Feb 5 2009, 10:45 am by Conor Clarke

An interview with Robert Barro

I spoke with Robert Barro of Harvard yesterday about the stimulus bill, fiscal policy, and related issues in macroeconomics.

I wanted to speak with Professor Barro after reading his piece in the Wall Street Journal about the multiplier on government spending. The piece, which argued that the multiplier has historically been much lower than the Obama administration hopes, produced a tremendous amount of response -- from Paul Krugman, Brad DeLong, Greg Mankiw, Matt Yglesias, and Tyler Cowen (some of them several times). And that response was notable, in part, because it turned into a reflection on the "standards" of the stimulus debate itself. I was interested to hear what Barro thought about his critics this debate.

He was admirably patient with my questions:

Conor Clarke: What I am trying to do is sort of apply a barometer to modern macroeconomics and see where the profession is, because I am sort of confused by a lot of things.

Robert Barro: [laughs] Probably the fault of the profession.

Well, one thing I am confused by is where all of this resurgent interest and fiscal policy came from. That's very broad. But where do you think it came from? When I took macroeconomics in college there was not a lot about fiscal policy.

It came from the crisis and memories of the Great Depression and the fact that monetary policy seems to have done not a tremendous amount, and conventional stuff doesn't look like its going to work anymore. And it's about grasping at straws to try and find something else.

And I take it from the Wall Street Journal piece you wrote last week... well, the piece is just specifically about measuring multipliers, but I take it that you are fairly skeptical in general that fiscal policy will boost aggregate demand.

Right. There's a big difference between tax rate changes and things that look just like throwing money at people. Tax rate changes have actual incentive effects. And we have some experience with those actually working.

What would you say is the best empirical evidence there?

Well, you know, it worked to expand GDP for example in '63 and '64 with the Kennedy/Johnson cuts.
And then Reagan twice in '81 and '83 and then in '86. And then the Bush 2003 tax-cutting program. Those all worked in the sense of promoting economic growth in a short time frame.

I'm the middle of a study where I am trying to estimate this overall, going back to 1913 -- sort of constructing some measure of the overall effect of the tax rate at the margin, at the moment. I'm just looking at that now, actually...

You're talking about the multiplier on a dollar of...

Well both things, but here I'm talking about the tax rate stuff. Get some measure of the effect of marginal tax rate that comes from the government -- federal, state, local. And then you can see what it looks like going down or going up and how the economy responds. And then, in addition to that, the government might be spending more or less money on either military stuff or not on military stuff. And we can estimate that at the same time. With the government spending stuff, the clearest evidence is in wartime. It's not that it's the most pertinent, but it's the clearest in terms of evidence because it's the dominating evidence at those times, especially during the world wars.

Do you read Paul Krugman's blog?

Just when he writes nasty individual comments that people forward.

Oh, well he wrote a series of posts saying he thought the World War II spending evidence was not good, for a variety of reasons, but I guess...

He said elsewhere that it was good and that it was what got us out of the depression. He just says whatever is convenient for his political argument. He doesn't behave like an economist. And the guy has never done any work in Keynesian macroeconomics, which I actually did. He has never even done any work on that. His work is in trade stuff. He did excellent work, but it has nothing to do with what he's writing about.

I'm not in a position to...

No, of course not.

I'm not in a position to know things like the degree to which Paul Krugman counts as a relevant expert on new Keynesian economics.

He hasn't done any work on that. Greg Mankiw has worked in that area.

And Greg Mankiw is, I guess, skeptical of spending for the same reasons that you are: he says that there's some empirical evidence -- I think he cites the Christina Romer study from 15 years ago -- that a dollar of tax cutting has a larger impact than...

The Romer evidence is very recent actually. It's an ongoing project.
I thought it's from 1993 or something like that. Maybe that's something else.

They have a current thing that's going to be presented at Brookings at the next meeting, where they have some estimates of how the economy responds to tax changes. It's not really looking at tax rates. It's looking at tax revenue, which is not the same thing. That's mostly what Greg was referring to, which is going to be presented in a few months.

I would need to go back and check. But one question, and I think Greg Mankiw raises this question as well, is, Why does this set of evidence depart from what seems like the standard Keynesian theory that a dollar of spending would have a larger multiplier than a dollar of tax cutting?

I don't think it is really confusing at all, because when you cut taxes there are two different effects. One is that you cut tax rates, and therefore give people incentives to do things like work and produce more and pay more -- maybe, depending on what kind of taxes. And then you also maybe give people more income. This income effect is the one that's related to this Keynesian multiplier argument, where it's usually argued that government spending should have a bigger effect. So that's the income effect. But the tax-rate effect, inducing people to do things like work and produce more and invest more, is a whole separate effect, and that could easily be much bigger than the multiplier thing, than the income thing.

This might just be my confusion, but the inducement to work, is separate from the idea of boosting aggregate demand and consumption in the short run.

Oh it's exceptionally different. But the experiment is that the government is doing something by changing the tax system to lower its collections -- by, for example, a tax cut. The response of the economy to that is not going just to isolate this business of giving people money. It's also going to have these incentive effects, more than tax rebates, on economic activity. It's going to be a combination of those two things -- income effects and incentive effects. One piece looks like this sort of multiplier stuff, which is analogous to government spending -- probably because the government spending has a first-round effect where it comes in and directly affects the aggregate demand -- and then in the second round it sort of looks like a tax cut. That's why the government spending thing is bigger in textbooks: because it has this first round in addition to all these subsequent ones.

But all that is just income responses -- people having more or less income, or the government keeping the money and then that shows up as people's income. None of that is about responses in terms of incentives -- incentives changing in response to lower or higher tax rates. And the evidence that Romer and Romer look at is combining the tax rate stuff with the income stuff. I didn't know it was possible to do that but, hey, you get different viewpoints form different people. But the study I am doing now is intended to include all these things together in one framework.

And when does this study come out?

Who knows. I mean, it's a big project, we've been working on it for a while. Part of it is just measuring, back since 1913, the effect of the tax rate that the federal government or the total government is levying on people. Measuring that was a big project. But we've sort of finished that.
I just have two more questions, quickly. One is that you've mentioned that monetary policies sort of seem to be stuck. And I guess there have been a couple of people -- Robert Lucas is one that comes to mind and maybe Greg Mankiw too -- who say there are other kinds of monetary policy that can still be pursued.

Oh I agree with that. There are things that they can still do. The sort of standard stuff. They drove the nominal rates on the usual government paper down to zero, and they drove down the federal funds rate, so they don't have any more leeway on that. But there is plenty of other stuff that they can do and that they are doing.

And what is that?

The Federal Reserve is buying up all kinds of other assets, like long-term government bonds. But they are also buying a lot of private stuff, and that will presumably have a substantial impact. I mean there's a downside to doing all this, but it should certainly have effects. So in that sense they haven't run out of ammunition. I agree with that.

The last thing is just about the stimulus bills as it stands. Two things here. One thing is what do you think about the ratio of spending to tax relief in the bill. And the second is, if you judge it by Larry Summers standard -- that stimulus be temporary, timely and targeted -- does it clear the bar?

This is probably the worst bill that has been put forward since the 1930s. I don't know what to say. I mean it's wasting a tremendous amount of money. It has some simplistic theory that I don't think will work, so I don't think the expenditure stuff is going to have the intended effect. I don't think it will expand the economy. And the tax cutting isn't really geared toward incentives. It's not really geared to lowering tax rates; it's more along the lines of throwing money at people. On both sides I think it's garbage. So in terms of balance between the two it doesn't really matter that much.

Well, presumably Larry Summers is not an idiot.

[laughs] That is another conversation. I have known him for 25 years, and I have opinions about that.

Well, presumably Christina Romer is not an idiot if you're...

They've brought in some reasonable people in terms of economic advisors. I don't know what impact they're having, and I suppose they have different views on Keynesian macroeconomics than I have. But I'm giving you my opinion about it.

I think Geithner is a good appointment. I think he's going to focus on what really matters, which is the financial system and the housing market. That's where they should be putting their efforts. That's where the problems came from.

Fixing the credit market, you mean?
That was the main problem in the Great Depression, too. Though then it was concentrated on commercial banks which were the main credit vehicle. That was the main problem in the depression and fixing that was the main thing that ended the depression.

Well since you brought it up... I have no idea what your views are on financial economics, but it seems like there's going to be another round of TARP-like bailouts. Do you have an opinion on how that should be structured?

That's a hard problem. I mean, they're basically floundering around -- the crew of the previous administration more than the current one. But I admit they're having a good effect by putting more resources into assistance. The exact way to do it is pretty tricky. It's not clear what the best thing to do is. Larry Summers did bring in Jeremy Stein, who is probably one of the best people in the area. I think he's going to have a lot of impact on that design. I hope so. That's another person they hired recently.

From Harvard?

Yeah, he's a Harvard economics department person. He's in the White House. Summers brought him in to advise particularly on the financial and housing issues, the design of the new regulations structure. That was an excellent appointment. That's the stuff that's really going to count. Not this spending thing. I mean democrats were waiting with all these ridiculous projects, and now they've got an excuse to bring it through politically.

Just one last thing. I think Joe Biden and a couple other people have said there's a fairly wide consensus among economists that fiscal stimulus in the form of a large spending bill is the way to go, and...

He said first that every economist thought that.

Well, that's Joe Biden hyperbole. But what is the lay of the land there? Presumably there are economists out there that take this seriously. And then there are economists out there who think there's a one-for-one crowding out with any government spending. And I guess, where does the profession fall on that spectrum?

Most economists haven't really been thinking about this issue, they haven't really focused on it. It's not their specialty. Most economists today, they haven't really been thinking about this kind of multiplier issue. Which goes back to that first question you asked about how come now we're so worried about this. I don't think most economists are focused on this, or that they're familiar with the empirical evidence. I don't think they've really worked on the theory. So I don't know, maybe they have some opinion that they got from graduate school or something.

I think my sense is that the sentiment has been moving against this kind of approach both within the economics profession and more broadly. I think the initial view was that "yeah, this is a terrible situation" -- which I agree with -- "and we've got to do something about this, and maybe this will work." I think there was support in that sense.
Are there any conditions under which you might think spending could have a positive effect on output or is it always going to be the case that as a relative matter that tax cuts are going to be better?

Tax cuts are bound to be better. I think the best evidence for expanding GDP comes from the temporary military spending that usually accompanies wars -- wars that don't destroy a lot of stuff, at least in the US experience. Even there I don't think it's one for one, so if you don't value the war itself it's not a good idea. You know, attacking Iran is a shovel-ready project. But I wouldn't recommend it.

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Comments (10)

Steve Koch
February 5, 2009 12:40 PM
Willem Buiter says pretty much the same as Barro (i.e. focus on fixing the house lending/financial system and don’t do stimulus). Buiter also says that USA and UK both face a big problem with debt because of budget deficits and trade inbalance and that they both need to be cautious about adding
debt. Buiter says the way to turn a recession into a depression is to go the protectionist route.

An analogy might be that the accumulated national debt is like a mountain (the USA) with enough snow (debt) that it will take little to trigger an avalanche (depression).

For some reason, there is little discussion that letting politicians spend a trillion bucks in fiscal stimulus with virtually no debate poses a huge moral hazard in terms of corruption and undue political influence on spending. It is also likely to be grossly wasteful and ill targeted.

Who in their right mind wants Nancy Pelosi (or Tom Delay, back in the day) micro managing the economy? It is absurd.

The stimulus package combines some stimulus with a whole lot of investment. It makes no sense to make huge investment decisions so rapidly. The investment portions of the stimulus package should be removed so that they can be discussed throughly in the future. That also simplifies the stimulus package and makes it much easier to understand and implement.

Obama says that there will be a disaster if the stimulus package is not passed immediately, without acknowledging that the bulk of the package has nothing to do with stimulus in the short run. He is obviously trying to panic the public into signing off on the investment (i.e. non-stimulus) part of the package, to ram this stuff through without an adequate public debate of the specifics.

Obama should stop playing politics with the financial crisis. It is not necessary to achieve his agenda (he has plenty of time and votes to pass the long term legislation) and makes him look like just another hack politician.

Obama might want to talk to Bill Clinton and see what he thinks. Clinton studied economics in depth and might have some useful insights.

Obama is trying to nip the recession in the bud but a more realistic and prudent goal may be to try to avoid a depression. Trying get out of the recession super rapidly may actually enhance the chances of going into a depression.

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**Ben Lockwood**
February 5, 2009 3:19 PM

For all his enthusiasm about tax cuts, Barro doesn't say much about how those cuts should be distributed across the population. But this seems like an important issue -- presumably we trade off a higher marginal propensity to spend tax cuts (among those with lower incomes) against a higher marginal product of labor (among higher income earners, who will work more if they get to keep more of their salary). How to balance this trade off is a key empirical question and goes to the heart of the debate between advocates of the Bush tax cuts and the "redistribution" Obama has proposed. Here's hoping that Barro's forthcoming research sheds light on this question.

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**Don the libertarian Democrat**
February 5, 2009 6:00 PM

"And the guy has never done any work in Keynesian macroeconomics, which I actually did. He has never even done any work on that. His work is in trade stuff. He did excellent work, but it has nothing to do with what he's writing about.'
I don’t see this as a particularly profound point. I mean, after all, he could be doing a lot of work in
his field and end up being wrong.

"None of that is about responses in terms of incentives -- incentives changing in response to lower or
higher tax rates.'

This is true, but we are constantly presented with incentives and disincentives. For instance, there's
a tax incentive to buy a house, and a tax incentive to save in an IRA. Also, since we're human beings,
our assessment of these incentives can change.

I tend to agree with Buiter, and also on the lack of specificity Barro gives. Telling us that people
often respond to monetary incentives isn't exactly earth shattering news. I like the idea of a cut in
Sales Tax to be withdrawn in the future, say $200 Billion, and Tax Cuts for Investment, say $100
Billion. Infrastructure about $100 Billion, and Social Safety Net Spending and aid to states as well.
This doesn't seem crazy, and has the merit of moving towards a compromise, in which I prefer
Edmund Burke's ideas over Barro's. Perhaps Professor Barro can offer his own plan or tell me if my
favorites seem reasonable.

Dallas

February 5, 2009 7:19 PM

It seems that all these discussions about stimulus and multiplier effects from increased govt
spending have an implicit assumption about the interchangeability of labor (fungibility of labor) that
may not be true in todays society.

It may make sense that if fiscal stimulus can employ the un-employed in a productive fashion, we
may stimulate the economy with a multiplier effect. However, our unemployed dry wall hangers are
not steel workers and heavy equipment operators and can't move to those jobs without years of
training. The politicians don't want to build more houses (which is what the unemployed
construction workers know how to do), but heavy construction projects like bridges, sewerage
plants, etc. all require a different type of "construction worker" with different skill sets.

In the 30's, when Keynes did his work, construction labor = construction labor and building a house
or a bridge just required a lot of general labor and wheelbarrows. Now "construction labor" has
fractured into many sub areas that are no longer interchangeable, ranging from dry wall hangers to
pipe fitters and heavy equipment operators (they are also specialized as to the type of equipment --
backhoes operators are not the same as heavy crane operators).

With todays labor specialization, throwing more demand at one specialty (ie. heavy equipment
operators) will rapidly deplete the small pool of available labor and then just take jobs from existing
productive activities. This just creates wage inflation in a narrow field without increasing aggregate
demand.

Times have changed !!!!!

southsiderosie

February 5, 2009 7:34 PM

Barro noted that "you cut tax rates, and therefore give people incentives to do things like work and
produce more and pay more -- maybe, depending on what kind of taxes....the tax-rate effect,
inducing people to do things like work and produce more and invest more, is a whole separate effect,
and that could easily be much bigger than the multiplier thing, than the income thing."

This assumption cuts to the heart of Keynes' critique of liberal economics: its seems to assume away unemployment. And frankly, I don't understand how a tax cut matters if you are unemployed - or even if you are afraid of losing your job. Wasn't the last "stimulus check" by and large put into savings or used to pay down debt?

There is also no guarantee that business tax cuts will automatically lead to more employment; why wouldn't companies simply pocket the extra profits and squeeze more hours out of their workers rather then spend them on expanding employment?

NickDanger  February 5, 2009 7:52 PM

One thing Barro is certainly an expert on is academic jealousy over Paul Krugman's popularity. Krugman actually has the audacity to explain things in a way people can understand. He hasn't devoted his life to useless, abstract modeling like Barro, so Barro deprecates him, viciously and mercilessly. Typical academic.

Elrod  February 5, 2009 7:53 PM

Sorry, but Barro sounds an awful lot like other supply siders out there who ignore real wage levels and the tilting of wealth to the upper end. The 2003 tax cut did nothing to increase wages in real terms, but it sure provided a lot of capital to Wall Street firms. Tax cuts on the lower end DO lead to consumption. Low-end folks just can't save very much. But high-end taxes lead to more savings and not consumption. Probably not even much investment these days either.

And the idea that shifting tax rates will such a behavioral effect seems rather dopey. Sure, if you’re talking about reducing a 70% level to 30% then you’ll have major behavioral change. But a shift of about 3-5% will do very little to incent people to work harder.

Eric F  February 5, 2009 9:13 PM

Let’s see what Adam Smith-worshipping glibertarian Robert Barro thinks about the stimulus...

What! He’s against it? That’s crazy, you must be joking. Next you’ll be telling me he supports trickle-down tax cuts instead...

jackdan  February 6, 2009 2:13 PM

Barro says this proposal is "just like throwing money at people"...which apparently isn’t stimulus...but that "the best evidence for expanding GDP comes from the temporary military spending that usually accompanies wars -- wars that don't destroy a lot of stuff." So building bombs is stimulus.

But how, exactly, is "temporary military spending" not "throwing money at people"?? If he can acknowledge that building bombs to drop on Iran can help the economy, how can he deny that weatherizing homes here at home can’t help?

The man is in denial.

timk  February 7, 2009 4:54 AM

With some astonishment, Krugman pointed out a glaring mistake in Barro's analysis of WWII data.

It would have been nice if Barro had responded to this criticism instead of just making snotty personal remarks about Krugman.