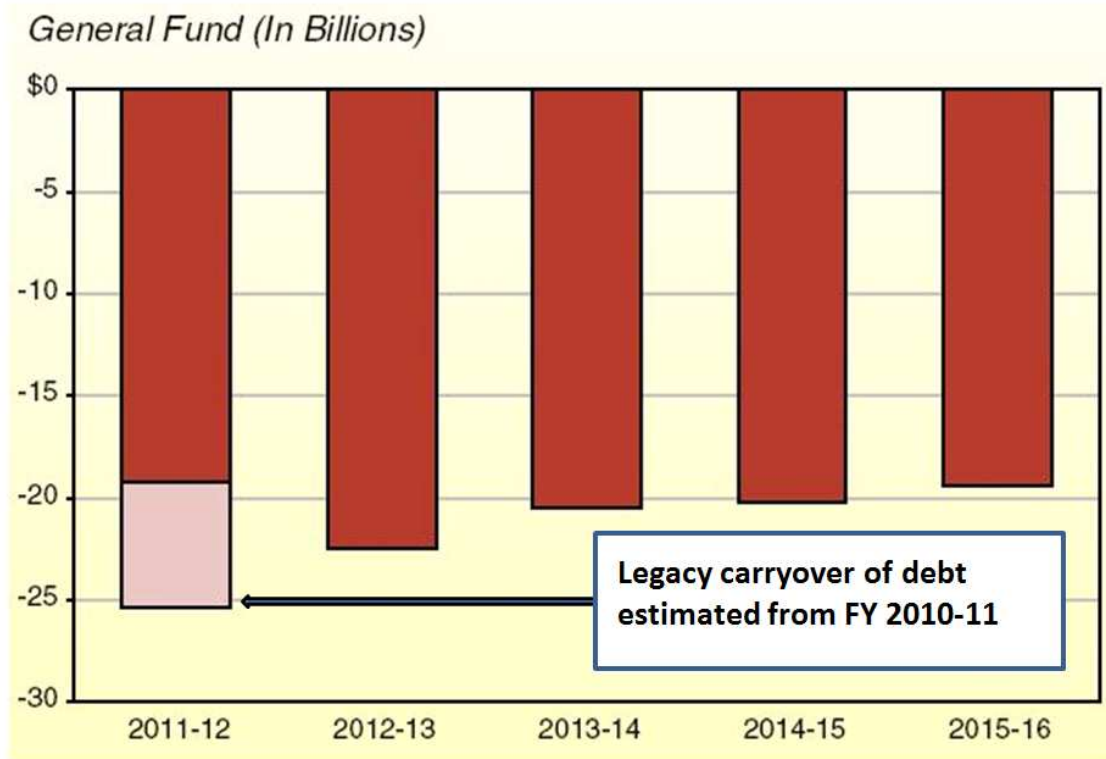
Figure 6: Employment Deviations from December 2007 Levels



Source: U.S. Bureau of Labor Statistics

Figure 7: California's Fiscal Situation Projected as of November 2010

### Projected Annual Deficits With No Change in Policy



Source: California Legislative Analyst's Office, *California's Fiscal Outlook: The 2011-12 Budget*, Nov. 10, 2010, Figure 2 (with titles modified in order better to describe the budget situation). Report available at [http://www.lao.ca.gov/reports/2010/bud/fiscal\\_outlook/fiscal\\_outlook\\_2010.pdf](http://www.lao.ca.gov/reports/2010/bud/fiscal_outlook/fiscal_outlook_2010.pdf)