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Capital

The Dog Days

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There is an epic and epically unpleasant debate that taking place for much of the last year about stimulus and austerity. On one side are the born-again Keynesians who believe that our recovery is faltering because we simply haven't spent enough to jolt the economy into recovery. This lot includes the Obama administration and some of its harshest critics. They point to the experience of the 1930s when, after signs of recovering, the economy slipped back into recession.

They have castigated the Germans for failing to be good economic citizens of the world for focusing on fiscal sustainability and not spending more. As *The New York Times* editorial page put it: "Germany also has contributed less than its fair share to the global stimulus, preferring to free ride on American and Chinese stimulus spending." Fair share? Free ride? "Instead of committing to more spending, Germany is now preparing a multiyear program of deep spending cuts. Given its troubled history, we can understand its fear of deficit spending and inflation. But right now more German austerity will likely cripple Europe's nascent recovery and Germany's own prosperity."

But *The New York Times* and its vituperative columnist were not alone in taking the Germans to the woodshed. The Obama administration, particularly Treasury Secretary Timothy Geithner, has been unrelenting in lecturing the Germans about increasing spending. On the other side of this debate are of course the Germans, the British and many in the U.S. who are concerned about the deficit and the unsustainable path it is on. It's a battle of austerity vs. spend-more-now to get the party started.

What is the "austerity" crowd worried about? This year the U.S. fiscal deficit is projected to be about $1.3 trillion or 9.1% of GDP. This is the largest it has been for 65 years save for the fiscal 2009 deficit that was 9.9% of GDP. The total deficit is now 69% of GDP, more than double the level in 2007 and it is rising. This is not just unsustainable; it is a potentially crippling problem that limits our flexibility as an economy and our ability to respond to future crises.

How does the evidence look so far? The German stimulus was smaller as a percentage of GDP as the critics noted and so far the German economy has been responding to the promised austerity with a sizzling performance. The most recent data report a 2.2% quarterly growth spurt, unified Germany's best-ever performance. Annualized this is a 9% growth rate--unprecedented for mature developed economies. This may not be sustainable but it does tell us something.

Unfortunately the lessons of Germany and the lessons of the 1930s have been lost in the inflated rhetoric of this debate. In the U.S. "austerity" has come to mean letting the Bush tax cuts expire. And further stimulus has come to mean a series of modest one-off quick fix jolts to encourage job formation. Cast in those terms its no wonder that U.S. voters seem to prefer none of the above.

What happened in 1937 in the U.S. to cause the U.S. to slide back into recession? It is argued that FDR got a sudden burst of fiscal anxiety and tried to make the budget more sustainable by cutting spending. Real government spending, measured in 1937 dollars, declined between 1936 and 1937, but by less than 0.7% of GDP. It then rebounded in 1938.

It is implausible that such a small and temporary decline in spending reduced real GDP by nearly 3.5% in 1938 or reduced investment by 20%. More likely is that the inexorable rise in taxes on dividends and the income from capital, along with a proposed tax on retained earnings had a chilling effect on investment. FDR was enamored of experimentation and experimentation created uncertainty. Businesses eventually shied away from capital formation, the primary engine of job growth, because the rules of the game kept changing.

The real lessons of the 1930s are connected to current policy debates by the issue of uncertainty. Germany decided that they needed some stimulus to deal with the worst effects of the Great Recession. But they also realized that, in order to encourage investment in the long run, they had to demonstrate a credible commitment to fiscal soundness. They had to outline a sustainable path and show a commitment to follow it. It doesn't matter that the austerity package hasn't shown real bite yet--what matters is that it will.

In the U.S., by narrowing the focus of this discussion to the expiration of the Bush tax cuts, the administration has sabotaged our recovery. Uncertainty is the enemy of capital formation. From a business perspective the only thing that is certain, gimmicks aside, is that there will be higher taxes on the income from capital. Not only do we not have an austerity plan, we don't have any plan. We do have a commission on the deficit that is supposed to report by the end of this year. But keep in mind that the delay and uncertainty is very costly. This is not the Manhattan Project. Germany delivered a fiscal plan in weeks. The U.K. delivered a fiscal plan in weeks. There are three components of any feasible plan: spending (we need to spend less), taxation (we need to collect more) and distortions (we need a tax system that distorts fewer decisions). Sadly we never get to a discussion of distortions.

This is an interesting battle to watch. Germany and the U.K. have voluntarily put their priority on fiscal sustainability. Many other countries, like Spain, Portugal and Greece, have done so involuntarily. The U.S. has opted for massive spending without a fiscal plan--labeling sustainability a "medium-term" problem. Time will tell us a lot. Unfortunately there is no way to watch from the sidelines. *Ich bin ein New Yorker!*

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