Capital

The Curse Of Economic Uncertainty

Thomas F. Cooley, 07.07.10, 6:00 AM ET

There is a remarkably testy debate going on about the tension between the desire for a coherent fiscal policy and the anemic recovery of the global economy. The most abrasive voice is that of economist Paul Krugman, who has been attacking German policymakers for addressing their fiscal deficits, loudly insisting on the need for more stimulus in the U.S. and labeling everyone who disagrees with him asinine. There was a lot of debate at the recent G-20 meetings but no support for the Obama administration's view that fiscal sustainability should be a "medium-term" goal (whatever that means) and that they should not abandon stimulus at a time when the recovery is fragile.

In sharp contrast to the U.S., E.U. members are cutting spending and tackling their rising deficits. Among the most dramatic changes of direction is the recent U.K. budget, which proposes expenditure cuts and tax increases totaling 113 billion pounds ($172 billion) to slash a deficit of 11% of economic output. Many of the spending cuts tackle a public sector that has grown enormously over the period of the Blair and Brown governments. Most members of the euro zone have also announced austerity budgets, and many have used the European sovereign debt crisis as an impetus to begin needed reforms of their labor markets and to attack bloated public sectors.

How do you settle a debate about the merits of fiscal sustainability versus continued stimulus? Do you resolve it by looking at the economic pain in Greece and concluding that its austerity isn't helping the country? Do you look at Ireland, which suffered a sharp contraction as a result of its fiscal reordering? No. Greece will be lucky to avoid restructuring its debt, and it will unquestionably pay a price for failing to deal with a huge inefficient public sector or an uncompetitive private sector. Similarly Ireland was forced to raise taxes and slash public sector wages to address the consequences of a burst property bubble and a loss of competitiveness. Ireland has begun to grow again, but its unemployment remains very high.

The simple truth is that there are times when countries have no choice but to acknowledge the unsustainability of their current policies and take steps to correct them. It is unfortunate that the worst recession since the great crash of the 1930s has forced so many countries to face this choice at the same time. But the fiscal problems facing most countries did not primarily result from the financial crisis and the recession. There have been two decades of public sector growth and fiscal expansion, the consequences of which were masked by growing economies.

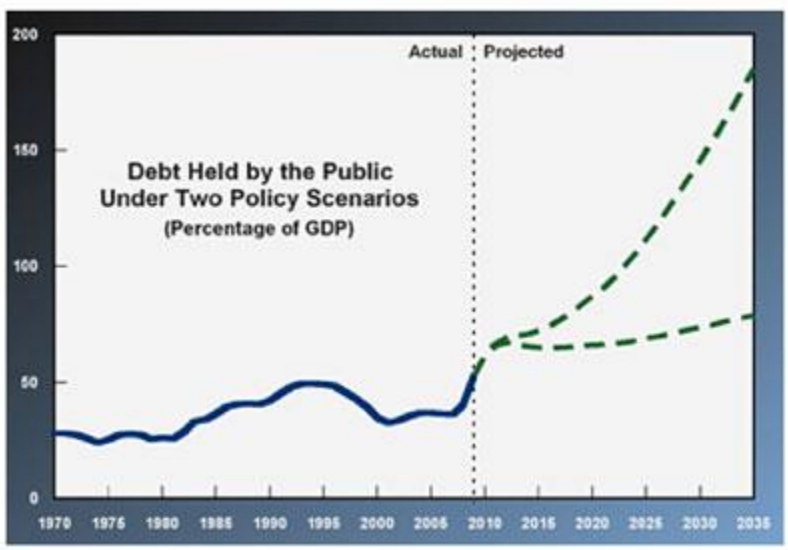
Countries do recover from fiscal austerity, and they do benefit from well-articulated, balanced fiscal policies, but seldom (if ever) without economic pain in the form of unemployment and lost output. A good object lesson is Sweden. The Scandinavian nation reformed its economy out of necessity in the 1990s and was sufficiently flexible in the recent financial crisis to come through it relatively unscathed. As every weekend warrior knows, one can mask the pain from an injury for a long time with medication, but masking doesn't address the underlying flaw. And it can make the long-term remedy far more painful. More important, uncertainty about what the fix is going to be is debilitating.

Every sentient being knows that the U.S. faces serious fiscal problems, but there is a lot of uncertainty about how extensive they are. The massive fiscal stimulus masked many of the problems facing state and local governments. Those problems are coming to the fore, and these governments are being forced to slash spending and employment. Nearly every state and local government across the country is looking at large budget shortfalls for their 2011 fiscal years, most of which begin on July 1, 2010. Since they are generally required by state constitutions or local charters to balance their budgets, they will have no choice except to raise taxes and/or make large cutbacks and lay off workers to bring spending and revenue into line. There is also a lot of uncertainty about the extent of underfunded pension liabilities and the impact they will have because they do not typically show up on budgets.

Everyone knows there is a problem but not what the solutions are going to be. The Obama administration has created a deficit commission to study the problem, but they won't report until the end of the year--after the midterm elections. Details are important, but this is not the Manhattan Project. The new British government came up with a plausible start on fiscal responsibility in very short order. Given the rhetoric and previous policy initiatives of the Obama administration, it is virtually certain that corporations and wealthy individuals are going to face higher taxes, but in what form?

The Bureau of Economic Analysis reports that U.S. corporations are sitting on $1.6 trillion in cash reserves, a record amount, because they are reluctant to expand in the uncertain policy environment. Even looking at the companies in the Standard & Poor's 500 index of blue chips--and stripping out financials, which are required by regulators to keep large cash reserves in order to cushion against risk--the cash-on-hand number is a whopping $1.1 trillion. Would a more transparent, business-friendly environment turn that cash into investment and jobs?

The Congressional Budget Office just published its most recent budget projections. They describe two scenarios for future budget deficits, shown in the following graph:



The more optimistic picture is one in which taxes increase sharply, health care costs are brought under control and spending is somewhat constrained. It still implies higher long-term levels of debt than we have experienced for the last 40 years. The other picture is one where we look like Japan. It is pretty sobering.

Our fiscal problems are daunting, and they suggest why a lot of folks are reluctant to just assume we can spend more on stimulus and pay the piper later. But they are not unsolvable. In the end I am convinced of one thing: The worst thing is that we don't have a plan.

Thomas F. Cooley is the Paganelli-Bull professor of economics and emeritus dean of the NYU Stern School of Business. He writes a weekly column for Forbes. He is a co-editor of the forthcoming book Regulating Wall Street: The New Architecture of Global Finance *(Wiley, 2010).*