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RESEARCH REPORTS

AIER publishes over 100 articles per month that are distributed in digital form. Research Reports contains Business Conditions Monthly plus 12 of the most representative, chosen here for popularity, variety, and relevance. These articles are often reprinted in venues around the web, including *Seeking Alpha*, *Intellectual Takeout*, *Mises Brasil*, and dozens of other outlets. To read all of them, go to

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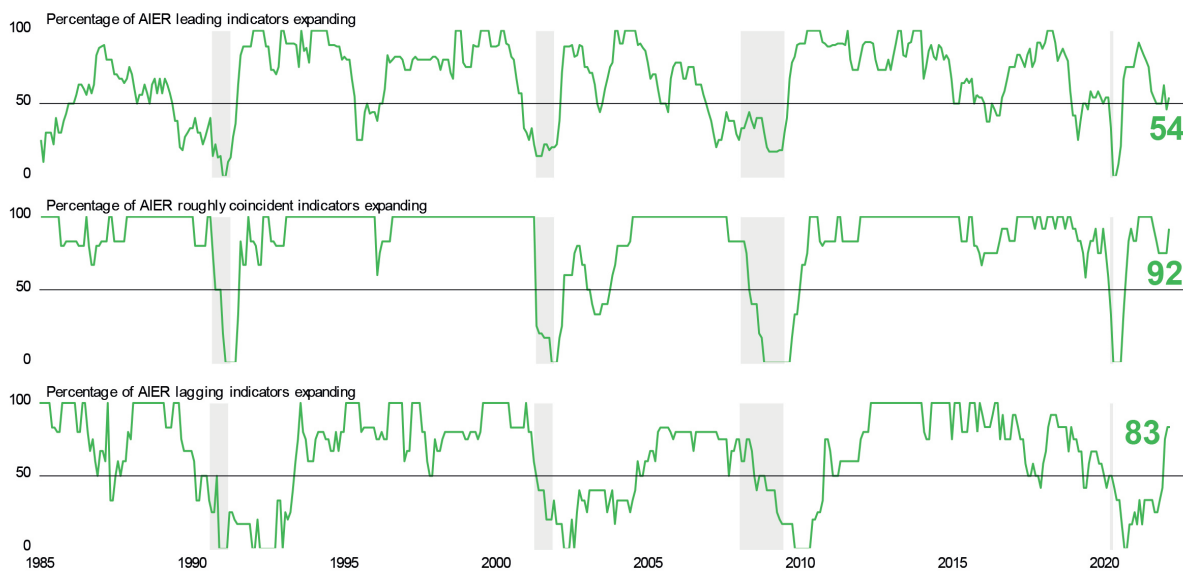
BUSINESS
CONDITIONS
MONTHLY

Robert Hughes

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AIER Leading Indicators Index Posts Sudden Drop, Risks Rise

Indicators at a glance



Note: Shaded areas denote recessions. A score above 50 indicates expansion.
Source: AIER.

Summary

As expected, volatility is creeping into the AIER business cycle indicators. AIER's Leading Indicators Index partially rebounded in March, posting an 8-point rise following a 17-point drop in February and a 13-point gain in January. The Leading Indicators Index is fluctuating around the neutral 50 threshold, hitting 54 in March after a 46 in February and a 63 in January. The average for the first quarter comes in at 54 versus a neutral 50 average for October through December (see chart).

Among the most significant forces driving the economy and at least partially responsible for the increased volatility include the persistent upward pressure on prices, the tight labor market, and fallout from the Russian invasion of Ukraine. Rapidly rising prices negatively impact consumer attitudes and consumer behavior including consumer spending. Rapid price increases have also provoked a new Fed tightening cycle, raising the risk of a policy mistake. Fallout from the Russian invasion of Ukraine has caused volatility in capital and commodity markets, especially energy markets, contributing to price pressures while also potentially further disrupting global supply chains. Offsetting these is the strong labor market which provides some support for consumer attitudes, incomes, and spending, though it also has the potential to ignite a wage-price spiral.

Increased volatility should be expected to continue in capital and commodity markets, the economy, and economic statistics over coming months. Expect continued volatility for the AIER business cycle indicators as well. Caution is warranted.

AIER Leading Indicators Index Partially Rebounds in March

The AIER Leading Indicators index rebounded in March, adding 8 points, partially offsetting the 17-point drop in February. The March level of 54 is back above the neutral 50 threshold following a 46 in February. February was the first reading below neutral since August 2020 in the wake of government lockdowns that sent the U.S. economy to the worst recession in history. Along with a 63 reading in January, the average for the first quarter was 54 following three consecutive months at the neutral 50 level for October through December.

Three leading indicators changed signal in March, with two showing improvement and one deteriorating: the average workweek in manufacturing moved from an unfavorable trend to a favorable trend while real retail sales improved from a negative trend to a neutral trend. The total heavy-truck unit sales indicator weakened in March, dropping from a neutral trend to a negative trend. Among the 12 leading indicators, five were in a positive trend in March while four were trending lower and three were trending flat or neutral.

The Roughly Coincident Indicators index improved in March, rising to 92 following four consecutive months at 75. Two indicators showed improvement in March with real manufacturing and trade sales improving to a positive trend and The Conference Board Consumer Confidence in the Present Situation indicator improving from a negative trend to a neutral trend. Overall, five indicators were trending higher: nonfarm payrolls, employment-to-population ratio, industrial production, the real manufacturing and trade sales, and real personal income excluding transfers, while one indicator, The Conference Board Consumer Confidence in the Present Situation indicator was in a neutral trend.

AIER's Lagging Indicators index was unchanged at 83 in March. January through March was the

first three-month run above neutral since the fourth quarter of 2019. No individual indicators changed trend for the month. In total, five indicators were in favorable trends, one indicator had an unfavorable trend, and none had a neutral trend.

Overall, labor shortages, rising costs and shortages of materials, and logistics and transportation bottlenecks are restraining production, and sustaining upward pressure on prices. Upward price pressures have resulted in substantial declines in consumer sentiment and may be impacting consumer behavior including consumer spending decisions. Furthermore, rapidly rising prices have also provoked a new cycle of Fed policy tightening, raising the risk of a policy mistake.

While cresting numbers of new Covid cases in late January and early February had the potential to support businesses' efforts to improve supply chains and expand production, geopolitical turmoil surrounding the Russian invasion of Ukraine has had a dramatic impact on capital and commodity markets, especially energy markets, adding to upward price pressures and launching a new wave of potential disruptions to supply chains and business activity.

The labor market remains the strongest support for the economy. Continued jobs growth, near record levels of open jobs, and rising wages help consumer attitudes and consumer spending, though they can also encourage a wage – price spiral. On balance, the outlook remains highly uncertain, and caution is warranted.

Private Payrolls Add 426,000 Jobs in March

U.S. nonfarm payrolls added 431,000 jobs in March, extending a run of 11 consecutive months and 14 of the last 15 months with gains above 400,000. The average monthly gain over the last 15 months is 562,000. Private payrolls posted a 426,000 gain in March, the 10th in a row and 13th in the last 15 months above 400,000. The average gain over the last 15 months is 530,000. Both total nonfarm

payrolls and private payrolls are less than 1 percent below their February 2020 peaks with total nonfarm down by 1.6 million and private payrolls down by less than 1 million.

Gains in recent months have been broad-based. Within the 426,000 gain in private payrolls, private services added 366,000 versus a 12-month average of 460,500 while goods-producing industries added 60,000 versus a 12-month average of 54,800. Within private service-producing industries, leisure and hospitality added 112,000 versus a 12-month average of 173,800 for the month, business and professional services added 102,000 (versus 91,300), education and health services increased by 53,000 (versus 50,100), retail employment rose by 49,000 (versus 45,600), and wholesale trade gained 7,000 (versus 12,800); transportation and warehousing lost 500 jobs (versus an average gain of 33,900).

Within the 60,000 gain in goods-producing industries, construction added 19,000, while durable-goods manufacturing increased by 22,000 and nondurable-goods manufacturing added 16,000 and mining and logging industries increased by 3,000.

Despite the strong, broad-based gains over the past year, only about half of the industry groups in the employment report are above their pre-pandemic levels. Transportation and warehousing is the largest gainer, with payrolls more than 10 percent above pre-pandemic levels. That may be a positive sign for some of the logistical problems plaguing U.S. businesses.

Average hourly earnings rose 0.4 percent in March, putting the 12-month gain at 5.6 percent. The average hourly earnings for production and nonsupervisory workers also rose 0.4 percent for the month and are up 6.7 percent from a year ago. The average hourly earnings data should be interpreted carefully, as the concentration of job losses and recovery for lower-paying jobs during the pandemic distorts the aggregate number.

The average workweek for all workers fell to 34.6 hours in March while the average workweek for production and nonsupervisory workers fell 0.1 hour to 34.1 hours. Combining payrolls with hourly earnings and hours worked, the index of aggregate weekly payrolls for all workers gained 0.5 percent in March and is up 10.80 percent from a year ago; the index for production and nonsupervisory workers also rose 0.5 percent but is 11.5 percent above the year ago level.

The total number of officially unemployed was 5.952 million in March. The unemployment rate came in at 3.6 percent while the underemployed rate, referred to as the U-6 rate, was 7.2 percent in March. In March 2020, the unemployment rate was 3.5 percent while the underemployment rate was 6.9 percent. For February 2020, the unemployment rate was 3.5 percent while the U-6 rate was 7.0 percent. The employment-to-population ratio, one of AIER's Roughly Coincident indicators, came in at 60.1 percent for March, still significantly below the 61.2 percent in February 2020.

It has taken two years, but the labor force is nearly back to the size in February 2020. However, with population growth over that time, the overall participation rate remains well below February 2020. The participation rate was 62.4 in March 2022 versus a participation rate of 63.4 percent in February 2020.

The March jobs report shows total nonfarm and private payrolls posted more strong gains. Both are close to matching pre-pandemic levels as is the civilian labor force. However, with population growth, labor force participation remains significantly below pre-pandemic rates. Getting people into the labor force and employed would likely help ease upward pressure on consumer prices.

Private-Sector Job Openings and Quits Remain Elevated

The latest Job Openings and Labor Turnover Survey from the Bureau of Labor Statistics shows the total number of job openings in the economy fell to 11.266 million in February, down from 11.283 million in January. The number of open positions in the private sector decreased to 10.185 million in February, down 50,000 from 10.235 million in January. Both remain at very high levels. The total job openings rate, openings divided by the sum of jobs plus openings, was unchanged at 7.0 percent in February while the private-sector job-openings rate held at 7.4 percent.

Two industry categories have more than 2.0 million openings each: education and health care (2.226 million) and professional and business services (2.088 million). Trade, transportation, and utilities (1.863 million), and Leisure and hospitality (1.705 million) are both above 1 million.

The highest openings rates were in leisure and hospitality (9.9 percent), professional and business services (8.7 percent), education and health care (8.5 percent), transportation, and utilities, trade (6.2 percent), and manufacturing (6.0 percent), and all are all above the pre-lockdown-recession private-sector peak of 5.1 percent. Among the private-sector industry groups, only construction (4.8 percent) is below 5.1 percent.

The number of private-sector quits rose, coming in at 4.106 million, up from 4.032 million in January. Trade, transportation, and utilities led with 1.061 million quits followed by leisure and hospitality with 863,000 quits, and professional and business services with 704,000. The total quits rate rose to 2.9 percent for the month, up from 2.8 percent in the prior month while the private-sector quits rate was unchanged at 3.2 percent.

The quits rates among the private-sector industry groups are still dominated by leisure and hospitality

with a rate of 5.6 percent, well ahead of the number two, trade transportation, and utilities, with a 3.7 percent rate, and number three, professional and business services, with a 3.2 percent quits rate. All the major groups within the private sector have a quits rate above the average over 2001 through 2019.

The number of job seekers (unemployed plus those not in the labor force but who want a job) per opening fell to 1.078 in February, a new record low. Prior to the lockdown recession, the low was 1.409 in October 2019.

The job openings data continue to suggest a very tight labor market. The tight labor market is leading to significant turnover among employees and contributing to the headwinds facing businesses as they try to boost production.

Consumer Sentiment Fell in March, Remains at Recessionary Level

The final March results from the University of Michigan Surveys of Consumers show overall consumer sentiment fell again, hitting the lowest level since August 2011. The composite consumer sentiment decreased to 59.4 in March, down from 62.8 in February, a drop of 5.4 percent. The index is now down 41.6 points from the February 2020 peak.

The current-economic-conditions index fell to 67.2 from 68.2 in February. That is a 1-point decrease for the month and leaves the index with a 47.6-point drop since February 2020. The second sub-index — that of consumer expectations, one of the AIER leading indicators — sank 5.1 points for the month, dropping to 54.3. The index is off 37.8 points since February 2020. All three indexes remain below the lows seen in four of the last six recessions.

According to the report, “Consumer Sentiment remained largely unchanged in late March at the same diminished level recorded at mid month. Inflation has been the primary cause of rising pessimism, with an expected year-ahead inflation

rate at 5.4%, the highest since November 1981. Inflation was mentioned throughout the survey, whether the questions referred to personal finances, prospects for the economy, or assessments of buying conditions.”

The one-year expectations has spiked above 3.5 percent several times since 2005 only to fall back. The five-year inflation expectations remained unchanged at 3.0 percent in March. That result remains well within the 25-year range of 2.2 percent to 3.5 percent.

The report states, “Confidence that economic policies will resolve the problem is essential. Unfortunately, half of all consumers unfavorably assessed current policies, more than three times the 16% who rated them favorably. Making the situation even more difficult, policy makers need to take account of two unusual sources of economic uncertainty, one rather minor (the new covid variant), and a major source of continued economic disruption (the Russian invasion of Ukraine).”

One positive note in the survey was continued favorable views of the labor market. According to the report, “The sole area of the economy about which consumers were still optimistic was the strong job market. Consumers anticipated in March that during the year ahead it was more likely that the unemployment rate would post further declines than increases (30% versus 24%).”

Consumer Confidence Improved Slightly as Expectations Plunged in March

The Consumer Confidence Index from The Conference Board rose slightly in March and remains at a moderately favorable level overall. The composite index increased 1.5 points or 1.4 percent to 107.2. From a year ago, the index is down 6.7 percent. The small change for the month hides much larger changes in the two major components.

The expectations component sank 4.2 points, taking it to 76.6 while the present-situation

component increased 10.0 points to 153.0. The expectations index is at its lowest level since February 2014 and only about 6 points above the 2001 recession lows.

Within the expectations index, all three components fell versus February. The outlook for the jobs market weakened in March as the expectations for more jobs index fell 2.0 points to 17.4 while the expectations for fewer jobs index fell by 1.9 points to 17.7, putting the net down 0.1 points to -0.3.

The index for expectations for higher income rose 0.2 points to 14.9 while the index for expectations for lower income rose 0.7 points, leaving the net (expected higher income - expected lower income) down 0.5 points to 1.2.

The index for expectations for better business conditions fell 2.6 points to 18.7 while the index for expected worse conditions rose 3.9 points, leaving the net (expected business conditions better - expected business conditions worse) down 6.5 points to -5.1.

For the present situation index components, current business conditions and employment conditions improved. The net reading for current business conditions (current business conditions good - current business conditions bad) was -2.5 in March, up from -7.5 but still a net negative. Current views for the labor market saw the jobs hard to get index decrease, falling 2.2 points to 9.8 as the jobs plentiful index rose 3.7 points to 57.2 resulting in a 5.9-point gain in the net to 47.4. A net above 40 is considered strong by historical comparison.

Inflation expectations rose to 7.9 percent in March, a record high; expectations were 4.4 percent in January 2020. Inflation expectations remain extremely high as prices for many goods and services continue to rise at an elevated pace. The extreme outlook for inflation is a key driver of weaker expectations among consumers.

Rising Prices Boost Retail Sales in February

Retail sales and food-services spending rose 0.3 percent in February following a 4.9 percent surge in January. However, these retail sales data are not adjusted for price changes. The AIER real retail sales indicator (adjusted using the total CPI) fell 0.1 percent in February following a 0.6 percent gain in January. The solid gain in January combined with a small decline in February resulted in a neutral trend in the AIER real retail sales. Nominal total retail sales are up 17.6 percent from a year ago while the AIER real retail sales indicator is up 9.0 percent from a year ago.

Core retail sales, which exclude motor vehicle dealers and gasoline retailers, fell 0.4 percent for the month, following a 5.2 percent jump in January. The decline leaves that measure with a 15.8 percent gain from a year ago.

Categories were mixed for the month with seven up and six down in February. The gains were led by a 5.3 percent rise in gasoline spending. However, the average price for a gallon of gasoline was \$3.68, up 5.0 percent from \$3.50 in January. Food services and drinking sales followed with a 2.5 percent increase while miscellaneous store sales rose 1.9 percent and sporting goods, hobby, and bookstore sales gained 1.7 percent.

Nonstore retailers led the decliners, down 3.7 percent, followed by health and personal care store sales, down 1.8 percent, and furniture and home furnishings store sales, off 1.0 percent.

CAPITAL MARKET PERFORMANCE

(Percent change)

	March	Latest 3M	Latest 12M	Calendar Year			Annualized		
				2021	2020	2019	3-year	5-year	10-year
Equity Markets									
S&P 1500	3.4	-5.0	13.0	26.7	15.8	28.3	16.5	13.5	12.3
S&P 500 - total return	3.7	-4.6	15.7	28.7	18.4	31.5	18.9	16.0	14.6
S&P 500 - price only	3.6	-5.0	14.0	26.9	16.3	28.9	16.9	13.9	12.4
S&P 400	1.2	-5.2	3.2	23.2	11.8	24.1	12.4	9.4	10.5
Russell 2000	1.1	-7.8	-6.8	13.7	18.4	23.7	10.4	8.4	9.6
Dow Jones Global Large-Cap Index	2.0	-5.7	5.6	16.2	14.7	23.8	11.9	9.8	7.9
Dow Jones Global Large-Cap ex-U.S. Index	-0.3	-5.8	-3.8	4.9	8.8	18.2	5.2	4.4	3.0
STOXX Europe 600 Index	0.6	-6.5	6.1	22.2	-4.0	23.2	6.3	3.6	5.6
Bond Markets									
iShares 20-plus Year Treasury Bond ETF	-5.6	-10.9	-2.5	-6.0	16.4	11.5	1.5	1.8	1.6
iShares AAA - A Corporate Bond Fund	-2.8	-7.5	-6.5	-4.2	7.1	9.1	-0.2	0.1	NA
Commodity Markets									
Gold	2.0	6.5	13.9	-4.0	24.8	18.7	14.4	9.3	1.6
Silver	1.9	7.5	3.4	-12.8	46.8	16.7	18.0	6.6	-2.6
Refinitiv CoreCommodities CRB total return index	9.7	27.1	59.8	38.5	-9.3	11.8	17.9	10.9	0.2

Sources: Barrons, Dow Jones, Frank Russell, iShares, Standard & Poor's, STOXX Europe 600, Refinitiv.

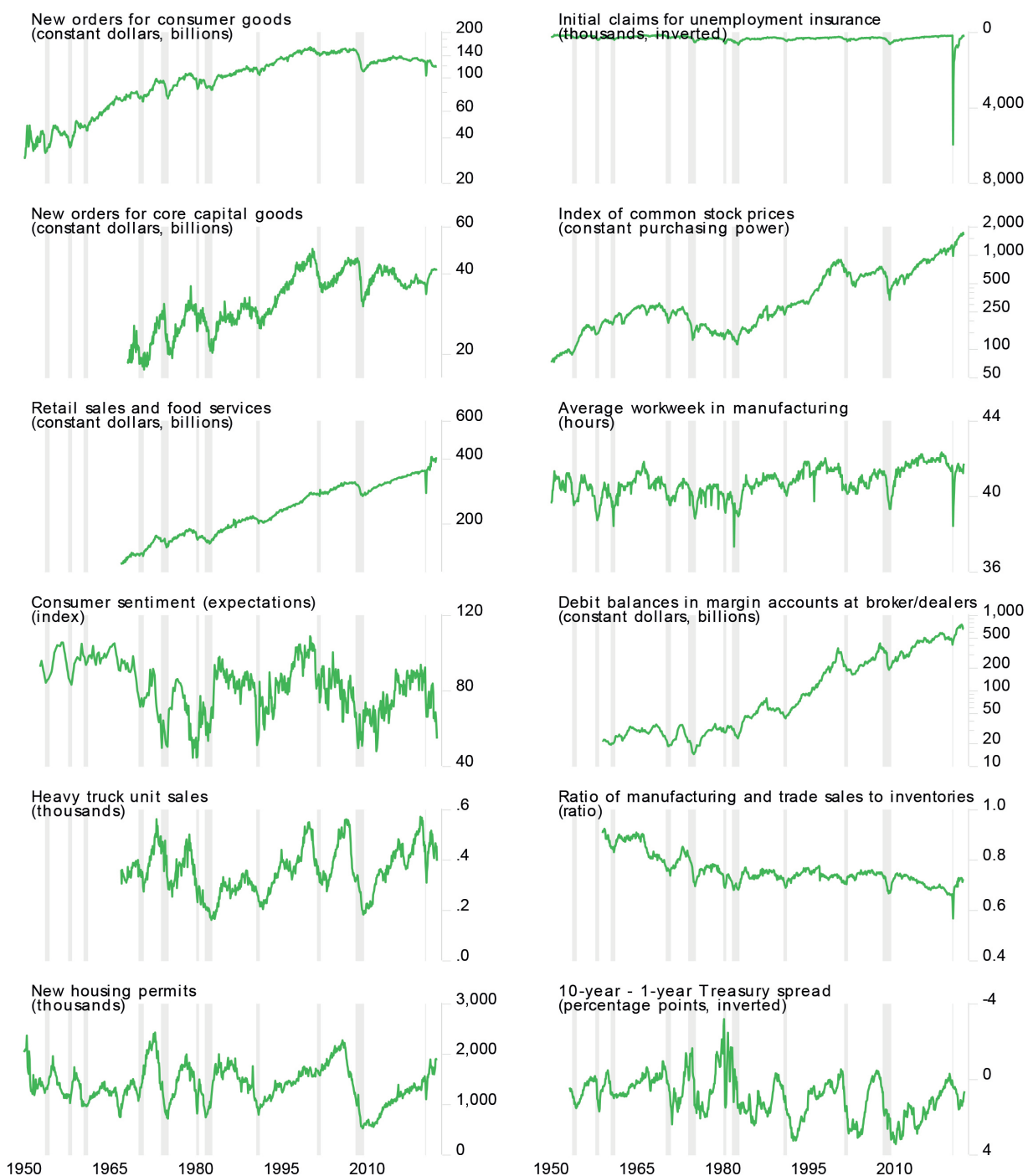
CONSUMER FINANCE RATES

(Percent)

	March	Latest 3M	Latest 12M	Average for Year			Average over Period		
				2021	2020	2019	3-year	5-year	10-year
30-yr. fixed mortgage	3.8	3.4	3.1	3.0	3.1	3.9	3.3	3.7	3.8
15-yr. fixed mortgage	3.0	2.7	2.4	2.3	2.6	3.4	2.7	3.1	3.1
5-yr. adjustable mortgage	2.9	2.6	2.6	2.6	3.1	3.6	3.0	3.2	3.1
48-month new car loan	4.6	4.6	5.1	5.1	5.1	5.4	5.2	5.0	4.7

Sources: Bankrate, Federal Reserve.

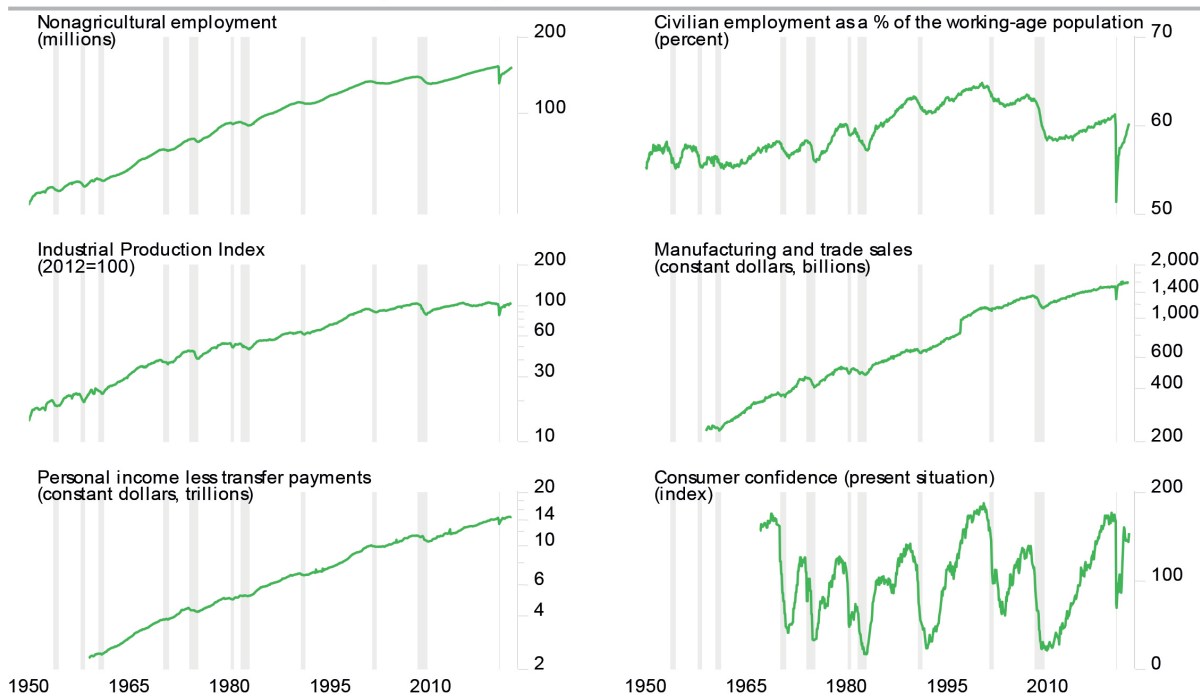
LEADING INDICATORS (1950-2022)



Note: Shaded areas denote recessions.

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, The conference Board, Census Bureau, Department of Labor, Federal Reserve, Institute for Supply Management, Standard & Poor's, AIER (Refinitiv).

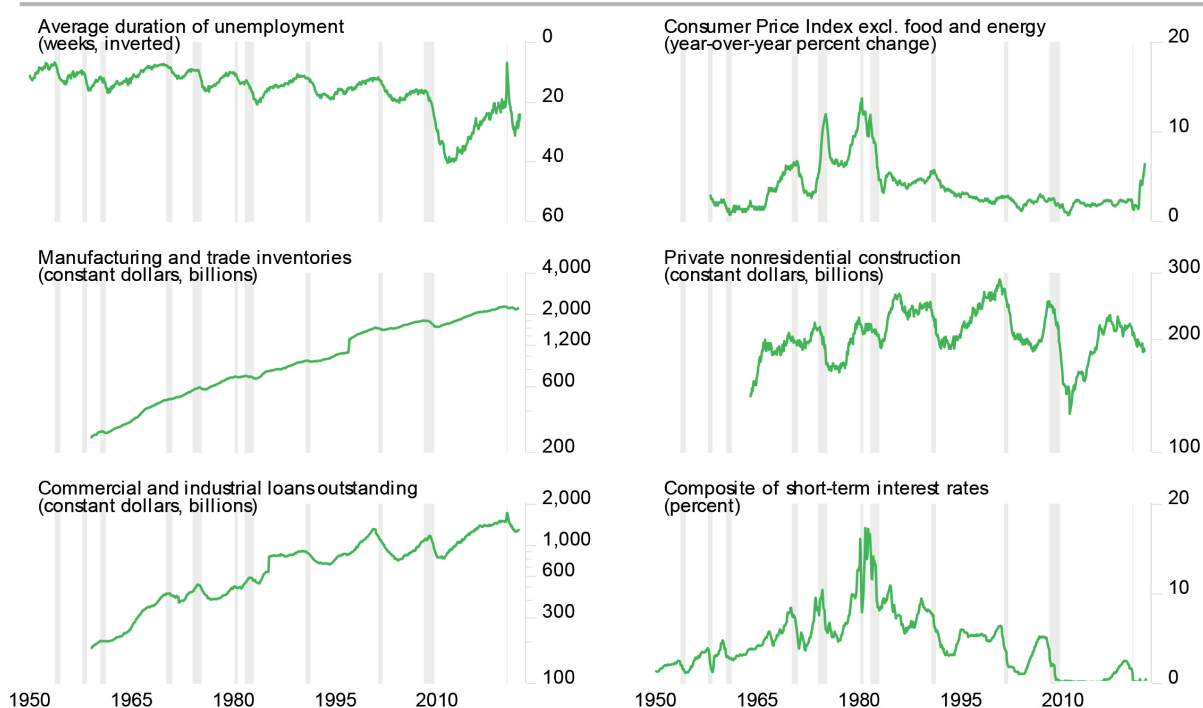
ROUGHLY COINCIDENT INDICATORS (1950-2022)



Note: Shaded areas denote recessions.

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, The conference Board, Census Bureau, Department of Labor, Federal Reserve, Institute for Supply Management, Standard & Poor's, AIER (Refinitiv).

LAGGING INDICATORS (1950-2022)



Note: Shaded areas denote recessions.

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, The conference Board, Census Bureau, Department of Labor, Federal Reserve, Institute for Supply Management, Standard & Poor's, AIER (Refinitiv).

Did Tipping Come from Slavery? The 1619 Project Lies Again

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Is the common act of tipping your waiter at a restaurant really a successor to slavery's harmful legacy? Does tipping your bartender or Uber driver mean you are perpetuating the structural racism of the 19th century? These are the implications of the latest claim by Nikole Hannah-Jones, creator of the *New York Times*'s 1619 Project.

In a characteristic tweet-thread, Hannah-Jones declares that “[t]ipping is a legacy of slavery and if it’s not optional then it shouldn’t be a tip but simply included in the bill. Have you ever stopped to think why we tip, like why tipping is a practice in the US and almost nowhere else?”

It’s not the first time that the 1619 Project has made bizarre claims that try to connect mundane aspects of everyday life to slavery. When investigating Hannah-Jones’s theory of tipping however, I soon discovered that claims linking the practice to slavery have recently become a trendy talking point of the economic far-left.

In 2020, a self-appointed “fact checker” for *USA Today* wrote an article rating the tipping/slavery connection as “true.” Other far-left organizations such as the Ford Foundation have promoted similar claims in recent years. Several of these works share a common source: they justify their narrative about slavery’s relationship to tipping by invoking the authority of Saru Jayaraman – an anti-tipping activist who leads a minimum wage hike advocacy organization. While Jayaraman’s position should not be dismissed out of hand, it is far from a dispassionate scholarly analysis of the practice and its history. A quick glance at her 2016 book *Forked* – allegedly the academic version of this thesis – suggests that it is embarrassingly light on evidence. The book

devotes fewer than 5 pages to the supposed slavery connection, very little of which relies on original sources or novel discoveries. It’s a flimsy book on which to stake such a bold thesis.

As we shall see, the tipping/slavery thesis has holes that emerge vis a vis the historical record. But first, let’s consider its basic claim. The anti-tipping movement’s story asserts that American restaurant owners turned to a tipping-based compensation model in the decades after the Civil War as a way to underpay African-American workers in the service industry. They connect this narrative to a modern-day call for raising the minimum wage, and expanding its scope to replace tips as the main income stream for service industry workers. Like much of the 1619 Project, this particular claim attempts to enlist the injustices of the past as an activist tool to enact progressive economic policies in the present, which they then rebrand as a necessary corrective to the horrors of slavery.

There’s a problem with this history, as well as the broader talking point about tipping that media “fact checkers” have taken to repeating and disseminating in recent years. They fundamentally distort the history of tipping, which long predates the American Civil War and the end of slavery.

Like many topics in early economic history, there’s no clear record of when the first tip was given to a worker in thanks for a service. The practice was, however, widespread by at least the late Middle Ages in Europe. Also known as a gratuity, the practice takes its more formal name from the medieval French term *gratuité* – meaning a small amount of money that’s freely or voluntarily given to a person. Gratuities were apparently very common in

that era – so common that they made their way into William Shakespeare’s plays. An example appears in *Twelfth Night*, first performed in 1602.

In the relevant scene, Shakespeare’s comedic knight Sir Andrew addresses a court jester, asking “I sent thee sixpence for thy leman; hadst it?” The performer responds “I did impetico thy gratillity,” after which Sir Andrew requests a song. A “gratillity” is an obsolete English variation on the word gratuity.

In *Tipping: An American Social History of Gratuities*, one of the most comprehensive historical surveys of the practice, author Kerry Segrave noted that the origins of tipping were vague, “but it may have begun in the late Middle Ages” and in “Tudor England (1485-1603), a shift had taken place in that visitors to private homes were expected to give sums of money (known as vails) at the end of a visit for service rendered by the host’s servants above and beyond the usual duties.”

With the passage of time, the act of giving a gratuity expanded beyond the nobleman’s court entertainers and into routine exchanges. Tips fulfilled a clear economic function. They allowed the purchaser of a service to convey satisfaction with the provider for the task being performed and contracted. An attentive waiter or bartender might expect a bonus in the form of a large tip, signifying customer satisfaction. Poor service, by contrast, might result in a low tip or no tip at all. Characteristically, the practice of tipping was not imposed by any central plan or committee. It likely evolved and spread over time, fulfilling an information problem around transactions. Simply put, it allowed a feedback loop between the service provider and the customer.

The practice of giving out gratuities was sufficiently widespread by the early 1700s that writers began to catalog the best practices of tipping etiquette. A representative example appears in the European travel writings of Edward Wright, first published in 1730. Describing a journey to Rome,

Wright recorded that the “usual Gratuity to the servant who shews a Palace is a Te-stone,” or the equivalent of about 18 English pence.

Another account by the English explorer William Dampier recorded the practice of extending a “small Gratuity to the Servant” from his visits to the Far East while circumnavigating the globe. Early 18th century laws recognized the practice’s use in transport as well, differentiating between a fee for a service to the “Master” of the coach line and “Money [that] be given to the Driver,” which qualified as a gratuity.

In time, tipping became a common practice for a multitude of duties – for meals in restaurants, for housekeeping in hotels, for cabin stewards on steamships, for stage-coach and carriage drivers, and as a way to convey satisfaction for musical entertainment. One English source from 1782 groused about the widespread adoption and even abuse of the practice, noting “those gratuities which were received some years ago as free gifts, and with a low bow, by clerks, waiters, drivers, servants in lodging houses, etc. are now imperiously demanded as a right.”

It’s unclear when tipping arrived in the United States, although newspaper accounts illustrate that it long predates the Civil War. What is certain, though, is that England had a well-established tipping culture in the 17th and 18th centuries. Segrave noted mentions of tipping as far back as 1668 from the diary of Samuel Pepys. It was a common enough practice by 1795 to garner frequent mention in newspapers. Short stories and novels increasingly conveyed that the practice was a routine part of life in England. Charles Dickens’ *Old Curiosity Shop* records its protagonist Nell Trent providing a “small gratuity” to a stagecoach driver for securing her a room at an inn. In another example, detective novelist Samuel Warren recounted a tale of a man who “incurred the enmity of this particular waiter in

consequence of having, out of his slender resources, given him too small a gratuity on the occasion of paying a former bill.”

The common use of tipping in Europe establishes a very different origin story for the practice than the slavery thesis would suggest. In all likelihood, the custom simply transited the Atlantic with the European settlement of the North American continent.

Some early 19th century European visitors to the United States noted that the practice was rare outside of the major cities, contrasting to its ubiquity in England. An 1822 travelog by John Howson noted that “[i]n America, travelers are not expected to bestow any gratuity upon the waiters of a tavern, except in the large towns.”

Other records from the period expressed disdain for the cultural association of tipping with aristocratic traditions from the Old World. In 1836 a British writer expressed hope upon hearing reports that the practice was as of yet rare in the United States, contending that “this absurd and degrading practice has been handed down to us by the aristocracy.” Debates of this sort over tipping would persist for decades thereafter.

Insofar as these debates attest to shifting American attitudes on tipping, a multitude of factors were likely at play. Early 19th century America was significantly more rural than Europe, and was at an earlier stage of economic development, where many businesses were sole proprietorships with services provided by their owners. We would accordingly expect to see tipping to first emerge in larger cities where a professional service industry was starting to take shape. And so it did in American locales such as New York and Philadelphia.

By the late 1830s, clear signs of an emerging tipping culture were apparent in the United States. An etiquette book by Eliza Leslie (the sister-in-law of economist Henry Charles Carey), published in Philadelphia in 1839, reveals that tipping had already

become customary in urban centers – even to the point of having elaborate practices and associated amounts that were specific to given tasks.

When staying overnight at the home of another, Leslie advised, “[g]ive a parting gratuity to each of the servants – the sum being according to your means, and to the length of your visit.” At public accommodations, ladies’ cloaks were to be deposited in the “charge of a responsible attendant; her care to be rewarded by a small gratuity.” Elsewhere in the book, Leslie advises on best practices for a variety of common services and scenarios at public businesses. Even the timing and mode of presentation had developed their own social customs: “When you give a gratuity to a servant – for instance, to the man who waits on you at table, or he that attends your room, or to the chambermaid or the errand-boy-give it at no regular time, but whenever you think proper, or find it convenient.”

Leslie further instructed that it is “right and customary to pay [doormen] extra for conveying your baggage up and down stairs when you are departing from the house or returning to it.” Persons in ill-health who required extra attendance were expected “to give a certain sum monthly to each of the servants who wait upon you.” Visitors to a Philadelphia hotel should similarly expect to tip for a variety of tasks with well-established rates and practices. For example, “[t]he errand-boy of the hotel carries parcels, and takes such messages as require an immediate answer. For a distance of any consequence, he will expect from twelve to twenty five cents. For little errands in the immediate neighbourhood, less will suffice.”

By the mid-19th century, a multitude of travel guidebooks and etiquette manuals appeared in print, advising on the customs and rates for tipping at different locales around the world (see Segrave, pp. 5-6). They offered advice not unlike that found in Leslie’s book, often tailored to specific cities or regions.

Some pieces such as the *USA Today* “fact check” hint at their awareness of this earlier history of tipping, only to handwave it aside for an alternative story in the United States that places the aftermath of slavery at the center of the story. They also contain clear inaccuracies, such as the contention that there was “no tipping in the United States prior to 1840” – a claim belied by the accounts documented here. The resulting story told by these sources is both oversimplified and willfully negligent of a broader historical context.

The post-slavery origin story of tipping is at odds with the evidence in other ways. Many 19th century commentaries on tipping clearly acknowledged its European origins, whether celebrating or lamenting its arrival in the United States. Mark Twain’s 1880 account of his journey through Europe, *A Tramp Abroad*, contained one such passage. “It seems to me that it would be a happy idea to import the European feeing system into America,” he wrote, referencing a particular type of tipping structure at European hotels that “keep a cashier on a trifling salary, and a portier *who pays the hotel a salary*.”

Twain recalled the case of “a portier of a great Berlin hotel paid five thousand dollars a year for his position, and yet cleared six thousand dollars for himself.” The example highlights an extreme extension of the economic practices around tipping, where the worker did not even have an income base beyond the gratuities he received. Yet Twain’s point remains: Through the incentives of tipping and the ability to raise an excess for the delivery of good service, the portier was able to vastly improve upon what he would have made on a simple untipped salary. Once again, Twain reiterates that some hotels in the United States had “borrowed the feeing fashion from Europe a dozen years ago” – a clear origin that had no connection to slavery.

It is indeed true that tipping, as with many aspects of routine economic exchange, suffered

under the distortions of racially discriminatory laws in the Jim Crow era. But those distortions do not explain the widespread adoption of tipping in other countries in the 19th century, or in Northern U.S. cities before the Civil War. They do not negate the clear European origin of the custom, or its gradual importation into the United States. Nor did they necessarily promote tipping at the expense of higher wages, as the account favored by Hannah-Jones, Jayaraman, and others contends. For example, the state of Mississippi passed a law around the turn of the century to prohibit tipping and gratuities across multiple service industry sectors. Similar laws were adopted in the former slave states of Tennessee, South Carolina, and Arkansas.

Supporters of the tipping/slavery thesis make little effort to explain this inconsistency, or the complications it creates for their historical narrative. Jayaraman, who apparently agrees with anti-tipping laws and advocates similar measures today, just glides right past the popularity of their precursors in the American South at the turn of the century. She does however tout an odd counterexample from Europe as it allegedly “continued to move in a no-tipping direction” around the same time. As Jayaraman (pp. 34-35) notes without even questioning the implications, “Italian dictator Mussolini banned tips being accepted from guests at hotels; the practice was seen as servile.” She then favorably contrasts this turn of events with the United States in the “same period and beyond.” The latter, she laments, “moved in the opposite direction, entrenching tipping and tips into custom and law.”

Taken as a whole, the incoherence of Jayaraman’s historical presentation is astounding. Tipping somehow emerged from slavery, even though turn-of-the-century anti-tipping laws appear to have clustered in the states of the old Confederacy. Meanwhile, her stated example of Europe’s anti-tipping turn comes from the fascist dictator Benito

Mussolini? It would appear that the tipping/slavery thesis is a case of badly mistaken history, which Jayaraman then haplessly shoehorns into present day ideological cause without even realizing the historical implications.

Even if we were to charitably interpret Jayaraman's thesis for calling attention to the role of tipping under Jim Crow era labor practices, it is not an origin story. At most, these accounts take a common and recurring practice that emerged externally to slavery, identify specific instances when racism was both pervasive and left its imprint on tipping and almost all other facets of life, and mistake those instances for a false genealogy of the practice. In this sense, the tipping/slavery thesis resembles similar erroneous claims from the 1619 Project. In one of the most notorious examples, 1619 Project contributor Matthew Desmond attempted to tie Microsoft Excel spreadsheets to slavery, simply because plantations – like almost any other form of production in that era, free or unfree – used accounting books.

The economic logic of tipping further suggests that if it was designed to subjugate workers of any race or ethnicity (including the Irish, Italians, and Germans who also faced labor discrimination), it was a bad mechanism to accomplish this goal. Individuals who engaged in repeated interactions with a tipped worker (e.g., bag porter, waiter) had a strong incentive to tip well to insure prompt service in the future. With other customers vying for quality service, there would naturally be upward pressure on tips, which served to benefit the laborer. An easier way to suppress the income level of any workers, irrespective of race or ethnicity, would be to mandate maximum wages and ban tipping (as in the example noted above).

Indeed, workers within the service industry today often make substantially more than the prevailing minimum wage when one includes tips

(both declared and undeclared) in the equation. The attempt to move away from a gratuities model of compensation and towards a standard “living wage” proved to be unpopular among the wait staff even prior to COVID (see also [here](#), [here](#), and [here](#)). The pain inflicted upon the restaurant industry during pandemic lockdowns furthered the return to tipping.

When one thinks about it, giving the customer the opportunity to reward a worker for personalized service can potentially undermine racist (and classist) attitudes. While there undoubtedly exist individuals who did (and do) not want to pay somebody highly for whatever reason (including race, ethnicity, beauty, or age), there will be individuals who do reward quality service irrespective of these characteristics. Better service will naturally fall to those who do tip well, and if those individuals who harbor ill will towards others want to receive similarly high levels of service, they will have to pay accordingly. (Readers are welcome to conduct their own experiment on this assertion at their favorite local tavern.)

These incentives stand in sharp contrast with the well-documented historical legacy of another economic practice: the very same minimum wage laws that the critics of tipping defend. Although minimum wages today are often depicted as a means of assisting the working class as a whole, their early 20th century antecedents were adopted with clear and explicitly racist motives.

Progressive era reformers – many of whom believed in racial eugenics and similarly discredited theories – recognized that minimum wage laws also came with unemployment effects at the bottom of the wage ladder. Labor union interests strategically exploited this outcome in the 1920s and 1930s, knowing that African-American workers would be the first group to face layoffs after the imposition of a minimum wage. White laborers benefited from the increased hourly rate that these statutes

mandated, but black laborers found themselves out of a job. It's no small irony that the racist origins of minimum wage laws go unmentioned in the narratives preferred by Hannah-Jones and the aforementioned "fact checkers," each of whom depicts the very same minimum wage system as an alleged corrective to the tipping economy.

It is not surprising that the typical rate of gratuities has increased over the years from roughly 10 percent in the 1950s to 20 percent today, benefiting those in the tipped service industry. Moreover, given that tipping represents a percentage of the overall bill, it tends to be a more inflation-resistant means of compensation compared to politically-determined minimum wage increases or the (potential) desire of employers to resist wage hikes.

These are important economic considerations, as they illustrate how the abandonment of a tipping economy could in fact harm the least well-off – both by undermining the beneficial signaling mechanism of the earned tip and through the potential disemployment effects of the proposed alternative of a minimum wage-only system. Now the critics of tipping have taken to augmenting their case with an error-riddled and distorted history of the practice – one that attempts to link it to slavery through a false narrative, all as it conveniently ignores the unambiguously racist history of their own competing minimum wage proposal.

At best, the critics of tipping are guilty of inexcusable sloppiness. At worst, they're selectively weaponizing the horrors of slavery to advance an ideological cause. The unsuspecting readers of legacy journalism and its self-appointed "fact checker" websites deserve better.

Note: the author thanks Tony Gill for his comments and suggestions on this article

– March 24, 2022

Understanding Unemployment

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Unemployment statistics are prepared by the Department of Labor for the US from surveys. The Census Bureau sends out the monthly household survey to 60,000 households, separating adults into those who are working for pay, and those who are not currently working for pay but are actively participating in the labor force. Most unemployed members of the labor force are actively looking for work. Small percentages are temporarily laid off, waiting for new jobs to start, or on strike due to a labor action. In each of these cases, the person has a job which is not currently providing income. These unemployed workers will presumably start or return to these jobs in the future. The labor force explicitly excludes certain categories, like anyone under 16, homemakers, retired people, or institutionalized adults. Institutionalized adults include students, patients in hospitals or other medical facilities including mental health facilities, retired people, disabled people, members of the armed forces, etc.

The unemployment rate is the ratio of the number of unemployed members of the labor force divided by the total labor force. It seems to hover around 5-6 percent, which we can consider the natural rate of unemployment, though it rises during and after a recession. Normally it takes about two years after the end of a recession for unemployment to recover fully.

Figure 1. U.S. unemployment, 2000-2022



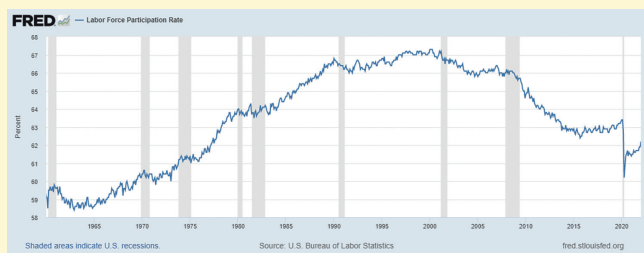
(Source: U.S. Bureau of Labor Statistics, Unemployment Rate [UNRATE], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/UNRATE>, February 6, 2022.)

In Figure 1 we can see that unemployment was around 4 percent prior to the mild 2001 recession, peaking above 6 percent in 2003, two years after the official end of the recession. The far more severe 2007-2009 Great Recession saw unemployment hit 10 percent, and stay above 6 percent until 2014. Unemployment was lower in 2019 before the COVID-19 recession than in 2000, but peaked at nearly 15 percent. Although unemployment fell very quickly below 6 percent, the COVID-19 recession has been very disruptive to U.S. labor markets.

The labor force participation rate is the ratio of the labor force divided by the total adult population. The labor force includes all employed and all unemployed people, but it does not include institutionalized adults or anyone who is not actively looking for work, unless they fall into one of the three special categories—waiting for a new job to start, temporarily laid off, or on strike. During a recession, especially one that drags on for more than about a year, the labor force participation rate tends to fall as unemployed workers become discouraged from

looking for work. As this happens, these workers are no longer counted as unemployed, because they're no longer counted in the labor force. This can make the unemployment rate start to fall, even though many people have still not found jobs. Looking at Figure 2, we can see about a two-year decline in labor force participation over some recessions but not for others. Falling labor force participation is most prominent for the 1961, 1970, 1990, 2001, 2007-2009, and 2020 recessions. Sometimes it starts to fall almost a year before the official start of the recession, and continues to fall until well after the recession officially ends. Another thing that is most pronounced in this figure is the growth in the labor force from roughly 1965-1995 as women increasingly entered the labor force over this period. Labor force participation rose from about 59 percent of the adult population to 67 percent during this period, mainly due to women joining the workforce. The 2001 recession seemed to reverse some of that progress, and the decline accelerated further after the 2007-2009 Great Recession, though it seemed to have stabilized at around 63 percent by 2015. The COVID-19 recession prevented many people from working, and it remains unclear whether labor force participation will recover, or how fast.

Figure 2. U.S. Labor Force Participation Rate 1960-2022



(Source: U.S. Bureau of Labor Statistics, Labor Force Participation Rate [CIVPART], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/CIVPART>, February 6, 2022.)

There are four different kinds of unemployment: structural, frictional, cyclical, and seasonal. Structural unemployment is associated with long-term, permanent changes in the economy, including technological progress that makes established industries obsolete. When textile firms in New England relocated to the South, that migration increased unemployment in New England, and lowered it in the South. When those same activities moved overseas to China or the Asian tigers, this increased unemployment in the Southeastern US, but lowered it in Malaysia, Indonesia, Vietnam, Guatemala, etc. Structural employment accompanies long-term structural changes in the economy, technology, and the structure of production.

Frictional employment is voluntary, and a certain amount is normal for a healthy economy and even beneficial. This occurs when workers quit one job to search for a new one. Workers are more likely to do this when their job prospects are favorable. The better the economy, the easier it is for workers to find a new job, so the higher frictional employment will be. Frictional employment tends to indicate that workers are in demand and that it will be easy for them to find new, higher-paying jobs. Structural and frictional unemployment add up to the natural rate of unemployment, which is thought to be about 5-6 percent for the U.S. This natural rate is generally higher in countries with more generous unemployment and welfare benefits, and less flexible labor markets.

Cyclical unemployment is associated with recessions. In a recession, aggregate demand collapses and the economy contracts. There is less demand for output, and firms respond by cutting back on production and laying off workers, so unemployment rises during recessions, as shown in Figure 1.

Seasonal unemployment affects some job categories more than others. During the Christmas season, retailers hire extra staff, as well as department store Santas. There is less demand for these seasonal

workers in July. Extra retail staff are also needed for firms that audit their inventory between Christmas and New Year's Day. Extra accountants are needed between February 1 and April 15. Similarly, construction workers are in greater demand during the spring, summer, and fall, than in the winter, when they generally cannot work outdoors. These seasonal spikes in labor demand go away after their busy season ends.

Unemployment is the most important measure of the business cycle's impact. The macroeconomic impact of a recession may be measured in trillions of dollars of lost GDP, but that is essentially an abstract and meaningless statistic. The real impact of recession is felt directly on the unemployed and their families, in lost income, lost opportunities, and a host of social problems, including impaired mental health, domestic violence, and substance abuse.

– March 12, 2022

How to Think about Inflation

ALEXANDER WILLIAM SALTER

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Everything old is new again: Inflation plagues the US economy. The Consumer Price Index is up 7.9 percent from a year ago. The Personal Consumptions Expenditures index is up 6.1 percent from a year ago. We haven't seen price pressures like these in 40 years.

If we want to understand inflation, we need a framework to organize our thoughts. Economies are fiendishly complex; without a model that helps us focus on the relevant details, we're lost in the woods.

Inflation means a general increase in prices. Equivalently, it means the dollar is losing purchasing power. Economists distinguish general price changes from relative price changes. The latter come from the forces of supply and demand operating in specific markets. The former are common to all markets.

We frequently use the concepts of *aggregate* demand and *aggregate* supply to analyze inflation. But despite the similarity in names, these concepts aren't the same as microeconomic supply and demand. Aggregate demand refers to total nominal spending in the economy. Aggregate supply means general productive conditions.

We measure inflation by tracking changes in a price index. There are many of these, each focusing on a subset of the economy, such as consumers' goods or producers' goods. Also, some price indexes that cover the same area are calculated differently. For example, the above-mentioned CPI and PCEPI are both snapshots of prices for consumers' goods. But what's under the hood is somewhat different.

Usually, inflation is caused by expanding aggregate demand. When aggregate demand (also called total spending or nominal gross domestic product) increases, prices for everything rise. They don't rise uniformly, of course. Inflation always has

some distributional effects. But these are typically small compared to the general phenomenon.

Expanding the money supply is the easiest way to boost aggregate demand. As we saw, the Fed printed tons of money when COVID-19 threatened the economy. Importantly, money demand rose, too. That blunts the inflationary effects of increasing the money supply.

Increased government spending doesn't usually cause inflation. There's a possible exception, however: If the government takes on so much new debt that the public expects money printing to bridge the fiscal gap, holders of dollars might want to unload them before they lose their value. Of course, when everyone thinks this way, the dollar depreciates! This hasn't been an issue for the United States in recent history, but the government took on an awful lot of debt to fight COVID-19. It could be the case now.

Action on the supply side can also cause inflation. When aggregate supply decreases (or grows more slowly than before), everything gets more expensive. The key here is productivity. If it gets harder to turn inputs into outputs, prices go up. This too contributes to inflation. We've heard a lot about the various logistics problems with global transportation, as well as a dearth of important producers' goods like semiconductors. Energy prices are markedly rising, due in no small part to the Russia-Ukraine conflict. All of these factors make production *in general* harder. In economics, harder means costlier. For a given amount of aggregate demand, diminished aggregate supply can only result in inflation.

Not all observed price hikes are inflationary. The price of cars, especially used cars, has risen faster

than prices in general. There's undoubtedly an inflationary aspect, because it's common to all markets. But there's also specific supply and demand changes in the car market that are causing higher-than-average price increases for cars. We distinguish between the *relative* price of cars increasing (microeconomics; supply and demand) and prices *in general*, including for cars, increasing (macroeconomics; aggregate supply and aggregate demand).

Just because we use different concepts to analyze relative and general price changes doesn't mean we can pinpoint how much of each is going on. Our price index measurements frequently pick up both. Economists have various statistical tools to sort out relative from general price changes. For us, what matters is the conceptual difference. Don't confuse what's common to all markets for what's particular to one market.

– March 13, 2022

FOMC Projects Higher Inflation

WILLIAM J. LUTHER (Director, Sound Money Project)

& MORGAN TIMMANN (Contributor)

At this week’s meeting of the Federal Open Market Committee (FOMC), monetary policymakers revised up their projections of inflation. The move was to be expected. Prices have grown much faster than the Fed had projected back in December. Ahead of the meeting, bond markets were pricing in around 3.3 percent inflation on average over the next five years.

FOMC member projections provide useful information for those interested in forecasting prices over the near term. The FOMC sets the course of monetary policy. And monetary policy is arguably the most important factor for forecasting prices. If the FOMC takes an accommodative stance, prices will continue to rise rapidly. If, instead, the FOMC tightens sharply, inflation will decline.

FOMC Projections

It is difficult to know how the FOMC will conduct monetary policy over the next few years, but FOMC member projections provide some indication. Members are asked to project inflation under the assumption that the Fed conducts monetary policy appropriately, as he or she sees it. Hence, the projections indicate how inflation will evolve if FOMC members do what they say they should do.

The median, central tendency, and range of FOMC member projections are presented in The Summary of Economic Projections and reproduced in Table 1 below. The central tendency of PCEPI projections is constructed by removing the three lowest and highest projections submitted for each period.

Median PCEPI Inflation Projection

Projection Date	2021	2022	2023	2024	Longer run
December 2021	5.5	2.6	2.3	2.1	2.0
March 2022		4.3	2.7	2.3	2.0

Central Tendency of PCEPI Inflation Projections

Projection Date	2021	2022	2023	2024	Longer run
December 2021	5.3–5.4	2.2–3.0	2.1–2.5	2.0–2.2	2.0
March 2022		4.1–4.7	2.3–3.0	2.1–2.4	2.0

Range of PCEPI Inflation Projections

Projection Date	2021	2022	2023	2024	Longer run
December 2021	5.3–5.5	2.0–3.2	2.0–2.5	2.0–2.2	2.0
March 2022		3.7–5.5	2.2–3.5	2.0–3.0	2.0

Table 1. Summary of Economic Projections on Inflation

The median FOMC member currently projects 4.3 percent inflation for 2022, up from 2.6 percent in December. Projections for the following two years have also increased. The median FOMC member now thinks inflation should be 2.7 percent in 2023, up from 2.3 percent in December, and 2.3 percent in 2024, up from 2.1 percent. The lower and upper bounds of the projections also tend to be higher, though at least one member still believes inflation should be back down to 2 percent by 2024. On the other hand, the highest projection for 2024 increased from 2.2 to 3.0 percent.

Forecasting Prices

Higher projected inflation rates over the next three

years suggest prices will be much higher than implied by Fed officials back in December. We forecast prices from FOMC member projections under the assumptions that (1) FOMC members set monetary policy consistent with their projections, (2) inflation is constant from month to month across each year, and (3) there are no unforeseen shocks to the economy over the forecast period. Forecasts from projections made in December 2021 and March 2022 are presented alongside the actual time series from January 2020 to January 2022 in Figure 1.

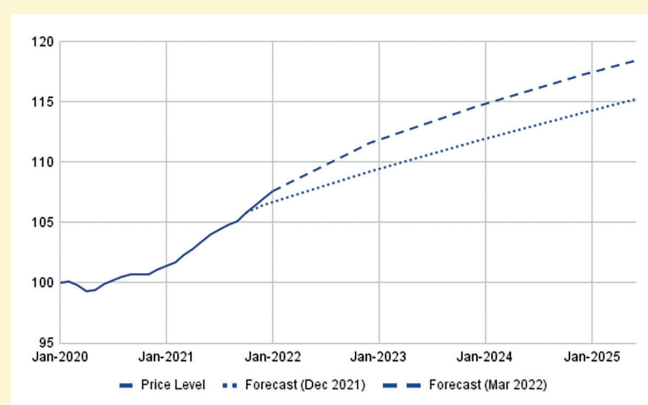


Figure 1. Forecast of Price Level from FOMC Member Projections

Our forecast of the price level based on median FOMC member projections indicates that prices will be roughly 11.8 percent higher in January 2023 than they were in January 2020, just prior to the pandemic. That amounts to a continuously compounding annual rate of inflation of 3.7 percent since January 2020. In December, the median FOMC member projected prices would be just 9.4 percent higher in January 2023—or, that prices will have grown at a continuously compounding annual rate of 3.0 percent since January 2020.

The median FOMC member now projects inflation will be 14.8 percent higher in January 2024 than it had been in January 2020—up from 11.9 percent projected in December. By January 2025, prices

are projected to be 17.4 percent higher instead of 14.3 percent higher, as previously projected. Based on current projections, one can expect inflation to average 3.2 percent from January 2020 to January 2025—50 basis points more than FOMC members projected in December and 120 basis points above the Fed’s average inflation target of 2 percent.

Last summer, one might have thought there was a chance that the Fed would adhere to its Statement on Longer-Run Goals and Monetary Policy Strategy and deliver 2 percent inflation on average. We don’t see how anyone could possibly believe that today. FOMC members are very clearly projecting that they will take no action to offset the high inflation observed over the last year; that inflation will likely remain above target through 2024; and that the price level will remain above its pre-pandemic trajectory forever.

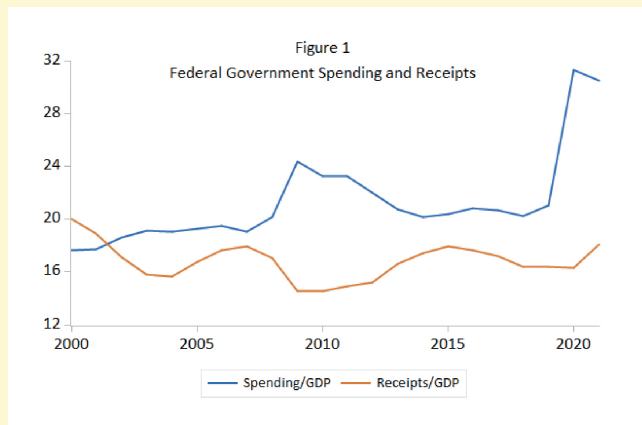
Fed Chair Jerome Powell’s November statement killed the idea that inflation would be transitory. The most recent projections from the FOMC show how deeply that idea has been buried.

– March 18, 2022

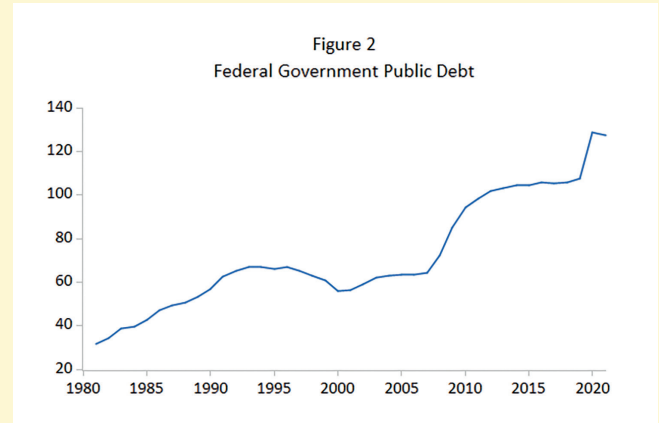
Government Debt and Inflation: Reality Intrudes

GERALD P. DWYER

The last couple of years have witnessed extraordinary spending by the federal government. It has been quite the party. Figure 1 shows government spending since 2000.



The increase to 30 percent of Gross Domestic Product (GDP) in 2020 stands out. Government revenue, also shown in Figure 1, does not jump. Federal government revenue in 2020 and 2021 is not particularly higher or lower than earlier years. The increase in spending was financed by dramatic increases in debt. Public debt issued by the federal government increased from 107.4 percent of GDP at the end of fiscal year 2019 to 127.6 percent two years later. As Figure 2 shows, the increase and the level are quite extraordinary.



Interest rates have been relatively low recently, which makes this level of debt not as onerous as it could be. In fiscal year 2021, the average interest rate on public debt was 1.8 percent per year. The low level of interest rates in the economy has made it possible for the federal government to borrow at historically low rates and to have relatively modest interest payments.

There is every reason to expect these low rates to disappear in the next year or two. In 1981, after the Great Inflation, the federal government paid an average interest rate over 13 percent in 1981 and 1982.

Inflation in the United States today is running over 7 percent per year; the low level of current rates will not persist. Whether the level of rates gets to 13 percent depends in part on the Federal Reserve. The Federal Reserve increased short-term interest rates at its meeting on March 15. Given the level of inflation of over 7 percent per year, there is little doubt that the Fed's target interest rate and the interest rates paid by the Treasury will be rising quite a bit over the next year or even two if inflation is to be subdued.

The implications of higher interest rates for the federal government's budget are not appealing. Even

at the low average interest rate of 1.8 percent per year, interest payments were 12.7 percent of federal government revenue in fiscal year 2021.

What will happen when average interest rates on public debt increase? Holders of public debt today at 1.8 percent are losing on average more than 5 percent of the purchasing power of their funds in a year. An average interest rate of 5 percent on public debt suggests interest payments equal to 35 percent of current federal government revenue. This interest rate is hardly an attractive proposition though. At an interest rate of 5 percentage points, anyone holding public debt at current inflation rates still would be losing 2 percent a year in purchasing power. An average interest rate of 7 percent, high relative to recent interest rates but not high relative to recent inflation rates, would require 50 percent of the government's revenue.

The Federal Reserve is currently committed to a slow increase in interest rates. A slow pace carries its own risks for controlling inflation. It does imply, though, that these extraordinary levels of interest payments compared to federal government revenue will not be reached in the near term. Just later rather than sooner.

There is a dilemma here though. Raising interest rates slowly given the current high inflation will let inflation get worse. Raising interest rates quickly has the potential to make the federal government's budget deficit dramatically worse.

Sooner or later, absent substantially lowering government spending or raising taxes, interest payments will overwhelm the government's budget. The situation might even be termed a sovereign debt crisis because all the spending, revenue, deficit and inflation choices are unpalatable.

One plausible resolution of the dilemma is to increase inflation even more than people expect. This would inflate away the extraordinary debt issued in the last couple of years. In a way, it resolves the

dilemma, just not in a very desirable way from the viewpoint of holders of depreciating US dollars.

– March 22, 2022

Stages of Quantitative Tightening

THOMAS L. HOGAN

Senior Research Faculty

In light of recent high inflation, the Federal Reserve has accelerated plans to tighten its monetary policy. Many in the press are reporting that in addition to raising its short-term interest rate targets, the Fed is about to end its expansionary program of quantitative easing (QE) in favor of a contractionary action of quantitative tightening (QT).

Some articles describe QT as the Fed actively “selling off its bond holdings” or state that QT will begin “on the heels of the central bank’s first interest rate increases,” presumably at its next meeting in March. However, QT is likely to occur in four phases, only the last of which involves actively selling bonds, and which may not begin for a year or more.

1. The end of QE

The Fed has been conducting QE asset purchases since March of 2020. It is currently buying \$20 billion per month in US Treasury bonds and \$10 billion per month in mortgage-backed securities (MBSs). Before it can enact a policy of QT, the Fed will need to end its QE balance sheet expansion.

For almost a year, the Fed has been discussing the possibility of slowing the pace of its monthly asset purchases. It only recently started doing so in November of 2021. This tapering was expected to continue until the summer of 2022, but that plan was accelerated when recent inflation turned out higher than the Federal Open Market Committee (FOMC) expected.

The minutes from the most recent meeting of the FOMC show that they discussed ending the asset purchase program after the previous meeting. However, the members ultimately decided to maintain their plan to continue QE until their next meeting, scheduled for March 15th to 16th.

2. Stable balance sheet

Once QE ends, the process of QT may not begin immediately. Instead, the Fed is likely to maintain a constant level of total assets for some time.

During this period, any proceeds from maturing bonds will be reinvested in bonds of the same duration in order to keep the dollar amount and maturity distribution of bond holdings roughly constant, although Fed officials have indicated they may adjust the composition of asset type by investing the proceeds of maturing MBSs into Treasury bonds.

3. Passive tightening

After a period of maintaining a stable size, the Fed is likely to begin passively shrinking its balance sheet by allowing some of the bonds it owns to mature without replacing them. The cash it receives as proceeds from these bonds will cancel out some of the cash reserves that the Fed owes to commercial banks, reducing the assets and liabilities sides of its balance sheet by equal amounts.

The Fed previously conducted passive tightening prior to the COVID-19 pandemic. Its total assets were relatively stable from 2015 until early 2018 and then declined through 2019 as the Fed allowed some assets to expire. Over that time, the balance sheet shrank from \$4.5 trillion to about \$3.76 trillion, a reduction of 16.7 percent from its peak size. More than half of that reduction occurred in 2018 alone, and this time around, Fed officials expect an even faster pace.

Passive tightening appears to be the main tool by which the Fed plans to conduct QT. Following the January meeting, the FOMC released a new statement, “Principles for Reducing the Size of the

Federal Reserve's Balance Sheet," declaring that the committee "intends to reduce the Federal Reserve's securities holdings over time in a predictable manner *primarily by adjusting the amounts reinvested of principal payments received from securities*" (emphasis added).

That said, the schedule for beginning QT has not been defined, and it may be many months before such a program begins. According to the FOMC's most recent meeting minutes, "a number of participants commented that conditions would likely warrant beginning to reduce the size of the balance sheet *sometime later this year.*" (emphasis added)

4. Active tightening

Eventually, the Fed may begin the process of active tightening by selling assets from its balance sheet. This approach would shrink the balance sheet more quickly than passive QT.

Even without active QT, however, the pace of balance sheet reduction with passive QT is likely to be faster than it was in 2018-2019. The average maturity of the Fed's asset holdings is shorter than prior to the pandemic, so passive tightening could be used to shrink the balance sheet more quickly than before, potentially making active tightening unnecessary.

Active tightening has never been conducted on a large scale to reduce the size of the Fed's balance sheet. It was not used to reverse the Fed's balance sheet expansions from 2008 to 2014. Given the FOMC's comments discussed above, it seems that if active QT is to be used at all, it may not occur until the end of 2022 or later.

There are several steps to go before the Fed starts selling assets to reduce the size of its balance sheet. That type of active tightening will probably not begin for a while.

– March 9, 2022

A Tale of Two Squeezes

PETER C. EARLE

Research Faculty

The biggest short squeeze I ever saw up front took place around Thanksgiving 1999. Interesting (and bad) things often occur at such times in financial markets: the senior (read: experienced) traders are off the trading desks, liquidity dries up, and ripples become tsunamis.

Before this introduction gets out of hand, a short squeeze is

an unusual condition that triggers rapidly rising prices in a stock or other tradable security. For a short squeeze to occur, the security must have an unusual degree of short sellers holding positions in it. The short squeeze begins when the price jumps higher unexpectedly. The condition plays out as a significant measure of the short sellers coincidentally decid[ing] to cut losses and exit their positions.

Although it's a somewhat obscure topic outside of financial markets, the concept has become more widely known in public discourse since, early in 2021, a handful of ho-hum, low volume (and hence low liquidity) stocks were investigated by a number of Reddit communities, most notably wallstreet-bets. When the groups determined that the stocks (including GameStop and AMC) had disproportionately massive short positions, they organized and began buying. In the panicked rush to escape rapidly losing positions, the short sellers had to buy frenetically, pushing prices even higher. And thus it was that GameStop ran from less than \$20 per share to almost \$350 per share in ten days.

GameStop stock price (2020 – present)



(Source: Bloomberg Finance, LP)

At the time, I attributed the behavior on both the institutional and retail sides to profoundly skewed risk appetites owing to a torrent of fiscal and monetary programs throughout the pandemic.

Ariel, 1999

So back to my story: The company was Ariel Corporation. This was during the dot-com era, so many were the attempts by firms to link themselves to the internet frenzy, whether or not that association was legitimate. In August of 1999 Ariel had traded as low as \$1.50 per share at negligible volume. The company announced that, despite reliably losing money for years, it had been approved by certain government entities to produce modem cards for internet access providers. And so on a week where experienced traders were at home, preoccupied with turkey, stuffing, and cranberry sauce, the stock began rising. It inched up to \$5 per share, spiked over \$6, then fell back to between \$4 and \$5 per share. And then, it began to climb.

First, to \$7, which excited a lot of younger and less experienced traders back on their desks.

Envisioning a fall back to \$4, they sold the stock short. At \$5 and \$6, they sold more stock short. At the price crossed \$7 per share, still more was sold short.

On November 23, 1999, the day before Thanksgiving, the stock spiked from just over \$7 to nearly \$11 per share. At this point the stock appeared on the radar of opportunistic retail traders, hedge funds, and proprietary trading shops. All began jumping in, and the short position grew. In all, how many shares were shorted? Tens of thousands, hundreds of thousands, millions of shares? All waiting for Ariel Corp stock to go back to its rightful place, in their eyes: back down to \$2 per share or lower.

Then came Thanksgiving. And for the record, Ariel did eventually trade below \$2 per share, on July 28, 2000. But first came Friday, November 26, 1999.

I was not short (fortunately), nor was I long (probably also fortunately). But from the trading desk that day, amid the thin liquidity that characterizes days like the forlorn, ritually understaffed, post-Thanksgiving Friday, I watched nearly every tick as Ariel Corp rose to \$15 per share. And then to \$20. Then, accelerating, to \$25, \$30, \$35, and above in an incredible, mounting hysteria. At one point I'm sure I saw a print at over \$50 per share, but who knows? Officially, which is to say in terms of the data that we have today, on that day a stock which had for years traded less than 100,000 shares per day—sometimes much less—traded over 50 million shares, rising to \$37 per share.

Ariel Corporation stock price (1999)



(Source: Bloomberg Finance, LP)

The message boards erupted shortly after 4pm that Friday. Rumors flew: that untold numbers of retail day traders were ruined; that a brokerage firm or two were in trouble; that this trader at that firm was “actually” long thousands of shares at \$7 or \$10 and rode them up, selling right at the top. Some scuttlebutt, of course, is more credible than others. What wasn’t speculative, however, is that the average size of an order in Ariel that day was 379 shares. As short sellers’ losses mounted, they sprinted into the market to purchase stock back at successively higher prices, drawing in other losing short sellers. And the stock of Ariel Corporation, a company which hadn’t made a profit since it began trading publicly in 1995, vaulted 410 percent in two sessions. It was delisted in 2010.

Nickel, 2022

The world some 8,123 days later was in many ways unrecognizable from that which prevailed in late November of 1999. Yet it was about to diverge even further from the past. Russian infantry, armor, artillery, and rocket units which had massed on Ukraine’s eastern border for months finally swarmed across the border, brutally seizing urban areas on their way west to capture Kyiv.

Russia has a relatively small economy, but it deals pivotally in a number of commodities which are

absolutely critical to modern life. Oil, natural gas, and grains are among them. Nickel is also among them, although it rarely gets as much attention as platinum, palladium, copper, aluminum, gold, and most others. About 20 percent of the world's nickel comes from Russia, and is used in making stainless steel, alloys, plating, and other uses (including batteries for electric cars). When Western nations around the world unleashed a deluge of financial sanctions against the Kremlin in response to the brutal attack on Ukraine, markets seized up. Individuals requiring a regular supply of physical commodities including oil, natural gas, grains, and nickel (among others), rushed into futures markets, buying to lock in prices for future delivery.

As early as February 22nd, nickel futures had risen to \$25,000 per ton, the highest price since 2011. On March 1, 2022, the EU announced that it would ban a number of Russian banks from accessing the SWIFT international payments by March 12th, other than for energy transactions. In anticipation of scarcity owing to both being blocked from SWIFT and concerns regarding the security of shipping on the Black Sea, futures contracts burst upward.

Over the rest of the week, the 3-month nickel contract (in metric tons) on the London Metal Exchange (LME) surged 19 percent. And on Monday, March 7, 2022 the price soared 82 percent to the highest price ever in its nearly four-decade trading history: \$52,700 per metric ton.

And then, not circumstantially unlike a quiet November Friday nearly 23 years earlier, the nickel market exploded upward. From the \$48,000 per ton opening price on March 8th over the next 18 minutes the metal futures contracts sawtoothed violently up to over \$100,000 per ton. It was an estimated 40 standard deviation move in price, which brought the 24-hour price change to roughly 250 percent. It also led the London Metal Exchange to close the market and break some 5,000 trades which had already been executed.

London Metal Exchange Nickel 3-month contract
(2017 – present)



(Source: Bloomberg Finance, LP)

In futures contracts, for each long position there is a short position. And so trading in futures contracts (and in options), unlike in stocks and other securities, is in fact a zero-sum game on a contract-by-contract basis: A profitable move up in a contract is a loss for the short seller on the other side. As was soon discovered, the March 8th chaos was in part a short squeeze triggered by a Chinese tycoon named Xiang Guangda, and sometimes dubbed “Big Shot.” Xiang is the owner of the world's largest producer of stainless steel and refined nickel, Tsingshan Holding Group.

Like so many other commodities, nickel production was leveled as global lockdowns and stay-at-home orders were put in place in the first quarter of 2020. As I described in the context of criminal syndicates organizing international catalytic converter-harvesting operations,

[a] large part of palladium's scarcity derives from the fact that it is not, or at least very rarely, mined directly: the metal is typically found as a side product of nickel mining ... In the spring of 2020, with Covid making its initial global march, many nickel and platinum mines closed entirely or reduced their labor force to skeleton crews. South Africa, which accounts for 36 percent of the world's annual

palladium sourcing and 78 percent of the world's platinum, shut down mines on March 27th, 2020 for six weeks.

Did Covid mitigation policies, to some extent or another, precipitate the nickel tumult? Yes, but peripherally, according to Jack Farchy, Alfred Cang, and Mark Burton.

The seeds of the epic short squeeze were sown last year, when nickel, like all commodities, was rallying from its Covid-era low. Xiang didn't believe the rally would last. He started increasing his short position on the London Metal Exchange ... Why bet against nickel when you have a nickel business? Xiang wanted to increase Tsingshan's production dramatically by producing so-called nickel matte for electric vehicle batteries. The company had plans to produce 850,000 tons of nickel in 2022, an increase of 40 percent in a year, according to a person briefed on them ... Everything changed when Russia invaded Ukraine.

When the LME nickel contract crossed \$50,000 per metric ton on March 7th, several firms and funds received margin calls approaching \$1 billion. Tsingshan's margin calls were estimated to amount to nearly \$3 billion. In the short 18 minutes that it took the nickel contract's price to double on March 8th—some of which, propelled by Tsingshan's traders desperately attempting to buy their short positions back at higher prices—the paper loss is thought to have exceeded \$8 billion.

Xiang Guangda – “Big Shot” – and his Tsingshan Holding Group were negotiating a bailout throughout the 10th and 11th of March. Those discussions hit snags when the impaired nickel trader indicated his intention to pay the margin calls with rescue loans,

but not liquidate his short position. Yesterday, on March 14th, several news sources indicated that a deal had been reached, and that there were more wrinkles to this story than a cheap suit with prunes stuffed into every pocket.

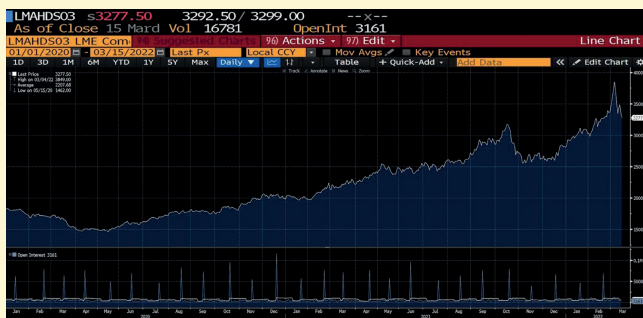
JP Morgan...[has] reached a deal to bail out the Chinese tycoon which is also its biggest nickel short counterparty. While by now most are probably tired of the neverending nickel saga on the LME, which has been exposed as a joke of a market catering to whale Chinese clients to avoid angering its Hong Kong (read China) owners...Tsingshan has reached an agreement with a consortium of...bank creditors on a standstill agreement.

The LME nickel contract, suspended since March 11th, will resume trading at 8am Wednesday morning in London, 3am EDT. In the interim the exchange has introduced a new daily trading limit: +/- 5 percent limit from the previous day's closing price. While that essentially prevents the events of the first two weeks of March 2022 from ever occurring again, many of the regular metal traders are disgusted, deriding the LME as the Soviet Metal Exchange.

In a series of posts on Twitter, Clifford Asness, founder of [the \$140 billion dollar fund AQR], described the LME as “slimeballs.” This was, he said, the first time he had been told “you don't get your legitimate profits because, gee, someone else, a broker who didn't manage things so well, might suffer.” “I'm accusing you [the LME] of reversing trades to save your favored cronies and robbing your non-crony customers,” he went on. The LME denied that parent company Hong Kong Exchanges and Clearing had influenced its decision.

As mentioned, when nickel resumes trading (six or seven hours from when this is being written) trading limits will keep prices from plummeting or skyrocketing as they might have otherwise. Meanwhile, prices of a handful of other critical metals—aluminum, notably—began moving more pronouncedly last week. Whether that was due to shifting financial circumstances behind broad-based commodity trading firms as nickel spun out of control, concerns about the Russo-Ukraine War, or both is unknowable.

**London Metal Exchange Aluminum 3-month contract
(2020 – present)**



(Source: Bloomberg Finance, LP)

The Ariel squeeze came and went of its own accord in market-based exchange. Artificial fetters on the nickel market may arrest volatility for the time being, but will mute the clamant information conveyed in wartime price signals. Would, rather than closing the market, the LME's allowing the nickel per ton price to have shot to \$150,000 have induced a groundswell of new nickel sources to come into the market? Might it have inspired a global assessment of potential substitutes? Or might it have performed the considerably salubrious task of driving the most careless/reckless/unlucky institutional global commodity trader(s) into economic oblivion?

Whether or to what extent any of that matters—because it may not—depends to a large degree upon the prosecution of the war, and especially how long

the hostilities endure. But two lessons loom unavoidably on the selvage. Securities and derivative exchanges are woefully far from free markets, worst of all when unrestrained pricing is needed most. And once again, the increasingly distant tendrils of pandemic policies are disrupting the present order, two years on.

Post-script: At 3am EDT, nickel contracts reopened on the London Metals Exchange after being halted for a week. Three contracts were bid, 8,600 were offered for sale. The market immediately fell 5%, and trading was halted again. The debacle persists.

— March 16, 2022

New Research Rejects Piketty and Saez's Rewrite of Economic History

AMELIA JANASKIE (Research Associate)

& DAVID WAUGH (Managing Editor)

In 2003, *The Quarterly Journal of Economics* published Thomas Piketty and Emmanuel Saez's article, "Income Inequality in the United States, 1913-1998." In the paper they used IRS tax records to estimate the level of income inequality during the 20th century.

Piketty and Saez identify a U-shaped pattern, or curve, when looking at how much of the total income is held by the top 10 percent of income earners throughout the 20th century. They argue that the century started with high levels of inequality, but a series of events—FDR's income tax hikes, two world wars, and the Great Depression—reduced top capital incomes, effectively leveling income share. In the 1980s, however, Piketty and Saez claim that the Reagan Administration tax cuts sparked an uptick in inequality as high-income individuals took a larger share of income in the US. They claim that the 1980s set in motion a rebounding of the U-curve.

Piketty and Saez attribute the leveling of inequality to higher taxation and the curbing of wealth growth by upper income groups. Their research pushes for progressive taxation and indicts capitalism for exacerbating income inequality. They end their article with this omen:

...our proposed interpretation also suggests that the decline of progressive taxation observed since the early 1980s in the United States could very well spur a revival of high wealth concentration and top capital incomes during the next few decades.

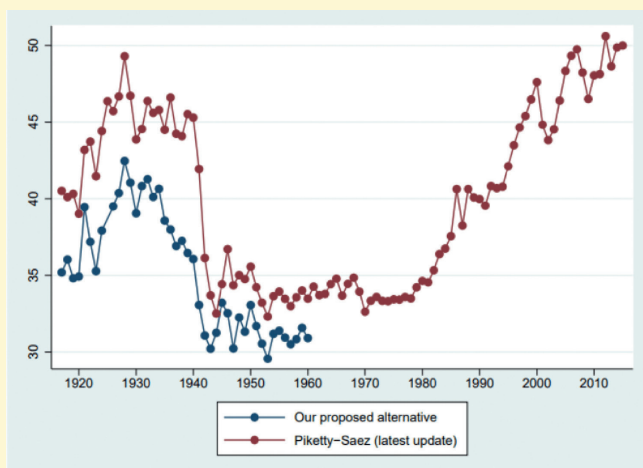
Piketty and Saez's paper inspired scholars to create similar datasets and serves as the basis for numerous

studies on inequality. It is the primary series for measuring inequality in the United States in the World Wealth & Income Database. Google Scholar indicates that the paper has been cited 4,763 times. Piketty and Saez built on the success of this paper with many other influential papers and books. They also worked with progressive politicians, such as Elizabeth Warren on wealth tax proposals to combat inequality.

How Pronounced is the U-Curve?

Despite Piketty and Saez's widespread acclaim, a new article in *The Economic Journal* reveals serious flaws with their core argument. Authors Vincent Geloso, Phillip Magness, John Moore, and Philip Schlosser show that Piketty and Saez overstate income concentration levels and trends. The authors explain the problems with Piketty and Saez's usage of historical IRS tax records and offer a revised series that accounts for their pitfalls.

While the second half of the U-curve has been heavily disputed, the authors instead focus on the first half of the U-curve (1917-1960), fixing inconsistencies and accounting errors in the original tax records and correcting for faulty assumptions. For instance, they find that the decline in top income shares was smaller than Piketty and Saez's estimates. The decline also began in 1929, many years before President Franklin D. Roosevelt implemented high top marginal tax rates. Below is the chart with their version of the top 10 percent income share, compared to Piketty and Saez:



in today's political climate. These revisions must be taken into account by policymakers seeking to reduce inequality via tax policy.

– March 14, 2022

As seen in the chart, the level of inequality is lower, the leveling is less pronounced, and the magnitude of the change over time is smaller than what Piketty and Saez claim. Ultimately, their findings dispute the purported causal link between high progressive taxes and lower inequality.

Implications of the Revisions

Geloso et al. rewrite our understanding of economic history in an important way. Their revised data series demonstrates Piketty and Saez overstate US inequality prior to 1960 by up to 20 percent in some years. Further, their paper provides evidence that the Great Depression was a stronger “leveler” of inequality than World War II and tax policy changes, as Piketty and Saez claim. These new adjustments change our reading of economic history, diminishing the emphasis on tax policy as a driver of economic equality in pre-1960 America.

Geloso et al.'s evidence discredits one of the main takeaways from Piketty and Saez's work: that fiscal policy tools, such as progressive taxation, are an effective way to reduce inequality. The revised data series do not support the claim that income tax policies reduce inequality in the United States. This development is significant because prominent policymakers rely on Piketty and Saez's research to justify tax increases. Inequality is a hot button issue

The Kids Aren't Alright

DAVID R. HENDERSON (Senior Fellow)

& RYAN SULLIVAN (Contributor)

One of the awful ironies of the pandemic lockdowns is that the people least at risk from Covid were among those whom the lockdowns hurt the most. We refer, of course, to the restrictions placed on children. Parks, zoos, and swimming pools were shut down. Little League seasons were canceled. In many states schools went remote for over a year. The evidence shows that these disruptions have had a substantial impact on children's learning, their expected lifetime incomes, their life expectancies, and their mental health. The kids are *not* alright.

Last December, Karyn Lewis and Megan Kuhfeld, two researchers at NWEA, a research organization, reported that student achievement at the start of the current school year was lower than for a typical year. There was a 3–7 percentage point decline in reading and a 9–11 percentage point decline in mathematics. That same month, education researchers Dan Goldhaber of the University of Washington, Thomas J. Kane of Harvard, and Andrew McEachin of NWEA plugged the Lewis/Kuhfeld data into a model to estimate how much those declines in learning would cause their lifetime income to decline. Their answer: \$43,800. This number was broadly consistent with a separate study by McKinsey & Company that found an average lifetime earnings loss of between \$49,000–\$61,000 per student. Aggregated across all US K-12 students, these studies show more than \$2 trillion in lost lifetime earnings for our youngest generation.

A recent report released by the World Bank paints a more dire picture. In that report, it estimates that the school closures could cause a loss of between 0.3 and 1.1 years of schooling, adjusted for quality. In its most pessimistic scenario, the World Bank estimates

that worldwide cumulative losses could total between \$16 and \$20 trillion in present value terms.

A National Bureau of Economic Research study released in November 2021 analyzed recent test score data across 12 states in comparison to previous years and found passing rates declined by 14.2 percentage points on average in mathematics and 6.3 percentage points in English Language Arts. The authors found that much of the decline was due to the closing down of schools.

Historical evidence suggests that these learning losses are likely to be permanent. A 2019 article published in the *Journal of Labor Economics* analyzed the effect of teacher strikes in Argentina on students' long-term outcomes in that country. The authors found that experiencing the average number of days of strikes during primary school reduced labor earnings of males and females by 3.2 percent and 1.9 percent, respectively.

In another study, researchers from the IZA Institute of Labor Economics analyzed long-term outcomes from one of the most extreme examples of learning disruptions – war. In that study, the authors compared Austrians and Germans who were 10 years old during World War II with their counterparts in neutral countries such as Switzerland and Sweden. The authors found that earning losses persisted into the 1980s. They estimated the earning losses to be about 0.8 percent of GDP.

Once these earning losses take hold, they lead to lower life expectancies. This connection was highlighted most prominently in a paper published in the *Journal of the American Medical Association* that analyzed data on school shutdowns early in the pandemic. The authors found that missed instruction

in the United States could be associated with an estimated 13.8 million years of life lost.

What makes these outcomes even more tragic is that they were experienced by children who, as was known early on, never had a significant risk of dying from COVID-19. As of the first week of March 2022, out of the nearly 950,000 Covid-19 deaths, only 865 were children under the age of 18. That amounts to about 433 children annually. This is comparable to a bad flu season in the US. For example, the CDC estimates that the actual number of flu deaths for children in the 2017-18 flu season was about 600.

Moreover, the school closings and lockdowns have led to a noticeable loss in children's mental health. This was apparent early in the pandemic. In a CDC report released in November 2020, researchers reported that the proportion of mental health-related visits from April to October 2020 for children aged 5-11 and 12-17 years had increased by approximately 24 percent and 31 percent, respectively in comparison to 2019 data. In a follow-up CDC report, researchers found that emergency department visits due to suspected suicide attempts were 51 percent higher among girls aged 12-17 years during early 2021 in comparison to the same period in 2019; among boys aged 12-17 years, suspected suicide attempt emergency department visits increased 4 percent.

In 2021, FAIR Health released a report that analyzed data from over 32 billion private health care claim records tracking data from 2019 and 2020. Claims for intentional self-harm as a percentage of all medical claims in the 13-18 age group were 90.7 percent higher early in the pandemic in 2020 than in the same time period in 2019. Furthermore, the authors noted, claims for generalized anxiety disorder increased by 93.6 percent over that same time.

Not much can be done about this now, other than to end the remaining restrictions on children. But there is a lesson for future pandemics: follow

the science. If the data say that young people are at very low risk, then treat them as if they are at very low risk. Maybe we're all in this together, as the propaganda goes, but we are not *equally* in this together. Treating children the way government officials did was morally wrong.

– March 21, 2022

Native American Tribe Hopes to Colonize the World With Digital Freedom

MAX BORDERS

Contributor

Drive about 30 minutes south of Charlotte and you'll find the bedroom community of Rock Hill. Just over the border in South Carolina, the Catawba tribe of Native Americans lives and works on a reservation there, just a short commute away from America's third-largest banking center.

Recently, these original Americans established something incredibly promising: a digital SEZ (special economic zone) similar to that offered by Estonia.

The Baltic region's freest country pioneered the e-residence program. That program allows one to be a legal resident of Estonia but live anywhere in the world. In other words, one can live in Egypt but incorporate her business in Estonia. She benefits from lower taxes, lighter regulation, and a stable business climate even if she incorporates far away.

The Catawba Indians have taken note.

Catawba Digital Economic Zone

The Catawba have the right to establish an independent commercial code as a sovereign nation. Indeed, the tribe defied stereotypes to establish a jurisdiction friendly to innovation and entrepreneurship – particularly digital entrepreneurship.

They call it the Catawba Digital Economic Zone:

“Special Economic Zones have been powerful instruments for economic development,” says Ronnie Beck, CEO of Catawba Corporations, “enabling rapid economic growth.” He continues:

SEZs often rely on tax incentives. But with our status as a sovereign jurisdiction, we are also able to create a best-in-class regulatory climate for the digital, fintech and blockchain sectors. Our plan is to allow these businesses

to operate with certainty, and under regulations that protect consumers that help mature the industry. The Catawba Digital Economic Zone will not only serve companies domestically and internationally but will create tremendous economic opportunities for our people of the Catawba Nation.

The play here is referred to as jurisdictional arbitrage. That means the Catawba are creating greener pastures for innovators and entrepreneurs – right in the middle of an empire in decline.

The Predatory State

The savvy Catawba tribe realizes that the US government is becoming increasingly predatory and unfriendly to enterprise – particularly Web3 industries such as cryptocurrency and decentralized finance (Defi).

As legacy financial institutions collude with the federal government to shore up their power in the face of competitive threats, they will lobby to strangle Web3 industries with red tape. After all, the federal government, Federal Reserve, and the legacy financial sector are locked in a corrupt *ménage à trois*. Wealthy elites benefit most from interventionist fiscal and monetary policy, as economist Richard Cantillon explained in 1755.

As inflation and debt spending continue, we, our children and grandchildren stand to inherit a colossal mess – all while subsidizing the wealthiest people in America along the way. We all know that's gravely wrong, no matter who voted for whom or which party is in charge. But as long as we operate in the dollar's matrix, we will be victims of these corruptive forces.

Exiting the Matrix

Cryptocurrencies and decentralized finance (Defi) allow one to escape this matrix. Native commercial sovereignty could provide some protection, that is unless the federal government continues its dark history of suppressing and marginalizing native peoples.

Bureau of Indian Affairs (BIA) commentary on the extent of Indian commercial sovereignty is murky:

Tribes possess all powers of self-government except those relinquished under treaty with the United States, those that Congress has expressly extinguished, and those that federal courts have ruled are subject to existing federal law or are inconsistent with overriding national policies. Tribes, therefore, possess the right to form their own governments; to make and enforce laws, both civil and criminal; to tax; to establish and determine membership (i.e., tribal citizenship); to license and regulate activities within their jurisdiction; to zone; and to exclude persons from tribal lands.

Limitations on inherent tribal powers of self-government are few, but do include the same limitations applicable to states, e.g., neither tribes nor states have the power to make war, engage in foreign relations, or print and issue currency.

Following a cursory review, therefore, it's unclear what sort of customer and company protections the Catawba Digital Economic Zone can offer at this stage in the development of Web3. Hopefully, it can be an additional layer of protection against a financial-government complex that is increasingly predatory and that sees cryptocurrency as a threat to its hegemony.

But the Catawba Digital Economic Zone is not without competition.

Próspera

On the beautiful island of Roatan in Honduras, legal and governance entrepreneurs have set up Próspera, a highly advanced SEZ. Indeed, Próspera recently launched a \$100 million security token raise such that accredited investors can make fractional investments in Próspera real estate:

“This groundbreaking approach to fundraising leverages the greatest benefits of blockchain technology – simplicity, security, and tradability,” said Próspera President, Joel Bomgar.

“By partnering with Securitize to issue our Security Token Offering (STO), we give our investors a frictionless and legally up-to-date way to have direct ownership in Próspera’s first Charter City development.”

Legacy powers should take note: Small, sovereign nations like Liechtenstein, Estonia, Singapore, and Dubai are successful because they are small and relatively nimble, they have liberalized, and they think of themselves as startups competing against great powers. We are likely to see more upstart zones such as Próspera and the Catawba Digital Economic Zone, particularly in areas seeking to bootstrap commercial inclusion and growth for their people.

Voice Ain’t Working. Let’s Exit

The emergence of new SEZs creates competitive governance opportunities. Unlike legacy states, these jurisdictions run like businesses, making them formidable – even in the shadow of lumbering powers such as the US. As each new system emerges, the cost of exiting a failing jurisdiction goes down. Each new zone represents an escape hatch that helps expand the sovereignty of free peoples, especially those who create entrepreneurial value.

When you couple competitive *terrestrial* governance with cloud governance (jurisdictions that exist everywhere and nowhere), entrepreneurs will find opportunities to get out from the thumb of

authorities bent on funding technocratic dreams and war machines. This creates a strange set of ironies for the 21st century, three of which come immediately to mind:

1. The American Dream is less likely to be found in the United States.
2. We might find that dream increasingly among Native Americans and in Central America.
3. Past victims of colonial oppression and corruption are becoming the exponents of freedom and good governance.

As the United States continues to decline, we need to find the exits.

If the Catawba Digital Economic Zone project is successful, Native Americans – of all people – will have saved a few scraps of freedom. That they're willing to share that freedom with the rest of us speaks volumes about the integrity of the Catawba people.

– March 30, 2022

Affirmative Action – Help or Hindrance for the Underrepresented?

GEORGE LEEF

Contributor

Starting in the days of Lyndon Johnson's Great Society, American colleges and universities embraced the idea that one way for the country to atone for its ugly history of slavery and racial discrimination was to give preferences to applicants from "underrepresented" groups. At first, that just meant students with African ancestry, but later came to include Hispanics, Native Americans, Aleutian Islanders and others.

Schools began to admit applicants from those groups even though they had weaker academic qualifications than the great majority of the students. The assumption was that they were helping them, because a degree from a more prestigious college would provide them with a big boost in life. The logic seemed clear: Since on average graduates of more prestigious schools like Harvard and Berkeley had higher earnings than graduates of less prestigious ones, increasing the numbers of minority students at them would begin to narrow the earnings gap between whites and others. Members of those groups would quickly be brought into the economic "mainstream" and begin to acquire positions of power and influence.

The theory sounded good. Almost nobody questioned it. And even today, belief in affirmative action (I'm going to drop that euphemism in favor of the more accurate term *racial preferences* for the remainder of this article) remains powerful within the education establishment.

In fact, to question or criticize it can get you in serious trouble, as University of Pittsburgh medical professor Norman Wang discovered when he criticized the use of racial preferences, arguing that putting race ahead of excellence would degrade the

medical profession. Law professor Jonathan Turley wrote of the case, "The only thing more unsettling than the actions of the university was the relative silence of his colleagues throughout the University of Pittsburgh as he was punished for expressing his academic views."

One of the more vociferous advocates of racial preferences is Holden Thorp. Thorp earned his Ph.D. in chemistry at CalTech and rose through the academic ranks to become the chancellor of the University of North Carolina at Chapel Hill. UNC's infamous athletics scandal of 2011 caused his career there to crash, but he subsequently began to climb the academic ladder again as provost at Washington University in St. Louis. He also serves as editor-in-chief for the prestigious magazine *Science*.

In that capacity, he contributed an editorial on Feb. 3 entitled "Science needs affirmative action."

In it, Thorp declared that science is struggling "to correct systemic racism" and "external forces press on, making it more difficult to achieve equity on all fronts...." He was particularly upset that the Supreme Court has agreed to hear two cases challenging the legality of the use of racial preferences in college admissions (one involving Harvard, the other UNC). He calls upon the scientific community "to mobilize against this latest assault on diversity."

So, what is Thorp's argument?

He writes, "Failure to enroll a diverse undergraduate population has already excluded outstanding people from science and limiting affirmative action will only make matters worse."

Thorp must know that virtually all of the top colleges and universities in America have been going to great lengths to "enroll a diverse undergraduate

population” for the last forty years. No one is being excluded from going to college and studying science or anything else. What I believe he means to say is that in the absence of racial preferences, there would be substantially fewer students “of color” admitted to universities such as Harvard and UNC. That is undoubtedly true. If it weren’t for such preferences, those institutions would admit fewer black and Hispanic students, and more students of Asian background.

Wouldn’t that exclude the students Thorp is concerned about? No, because students who don’t get into their top, most prestigious college picks just enroll somewhere else.

Think for a moment about those Asian students who are rejected at Harvard, et al, in order to make room for “diverse” students. They’re excluded from Harvard, but not from going to college. They simply enroll in one of the other schools to which they applied. If the Supreme Court were to rule against the legality of racial preferences, that wouldn’t exclude anyone from Harvard, but would mean that students who didn’t have high enough academic qualifications would have to go to a school where their qualifications were on a par with most of the other students. A black student who wanted to study engineering at Harvard might, for example, go to Purdue instead.

Without racial preferences, students would be accepted where they are a good match academically. Elite institutions would have fewer “diverse” students and other, somewhat less prestigious ones would have more of them. Why would that be harmful to science or anything else? It wouldn’t be.

Actually, there is good reason to believe that it would be better for the students. That is because it’s no benefit to be put into competition where most of your fellow students are more prepared for academic rigor than you are. We’ve known that for nearly twenty years.

The Andrew W. Mellon Foundation published a book in 2003 by two scholars, Stephen Cole and Elinor Barber entitled *Increasing Faculty Diversity: The Occupational Choices of High-Achieving Minority Students*.

Why weren’t more black and Hispanic students going to grad school to pursue faculty careers? Cole and Barber argued that the main problem was that many of the supposed beneficiaries of racial preferences earned low grades in their courses, thus deterring many from continuing on to grad school. They wrote that many of the best prepared minority students “are admitted to schools where, on average, white students’ scores are substantially higher, exceeding those of African Americans by about 200 points or more. Not surprisingly, in this kind of competitive situation, African Americans get relatively low grades. It is a fact that in virtually all selective schools (colleges, law schools, medical schools, etc.) where racial preferences in admission is practiced, the majority of African American students end up in the lower quarter of the class.”

Rather than giving an endorsement for increased “diversity” efforts as the Mellon Foundation had clearly been expecting, Cole and Barber argued against it. They advised high-achieving minority students not to go to the most prestigious possible school, where they’d be admitted with the benefit of preferences, but to schools where they were most likely to do well academically. (After publishing the book, the Mellon Foundation chose to ignore it, since the authors’ conclusions ran contrary to the ingrained belief that racial preferences are good.)

The Cole/Barber research was supported by a study done in 2012 at Duke University by economists Peter Arcidiacono and Esteban Aucejo and sociologist Ken Spenner. Their paper, “What Happens After Enrollment? An Analysis of the Time Path of Racial Differences in GPAs and Major Choice” concluded that students who had been admitted with

preferences (whether racial or other kinds) were far more likely to drop out of academically demanding majors such as science, math, or engineering and into easier ones. In short, if your goal is to get more students through demanding undergraduate majors and into scientific work, you ought to oppose preferences.

I'll mention one more reason why racial preferences are counterproductive. Students often receive a superior education at smaller, less prestigious colleges and universities. That's because the faculty at such schools tend to give more attention to undergraduates. At the elite institutions like Harvard, undergraduate classes are largely taught by harried teaching assistants, not by the superstar faculty members. A black student who chooses to enroll at one of America's Historically Black Colleges and Universities (HBCUs) is more apt to do well in his science major and then go on to grad school than one who gets the dubious benefit of a racial preference to enroll at Harvard.

Scientists should carefully examine the evidence before announcing their conclusions. If you examine the evidence concerning racial preferences, you have to question whether they don't do far more harm than good.

– March 5, 2022

Why Declare War?

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Most agree that war is good for “uh! absolutely nothin’.” Unfortunately, it remains a part of life and, for too many people, death. Limiting war’s devastating effects on citizens constitutes one of the few legitimate functions of governments, but too many have been distracted by other missions, many of dubious import or tractability, to provide peace.

The best governments make peace a paramount priority through deterrence and diplomacy. Look at George Washington’s Farewell Address for a clear statement of such principles. America’s Framers knew, though, that in some circumstances war becomes the least bad option, though when that line is crossed could be a matter of dispute.

So the Framers made POTUS Commander-in-Chief but checked his (or soon her) power by putting Congress in charge of military appropriations (Article I, Section 8, Clause 1). The Framers also gave Congress, in Article I, Section 8, Clause 11 of the Constitution, the sole authority to declare war. That clause says that Congress shall have power to “declare War, grant Letters of Marque and Reprisal, and make Rules concerning Captures on Land and Water.”

Comparing the power of POTUS to that of the British monarch in Federalist No. 69, Alexander Hamilton wrote:

The President is to be Commander in Chief of the army and navy of the United States. In this respect his authority would be nominally the same with that of the King of Great-Britain, but in substance much inferior to it. It would amount to nothing more than the supreme command and direction of the military and

naval forces, as first General and Admiral of the confederacy; while that of the British King extends to the *declaring* of war and to the *raising* and *regulating* of fleets and armies; all which by the Constitution under consideration would appertain to the Legislature.

The idea was that POTUS could respond to emergencies quickly, out of current budget appropriations, but not engage in long-term, large-scale hostilities without Congressional approval. What constituted a long-term or large-scale conflict was contentious, for example in the military campaigns against North African city states and American Indian nations.

What the Framers did not expect was for Congress to abrogate its responsibility to formally declare war, or in other words to fund a nontrivial *de facto* war (actual state of war) indefinitely without making it *de jure*. Yet, despite fighting many armed conflicts over the last 8 decades, the United States Congress has not formally declared war since 1942, against three Nazi satellite nations in the Balkans.

When American military forces become embroiled in combat for years, as in Iraq and Afghanistan, or in operations, like Korea and Vietnam, that threaten to escalate into major power conflict, Congress should debate the matter and then vote on a formal declaration of war, not leave it up to POTUS. Declarations of peace, so to speak, are usually done by treaty and hence the work of the executive branch but ratified by two-thirds of the Senate per Article II, Section 2, Clause 2. Declarations of neutrality, by contrast, have been safely left to POTUS, as in 1793 and 1914.

So the situation is complex, and deliberately so. Congress and POTUS are different parts of government, elected in different ways, for different reasons, and for different terms of office, so they have different incentives. When those incentives align, most likely America should go to war. When they don't, the nation can get sucked into, and then mired, in conflicts on dubious grounds.

While POTUS (and VPOTUS, sort of) is the only nationally elected officeholder, the term is four long years and is now term-limited (though not as strictly as I would like). It's a truism that the surest way of winning a second term is to engage the country in *de facto* war, so checking the president's war-making powers is essential lest the nation repeat the fiascos of 1964 (Vietnam) and 2004 (Iraq and Afghanistan occupations).

The entire House of Representatives comes up for reelection every two years, but Representatives can remain in office for as long as they can win reelection. So they tend to be much more attentive to public sentiment than POTUS and the two-thirds of Senators not up for reelection in any given cycle. Although each Representative represents only 1/435th of all Americans on average, collectively they represent current public opinion much better than POTUS does.

Both Houses of Congress, 535 voting members in all, also represent a type of collective wisdom that one person, especially one person surrounded by a bunch of sycophantic advisors can never achieve. While crowds can be wrong, like during the height of financial bubbles, they tend to approximate right answers on average. Individuals, by contrast, can be way off on everything, a lesson Americans are relearning in real time.

Declarations of war are also important because they are much more salient and somber than making a series of "supplemental" and "emergency" budget appropriations designed to hide the total cost of

conflict from taxpayers, and to shield legislators from the wrath of voters opposed to drawn-out occupations and the suppression of masses of people yearning to be free.

Most importantly, though, a formal declaration of war comports with international law and treaties. Nations that formally declare war as a matter of course are much less likely to make sneak attacks, striking first on slight or no provocation. Like Russia.

Nations with such a strong rule of law that they insist on formally declaring war essentially follow the non-aggression principle. They can be trusted in matters of diplomacy and, perhaps more importantly, they can be trusted with direct foreign investment and portfolio investment. That is because they will not take anyone's stuff without due process of law.

America was once such a nation. After formally declaring war, Congress can unleash privateers, legal pirates who roam the seas searching for foreign combatant booty to sell for a profit. Congress can also order the seizure and sale of other property owned by foreign combatants. It has actually done so, most famously during the two world wars when its "Alien Property Custodian" (APC) seized the assets of Germans, and other foreign combatants, held them in trust, and sometimes sold them, lawfully under the Trading with the Enemy Act of 1917 (TWEA).

Details of the APC's activities are lacking, though Records of the Alien Property Custodian are stored in the National Archives and its actions were summarized in various published reports and law journal articles. Historical treatments of the APC remain few, though, as most historians are too busy fretting about culture and race to study institutions, even important neglected ones like the APC, in any detail.

The APC's powers continue to exist, though tellingly transferred from the Department of Justice

to the Treasury Department's little-known Office of Foreign Assets Control. This is the crew that handles the technical details of embargoes and other economic sanctions today.

As usual, Congress has delegated power, perhaps too much power, to POTUS. The 1977 International Emergency Economic Powers Act (IEEPA) allows POTUS to declare a domestic emergency when events wholly or largely occurring outside of the United States threaten the nation's military or economic security. President George W. Bush invoked it in 2001 after the 9/11 attacks in Executive Order 13224 to tamp down on terrorist financial networks, including the Holy Land Foundation for Relief and Development.

While EO 13224 may have shown that it is important to delegate authority to the executive when time is of the essence, the cost of TWEA and IEEPA was further empowering POTUS. President Trump's 2019 use of IEEPA to address a purported immigration emergency on the Mexican border, for example, brought howls from many. (And we recently saw in Canada how emergency powers can be used to punish political opponents.)

Obviously, allowing a leader to unilaterally declare an emergency that empowers him or her provides the wrong incentives, especially when only a joint resolution of Congress can override POTUS's state of emergency declaration. Good luck with that if the President's party controls Congress. The devil in these details is that voters tend to blame individual politicians for their actions rather than their inactions. So legislators have an incentive to "let POTUS do what POTUS gonna do" even if his actions may blunder the nation into a de facto war that can be financed on the sly.

In short, due to overzealous delegation and the erosion of an important Constitutional check, people can die, the nation's international reputation can be sullied, and fortunes can be lost, or made, without

the real democratic accountability afforded by formally declaring war.

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