How to have growth beyond stimulus

Keynesian economists blame the sluggish US growth and lack of job creation on the insufficiency of stimulus measures. If only Congress had agreed with President Obama to greater stimulus, they say, the current US recovery would have been much stronger. This is a dubious proposition. The deeper problem lay in the limitations of fiscal stimulus as a response to the 2008 crisis.

Stimulus spending has been sizeable. According to the International Monetary Fund’s measurement of these things, the fiscal stimulus has been large and persistent. The IMF looks at “general government structural balance as a percent of potential GDP,” which measures the general government budget balance net of automatic stabilisers — spending that kicks in during downturns, such as unemployment benefit. In 2007, the structural deficit was 2.8 per cent of gross domestic product. This rose to 5.0 per cent of GDP in 2008, mainly because of tax cuts implemented by the Bush administration at the onset of the crisis. With Mr Obama’s stimulus program, the structural deficit rose further to 7.5 per cent of GDP in 2009, and stayed at roughly that level through 2011.

Thus, the structural fiscal expansion was more than 4 per cent of GDP on a sustained basis during 2009-11 compared with 2007. The actual deficit including automatic stabilisers and the Troubled Asset Relief Program (bank bailout) funds was far larger, rising from 2.7 per cent of GDP in 2007 to 13.0 percent of GDP in 2009, 10.5 percent of GDP in 2010, and 9.6 percent of GDP in 2011. Net public debt as a share of GDP soared from 48.2 per cent of GDP in 2007 to 80.3 per cent of GDP in 2011, according to IMF data.

Fiscal stimulus, in short, has been tried, but did not succeed in spurring a robust recovery. Advocates of stimulus bemoan the idea of reversing the fiscal expansion now, in view of the weak economy, and argue that it be prolonged and expanded. The original idea of the stimulus, however, was as a temporary measure that would make a bridge to self-sustaining private-sector-led recovery.

The Keynesian interpretation in late 2008 and early 2009 was that the economic downturn was a cyclical matter. A housing boom had turned temporarily to bust. Consumer spending was temporarily down. Temporary tax cuts would boost consumer spending while a temporary boost in government spending would create temporary jobs in construction and preserve jobs in cash-strapped state and local governments. By 2010 or 2011, a natural recovery would replace the temporary fiscal boost, and allow it to be withdrawn.

Yet the cyclical recovery proved to be anaemic. The national accounts suggest some reasons why. First, the housing bust did not reverse itself. As of the first quarter of 2012, real investments in residential structures remained 55 per cent below the 2005 level. Yet this was not surprising. It was neither possible nor desirable to re-inflate the housing bubble.

Second, the fiscal stimulus was at least partially offset by a rise in household saving. Economic theory and experience teaches that temporary tax cuts and transfers to households, of the kind implemented repeatedly in recent years, are partly or wholly saved. Households pay down their debts rather than making new outlays on consumer goods.
Many state and local governments apparently used the federal transfers to replace rather than augment their own revenues and to replenish their own financial balances, rather than to reverse their plans for layoffs and investment cutbacks. There was no rise in overall government investment (i.e. federal, state, and local) spending as a share of GDP. The stimulus was almost all in the form of tax cuts and transfer payments rather than outlays for investment projects.

Two major implications of the Keynesian interlude are the following. First, and most importantly, there has been no new dynamic growth sector in the US economy to replace the defunct housing boom. Consumer spending did not surge; housing did not return; private investments in industry did not take over; and public investments did not fill the gap. Second, the multipliers on short-term Keynesian stimulus measures proved to be low and variable rather than high and predictable. The continuation of the Keynesian option at this stage is therefore unappealing: a further build-up of public-sector debt with little guarantee of job creation or a reliable exit strategy.

The tragedy is that the Republican opposition to the Obama-led stimulus measures is even wider off the mark. The Republican strategy would make the temporary tax cuts permanent, and even create new tax breaks for top earners, to be paid by swingeing cuts in programs for job training, education, infrastructure, the environment, and support for the poor. The Republicans live in a world in which the rich are the only worthies in the society (the “job creators”), the unemployed and poor should fend for themselves, and public goods do not exist. And they do so despite thirty years of failed trickle-down policies that have created unprecedented inequality, deepening poverty, and no solutions to the loss of jobs.

There is another way, not represented by either US political party. It would be based on the following four premises.

First, the US (and Europe) needs a new source of long-term growth, not a short-term Keynesian bridge to consumer-led growth.

Second, the highest social returns can be achieved by bringing the new technologies – information, communications, transportation, materials, and genomics – to bear on the problems of sustainability and the quality of life. Long-term growth (and quality of life) should be based on an investment-led transition to a low-carbon, low-pollution, and high-amenity built environment, drawing upon the cutting-edge advances of science and engineering.

Third, the transition to sustainability requires a mix of public and private investments. As one example, private investments in low-carbon energy (wind, solar, nuclear) need to be linked to public investments in long-distance transmission grids. Similarly, the transition to smart electric-powered urban mobility will require a mix of private investments and public infrastructure. The public investments should be financed in part through long-term borrowing backed by dedicated future revenue streams (e.g. public-sector tariffs and gradually rising carbon taxes).

Fourth, rather high levels of taxation as a share of national income (as in the highly successful economies of northern Europe) are needed to keep budget deficits low while also ensuring adequate
public revenues for universal coverage of high-quality public services and human capital investments that span early childhood through public education, apprenticeships, and job training.

While there are absolutely urgent short-term matters to face — notably putting out the fire of bank runs in the eurozone — the deep solution to the crisis of the high-income countries lies in a long-term vision of sustainable development, one that promotes a mix of complementary public and private investments. To get there, we need to move beyond the stale US political debate pitting short-run Keynesian stimulus on one side versus trickle-down economics on the other.