Let’s get fiscal

By Bill Emmott

June 8, 2016 – *Project Syndicate*

Everyone knows there is no gain without pain. But there can be pain without gain – a lesson that Western populations have been learning the hard way since at least 2012. With years of fiscal austerity in the United States, Europe, and Japan having achieved nothing, it is time for governments to start spending again.

The proposal will be met with outrage from many governments, especially, but not exclusively, Germany’s, and will be dismissed by the many political candidates who treat sovereign debt, built up by the incumbents they are seeking to depose, as the devil’s work. But beyond ideology and self-interest lies a simple and unavoidable truth: austerity is not working.

Japanese Prime Minister Shinzo Abe reluctantly acknowledged austerity’s failure when he announced on June 1 that his government would postpone a planned increase in the country’s consumption tax. Far from helping to control Japan’s budget deficit and huge public debt, the tax hike probably would have reduced revenues. After all, the previous hike, implemented in April 2014, quickly drove the economy back into recession.

The eurozone – the developed world’s leading champion of austerity – has yet to come to the same realization, despite glaring evidence. In 2012, eurozone leaders signed a fiscal compact aimed at controlling public debt – which, in total, amounted to 91.3% of GDP, according to the International Monetary Fund – by forcing countries to cut spending and raise taxes. By 2015, the eurozone’s budget deficit, as a share of GDP, had fallen by two-thirds from its peak in 2010.

Yet gross public debt had actually increased, to 93.2% of GDP. Indeed, while Germany has managed to reduce its gross public debt, from 79.7% of GDP in 2012 to 71% last year, debt ratios in France and Italy have continued to rise, despite tight fiscal controls (especially in Italy).

Elsewhere in Europe, the United Kingdom has followed a similar trajectory, with gross public debt increasing from 85.3% of GDP in 2012 to 89.3% of GDP in 2015. And in the US, the debt ratio rose from 102.5% to 105.8% over the same period.

The problem, of course, lies in sluggish economic growth, which undermines wage growth, weakens tax revenues, and makes it impossible for governments to pay down their debts. Among the biggest drags on growth today is fiscal austerity. The more governments cut their deficits, the faster growth slows – and the further out of reach debt-reduction targets become. Thus runs the self-defeating cycle of fiscal austerity.

To be sure, this is not always how austerity works. In the inflation-plagued 1970s and 1980s, when investors’ demand for inflation-risk premia pushed up long-term borrowing costs, larger deficits tended to boost long-term interest rates further, while smaller deficits reduced them.

It was this experience that caused policymakers after 2010 to assume that reducing government demand would help to boost private investment. (In the eurozone, it should be noted, arguments for fiscal austerity were also fueled by mistrust among governments, with creditor countries demanding that debtors endure some pain in exchange for “gains” like bailouts.)

But times have changed. For starters, we are no longer living in an inflationary era. On the contrary, Japan and some eurozone countries face deflation, while inflation in the UK is essentially zero. Only in America is inflation picking up – and only gently. Moreover, long-term borrowing costs are at historic lows, just as they have been throughout the last five years. Pursuing austerity in this context has resulted in a drag on growth so severe that not even the halving of energy prices over the last 18 months has overcome it.

Expansionary monetary policy – that is, massive injections of liquidity through so-called quantitative easing – is clearly not enough, either. While QE does serve a purpose – and remains necessary in Europe and Japan – it has failed to stimulate private investment and accelerate job creation and wage growth.

Some direct intervention in wages may help. The UK has implemented an increase in the mandatory minimum wage, and some US states, led by California, will soon follow. Japan, which faces stagnant wages, despite apparent labor shortages, may stand to benefit the most from this approach.

But, in today's world, nothing can substitute for fiscal expansion. Many countries, particularly in Europe, need to boost public investment in infrastructure. More broadly, Europe needs a new Marshall Plan, this time self-financed, rather than funded by the Americans, to kick-start economic growth and boost productivity. There is plenty of scope for a similar program in the US, too. Such spending could even help get tax revenues growing, by pushing employment and wages higher.

At a time of low borrowing costs and little to no inflation (or even deflation), austerity is not the answer. It is time for policymakers to recognize that there is no need for pain that is not bringing any gain. It is time to get fiscal.

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