

Perspective: Austerity or stimulus? What we need is growth

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Greece is collapsing, Italy and Spain's output is declining, and even Germany and Great Britain are slowing down. In addition to their direct economic costs, these "austerity" measures aren't even swiftly closing budget gaps. As incomes decline, tax revenue drops, and it becomes harder to cut spending. A downward spiral looms.

These events have important lessons for the United States. Our government cannot forever borrow and spend 10 percent of gross domestic product each year, with an impending entitlements fiasco, to boot. Sooner or later we will have to fix our finances, too. Europe's experience is a warning that austerity — a program of sharp budget cuts and (even) higher tax rates, but largely putting off "structural reforms" for a sunnier day — is a dangerous path.

Why is austerity causing such economic difficulty? What else should we do?

Lack of "stimulus" is the problem, say the Keynesians, epitomized by the New York Times and its columnist Paul Krugman, who has been crusading on this point. They claim that falling output in Europe is a direct consequence of declining government spending. Yes, 50 percent of GDP spent by the government is simply not enough to keep their economies going. They — and the U.S. — just need to spend more. A lot more.

Where will the money come from? Greece, Spain and Italy simply cannot borrow any more. So, say the Keynesians, Germany should pay. But even Germany has limits. The U.S. can still borrow at remarkably low rates. But remember that Greece was able to borrow at low rates right up to the moment that it couldn't borrow at all. There is nobody to bail out the U.S. when our time comes. What should we do then?

The traditional Keynesian answer was: Move on to monetary stimulus. Deliberately inflate and devalue. Break up the euro so the southern European countries can inflate and devalue even more.

Lately, Keynesians have been pushing an even more audacious idea: Deficits pay for themselves. In a March 17 column, Krugman wrote: "there's a plausible case that spending more now actually improves the long-run fiscal picture."

U.S. federal revenue is less than 20 percent of GDP. For deficit spending to pay for itself, then, \$1 of spending must create more than \$5 of output. Economists have been arguing about whether this "multiplier" is more or less than one; five is beyond any reported estimate. Keynesians made fun of "supply siders" in the 1980s, who made similar claims for tax cuts. At least those cuts had incentives on their side, which stimulus doesn't.

Is there another explanation, and a more plausible way forward?

The stimulus explanation is curious for what it omits. Think of Greece.

Is it irrelevant that Greece is 100th on the World Bank's "ease of doing business" list, behind Yemen; 135th on "starting a business" and 155th on "protecting investors?" Is it irrelevant that professions from truck driving to pharmacies are still rigorously protected, that businesses can't fire people, that (according to a Greek colleague) you can't even get a driver's license without paying a bribe? Does it not matter at all that, as the International Monetary Fund delicately put it in its latest report on Greece, the "structural reform program" aimed at "deeply ingrained structural rigidities in labor, product, and service markets" got nowhere?

Doesn't it matter that Greece has a high combination of individual, corporate, wealth and social taxes? True, Greeks famously don't pay taxes, but businesses that must operate illegally to avoid taxes are much less efficient.

Money is fleeing Greece, Italy and Spain. Does talk of exiting the euro, followed quickly by devaluation, inflation (the IMF predicts 35 percent in Greece, should it leave) and capital controls, have nothing to do with lack of investment?

Keynesians urge devaluation to gain competitiveness. Greek wages have in fact declined about 10 percent to 12 percent, according to the IMF. Yet investment and production aren't turning around. Greek "demand" needn't matter — the whole point of the euro area is that Greece can sell to Germany, so long as Greece stays in the euro area. But it isn't happening. Is that a mystery? Would lower wages compel you to invest money in Greece; surmount a thicket of regulation; and expose yourself to the threats of wealth, property and business taxation, currency expropriation and capital controls, or even nationalization?

In sum, isn't it plausible that a good part of Europe's austerity doldrums are linked to "supply," not "demand"; "microeconomics," not "macroeconomics"; weeds in the economic garden, not a want of fertilizer? Isn't it plausible that factors beyond simple declines in government spending matter in a debt crisis?

That insight suggests a different strategy: Let's call it "Growth Now." Forget about "stimulating." Spend only on what is really needed. We could easily stop subsidies for agriculture, electric cars or building roads and bridges to nowhere right now, without fearing a recession.

Rather than raise taxes further on the "rich," driving them underground, abroad, or away from business formation, fix the tax code, as every commission has recommended. Lower marginal rates but eliminate the maze of deductions. In Europe, eliminate the fears of wealth confiscation, euro breakup and currency devaluation that are driving savings and investment out of the south. Most of all, remove the profusion of regulation and (increasingly) direct government management of the economy.

Europe is beginning to figure this out. Italy's prime minister, Mario Monti, is addressing his country's debt crisis by proposing far-reaching deregulation, now. While his proposals aren't complete or close to radical enough, and they are combined with some unfortunate business-stifling tax increases, it's remarkable that anyone in Europe is beginning to talk about this.

"Structural reform" is vital to restore growth now, not a vague idea for many years in the future when the stimulus has worked its magic. It's also a lot harder politically than the breezy language suggests. "Reform" isn't just "policy" handed down by technocrats like rules on the provenance of prosciutto; it involves taking away subsidies and interventions that entrenched interests have grown to love, and have supported politicians to protect. They will fight it tooth and nail.

That is even more reason to address this now, while there is a crisis. The will to do so may evaporate if better times return, and the ability to do so might disappear if the economies plunge.

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