Research Reports

Volume LXXXVIII

April 2024

AIER | AMERICAN INSTITUTE *for* ECONOMIC RESEARCH

RESEARCH REPORTS

AIER publishes over 100 articles per month that are distributed in digital form. Research Reports contains Business Conditions Monthly plus 10 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.
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Contents

Business Conditions Monthly

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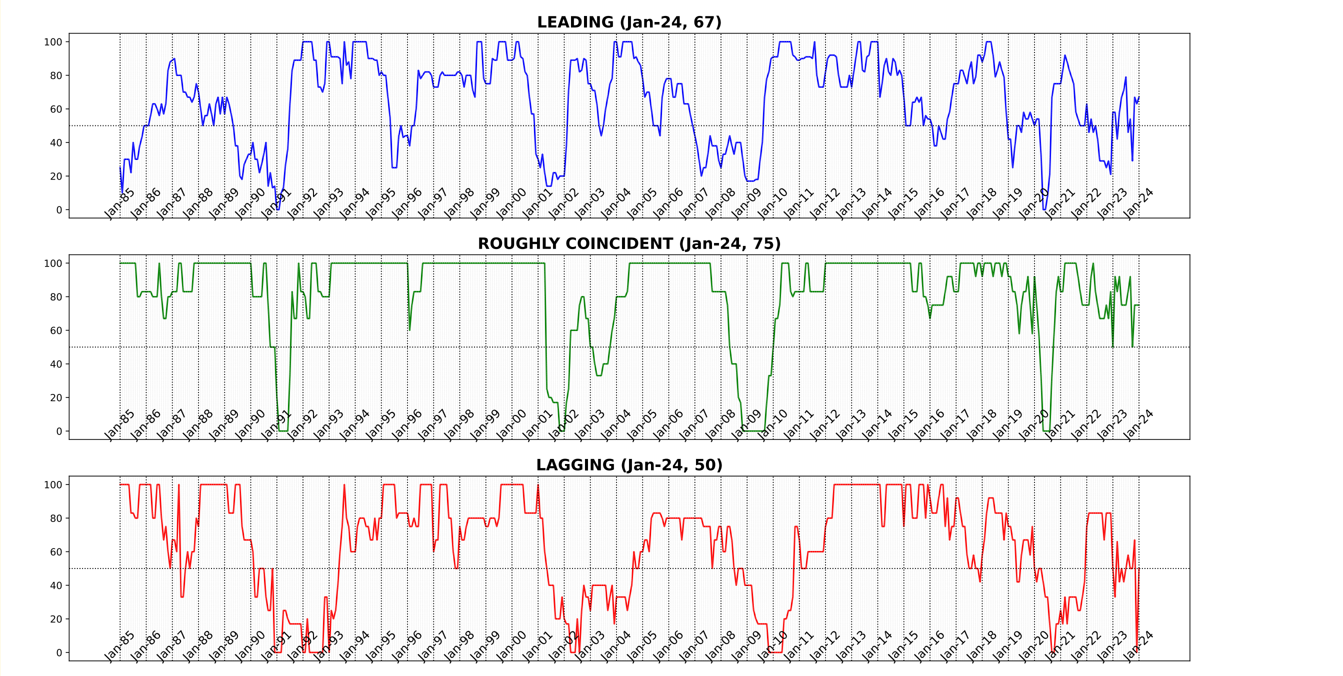
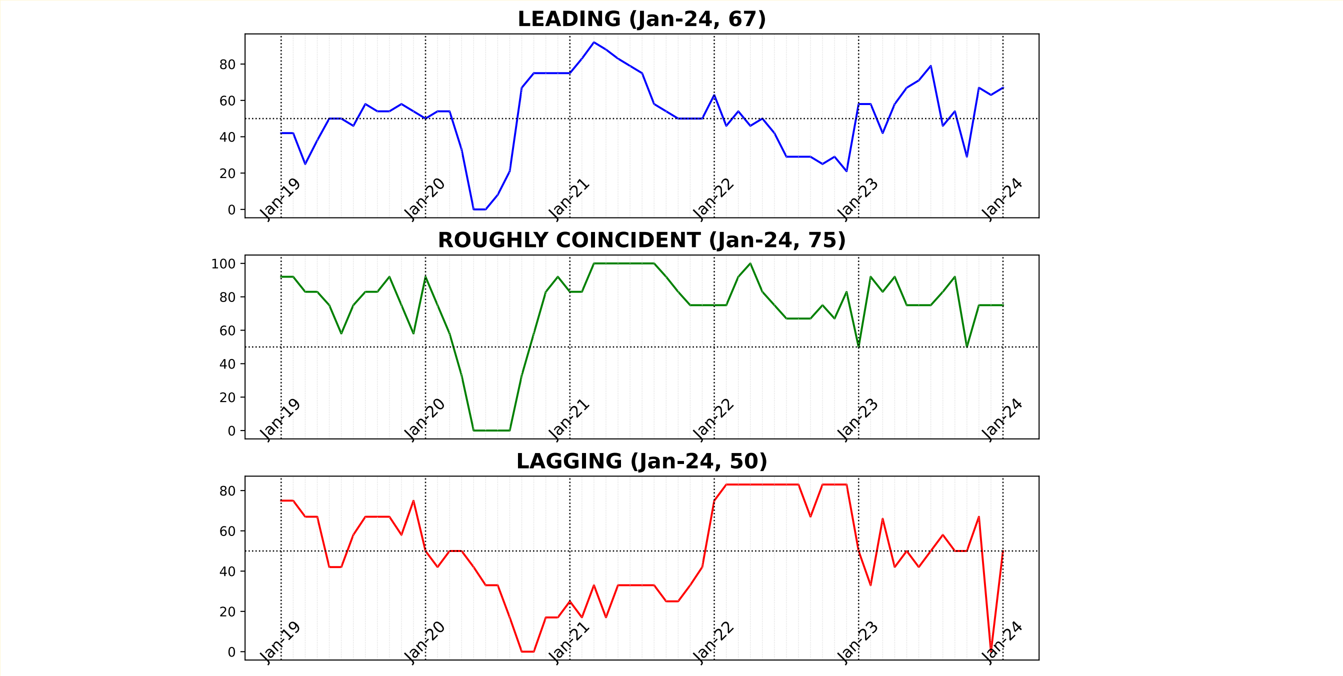
In January 2023, two of the AIER Business Conditions Monthly returned to the expansionary levels which characterized the last six to eight months. The Leading Indicator returned to its November 2023 level of 67 after dipping to 63, while the Roughly Coincident Indicator spent a third month at the 75. The Lagging Indicator, which plunged from 67 In November 2023 to 0 in December returned to 50, again exemplifying the high noise-to- signal ratio in post-pandemic economic data.





(Source: Bloomberg Finance, LP)

Leading Indicator (67)

Among the components of the Leading Indicator, seven rose, five declined, and two were neutral.

Rising were the University of Michigan Consumer Expectations Index (**14.4 percent**), United States Heavy Trucks Sales (**10.5 percent**), 1-to-10 year US Treasury spread (**10.4 percent**), Conference Board US Leading Index of Stock Prices (**2.6 percent**), Inventory/Sales Ratio: Total Business (**0.7 percent**), FINRA Customer Debit Balances in Margin Accounts (**0.2 percent**), and the Conference Board US Leading Index Manufacturing, New Orders,

Consumer Goods and Materials (**0.1 percent**). The US Average Weekly Hours All Employees Manufacturing and Conference Board US Manufacturers New Orders Nondefense Capital Good Ex Aircraft were both neutral. Adjusted Retail and Food Service Sales fell (**-1.1 percent**), as did US New Privately Owned Housing Units Started by Structure (**-5.9 percent**) and US Initial Jobless Claims (**-13.6 percent**).

At 67, the Leading Indicator suggests continuing expansion, if moderately. It also did so during the spring and summer of 2023 before spending the fall in neutral and contractionary territory, rebounding in November.

Roughly Coincident (75) and Lagging Indicators (50)

The Conference Board Consumer Confidence Present Situation rose by **5.2 percent**, as did its Coincident Personal Income Less Transfer Payments (**0.2 percent**), Coincident Manufacturing and Trade Sales (**0.2 percent**), and US Employees on Nonfarm Payrolls (**0.1 percent**). The US Labor Force Participation Rate was unchanged, while the Industrial Production index fell (**-0.5 percent**).

The Lagging Indicator had two rising, two falling, and one neutral component. The Conference Board US Lagging Avg Duration of Unemployment rose **6.7 percent** as US Commercial Paper Placed Top 30 Day Yields rose **0.4 percent**. The Conference Board US Lagging Commercial and Industrial Loans and the Census Bureau's Private Construction Spending (Nonresidential) both slid **-0.1 percent** from December 2023 to January 2024. US CPI Urban Consumers Less *Food* and Energy was unchanged.

The Roughly Coincident Indicator has been the most consistent of the three Business Conditions Monthly indicators, remaining at an expansionary level of 75 or above throughout much of 2022 and all of 2023 with the exception of January and October 2023. The Lagging Indicator, having remained at largely neutral levels throughout 2023 before collapsing to zero in December 2023, is likely the most buffeted by continuing economic misalignments.

Discussion

The ongoing discourse surrounding the US economy has recently centered on the resilience and sustainability of consumer spending. Amidst a backdrop of escalating prices, rising interest rates, and diminishing post-pandemic savings, the vigor of consumer expenditure has been an ongoing surprise.

Yet in February 2024, headline retail sales witnessed a more subdued resurgence than anticipated, thought primarily to owe to a weather-induced uptick following January's sales slump. Notably, sales growth was largely credited to demand for building materials and garden equipment. Elsewhere the consumption data showed only marginal improvement, reinforcing the notion that consumers are approaching the limits of their spending capacity amidst dwindling savings, apprehensions about borrowing amidst elevated interest rates, or an outright inability to access credit – as the popularity of Buy-Now-Pay-Later plans during the 2023 holiday season suggested. It thus appears that February's retail sales figures signal the long awaited waning of spending momentum, particularly within the services sector, which aligns with the prognosis of a decelerated consumption growth trajectory ahead.

The underestimated resilience of consumption has relied on the interplay of the labor market's recovery from pandemic policies, consumers' propensity to tap into savings and credit, and elevated interest earnings. Nevertheless, these three pillars appear poised to transition into headwinds as 2024 draws on. Analyzing future consumer activity may employ two distinct analytical methodologies: a top-down or bottom-up approach. The top-down method assesses spending dynamics based on momentum and household wealth relative to income, whereas the bottom-up approach examines consumption as a product of wage growth, personal savings, and net interest impact. The top-down approach suggests a distinct but mild slowdown in consumption by year-end. The bottom-up framework focuses on the implications of rising unemployment and Federal Reserve rate cuts on wages and wage growth, personal savings, and interest income. When the Fed reduces rates – as it is continuing to project that it will do three times over the remainder of 2024 – consumers experience a decline in net interest income due to the faster decrease in interest versus borrowing costs. Simultaneously, increased unemployment and underemployment tend to prompt higher rates of saving. As a result, consumption is expected to decelerate from the rapid pace seen last year, but unless a significant negative economic event occurs, it is unlikely to plummet. In both scenarios, US consumer spending is likely to decline over the next two or three quarters, requiring sources of US economic growth (as measured by GDP) to come from elsewhere.

The long tail of pandemic disruptions are continuing to obscure the economic landscape, yet there are emerging trends that warrant attention, albeit often deep within reports featuring seemingly robust headline figures. Following a late-year and early-2024 slowdown, there are mixed indications of a continuing slowdown ahead: restaurant bookings, closely linked with credit card transactions, initially dipped during January's cold spell but have since recovered. Yet, gasoline demand, which saw a decline in late January, has rebounded, and air passenger traffic has shown improvement in early March.

Truck demand, serving as a proxy for retail activity, experienced fluctuations since late December but has shown a stronger upward trend in March. Sentiment among box makers, another indicator, remains guarded, with expectations of flat first-quarter demand compared to a year earlier. The housing market remains sensitive to changes in mortgage rates, with a drop below 7 percent in early March prompting an increase in home purchase applications. Although iron and steel production saw a slight rise in February, industrial production fell well short of expectations in January due to cold weather impacting nondurable goods manufacturing and mining. The stabilization of oil rig numbers in late 2023 and early 2024, following a significant decline due to oil price drops and rising labor costs, is another noteworthy development. While jobless claims indicate minimal firing rates, continuing claims have remained above pre-pandemic averages since late September, indicating a challenging job market environment for the unemployed.

Small-business owners are experiencing a notable decline in optimism, driven by profit pressures arising from high labor costs and ongoing apprehensions about future conditions, particularly with respect to tax and regulatory policies in the wake of the upcoming November elections. On both sides, the signature economic points of either ratcheting up taxes on businesses or imposing double digit tariffs on foreign goods, are taking a toll on entrepreneurial sentiment. The NFIB Small Business Optimism index fell to 89.4 in February, below both the prior reading of 89.9 and the expected 90.5. Plans for job creation over the next three months dropped to 12 percent, the lowest since May 2020, with significant decreases in job openings observed across various sectors such as transportation, agriculture, retail, and services as compared to the same period in 2023.

Despite a notable increase in job openings in the construction sector, more than half of small businesses report difficulty filling vacant positions. Additionally, actual sales declined, and a net

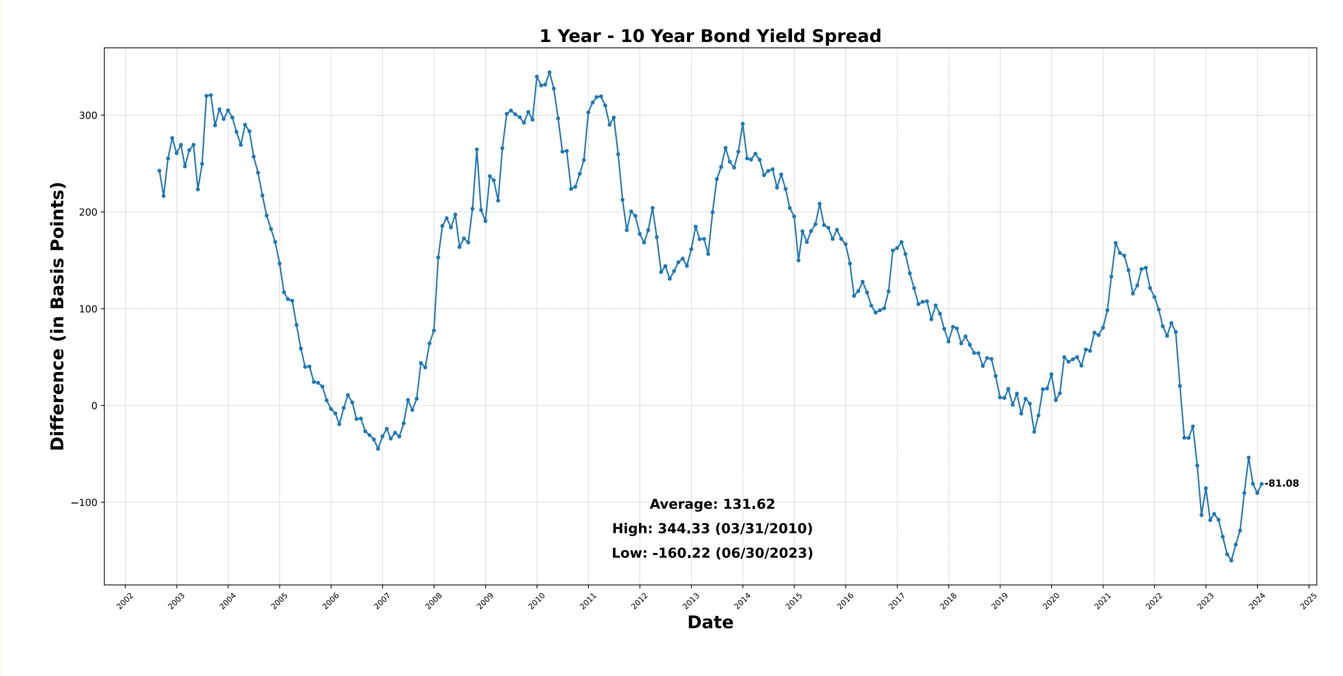
-7 percent of owners plan to invest in inventory over the coming quarter.

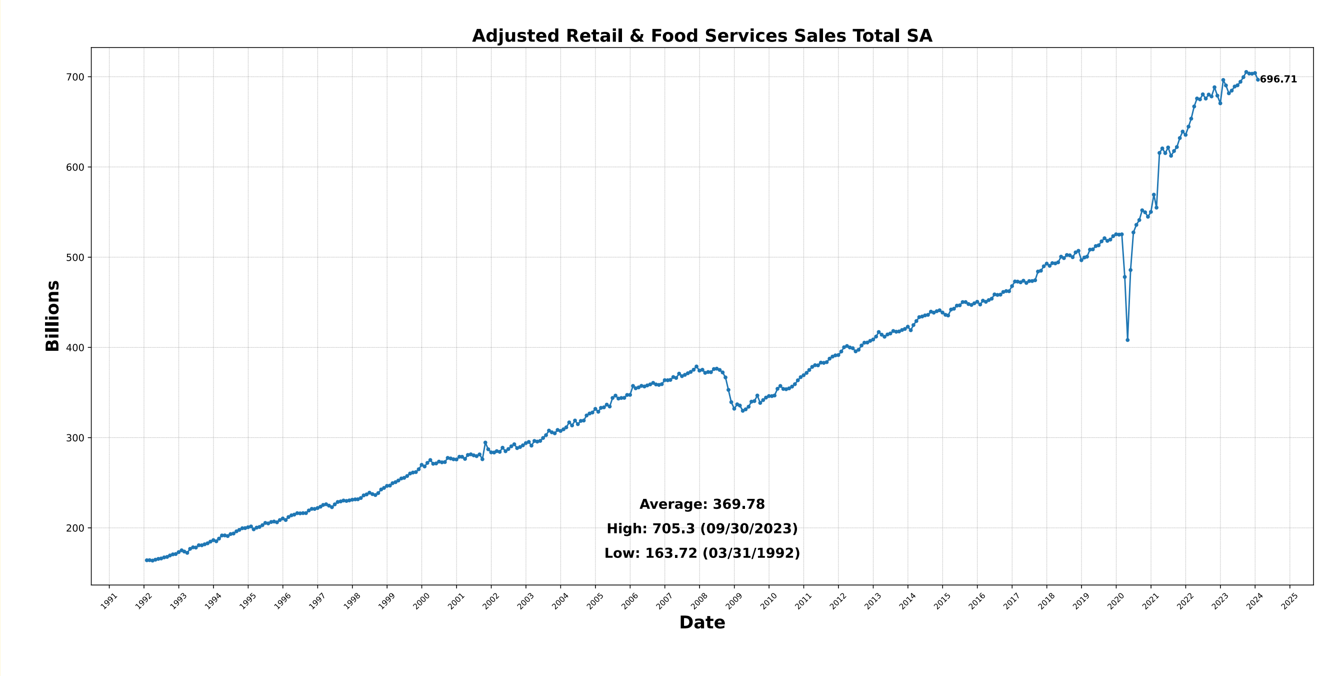
Company earnings are continuing to deteriorate alongside dampened expectations for general business conditions and compensation plans, which fell to their lowest level in three years (since March 2021). The proportion of owners raising average selling prices decreased to a net **21 percent**, marking the lowest reading since January 2021. Overall, the majority of National Federation of Independent Business components evinced a downturn in February, reflecting the prevailing economic environment and persistent trends. Sentiment has remained consistently below its 50-year average of 98 since August 2021.

Recent data from both the Consumer Price Index and Producer Price Index indicate that core and "supercore" PCE inflation, closely monitored by the Fed, moderated only marginally in February. Nevertheless, and fulfilling the Nordhausian prognosis, Fed Chair Jerome Powell has expressed the possibility of the FOMC implementing rate cuts "well before" inflation reaches the 2-percent target with market implied policy rate markets strongly forecasting the first cut to come in June or July.

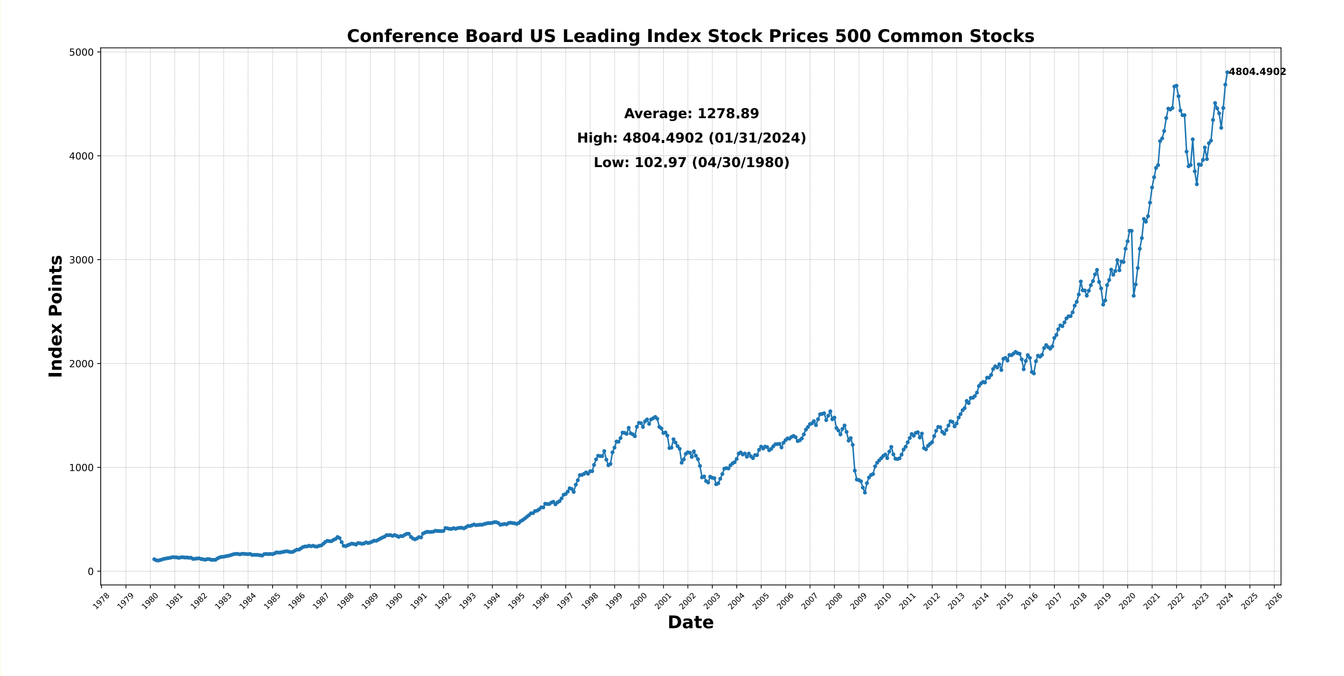
Only the price of gold, which recently hit an all time record price of $2,185.75 per ounce, appears appraised of the growing tenuousness of the US economy. In addition to a softening labor market and US consumer activity finally appearing to hit a wall, the potential for shocks of an endogenous or exogenous nature is elevated. (In the former category, the S&P 500 is up nearly **10 percent** since the start of the year on extremely narrow breadth; in the latter, front-month West Texas Intermediate oil prices are currently trading for less than they did in the immediate aftermath of the October 7th attacks.) Increasing possibilities for political instability and civil unrest as the November elections draw nearer must also be taken into account. For these and related reasons, our forecast for 2024 remains characterized by an expectation of economic contraction.

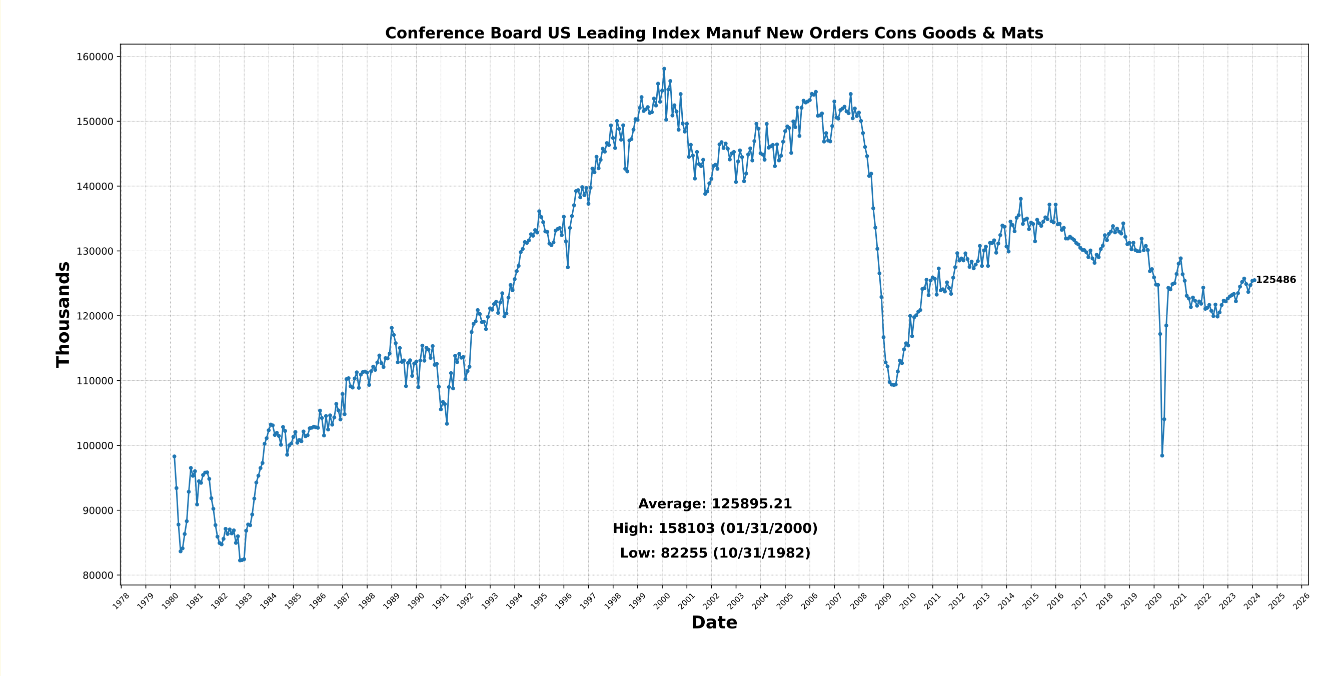
Leading Indicators





(Source: Bloomberg Finance, LP)





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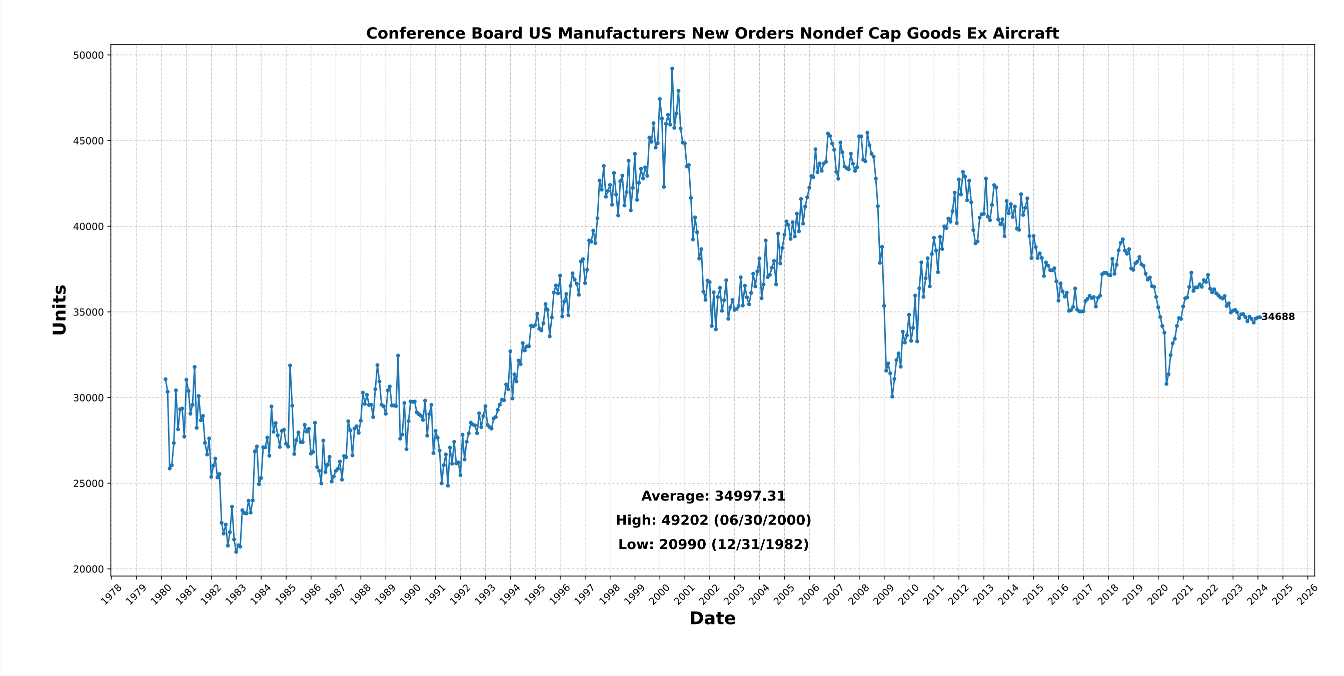

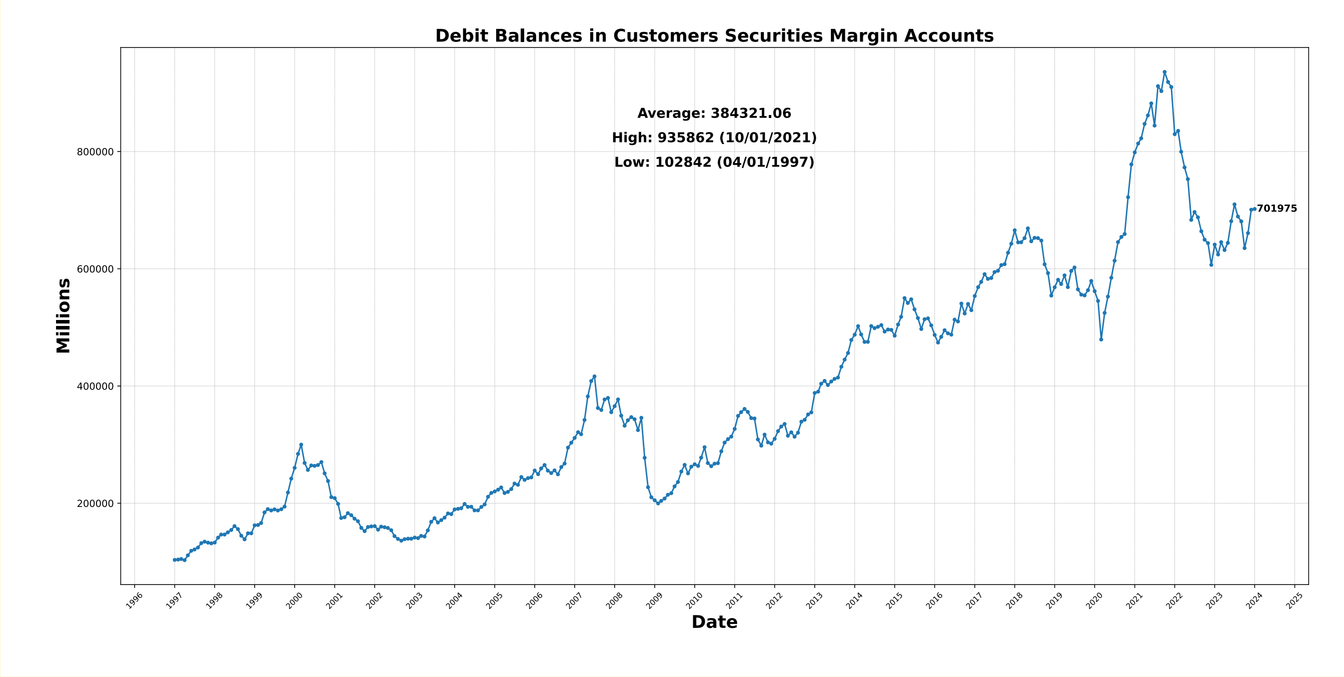

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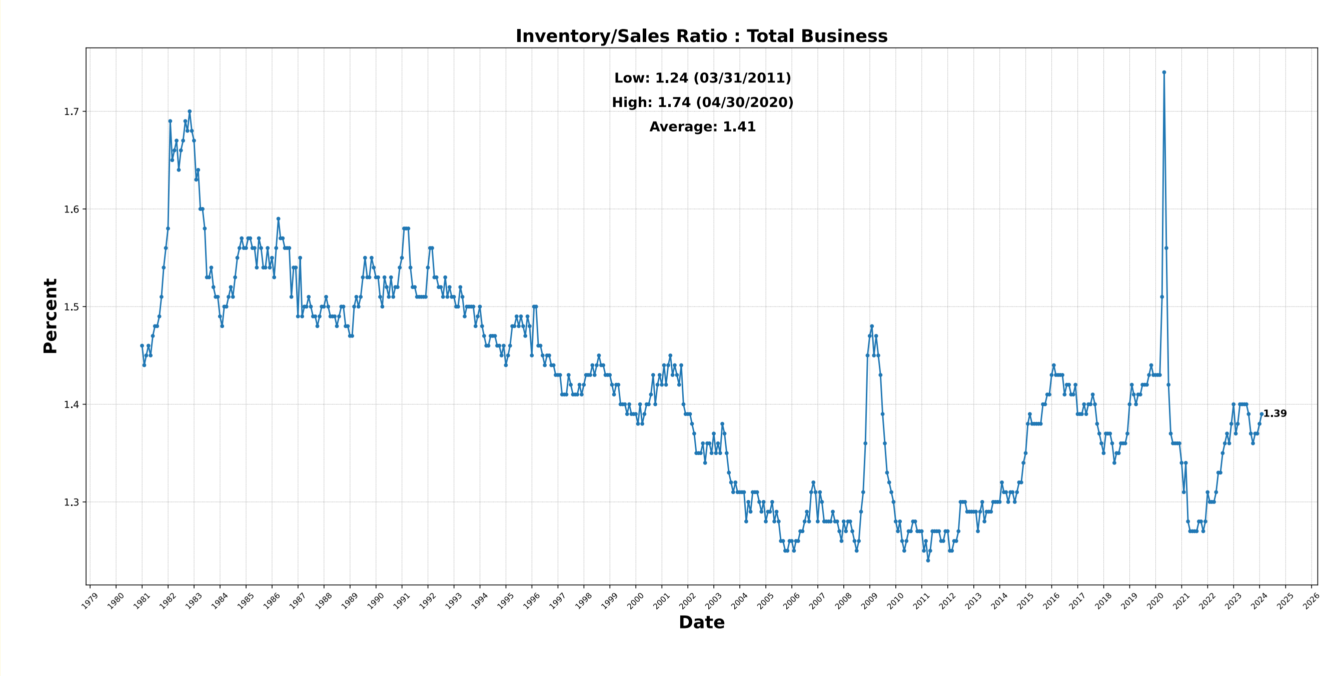

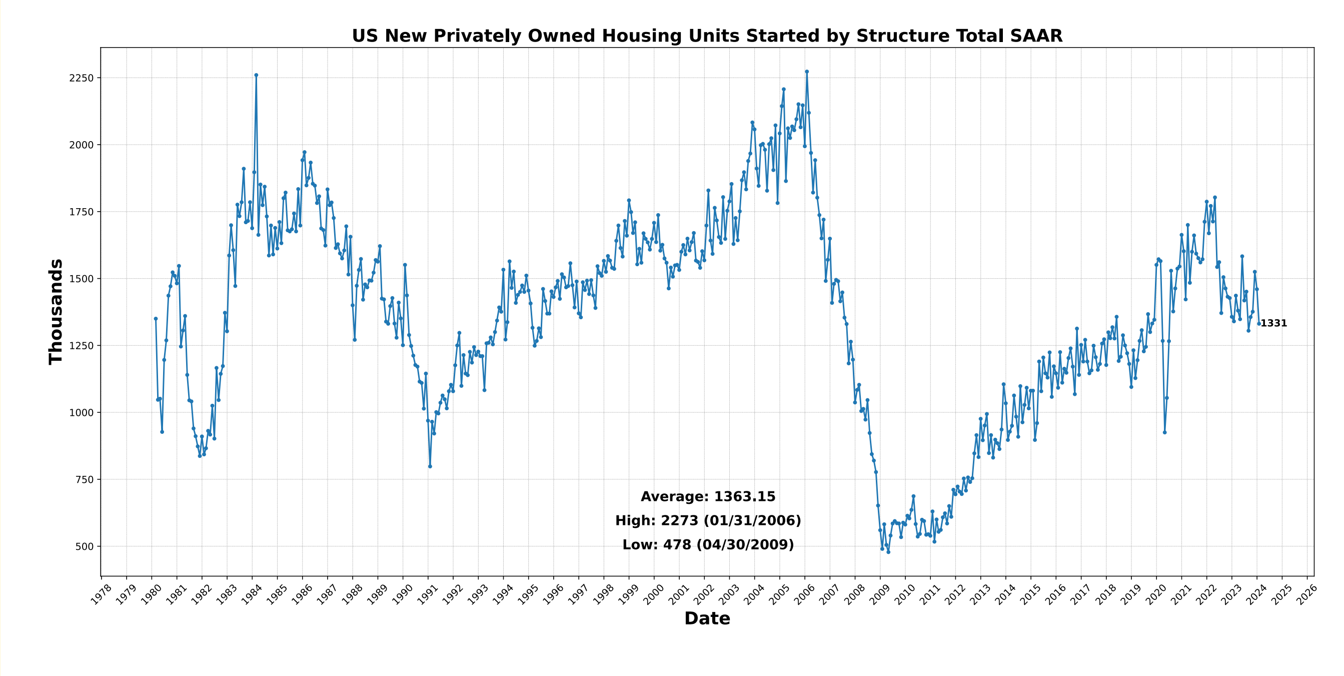

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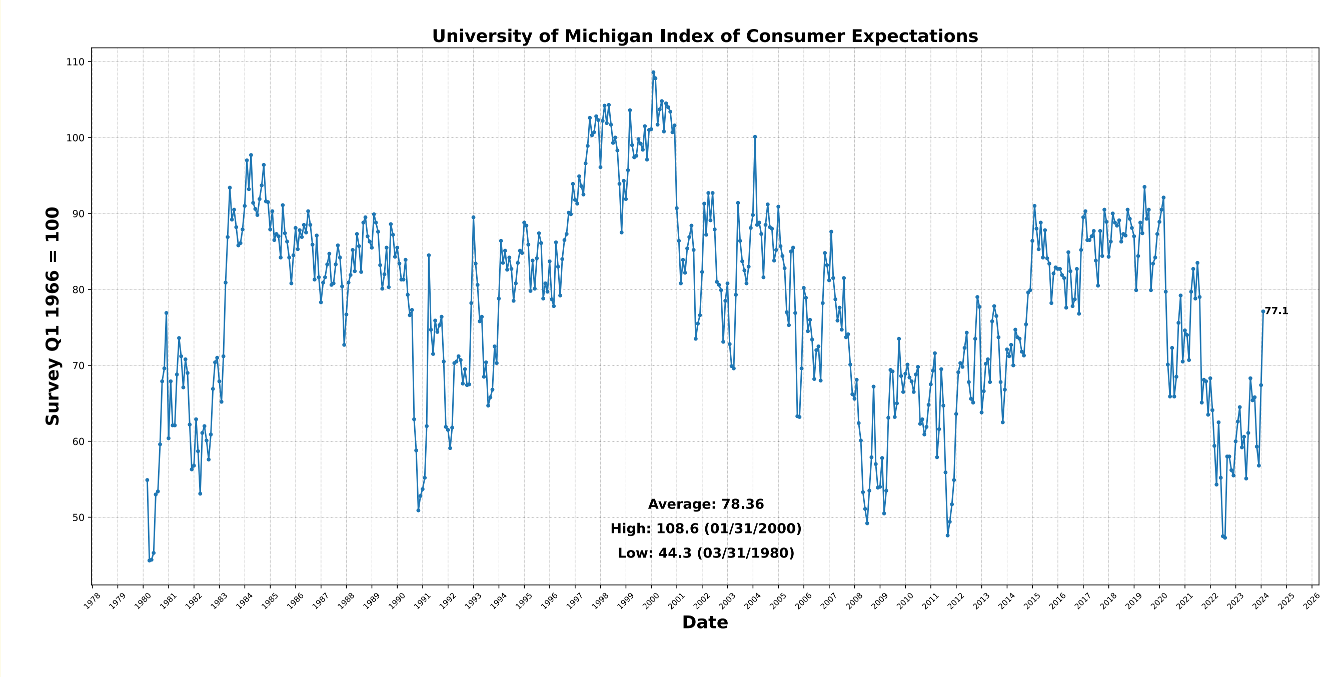

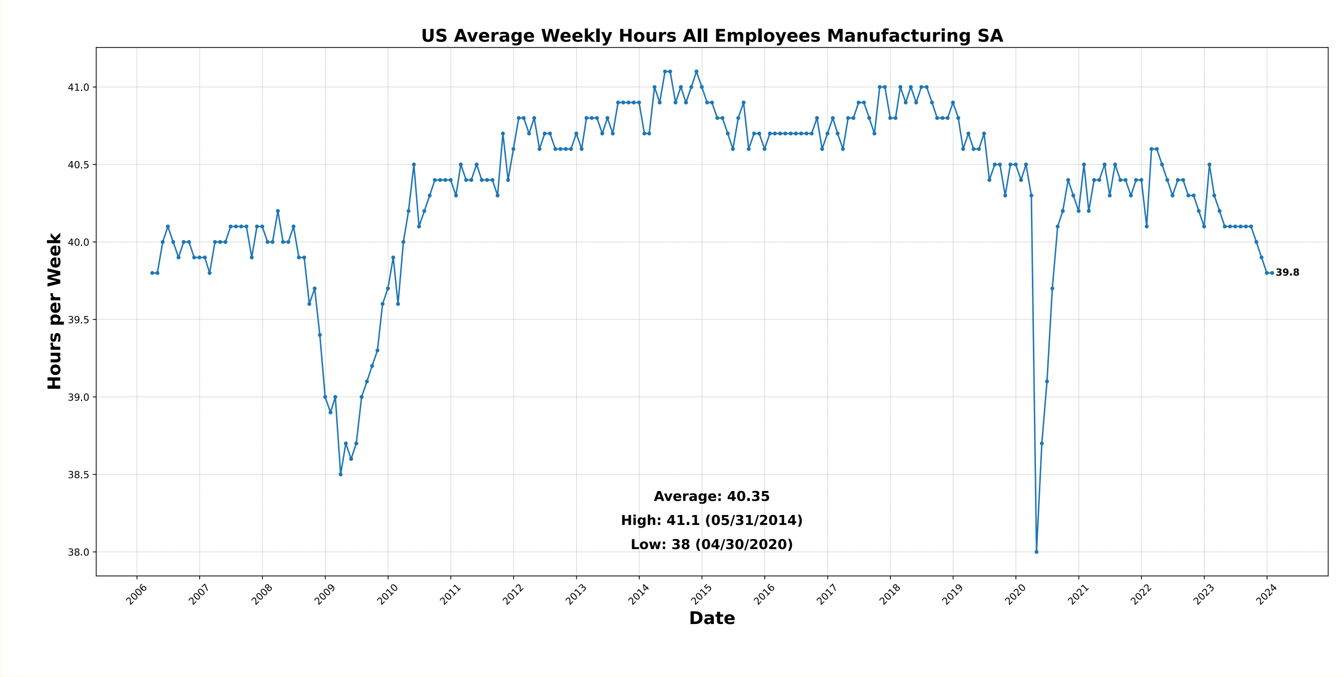

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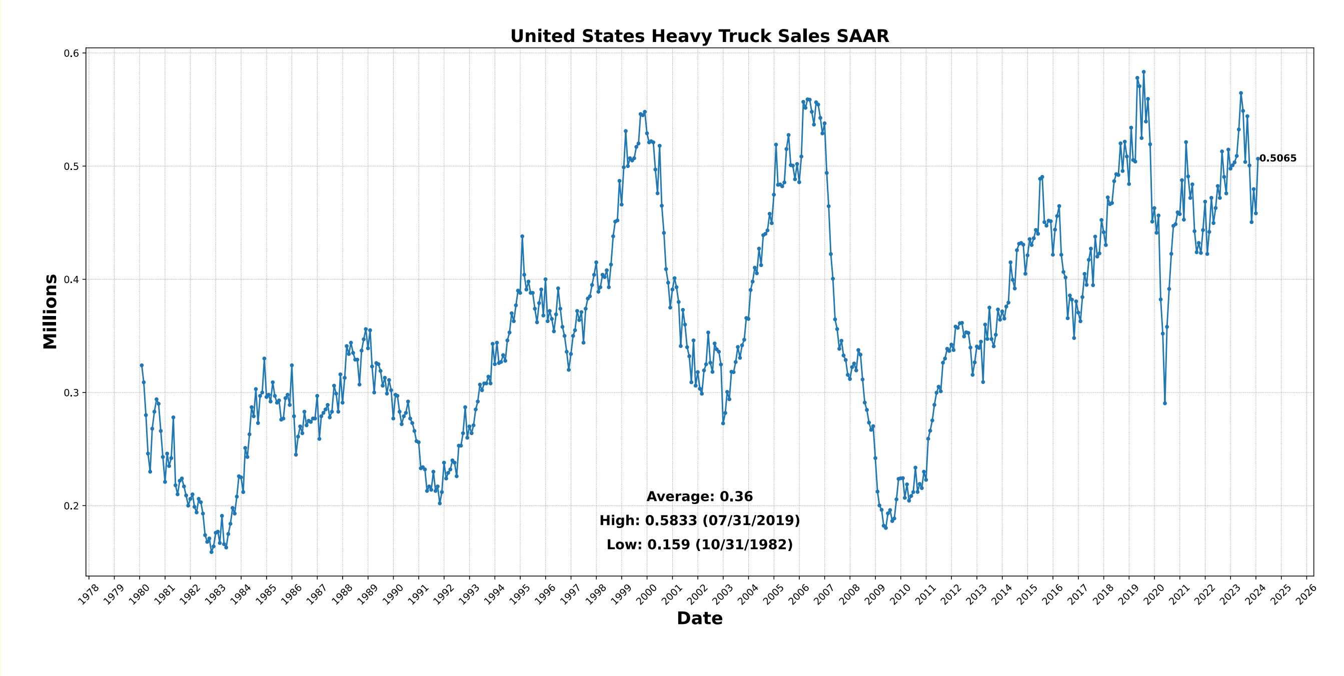
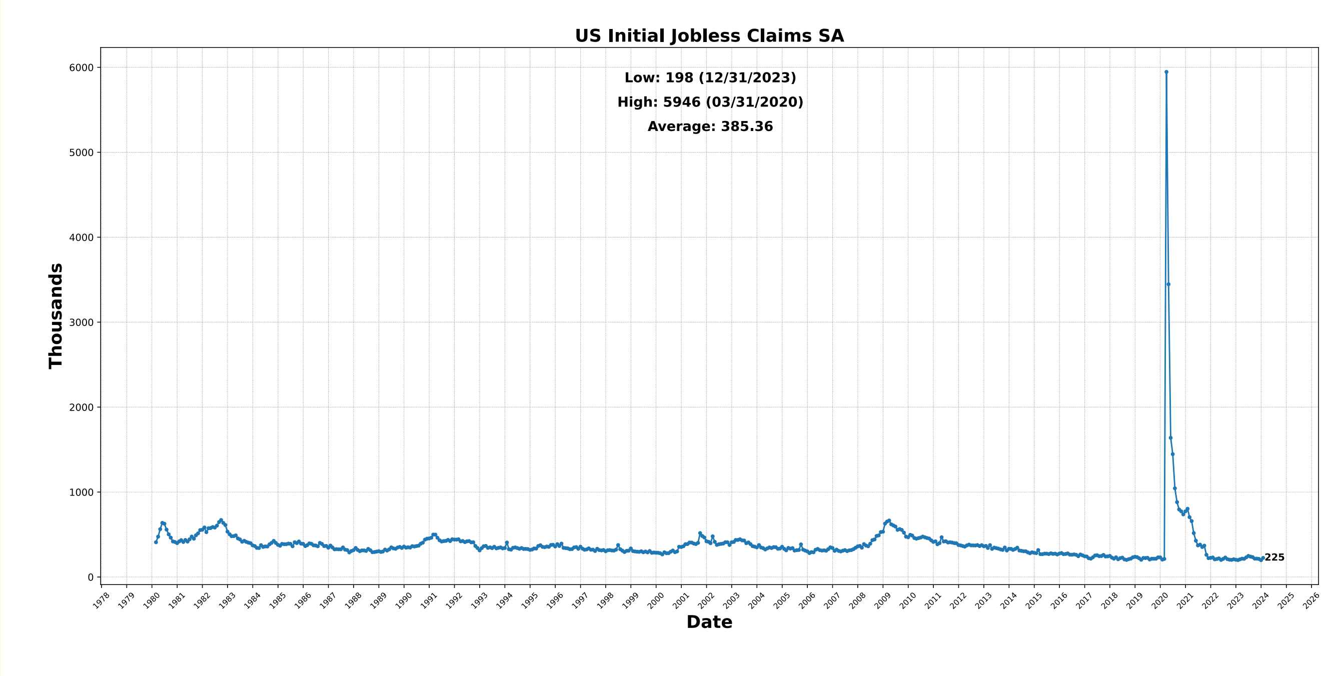
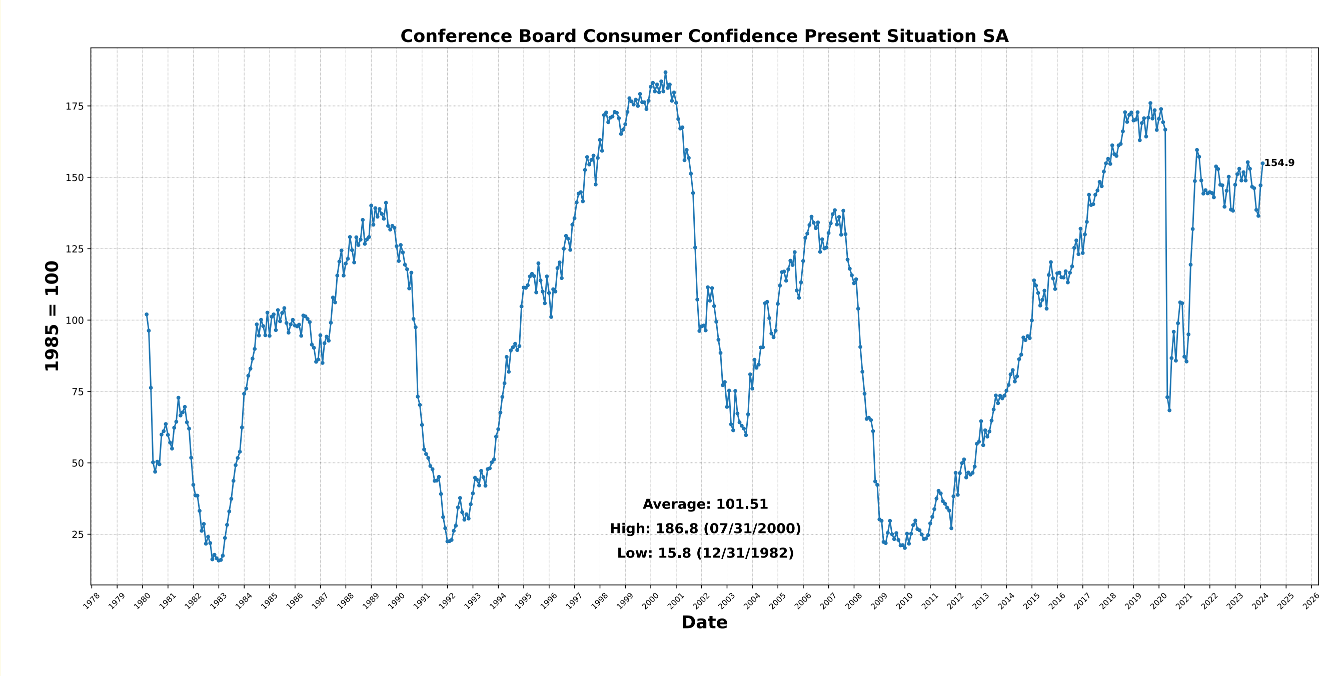
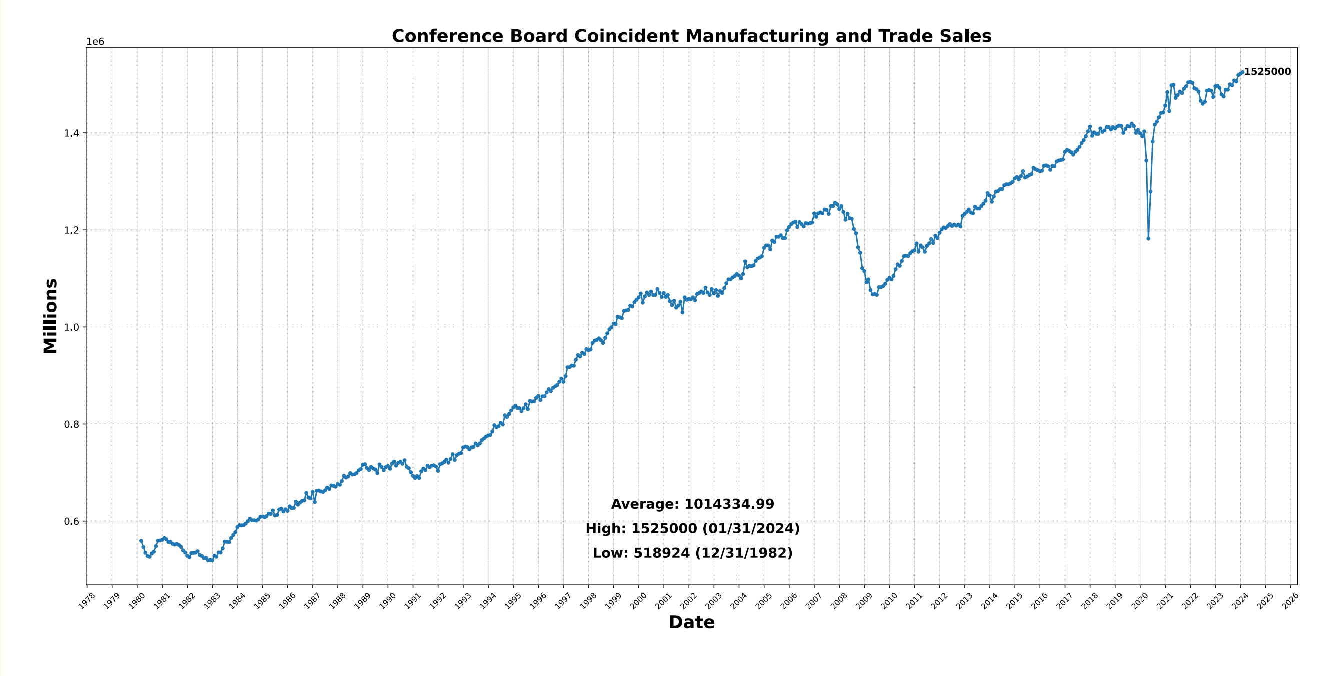




(*Source: Bloomberg Finance, LP*)

Roughly Coincident Indicators





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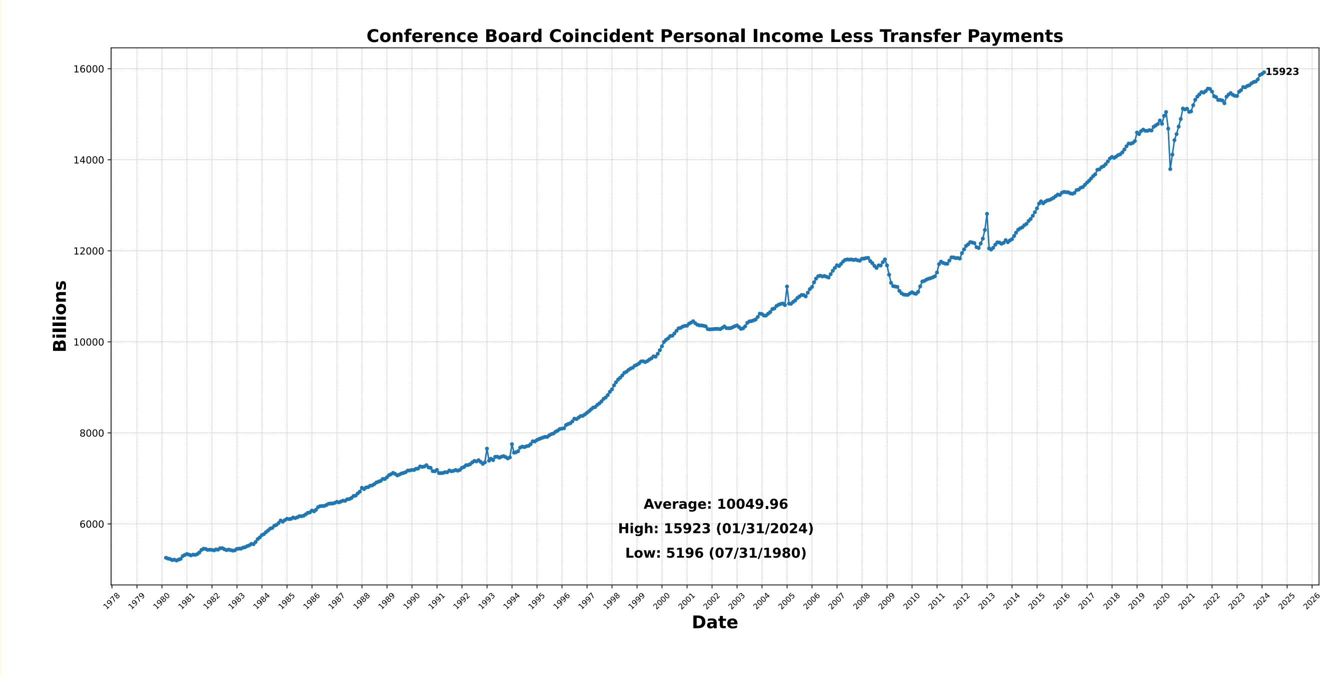

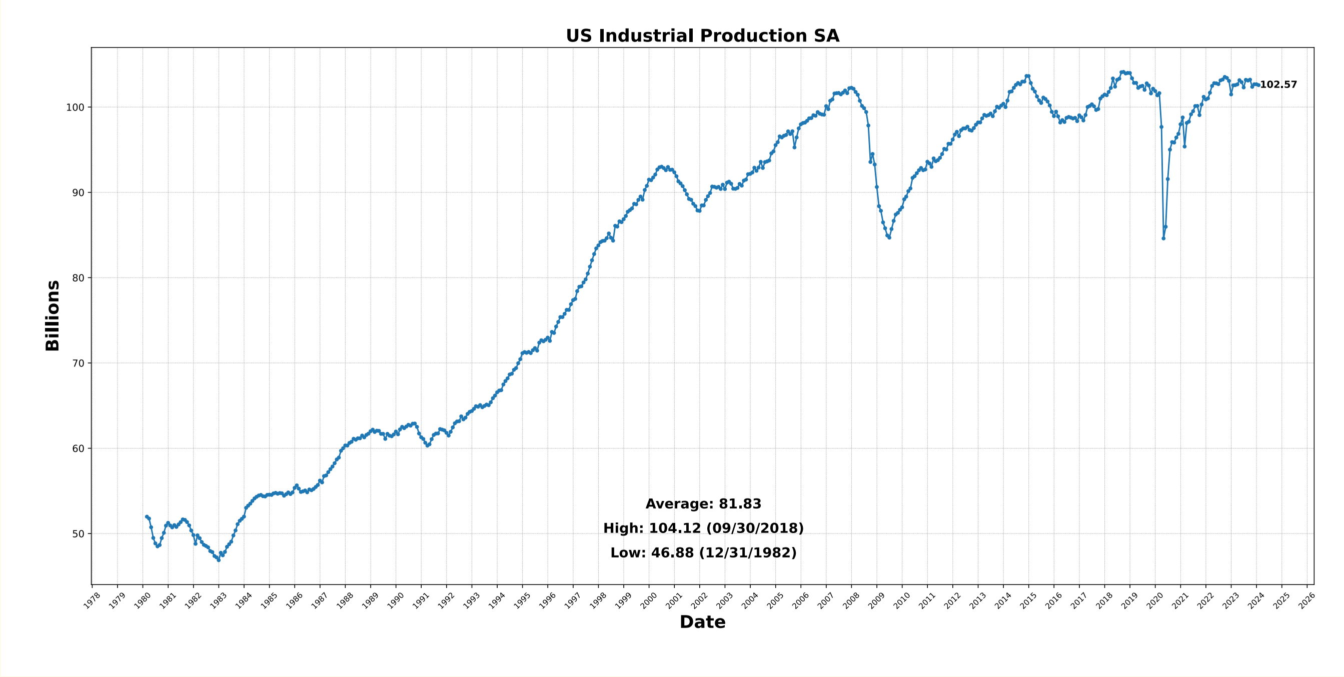

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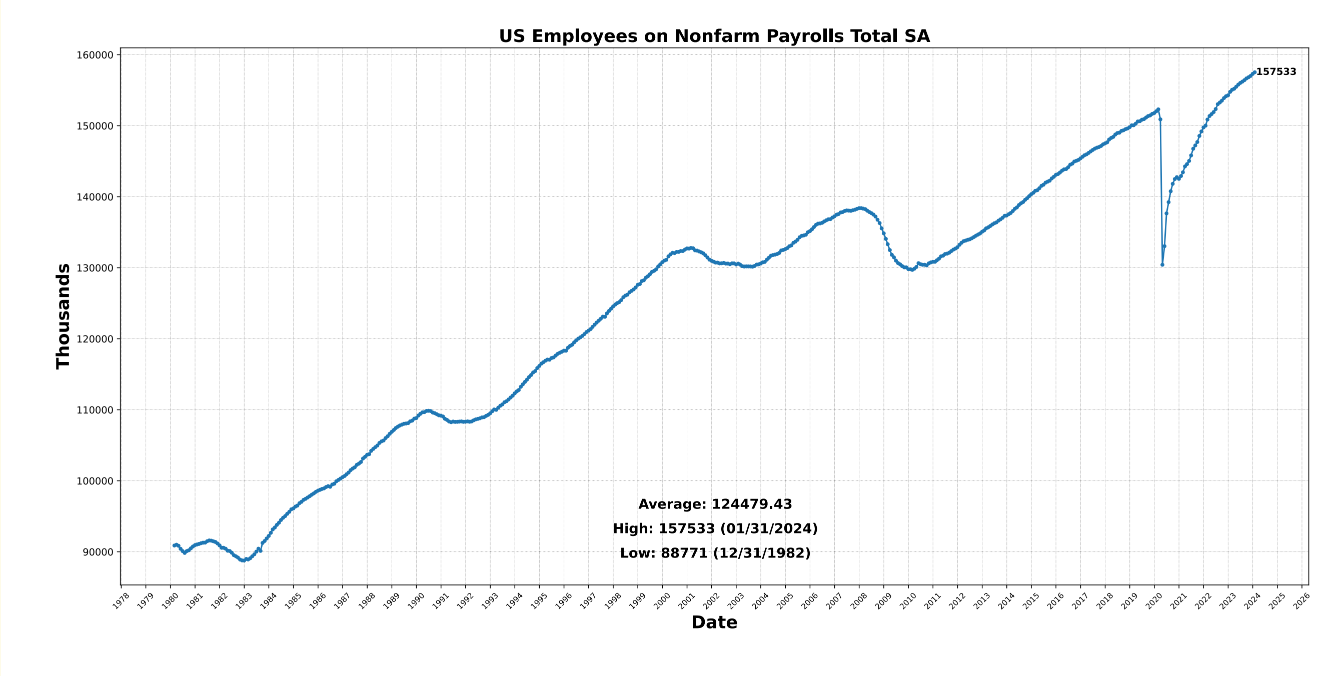
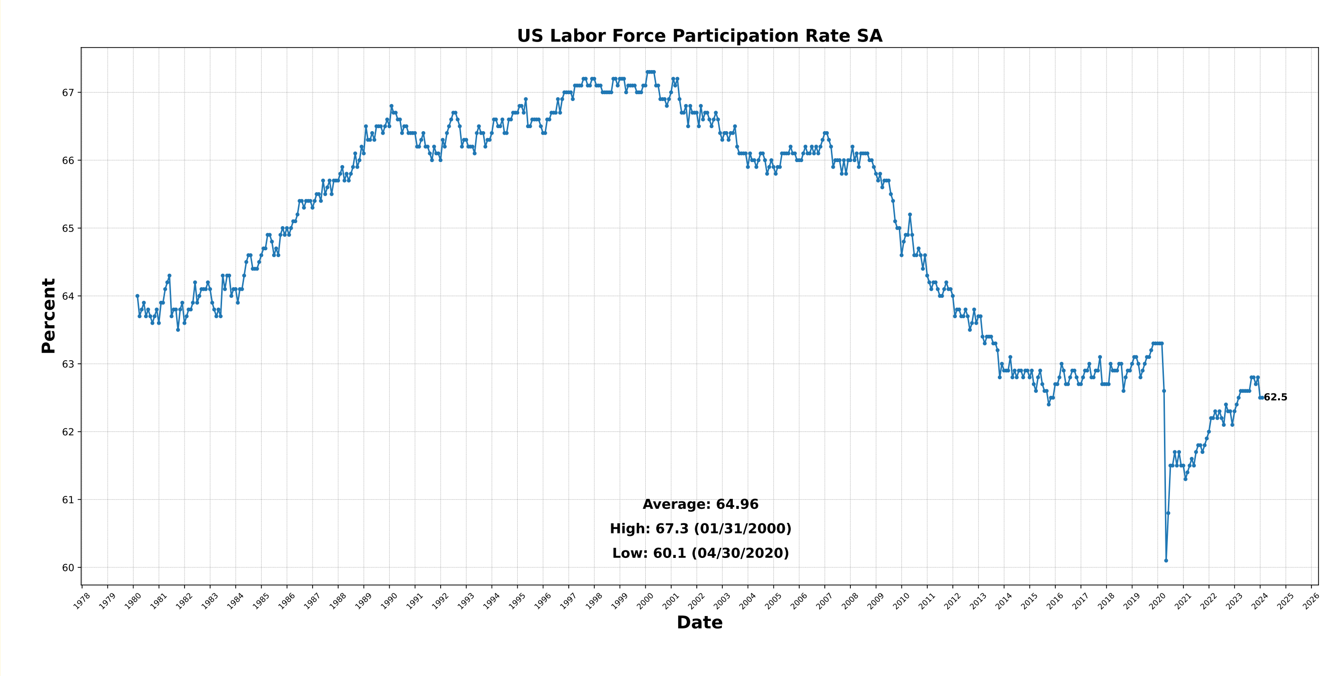
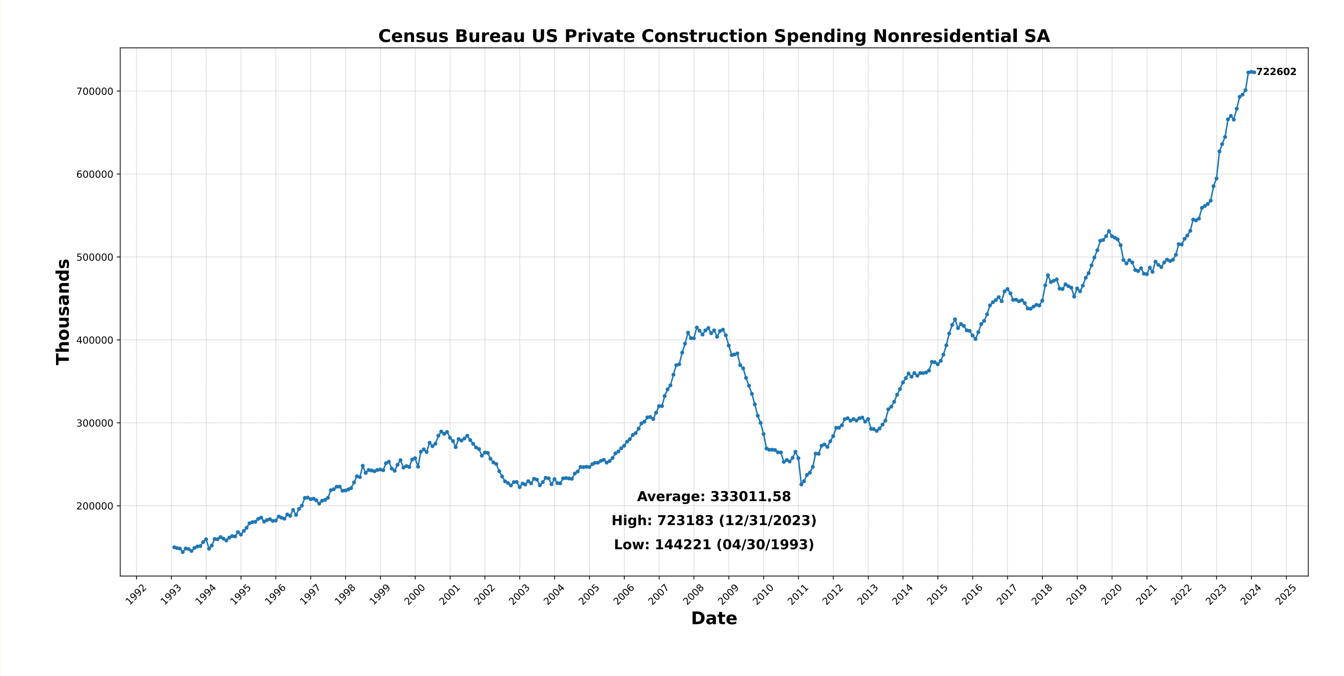
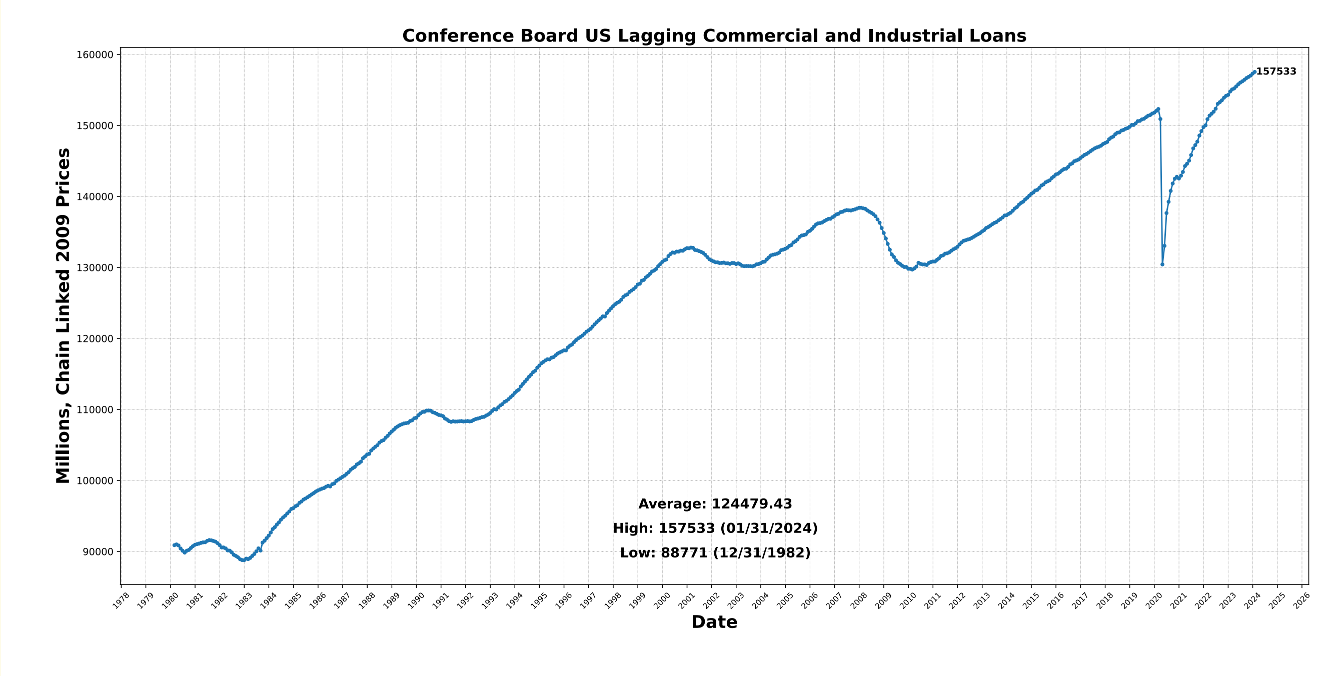




(Source: Bloomberg Finance, LP)

Lagging Indicators





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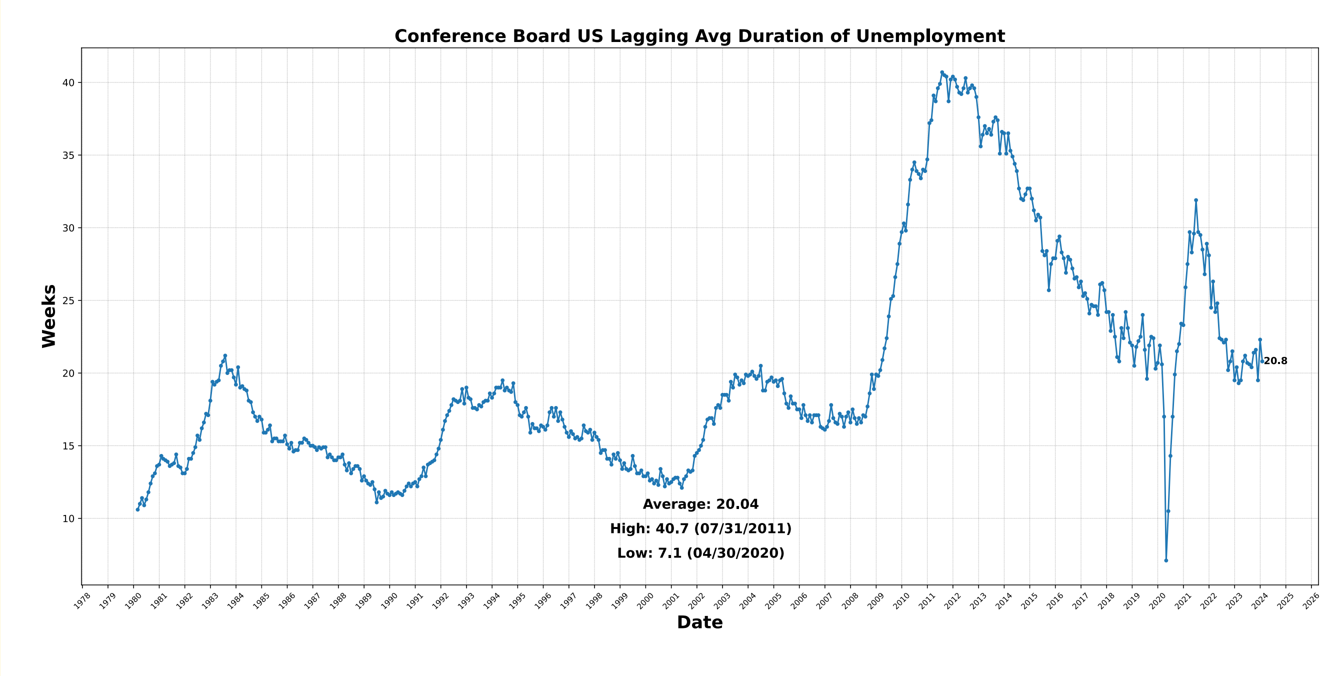

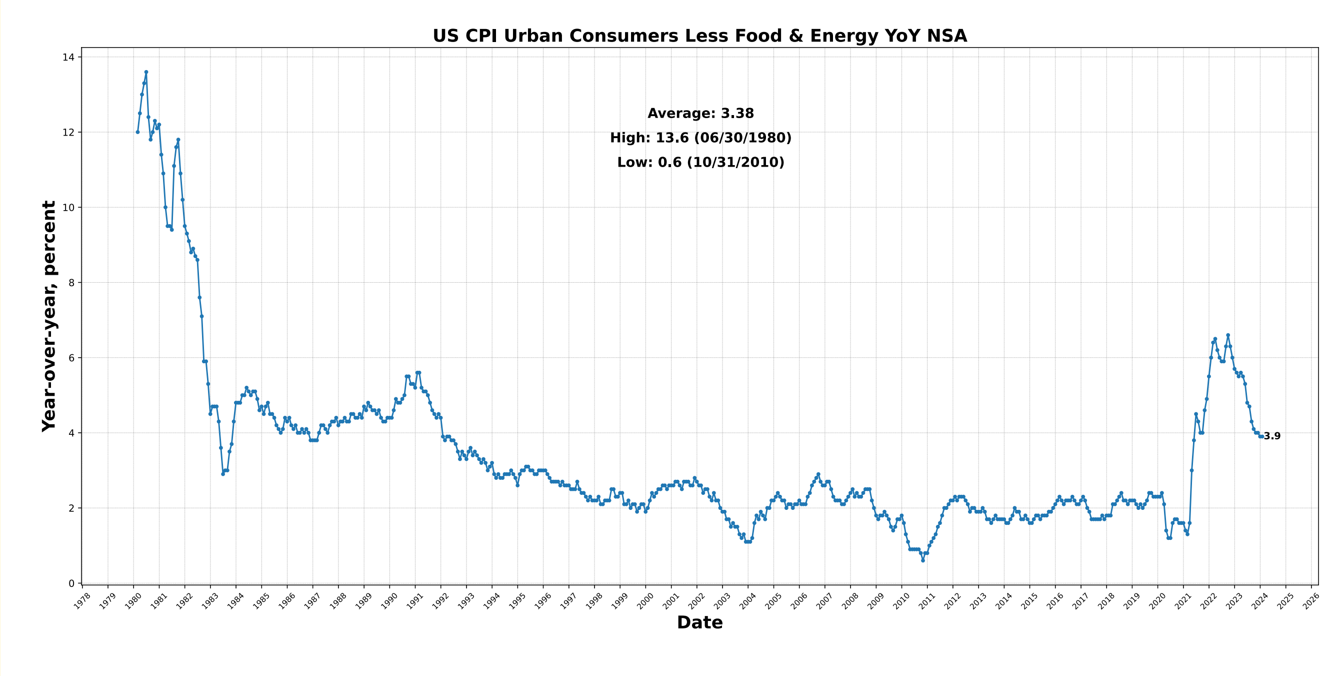

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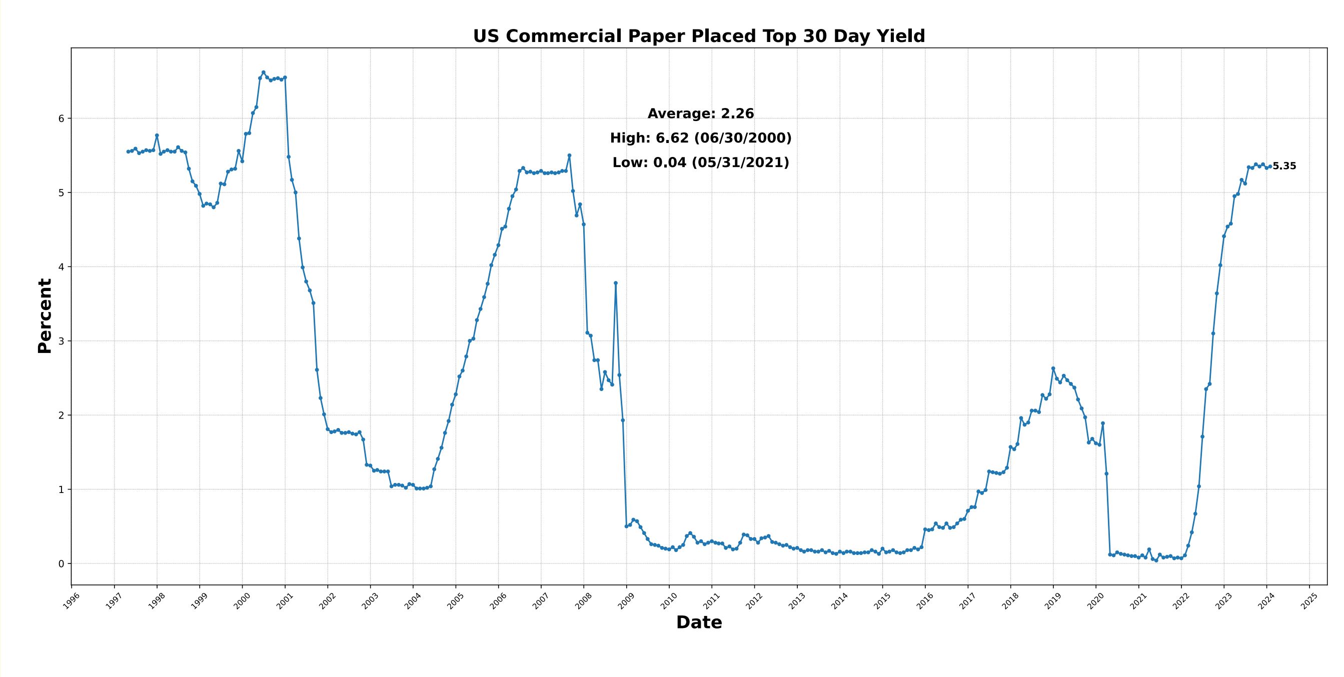
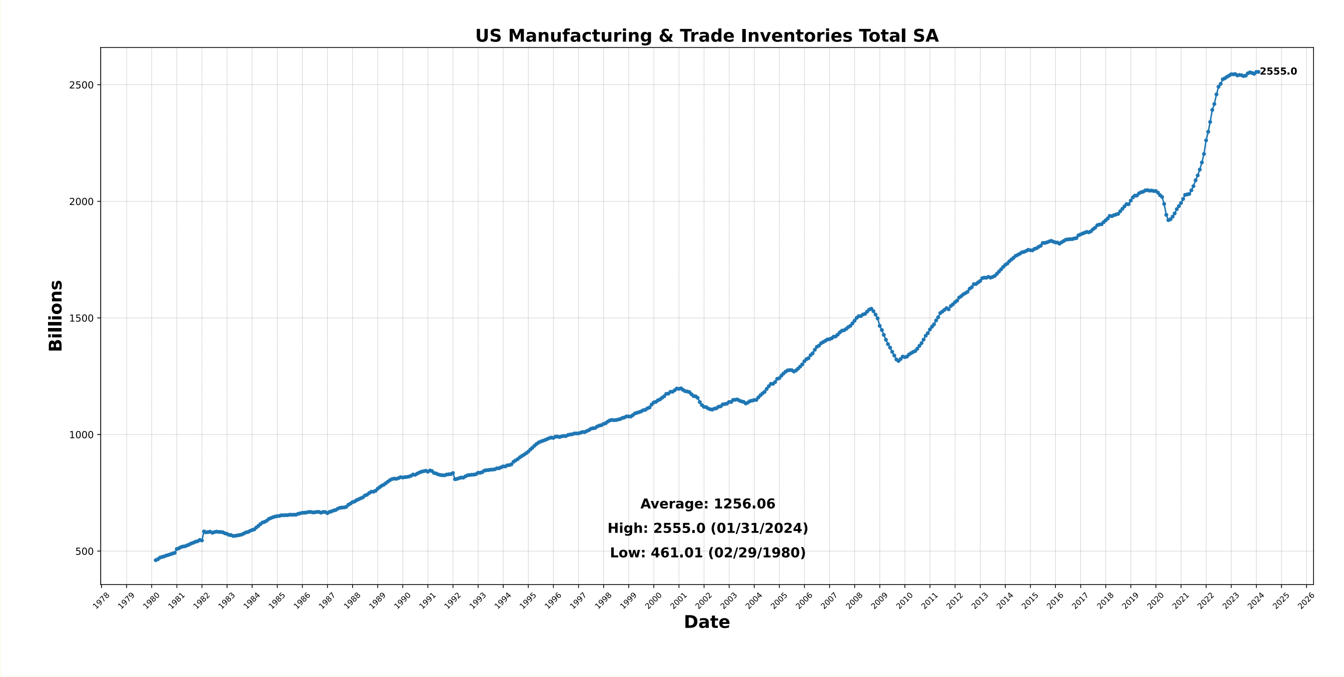




(Source: Bloomberg Finance, LP)

Capital Market Performance

SPR		S&P 1500 Composite Index	+4.15%	+9.92%	+30.19%	10.8211	14.2950	12.3434
SPXT	d	S&P 500 Total Return	+4.21%	+10.61%	+33.13%	11.5029	14.7161	12.6862
SPX	d	S&P 500 INDEX	+4.15%	+10.29%	+31.14%	11.4826	14.6973	12.6706
MID	d	S&P 400 MIDCAP INDEX	+4.94%	+7.48%	+22.06%	5.5811	10.8369	9.3974
RTY	d	RUSSELL 2000 INDEX	+1.68%	+2.78%	+16.78%	-2.5232	6.9377	7.0982
SXXP	d	STXE 600 (EUR) Pr	+2.75%	+5.76%	+14.72%	9.5184	9.0455	7.4125
TLT US	d	ISHARES 20+YR TR	+.41%	-6.37%	-11.98%	-9.3645	-3.0496	.9969
QLTA US	d	ISHARES AAA - A	+.03%	-1.86%	-.10%	-2.3122	1.0037	1.9487
CRY	d	TR/CC CRB ER Index	+5.95%	+7.68%	+12.42%	14.9499	9.1306	-.9426
XAU		Gold Spot $/Oz	+6.61%	+6.24%	+9.06%			
XAG		Silver Spot $/Oz	+8.49%	+3.36%	+10.71%			
ILMBNAVG		Bankrate 30Y Mortgage Rates Na	-1.92%	+.99%	+2.58%			
ILMINAVG		Bankrate 15Y Mortgage Rates Na	-.76%	+2.18%	+6.31%			
MB301ARM		5 Year ARM	+.48%	—	+13.44%			
ILA3NAVG		Bankrate 30Y Fixe Mtg Refis Na	—	+2.21%	+16.44%			

A Tale of Two Economies

Paul Mueller
Senior Research Fellow

Is this the best economy or the worst economy? It depends on who you ask.

Many people say that the US economy is doing great. We have had record stock prices, modest GDP growth, low unemployment, and falling inflation. Current economic forecasts have grown more positive and consumer sentiment has improved. Even real wages, which fell during the high inflation of 2021 and 2022, have begun recovering. Not only is official unemployment low, but labor force participation has also been recovering from its low after the disastrous COVID policy in 2020.

Given the dire predictions and expectations of most economists (me included), 2023 was a good year for the economy. This is particularly evident if you compare the United States with other developed countries. Europe's growth was slow. Many other developing countries had subdued growth in 2023.

So, reporters can be forgiven for their optimistic and positive views of the US economy. The macro data from 2023 looks pretty good, and the storm clouds seem to have receded. But there are also reasons to suspect that we may be in the eye of the storm, not in its rearview mirror.

The tale of two economies involves the widely varying experiences of different people. Those who own assets like houses or stocks saw a dramatic increase in their wealth over the past three and a half years — over $12 trillion in house equity and almost a doubling of stock prices. And professionals who are more likely to have jobs in industries receiving billions of dollars of government largesse have also seen healthy wage increases. But millions of Americans have not seen these gains. They have only seen higher prices.

And from their standpoint, this is the worst of economies.

One issue is distress in the commercial real estate market. Office occupancy has still not recovered to pre-pandemic levels in most places — and in badly governed cities like San Francisco and Chicago, it may not recover for decades. Companies that bought and financed commercial buildings before 2020 have been struggling with their loan payments — especially those that have floating rate debt or balloon payments requiring refinancing. The financial woes of commercial real estate companies can quickly become financial woes of the regional banks who lent them trillions of dollars in the first place and could be left holding the bag of depreciated office buildings.

Government spending will also become a drag on the economy soon. Artificial economic stimulus through massive spending bills like the Inflation Reduction Act (infrastructure bill), CHIPS Act, and others will taper off as the months go by. But politicians and bureaucrats don't have a magical crystal ball telling them which projects, technology, or companies will be successful. Much of this extra spending, while billed as investment, will likely end up wasted on inefficient companies and unproductive projects.

This connects to another future drag on economic growth: government deficits and debt. It's no secret that US national debt has been growing at an alarming rate over the past two decades. In an era of high interest rates, that growing federal debt has become a big problem for government budgets. Last year the US government spent about $875 billion dollars in interest on the debt. That's more than the federal government spent in its entirety in 1983. There are three possible resolution scenarios to federal government borrowing and spending — none of them good for economic growth in the near term.

Congress could continue to spend trillions of dollars more than they receive in tax revenue. That will make interest rates rise even higher and reduce how much companies invest as more dollars flow to the federal government. Less investment means less growth.

Alternatively, the Federal Reserve could step in to keep interest rates from rising by buying large amounts of government debt with newly created money. While reducing the drag of higher interest rates on investment spending, this Fed intervention would cause inflation to rise. Although high international demand for dollars offers some protection against inflationary pressure, we saw the limits of this protection in 2021 and 2022 after dramatic monetary expansion.

A third potential scenario involves austerity. Congress could muster the will to tighten its belt and reign in spending. Such austerity would likely slow the economy temporarily as companies adjust to the spigot of federal dollars being turned off. Over time, though, less federal spending will create more room for private sector investment and production. While these three scenarios have different long-term effects, none of them look good for the economy over the next 12-24 months.

These two economies are unlikely to coexist for long. One of these "economies" will come to dominate in 2024. Either the low unemployment, falling inflation rate, and expanding real output economy will lead to real wage gains, smaller government deficits, and reductions in household indebtedness…or imploding commercial real estate portfolios, pinching credit card debt interest, and runaway federal debt will drag the real economy down causing unemployment to rise, growth to slow, and stock prices to retreat.

Has the storm passed or are we in the eye of it? If only we had a crystal ball…

– February 12, 2024

Public Choice Sheds Light on the Bipartisan Tax Deal

Thomas Savidge
Research Fellow

At the end of January, the House of Representatives passed the Tax Relief for American Families and Workers Act of 2024 with bipartisan support and it is now onto the Senate. Despite the bill's name, it does not help the average American. Instead, it creates carve outs for specific interest groups and further complicates the tax code. A better tax bill would have simplified the tax code and lowered income taxes to help Americans keep more of what they earn.

Of course, we do not live in the ideal world. This bipartisan tax bill (as most other bills) is the result of logrolling, the practice of trading votes. For better or worse, logrolling is a part of the democratic process and understanding how it works can shed light on why certain political outcomes occur.

Logrolling for Desired Outcomes

The bipartisan tax bill created, restored, and increased numerous deductions for both personal and corporate income taxes. Deductions sound nice, but deductions further complicate the tax code while concentrating benefits for specific groups of Americans and dispersing costs.

Among several other deductions, this tax bill restored two major business deductions (pushed by the right side of the aisle) and increased the child tax credit (pushed by the left side of the aisle, but also favored by certain Republican members) through 2025. The bill also provides a laundry list of new deductions, such as business deductions based on EBITDA (earnings before interest, taxes, depreciation, and amortization) as well as increased the low-income housing tax credit (LIHTC). There was even a promise made to New York Republicans to discuss removing the cap on the State and Local Tax (SALT) deduction. Members of Congress on both sides of the aisle got desired deductions in the bill, but no one got everything he or she wanted.

This is a textbook example of logrolling. Elected officials on either side of the aisle are willing to offer concessions to the other side in exchange for a desired policy in return. The legislative process runs on compromise. A member of congress would rather get part of what he or she wants than get nothing and face potential backlash from voters at the polls. Logrolling, however, can result in voter confusion. If voters notice their representative engaging in logrolling often enough, the elected official may come off as unprincipled.

Unfortunately, the more government increases its scope of authority, the more logrolling will occur, resulting in greater voter confusion.

The logic of collective action can also explain why elected officials have an incentive to cater to the smaller interest groups that benefit from expanded deductions instead of lowering tax rates for all Americans. According to the logic of collective action, small homogenous groups with strong communities of interest have greater stakes in favorable policy decisions, can organize at lower costs, and can more successfully control free riding when it comes to taxes and spending than the population at large. Elected officials will cater to these smaller groups' demands with the hopes that doing so will aid their reelection.

A "Tax Relief" Bill That is Not Relieving

Outside of the halls of Congress, ordinary Americans are no better off than they were before. These deductions concentrate benefits to those eligible to claim those deductions and disperse the costs to everyone else. Even if a family or business owner is eligible for the new deductions, there is still the risk of being audited. The IRS promises to ramp up enforcement this tax season, with thousands of new IRS agents and using AI to check compliance. If these deductions take effect, the IRS will be making compliance checks on those who claim them.

These deductions further complicate the tax code and increase uncertainty because these deductions are set to expire at the end of 2025. The complexity of the tax code is already dizzying to Americans. A recent survey found that **35 percent** of Americans are worried about filing their taxes incorrectly, **37 percent** are struggling to understand what deductions to take, and **29 percent** are afraid of being audited. It is not just the average American that feels this way. Former Secretary of Defense Donald Rumsfeld wrote to the IRS in 2014, stating:

> *The tax code is so complex and the forms so complicated, that I know that I cannot have any confidence that I know what is being requested and therefore I cannot and do not know, and I suspect a great many Americans cannot know, whether or not their tax returns are accurate.*

Adding and temporarily changing deductions will bring greater stress, not relief.

Can We Get Genuine Tax Relief?

If Congress really wanted to give taxpayers relief, it could have let Americans keep more of the money they earn. Instead of having Americans jumping through hurdles to claim deductions with the hope of getting some of their money back, it would be better for the government to not take the money in the first place.

Ideally, Congress would vote to simplify the tax code. Instead of seven tax brackets and a myriad of deductions, switch to a flat income tax. This will reduce the anxiety Americans feel every year when filing their taxes. Instead, they will pay a flat rate and be able to file their taxes on a postcard. It would also be ideal for the federal government to keep the rate low. Research also shows income taxes are the most harmful tax for economic growth, so getting personal and corporate income taxes as close to zero as possible would help Americans.

Easier said than done. If the income taxes were repealed, Congress would need to dramatically cut spending to avoid a fiscal crisis, as well as avoid the allures of debt- financed spending and spending through money creation.

The best way to limit the frustrations of logrolling is to limit the scope of government. While it is no small task, the first step to a freer society is understanding how the mechanisms of government work and why policy outcomes occur.

– February 15, 2024

Reforms for West Virginia's Future

William Ruger
President

Jason Sorens
Senior Research Fellow

Recently, we spoke at the West Virginia State Capitol to a group of legislators and policy wonks, in collaboration with the Cardinal Institute, the state's new free-market think-tank. Our topic was the lessons of Freedom in the 50 States for West Virginia.

West Virginia scored 32nd on freedom in the latest edition of *Freedom in the 50 States*. This is a problem because our research shows that a one-unit increase in economic freedom drives a 1.2-to-**1.8 percentage**-point increase in real (inflation-adjusted) personal income growth the following year. Taking the midpoint of that range, that means if two states start out with economies of the same size, but one has a one-point advantage on economic freedom over the other, the first state will double the size of the second state's economy in about 47 years.

West Virginia's economy has been stagnant for a long time, but there are signs that recent reforms are starting to turn that around. West Virginia enjoyed the third-best improvement on freedom out of all 50 states since the end of 2020. And perhaps not coincidentally, it has now started to enjoy net migration in-flows.

There's still more the Mountain State (#32) could do, especially since some of its neighbors — especially Pennsylvania (#18), Virginia (#12), and Ohio (#21) — do a lot better on freedom.

We recently visited West Virginia's state capitol in Charleston to talk to legislators and the public about our study and the policy opportunities that could promote freedom and free enterprise, as well as the economic growth these create.

We argued that the number one area West Virginia could work on is fiscal policy, where the state scored 37th. The legislature did enact a big income tax cut in 2023, which should help with scores in future editions (the current index is good as of the beginning of 2023). But West Virginia also has high government spending at the state and local levels, high public employment, and debt, all of which suck resources out of the more productive private sector.

It's hard to turn around a state budget overnight. It takes commitment to finding efficiencies, moving functions to the private sector, and setting up rules that will restrain spending for the long term.

One of the things West Virginia could start doing right away is downsizing the government workforce. State government employment as a share of total employment is more than twice as high in West Virginia as in the US as a whole. And local government employment is also higher than the US ratio.

To find out where cuts might work best, we dug into the data to find out why public sector employment is so big in West Virginia. We found that West Virginia is the fourth-highest- spending state on highways in the US, as a share of personal income. The only states higher are Alaska, and North and South Dakota. Other rural, mountainous states like Vermont, Montana, and Wyoming are a lot lower. And we found that state and local government employment in highways, again as a share of total employment, is three times the national average.

The other area where spending and employment are high is "general administration." West Virginia is the fifth-highest-spending state in that category. To us that sounds like inefficiency. Is West Virginia a noticeably better-administered state than others for all its extra spending and employment in this area? It doesn't seem like it.

Finally, the growth of non-instructional staff in elementary and secondary schools has been a major driver of escalating public education costs everywhere, but in West Virginia the problem is especially acute, with the percentage of local employees in this category well above the national average. Again, this figure suggests slack or inefficiency in the system rather than high-quality services.

While most states have seen their debt-to-income ratios come down over time, West Virginia also has a stubborn debt problem. The state and local debt to income ratio is over **21 percent**, while the liquid assets of governments in the state are only **13 percent** of income. States that have enough liquid assets to cover their debt have significantly better credit ratings, our research shows, allowing them to pay lower interest rates on bonds.

Getting government spending and employment under control will allow the Mountain State to improve its debt and assets position and reduce the stream of future tax revenues going to (mostly out-of-state) creditors.

We also found plenty of inefficient government regulations West Virginia could eliminate. Certificate of need (CON) laws and outright moratoriums blocking the development of medical facilities are near the top of that list. Hospitals are a powerful lobby in every state, and it's understandable that they want to keep competition out. But that's bad for consumers — and for state government as a purchaser of medical services for its own workforce.

Lobbyists will sometimes defend CON laws as protection from new medical facilities "cherry-picking" patients covered by private insurance, which pays higher rates than

Medicaid. But using regulations to block such "cherry-picking" doesn't reduce *actual* costs; it just hides them. It forces non-Medicaid patients — that is, most of us — to pay a hidden tax on our treatments. Meanwhile, it reduces medical competition and innovation.

West Virginia scores badly on protecting private property from civil asset forfeiture. Currently, law enforcement officers get *100 percent* of the proceeds from auctioning off property they have seized, giving them a strong incentive to seize more property. And innocent owners have to *prove* their innocence, rather than putting the burden of proof where it belongs, on the government. No criminal conviction is required. West Virginia needs asset forfeiture reform.

West Virginia also scores below average on occupational freedom. The state doesn't let nurse practitioners prescribe treatment without physician supervision, as many other states do. The state licenses a number of occupations some other states don't, like sign language interpreter, sanitarian, clinical lab technologist, veterinary tech, athletic trainer, and well driller.

West Virginia is also one of those states with a silly combination of anti-price-gouging and sales-below-cost laws. Retailers can run afoul of the former if they price their goods too high, and of the latter if they price their goods too low! Economists hate these laws because they impede the functioning of the price system to attract goods where they're needed most.

In short, West Virginia has a lot of policy areas where it could improve. Right now, you could say the state is mired in the economic theories and nostrums of the past, a Great- Depression-era philosophy of government jobs and "managed" competition. Fortunately, legislators have started to shake off the slough of interventionism in recent years, and they should keep at it. In a few years, West Virginia could have all the right policy conditions for an economic Golden Age.

– February 15, 2024

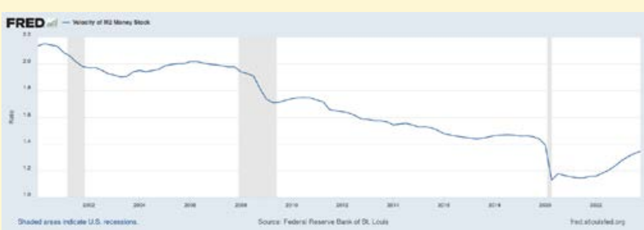
Congress Overspends, but the Fed Inflates

Alexander William Salter
Senior Fellow, Sound Money Project

Writing in *The American Conservative*, Rep. Josh Brecheen (R-OK) recently blamed inflation on irresponsible fiscal policy. He cites a barrage of statistics on the magnitude of the national debt, the looming insolvency of Social Security and Medicare, and the burdens high prices create for American households. Rep. Brecheen is partly right: perpetual deficits are bad for the economy, as well as for constitutional self-governance. But runaway deficits are not the primary cause of inflation. The Fed, not Congress and the President, is the chief culprit.

The connection between government spending and inflation seems obvious. Fiscal policy affects aggregate demand by changing total dollar-valued spending in the economy. If the government ratchets up spending, financed by borrowing, that should inject a new flow of funds into the national income stream. This is standard income-expenditure Keynesianism — and it's wrong. We know this from history. Remember, the deficit increased significantly under Presidents Reagan and Obama. Inflation remained relatively static.

As Clark Warburton described it 80 years ago, deficit spending can increase dollar-valued national income only if it increases a) the rate of spending (velocity) for a given money supply or b) the money supply itself. Let's consider each in turn.



Deficits and Velocity

Deficit spending influences the rate of money turnover, which economists call the velocity of money. But its effects are small. Interest rates are the most probable mechanism. All else being equal, if governments are borrowing more to finance deficits, then demand for capital increases. That should push up interest rates. Higher rates, in turn, increase the opportunity cost of holding money. Hence we should see faster spending; velocity goes up.

Empirically, the increase in velocity following an increase in deficit spending appears to be small. It certainly does not explain high inflation from late 2021 to early 2023. Velocity declined sharply amid the uncertainty of the first two quarters of 2020. Although it picked up in 2022, it remains below its Q4-2019 level.

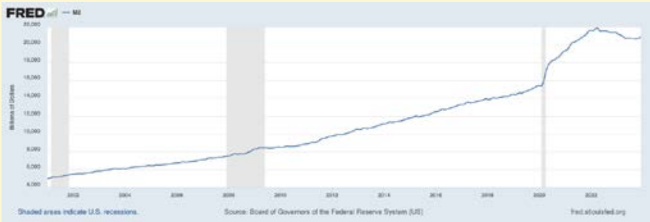
Deficits and the Money Supply

The extent to which deficits increase the money supply, if at all, depends on how the buyers of government bonds finance their purchases. If it's spent out of existing cash balances (either by households or businesses), the money supply doesn't change. But if the banking system expands its liabilities to purchase the bonds, the money supply grows. This effect is noteworthy. As Warburton showed, the government's overall fiscal stance had little power to explain dollar-valued national income, and hence inflation. But the money supply could.

Even traditional fiscal operations have a monetary mechanism.

Much has changed since Warburton's day, of course. Financial innovation destabilized the velocity of several common measures of the money supply, leading the economics profession to sour on monetarism. (But as economists such as Peter Ireland and Joshua Hendrickson have shown, velocity for the Divisia monetary aggregates, which weight money-supply components based on liquidity, remain quite stable and predictive of aggregate demand.) Monetary economists pay much more attention to interest rates. They shouldn't; the money supply still matters most, especially when we consider Fed policy.

Everybody knows Washington spent an incredible amount of money during the COVID-19 response years. Everybody also knows the Fed massively increased its holdings of government bonds during the same period. In 2019, the deficit was just under $1 trillion; it ballooned to more than $3 trillion the next year. Over the same period, Fed holdings of Treasury debt rose from just over $2 trillion to nearly $4.75 trillion and peaked at just shy of $5.75 trillion in Summer 2022. As a result, the M2 money supply exploded from $15 trillion to almost $20 trillion at the end of 2020, reaching a maximum of $21.7 trillion in March 2022. As noted above, velocity declined over this interval, but only by about **15 percent**. The money supply increase was roughly **40 percent**. Consequently, inflation was higher than it had been for a generation.



At most, large deficits impelled the Fed to support the market for government debt by purchasing more debt than it should have. The central bank, not the fiscal authorities, is the residual determiner of aggregate demand. We can quibble with certain details — for example, Warburton's Fed adhered to a pseudo-gold standard whereas ours is pure fiat — but the basic relationship between money, dollar-valued national spending, and inflation remains the same as in Warburton's days.

Deficits are bad for the economy because they transfer resources from the productive private sector to the unproductive public sector. Deficits are bad for self-governance because they transgress a basic small-r republican commitment: not to saddle future generations with crippling debt before they are even old enough to vote. Rep. Brecheen is absolutely right to rail against fiscal follies. But he has the wrong target in his crosshairs if he's concerned about inflation. Rather than pile on the feckless Biden administration, whose economic incompetence voters already know, he should raise public awareness about the Fed's monetary mischief and work hard to bring the rule of law to monetary policy.

– February 28, 2024

Is Inflation on the Rise Again?

William J. Luther
Director, AIER's Sound Money Project

Inflation picked up in January, according to the latest data from the Bureau of Economic Analysis (BEA). The Personal Consumption Expenditures Price Index (PCEPI), which is the Federal Reserve's preferred measure of inflation, grew at a continuously compounding annual rate of **4.1 percent** in the first month of the year. The PCEPI has grown at an annualized rate of **1.8 percent** over the last three months and **2.5 percent** over the last six months. Prices today are **8.4 percentage** points higher than they would have been had they grown at an annualized rate of **2.0 percent** since January 2020.

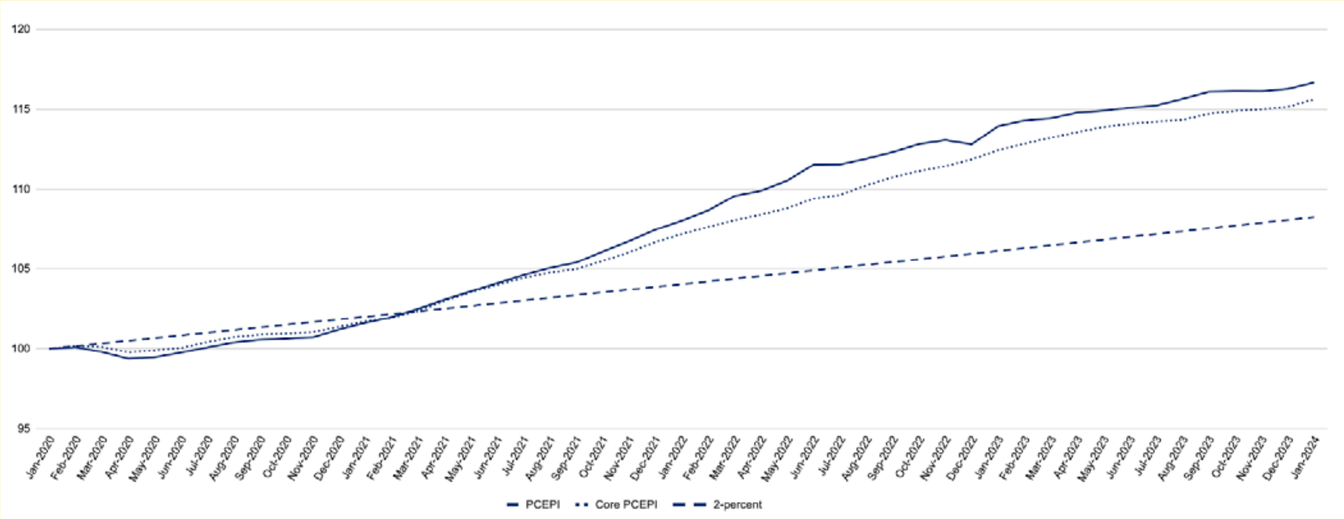


Figure 1. Headline and Core Personal Consumption Expenditures Price Index with 2- percent Trend, January 2020 – January 2024

Core inflation, which excludes volatile food and energy prices, also increased. Core PCEPI grew at a continuously compounding annual rate of **5.0 percent** in January. It has grown at an annualized rate of **2.6 percent** over the last three months and **2.5 percent** over the last six months.

There is no denying that measured inflation increased considerably in January. The question is whether it means inflation will likely be higher than previously expected in the months ahead. There are at least two reasons to think the January uptick is just a blip, and will be followed by much smaller price increases in the months ahead.

First, the increase in inflation was partly due to a surge in imputed prices. Imputed prices are quantified opportunity costs. What didn't happen is not directly observed and, hence, must be estimated. Consider owner-occupied housing. Whereas the price a renter pays his landlord for housing services can be measured, the price an owner implicitly pays herself to live in her own house cannot. Economists at the BEA must estimate the price of owner- occupied housing in order to estimate the general level of prices. Similarly, some services provided by financial and nonprofit institutions serving households are not directly observable.

Although economists at the BEA surely do their best to accurately estimate imputed prices, there is no guarantee that they get it right. Correspondingly, some degree of skepticism is warranted when imputed prices diverge from market prices, as they did in January. Market- based PCE, which is a supplemental measure offered by the BEA, is based on household expenditures for which there are observable prices. It excludes most imputed transactions. The market-based PCE price index grew at a continuously compounding annual rate of **3.1 percent** in January. It has grown at an annualized rate of **1.3 percent** over the last three months and **2.4 percent** over the last six months. Maybe imputed prices are rising more rapidly than observable prices, as estimates suggest. Or, maybe, those estimates are overstating the rise in imputed prices.

Second, the usual seasonal adjustment for January may be insufficient for January 2024. Many prices reset in January, as contracts are renewed at the start of the year. To prevent a spike in CPI inflation each January, the BEA adjusts the data to account for the typical January price increase. This procedure essentially apportions some of the increase in January prices to other months, as if the prices had grown gradually from one month to the next instead of suddenly each January.

Seasonally-adjusting price level data works pretty well in normal times. But, in unusual circumstances, the seasonal adjustment may over- or under-state actual price changes. When prices are rising faster than usual, the seasonal adjustment — which accounts for the usual increase in prices —will not apportion enough of the January price increases to other months. Consequently, the seasonally adjusted price level will tend to overstate inflation in January (and understate inflation in other months). Robin Brooks recently made this point in the context of the Consumer Price Index (CPI), but the argument applies to the PCEPI as well.

Brooks describes the January 2024 uptick in prices as "an echo of last year's start-of-year price resets that made inflation in early 2023 look much worse than it really was." In January 2023, the PCEPI grew at a continuously compounding annual rate of **6.7 percent**. It had grown at an annualized rate of **3.5 percent** over the prior three months and would grow at an annualized rate of **3.0 percent** over the subsequent three months. In hindsight, January 2023 was an outlier. January 2024 looks likely to be an outlier, as well.

Following the January inflation data, most commentators fall into one of two categories: those concerned because they believe we are experiencing a resurgence of inflation, and those unconcerned because they believe the January uptick in inflation is just a blip. In contrast, I believe there is cause for concern even though the January uptick will likely turn out to be just a blip. Why? Because it will likely lead Fed officials to keep monetary policy tighter for longer.

In a recent talk, Fed Governor Christopher Waller said the January inflation data reinforced his "view that we need to verify that the progress on inflation we saw in the last half of 2023 will continue." He said "there is no rush to begin cutting interest rates to normalize monetary policy."

Waller rightly acknowledges that the January increase in inflation "may have been driven by some odd seasonal factors or outsized increases in housing costs." But he errs in thinking "the strength of output and employment growth means that there is no great urgency in easing policy." The available data is historical and monetary policy acts with a lag. To avoid overcorrecting, and pushing the economy into a recession, the Fed must ease monetary policy before the data clearly demonstrates inflation is back down to **2 percent**.

The Fed failed to tighten policy swiftly as inflation picked up in the second half of 2021. Consequently, prices rose much higher than they should have. It has similarly failed to ease policy as inflation returned to its 2-percent target in 2023. The Fed should be looking ahead and adjusting monetary policy in light of its forecasts. Instead, its eyes are fixed on the rearview mirror. Let's hope the Fed adjusts its trajectory before it is too late.

– March 1, 2024

Fed Admits It Was Wrong – Kind Of

Thomas L. Hogan
Senior Research Fellow

During the pandemic recovery, inflation reached the highest rates in 40 years, largely driven by the Federal Reserve's excessive monetary policy. The Fed got "behind the curve" by not raising its interest rate target fast enough, even once it became apparent its own policy was to blame.

While some officials are reluctant to accept it, Fed Chair Jerome Powell now acknowledges the Fed's mistakes. When asked in a recent interview whether the Fed was too slow to recognize inflation in 2021, Chair Powell admitted, "in hindsight, it would've been better to have tightened policy earlier."

In truth, the Fed was not simply too slow to recognize inflation. Rather, it worsened inflation by continuing its monetary expansion even after the negative effects were known.

Transitory Inflation?

From the early pandemic recovery through mid-2021, inflation appeared to be largely caused by supply-chain disruptions, which led to shortages of production inputs like lumber and automotive computer chips. These problems restricted supply and drove up the prices of homes and cars, respectively.

According to Powell, such dislocations led the Fed to misidentify inflation as primarily a supply-side phenomenon. "We saw what we thought was that this inflation, seemed to be mostly limited to the goods sector and to the supply chain story," he said.

If that alone were the issue, inflation would have been only a "transitory" problem that dissipated as the economy recovered and supply problems alleviated. As Powell describes, "we thought that inflation would go away fairly quickly without an intervention by us."

A Rise in the Fall

By the fall of 2021, prices were rising across the economy, not just in supply-constrained sectors. Such broad-based increases seemed to have been caused by excessive monetary policy rather than by supply-side disruptions.

Powell acknowledges this in his recent remarks, noting that "in the fourth quarter of '21, it became clear that inflation was not transitory in the sense that I mentioned."

While the admission is heartening, the Federal Open Market Committee (FOMC) should have realized even before the fourth quarter that rising inflation was increasingly demand- driven.

Powell then adds, "and we pivoted and started tightening." But did they?

It is true that Powell changed his language, saying at the FOMC's November press conference that Fed officials "accept responsibility and accountability for inflation in the medium term," and that, "the level of inflation we have right now is not at all consistent with price stability."

Despite these admissions, however, the Fed was still actively expanding the money supply at that time and did not actually start tightening for another four months.

Although the Fed slowed the rate of its open market purchases in December of 2021, it continued its expansionary quantitative easing (QE) program until mid-March of 2022. The FOMC raised its interest rate target range slightly in March but did not make substantial increases until May, six months after acknowledging its responsibility for high inflation.

In fact, the Fed engaged in a passive monetary expansion through May of 2022 since real interest rates were actually falling. What matters for economic activity is the real interest rate, that is the short-term interest rate minus the rate of inflation. Since inflation was increasing by more than the Fed's target rate from late 2021 through mid-2022, real interest rates were falling.

So rather than starting to tighten policy in the fourth quarter of '21, as Powell described, the Fed was implicitly loosening policy through May of '22.

Lessons Not Learned

Powell credits the Fed's actions for bringing inflation back down towards the Fed's two percent target. "It's essential that we did that," he said in his recent interview. "It was critical that we did that. And that's part of the story why inflation's going down now."

While it is true that the Fed's actions helped bring inflation down, it is hard to give Fed officials too much credit: they solved a problem they created. Had the Fed started tightening in late 2021, as Powell claims, it could have prevented inflation from surging. Instead, officials pushed it to the highest rates in 40 years.

While it is notable that Powell admits the Fed was too slow in identifying monetary policy as a cause of inflation, we should recognize that the Fed failed to act for several months after this problem was known. We can hope that acknowledging this mistake will improve Fed policy by helping prevent such errors in the future.

– March 5, 2024

High Costs, Greenlash Hit Europe

Nikolai G. Wenzel
Associate Research Fellow

The eyes of the world may be on the US presidential election. But another, usually sleepy campaign is underway: European Parliament elections in June 2024. Most of the action takes place in the executive and bureaucracy (the European Commission). But Parliament must approve laws. This could have interesting results for the European Union (EU) Green Deal.

The Green Deal was first implemented in 2019, with a series of environmental measures. Most notably, the EU committed to cutting CO2 emissions by **55 percent** by 2030. The EU is set to push for carbon neutrality by 2050, a measure that will require approval from the newly installed parliament. But, since the summer of 2023, the Green Deal has been on regulatory pause, as the EU faces a "greenlash" against environmental policies. In the face of inflation, consumers and trade groups are starting to resent the cost of environmental regulation. Over the past few months, proposals on industrial pollution, pesticide restrictions, and conservation have all been tabled at the EU level. A ban on new combustion engines, effective 2035, still stands, but it is facing increasing resistance.

The pushback against the EU Green Deal started at the national level. Italy's right-wing government is pushing back against the 2030 emissions goals and building efficiency regulations (although it is still willing to accept EU green subsidies to clean up its electrical grid). Dutch farmers have been protesting against nitrogen curbs. Last August, Poland filed suit against the European Commission in the European Court of Justice, claiming that the 2030 emissions goals were unconstitutional (earlier this month, the new prime minister announced that Poland would be withdrawing the suit). German voters rejected a summer 2023 law that would have mandated **65 percent** renewable energy for building heating, and they are pushing back against efforts to ban cars inside the country's biggest cities.

Recently elected political parties in Finland, Luxembourg, the Netherlands, and Sweden have already bruited opposition to further environmental mandates.

In the past few months, farmers in France, the Netherlands, and Spain have used their tractors to block highways in protest of higher costs and regulations. The center-right European People's Party (EPP), which has traditionally defended business and rural interests, has taken note. Although it initially supported the Green Deal, the EPP has started to grow less enthusiastic about it. The EPP is the largest political party in the EU Parliament; polls indicate that it, along with harder right parties and the euroskeptic European Conservatives and Reformist group (ECR) will make gains. In light of the overall mood, the future of the Green Party is uncertain; the party, which held a mere **6 percent** of seats in the 2004 election, inched its way up to **10 percent** in the 2019 election. Recent polls indicate the Greens will take a drubbing at the polls in June.

To an economist, it is tempting to remind voters, once again, that There Ain't No Such Thing as a Free Lunch (fortunately, the readers of these pages, who already know this principle from the writings of Robert Heinlein or Milton Friedman, need no such reminder). Like any other good, environmental protection has an opportunity cost: in expenses, of course, but also in growth and innovation. Surveys indicate that the majority of Europeans support green laws; however, a majority is also increasingly worried about the cost.

Despite funding pressure from governments and social shaming from civil society, the science on environmental protection is not settled – there remains serious doubt about what damage is anthropogenic, and what the cost-benefit analysis of remedies might be. But in a sense, the science doesn't matter. Let me qualify that: the sciences do matter, of course.

But in a sense, the science doesn't matter. Economist F.A. Hayek explained that "the facts of the social sciences" are the beliefs that acting agents hold about the world; indeed, these beliefs will guide their action. If European voters equate recent heatwaves and wildfires with environmental degradation, they will tend to vote for green policies, even if there is no clear scientific link between human action and the natural disasters – or between EU regulations and curbing those disasters.

This presents an interesting twist about rationality. Economist Bryan Caplan coined the concept of "rational irrationality." In this phrasing, irrationality is a good like any other, with a price. If I believe that I can fly off the tenth floor of a building, I will pay a high cost; my irrationality is irrational. But if I believe that more state spending will solve perceived environmental problems, my irrationality will have no cost to me at the polls, as I can largely pass the costs on to others. I can rationally enjoy my irrational beliefs. With tight economic conditions, European voters are now confronted with the price of EU policies, and re- evaluating their cost-benefit analysis. They may be aware (or believe they are) of a link between environmental degradation and the Green Deal. But they are also aware of an EU- wide growth rate of less than **1 percent** (**.5 percent** for 2023, and expected at **.9 percent** for 2024), and inflation that remains above **6 percent**.

Environmental protection is still a pan-European passion, and one of the European Commission's top policy goals. It will be interesting to see how the Green Deal plays out in the June elections and beyond.

Speaker Tip O'Neill was on to something when he proclaimed that all politics is local.

– March 6, 2024

“Stabilization” Is Just Bad Old Rent Control

Jason Sorens
Senior Research Fellow

The Washington State House has passed a bill to cap rent increases at **7 percent** a year. The Senate has yet to vote on it, and the governor has not taken a position. If enacted, this law would hurt renters, including low-income renters.

Advocates of the legislation call it “rent stabilization” rather than “rent control,” because “rent control” has gotten a bad name over the years (and for good reason). But in practice, it works the same way.

Capping rents means lots of people will want to rent at the capped rate, but fewer units will be available to rent, creating a shortage. After all, owners of apartment buildings can put their units to alternative uses, selling them off as condos, converting them to office spaces, occupying the units themselves, or simply leaving them vacant.

In the long run, rent caps encourage apartment owners to skimp on maintenance as well. So fewer units are available, and they are of lower quality

The Washington legislation exempts apartments built in the past 10 years. But the law could still discourage new apartment construction. After all, builders have to keep in mind the possibility that 10 or 15 years from now, those new units themselves will be added to rent stabilization. This is precisely what has happened in New York over and over again.

Once a place adopts rent caps, it’s very hard to un-ring the bell and make investors feel safe again about building new apartments.

Advocates of rent stabilization say that “vacancy decontrol” — letting rents adjust when a tenant moves out — makes the legislation less harmful. But rent stabilization makes tenants less likely to want to move out. That makes it harder for young people and workers moving to an area to find a place to rent, and keeps people locked into locations where it might not make sense for them to live anymore.

In markets that have had rent caps for many years, there’s even a well-known scam, described in Tom Wolfe’s *Bonfire of the Vanities*, whereby a renter pretends to still occupy a unit, while subletting it to someone else, to avoid vacancy decontrol.

Advocates of rent stabilization also say that a high rent cap, like one that limits a one-year increase to **7 percent**, is less harmful than traditional rent control. But it’s no defense of a policy that it might cause only a little harm. And in any case, a 7-percent cap could cause a lot of harm.

Why might a housing provider need to raise rent more than **7 percent** in a year?

First, inflation might run above that rate. We just went through a year in which inflation topped **9 percent**. It could happen again.

Second, even if inflation doesn’t run that high, rent inflation could run that high if land-use regulations have choked off housing supply and demand is growing. Again, the recent pandemic is a case in point: Americans’ demand for housing went up because people were spending more time at home, but a lot of places did not let property owners build lots of new units. Last year, annual rent growth topped **10 percent** in several markets that have limited the supply of new homes.

Third, repairs and renovations can be costly for housing providers, and the value of these improvements, especially after a tenant has stayed several years and if building codes change, could justify a rent increase of much more than **7 percent**.

Fourth, the city of Seattle requires a court order to evict a tenant. For instance, if the tenant is involved in drug activity, the housing provider has to prove it in court. But a housing provider might prefer not to get the police involved. Sometimes a rent increase is the only realistic way to get rid of a problem tenant. In this way, just-cause eviction laws and rent stabilization laws interact to make it extremely difficult to remove tenants who are damaging the property, annoying their neighbors, or engaging in illegal activity.

The economic research on rent caps shows unequivocally very large economic losses, even for tenants of those units themselves. A recent study of San Francisco rent caps shows that after adoption, corporate housing providers reduced supply by **64 percent**, while individuals reduced supply by **14 percent**. Perhaps the definitive study of the welfare effects of rent control in New York, published in *Journal of Urban Economics*, found that even tenants in rent-capped units suffered from the policy.

Thus, it's no surprise that only **2 percent** of top economists agree that "ordinances that limit rent increases for some rental housing units, such as in New York and San Francisco, have had a positive impact over the past three decades on the amount and quality of broadly affordable rental housing," while **81 percent** disagree.

Rent caps also have unintended consequences in other markets. Rent caps reduce the value of multifamily properties, because owners and investors expect to earn less. In New York, a recent tightening of "rent stabilization" drove down multifamily properties' values by more than **30 percent**, leaving some housing providers with negative equity and encouraging foreclosure. As a result, a major housing lender has incurred large losses, and investors are worried it could go bankrupt.

Instead of rent caps, cities and states can make housing affordable by letting people build more of it. That's just what has happened in the last year in several Sunbelt markets.

Investors are even complaining that multifamily has a "supply problem," meaning too *much* supply, resulting in rent declines.

Just about the worst way to "help" renters is by punishing property owners for providing rental housing, which is just what rent caps do, regardless of whether they call them "rent control" or "rent stabilization."

– March 13, 2024

Unrealized Gains Tax is an Economic Fallacy

Vance Ginn
Associate Research Fellow

Taxing unrealized capital gains on property, stocks, and other assets is not just a bad idea, it's an economic fallacy that undermines economic growth and personal liberty.

Unfortunately, President Biden's $7.3 trillion budget proposes such a federal tax. Vermont and ten other states have made similar moves.

This tax should be rejected, as it is fundamentally unjust, likely unconstitutional, and would hinder prosperity and individual freedom.

A tax on unrealized capital gains means that individuals are penalized for owning appreciating assets, regardless of whether they have realized any actual income from selling them.

If you purchased a stock for $100 this year, for example, and it increased to $110 next year, you would pay the assigned tax rate on the $10 capital gain. You didn't sell the asset, so you don't realize the $10 appreciation, but must pay the tax regardless. The following year, it dropped to $100, so there was a loss of $10. Would you be able to deduct that loss from your tax liability?

The devil is in the details of the approach to this tax, but the devil is also in the tax itself.

Adam Michel of Cato Institute explained two types of unrealized taxes in President Biden's latest budget:

> *Under current law, capital gains are taxed when the gain is realized — when the investment is sold and there is an actual profit to tax... The budget proposes eliminating step- up in basis, making death a taxable event. The change applies to unrealized capital gains over $5 million for single filers ($10 million married).*

And secondly,

> *The budget proposes a new minimum tax of 25 percent on income and unrealized capital gains for taxpayers with more than $100 million in total wealth. This new minimum tax would be a third, parallel income tax system, adding to the existing alternative minimum tax. The new minimum tax applies to two entirely new tax bases — wealth and unrealized capital gains. Defining and taxing wealth and unrealized capital gains pose numerous practical challenges and high economic costs.*

Taxing unrealized capital gains contradicts the basic principles of fairness and property rights essential for a free and prosperous society. Taxation, if we're going to have it on income, should be based on actual income earned, not on paper gains that may never materialize.

Moreover, taxing unrealized gains hurts economic activity by discouraging investment and capital formation, the lifeblood of a dynamic economy. When individuals know their unrealized gains will be taxed, they have less incentive to invest in productive assets such as stocks, real estate, or businesses. This leads to a misallocation of resources and slower economic growth.

Additionally, this tax reduces the capital available for entrepreneurship and innovation.

Start-ups and small businesses often rely on investment from individuals willing to take risks in the hope of eventually earning a return on their investment. By taxing unrealized capital gains, we discourage risk-taking and stifle innovation, essential elements for improving productivity and raising living standards.

The tax undermines personal liberty by infringing on individuals' property rights and financial privacy. It gives the government unprecedented control over people's assets and creates a powerful disincentive for individuals to save and invest. This is particularly troublesome in an era of increasing government surveillance and intrusion into private affairs.

Proponents of taxing unrealized capital gains argue that it is a way to address income inequality and raise revenue for social programs. This argument can't withstand scrutiny. This tax does little to address the root causes of income inequality, such as government failures in fiscal and monetary policies. Instead, this new tax would merely redistribute wealth from productive individuals to the government, thereby further misallocating hard- earned money.

Furthermore, the tax revenue raised from this tax will be far less than proponents anticipate, as individuals will work less, invest less, and find ways to avoid such taxes through legal paths. This would result in less economic prosperity and a resulting decline in tax collections.

From an economic and moral perspective, taxing unrealized capital gains from property, stocks, and other assets is a bad idea. It undermines economic growth, stifles innovation, and infringes on personal liberty. Instead of resorting to the misguided policies of the Biden administration and some states, we should remove barriers created by the government.

These include reducing spending, taxes, and regulations. We should also impose fiscal and monetary rules.

Achieving these goals and ending the bad idea of a new tax on unrealized capital gains will encourage investment, entrepreneurship, and economic opportunity for all. Only then can we truly unleash the potential of a free and prosperous society.

– March 15, 2024

Another Year, Another Crisis

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The one-year anniversary of the collapse of Silicon Valley Bank (SVB) is upon us. And while some of the factors behind that catastrophe have been tamped down, a new crop of problems have emerged to cast a shadow over the banking system and the health of the US economy. In the year since, only the sources of difficulty have changed.

In March of 2023, the size and rapidity of the Fed's rate hikes had driven a handful of banks with highly concentrated deposit bases into duration gaps, triggering runs and ultimately failure and government seizure: Silicon Valley Bank, Signature Bank, First Republic Bank, Heartland Tri-State Bank (a complicated situation), and Citizens Bank of Sac City Iowa.

Within that same month, Silvergate Bank voluntarily liquidated, and Credit Suisse First Boston collapsed. The demise of the latter owed not to rapidly rising interest rates, but a litany of accumulated blows over the years ranging from scandals, bad strategic choices, and periodic trading losses.

Hundreds of other US banks, though, were sitting on between $600 and $700 billion of unrealized losses in long-dated US Treasury and agency securities. To ensure liquidity the Fed unveiled the newest in a growing catalog of emergency programs, the Bank Term Funding Program (BTFP). The BTFP provided yet another "window" for financial institutions to pledge securities over a defined term: this one lending against positions at their par values, a clear sign of the immense damage that the Fed's delay in fighting the inflation (that they themselves caused) wrought. That lending window closes today.

As March 2023 became April and then summer, the inevitable questions came: "Are we out of the woods? Will more banks fail? Is this the start of another 2008?" Yet by July 2023 the KBW Regional Banking Index and the S&P Regional Bank Index were headed higher and the general view that the crisis was over took hold. The common wisdom now holds that last year's bank problems were isolated to a small corner of the universe of financial institutions. More importantly, the troubles were not systemic, at least not in the regulatory sense.

KBW Regional Bank Index and S&P Regional Bank Index, 2022 – present

(*Source: Bloomberg Finance, LP*)

But that's not completely true. Moral hazard was, as it often is in such cases, ratcheted up. In the most recent episode, depositors of several of the failed institutions with tens of millions of savings in excess of the Federal Deposit Insurance Corporation (FDIC) limit of

$250,000 were immediately made whole. Ironically, despite the current administration's loud and vocal opposition to "junk fees" at banks, they are exactly the means by which the expense to rescue venture capital firms and their portfolio companies will be recovered from mom and pop accounts throughout the US banking system.

Unrealized bank losses now exceed $2 trillion. Those are paper losses, thus unrealized, but their impact on regulatory minimum capital requirements is beginning to collide with yet another source of financial jeopardy. The pandemic policies which forced countless firms to operate from home taught business owners and managers that a huge source of overhead, commercial rents, were (to use the governments' own parlance), nonessential. Company owners were more than happy to jettison a significant operating expense, but that flight has been costly to both the owners of commercial real estate and the banks that lent heavily to build, purchase, and manage those structures.

One year after the collapse of Silicon Valley Bank and a handful of others, with hundreds of banks sitting on impaired securities, rapidly declining values on commercial real estate loans are further pressuring banks. Plunging rates of occupancy coupled with high interest rates have made writedowns and collapsing valuations commonplace, with an average decline in office space properties of at least **25 percent** as of February 2024.

There are anecdotes of once loftily-appraised buildings and portfolios trading hands at $1, and the opacity of those markets leads to a troubling dynamic. Eventually all commercial real estate will need to be reappraised for refinancing, which will inevitably be at higher rates, given the Fed's tightening campaign. With a $900 billion wall of refinancings coming, should banks with loans out to ventures dissipating in value raise capital preemptively, liquidate some of their beaten-down bond positions, or sit tight and wait to see how the valuations of the assets underlying their particular loan portfolios fare? Surely some buildings and complexes will evade the winnowing markdowns, while others will be utterly wrecked. Again owing to the nature of this most recent dilemma, systemic failures are not likely. But a tightening of credit, even if the Fed is lowering rates by then, will likely drag down economic growth. Some banks may fail, and while the liquidation of malinvestment runs its course, large commercial vacancies are likely to add to rising urban blight in the United States.

One year ago at this very time, the question was: how bad will it get? And this year the question is: how bad will it get?

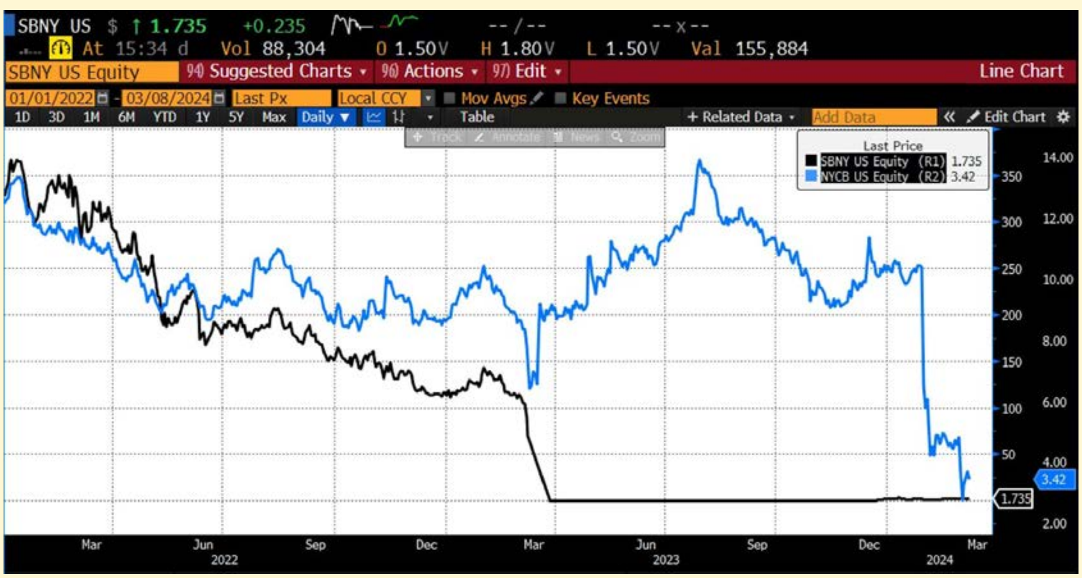
If it seems like over the past few decades America has stumbled drunkenly from one crisis to the next, that's because it has. As Eichengreen and Bordo wrote in 2002,

> *[A] randomly selected country had a five percent probability of experiencing a crisis in a randomly selected pre-1914 year. Since 1973, in contrast, the corresponding probability has been twice as high (10 percent for the same sample of [industrialized] countries, 12 percent for the expanded sample, the latter reflecting the even greater incidences of crises in low-income developing countries. While [as of 1998] the frequency of banking crises was roughly the same before 1914 and after 1972, currency crises were much more frequent in the final quarter of the 20th century (and, as a result there was a growing frequency of both banking and currency crises together).*

It certainly seems as if, after 2008, the pace of economic emergencies in or close to the United States has accelerated. Not long after Lehman failed there was a sovereign debt crisis in Europe (2010 – 2012), the Flash Crash (May 2010), a domestic debt ceiling crisis (2011), the "taper tantrum" (2013), the collapse of a large portion of the oil industry between 2014 and 2016, market volatility arising of tariff policies between 2018 and 2019, and then scores of crises arising from COVID policies after March of 2020.

Perhaps most emblematic of the increasing pace of economic problems are the embattled depositors of the now shuttered Signature Bank of New York, shut down by state regulators on Sunday, March 12th, 2023. The bank was heavily involved in crypto businesses, a sector which was started and grown largely out of distrust of the increasingly interventionist, fiat money central banking era. As the Silicon Valley Bank problems grew on the other side of the country, worries about Signature Bank's risk controls led to its seizure. Its customers — many of whom businesses and individuals already wary of fiat finance — were moved to New York Community Bank (NYCB), a storied Queens-based real estate lender. That firm, less than one year later, is now thickly ensnared by the burgeoning real estate morass.

Stock prices of Signature Bank of New York (black) and New York Community Bank (blue), 2022 – present



(Source: Bloomberg Finance, LP)

And on it goes. Asset price volatility and changes in real interest rates have been stalwart challenges for as long as there have been financial markets, however simple or crude.

What's increasing the tempo of upheaval are newly ascendent forms of risk, all of which are next to impossible to measure and increase financial vulnerability: moral hazard, increased incentives and opportunities to reach for yield, interest rate expectations, and multitudinous systemic connections. (It would be inaccurate to suggest that these types of risk did not exist in the past, but in fact they were rare and minimal in their influence.) From inflation to a Fed tightening cycle, to banking losses and now real estate tremors, we again find ourselves climbing tenuously out of one hole only to collapse limply into another. Until the root issues of financial fragility are confronted and resolved — an fiat currency and the escalating time-preference of managerial behavior and business plans it engenders — the revolving door of economic crises will continue to turn. Hopefully I won't be writing another such article in March of 2025; the odds are, I will.

– March 11, 2024

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