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# How to (Really) End This Depression: a Response to Paul Krugman

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*his is Polly's most recent post to date at her excellent blog, Econamici. — L. D.*

In the May 24 *New York Review of Books*, Paul Krugman writes, "The truth is that recovery would be almost ridiculously easy to achieve; all we need is to reverse the austerity policies of the past couple of years and temporarily boost spending." He continues, "…The strong measures that would all go a long way toward lifting us out of this depression should include, among other policies, increased federal aid to state and local governments, which would restore the jobs of many public employees; a more aggressive approach by the Federal Reserve to quantitative easing (that is, purchasing bonds in an attempt to reduce long-term interest rates); and less timid efforts by the Obama administration to reduce homeowner debt."

Krugman supports his case for a big increase in spending chiefly by looking at wartime spending. He also cites an estimate, based on comparing military spending across states, that "a dollar of spending actually raises output via around $1.50."

In short, Krugman makes what he calls the "textbook" Keynesian case for big government spending, no matter on what, financed by borrowing and easy money.

As a liberal economist myself, I favor increased public spending — but only on the right things, and especially not on the military. We should increase spending for public services like health, education, pensions, local infrastructure like water and sewer systems. And we should pay for these programs by high progressive income taxes, loophole-free corporate taxes, and property taxes at the local and state levels. Property taxes are truly the best tax we have on personal and corporate wealth.

So how does the Krugman/textbook-Keynesian argument go wrong? It goes wrong because it ignores both the distributional and the marginal incentive impacts of public policy.

Start with military spending. Military spending is notoriously intensive in natural resources and capital, which means per dollar spent it creates very little employment — while diverting funds from more productive possibilities. In the May

28 *Nation* Robert Pollin and Heidi Garrett-Peltier of The Political Economy Research Institute of the University of Massachusetts at Amherst show "How Cutting the Pentagon's Budget Could Boost the Economy." Mason Gaffney has been making the same argument for many years.
Krugman rests much of his case for military stimulus on the dramatic recovery before and during World War II. But so much else was going on at the same time: the economy was surely recovering anyway from the Great Depression; there was a tremendous public investment in health, education, and training of millions of young men, and simple patriotism brought out volunteers in droves.

Military spending is just an extreme example of the kind of resource and capital-intensive spending that damages the economy. Other examples include bridges and highways to nowhere, high-speed rail in low-density regions, or the notorious Keystone oil pipeline from Canada's tar sands to the US Gulf.

Now look at taxes. Something else happened during World War II: a huge increase in progressive income taxes. In the *New York Review* article, Krugman notes but dismisses as secondary a connection between high taxes and high employment rates. Not so fast! High progressive taxes on personal incomes or corporate profits create what's called an income effect. Taxes on high incomes and high profits puts the squeeze on those who have previously enjoyed, if not a life of ease, at least a life of luxury — and thus encourages people and corporations to find more productive uses for their assets.
Krugman also calls the current payroll tax credit "not an ideal stimulus." In my view, the payroll tax is a major discouragement to hiring, especially the hiring of low-wage workers by small business, because it has a powerful marginal effect. That makes the payroll tax credit an excellent stimulus — one which should be increased further.
So how do we pay for the right kind of public spending? Krugman rejects tax increases as part of a solution. Rather, he would rely on borrowing and expansionary monetary policy. What's the problem? Here, the conservatives are correct, though often for the wrong reasons.

What's wrong with borrowing? Well, it does raise the annual deficit and national debt. It does "crowd out" private lending, especially to small business. Meanwhile lenders — whether wealthy individuals, corporations or foreign governments like China — get to enjoy nice low-return, super-safe investments that do nothing for the US economy. This is the opposite of the income effect of progressive taxes!

What's wrong with expansionary monetary policy, as in quantitative easing? Conservatives claim it will cause inflation. I don't think there's much inflation risk, so long as the big banks' vaults remain stuffed with garbage. But precisely for that reason, the big banks won't lend the money to risky but productive, employment-

generating small business. They'll lend it back to the US government, or worse — like J. P. Morgan of late — gamble with it in the international financial markets.

No, recovery will not be "ridiculously easy." Not until Americans rise up to challenge Grover Norquist and his tax cut henchmen. That's a long, tough, political battle with no easy textbook answers.