



## Policy Note 2003/1

# THE BIG FIX: THE CASE FOR PUBLIC SPENDING

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Keynesian economics is back. As John Maynard Keynes stressed, total spending matters-and not who does it or for what purpose. Tax cuts and deficit spending are, therefore, on the agenda; low interest rates seem here to stay. Stimulus is the watchword of the day. It remains only to fill in the details, or so it seems.

**THE ECONOMY IS IN TROUBLE.** Investment, far below what it was two years ago, shows little sign of revival. Consumer spending, having held up remarkably well during the same time, is now more likely to tail off than to accelerate. And though the federal government could soon be spending an extra \$100 billion to \$200 billion on war, its spending otherwise is also in decline.

The Bush team knows all this. And it realizes that the president's neck is on the line if stagnation continues and unemployment rises into 2004.

And so, Keynesian economics (my native creed) is back. As John Maynard Keynes stressed, total spending matters-and not who does it or for what purpose. Tax cuts and deficit spending are, therefore, on the agenda; low interest rates seem here to stay. Stimulus is the watchword of the day. It remains only to fill in the details, or so it seems.

But quick-convert Keynesians are unlikely to be good ones. And their programs, based on crude ideas and analogies-for instance, to the tax cuts that led to the Reagan boom of 1984-may prove ineffective today. This is the political danger President Bush faces, and one that any Democratic opponent had better try to understand.

Though tax cuts aimed at the middle class might keep its spending going for a time, the president will aim his tax cuts first and foremost at business and the rich. But lowering taxes on profits and capital gains by no means ensures that American corporations will rev up their investments. They might. But it is a shaky bet, since many companies doubt they can earn the profits that would enable them to benefit from the breaks.

If firms were to get tax breaks they didn't plow back into growing their companies, then tax cuts simply would be passed along to shareholders as dividends or to executives as salary. In neither case could we expect the effect on consumption spending to be large. And so, if the Bush tax cuts fail to stimulate investment, they won't have much effect on consumption either.

Bush's consumption plan has one main tenet: relying on Federal Reserve Board Chairman Alan Greenspan to keep interest rates low so that households will continue to borrow. But this fix, which has undeniably worked so far, may run out of steam soon. How much more debt will households willingly incur? How much more will banks willingly lend? And, having cut short-term interest rates to the bone, how far can the Federal Reserve bring down long-term interest rates without putting a lethal squeeze on bank balance sheets? Banks make their money, after all, on the spread.

In government, budget slashing at the state and local levels could unleash chaos. State and local governments are looking at revenue gaps that would require them to cut spending or raise taxes by more than \$100 billion to balance their budgets. This potential for homegrown disaster seems to have evaded the administration's radar so far.

The Bush strategy is therefore unlikely to generate the growth and profitability required to restart strong business investment, stabilize households and basic government services, and bring down unemployment. A war with Iraq would certainly stimulate spending and profits. But if Iraq proves to be the puny opponent that the administration expects, then even that boost would be at best temporary and fairly small.

This opens the way for Bush's opponents to advance a different program. But such a program cannot be built on nostalgia for the Clinton years, with their balanced budgets and booming markets. That bubble has burst once and for all. The current problems, which were not created by Bush alone, must be solved in new ways.

First, Democrats should stand for saving the government that we have. State and local government spending on schools, health care, the environment, and core services is deeply needed and well supported. That spending is also imperiled. A federal revenue-sharing program is the simplest way to save it, though other devices, such as increasing the Medicaid match, would help as well.

This kind of spending would, of course, bring deficits. But in fact, the deficits already exist. Either they will be dumped on American households-through higher state and local taxes or service cuts-or the federal government can shoulder the debt for the next few years, as it alone can afford to do.

Second, Democrats should support temporarily cutting Social Security payroll taxes now, to encourage private consumption by working families. If Congress refused to pass a permanent repeal of estate taxes, revenue expected from that source could be credited to the Social Security Trust Fund, keeping it more or less whole. What better way to promote fairness than to recycle accumulated wealth into the retirement system that supports us all?

Third, if the private sector won't invest, let Democrats call for the public sector to take up the slack for a while.

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For starters, the government should devote resources to solving one of our biggest problems: energy. We need a more diversified transportation system. We need programs that promote conservation and the development of renewable fuels. The government can also help by enacting needed social improvements such as extended unemployment insurance, universal health coverage, and a prescription drug benefit.

Such measures-if large and bold enough-would position the Democrats as pro-growth and anti-unemployment in ways Bush could not credibly claim to be. But we must also recognize the dangers of our situation, for these affect us as Americans, Democrats and Republicans alike.

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The lurking economic threat today is to the dollar. We no longer live in the world of 1969, when the Bretton Woods institutions-the exchange-rate system then run by the International Monetary Fund-protected us (up to a point) against the financial excesses of Vietnam.

Nor is it still 1981, when then Federal Reserve Board Chairman Paul A. Volcker could defend the dollar with double-digit interest rates. Today interest rates must remain low, but even so, our ability to grow depends on the caprice of global markets. It depends specifically on the willingness of the rest of the world's nations to add to their holdings of dollars and dollar debts. This they have done, without fail, for 30 years.

But will they continue, in the face of low interest rates, a flat stock market, deepening Japanese stagnation, debt defaults in Latin America, and perhaps an unpopular war? Or will they start shifting assets out of dollars, adding a dose of devaluation, and perhaps inflation, to our miseries? Will they perhaps turn Europe-with its balanced economy, diversified energy sources, and low military spending-into a rising center of world finance? And if that starts to happen, how on earth should we respond?

It's not an easy question. There is certainly no easy answer. But we may need to ponder it if we hope to enjoy a return to prosperity any time soon.

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