Mitchell's Musings 10-3-11: No Multiple Choices in Political Economy?

Consider the following situation: You are driving up a hill when your car runs out of gas. You should have been paying attention to the fact that the gas gauge was nearing the "empty" mark, but you were so entranced with how nicely the car had been running up to that point that you failed to look at what the gauge was indicating. The engine stalls and the car slows to a stop and begins to roll backwards. So you step on the brake, halting the dangerous backward roll. But, of course, just stopping the car from rolling backwards – although it prevents disaster - does not solve your problem; you aren't getting to your destination. Luckily, there is a gas station where you have stopped so you can refill your tank. You then restart the engine, step on the accelerator, and resume driving up the hill. Given the degree to which you have depressed the accelerator, however, it turns out that the car is moving up the hill more slowly than you would like.

Given this scenario, you should:

a) Reason that since stepping on the accelerator as far as you did didn't produce sufficient speed, stepping on the accelerator has no effect at all and you should take your foot off the pedal.

b) Reason that – although you are going too slowly now - you should not depress the accelerator further because- if you do - you might end up going too fast after you get to the summit of the hill and you begin to descend.

c) Reason that putting gas in the tank and stepping on the accelerator deprived the car of its natural ability to travel at the desired speed. You should stop the car, drain the tank, and wait confidently for the car to get you to your destination on its own.

d) Reason that there has been a structural shift in the law of gravity since your car resumed travel and that, therefore, there is nothing to be done other than to continue to drive more slowly than you would otherwise like. Eventually, you will get to your destination.

e) Depress the accelerator further now. When you get to the top of the hill, ease up on the accelerator. If the car nonetheless goes too fast on the down side of the hill, take your foot off the accelerator and apply the brake to maintain the desired speed.

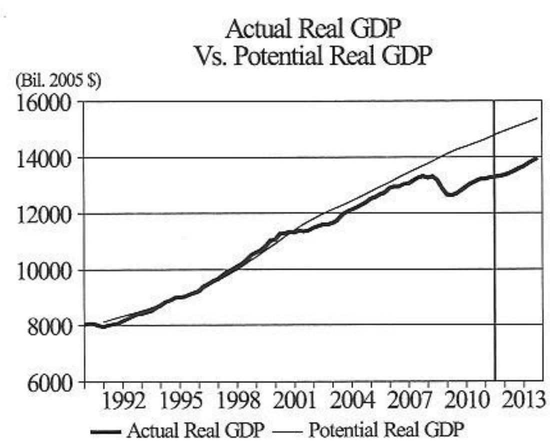
I hope you will see some analogy in the story above to the economic crisis of 2008 and beyond and to the debate about what was done in response to the crisis and about what to do now. I also hope you would select option "e."

Obviously, I have framed the story to fit my view of the way the macro-economy functions and how it responds to policy. Critics would find fault with various aspects of my car-economy analogy. But note that even if you agree 100% with my framing and analysis, there is one subtle assumption in my little tale. I assume that there is an Option "e."

Option "e" states that you can take a corrective action after first making a forecasting error. That is, you depressed the accelerator to a given degree, assuming that (i.e., forecasting that) the car would travel at the desired speed – and your forecast turned out to be incorrect. You underestimated what was needed. But because option "e" is assumed to be available, your initial forecasting error is not critical. You can always make an iterative correction. Indeed, drivers typically do not know how many inches of accelerator depression are needed to maintain the speed of a car on a given grade of a hill. The freedom to adjust the accelerator continually makes that precise knowledge unnecessary. Drivers simply adjust the accelerator until the car travels at the desired speed.

Political economy is not as kind to policy makers as cars are to drivers. As a policy maker, you may have a one-shot, discrete opportunity to implement a remedy and – if the forecast on which you base that remedy is incorrect – a later iterative correction may not be readily available. So, first, there is an issue of the degree to which economic forecasts can be accurate. Second, the ability you have to make an iterative adjustment depends in a democracy on how the public feels about what has happened and how those perceptions are determined.

I thought about these matters while attending – and speaking at – the latest UCLA Anderson Forecast program two weeks ago. Below is a chart from that program that summarizes the Forecast. The Great Recession takes the form of a large gap opening up between potential and actual GDP. Note, however, that there is no forecast on the chart of a second decline, i.e., there is no formal double-dip recession: What is depicted is a stalled, sluggish economy that will not get to full employment – or anywhere near that point – anytime soon. (Indeed, unemployment begins to rise in the near term under the UCLA Forecast as job creation does not keep up with labor force growth.)



The UCLA Forecast, like others, is based on a combination of modeling and judgment. Most past recessions have resulted from downturns in particularly cyclically-sensitive industries such as construction and manufacturing. The no-double-dip prediction in the UCLA Forecast was based on the (sad) fact that these industries are already so depressed that it would be hard for them to contribute more to a double dip.

Such judgmental reasoning, and more formalized econometric modeling, is based on past experience. But the problem today is that the current situation is extraordinary; what normally happens is not necessarily a good guide. There isn't much past experience to go on. The chance of a forecast error is therefore greater than in normal circumstances. In the question-and-answer period at the UCLA Forecast program, the forecasters acknowledged that an unforeseen event – perhaps a crisis in the Middle East that substantially jacked up oil prices – could tip the economy into a double-dip recession.

If you were a macro-policy maker – and if you were basing your actions on the UCLA Forecast – an important question is whether you have the equivalent of an Option "e." That is, you would assume – as the Forecast suggests – that there will be no double-dip recession. But if you turned out to be wrong, would you be able to make a midcourse correction to address that event?

A major constraint on your options is public perception and agenda framing. Below is a chart from a monthly opinion poll in California taken by the Public Policy Institute of California (PPIC). The poll makes it clear that what is of greatest concern to the general public, and to voters, is the economy and jobs. Issues that political types may think are important to people – education, immigration, etc. – hardly register.

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

Top four issues mentioned	All Adults	Party			Likely Voters
		Dem	Rep	Ind	
Jobs, economy	67%	73%	64%	66%	67%
Education, schools	6	7	7	4	6
State budget, deficit, taxes	6	6	10	11	10
Immigration, illegal immigration	4	2	4	4	3

Source: http://www.ppic.org/content/pubs/survey/S_911MBS.pdf

When people are asked to judge the success or failure of economic policy, they judge on the basis of what actually happened, not what might have happened or what was averted.

"Since taking office, have Barack Obama's economic policies made economic conditions better, worse, or not had an effect so far?"

	All Adults	Party			Likely Voters
		Dem	Rep	Ind	
Better	26%	42%	8%	23%	27%
Worse	29	10	68	30	37
No effect so far	40	41	19	42	31
Too soon to tell *(volunteered)*	2	3	1	–	2
Don't know	3	3	4	4	3

Over two thirds of respondents to the PPIC poll view recent policy has either having had no effect or having made things worse. Note that by some measures, things *can* be said to be worse than in January 2009. The unemployment rate, for example, back then was 7.8% (albeit on the rise) as opposed to the latest 9.1% (in August 2011).

PPIC pollsters then went on to ask about remedies, but in a specific way. Federal spending is posed as one solution (so note that the pollster is implicitly telling respondents that spending is a plausible economic policy to undertake) versus budget deficit reduction (so the pollster is implicitly telling respondents that deficit reduction is a plausible economic policy to undertake). The choice is put as "spending *to help the economy recover*" versus budget deficit reduction – without the added phrase about helping the economy recover. Did respondents assume, given that there was a choice of two, that both would "help the economy recover"? You can't tell for sure but it is certainly possible that posing the issue in this way – and this is the way pundits have been posing it – suggests that perhaps either one would help the economy recover.

"If you were setting priorities for the federal government these days, would you place a higher priority on spending to help the economy recover or a higher priority on reducing the budget deficit?

	All Adults	Party			Likely Voters
		Dem	Rep	Ind	
Spending to help the economy recover	56%	64%	25%	55%	48%
Reducing the budget deficit	39	31	70	43	48
Don't know	5	5	5	3	4

Note also that since over two-thirds think that Obama administration policy – which has focused on spending – had no effect or has made things worse, at least some respondents who favored spending in the question above must also have believed that spending had no effect or made things worse – or were unaware of what Obama administration policies were.

As is well known, initial forecasts of the Obama administration economists overestimated the impact of the stimulus program and other related efforts. But the ability to make an iterative adjustment (an Option "e") was quickly limited by the political system. Voters know only what has happened, not what might have happened. They don't have a defined economic model; at most they have predilections about what is good or bad policy. If clear progress is not perceived, incumbents are blamed and the tilt is toward the opposition in the next election (two years later). In the U.S. political economy, there is a *de facto* intolerance for forecast errors – even though such errors are inevitable, particularly in an unprecedented situation.

If there is any lesson from the Great Recession, it is that attention must be paid to expanding the macro-policy "option space." There can't be just a one-shot fix; there needs to be room for iterative adjustment and midcourse corrections. The trick seems to be less in trying to sell the public a model of how the economy operates and how it responds to policy - and more in trying to convey that economic recovery is a work in progress.