ECONOMICS U$A
21ST CENTURY EDITION

PROGRAM #18
FISCAL POLICY

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(MUSIC PLAYS)
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FRANK STASIO: Economics USA a 21st Century Edition Audio Supplement designed to explore 21st century challenges to micro and macroeconomic principles. The subject of this addition is fiscal policy. Our guest is Dr. Michael Munger. Dr. Munger is a professor of Political Science at Duke University. I'm Frank Stasio.

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FRANK STASIO: Professor Munger, welcome.

MICHAEL MUNGER: "It's nice to be on the show."

FRANK STASIO: We are talking about fiscal policy and when we talk about fiscal policy we are talking about the theoretical ability of the government to use tax and spending authority to adjust the economy to maintain stability. So, how do we know about the actual effects? How much do we know about the actual effects of fiscal policy over the years? I'm thinking about the WPA, massive spending program in the 1930's, but it did little to bring the nation out of the depression. It took World War II to do that, and then let's take the famous Kennedy tax cut to stimulate the economy in the early 1960's. By the time it was enacted, there were already signs of recovery. So what's the research on the actual impact of fiscal policy?

MICHAEL MUNGER: "One of the things you can probably say about fiscal policy is most general statements about it are wrong; and it really matters what the composition of spending is, and what a lot of macro economists have tried to do is aggregate beyond the level of the particular kind of spending, or the particular kind of taxes, till there is really a false dichotomy. So there are some people that claim for every dollar that the government spends, it creates a dollar or more in growth, and that would be surprising if it were true, unless you consider what we're spending the money on. So the programs during the Great Depression were a product of John Maynard Keynes's theory that: well in the long run we're all dead, but what we have to do is stimulate the economy in the short run, and he actually proposed, I think half jesting, that if you had a bad enough problem with unemployment then what you could do is bury dollars in mayonnaise jars and, in effect, pay other people to dig them up."

FRANK STASIO: So it depends, as you said, on what we are spending the money on. Why then was the money spent in the Depression? First of all it took awhile. Do you agree that in fact that's not the thing that got this country out of the Depression? It was World War II spending?

MICHAEL MUNGER: "The big problem we had during the Depression was that business started to accumulate large amounts of cash, and was unwilling to invest it, and that may sound familiar because that's exactly what's going on now. I think a lot of people, in retrospect, attributed it to the fact that they weren't sure what the policies of the government were going to be, and they weren't sure if the investment was going to produce. You don't want to be the first one. You don't want to be walking through a place with a bunch of booby traps and be the first in line; and so they were not really willing to invest, and then when no one else did, over time the unemployment rate didn't start to go down, consumers didn't start to buy again, and so I think it is true in 1939 or 1940 was the first time we started to turn up, and a lot of that was anticipation of war production."

FRANK STASIO: So what is it that would make fiscal policy work? What kind of spending works, and what kind of spending doesn't? You said that you think the multiplier effect is really rarely an effect that is a dollar spent generates two dollars in income. When does it, and when doesn't it?

MICHAEL MUNGER: "Most of the time you have to justify the spending on its own merits, so one of the things that we know is that in the short term it's very difficult to use fiscal policy to have much of an impact. We've seen that recently after the stimulus in 2009, 2010, and we saw it during the 1930's. The real problem is the way to get growth over the long run is to have improved education and improved infrastructure, things like roads, bridges, electrical infrastructure, things that people can depend on over the long term. Over the short term I know that this government spending is going to run out. We saw this in a lot of states, and we saw this with a lot of companies. They know that the spending is going to run out. They use it to pay off their debts. They use it to improve their financial position, but they don't use it to create new jobs, because it won't last beyond the point where it is cut off."

FRANK STASIO: “So there has to be some geared for it to work. There has to be some guarantee of a sustained policy over time, or at least know a timeline, and what that timeline is.”

MICHAEL MUNGER: “The difficulty is that politicians—and this is true of politicians on all sides—may benefit from uncertainties. So they say, ‘We’re going to give you this, and if you come back to us we may do it again,’ and that’s true for welfare programs or corporate welfare, for oil depletion allowances. It’s true for all corporations. That means that they’re going to keep coming back for more. It would help if we’d just say, ‘This is one time for all. Here’s the wages you are going to have, and here’s the policy.’”

FRANK STASIO: Increasingly policy makers have to consider the growing national debt, the increasing size of deficits when they make fiscal policy. How has that changed the debate since the 1930’s?

MICHAEL MUNGER: “Well interestingly in the 1930’s, even in 1936, Franklin Roosevelt was very concerned about the deficit in a way that in retrospect seemed sort of silly. The reason that we cut back government spending in 1936, sort of unexpectedly, was the concern by the democrats about the size of the deficit. Well right now the federal deficit is about 14.5 trillion, and the amount of that that’s actually held in private hands is 9.5 trillion, with the other 5 trillion being held by the government itself, and so there’s two different parts of the deficit now to worry about. One is the amount that the government owes to other people and has to pay principle plus interest. The other is the part that is in the Social Security Trust Fund.”

FRANK STASIO: So those are going to end up being debts. They are going to cost us all in the long run.

MICHAEL MUNGER: “It’s really paradoxical. Harry Truman said he wished he could have a one- armed economist, because economists always say, ‘on the other hand.’ Well the problem we have with Social Security is, if you are a private pension fund and all of your money was invested in US Government or Treasury Securities, that would be an extremely Conservative investment. We said that was great. Well that’s what Social Security does. They’ve invested all of their money in US Treasury Securities. So it really isn’t true that we’re on the verge of bankruptcy. What’s true is we have to get our fiscal house in order.”

FRANK STASIO: If the government stimulates the economy though, through spending programs, doesn’t that create, doesn’t that generate wealth, doesn’t that generate money that can be circulated through the system and then ultimately strengthen the economy?

MICHAEL MUNGER: "The problem with that reasoning, and it could be true, but it just isn't necessarily true. The problem with that reasoning is something that I've called, I've said that US Policy is daft, and what I mean by daft is that deficits are future taxes, and so what we see is that government spending that is deficit financed. We're taking money, either from current tax payers, or worse from future tax payers who have no voice in it, and we're spending it. The question is what are we spending it on? Well, if we are spending it on current services so that we are not actually paying for the amount of services that we're getting, that's not going to create growth, that's not going to create jobs. All it is, is a drag on future generations. What we are not doing is spending it on infrastructures, railroads, education. If we were doing those things then yes, perhaps it would create jobs over the long term."

FRANK STASIO: Let's take a look at this from the supply side. If the government cuts taxes that puts money into people's pockets, they spend, the economy grows, deficits fall, right?

MICHAEL MUNGER: "The answer is no. Remember almost anything we say about deficits is wrong, so there are many plausible things, they just happen to be mistaken. The two biggest tax increases in US history were during the Reagan, and first Bush Administration and the second Bush Administration, and the reason is the deficits are future taxes. So the two huge increases in the deficit were Reagan- Bush, and then Bush two. So what happened was yes, we cut taxes, but we didn't cut spending; so we just decided we were going to live above our means, and we were going to finance that by taxing unborn, future generations, who are unrepresented in the political process."

FRANK STASIO: Then does that mean you eliminate taxes and you eliminate government spending, and the market will take care of all of this and then we don't have to worry about, the government really has no role in moderating the economy?

MICHAEL MUNGER: "Government can't do much that's effective in moderating the economy. What we've been doing is having sort of a false stimulus. I think one of the things that's disturbing about the current debate is that the democrats seem to be saying, 'We're not going to cut spending. We're going to continue to have high spending no matter what'. The republicans say, 'No matter what the question is, the answer is to cut taxes'. The result is that we have increasing deficits. The problem with that kind of increasing deficit is that it's really a transfer. It's really a tax increase. What I don't see is anyone willing to step up and say, if we're going to worry about deficits, we're going to have to cut spending on the military. We're going to have to get control of entitlement spending, and we’re going to have to raise taxes, because we’ve raised taxes already on future generations. The myth is that the United States is somewhere near bankruptcy. That’s absurd. We’re not near bankruptcy. A bankrupt company has no way of raising revenue. If we like our current level of spending, and people seem to. If you ask them, they like the current level of spending. Just raise taxes. The United States is grossly under-taxed compared to European countries that have sort of the same level of services. So if you like the current level of spending you have to raise taxes. To say we're near bankruptcy is wrong. We have plenty of ways to raise revenue.”

FRANK STASIO: But is it feasible to, if you don’t like taxes, and that might be the other side to this, say you know what? Now that you say that, and you put it that way Professor Munger, I’d rather do away with those programs, because I don’t like to pay taxes; and I think if these services are worth anything, if people really want them, the market is going to take care of that. We won’t have to tax. The government won’t have to spend, but the market will take care of it.

MICHAEL MUNGER: “Market, if anything, we’ve seen a transformation from the market focusing on new investment, and productive investment into two kinds of activities, both of which are actually damaging. One is rearranging financial derivatives and financial services in ways that actually destroy wealth, and the other is what economists call "rent-seeking", or investing in getting the government to protect them from competition. So to the extent that those are the incentives that we have created, we actually have a problem where both sides should be upset. Very soon interest payments are going to be 20% or more of our annual budget. What that means is, it’s going to be hard for the government to provide the kind of services that people on the left say they want; and we're going to be crowding out private investment, which people on the right say they care about. So, together we should be able to do something.”

FRANK STASIO: Do we have to recalibrate the impact of fiscal policy now because we operate on a more globalized economy then we did in the 1930’s?

MICHAEL MUNGER: “One of the problems that the United States faces right now is that we’re in a very brief period of great good fortune, because no matter how bad our policies are, the ones in Europe are worse, and in particular the euro right now is all covered in grease. So the US dollar is being propped up even though it’s falling against gold, silver, and a number of commodities. So we’re seeing a kind of inflation that’s being produced by the fact that people in other countries are not willing to hold dollars as they were. But in the short run we can get away with it because the European policies are even worse. We have about a two year window before global financial exchange, dollar currency exchanges, just bite us in the bottom.”

FRANK STASIO: Are budgets really seen as a tool of economic stability anymore? Aren't they almost exclusively now political documents, political statements?

MICHAEL MUNGER: "I blame the parties for that. Maybe I ultimately blame the voters. The answer to that question is yes, unequivocally, yes, but the reason is that the democrats say, 'We're going to protect your spending' the republicans say 'We're gonna protect your tax cuts,' but everything else is on the table."

FRANK STASIO: Someone once said, "Trying to fine tune the economy is like adjusting a shower in a cheap motel." Even if politics weren't a factor, would it be possible to do the math, and to figure out the right balance of taxes and government spending to keep an economy moving without inducing inflation?

MICHAEL MUNGER: "Milton Freedmen said a number of things that I think were pretty smart, but one of the things he said that I thought was smartest was, 'Whatever tax policy is most efficient is the one we currently have'. So as long as you have a balanced budget, business consumers can adjust to taxes. The problem is when we constantly cut taxes as a way to buy votes from elites. If you do that it means that they're expecting more and more in order to provide the vote. If we just live within our means and say, 'Here is the spending we want. Here is the amount of taxes that have to finance that,' that's the policy that's best."

FRANK STASIO: Professor Munger, thank you very much.

MICHAEL MUNGER: "You're welcome."

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FRANK STASIO: Dr. Michael Munger is a Professor of Political Science and Economics at Duke University and the Director of the Joint Program for Philosophy, Politics, and Economics at Duke and the University of North Carolina at Chapel Hill. I'm Frank Stasio.

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