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The Spending versus the Austerity Debate

There is a very important debate taking place on the best way to fix our economy between those who favor more **spending** versus those who favor **austerity**. Recently the spending camp has been very vocal in promoting their theory, including recent papers by Larry Summers, Brad DeLong and Paul McCulley, Zoltan Pozsar and a new book by Paul Krugman.

What is not in dispute in the debate is that the private sector is deleveraging as an aftermath of the financial crisis, negatively impacting growth. What is in dispute is the appropriate response.

The critical difference between the two camps is the appropriateness of discretionary fiscal policy. Economists who support the austerity viewpoint believe if the government borrows to spend, there is no lasting improvement to the economy and you eventually just end up with more debt (technically stated a multiplier less than one). As explained in the introduction to their paper DeLong and Summers believe government spending will pay for itself: "We argue that, while the conventional wisdom rejecting discretionary fiscal policy is appropriate in normal times, discretionary fiscal policy where there is room to pursue it has a major role to play in the context of severe downturns that take place in the aftermath of financial crises…the likely multiplier associated with fiscal expansion is likely to be substantially greater and longer lasting than in normal times."

Both sides have fancy models to prove their point but as everyone should know by now all of these models have flaws because we are dealing with a social science not a hard science. Nevertheless the debate should focus on the risks and rewards of pursuing more spending with both sides acknowledging their vulnerabilities, not hiding behind their political affinities.

The biggest risk with too much austerity is the potential to push the economy into an unnecessary downward spiral. At roughly $54 trillion our nation's net worth is still massive so ignore the Armageddon scenarios professed by some alarmists. However, our recovery remains very fragile. If the federal government tried to balance the budget while the private sector and state and local governments are deleveraging, our economy would suffer a severe downturn, confidence would plummet and ironically our debt to GDP would most likely worsen. While a federal balanced budget is not practical immediately our politicians could improve the quality of the spending and desperately need to reform entitlements and our tax code.

Too much of Obama's stimulus package was transfer payments and tax relief to individuals and states that was saved (or used to pay down debt) and had no lasting impact on growth. For growth related spending we should look no further than our nation's infrastructure. The American Society of Civil Engineers gave America's infrastructure ratings a cumulative grade of D and estimated a 5 year investment need of $2.2 trillion. Given low interest rates and many unemployed construction workers it is reasonable to expect a positive return on spending in this area. Keep in mind, however, that infrastructure spending is not a quick fix and can be wasteful, so we need to develop a better process to spend wisely.

The austerity camp rightfully argues there is a limit to the amount of borrowing and spending that can occur. Europe is currently learning that lesson. While we are not yet in a similar position, at some point our deficits will undermine confidence and impair our ability to borrow. Skeptics are right to point out that the spending advocates were claiming that the private sector was supposed to be taking the lead in making new investments by now as an outcome of the original stimulus package. Progress here has been slow. Finally, if private sector deleveraging still has a decade to run like some claim, it is unlikely that federal government spending can fill that void completely, a possible outcome not currently addressed by the spending advocates.

From our perspective the reality is that our economy is complex and adaptive, and it is impossible to know with precision the correct policies to solve our growth and employment problems. Most likely, despite the conviction of each side, the best solution is probably a combination of both approaches. More debt can and should be taken on if the future return on the spending is greater than the current outlay. However, we need to pay for two decades of debt-fueled growth by first repairing private balance sheets and then public balance sheets. We should expect suboptimal growth until this rebalancing has taken place. Likewise, we need to insure the stability of long-term public finances by reforming entitlements and taxes now. We will eventually get there, but the road is likely to be rocky.

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