

The paralysis of fiscal policy: a triumph of emotion over economics

The U.S. economy is growing, but remains close to the bottom of a very deep hole. Unemployment is between 9.5% and 16.5%, depending on which of the official measures you prefer. Meanwhile, many people are working well below their capabilities to make ends meet.

With all this underemployment there's no shortage of capacity to produce goods and services. What we lack is spending. In this context monetary policy is relatively feeble. In a weak economy, consumers and businesses are not creditworthy, so even if interest rates can be lowered further they won't help much. What's left is fiscal policy – federal government spending.

Since we're desperately in need of more spending, and the private sector isn't doing enough, it's a bit of a mystery why a groundswell of public and political opinion has lined up to oppose government spending. People appear unwilling to accept that the financial crisis, the recession, and the sluggish recovery represent a huge failure of the private sector. Without last year's stimulus package of government spending we would be in far worse shape than we are. And given the current economic headwinds, the private sector will not automatically rebound by itself in an acceptable time-frame.

Analogies to the 1930s seem on the surface unrealistic – we haven't seen long lines at soup kitchens and catastrophic waves of bank failures. But the comparisons are important, since it's largely because of government interventions that we didn't spiral down further. Sure, unemployment rose to 10% last year, but in the 1930s it reached 25%, and the economy didn't really recover until the ultimate government spending program known as World War II.

What does this have to do with today's economic outlook?

Right now we're approaching the end of the economic jump-start provided by the fiscal stimulus package and the usual post-recession inventory cycle. Job growth has not turned up strongly, and there are legitimate fears that private demand will not pick up the slack as these temporary boosts fade. It's easier to keep the economy rolling than to turn it around after it stalls, so it makes sense to take out some insurance against a renewed downturn in the form of some



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extra government spending. The potential costs in terms of lost economic output, quite apart from the human damage, dwarf the amounts being discussed. Many trillions of dollars are at stake, and millions of people's lives.

So why the opposition? Extending benefits to the long-term unemployed, and providing assistance to financially strapped state and local governments, would quickly flow into incremental spending.

The main popular concerns are legitimate in normal times, but they are misplaced in the specific circumstances of today:

1. **Fear of excessive debt:** the US government's debt is not excessive right now according to the financial markets, which are happy to lend at historically low interest rates. It's important not to let the debt become excessive in the future, and we need a long-term overhaul of spending and revenue. But for now, with the markets signaling a high risk of renewed recession, a few hundred billion dollars of increased debt would be a small price to pay to raise the odds of a solid economic recovery.
2. **Suspicion of government intervention:** a prejudice against government intrusion into the economy is healthy – free markets generally work far better than governments to encourage investment, innovation and efficiency. But free markets also generate deeply harmful depressions from time to time, and there's no puritanical merit in enduring years of pain when a sharp nudge from public spending could kick the private sector back into its habitual pattern of growth.

- Skepticism about bailouts:** handing out taxpayers' money to people who aren't working or aren't paying their mortgage is distasteful, and in normal conditions creates perverse and undesirable incentives for idleness and irresponsibility. But with today's unemployment rate, it's inconceivable that a large number of job openings are remaining unfilled – extra benefits may be affecting who gets hired, but not the level of unemployment. Help for state and local governments might also seem to reduce incentives for efficiency, but right now it is critical to averting mass layoffs of teachers and police.

The bottom line is that there are powerful reasons for pushing out more federal money into the economy on a strictly temporary basis. Spending is needed

now – austerity will be needed later. Ideally we would combine the two, legislating triggers that would ramp up programs now and eliminate them as the economy improves. Further ahead some large cuts in major programs (Medicare, Defense) will be vital to correct the structural deficits that were already baked into the budget before this recession.

But while we're worrying about the long run, it makes no sense to allow misplaced fears to inhibit us from boosting the economy right now. Government spending saved us from a rerun of the 1930s, and it can nudge the private sector back into action now. The government should pull back once the momentum of growth builds, but to stop its efforts now would be a potentially disastrous error.

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