Moralizing economic policy

One of the frustrating things about economics is the way policy debates often morph into morality plays. Whether the issue is fiscal policy or gasoline prices, Americans tend to think of them in terms of victims, villains and heroes. In contrast, economists think in terms of costs, benefits and incentives. The two approaches imply very different world views.

Consider the issue of government debt. Deficit spending has been used frequently during economic downturns, and it’s important in our slow recovery from the 2008-09 recession. Why? It’s simple arithmetic. Consumers are cutting back and spending less than their income. That’s fine on the household level, but for the economy as a whole, spending roughly equals income. Depressed national spending means depressed national income and higher unemployment, and that discourages spending.

But the arithmetic doesn’t matter, because Americans hate debt. Or at least they do now. They didn’t mind deficits during the 2001-02 expansion, when tax cuts and an expansion of Medicare created our long-term debt problem. Only when short-term deficits became a necessary response to the Great Recession did people decide they hated them.

Did you know the German word "schuld" means both "debt" and "guilt"? For Germans there’s a close link between the two concepts, and Americans seem to agree. But economists on the alleged guilt of incurring debt get us nowhere.

There’s a similar flavor to opposition to government bailouts. Numerous politicians have cited the Toxic Asset Relief Program as one of the outrages that drew them into politics. TARP included bailouts of financial institutions as well as General Motors and Chrysler.

Once again, the arithmetic says the bailouts were a great deal. TARP prevented financial ruin, and yet the nonpartisan Congressional Budget Office estimates that due to income from interest, dividends and stock sales, TARP will cost taxpayers only $25 billion. That’s far below the program’s original $700 billion price tag and the equivalent of just six months of emergency unemployment benefits.

Good deal or not, Americans hate bailouts and see them as a reward for bad behavior. To economists, the issue is less about the past than the future. Will bailouts give bad actors an incentive to act badly again? Ironically, economists call this moral hazard.

But private insurers deal with this all the time. They make us keep our vehicles in good repair and they give discounts for smoke detectors. In other words, insurers regulate our behavior to minimize the risk of moral hazard. This is precisely why federal deposit insurance regulates bank reserves, and why TARP had to be followed by financial reform.

Oddly, many politicians who hated the bailouts opposed reform. I guess the lack of sensible financial regulation doesn’t generate much moral outrage.

Other issues bring out the moralizers as well. When oil prices soared in 2008, the reason was simple supply and demand, fueled by growth in emerging economies around the world. But instead of blaming remote economic forces, many people believed that evil speculators were pumping up oil prices. The airlines even mounted an ad campaign to that effect.

The moralizing instinct is a strong one, because humans care about fairness and morality. But it can be a very bad way to make economic policy.

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