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A Brief Guide to the US Stimulus and Austerity Debates

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Should we allow the fiscal cliff, with its across-the-board spending cuts and big tax increases that will affect almost every American, to take effect? Economists have been weighing in on such fiscal policy questions in what seems to be the most intense election-year debate in many years. To help our readers keep track of this debate, we offer a list of some of the specious arguments against fiscal stimulus and for austerity, together with brief responses in italics.

"A strong recovery is unrealistic."

Using evidence from many historical episodes worldwide, some economists observe that "financial recessions," unlike garden-variety downturns, are not followed by quick recoveries. Since recuperating from this kind of recession is inevitably slow, the argument goes, Keynesian approaches involving stimulus packages and automatic stabilizers will exhaust the country's capacity to pay long before politicians' promises of full employment are realized. Others argue that the recent fall-off in employment is mostly supply driven. Specifically, the claim is that overly generous unemployment benefits and food stamps have led to a reduction in the amount of labor people want to bother selling. As a result, firms' costs have risen, or have not fallen fast enough to keep economic growth going. According to this supply-side argument, putting money in people's pockets may help them buy things, but it does nothing about production costs, and hence nothing about the root cause of a weak recovery.

The US federal government has no solvency constraint. It cannot go broke and does not need to retire all of its debt. The federal government's freedom to spend on behalf of the public opens the way for a large stimulus effort that can accelerate a recovery from the enormous financial shock of 2007–08 and ensuing recession. Cuts in benefits, like reductions in wages, undermine demand for consumer goods, and, in general, the dismal science's view of the effect of government benefits on work effort and the labor supply is often somewhat overblown. Moreover, eligibility rules have not changed fast enough to cause such a sudden jump in normal levels of unemployment. It is no coincidence that large increases in the unemployment rate began in late 2007, almost immediately after the numbers of mortgages with overdue payments began to rise and the housing bubble began to deflate. No significant easing of eligibility rules for government benefits occurred at that point in time.

"Fiscal policy does not matter."

The argument here is that, in response to fiscal stimulus, consumers will simply put aside more savings to pay anticipated future tax increases. As a result, a Keynesian tax cut or spending increase has, according to this view, virtually no effect on long-term disposable income and therefore a near-zero effect on output and employment. Whether taxpayers foot the bill now or in the future makes no difference, as long as the incentives involved are the same in both cases.

Households are rarely shrewd enough to put aside exactly the amount that this orthodox theory prescribes. Many do not save at all in a given pay period. Moreover, there is no rule that says a given deficit will be "paid for" at some particular future date, or ever. In fact, the government usually sells new securities to pay off its old debts as they come due. For these reasons, people have no way of forecasting possible tax increases. In fact, it is by no means even clear that they usually have a good sense of their future gross incomes.

"Focusing on the short term at the expense of the long term is irresponsible."

This view frames Keynesian stimulus as a dangerous narcotic for the economy. Often, proponents of this outlook compare fiscal stimulus to various kinds of irresponsible, short-term-focused behavior—say, raiding a pension fund, or using up your savings to have a big party.

Heavy borrowing is usually not prudent for individuals, families, or firms but often makes sense for major investments, which incur heavy costs up front in the interests of a long-term payoff (such as owning a home). Public deficit spending (on investment or consumption) makes the most sense at the federal level in the US case, since the central government, as the issuer of a sovereign currency, has no real solvency constraint. This gives the federal government the ability to set its spending policies with full employment, low inflation, and other policy objectives as its only guidelines.

"The concept of ever-increasing GDP growth is dangerous and outmoded."

Steady and rapid growth, according to this argument, cannot proceed without despoiling the environment or bringing on cataclysmic climate change. Therefore, while jobs and material goods represent important needs, they will eventually have to be obtained in some way other than by reliably achieving 3 or 4 percent real GDP growth.

It is possible to encourage growth and employment in ways that do not plunder the environment. For instance, a full-employment program in which the government guarantees a paying job to all who are ready and willing to work, like the employer-of-last-resort program advocated by Hyman Minsky, could incorporate direct job creation in "green" projects or in other activities, such as care work, that have relatively benign environmental impacts.

The big economic arguments have changed over the years, but the ideas of John Maynard Keynes and his followers have already stood the test of time. They offer great insight in this campaign season.

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