

Paul Krugman on Deficits, Taxes, Inflation, and Recovery

By Dan Richards
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Paul Krugman is a professor of Economics and International Affairs at Princeton University, and the author or editor of 20 books and more than 200 papers in professional journals and edited volumes. His field of expertise is in international trade and finance, with his current academic research focused on economic and currency crises. Mr. Krugman also writes for a broader public audience, including his Op-Ed columns for the New York Times, Foreign Affairs, and Scientific American. Professor Krugman received the 2008 Nobel Prize in

Economics.

Dan Richards interviewed professor Krugman on January 4 at the annual meeting of the American Economic Association in Atlanta, GA. This interview is one of a series that Dan is conducting at that conference, and we will provide links to videos of his other interviews. He is president of Toronto-based Strategic Imperatives.

You've been among the leaders in supporting fiscal stimulus initiatives by the US government. On the contrary side of that argument, some question whether large-scale deficit spending creates employment. But stimulus has not worked consistently in the past. For example, under President George W. Bush, the government spent nearly \$500 billion – not necessarily as part of a stimulus program -- yet employment dropped.

The employment drop came at the end of his term and the deficit spending came relatively early.

There is a world of difference between environments in which the Fed has cut rates to zero, and can cut no further, and situations in which monetary policy is operating in a normal environment and is effective. Deficits from 2004 onwards were taking place in an environment where the Fed was raising rates because it was afraid the economy might overheat. You wouldn't expect any job creation from fiscal deficits there. It is being offset.

The point right now is we are in a situation where the Fed, if it could, would probably have a Fed Funds Rate of -0.5%. But it can't, so we are constrained. So this is a situation in which fiscal expansion can have a big effect.



This is not just off-the-cuff stuff. For what it's worth, if you take the kinds of models that I come closest to believing in, they say that when you are up against a zero bound, fiscal policy is completely different. It is an order of magnitude different in terms of what effects it can have on employment.

You have suggested that there is a chance we can fall back into another recession if we do not have additional stimulus spending. How big, roughly, a stimulus package is called for?

If I could do it, I would have another package as big as the first one, if there were no political constraints.

We are still at 10% unemployment in the country, with full employment being more like 5%. That's a really big gap.

My analysis says we should try to close that entire gap. Some suggest we should close a large part it. We're not doing it. So that calls for a large stimulus.

I'll take whatever I can get. In January of last year, [Chair of the Council of Economic Advisors] Christie Romer's back-of-the-envelope calculation said \$1.2 trillion. What they actually did, once you take out the stuff that isn't real, was \$700 billion. The economy has done worse since then, versus what was expected. To say that we should double it to \$1.4 trillion, total, is perfectly reasonable, except that it is completely out-of-bounds politically.

If there was an additional stimulus package, perhaps not at the level you would like, what lessons can we take from the previous one?

As best as we can make out, the tax cut portions were ineffective as predicted. People saved the money for the most part, instead of spending it.

There were basically three components to the spending. There was actual infrastructure spending – purchases of goods and services; there was aid to state governments, which was a way of attempting to sustain spending on goods and services; and there were tax cuts. I guess you say there were four, if you include transfer payments, such as unemployment insurance.

The tax cuts look ineffectual. The aid to state governments looks like it did quite a lot to sustain spending.

The infrastructure money was spent, which is a good thing. If we could do more, you would do more of that. You would do more government purchases of goods and services, or aid to local government so that they can sustain purchases of goods and services.



Probably, the transfer payments – the aid to people in need – was a pretty good stimulus. So that's what you would do if you could.

I have one important thing to say, if you are asking whether these things are really a good investment. That is an interesting question and an important one, but it has no relevance to the job creation in the short run. You could hire people to dig holes and fill them in and it would be an effective job-creation measure.

In Canada, there was a big focus on the stimulus programs. It was a smaller than in the US, but a big focus was on shovel-ready programs. One of the criticisms is that even though the budgets have been passed, the money hasn't been spent.

Shovel-ready turns out to be a bit of a misnomer. Even if the money is allegedly ready to go, it takes a while to get things going – unless it is China where issues of environmental impact and corruption don't matter.

That has turned out not to be a big concern. People were worried we would pass the bill in February and some of the spending would not happen until the middle of 2010, by which time the economy would have already recovered. That has turned out not to be an issue.

I was saying that right from the beginning. Based on everything we knew about the aftermath of financial crises, this was likely to be a really prolonged period of depressed economy. It was not going to be an issue of whether it took a year or two for projects to come on line. That was less important than people were saying.

You're not as concerned about the lag effect from the time the program is passed to when the money spent.

No. If the stimulus program had been a really huge shock treatment, then I would be concerned that having it come on-line slowly would diminish the shock and awe. But it isn't.

In a way, now we wish there was more stuff that was coming on-line. The stimulus is going to start fading in the second half of the year, and many people now wish that it wasn't.

Going back to the Reagan years, the US has made tax reduction a priority – some would say an obsession. The most recent OECD data, going back to 2008, shows US tax revenues at 28% of GDP, with Canada 42%, and European countries, such as Germany, France and Asian countries at 50% or higher. The only major



country that has lower tax rates is Japan. Looking at that data, is there room for a permanent increase on tax rates in the US?

There's a little bit of a correction one needs to make on those things. The US health care system has a lot of private premiums which would be tax collections elsewhere, for example in Canada. It's because employer-based health insurance is so heavily regulated and subsidized and you probably should add another several percent of GDP to the effective tax rate.

Advanced countries can collect a lot of taxes. Claims about the horrible disincentive effects of high tax rates are greatly exaggerated.

I'm not for going back to the great socialist Dwight Eisenhower and 90% top marginal tax rates.

We can have more taxes. In fact, even if we get healthcare expenses under control, it's very difficult to see how we manage in the long run without adding at least several percent of tax revenue to GDP.

So in your view we need higher tax rates. Where would you focus those? What is your view on consumption taxes, which is what most of the rest of the world, in the advanced countries, focuses on?

I don't have a strong view.

Countries that have strong social insurance systems do tend to rely a lot on consumption taxes. It's an interesting thing. Their tax systems are not especially progressive and are actually less progressive than the US. But their overall system is much more progressive because of the strong social insurance. In a way, that makes sense. You want to have taxes that are a broad consumption tax. To the extent that there are disincentive effects from higher taxes abroad, consumption tax doesn't do a lot in that direction, whereas a VAT can be used to finance the stuff that you need to do.

I'm not really wedded to it. Something like a VAT is certainly one way we can go. As we know, most of the advanced world does derive a lot of revenue from that.

We talked about marginal tax rates earlier. If 90% isn't the right rate, in your view what is the appropriate rate?

I don't have a really strong view on this. We were talking about this last night at one of the various parties.



There is a pretty good case, at very high incomes, to have something like a tax rate in excess of 50%. We had a 70% tax rate for a good part of the 1960s and 1970s at the top end and survived with that. We had a 50% rate for a good part of the Reagan years, which people forget about. I would be willing to go north of 50% but I don't know how high.

If you put a super-high rate on income of \$5 million, then you are basically hitting only sports stars and Wall Street wheeler-dealers.

You don't have much sympathy for sports stars and Wall Street executives?

For sports stars, if we reduce their incentive with notice, then it's probably a good thing. The same is true for Wall Street.

There is a growing fear about deficits that are out-of-control, not just in the US but around the world. To what extent are you concerned about this, and especially when they are externally funded?

I don't think the externally funded business makes a whole lot of difference. That's a big misunderstanding.

If the Chinese decided they wanted to stop buying dollar securities, we should send them a thank you note. What they would be doing is in effect carrying out quantitative easing on behalf of the Fed. That's a whole other argument, which nobody seems to get, even though it's crystal clear to me.

I'm not worried about deficits. The flow does not concern me. It's the stock – the fact that we are looking probably at consolidated debt at all levels of government of 80% or 90% of GDP 10 years from now. That's not five-alarm level but it's not good. We've seen examples of advanced countries, even ones with somewhat wobbly governments, going to debt levels that high and higher without trouble. But it's a level that makes you a little worried.

What that debt concern says about what we should be doing about economic stimulus now is almost nothing. Suppose we did my \$700 billion of additional stimulus. Bear in mind we are now predicting \$9 trillion of additional borrowing over the next decade. That would make the economy stronger, and some of it would come back in the form of revenue – probably more than \$200 billion. That would be adding \$450 billion, so it would be raising an extra 5% on the total amount of debt we are going to accumulate.

Plus a stronger economy would probably mean better long-run growth. So it would be easier to borrow. The point is basically is that the debt level as an argument against fiscal stimulus just doesn't work. The arithmetic doesn't work.



It's not going to make much difference one way or other whether we support the economy.

It is an argument that we need to do something going forward. What can make this thing sustainable? We have got to have health care reform. We have to index cost growth in health care. Then you need some major cuts in spending – I'm not sure where they would come from – or you need substantial additional tax revenue, not now but once the crisis is over.

On the health care program, you have written that it is not necessarily everything that everyone would have wished, but it is a significant step forward. It is hard to argue against that in terms of insuring 30 million previous uncovered individuals. However, my understanding is that the estimate from the Congressional Budget Office (CBO) would suggest that it will not reduce spending on a net level.

There is a one-time bump up due to the fact you're covering all those people who weren't previously covered. There is a slight reduction, even in the CBO estimates, in the growth rate of health care spending. The trend has improved.

The CBO, by its nature, can't put numbers on squishy stuff. The health care reform includes a whole bunch of pilot programs, initiatives, and attempts to do things, and nobody knows which one of them will work. But it's a pretty good bet that at least one of them will work.

It creates a more or less commitment to near universal coverage with subsidies that are not a fixed amount, but that are actually designed to satisfy an affordability criterion. If health care costs grow faster than expected, that will show up as a rise in subsidy levels, which is going to create a political imperative to do something.

We've had the situation where our safety valve for rising health care costs was to toss more people into the dust bin. We're ending that. The bill doesn't solve the health care cost problem. But it makes a stab at it and it creates a situation where we will do more in the future.

Today's *Wall Street Journal* had a piece that talked about concerns that Japan is entering its third decade in terms of depressed economic growth. What lessons can the US draw from the Japanese experience?

Be very afraid. The maximum likelihood estimate of how long it takes to recover from a financial crisis, based on the Japanese experience, is forever. They are still not out of the woods.



The Japanese have never had a dramatic recovery program. What they've had is ameliorative programs. They cut interest rates as far as they could. They've had fiscal support, which has been enough to keep the economy from plunging but never enough to generate a boom. The theory of the case has always been that eventually private market forces would come along and generate the recovery and they could withdraw the stimulus. That is not happening.

You need something more aggressive.

We have a real shortage of role models. Recoveries from financial crises almost invariably are export-led. The trouble is now we have a global crisis and you can't do that – unless Mars becomes an export destination. You look for examples of financial crises where export-driven recovery was not an option. Japan, to the extent they had a recovery for a while, was export-driven. But Japan is a relatively closed economy and they never really recovered.

The Great Depression was ended through a mega-fiscal stimulus on a scale that is presumably impossible as a political matter. [Ed. Note: For an alternative explanation of the reasons the Great Depression ended, see this article: [Bruce Greenwald on Structural Problems in the Economy and Unemployment](#)]

I have spent a lot of time worrying why did World War II work? We understand why it generated a lot of employment. Why didn't we slide back to the Depression after it was over? Part of the answer is that there was a fair bit of inflation in the world. We actually inflated away a lot of the private debt.

What is your best estimate for the average GDP growth over the next three years?

Something like 3%, above trend but not dramatically.

In 2010?

I'm much more worried. It will be more like 2%, below trend.

Which worries you more: a spike in inflation from deficits or a double-dip scenario that takes us into another recession?

I am not worried about inflation at all. I am worried about a double-dip or jobless recovery much more so.

Based on your outlook for global growth, for an America with a time horizon of 10 years or more, what would be your recommended asset allocation?

Personally, I am very risk averse.



Do you own gold?

It's a barbarous relic. I would feel bad about owning it, even if I was making money on it.

There has been a lot of talk about the grade of "B+" that President Obama gave himself. What grade would you give President Obama for his first year in office?

I was going to say a "B," but I have moved him up to a "B+" because of healthcare. This may not win him a lot of votes and may not pay off for the Democrats in the near future. But this is huge. We have spent more than 60 years to get to where we are now. It's a highly imperfect bill. But, my God! Just five years ago we were desperately trying to prevent the privatization of social security. And here we are now with a more or less universal health care system. That's a big deal. And history may say that is the important thing that happened.

As you look forward to 2010, what one piece of advice would you give to President Obama?

Do everything you can to stimulate the economy. They may have shot their bolt on that dimension.

The other thing is that they need to take on the financial sector and financial reform, partly because it is important, but also because they need a little bit of symbolic victory. He needs to guillotine at least one Wall Street person, just for the form.

If you look more broadly, there has been very dramatic progress, particularly in emerging markets. To what extent are more optimistic about the progress we have made globally versus in the US?

There is no question that if you count the number of people who have seen dramatic improvement versus dramatic worsening, the improvements greatly outweigh. To say to the unemployed American, who is losing his house, "but the Chinese have done great," is not a very helpful statement.

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