Economics

Department Alumni Newsletter

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Bob Stonebraker, editor

What is an IUP? What image leaps to mind? Since quietly dumping the controversial "Big Indian" in 1991, IUP has had no mascot. We've floated adrift in a marketing maelstrom with no institutional symbol to rally the troops or point us toward port. Not much longer. The *"help wanted"* sign is out; potential mascots are invited to apply. With a truly unique symbol, IUP could differentiate its product in a new way. What a marvelous opportunity for an institution with a name-recognition problem. The marketing and publicity potentials are enormous.

Initial proposals -- the Crimson Hawks or the Crimson Thunder --do not excite me. *Hawks* is used elsewhere and *Thunder* conjures up visions of muddy paths, inverted umbrellas and wet socks. Neither seems related to the past heritage or future dreams of IUP. Is there an alternative? How about something with a local flavor -- perhaps a famous Jimmy Stewart character (the IUP Harvey's?), or a coal mining term (the IUP Pits?). No. I decided to champion a mascot/nickname that shouts "academics matter at IUP." Whoa. Radical.

Would the *Crimson Scholars* work? Can you imagine a mascot -- decked out in crimson academic regalia and shaking an academic mace -- leading cheers in Memorial Field House? I'm not wedded to *Scholars*. History is filled with men and women who personify intellectual integrity and the thirst for knowledge -- could we adopt one? Would hanging an "intellectual" nickname on a university be too radical? What would people think? Would it taint IUP with terminal dorkism? Or, might it send a bold message to potential students, to potential athletes, and to their potential employers?

This may be our only opportunity to make such a public statement about how we perceive IUP. We should be very careful about what statement we choose.

And on another note....

Meanwhile, our retirements -- especially Don Walker's -- and the newly-announced Walker Scholarship Fund have prompted a record alumni response. Great. We love hearing from you. Now, if you'll all send checks to the Foundation for IUP earmarked for the Donald A. Walker Department of Economics Scholarship Fund, we'll be happier still. Is that crass? Of course. We economists can be a crass and greedy lot. And, we're not embarrassed. We know others can be just as crass and greedy; they are just more reluctant to admit it. Send the money.

Nick Karatjas has agreed to step in as our new chairperson, and Yaw Asamoah has filled in this semester while Nick is on sabbatical. Luckily, we are blessed with many energetic and capable professionals. No doubt we'll fumble a few handoffs as we shuffle line-ups, but our basic game plan remains intact: care about our students, challenge our students, and offer the best undergraduate education we can offer.

Bob Stonebraker, editor

It's 1931 in Moscow, and It's Still Spreading

by
Willard W. Radell, 1998

The article reproduced below was written in 1992. Subsequent events have made the article as timely now, in 1998, as it was then. Since 1992, we have learned to fear a situation in which 50,000 people, who know how to make a Hydrogen bomb, haven't been paid in 6 months. Will the Ukrainians have enough money to manage the unstable, erratic and dangerous continuing situation at Chernobyl?

Our Federal Reserve officials have begun to use the "d" word -- *deflation*. The first economies to feel the macroeconomic implosion of Russia were Japan, Southeast Asian economies and what used to be called West Germany. It has now spread to Latin America, and Central and Western Europe. Since our prosperity is largely dependant on the prosperity of our neighbors, we now are being buffeted by the economic hurricane raging on the globe.

How well are we prepared? There is no Marshall plan for the winners of the Cold War to provide liquidity to the losers to maintain them as good customers. There is no GI Bill to preserve the spending power of the scientists and technicians who maintained our defensive position. There isn't much of a progressive income tax anymore and welfare has lost some of its role as an automatic macroeconomic stabilizer as states transition to "two years and out" rules on welfare.

We have one big Ace in our hand. The Federal Reserve is now attempting to maintain liquidity. But whatever is done, the Fed's attempts to turn back the tide will be constrained to the degree that what used to be the world's 7th largest economy (Russia and its Republics), continues in its deep depression.

The following version, published in this newsletter six years ago, rings just as true in 1998 as it did in 1992.

It's 1930 in Moscow, and It's Spreading

by
Willard W. Radell, 1992

One of the most ignored economic consequences of the break-up of the USSR has been the macroeconomic shock wave implicit in the end of the most expensive war in history, "the cold war." Reasons for the ignorance range from knowledge and reason blinded by ideology, to inadequate understanding of the extent to which national economies are linked in the "new world order. "

In Russia, as at the University of Chicago, macroeconomics has not been a totally politically-correct area of study. In the USSR Keynes was viewed as an apologist for capitalism, and what we call macroeconomics was dubbed by Soviet economists as "bourgeois economics" or "capitalist economics. " In their view, the insights of J. M. Keynes on depressions, aggregate expenditures, propensities to consume and 'repercussions' of quantitative shifts in fiscal policy were theories that only served to prop up a dying system - capitalism. Government-sponsored programs to increase aggregate expenditure and to support incomes were viewed by the Soviets as a capitalist trick to keep the ruling class in power by mitigating the "inevitable" crisis of capitalism.

Ironically, while Keynes's macroeconomic insights were being rejected in Russia as being too far to the right, in the U.S., political conservatives rejected Keynesian insights as being too far to the left.

Perhaps the most repugnant feature of Keynesian economics to American conservatives was one of the weapons of choice to fight recessions, government spending increases. To conservatives, the implicit increase in the relative share of government during anti-recessionary fiscal campaigns was an unacceptable consequence except in times of war.

Because Russians had rejected Keynesian economics, and are now seeking council from American economists who do not think well of Keynesian fiscal approaches, they are being surprised by the profound depression of their economy. Had they a better grounding in "capitalist" economics, they would not be surprised by their recent lack of economic success.

What transition policies have led to recession?

1. Peace Dividend. Bernard Mandeville of the 18th century discovered that whether spending or incomes make sense, are wasteful, or are productive makes little difference on a grand scale. Whether military spending serves a shining-star democracy or a socialist police state does not determine what economic impact spending changes will have.

Many ex-Soviets, who perceived that military spending was wasteful, incorrectly expected that cutting out military expenditures would lead to greater wealth and income. The problem is that military budget cuts, even for the most wasteful military imaginable, are reductions in government expenditure that are indistinguishable from other cuts in aggregate expenditure. Unless those cuts are explicitly offset by increases in expenditure in other sectors of the economy, 19th century liberal incantations will not be sufficient to ward off recessionary demons.

During World War II our U.S. economy was similar to the old Soviet system. We had wage and price controls on almost everything, rationing, and a command structure that allowed the federal government to dictate what was to be produced and in what quantities. In U.S. manufacturing plants, quotas and targets replaced the discipline of the marketplace. When we converted from a military command system to a market economy in 1945-46, we expected and got a short, sharp recession. Why was it over so quickly? It ended because we didn't expect a peace dividend and put together programs like the GI Bill that assured the flow of expenditure in the transition period.

2. 100% Money. In the old Soviet system the monopoly bank required a reserve requirement of 100%. Thus, the money creation multiplier was 1.00 and economic optimism could not be financed to allow big increases in investment.

In contrast, the U.S. after World War II had a well-developed fractional reserve system that allowed healthy increases in money supply to back investment serving America's optimism. That meant that the sizable cash balances from the war years when Americans were making money but had nothing to spend their money on (how many 1944 Chevrolets have you seen?) could be parlayed into magnified investment in housing, education, and plant and equipment purchases.

To make matters worse in Russia, some recent policies have actually led to destruction of money to fight inflation. While there is no doubt that money destruction is an effective prescription to fight inflation, depression is its major side effect. The money destruction will undermine any beneficial effects that might come from the development of a fractional reserve private banking system and private capital markets.

3. Ending Subsidies to Former State Enterprises and Cutting the Turnover Tax. The turnover tax was a way to tax those Soviet factories that were making profits. Those factories that made planned losses were given subsidies. Eliminating both had the effect of reducing government spending and taxes.

You will remember from your principles of economics (balanced budget multiplier) that the impact of linked reductions in government spending and taxation is recessionary. The ex-Soviets weren't ready for that one because they didn't take "capitalist economics" and those who did, didn't think it applied to Russia.

4. Privatization. While all economists I know support privatization, if, as is true in Russia, that privatization is done so that anything that is not set in concrete is suddenly put up for sale, commodity prices will fall. According to Radell's 9th law,"every income is tied to the price of something." The effect of large quantities of commodities being dumped on world markets for whatever they will fetch, presses nominal incomes lower. In the short-run that damps expenditures and incomes as well as providing a mechanism to make the profound recession raging in the formerly Soviet republics spread throughout the world.

Americans have not yet fully realized that when the Berlin Wall came down, the falling economic barrier between East and West would give us a stake in the economic health of Russia (and other formerly Soviet republics). After World War II, Keynesian ideas dictated a Marshall Plan - not just for Japan and Germany, but for us. The federal government provided liquidity so that the losers could be good customers for privately produced U.S. goods. In that way we avoided a post-war depression.

Now that the cold war is over and we won, there is not yet a Marshall Plan of significant magnitude for the losers. They would like to buy American, but can't without transmitting their recession back to us by dumping commodities on world markets. Thus, we and the Russians founder, searching for a sensible post cold war foreign economic policy, without the path-breaking insights of two long-defunct economists, Mandeville and Keynes.

Surpluses and Saliva

In October 1969, The New York Mets accomplished the impossible. The erstwhile doormats stunned sport fans with a World Series triumph. In October 1998, Mark McGwire accomplished the impossible. Demolishing Roger Maris' record, he stunned sport fans by rocketing his 70th home run.

In October 1969 the Nixon Administration did the impossible. It finished the fiscal year with the first federal budget surplus of the decade. In October 1998, a besieged Clinton Administration did the impossible. It finished the fiscal year with the first federal budget surplus since 1969. It must be something in the water.

What happened?

Yes. A surplus. After running up $3.5 *trillion* in deficits since 1969, Washington eked out a $71 billion surplus in fiscal 1998. Was it some miraculous feat of political will? Not really. The unexpectedly robust economy helped. Unexpectedly strong economic activity pours unexpectedly high tax revenues into the public coffers. And, the baby boomers did the rest. Yes, the boomers did something right. At the peak of their earning years, boomers dumped more taxes into the social security system than current retirees pulled out -- a mix that will reverse in another 15 years when the boomers themselves storm the retirement beaches in force.

Of course, there is minor fiscal chicanery afoot. The "official" federal budget did amass a $28 billion *deficit*. However, the social security system rang up a $99 billion *surplus*. Theoretically, social

security trust funds are not part of the official budget. But, in order to report a surplus, Clinton and Congress threw them in anyway. Oh well. A surplus is a surplus. Beggars can't be choosers.

With the bottom line wallowing in the black, might the budget rhetoric cool? No such luck. Never underestimate the creativity of demagogues. Partisan squabbles over the budget surplus have proved every bit as contentious and ill-informed as those formerly waged over soaring deficits. As usual, the rhetoric is largely cosmetic; lots of bluster, but little substance.

President Clinton has pushed saving the surplus to protect social security. Impossible. The surplus cannot be saved for the future in any meaningful way. In fact, it is already gone. In the normal course of a month, billions of dollars worth of outstanding government bonds mature. The Department of Treasury routinely issues new bonds to raise the funds needed to repay those that are maturing. With a $71 billion surplus, the Treasury simply issues $71 billion less in new bonds. The result? A $71 billion drop in the value of outstanding government bonds; a $71 billion drop in the National Debt.

The critical question is not how to use the 1998 fiscal year surplus, it's already been used to pay off a piddling part of our nearly $5.5 trillion National Debt. The critical question is what to do next? Given current tax and revenue projections, more surplus years are on the horizon.

We have three choices:

1. *Keep 'em coming:* Stay the course. Let the surpluses roll in and whittle down the National Debt.
2. *Go shopping:* Break out the check book. Spend the would-be surplus funds on new government projects. Whose pet projects should be expanded? Everyone has the same answer...."mine."
3. *Give it back* : Wipe out future surpluses with a tax cut. Which taxes should be cut? Everyone has the same answer...."mine."

Surpluses and economic growth

Which option is best? It depends. If long-run growth is your goal, the *keep 'em* coming option looks attractive. Growth is driven by investments in technology and new capital goods; investments that enhance labor productivity and drive up output per person. But, savings are a prerequisite for investment. If we do not save, we have no funds to lend firms trying to borrow and invest. Saving drives investment, and investment drives growth.

Alas. Personal saving in the U.S. is a disaster. Never very high by Japanese or European standards, personal saving rates in the U.S. have been in a steady decline ever since the Reagan tax cuts of the early 1980's unleashed a torrent of consumption demand. In 1980, Americans were saving about 8 percent of their disposable income. By 1990, the rate had fallen to 5 percent and, in recent months, it plunged below 2 percent. Wall Street's remarkable run is partly to blame. Soaring stock prices fattened financial balances. When portfolio values swell to record levels, consumers see less need to save.

If personal saving dries up, where will we get the funds needed for new investment? There are two other potential sources. The first is foreign funds. We can import savings -- and have been doing so since the early Reagan years. However, many Americans are uncomfortable with the notion of foreign investors taking ownership of U.S. corporations and assets. The second alternative is *a government budget surplus*.

Yes. A federal budget surplus has the same impact as personal saving. When the government runs a deficit, it finances the deficit by selling bonds. Deficits make the federal government a net *demander*

of funds in financial markets. They draw monies out of the market that could have gone to finance private borrowing.

Surpluses reverse the process. Federal surpluses turn the government into a net *supplier* of funds. With a $71 billion surplus, the Treasury will pay off $71 billion more in maturing debt than it will issue in new debt. That's a net increase of $71 billion available to fund investments in new capital and technologies. More federal budget surpluses means more funds for growth-enhancing investment.

Left-leaning politicians favor another option....the go *shopping* option. After all, they argue, economic growth requires public as well as *private* investments. Growth requires a well-educated and well-trained labor force; it requires a solid infrastructure of modernized highways, bridges, ports, and dams; it requires cities in which people are unafraid to walk and work. In short, it requires more government spending. More spending on basic scientific research, more spending on education, more spending on highways, more spending on improving the quality of life in general.

Are they correct? It depends. Where are the social rates of return higher? Will an extra billion dollars invested in education and highways create more long-run growth than an extra billion dollars invested in a new machine tool factory? Liberals are likely to say, "yes." Conservatives, convinced that all non-defense government spending falls into a black hole, answer, "no." I do not know the answer. But, I do know it is something about which intelligent, well-meaning people can disagree.

What about the final option...the *give 'it back* option? Tax cuts always offer a political boon. Representatives from both parties, but especially from the political right, salivate at the thought. But, be careful. We have slipped on that saliva before.

The Reagan tax cuts of the early 1980's launched the slide in personal savings that afflicts us still. History is clear. Long-run tax cuts are spent, not saved. A boom in consumption is fun in the short run, but wreaks havoc in the long run. In terms of long-run growth, tax cuts are the least attractive option.

Will it matter? Politicians are notoriously focused on the short run. After all, the long run is *after* the election, and voters enjoying increased growth ten years from now might not relate it back to earlier decisions to maintain a budget surplus. Will representatives follow their sense, or follow their saliva?

Graduation Rates: Up or Down?

by
Steve Campbell

Steve Campbell ('85) has been teaching high school mathematics in Houston, Texas while working on his doctoral dissertation in economics from Penn State. Emboldened by my persistent claims that "economics is everywhere," and encouraged by my continuing requests that alumni write articles for the newsletter, Steve submitted the following. It's a great article. Who's next?

While continuing my graduate work, I taught math at a high school just outside of Houston. Both my wife and Capital One Visa agreed that having a steady income was a good thing. As spring approached (which in Houston occurs around mid-January), school administrators' thoughts turn naturally to baseball players reporting to training camp and to graduation rates for seniors.

Failure rates, especially for seniors, are a concern for teachers and administrators alike. Rates that

are "too high" raise eyebrows at the state level where schools are judged, in part, by how effectively they graduate seniors. Graduation rates are also a major concern for parents who have already loaded film in the camera and invited long-lost aunts and uncles to the big graduation blowout. All in all, high failure rates please very few people.

My school called a meeting in mid-February (spring had passed and summer was underway) to address the topic. We were told stories of irate parents, quite annoyed and puzzled to learn that their child would be missing this year's graduation ceremonies. While it became clear that such situations were to be avoided where possible, any notion of "passing more students for passing's sake" was officially eschewed. No one asked to compromise the integrity of a high school diploma. Indeed, such a request would be foolish. Mere *requests* for higher graduation rates could easily be ignored by the majority of teachers. There was a more effective approach...*use the principles of economics.*

Costs and benefits

Let's look at this from the teacher's perspective. Ultimately, a failing grade comes from my pen or the grading program on my computer. While it's certainly true that the student is the one who earns the grade, I have the final say as to whether or not the work is worthy of a passing grade. My students do not record their final grade, *although such a policy would really cut back on failure rates,* I do. Economic theory tells me that I should "produce" failing grades up to the point where marginal benefit equals marginal cost.

Benefits to the teacher of failing a student are difficult to measure. I get no direct benefit from bubbling an "F" on the scantron. Students might easily imagine me waking up, dusting off my coffin, and merrily assigning failing grades. But, believe me, this portrayal is highly inaccurate -- I never dust anything. The core of a teacher's benefit to issuing a failing grade is the academic integrity. Teachers, we hope, assign a failing grade because the student has demonstrated that he/she needs a deeper understanding of the course material. Teachers derive benefit from knowing that they are not passing along an ill-equipped student to the next course, college, or into the job market.

What about costs? Teachers incur costs when they fail a student. These costs may include answering to angry parents, filling out necessary paperwork, and suffering guilt for possibly denying a student a timely graduation. *Personally that last one is a stretch.* Given costs and benefits, individual teachers arrive at some "optimal" number of failures. Naturally these rates need not be zero. And, teachers who view the "costs" of failing a student as minimal (or even zero) will have higher failure rates than teachers who find paperwork and dealing with parents costly. *I know you are picturing the graphs in your head.*

Changing the rules

Initially, my school attached almost no bureaucratic costs to failing a student. In February the rules changed. More accurately, the costs changed. A new policy required teachers to immediately call the parents of any senior in danger of failing. Answering machines were not considered sufficient notification -- students often get home first. Teachers were instructed to continue calling until they spoke directly with a parent. Fearing "Caller ID," some teachers returned to school in the evenings to make their calls or simply used a pay phone.

The policy also required teachers to keep official logs to document when the parent was contacted and what steps were being taken to remedy the problem. This new paperwork was to be collected about every three weeks.

What was the end result? Faced with higher costs and unchanged benefits, many teachers failed fewer students. It was just what an economist would predict. My only shock was to learn that some teachers were *surprised* when their colleagues began failing fewer students. I was tempted to keep a graph in my wallet to explain this result, but I didn't.

This was not some devious scheme cooked up by an administrator who remembered her economics. But, intentional or not, the end result was the same (in direction if not magnitude) as mandating higher passing rates. No teacher would walk into a room and announce *"I have great news folks. I have recalculated my optimum grading standards and, as a result of increased costs, fewer of you will fail."* Teachers know how to be more subtle. There are less obvious ways to lower failure rates including less rigorous tests, fewer homework assignments, and less stringent make-up policies for missed work. Any or all of these would effectively lower the failure rate to the new optimal level.

Student response

If this sounds bleak, hang on. There's more. Let's look at this from the student's point of view. A student's effort greatly impacts the grade he/she receives. There are undoubtedly benefits to receiving good grades, but the effort is costly. Rational students will exert effort only if the marginal benefit exceeds the marginal cost.

The "price" or cost of goofing off is a lower grade -- or at least some non-zero chance of receiving a lower grade. When teachers, seeking to reduce failures, produce less strenuous tests and more lenient make-up policies, they effectively lower the cost of goofing off. Students, even those in danger of failing, are savvy enough shoppers to "consume" more when the price goes down.

What a nightmare! Students may understand it is rational to cut back on effort, but it is difficult to determine exactly how much to cut back. For many, it is a process of trial and error. What if students "overshoot" and cut back too much? Teachers then will find they have even more students in danger of failing. This triggers more phone calls to parents and more paperwork and might result in even less strenuous tests, and even fewer homework assignments. These actions will lower the cost of goofing off even more and the whole process could begin again.

So now what? Should we throw up our hands and surrender? Is there a better solution? In general, you're asking for trouble when benefits and costs are not aligned. Since most of the benefit of passing grades goes to the student, why not place most of the costs in the students' laps as well. Instead of raising the costs of failure to teachers, why not raise the costs to students instead?

Forcing students to bear more of the costs of a failing grade effectively raises the price of goofing off. With a higher price less goofing off will be consumed. You just might find lower failure rates, not because teachers have higher administrative costs, but because students optimally choose to increase effort. Doesn't that sound a little nicer? You'd get a different answer depending upon who you asked.

Humbug Revisited

It is no secret that Christmas has become big business; that its sacred message is often swamped by a secular marketing barrage. What is less appreciated is that this commercialization extracts enormous economic costs as well. Not only does the frenzy of gift giving detract from the religious spirit of the day, it throws big bucks down the economic toilet.

Each Christmas, millions of Americans hit the malls looking for that perfect gift. We roam the aisles and thumb through catalogues. Occasionally we hit the jackpot and uncover that unique, special gift. But, it takes luck. It usually means we found something the other person did not know existed; a difficult chore since our friends and family usually roam the same aisles and thumb through the same catalogues as us. More often our search for something special fails. We buy something they "wouldn't buy for themselves," but only because they don't want it. *Bah, humbug.*

The result? Despite the stress, bother and additional hair loss, our gifts are often the wrong size, the wrong color, the wrong style, or the wrong flavor. Gifts so lovingly picked and graciously received end up being unused, abandoned, or relegated to attic shelves and basement boxes.

Deadweight losses

None of this should surprise an economist. Economists presume consumers have already allocated their income in an optimal way; they've already bought the items generating the most value or "utility" per dollar. Even if our gifts are extravagant and beyond the means of our recipients, consumer theory says the best we can hope for is to duplicate what they would have purchased themselves with the cash. Paying more for gifts than recipients think they're worth is inevitable.

That's the economic cost. If we spend $25 for a gift that recipients value only at $21, we've created a "deadweight" welfare loss of $4. We've tossed $4 of potential economic value into an irretrievable black hole. Using a sample of his Yale undergraduates, economist Joel Waldfogel estimates the deadweight loss of Christmas is between 10 and 35 percent of the value of the gifts purchased. Big bucks. Waldfogel's solution? Give cash. Cash eliminates the deadweight loss.

Did anyone notice? Those of you who keep back newsletter issues on your coffee table; go check page 10 of the Spring 1994 edition. It should look familiar. I just reprinted half the article. I figure if I have trouble remembering my telephone number, most of you won't remember a four-year old newsletter article.

Toutkoushian to the rescue

Was Waldfogel correct? Should we paste a *bah, humbug* over the whole idea and abandon non-cash gift-giving? According to Rob Toutkoushian ('84), not necessarily.

First, do you remember the old *"it's more blessed to give than to receive"* adage? The above analysis ignores any possible utility the giver might receive. Yet, givers clearly can procure pleasure from the process. Instances in which the value to the giver exceeds the deadweight loss to the recipient still create positive net benefits to the pair.

Sentimental value throws a second wrench into the mix. Waldfogel deliberately asked students to ignore any sentimental value of their gifts. What we if attach extra value to gifts *because* they are gifts? Sentiment itself does not invalidate the conclusions. A new sweater from my wife takes on added value because it's from my wife. Even if I don't like the sweater, I value it because it's from her. But, sentimental value accrues to sweaters I *do* like as well. Given the choice between a sentimental sweater I like and one I don't like, I'll choose the one I like every time.

Toutkoushian identifies a second, and more important, scenario. What if the amount of sentimental value depends upon the nature of the gift? What if part of the purpose of the gift-giving game is to prove how well we know the tastes and preferences of the recipient? What if gift-giving is a test?

Rob notes that spouses often have the most at stake. For example, suppose Annie, who drinks only tea, receives an assortment of coffees for a gift. If the gift is from her great uncle, twice-removed, she may simply laugh. If the gift is from her husband, all h*** might break loose. Husbands are supposed to know better. A loving husband would sense her desires. A loving husband would expend the necessary time and energy to find a more appropriate gift. The perfect gift affirms the closeness of the relationship; it pollinates the marriage with warm fuzzies. The sentimental value rises when the gift manifests the effort and understanding necessary to nurture relationships. Coffees -- and cash -- fall short of the mark.

Will cash gifts *really* reduce the deadweight loss of Christmas? Who wins? Waldfogel? Toutkoushian? Divorce lawyers?

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