The Krugman Thesis

Krugman is right. The rich have more now than they have ever had in the history of the universe. Under "globalization," they never lose.

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President Reagan cut taxes in 1981 believing there would be an enormous increase in labor supply and savings — so much so that the resulting boom in the economy would actually increase government revenues. But the supply-side predictions were wrong, and deficits soared. One might have thought the overwhelming results of this experiment would have marked the demise of supply-side economics. But no. In one presidential election after another, conservative candidates such as Bob Dole and Steve Forbes have tried to resurrect these views, but they have failed to hit a resonant chord. American voters have learned the lessons of 1981, but some of their would-be leaders have not.

Paul Krugman suggests, though, that while supply sides have yet to claim victory in the intellectual battle, conservatives are winning the war. They have obtained everything they fought for, from lower income and capital gains taxes to welfare reform. Consequently, the rich are getting a larger share of the pie. So what are conservatives campaigning for?

I say we shouldn't be surprised. The rich have more now than they have ever had in the history of the universe. But greed — among a few — has no bounds. Some people still maneuver to protect and increase their gains, and to concentrate power and

In a column in the New York Times (1/26/00), MIT professor Paul Krugman, the economic community’s resident intellectual provocateur, was at it again. Referring to the Reagan supply siders and the then presidential candidacy of Steve Forbes, Krugman writes, “Who needs another crusade when you’ve already won.” Continues Krugman:

“Consider, if you will, how America at the end of the Rubin-Summers administration compares with America at the end of the previous Democratic presidency. In 1980 the wealthiest taxpayers faced a marginal tax rate of 70 percent — that is, they got to keep only 30 cents of each extra dollar they earned. Now they get to keep more than 60 cents. In 1980 conservative social critics warned that excessively generous welfare was sustaining a culture of poverty; in the 90’s Bill Clinton ended welfare as we knew it. In the late 70’s powerful unions extracted huge wage increases in industries like autos and steel; today only one private-sector worker in ten is unionized, and the unions that remain are shadows of their former selves.

“And even more important than these changes in policy is the changing shape of the economy itself. In 1980 conservative critics used to complain that enterprise was not being rewarded, that stock prices had declined in real terms, that America was becoming a society in which it just wasn’t worth trying to get rich. Twenty years later, after a decade that makes the 1920’s seem merely meowing by comparison, it is hard to see what more the rich could ask for.

“So why can’t the Reagan supply siders simply declare victory and go home? . . . There is one important thing that the supply-side movement has not gotten, and still desperately wants: intellectual vindication.”

Do you buy the Krugman thesis? Or is the MIT professor merely toying ironically with his intellectual sparring partner, Treasury Secretary Larry Summers, about the credit for today’s New Economy? A hundred years from now, what will economic historians say about the decade of the 1980s and 1990s?
wealth in their own hands. They call for even lower taxes and protect myriad hidden and not-so-hidden subsidies for special interests. They claim that “globalization” benefits all, but only if international investors are guaranteed a profit. This leads, for example, to bailing out international creditors. The people who end up paying are usually individuals outside the international capital markets — poor farmers in Brazil, workers in Korea, or small businessmen in Indonesia, for example.

There are fundamental issues about which reasonable people differ: What should be the role of the state? How do we best combine individual responsibility and freedom with a sense of social justice, creating a society with greater equality of opportunity? Americans increasingly agree that the country needs to address these questions collectively, as a nation. While welfare rolls are down, former recipients remain largely poor. Their life prospects are so bleak that they do not even hope for the American dream. The budget surpluses now, at last, afford us an opportunity to make a frontal attack on poverty in our country. While money alone is no solution, money can make a difference. It is a far better use of these surpluses to address these problems — and to preserve social security — than to give even more to those who already have so much (even if their incomes are well earned). I have been struck by how many among the better off in our society agree with this view.

And Americans also agree that the government can do much to curb unfair economic gains. Both parties have increasingly expressed their revulsion toward economic opportunism. Republicans such as George Schultz and conservative think tanks such as the Cato Institute have raised their voices against a corporate welfare agenda they find as distasteful as I do.

Destroying the apparatus of government, as some supply siders suggest, would not magically lead to prosperity and happiness for all. Markets alone do not work perfectly. Without government intervention, the poor grow poorer and the rich grow richer. And Krugman is right: Who wants to be a cheerleader for the rich?

The Reagan tax cuts and defense buildup were simply “Keynesian” stimuli to aggregate demand.

JAMES TOBIN

Thank goodness Paul Krugman has the guts and wits to tell it like it is: Reagan supply-side dogmas are political ideology, not professional economics. Neither the logic of economic theory nor the evidence of empirical econometrics provides support for supply-side policies — notably tax cuts, the Republican refrain from Reagan to Bush to Dole-Kemp to Bush.

The simple rationale of supply-side claims, their kernel of truth, is the incentive effect of taxes. Mainstream economists, including Krugman, have always recognized these and measured them. Those effects, important in microeconomic contexts (those concerning specific commodities and markets) are just not strong enough to make big differences in national and world macroeconomic outcomes (those relating to differences between prosperity and depression or between high and low rates of sustainable long-term growth).

In addition to incentive effects — “substitution effects” in economists’ lingo — there are important “income effects,” for example, gains of tax cuts to particular taxpayers. Undergraduate students learn about both effects, but political supply siders forget or remember each as convenient. Does cutting wage taxes induce people to work more? Maybe, but many will get more after-tax income without additional work. Does cutting taxes on income from wealth encourage saving? Maybe, but many savers will get more income without becoming more thrifty, and may even save less. Lower taxes on realizing existing capital gains provides income effects without any incentives at all.

Income effects are demand-side effects. That’s why they may help in business cycle recoveries, even if their incentive/substitution effects are weak. That is also why they might have unwelcome inflationary effects when the economy is tight.

Reagan tax cuts and defense buildup in the 1980s were the biggest “Keynesian” stimuli to aggregate demand our government ever delivered in peacetime. They helped generate recovery from the double-digit unemployment of 1982. Were they indispensable? No, we recovered from many other post-1945 recessions without such undisciplined deficit spending.

Federal Reserve Chairman Paul Volcker triggered the recovery in 1982 by easing up on his anti-inflation monetary policy. He could have, probably would have, steered the economy to recovery without Reaganomic fiscal policy. For Volcker’s Fed, Reagan deficits were an embarrassing threat that made interest rates higher than necessary. The Fed, under Volcker’s successor, Alan Greenspan, has presided over the remarkable expansion of the 1990s, when fiscal policy has been the polar opposite of the previous decade.

The test of supply side is what happened, not to actual economic activity as demand stimuli put existing idle labor and capacity to work, but to productivity — the growth of outputs from given inputs. Despite the structural make-over of our economy to suit the tastes of the supply siders reviewed by Krugman, economy-wide productivity growth rates have been lower than they were in the bad old days of high taxes, over-regulation, and strong unions before 1973, and lower specifically than in the 1961-69 expansion, the previous record-holder for length.
Don't be distracted by Krugman’s trademark irony. The Reagan supply siders should receive little credit.

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Paul Krugman’s trademark irony may distract some readers, but his meaning seems clear. With the economy performing so splendidly in the Clinton-Greenspan era, the political justification for sharply cutting back government or uprooting the tax code and social security has crumbled. As for who or what is responsible for the last four years of high growth and productivity gains, and low unemployment and inflation, Krugman is too fine an economist to believe that these basic conditions can be traced back to a tax rate cut twenty years ago. The lower rates had modest positive effects at the time. More recent and decidedly non-supply-side policies, however, have played a larger role in our current happy state. Most notably, they are (i) deficit reduction which included tax rate increases, (ii) deft monetary policy based on the tighter fiscal conditions, (iii) an expansion of trade, and (iv) the deregulation of important sectors. Moreover, technological innovation and hard work by private-sector managers, workers, entrepreneurs, and investors have meant as much or more as anything government has done.

It is hard to know how economic historians one hundred years from now will assess these conditions. That assessment will depend mainly on how the next century unfolds. If the economy has now returned to the country’s long-term trend growth rates for GDP, productivity, and inflation, the below-trend problems of the 1970s and 1980s will be forgotten in one hundred years—along with the political debate over the role that marginal tax rates played in these problems.

More likely, a discerning economic historian at the dawn of the twenty-second century will view the 1980s and 1990s much as we now view the 1890s and 1900s: a time defined by the spread of new technologies, globalization, and broad business responses to both. A century ago, electricity was the new technology raising productivity, international trade was growing rapidly, and businesses were responding to these two trends by consolidating and adopting mass production techniques. Today, it’s information technologies that are driving higher productivity, and companies are remaking themselves to be more flexible and decentralized, or reinventing themselves as e-businesses. Recent times, such as the late-nineteenth and early-twentieth centuries, have also seen a big and distinctive leap in international economic activity. Current forces of globalization are leaving both capital and production markets more open and less regulated, as well as larger and more highly differentiated.

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I love these debates, because they are mischievous and essentially irrelevant, and Paul Krugman is very good at pricking balloons. Where he hits the nail squarely on the head is in identifying this craving on the right for “intellectual vindication.” It seems to be an endemic phenomenon among conservatives. Consider, for example, the triumphalism of Thatcheries in Britain in the 1980s, or even the cockiness of the entrenched Japanese bureaucracy which thought it had discovered the Holy Grail twenty years ago. By comparison, advocates of the current Clinton-Blair “Third Way” philosophy appear pallid and doubtful.

Still, since victory has a thousand fathers and defeat has none, it is inevitable that everybody wants to claim paternity for the wondrous New Economy. I would not know whether to ascribe the most credit to Volcker, Greenspan, Rubin, Gates, or some generic American genius that applied itself, in this cycle, to information technology. But I do know that the economy came into full flower on Clinton’s watch and that it might not have done so but for the passage of the 1993 deficit reduction budget act and the President’s willingness to leave the Federal Reserve well alone.

Economic historians will doubtless look back on the last two decades and conclude that, although inflation was tamed, ideology mattered curiously little other than to politicians. Reagan cut taxes, as promised, and the good times did roll for the affluent. But he also presided over a tripling of the deficit and debt, which was not in his confident game plan. Clinton increased them, but at no cost to the economy. And thanks to the stock market and wealth creation, the U.S. economy entered the broad sunlit uplands of surpluses as far as the eye could then see. If anything, it was the age of eclecticism, with a Democratic president declaring, remarkably, that the era of big government was over.

They might also note, with regret, that opportunities were not taken to reform the social infrastructure and address grow-
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Historians invariably interpret any period in light of what happens afterwards, not in the perspective of contemporaries. Thus historians will assess the eighties and nineties on the basis of what happens during the next couple of decades. If the stock market crashes sometime during what the Economist suggests we call the naughties, we can be confident that historians will find the seeds of the crash were sown during the nineties and even the eighties; many flaws will be identified. If the stock market does not crash and the U.S. economy continues to perform well, historians will hail the nineties, and even the eighties, as the beginning of a new era; blemishes will be ignored.

We must not forget that a noteworthy legacy of the eighties was a trebling of the national debt — a staggering increase of over $2 trillion. This debt, much of it to foreigners holding claims on the United States, will impose a heavy interest burden for years to come. During these two decades, the United States shifted from being a large creditor to being the largest debtor to the rest of the world. We began to repay marketable federal debt in 1998, but we are still arguing about it, and it is doubtful we will ever return to the level of 1980.

The large deficits occurred despite the hotly debated tax increases of 1986 and 1990 and despite the almost- unnoticed social security tax increase in 1983, the largest tax increase in American history. By the late nineties, Americans paid 2.5 percent more of their wages into social security than they did in 1980. The total (federal, state, and local) tax burden rose from 30 percent of GNP to 32 percent in the late nineties — which is still modest compared with tax burdens in most other rich countries, but hardly the reductions sought and claimed by the supply siders.

Deregulation in the 1980s was helpful in aviation and inland transport. But with inadequate supervision, deregulation also gave us the savings and loan crisis, which cost American taxpayers over $125 billion.

Historians will not, I hope, assess the United States in isolation, given all we hear about globalization. While the United States grew about 3 percent a year throughout the two decades (mainly labor force growth in the eighties and productivity growth in the nineties), the 1980s were considered a “lost decade” by many developing countries, especially in Latin America and Africa. But the world’s two largest countries, China and India, grew very well as did Japan in the 1980s.

Japan stumbled in the 1990s, and Europe imposed constraints on its growth to prepare for the euro. But the big news of the 1990s was the collapse and disintegration of the USSR and the transformation of its former satellites into market economies. Partisan historians will debate for years the relative roles in this dramatic development of Reagan/Thatcher rhetoric as opposed to the structural weaknesses and intrinsic flaws of centralized economic planning.

The notion that economic problems have been overcome is not completely credible.

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As a rule and no matter the topic, Paul Krugman has a different view. And he will write about it in an engaging style. But to have him take on the supply siders when the voices of Paul Craig Roberts, Arthur Laffer, and Jude Wanniski are heard less and less is surprising, especially after the hiccups of stock markets in January 2000 as well as Krugman’s interest in the 1990s financial crises. The upper classes have been enjoying their rising wealth these last years, despite Alan Greenspan’s “irrational exuberance” remark of December 1996. But they are a bit nervous, mostly about price-earnings ratios. A forthcoming book by the London financial adviser Andrew Smithers, using James Tobin’s [the letters] (ratio of the stock-market price of corporations to book values), asserts that the markets overvalued shares at the end of 1998 by 2.5 times. James Grant is more assertive than this. And even Abby Cohen is beginning to hedge her distinctly optimistic forecasts. On the other hand, two earlier bears at J.P. Morgan appear to have had epiphanies and embraced the “new era,” while those of us brought up in the depression and fearful for a long time have converted to the dictum, “crash, to be sure, but can’t say when.”

If Paul Krugman is suggesting that Steve Forbes should declare victory go home, a large number of us voters would join him. But the notion that economic problems have been overcome is not completely credible, given the deficits in personal savings, the balance of payments, the country’s massive indebtedness to holders of short-term treasuries, and the WTO’s troubles in Seattle. Those invited to Davos and able to pay the cover charge may be content. But as the distributional gap between the rich and the rest widens, such contentedness is probably not shared by all. Nor is serenity in the months or years ahead assured.