The Agenda for Shared Prosperity

Edited transcript of Joseph Stiglitz remarks and Q&A from the "Beyond Balanced Budget Mania" forum

April 12, 2007 – 2:00 pm-4:30 pm
Economic Policy Institute, 1333 H St., NW,
Suite 300, East Tower, Washington, DC

Speakers and Presenters:

Joseph Stiglitz, Professor, Columbia University and Nobel Laureate, economics 2001; Keynote speaker of Agenda for Shared Prosperity's "Beyond Balanced Budget Mania" forum
Lawrence Mishel, President, EPI
Robert L. Borosage, President, Institute for America's Future and Co-director, Campaign for America's Future

Q&A Discussants:

Thomas Palley, Economics for Democratic & Open Societies
Frank Clemente, Change to Win
Robert Kuttner, The American Prospect

LAWRENCE MISHEL: Welcome to this forum of the Agenda for Shared Prosperity. We at EPI, working with dozens of folks in academia and other policy groups, have undertaken this initiative for a number of reasons. First, the economy has been failing the American people in terms of providing growing living standards across the board. We note in particular the gap between productivity and wages, and productivity – the output of goods and services for hour worked which describes really the growth of the pie that we have to share – has grown around 15 percent since 2001. But the wages of both high-school-educated workers and college-educated workers has been flat in that time.

We believe that reconnecting the growth of the economy to the growth in pay is the great economic policy challenge of our day. And it should be the yardstick we use to measure any agenda for the economy: whether in fact it will reconnect pay and productivity. A second reason we started this policy initiative is that it's pretty clear that conservative policies have failed. Tax cuts have not provided shared prosperity. The American people now understand that individualized solutions like Social Security privatization or having your own health savings account or your own unemployment insurance account or your own this account, your own that account, is not going to address the needs that they have.

Third, a policy initiative is needed because the timid approaches that some are offering, even on the center left, are not up to the challenge. A few middle class tax credits for this or that are not going to address the need that the American people have for rising incomes in the face of all the pressure for downwards wages and the loss of quality jobs. Nor will an approach which is focused on accelerating globalization and balancing the budget be anyway sufficient to obtain shared prosperity. Instead, we believe we need solutions at the scale of the problem. Let me just describe a little bit about where we are headed in our policy initiative.

First, we believe that retirement income security is important. And the issue should not be reduced to how we fix Social Securities finances. The issue is how we provide the retirement income that the American people need which we believe to be 70 percent of their pre-retirement income is what they should get in retirement. How do we that? Second, how do we have a system that provides a health care that's affordable and accessible to everybody?

Third, we need a macroeconomic policy that gets us to low unemployment and keeps it there and keeps focused on that as the main priority. Fourth, we need a way to have workers, working people, share in this prosperity. And the one instrument for that which has not been available is people having the real right to organize and bargain collectively to be able to get their share of the pie.

Fifth, we need policies that address work family issues, that people can be both workers and raise families in a satisfying way. And last, I'll just mention education policies to close the great achievement gaps across income groups and by race and ethnicity. We will never be able to close these gaps unless we have a broad-based approach that includes really sizeable investments in early childhood development and early childhood education, unless we have social policies that provide for diminishing the poverty rates, the excessive housing mobility, health problems and so on that disadvantaged students face. So we need broad-based policies to make a reality of the promise of closing the achievement gaps.

That's just a taste which leads us to budget policy, the topic of today's forum. We're going to examine issues of short-term budget policy as well as long-term budget policy. Now, it's absolutely essential to start from the point that budgets reflect our priorities. They reflect our values. They reflect our values as much as anything else we do in this society.

And we need budget policies that allow us to address the nation's needs. That's clearly important. Unfortunately, the budget policy discussion too frequently focuses on two matters and leaves important matters undiscussed. One matter stressed by the conservatives is how do we cut revenue and keep it down? On the other hand, there are those who focus on how do we balance the budget as quickly as possible? Coupled with that is a focus on a so-called entitlements crisis.

By focusing either on tax cuts or deficit reduction and balancing the budget, we leave out a discussion of what we need for spending and what it takes to address the nation's needs. How do we address the nation's needs? How are we going to have a budget that addresses our social needs or addresses our need to invest in the future, whether for investing in children, energy renewables, health research, or transportation? We are providing this forum today to try to have a more balanced discussion of budget policy. And with good timing, we have Professor Stiglitz now with us.

What can you say about Professor Stiglitz other than this is a man who's really done it all. He's earned the highest honors any academic can hope to earn, starting with receiving the John Bates Clark Award which is given every other year to an economist under age forty who is judged the best economist of their generation. And just to top that, he became a Nobel Laureate in 2001.

But even before he became a Nobel Laureate, he had already achieved the highest positions in the policymaking world being the Chair of the Council of Economic Advisers under President Clinton and the Chief Economist at the World Bank. Over the last ten years, he's also emerged as a leading public intellectual, addressing popular audiences through books and other means like speaking to audiences like we have gathered today.

But Professor Stiglitz's contributions are critically important because they are a challenge to what I would call market fundamentalists. That has been true of his work at the theoretical level. And it's also been true in how he has approached policy, policy discussions about globalization, as well as domestic policy. I think you'll hear today that he's very willing to challenge the conventional wisdom if that's what the right economics dictates. So without further ado, Professor Stiglitz.

JOSEPH STIGLITZ: Well, it's a pleasure to be here and to talk on this very important subject. Budget debates are a useful way of trying to focus attention on fundamental issues on what the country's priorities are. But they also reflect views of the economy, of economic behavior. I think it's understandable that there should be a lot of focus on the deficit at the current time given the absolute mismanagement of the budget macroeconomic policies over the last six years. The magnitude of the increase in the deficit in the last six years has been very large.

But as one recognizes that we've had six years of badly managed budgets and badly managed macroeconomics, we have to look at what the realities of our economy are today. And that includes addressing some of the important social and economic priorities.

As we talk about deficits, we have to ask the following question about economic structure. If deficits lead to decreased growth, then a dollar spent on some activity has a cost that is in some sense greater than a dollar. Because we spend a dollar. We don't change taxes. The economy doesn't grow as well. On the other hand, if deficits lead to a stronger economy, then that means the net cost is less than a dollar. And to ascertain that, one has to make a judgment about where the economy is today.

There are four propositions I want to put forward this afternoon. The first is that we should never actually focus just on deficits, but on broader economic concepts. The deficit is only one of several accounting frameworks. And it’s probably not the best way of assessing either the fiscal position of the economy or its economic position. I’ll come back to each of these four propositions in a minute.

The second is deficits may or may not matter depending how the money is spent, how they arise and the state of the economy. The third is that the country has a large number of priorities, real priorities. I’ll only talk about three of them, the challenge of globalization, the growing inequality, the health care crisis. But there are others such as our problems of energy and climate change. Meeting these, some of these, will require spending money that might create the larger deficit. And I’m going to try to argue that in fact if this money is spent well; it does make sense to do that, even if it led to a greater deficit.

And the fourth proposition is that the current state of the economy is such that deficit reduction, done the wrong way, could have a large macroeconomic cost. So that if you put it another way, if we spend money the right way, it could have two benefits, the direct benefit as well as the benefits that come from macroeconomic stimulation.

Maybe I should begin by giving what I think are two further points that are illustrative of these four points that I hope represent a consensus, not of everybody in Washington, but I think of all the right thinking people in Washington.

The first is that we as a nation and world would be better off if we ended the war in Iraq and reduced defense expenditure. That not only the expenditures in Iraq, but Star Wars weapons, represent weapons that don't work against enemies that don't exist. And if you waste money, that's a bad thing. Keynes talked about digging holes and pump priming and argued that even that could be a benefit. But I think given the list of priorities that the country has, we have a lot better ways of spending money than this particular form of pump priming. And in fact, this particular form of pump priming doesn't prime the pump very much. Because, as I argued in my paper on the Iraq war costs, the feedbacks of the re-expenditures don't come back to American as strongly as other forms of expenditure.

The second proposition, illustrative of this general view, is that there are ways of changing our tax structure, raising taxes on upper-income individuals, lowering taxes on lower-income individuals, packages that could reduce the deficit and strengthen the macro economy. So, a redesign of our tax structure could accomplish several of the objectives that I have talked about earlier.

Now, behind what I'm saying right now is a view that the economy is potentially going through a difficult time. I think most people see the economy right now as being weak.

The consensus forecasts are that growth in the United States will be slower this year than it was last year. And even conservative economists see a significant probability of a serious slowdown of the economy. Some people even see a recession. The mistakes in tax and monetary policy that we have made over the last six years are coming home to roost.

The mistaken tax policy, the tax cuts of 2001 and 2003, forced the burden of macroeconomic adjustment on monetary policy that led to low interest rates. Low interest rates did not lead to high levels of investments. The nation’s balance sheet in a sense was such that people took on more debt. But they didn’t spend that debt in productive real investments. In traditional monetary policy, lower interest rates lead to more investments.

So that while there’s more public debt, there’s also an increase on the asset side. In this particular case, what happened was that people refinanced their mortgages, took out larger mortgages. And it was the real estate sector, both directly and indirectly through refinancing of housing that provided a major stimulus to the economy that helped us to get out of the recession of 2001. But that has left a legacy of indebtedness. And it’s important in this not to look at average numbers, but the whole distribution.

And that we are now seeing real problems in the subprime sector. And it’s now reflecting in some other sectors that are also risky sectors of the mortgage market.

Forecasts continue to be that private housing prices will decline. It will be difficult to sustain the economy. In other words, in the last couple of years, consumption has been sustained by people taking money out of their houses. With house prices going down, that's going to be very difficult to continue, and let alone to increase in a way that would facilitate growth.

And that is one of the reasons that many people are pessimistic about the economy today. The problem is with that kind of weak economy, fiscal contraction – particularly poorly designed fiscal contraction – would exacerbate the problem and therefore risk the economy having a more significant slowdown than it otherwise would have had.

Now, that means we have to focus a great deal on managing aggregate demand and the difficult problem of rectifying the balances that we accumulated over the last six years. And there are ways of doing it. The example that I talked about before of redesigning our tax structure. We can redefine our tax structure in a way that would address the problem of the growing inequality in our society, stimulate the economy and reduce the deficit. But that will require careful modeling, careful analysis.

In 1993 at the beginning of the Clinton administration, we faced a problem of a very large deficit, much larger than today, and a weak economy. And we designed a package that had the effect of stimulating the economy. But we were very careful in designing the tax policies. We postponed the tax increases, most of the tax increases, until after the economy had recovered. And we focused what tax increases there were on upper income individuals so the impact would be minimal.

As another example, I think stronger expenditures on social programs – strengthened safety nets, more provisions for unemployment insurance – could again enhance growth and stability and help the economy face the challenges of globalization.

Before talking about these challenges of globalization, I wanted to go back to the first point. I wanted to emphasize a little bit more on what deficits mean and why we shouldn’t focus on deficits themselves. What really matters is the country’s balance sheet, its assets and its liabilities. Consider a company. You would never say, oh, this company is borrowing a lot and therefore, it is a bad company. You would always say what is it borrowing for? Is it for investment? You want to look at both its assets and its liabilities. You want to look at its balance sheet.

And you might also want to look at some of these cash accounts. But you would certainly want to look at its balance sheet. Well, when we talk about the deficit, we’re talking about only one part of that balance sheet. We’re talking about what’s happening to the liabilities, what it owes, but not to what it’s spending the money on.

And if you are borrowing money, which the United States has done, to finance a war in Iraq or to finance a tax cut for upper-income Americans, then the country is being left worse off. The balance sheet does look worse. You have a liability, but you don't have any asset on the other side. But if you are borrowing money to invest in education, technology, or, say, the safety net, then you may have a stronger economy. And this is particularly true when you're facing the kind of problem that our economy is facing today.

Yesterday, I was talking to the former Finance Minister of Sweden. And Sweden has been one of the countries that has been most successful in facing the challenges of globalization. It's a small economy, very open, with a significant manufacturing sector. In terms of some of the rhetoric that you hear in Washington and elsewhere, it should have been a disaster case. They have one of the highest tax rates. And it's not only true in Sweden: Finland and all the other Scandinavian also have very high tax rates. If you only looked at tax rates, you would say these countries would be a disaster. And we had a discussion in which the view was that their success was *in spite of*. No, it's not only in spite of, it was *because of* the high tax rates.

Why is that? It sounds counterintuitive. Well, the answer is it's how the money is spent. Again, looking at both sides of the balance sheet. It was spent in ways that led to a stronger economy, enabling the economy to face some of the challenges of globalization. The net result of this is that, for instance, Sweden and the other Scandinavian countries do much better than the United States on broader measures of success like human development indicators that look at not just GDP per capita, but also look at health and longevity in terms of labor force participation. They’re doing very well. And they have a sense of social solidarity.

In a whole variety of indicators, they are doing not only well, but better than the United States. The United States has been, as I say, facing the big challenges of globalization and of inequality. Most of you know the data better than I do. That while US GDP has been growing, median income in the United States has been stagnating, actually going down in the most recent years. And people at the bottom, salaries have also been stagnating, not just recently but for a number of years.

Globalization necessitates people responding to change or moving from job-to-job. And in the Swedish model, they responded by providing for active labor policies and systems of social insurance that facilitate people moving from job-to-job and provide them with security. One of the aspects of success in a modern economy is willingness to undertake risk. And they would argue that because they have greater security, people are more willing to take risk. They’ve managed their macro economy to have full employment. But not only full employment at low, but full employment at high wages.

And so they have addressed a lot of the problems of insecurity, not perfectly but far better I think than the United States. And the result is, at least in many of the countries of Scandinavia, a much greater willingness to embrace change, the kinds of change that one needs in a dynamic economy.

All of this takes money. It doesn’t come free. How you finance that, whether you do it out of taxes or deficits, may be of second order importance. In the long run, obviously, things have to be paid for. Resources have to be paid for. But as Keynes said, in the long run we’re all dead. In the short run, we face a situation where we have the risk of a weak economy. And that short run context involves, a combination, I think, of a restructuring of our tax structure that would stimulate the economy more and provide greater equality to deal with the growing inequality that has faced the country over the last thirty years.

This would allow individuals to take more risk, invest more in education and technology, assisting active labor market policies that allow people to move from job-to-job. These kinds of comprehensive investment programs I think can provide the basis of a more dynamic economy that will in fact lead to, not only greater economic growth, but a more cohesive society.

Finally, let met just say a few words about a couple of the other issues that I think are areas that we need to spend more. And Henry’s going to talk to you more about health care. And I agree with everything he says. So I don’t want to repeat what he’s going to say. But let me just for matters of emphasis bring out a couple of points.

The first is that there has been a lot of misrepresentation of the nature of the problems that we face with an aging population. There was an attempt by President Bush to scare us about the problems of Social Security. The numbers did not reflect, I think the real nature of the risk. Obviously, there’s uncertainty. There’s uncertainty about all the parameters, about growth rates of the economy, growth rates of productivity, migration, all the numbers that go into forecasting a program that’s going to be going on for years in the future. And those inherently are difficult and uncertain numbers.

But two observations are worth making. The first is that the kinds of numbers that have been used to sell the tax cuts, optimistic rosy scenarios, are markedly different than some of the more pessimistic scenarios that are being used to say that we face a major problem of Social Security. For instance, some of my colleagues told me that if you just adjust the numbers on my migration and make the numbers of migration more realistic, the problems of the deficit and Social Security essentially go away.

The second thing is to put the numbers into perspective. Some of you may know the paper that I did on the cost of the Iraq war where we conservatively estimated the cost of the Iraq war between one and two trillion dollars. And that provides I think a new measure, a new metric, that I use for defining the magnitude of a problem. We could put Social Security on sound financial basis for the next 75 years for approximately somewhere between one-quarter to one-half of an Iraq war.

So if we can afford the Iraq war, what are we talking about a serious problem of financing, Social Security? It is a significantly smaller challenge. The health care most people think of is a more serious problem. But it's a problem with our health care system as a whole, both public and private. And there are a couple of things within our health care system that we can do that would potentially address again a very significant fraction of the problem.

For instance, we are facing skyrocketing drug costs. And a few reforms, like allowing the government to bargain for prices and creating a pharmacology list of drugs that are more effective like Australia does, would do wonders in using drugs more effectively. So what we need here is social science innovation – not even innovation, to compare with our innovation in our medical sciences – to figure out how to deliver the medicines in a way that is more efficient.

In general, the innovation system that we have for testing and making drugs is a very inefficient system based on monopoly and conflicts of interest, a variety of distortions, which lead to higher prices and I think less performance certainly per dollar spent.

A second observation is that practices, standard practices, on a large number of areas differ in various parts of the country. And in ways that are not really systematically related to outcome. And that at least suggests that if you switched from the most expensive to the least expensive practices that are consistent with equally good outcomes, there would be very large savings in costs that would help put the health care system on sound footing.

Now, the final challenge I wanted to just mention very briefly is climate change. I think the evidence that has come out this year has made it even more compelling than it was in the past. I was on the governmental panel of climate change in the 1995 review. And the evidence was overwhelming then. But we made a mistake. We did not expect, I think, it to play out as fast as it has. One of the aspects in which it's come out much faster is, for instance, we didn't anticipate the melting of the artic as rapidly.

I should tell a little story that I was in Davos where all the muckity mucks get together. And at a meeting session, oil executives were talking about climate change. And some of them were saying, you know, you guys are really looking at things in a very pessimistic way. You should look at the bright side of things. And what was that? And they said, well, because the artic ice cap is melting so fast, we will be able to get the oil underneath the artic sea at a much lower cost than previously we had calculated.

So there is a silver lining perhaps in every cloud. But the notion that it is clear that the accumulation of greenhouse gases in the atmosphere represent a significant risk. If we had many planets, we'd conduct an experiment on this planet and if it comes out the way that almost all the scientists are agreed will happen, we go onto the next one and say, well, we made a mistake. Too bad. That would be one thing. But the fact is we can't go onto another planet. And if we make a mistake here, we have no alternative. And the consequences could be very severe.

It reminds me of a little joke that I heard about two planets actually going around and not bumping into each other, but coming close. And one of them was sighing, saying, you know, things are really terrible with all these humans, you know, the problems. And the other one that doesn’t have any problems said, don’t worry. It only lasts for a little while. And that sort of encapsulated the problem of global warming.

Some of the things we can do to deal with global warming will actually save us money. Getting rid of the energy subsidies that we have, including the depletion allowances that we have for oil, would save us money. The ethanol subsidies are outrageous. It almost costs as much in oil to get a gallon of ethanol, so the net output of that system is almost negative. We have a 50 cent tax on sugar-based ethanol, for instance, from Brazil. And we give a 50 cent subsidy to American corn-based ethanol. So we have an enormously distorted system. And getting rid of some of these distortions in energy would actually save us money.

But there are other things we will need to spend money on. We will need to spend money on a whole variety of technological innovations to address the challenges proposed by global warming. Research expenditures in this area have actually gone down in the last twenty years. So these are examples of things where we will need to spend money.

In short, what I wanted to say is just repeating what I said before: don't just ever focus on the deficit. Look at the broader set of issues. Among the broader set of issues are where the economy is today? And the economy today, I think, has a certain degree of precariousness where unthoughtful deficit reduction could have adverse effects. I think there are ways of restructuring our tax structures that could stimulate the economy, address some of the most problems of growing and equality and reduce the deficit.

But more generally, there is a wide agenda facing our society, important priorities that need to be addressed that will require expenditures. And the value of spending has to be weighed against the cost of any deficit. I think there are lots of ways that we can cut expenditures, most importantly in the defense area. But if we fail to do that, it is still almost surely worthwhile spending money in these other areas even if it has some effect on the deficit.

MISHEL: I want to take the privilege of asking the first question. There's much to be proud of in terms of the accomplishments of the economy in the Clinton era, especially the fast growth in incomes and wages starting around 1996 when I think you were actually the CEA Chair. Some people have attributed that to fiscal responsibility as the major cause. And I'm just wondering if you would comment on that.

STIGLITZ: Just like everybody would like to claim that it was because they were in office then that the economy did well. But one has to be very careful at attribution. I think the same thing is true about every policy that was in place. The idea that deficit reduction leads to a strong economy was an idea that Andrew Mellon tried in the midst of the Great Depression. And the effect, of course, was not positive. Then came Keynesian economics. Except when the economy is weak, increasing deficits and government spending can help stimulate the economy.

And that idea has remained at the center of economic analysis. It's been tested over and over again, and thought through in theoretical models. And I would argue it is as valid today as it was 75 years ago when Keynes put these ideas forth. Now, we've had some recent experiments at deficit reduction in the midst of an economic downturn. Nobody in their right mind might have done this. But IMF did this experiment.

And because of these experiments, we have lot more information. And we know that these kinds of policies of reducing the deficit, reducing the deficit in a recession or tightening monetary policy makes things worse. It happened in Argentina. It happened in Korea. It happened in country after country. Now, that poses the question, what about the United States in 1993? Is it an exception to this rule?

Well, that was actually one of the questions that I posed in my book "Roaring '90s". And there I point out two things. One, we were very careful in the timing of what we did. I mentioned that before. We didn't increase taxes and cut back expenditures until after the economy was already in its recovery pattern. And secondly, the way we increased taxes was mostly on upper-income individuals who we thought would have a lesser effect on the economy than increasing taxes on average Americans. And I think we were right.

Now, there is another thing that was peculiar about that particular period. And it’s important to realize the special circumstances that prevailed at that period. And that was the banking system had a large number of long term bonds. How it had come to all of this is a complicated story dealing with peculiar regulations that have no sound basis where the Fed decided that long-term government bonds were going to be treated as safe assets, even though long-term government bonds are still risky.

Because even though the government is not likely to bolt, our experience is that there is risk in the market price because of interest rate volatility. They were treated as a safe asset for purposes of capital adequacy, and risk-adjusted capital adequacy requirements. And that provided the incentive for banks to hold long-term government bonds rather than loans.

That contributed to the weakening of the U.S. economy. Banks held back their loans and the economy was weakened. But it was a very risky strategy. And the way the bookkeeping was done was also very bad. Long-term government bonds were yielding seven, eight percent. Short-term bonds, three or four percent. What’s the difference? Why were these two not the same number?

Well, there's a basic arbitrage formula that says the reason people were willing to hold the long-term is that long-term bonds are risky. And the expected value was that on average the long-term bonds were going to fall in price. And that was because it was expected that long-term interest rates were going to rise. It's a long answer. But the bottom line of all this is that they were gambling that they were allowed to book the income that they got on the long-term bonds even though they should have been putting this money on the reserve against the possibility, probability, that the bonds were going to go down in price.

So as a result of these complex income accounting mistakes and regulatory mistakes, they were induced to hold these loans. Well, not every mistake in policy turns out bad. On average it does. But in this particular case, what happened is Clinton got elected and actually even before that, there was an agreement in 1990 under Bush. And the process of deficit began. And as that happened, for a whole variety of reasons, the long-term interest rates came down. Whether it was due to the borrowing or to other global economic factors doesn't make any difference. Long-term interest rates came down.

And when the long-term interest rates came down, the price of these bonds went up. And it recapitalized our banking system. And the banking system once it was recapitalized was able to lend more. So it might have happened without deficit reduction. It might have been just luck. Or it might have been the deficit reduction contributed a little bit to the decline of interest rates and therefore stimulated the economy. But whatever the view is, one should not think of that as a normal situation. It was a peculiarity, a result of some bad regulatory mistakes, bad accounting. And good luck had it that Clinton was in office when these mistakes had their positive consequences.

QUESTION AND ANSWER SESSION

THOMAS PALLEY: I'd like to press you a little bit more on this question between budget deficits and interest rates. It's really argued around town here that the case for reducing the deficit is that it will lower interest rates. What is your view on that?

STIGLITZ: There are two things. One is, what is the role of the Fed in controlling interest rates? The Fed has pretty good control of short-term interest rates. It is able, so far, to set the short-term interest rates at effectively any level that it wants to. It got them down to one percent. Now they're at five percent. So I think that it is clear that there is no clear relationship between those short-term interest rates and budget deficits.

Now, of course, the Fed looks at inflation. And that has to do with aggregate demand and how aggregate demand is showing up as inflation. That's why I say you have to pay very close attention to aggregate demand and the kind of shifts that I described before, for instance, in tax policy that were designed in ways to have offsetting effects on aggregate demand and leave that unchanged.

The second general point is we live in global financial markets. And so that even in terms of medium and long-term, our American financial markets are obviously affected by global liquidity. What Japan's central bank and financial markets do and, more broadly, their savings affect interest rates. We are not in a state where we are a fully integrated global economy. And so it is probably the case that budget deficits do have some effect on medium and long-term interest rates. So I don't want to ignore the possibility.

But finally, let me say all of this is very contingent on the state of the economy. It's more likely to have a significant effect when what you worry about is crowding out. And crowding out is more likely to be a significant problem when the economy is at full employment. If the economy is not at full employment, then it's less likely to be a problem. And what I articulated before is the view that there's a significant risk that the U.S. economy is going to be operating at less than its potential. And that's what I would be focusing on right now.

FRANK CLEMENTE: You several times talked about tax policies and the importance of them in terms of stimulating growth and dealing with income inequality and investment. Could you articulate your top three priorities in the tax area?

STIGLITZ: Well, the most important priority, I think, is on the degree of progressivity. I think we need to restore progressivity at least to where it was before. A second issue, and maybe that's part of this, is that we ought to be thinking about moving towards what one Senator has called a fair tax, where we tax capital gains, dividends, and wages all at the same rate. I think the argument for preferential treatment, capital gains, has always been very questionable. It leads to all kinds of distortions, tax evasion.

And the argument that was put forward for preferential treatment of dividends was to avoid double taxation, remember in 2003. Well, at the time, people said, well, what about firms that weren't paying taxes? They said, well, we'll take care of that. We'll only give relief for the firms that are already paying taxes. But, of course, in those midnight sessions when the bill finally goes through Congress, that particular provision was deleted. And so now we have many cases of zero taxation, not double taxation.

But a most important point is if the agenda had been to eliminate double taxation, there are many ways of eliminating double taxation and maintaining progressivity. What was done in the 2003 case was not focused on double taxation, but was focused on reducing progressivity. So I would have said, okay, I understand the issue of integrating our corporate individual income tax but there are ways of doing that that maintain progressivity.

ROBERT KUTTNER: As a secondary justification for getting that budget deficit reduced or getting the budget to surplus, you hear the trade imbalance blamed on macroeconomic factors. Some people argue that the trade imbalance is also partly the result of structural factors such as the fact that other countries practice a greater degree of economic nationalism than we do. And that the macro story is really more of an accounting identity that doesn’t really tell you the direction of causality.

Where do you come down in that debate? How much of it is structural? How much of it is macro?

STIGLITZ: Well, actually, my view is a little bit more complex. And I have a chapter in my book “Making Globalization Work” where I try to deal with it. There is a basic identity, almost an identity that says that if you increase the fiscal deficit and you don’t change anything else, the trade deficit goes up. And that’s called the twin deficit problem. But if you look across countries and if you look over time, actually there’s very little relationship between the fiscal deficit and the trade deficit.

And that raises the question, what is going on? First, the proposition that fiscal deficits cause trade deficits is almost a tautology if you understand the basic identities. The second is an observation, empirical observation, that there doesn’t seem to be any clear relationship. But, of course, when the world changes, it doesn’t hold everything else constant in the way that we did in the first experiment.

One way of thinking about what happened in the United States, our trade deficit has been constantly increasing. Underlying this was a period where we had a very large fiscal deficit. And then in the Clinton administration, we got the fiscal deficit down. And now we’ve got the fiscal deficit up again. But our trade deficit just moved very smoothly upward the whole time.

Now, what’s going on? In the 1990s, we were lucky that we had an investment boom. Lots of people can talk different stories about technology, about irrational exuberance, about all kinds of stories. And we can talk about the story that I talked about before. The net effect of which was we didn’t need a fiscal deficit to keep the U.S. economy at full employment because we had these irrationally exuberant people that were investing sometimes in a crazy way.

You know, at the end of the 1990s, 97 percent of the optic fibers had not seen the light. And, you know, that’s great if it was a private sector pump priming, wasting money. But it helps the new information-age economy. And you didn’t need deficit reduction. Now, if you have a large trade deficit, if you’re going to get the economy to full employment, then you may need a fiscal deficit to stimulate the economy.

The magnitude of the fiscal deficit depends on how you structure your tax policy. So the Bush administration should be blamed for having a very badly designed tax policy that minimized the stimulus per dollar of deficit. It took a lot of work to get a policy that was so badly designed. But they did it. There are lots of other tax policies that could have had equal stimulus with a lot smaller deficit.

So we've actually done some testing of this in various countries. In particular, Canada comes out very clear that the trade deficit causes the fiscal deficit. In other words, when the trade deficit goes up, the fiscal deficit responds because the government wants to maintain full employment.

So the underlying problem then is to figure out what are the forces, the structural forces, giving rise to the trade deficit? And it's not, I would argue, so much of the imbalances in protection policies. As it is, there's a basic identity that the trade deficit is the difference between savings and investment. And Americans aren't saving very much. Last year, American saving was negative, household saving was negative. And that is a peculiarity of the United States. And we can have a big debate of what the reason for this is. But it is an abnormality.

And so long as we have that, it is likely to be the case that we will have problems of a trade deficit. But all this is part of a complex equilibrium system. And what we argue in the book "Making Globalization Work" is that one of the underlying structural reforms has to do with the global reserve system that helps account for why people are willing to continue to buy dollars, U.S. Treasury bills, even in a world in which confidence in the dollar is weakening.

ROBERT L. BOROSAGE: Thank you, very much.

(END OF TRANSCRIPT)