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**Professor Paul Krugman**  
*Whither America?*  
**London School Of Economics**  
**Wednesday 26 May 2004**

Chair                      That shows what a pleasure it is to have Paul with us again. For what has become the sort of annual Krugman lecture, delivered by Krugman, this is very nice for us. As you know, Paul is one of the world's greatest economist. He made great contributions in his extreme youth, to the new trade theory which explains and interprets inter industry trade, that is why he was given the John Bates Clark prize for the best economist under 40. But he's now over 40, and he has therefore felt free to broaden his canvas to include more or less everything which is wrong with the world. As you know, he writes a celebrated column in the New York Times in which he is doing a great deal, I think, to draw attention to some of the things which are not right in the world.

He is currently visiting the Centre for Economic Performance which he does every summer, very nice for us and even better this year because he's not going on his bicycling holiday because he has to finish his block buster on economics, but he can do the advertising and I won't stop him. Paul, come and tell us about the world.

Paul Krugman            We have advanced technology here, but I am still going to use paper with a bit of stuff. So:

I gave a dummy title for the talk, which turns out, to be right: Whither America. Those of you who heard me last year: I talked a lot about increasing in equality and the political economy thereof, and this year I am going to talk about that as well. Since the title is Whither America, I should tell you all I am going to follow the Basil Fawlty principle from the famous, "Don't mention the war" episode, though we can't totally avoid it. Given one hypothesis about what's happening, it may matter quite a lot and not just for the short run. But I am going to be talking about political economy and not ... I probably won't be able to stop myself at some point, since it does dominate all our thoughts, but I will try to stay off it.

I am not going to talk about what's happening to employment or GDP, but my starting point will be to take a look at the budget and budget policy, and give you some fairly remarkable numbers about where we are right now. This is the United States according to what the Congressional budget office now projects. They are projecting a budget deficit of 4.2% of GDP. There are worse budget deficits out there, it is not in itself completely extraordinary. One thing to say about it though, is that it has very little to do, according to their estimates, with the business cycle, the economy is still a long way from fully recovered but it is not the main story, it is a structural budget deficit around 3.5% of GDP which is overwhelmingly attributable to the tax cuts that have taken place under the Bush administration. If you take all of them - if you do this stuff you are talking about EGGTRA and JGTRRA, because all of these bills have got ... I think there is something deeply indicative about what's going on in the US, the kitsch with which legislation is named -

we have the Job Growth, Tax Reform, and Recovery Act. The USA Patriot Act is actually the name of the thing, so EGTRRA is the economic growth tax reform and recovery act, and JGTRRA is the Job Growth Tax Reform and Recovery Act. They all have these wonderful, very kitschy names. But, if you take the three tax cuts, the big ones in 2001, 2003 plus the smaller one in between, together, it is big, it is 2.6% of GDP. It dwarfs even the effects of military spending and Homeland security and all of that as a source of the deficit. So we have this large structural deficit which would still be there without the tax cuts but is much larger because of the tax cuts and it is bigger than it seems to be because demographics. We have an aging population, there are other reasons for long run budget woes, but we do know that the baby boomers are going to hit the retirement systems in less than 10 years now. So there's a big overhand.

In a crude way you can do much more sophisticated ways of estimating what that really implies and I have actually got Larry Kotlikoff's new book to try to review right now. But, a crude way is just to take the Social Security system which is the biggest retirement programme, which has a current surplus which was supposed to be used to secure its future. It is not actually big enough, not quite but it is about 1.5% of GDP. So really that should be not counted ... that should be counted as an addition to the deficit, put it this way, if we look at the on budget deficit which doesn't include Social Security, it is another 1.5% of GDP. So we are already up to a fundamental or true, or properly accounted deficit of at least 4.9% - 5% of GDP for the Federal Government. Again this is a pretty big number.

The last thing to say, if the tax cuts were temporary designed for economic stimulus this wouldn't be all that much to make a big deal about, but of course they are not. They are intended and propagandised for as a permanent set of tax cuts which we must never ever roll back, in fact we should have more of them. So these are part of what's intended to be a structural reduction in revenue for the US economy, which means, if you take all of this seriously that this deficit isn't going away. Anything that we should be getting from economic recovery is already in there in the fact that the structural is a bit smaller than the actual. And, if you take into account the overhang of the eventual cost of retirement programmes, it is really substantial. It is more than 5% of GDP. And for scaling you just want that which is what is Federal spending in the United States. It is around 20% of GDP.

I am not going to give you the break down in detail but just to say 3% is the basics of running of the government, the mechanics of doing it, the Court system and so on, pretty much incompressible. 4% military spending, presumably incompressible. 2% interest on the debt, incompressible. So what's left really is not much more than half of that, around 11% of GDP which is almost all social insurance programmes. If you say, everybody is against Government spending and we should cut Government spending, what do we mean here? The answer is that actually we are talking about a close to 50% cut in the Social Insurance programmes which would be what is needed to balance this budget. And Social Insurance programmes means a little bit of it, one piece of it, Medicaid is means tested, but for the most part it is middle class social insurance programmes. And that's the picture.

What makes them think - everybody says we are not going to cut those programmes - what makes them think this is going to work out? What's the economic theory, or budgetary theory under which all of this is possible? The administration always has projections which show the budget deficit falling in half over the next 5 years and each year they issue such a projection, and each year the deficit is bigger than the year before and they revise. Those are not to be taken seriously!

The truth is that the current projection which says that the budget deficit is going to fall is based in part on expiring tax provisions which the administration is lobbying hard to have made permanent. So what they are actually saying is the budget deficit will shrink substantially according to our plan which depends upon Congress not doing what we ask them to, a little bit peculiar.

Anyway. So is there a theory about supply side economics, about growth, that will solve the problem? Well, maybe somebody believes it, but there is every reason to believe that - I have no idea what George Bush thinks about the Budget - but there is every reason to believe that the ideological architects do not believe that this is sustainable. That they in fact aim to use Budget Deficits as a way to force fundamental cuts in government programmes.

And it turns out that this is the second time we have been down this route. We had the rise of supply side economics in the 1980s and a few years later some of the key figures got a little garrulous and actually talked about what they actually thought they were doing at the time.

Irving Kristol, a very important neo Conservative, not in the foreign policy sense, though I guess that too now, but neo Conservative intellectual whose publication, the Public Interest, did a lot to create Supply side Economics as a political force, later on waxed nostalgic about the days. He talked about why he supported this and he says, well the task I felt was to create a new majority because he wanted to reverse America's liberal drift, which evidently would need a Conservative majority, which came to mean in turn a Republican majority so political effectiveness was the priority, not the accounting deficiencies of Government. And then, just in case you weren't quite sure what he means by that, he talked approvingly of how he and his friends had a rather Cavalier attitude towards the budget deficit and other monetary and fiscal problems. In other words, the tax cuts ... they did not actually care whether the arithmetic added up, this was just a political platform, which I think one has to say is the same this time around. David Stockman, who was Regan's budget director for a while until he was a little too frank with a reporter, actually talked about what has become the common phrase now, starving the beast.

We have all these nasty social insurance programmes, the legacy of Franklin Roosevelt and Lyndon Johnson, they are actually very stingy compared with European norms. Even post Thatcherite British norms, but nonetheless Conservatives really hate them, but they are also very popular. So how do you take them on and the answer is, well you deprive the Government of the revenue. And then you say, well look, what can we do, we have to cut the spending, the revenue just isn't there. And that has clearly been the political strategy for the long game of the ideologues behind the Administration.

All of which is fairly familiar stuff in the US now, although if you said it 2 years ago you were accused of being a nutty conspiracy theorists, and now everyone says, well of course, that's how it goes!

One very important point, I think, is that the political theory behind starving the beast, is actually completely untested. It's a belief that they can actually do this, that they can turn around and say to people, well you know we have these budget deficits, we need to cut spending and we can't raise taxes, which would be a terrible thing, so we can cut these extremely popular programs. The actual track record is that neither Reagan, nor Bush so far, has in fact done significant cuts in these programmes, so there's an alternative possibility which is that we are a banana republic. That we have these programmes which we can't cut, and taxes that we can't raise, and we have these enormous deficits which continue until the financial markets say wait a second, and all hell breaks loose.

There's firm belief that it is going to work. As I say, with no real basis in experience. And for what it is worth, the major domestic policy initiative other than tax cuts to come out of the Bush administration is a major expansion in Medicare, one of the key entitlement programmes. It happens to be an expansion calculated to deliver minimum benefit at maximum cost, but nonetheless it is an expansion in the programme, so it is a funny thing.

Am I accusing our administration of launching into a really very bold policy without carefully considering things that might go wrong? Gosh, they would never do such a thing!!

Here's the point though, which gets me to the political economy. Suppose it works, leave aside the crisis risk with the possibility that you never do get contraction. What you are really talking about here is a programme of cutting taxes and then cutting spending on entitlement programmes. For all we may say about wasteful government spending the programme that would have to be cut are transfer programmes to the general public - primarily to the middle class. There is some means testing involved, but broadly speaking these are programmes that go to ordinary families, the public at large count on these programmes. Why would people support that kind of move? Why would people support that plan of action to cut taxes? And then cut these social programmes?

You might say that people gain on the swings what they lose on the roundabouts. Something like that. That, alright the typical family will find that taxes are cut at the same time that benefits are cut, and maybe it is all awash, and then we have the efficiency effects of lower taxes and people are convinced that that's all a good thing. There is actually no particular evidence that tax cuts in this range have any notable, favourable effect on the economy, you just can't find evidence that you get an acceleration in potential growth, an acceleration other than possible temporary business cycle recoveries. And the question you would ask is, is it reasonable for ordinary families, for the majority of voters, to believe that they are at least going to be roughly compensated for the loss of social programmes, like tax cuts.

That's where it becomes important trying to understand what's going on - to look at whose taxes actually get cut. And, we actually now do have better numbers than before. This is the latest estimate of the three Bush tax cuts combined. It is actually as fully implemented. So there are pieces of it that aren't yet in place. Most notably the estate tax phases out over the rest of this decade. It is of course very tilted towards the top. Some of you may know, by the way, that one of the quirks of the law, the salesmanship that has been used, is that the estate tax as now written gradually phases out, and has completely gone by 2010, and then springs back to 2000 schedules in 2011. So, if you have a large fortune and you happen to die in 2010, it goes untaxed and if you make it into January of 2011 most of it is taxed at a 55% rate, which would lead to some interesting incentives in late 2010! Anyway, no one thinks that's going to happen.

Point to make here. The tax cuts, there are lots of ways to say this, but I think this is the clearest version, the tax cuts are very heavily tilted towards people high up the income distribution. If you look at the bottom quintile, OK nothing. This is the .. the percentage change in after tax income, how will the after tax distribution of income change compared to the pre-tax. Modest tax cuts for people ... nothing near the bottom, modest near the middle, as you go up towards the top they get much much bigger. And, the top 1% which in the US starts at about 300,000 a year, family income gets a 6% increase, way above the average. And, people with more than a \$1 million income, which is about .13% of the population, gets a 7% increase in after tax income.

If I had done it in a different way and asked about distribution of the tax cut. What do you actually find is that this class gets more ... the tax cuts for the 0.13% of the population with incomes of more than a million, are substantially larger than the tax cuts for the first three quintiles. So the elite gets a bigger tax cut than 60% of the population.

The thing is, you could say, if we had a budget surplus and you wanted to cut taxes to return the surplus to the public there might be some case for tax cuts that at least reflect income. Maybe if you were worried about incentive effects, even tax cuts that went somewhat disproportionately to the top. But the point from earlier is that we are actually cutting taxes into a deficit. We actually have a budget deficit of sustained long run budget shortfall even without the tax cuts. And by having tax cuts we accentuate that which means that the tax cuts are ... we have a gain for the middle quintile. People in the middle of the income distribution have 2.3% higher after tax income, because of the cuts. But that's a little bit like somebody giving you a lavish Christmas gift, purchased on your credit card! Where does that money come from? It has to come from a cut in programmes that in turn benefit middle income families.

We don't know how the cuts will play out, if they will play out, how it all works. But if you assume that the starve the beast thing works, and there really are cuts in these big nasty things like social security and Medicare, it has to be, given this distribution of income, that something ... There's no way that you can avoid having at least 70% of the population losing from this policy share. Probably 80%. What we are looking at, it appears as a policy that is ... it is a redistributive policy compared to the starting point. And it is a redistributive policy from the bottom 80% of the population to the top 20%, and particularly, extraordinary distribution from the bottom 60% to the top 0.13%. It is a kind

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of amazing thing, not what you would expect to happen with majority voting. What's going on?

What makes it even more puzzling is if you look at the context of what's been happening in the United States. So, here are percentage changes in income from 1979 – 2001 by different parts of the distribution within the United States. Again, bottom quintile, next quintile, third quintile, fourth, fifth, top 10%, top 5 and last is top 1. This is the Congressional Budget office estimates, they don't go narrower than that, but we know from other data that if I had the top 0.1, roughly that 1 million-plus class, we would be looking at something like a 500% increase. And the last time I talked to you I talked about the reasons why this might be happening. I am not actually going to try and get into that this time, but we have certainly had a radical increase in inequality, and if you have a political model anything like median voter theory you would expect the policy response to this to be redistribution the other way. You would expect that the public would be moving towards more progressive taxation, soak the rich, increase the benefits for the middle class, because in some sense, people near the middle of the income distribution are ... have less at stake in the overall level of taxes because they have a declining share of the income and ought to favour something that soaks the people that are claiming a radically increased share of income at the top and are there to be soaked.

If you read some Conservative commentators they seem to have a constant fear that any day now we are about to have a shift towards soak the rich economic policies. They are constantly afraid, they look at the fact that the share of taxes paid by the top 1%, or top 5% of the income distribution has been rising over time, and they say, doesn't that encourage irresponsible leftist, populist politics among the public. The funny thing is that the increase in the share of taxes, paid by people at the top, is entirely the result of a soaring share of income at the top. In fact, up until 2001 if anything, the tax system became less progressive. They went back and forth but overall basically we were soaking the rich less than before, and now of course, these last three years, we have a radical move again towards taxes being cut at the top compared with minimal cuts at the bottom.

The political puzzle is how can this be happening? How can that be? We have a democracy, at least for a little while! And, we have majority rule and it would appear that we are having policies which are heavily tilted against the heavy majority of the public, so how can that happening? It is not just Bush. One of my favourite discoveries of the last few years has been the work of Keith Poole and Howard Rosenthal and Nolan McCarty, political scientists who do quantitative measures of political positions. And they use votes on bills to quantify where people stand on a left right spectrum. They actually try for multi dimensions and it turns out that more and more US politics is just a left right spectrum. And you can use positions on various issues, just to say vaguely. If you make the hypothesis that issues are lined up from left to right, and the people are lined up from left to right, you can go searching for an ordering of issues and people that lets you extract where people are. And also lets you compare these things over time. So you can get positions, you can ask about the drift, and here I just stole this directly from a someone else, but this shows where we have been going, and it is a little too small to read, but I can tell you what it is. These are ranking Presidents, using their position on a

number of issues that you can use to scale them. From Liberal down, Conservative is up. I don't think there was a value judgement implied in that!

So we go back and forth, we have Republican versus Democratic Presidents. We have Eisenhower and Kennedy, Johnson, Nixon, Ford, Carter, Reagan, Bush 1, Clinton, Bush 2 all ranked. What you can see is, yes Democrats are more Liberal than Republicans. Quite a lot. And, there are big swings in policy but if you look at the overall trend you discover that both parties are moving to the right. That the actual drift of policies has been, and this is essentially economic scaling, the actual drift of policies has been towards less progressive taxation, less redistribution, more favourable policies to the economic elite, even at a time when the economic elite is becoming ever more distant, ever richer, compared with the typical resident of the country. It is a bit of a puzzle.

I actually wonder. This is the scale using these issues, if you actually look at the content of the policies, I guess there are different ways that you might look at it, but if you look at things like rates of corporate taxation, or top marginal tax rates Eisenhower looks like a raving socialist compared with modern politics. We had a very very much higher taxation both of profits and of people with high incomes in the 50s than we do today. By Eisenhower era standards Clinton policies look extremely conservative economically. So, it is a remarkable drift, and again it is going opposite of the way you would think if you had a simple median voter theory in which the typical person's interests are represented.

How can this be happening, that's the big question. How can it be that the world's second largest democracy, the world's richest democracy, biggest GDP democracy, appears to have its policy drifting in a direction, or in the case of Bush, galloping in a direction that is contrary to what you would have expected people to vote for, to support? There are, broadly speaking, two not mutually exclusive ways to think about it. One of them is that there actually has been a fundamental shift in the nature of politics. That the economic elite is just more powerful and the concerns of ordinary middle or working class people are less well represented in the political process than they used to be. And there is some ... there's quite a lot of evidence for that. The other is that it has always been true, that the economic elite actually dictated policy. But, that the economic elite is, for whatever reason, less concerned with the general state of the population than it used to be.

I am trying to educate myself more about this, so a lot of what I am going to say is tentative. Let me just say that as my economic bias, I liked two, because it is more fun to work on. It is easier to just do as an economist. But I suspect that really is a lot of one, going on, and the two of course interact.

Let me just take a moment. I am going to be more of an economist here for a second, and tell you, give you a simple example of how two could work. The idea is not original, I have been talking to Roland Benabou who is down the hall from me at the Woodrow Wilson School at Princeton, and a lot of this is based on work he's done. But of course if I have screwed up his ideas it is my fault. Actually, a couple of my colleagues had a paper with an acknowledgement, for the authors' joint paper, that the authors would like to

thank each other for helpful discussions and blame each other for remaining errors, but I can't quite do that!

This is a Benabou inspired but Krugman ruined thing. Think about a three person society. So bear with me for a moment here, in which two people have got incomes of 30, and one person has got an income of 60. And this is Roland's big idea. He said to make this story work, the kind of story, you actually have to think that Government does good. Strange idea in modern America. But actually the Government is a force for good, and in particular he has got this idea that the Government can do something which is really quite productive. The benefits are a lot bigger than the costs in tax payer money. So in this case, think of it of building a public good, although as I said, the real crux is actually social insurance. But still, think of it as building this – ah, about the textbook: Advertising for the text book! My wife and I are writing a text book and for public goods the motivating example is the great stink of 1858 in London and the building of the sewer network that moved the stink downstream. So we are talking about building the sewer network.

Let's say this costs four per person and benefits everybody seven. So it's a socially productive project. But let's just say that the way you are going to have to do it is where the tax is proportional to income. So, and let's just imagine for whatever reason, and we will come back to the reasons in a bit, it is the wealthy third that controls the agenda. If you had to pay for this project with a tax, if you look the total income is 120, so you have to have a tax where the cost of it would be 12, four per person, so you would have to have a tax rate of 10% which means that the wealthy person there would pay six, but gain seven from the project. So he would be in favour of it so it would go through.

But, now let inequality increase. And in this case inequality increases in a way that nobody loses, just that the wealthy person gets richer, his wealth goes to 120 and the same project is on offer. And now the wealthy person says, well OK, total income here is 180, if we are going to pay for this project we have to take  $1/15^{\text{th}}$  of total income which means I am going to pay 8 for it, and the project still produces gains of 7 for each person and now the wealthy third is against the project. Which makes society as a whole poorer: there's something good that we could do, but the wealthy individual is alienated from the needs of society because he's so much wealthier than the society as a whole. So this is a little bit ... an American example of economistic thinking. But if you put it in greater generalities you would say that the wealthy ... if the economic elite - wherever you chose to start that - becomes increasingly distant in the way it lives and its economic concerns, and increasingly dominant in the tax base because it is so wealthy, they will have diminishing incentive to support programmes that are for the broader social good.

I can then get blurry and actually mix my stories a little bit and say look, if you get a situation in which wealthy people send their children to private schools, and live in gated communities. They are probably not going to have much interest in adequate public for funding schooling and public safety and we are just going to be in a situation where you would expect those people to become increasingly unsupportive of the institutions of a generous government.

I think this supports it. These political scientists who work on this, their first big result was ... actually I showed you the rightward drift, but the really big



result they have found is the political polarisation. Both within the legislature and among individuals, what you discover is that the US is pulling apart politically, the centre does not. I think at this point there are no cross overs, for example in the House of Representatives. As measured by this, there are no Democrats to the right of any Republican. No Republican to the left of any Democrat. There used to be a substantial overlap, it has gone. If you just look it has all pulled apart. And in terms of individuals as well, somewhat surprisingly, it is more extreme in Washington than it is in the real world, but there is a political polarisation that has gone on. Which explains a lot about US politics right now. You say why don't the Centrists step in and stop whatever the outrage of this morning, or this afternoon, and the answer is that there are no Centrists any more in the US, it's all gone.

The most recent research finds, they were asking, they noticed that political polarisation has been increasingly rapidly at the same time that income inequality has been increasingly rapidly. They thought that maybe what's happening is that, if you get an income it tends to be to the right or left, and because people are pulling apart in income that is also pulling them apart in political views. It turns out that is a relative minor factor, what's actually happening is that within economic groups people are becoming increasingly ... the association of your political views with your income has increased. If I were to summarise it quickly, I would say that the result is that rich people have really become much more right wing than they used to be, at any given level of richness. Which is roughly consistent with this kind of story, just loss of interest.

Ok. Do I think that's the whole story or even most of it? And the answer is no, it there are certainly other stuff going on and very important things going on. Which is that there appears to have been a shift. And besides, this all sounds ... I guess I should say, I don't believe in classes as units of action. But I do believe that economic interests matter. And that you just cannot discuss US economic and social policy without bearing in mind that the policies have very differential impacts on people at different level of incomes. And that what seems to be happening is that the policies increasingly reflect the interests of people with very high incomes, and not people with middle to lower incomes. The alternative is that there is just been a shift of power to the top.

Now, why doesn't the median household rule? Isn't that what we are supposed to believe about the way that democracies work, that one person, one vote, and that parties compete for majorities. And so the median person should rule. Well, OK, first thing to say, particularly in the United States, voter participation is not very high. And it is income related. So the median voter is at something like the 60<sup>th</sup> to 70<sup>th</sup> percentile of income. So right there you already have some reasons why policies don't reflect the interest of the median household. That in itself is not enough, the policies appear to be tilted a good deal more, at least 75 – 80% of the population lose, and the big beneficiaries are way up there at the very top. I think I probably said this last year, but you ask, when will this stop in the US? I think one vision I have is that it stops when the upper middle class realises that these politics are biased even against them, when people realise that it is really the very very top that benefits. I have this vision of the March of the million assistant Vice Presidents on Washington! Probably motivated by the alternative minimum tax, but you don't want to know.... Anyway...

It is not just voter participation. There is the role of money in political campaigns and that's obviously produces a bias towards the top. There's .. what do I know about this, nothing. But you can't talk about US politics, obviously, without talking about cultural divisions and both the religion and the race issue. And if you read Kevin Philips's new book about the Bush dynasty, actually Philips is the person who saw the Republican majority, Republican victories coming back in the 1960s and it is basically an old line Republican who is now horrified at the way things are going and has become big on the question of favouring the elite against the ordinary citizen. But, he emphasises a lot the role of Evangelical Christianity in the whole political scene. And if you want, just now, stepping completely away from my economics roots, just a question, what is the ruling coalition in the United States today, it is a coalition. It is not just the capitalists against the workers, it is the economic elite and the religious right. The religious and cultural right, but more and more that just means religious. So it is the alliance of the plutocrats and the preachers really that is running the country.

That is something that is relatively new. There has always been that religious element, there has always been the cultural element, but it didn't break in favour of conservative and economic policies to the same degree, 30 years ago. Race. We are still ... if the Confederacy had managed to secede, US politics today would look rather European. Just count up the votes and see how different the political scene is and of course it matters within Northern states as well so it is a very big thing.

Decline of alternate power centres. Some people have done work on this, there needs to be a lot more. But if you ask: what was the basis of these relatively pro welfare state, pro social insurance policies, pro progressive taxation policies during the long period after World War II. There were powerful counter weights to the monetary influence of wealthy donors. And in particular, above all, Unions, were and still are even though they are much diminished. The Unions are still terribly important to get out the vote efforts, and of course to some degree still for fundraising and finance. Let me just show you this – there are various numbers. This is the unionized share of the private work force. Government workers remain mostly Unionised. They actually have not expanded as a share of employment over this period, but it is softer if you look at that. But basically what we have seen over the past 30 years is the collapse of the private union movement in the US. Why did that happen? It is partly political, I am sure there people in this room who know more than I do. But just to say, clearly that is very important, it means that an important base for redistributionist policies, for social insurance policies is greatly eroded. So that's got to be an important part of the story.

There's more. Just before I came over here I discovered that there is a new study, I find this about 20 minutes ago and it turns out to be perfect. It was looking at experts on public radio in the United States. Public radio by repute is highly liberal though it is not actually in reality anymore. But in any case, they get experts to come on and talk about the issues of the day and where do you go for experts, where do you go for think tanks. So someone went through and looked at all the experts and asked what kind of Think Tanks do they come from. And the answer is 4:1 from Conservative Think Tanks. And that's not surprising because there are more and much more lavishly funded

Conservative Think Tanks. And it was not always thus. There wasn't really a Conservative Intelligentsia in the United States, not a well supported one, in 1970. And there was a deliberate creation of the network of Think Tanks, of publications etc that now very largely dominates public discourse, provides the 'facts' that often dominate news reporting. If you ask how did that happen, the answer is that a few intellectuals convinced a few billionaires to put up the money.

If you look, there's a vast array of right wing Think Tanks, organisations, publications, in the United States, nearly always it sounds like it is a very diverse group, but if you look at the funding it all comes back to 8 major foundations. The Scaife family, the Coors family, the Bradley Foundation. This was a case of organisation and a few people, including Irving Kristol who I quoted earlier, helping to organise this network that in turn shapes the debate. And one of the things always important to realise in trying to understand political economy is that most people don't have time to study the issues. They take up impressions about where things are. And so propaganda that's done skilfully, works.

The famous one is the estate tax. If you ask people how many people actually end up paying estate tax in the United States, the correct answer is less than 2% but most of the public people think that the majority of people pay some estate tax. That happens rarely enough, but you don't usually pay attention to it, so if you heavily propagandise it works. Ad campaigns. There was an ad campaign against Tom Daschle, the senate minority leader, which castigated him for supporting maintaining the estate tax and showed a barber lamenting that he wouldn't be able to leave his business, intact, to his family. And of course the estate tax doesn't kick in for a couple until it is at least \$1.5 million in assets. So that was some barbers shop.

Anyway, the last thing of course media ownership, concentration. I don't know, in much of the media it is quite subtle. I am sure that at some level as a Time Warner employee, being a real muckraking populist is not too well received. It is not in much of the media. It is not a case of the ownership says, we want you to follow a Conservative economic line, but there's got to be an influence. And then of course there is a significant segment where ... your fantasy might be that if you are a part of the Murdoch empire, if you work for Fox News in the United States that every morning you get a memo that tells you how to slant the news today. Well, you do actually, it is called the Memo so it works exactly as you might have thought!!

Now the big question. All this is happening. Of course it was given tremendous ... I think that the 2001 tax cut in the United States which was ... is a little bit more than half the numbers I showed you, was pushed through because people didn't really understand what the numbers were, they thought there was a budget surplus. The 2003 tax cut which is what bumps this up from 1.5 to 2.6% of GDP and makes this a much much bigger story was something that was pushed through immediately after the fall of Baghdad. So it really was a case of exploiting the political momentum of war to make it happen, so I am breaking my Fawlty principle, but it is important. In general in the United States what we have seen over the last 3 years - this trend towards an increasingly tilted economic and social policy - was given a huge acceleration by the political pay off to the Bush administration from its reputed

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stature of leading the war in terror. It was amazingly difficult to answer questions like, since when do you cut taxes in the face of a war, but it clearly gave them a lot of political momentum.

Now the questions we have to ask are both related. One, when you follow these policies, when you follow reverse Robin Hood policies, do they actually in turn create the political basis for more policies of the same kind. That is, is their feedback. Does the reign of a right wing Government create the political basis for continuing right wing government? What's very clear is that the intellectuals and lobbyists behind this do very much believe that. They don't believe that we hold the White House this time around, we hold Congress this time around, let's get our policies and of course there will be other guys in later on. They believe that they can use their dominance to lock in an environment that works to their benefit.

For what it is worth, it is very clear that there were positive feedbacks in the original rise of the welfare state. If you go back in the United States to the New Deal, you see that the Roosevelt administration didn't just introduce policies but also, pretty much deliberately fostered the growth of Unions, which provided a power base, and increased Government employment, so Government employees became a power base. The original tax and spend which everyone in the US talks about, but the original phrase comes from one of Roosevelt's political advisers, we are going to tax and spend, tax and spend, win and win. By expanding the role of Government and expanding the redistribution programmes, they were also creating the political base for their agenda to continue. Clearly you could do this in the reverse direction, or at least you might think you could do it in the reverse direction.

Particular examples now, privatisation. One of the things that is a constant theme here is out-sourcing Government services, switching them from Government employees to private firms. That's always done allegedly for efficiency although it turns out that the evidence for cost savings is very very weak and in many cases pretty much negative. But one thing it does do is it gets rid of public sector workers who have an interest in maintaining strong Government. It gets rid of unionised public workers, which is another one of the last bastions of Union membership. And, it also creates a class of donors who pay for the right to keep on getting the contracts and we are not going to mention Halliburton! There is a lot of positive feedback that can happen here and so there is a real possibility that this can all be locked in.

Then of course the big question. Are we looking at a swing of the pendulum back and forth, the cycles of American politics, or are we looking at a place where we lock in a much diminished, much more pro elite, much less social insurance type society for an extended period. And, I guess what I should have put up here, if that's true and of course we all have pretty ... there's a conspiracy theory, if you like, in all of this in terms of what's happening in the US. The general rule of US politics these last three years has been that last year's crazy conspiracy theory always ends up being today's conventional wisdom. But, in any case, assuming all this happens and it really is a radical swing, you don't see this happening in other countries. You see bits of it but nothing like the same extent, so one question in the United States, which is already quite different from the rest of the advanced world, is it going to look like a completely different society. Is the United States going to go back to a

1920s style dog eat dog capitalism while the rest of the west is a post WWII social insurance state, and how much will we be able to talk to each other and deal with each other, if we diverge that much.

Last point. If you believe these kinds of stories about positive feedback, swings of the pendulum that get locked in place, contingent events can cast a very long shadow. So that you could have argued that ... put it this way, six months ago you could very easily have argued that the terrorist attack on the United States was going to indirectly have the effect of locking in a very major shift to the right in US politics. And I have to say that if you asked me this week I would say the debacle in you know where has a pretty good chance of unlocking the whole thing and causing the pendulum to swing the other way. But I guess we will find out the first stage of that in the next six months. Thanks.

Chair                      What a marvellous, wide ranging talk. Things to agree with and things probably to disagree with.

Question 1              Thank you Sir Krugman, really interesting talk. I would like you to elaborate a little on the issue of protest .....? because there is something I don't quite understand. Usually people who are making a lot of money under that paradigm should be ashamed of themselves and re-distribute a little more. The United States still has the highest number of Foundations which in some sense give a little bit back of money. How would you address this issue.

Paul Krugman            It is a little interesting, there are two things that are really a little different about the US from some of the tradition, in that you find that the whole idea of clarity and ... there is an old tradition where religiosity goes with actually a strong social concern, but not apparently in the big politically effective religious groups in the United States. Although there is another side to it and some people say there is a Christian left in the US too but it is much less well organised and much less effective. The whole business about philanthropy, maybe there comes in time ... I would say the feel right now is more like the early gilded age in the US. The big philanthropic era came later on, progressive era, and there doesn't seem to be very much of that right now. What's actually interesting is where you do see signs of it, how virulent the reaction is. So, the biggest campaigner for retaining the estate tax is Bill Gates senior. The father. And he's been trashed and Gates himself has been trashed for vile motives in the Wall Street Journal. How dare he suggest that people like himself should continue to pay taxes. It is a very odd environment.

The other thing to say, there are funny sociological under currents and one of them is really the whole issue of nepotism which I thought in the US context was ... it was poisonous to have even the appearance of, but now it is all over the place. It is quite open, again the current administration has always been, there have always been family ties, and God knows, I work half time for a publication that's owned by a dynasty. But now you see a lot of sons and daughters of ... I think it is hard to find a top level Bush Administration official who doesn't also have at least one offspring with a medium level job in the Administration. Its kind of remarkable.

One last thing, it really important that I talk about this. There has been some reporting in the last few days about the staff in the Green zone in Baghdad.

Which turns out who are these people, who is actually there. It turns out they are very young, very inexperienced, they all seem to have been hired because they posted their résumés at the Heritage Foundation. But one person who was interviewed a lot, talked a lot about the challenges, turns out to be the daughter of Michael Ledeen who is a prominent neo-Conservative and one of the architects of the war. So a lot of the people involved seem to be sons of, daughters of. I think it is again this ethos of wealth building, somehow it has really transformed the country. It doesn't seem a lot like the country I grew up in.

Question 2      As an antidote to this Administration's dilution of their own economic plight, you suggested that this Administration needs rapid growth to make up. At the same time, in your own Paper New York Times or Washington Post, you suggested that the complaints may be good so the Government demands free movement of capital and goods but, when it comes to the threat of .....? that migrant workers like me who are professionals, I am not talking about .....? to the Mexican border, but who appreciate economics like you. Part of the Administration is abusing us, why is this happening.

Paul Krugman      This is about the closing down of visas and all that.

-      Precisely, yes.

Paul Krugman      It is not an economic policy. It is crazy stuff and it is hitting randomly. It is not an economic policy it is a security policy. This whole business of ... leaving aside the war and all that, just the response in trying to clamp down on individuals has been this sinister, Keystone cops routine. Where, on the one hand lots of people are being arrested or deported for no particular basis. But on the other hand they seem to have no idea what they are doing and it is disrupting. One of the things, I gave a little seminar here yesterday, some of the puzzles in our data appear to possibly be explained by a sharp drop in immigration in the last few years, which is not a result of policy but a result of just intrusive, crazy, homeland security behaviour.

Question 3      Your analysis, if you compare with your analysis Brazil and the US, why do you get differences in outcome of voter behaviour and now, in the case of Lula in Brazil and somebody like Bush in the US?

Paul Krugman      One answer is there maybe a reversing point or at least an equilibrium point. Presumably this doesn't go on without limit until two families have all of the GDP. My march of the Assistant Vice Presidents on Washington eventually puts this to a stop. The other thing is, my understanding which is very very limited about Brazil, is that although it has enormous income inequality, it also has very powerful public sector unions, which is the core of Lula's support. But also, there are moods, you can always be a little too mechanistic about these things which as an Economist I tend to do, but there are also points when the public say we are sick of this. The progressive movement in the United States arose at a time when there was nothing about the income distribution that made people in 1910 more prone to reform than people in 1890. But people had finally had enough of it all.

For what it is worth in US electoral politics right now the big surprise is that we currently have a system where hard money can't be given by organisations,

it has to be given by individuals. And the 2000 dollar limit which actually means that what you want is the high income classes, but not billionaire types to all pony up their 2000 dollars. And just six months ago we were thinking that was a huge advantage for the Republicans. There were, we thought, just not enough people willing to give their 2000 dollars to a Democrat. But in the last month Kerry has raised twice as much as Bush. And I think that's just a lot of fed up Assistant Vice Presidents who really want these guys out.

- Question 4      The more I practise economics the more I feel I should have studied more politics. I was here at the LSE. One of the questions you raised, immediately, what could be the countervailing forces for the shift of how the power elite you talked about. The Unions clearly know more. I wonder whether Universities could play a role in that, and how effective they are at doing that they may, or may not be. And whether in the way what Universities are being increasingly funded these days, whether that role is to become more difficult if they can play that role in the future.
- Paul Krugman      What I think we talked about in terms of countervailing powers is probably, actually, Unions could stage at least a partial come back. It is hard to see why, necessarily they have to be so far down. But then, other things are less clear. Universities yes. University professors are not known for cohesive action! As any Administrator will tell you. Herding cats is the usual phrase. There is an issue that there are a lot of ... the whole issue of funding is a big one. It is not just how University research is funded, but I think also if you were to ask about academics and how academics make a living you discover in the United States at least that in many fields University salary is only a piece and that's got to make it difficult as well. If you want to talk yourself into a pessimism that says this is unstoppable dominance by money politics you can get there. But I guess I have hopes that there is some idealism that can turn it around.
- Question 5      I am wondering if you might comment on the part of this whole picture that you drew for us at the beginning that is played in the US by tax expenditures, particularly the reduction for mortgage interest in the charitable donation deduction from both an economic perspective and a political perspective?
- Paul Krugman      I can be briefer on that, because the answer is I haven't thought it through at all. The mortgage deduction is a really distorting thing, and if they try to take mine away I am going to get furious!!
- Question 6      Can you comment on what you think about John Kerry's proposal for rescuing American jobs being outsourced over seas and in terms of his ideas on trade policy and tax incentives?
- Paul Krugman      The job parts of the proposal, the pre-notification and so on is very mild stuff. Its basically speed bumps to slow up the process of companies about to outsource. It is unlikely to stop a company that really has decided there is a huge advantage to operating in Bangalore. So it is nothing ... I guess ... you could under some very expansive definition call it protectionist, but barely. And, I think it was the mildest proposal that he could come up with that would at least show that he was addressing the issue. I have not actually done the homework on the tax proposal, but again it appears to me to be something that is defensible on grounds other than repatriation of jobs. It makes a fair bit of sense just as a tax proposal. So again, it is very mild.

I will give you my prejudice which I can't justify with a lot of documentation. I can tell you that the people around Kerry are very internationalist. If it is Kerry it is going to be reconstituting a lot of the Clinton economic team. He will have to do some things for the Labour supporters but if I were a European worrying about protectionist presidencies, I would actually be more concerned about a second Bush term. I guess, even though they are trying to portray it as Kerry the protectionist, if you actually look at the details of the proposals there isn't much that is protectionist in them and if you look at the people you have a pretty good assurance that these are multi lateralist types who are not likely to go out and defy the WTO.

Question 7      I would be interested in knowing your opinion about what consequence is the right wing shift in American politics is going to have on European politics because there seems to be a ideological long wave that is effecting Europe at the moment where by there is a tendency towards rolling back the States pretty much modelled on the American model.

Paul Krugman      Hm. I think you really have to look at the US to understand how mild anything that happens in Europe is by comparison. My understanding is, if you actually look at the specifics is that post Thatcher Britain we are still a much more generous welfare state than anything the US ever had. So what you think of as a radical rightward shift looks to us still like creeping socialism! In the European context, if I were sitting here, particularly if I were sitting in Germany I would be reviled as a right wing, laissez faire, because incentives to matter and there is such a thing as over regulation in all of that. But, its nothing like the real attempt to gut the whole social insurance system that you see in the US and Europe, it is just hard to contemplate.

Question 8      There is a puzzle, despite all your brilliant explanations, you are describing a situation in which 80% of the people lose. In a highly educated country with a reasonably diverse media, lots of brilliant people like yourself, and a very very large party which was recently in power, which has this 80% of the population to capture. It seems to me a simple staggering failure of political entrepreneurship!

Paul Krugman      Well, yes! What do we know. There is a tremendous diffidence about making the issues. I have no brief for Democratic leadership, or political leadership anyway these past 20 years. It is a question. Let's just say it is a mystery. You do wonder why it has been so easy for one side to wrap itself in the flag, and also wrap itself in family values and the other is so ineffectual. It is a source of puzzlement. The question I guess is, does this mean that this is wrong, that the public really understands that these policies are helping them. And the answer is that I don't think that's true. I think you can be reasonably clear on the actual math that the public is by and large voting for policies that are against its interests.

For what it is worth, polling on questions, do you think that more tax cuts are a good thing? Which has a higher priority, tax cuts or reducing the deficit. And so on down the line. Also the public actually appearing to have quite liberal views at this point, or at least not nearly as conservative as the Government. And they also show quite a strong streak of populism, that people generally feel that corporations and the rich are not paying enough taxes and it is a



remarkable thing that you can't get political traction out of this. It is true, I think if that were the issue on which the campaign was going to hinge there would be an easy Bush win. Not because people necessarily agree with him but because they can't get exercised about it. And the other things dominate. As it happens that doesn't appear to be what it is going to be about.

Question 9      We all react with considerable indignation at the prospect that the top 0.13% of the population get the benefits of the swinging tax cuts, but doesn't this component of the population arrange its tax affairs in such a way that probably doesn't pay that much by way of tax anyway. So when you do deliver tax cuts there it to some extent reduces the incentive for them to use expensive tax consultants and lawyers to dodge taxes. i.e. share of the cake, versus the overall size of the cake.

Paul Krugman      Actually there has been quite a lot of work on that and it is true that if you look at actual effective tax rates, because of course we don't know about totally concealed income. But it looks as if actual effective tax rates, the problem of not having transparency ... if you look at income versus tax rates at the Federal level we have a mildly progressive system that then does that at the very top. It is in fact true that people with very very high incomes manage ... I think it is ... should know the numbers off hand but I don't, but the top 400 tax payers end up paying about 5% points less than the average top 1%. And, that's largely ... but we think that's largely because the US tax system favours capital income over earned income, in particular the capital gains over earned income. And the very wealthy basically realise their income primarily through capital gains. And, deeper analysis apparently says that here's where the fact that people are not moved in and out of the top 400 matters quite a lot, if you take people's 5 year incomes it is more like this. So there isn't actually a significant drop off for the super rich, except for the people who are always super rich, which is Bill Gates and a few other people.

I think the point is that it is not that easy in today's world to actually just completely have your income, a very very high income disappear off the radar screen. And with a little effort at enforcement you can actually get the income as well. I don't think it is actually a case where those people don't pay taxes anyway. They do a lot of stuff and tax avoidance is rapidly on the rise, and tax evasion is rapidly on the rise, which is another story by the way. The Internal Revenue service is radically under funded and under staffed and all indications are that a marginal increase in its resources would collect a lot, a very high return investment for the Government, and that's by design. It has been deliberately starved and that's a whole other story. And actually David Cay Johnston of the New York Times has a very good book on all that – "Perfectly Legal" - which is pretty impressive, again for the chicanery involved politically, but that's another story.

Question 10      We have heard about the voodoo economics and most recently economics seems to be sort of ruled by a Disneyland scenario. I am wondering when you say that there has been no action on the part of the professorial class I am wondering about the economics professors, and where you feel you stand in this. Sometimes I see you as a lonely voice in the whole economics profession, but do you feel isolated here?

Paul Krugman      Actually, economics professors have got a lot noisier lately on both sides. But, to my misfortune I am actually out there twice a week in front of a large number of people but it is ... but Alan Blinder, a lot of people are talking much more these days. What I think is hard for a lot of my colleagues, you want to believe that we are actually having a serious discussion, that when we talk about these things that we really are talking about actual trade offs and ... it is very hard for an academic to grapple with the notion that the budget projections by the Government of the United States are blatantly, almost sneeringly dishonest. So it is kind of hard to get into it, but I think it is happening more. Actually, if we come out the other end of this tunnel I think actually we will feel that there are a lot of people who did step up and try to make a difference.

Chair                I think you have been too modest in your answers to these two questions about academia. I actually went to Princeton, I think on the day, that war broke out and when I got there I was amazed to find that the vast majority of the people there were opposed to the war. Certainly sitting here in England you would never have known this and I think it is really incumbent on Academics to engage more in the public debate than many of us do. And the historic justification for Universities was always that they were an independent source of social criticism. And I think that many of us have not performed that role as we should have done and as Paul has. And I think he's a shining example to us and that is certainly why he's made the impact he has, why all of you are here, and why you have responded as you have to having him here. Thank you very much Paul.