Should governments spend away?

By Raghuram G. Rajan
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With sovereign-bond markets still showing little concern for the massive levels of borrowing and spending across advanced economies, it is tempting to think that there is effectively no limit to further stimulus. But we owe it to future generations to recognize how spending today could affect investment tomorrow.

Advanced economies have already spent enormous amounts providing pandemic relief to households and small- and medium-size businesses. The International Monetary Fund's June outlook estimates that, including fiscal measures and credit guarantees, spending reached approximately 20 percentage points of GDP. In the United States, Congress is considering new spending ranging from 5% of GDP (Republicans) to 15% (Democrats). And still more government spending, and thus borrowing, will be needed by the time the pandemic is behind us.

Economists have argued that current low interest rates mean that sovereign debt remains sustainable at much higher levels than in the past. They are right, provided that nominal GDP growth returns to a reasonable level, interest rates stay low, and future governments limit their spending. Even if the first two assumptions hold true, the third behooves us to assess the quality of current spending.

In normal times, responsible governments aim for a balance over the course of the business cycle, repaying in upturns what they borrow in downturns, with the cohorts that benefit during the first phase repaying during the second. There is, however, no chance that the massive debts accumulated during the current crisis will be repaid soon. Even with higher taxes on the rich – a policy that will meet with intense opposition and arguments against growth-stifling austerity – a large share of the accumulated debt will be passed on to future generations.

In the past, such debt was easier to repay. Because strong growth meant that each successive generation was richer, past debts shrank relative to incomes. Yet today, societal aging, low public investment, and tepid productivity growth all militate against our children being much richer than we are.

After all, we are already bequeathing to them two enormous challenges: looking after us when our entitlements run out of funding, and addressing climate change, which we have done almost nothing to combat. Worse, having limited our investments in their health and education, we have left much of the next generation underequipped to lead productive lives.

By further limiting the next generation's ability to make public investments, the debt that we pass on will likely weigh down future incomes. And if we deplete overall borrowing capacity now, future generations will be unable to spend as needed if they encounter another "once-in-a-century" catastrophe like the two we have experienced in the last 12 years. Intergenerational fairness should be as important as intra-societal fairness for those alive today.

In practical terms, this means that the notion that anyone should be made whole because the pandemic "wasn't their fault" immediately becomes untenable. While many countries do compensate uninsured homeowners hit by a localized flood or an earthquake, people in unaffected parts of the country pay willingly (through higher taxes) because they know that they would receive the same treatment. With a shock as large as the pandemic, this calculus no longer works; the burden inevitably must fall on future generations, who obviously bear no responsibility for the pandemic or the response to it.

Therefore, we must target our spending carefully. As the pandemic and its consequences persist, we must shift to protecting workers, not every job. All laid-off workers should, of course, be provided a decent level of public assistance, certainly until overall employment starts to recover. It is morally right for a rich society to provide a safety net for all, and it is in everyone's interest that workers and their children retain – or even enhance – their capabilities during the pandemic.

Having done that, authorities should be more discriminating in the firms they support, allowing the market to do most of their job. For example, in normally flourishing neighborhoods, small businesses start up and shut down all the time. While failure is painful for the proprietor, there is little permanent damage to the economy. If there is sufficient demand for flowers when the economy recovers, a new florist can start up at the site of the old one. Consequently, it is not cost-effective for the authorities to freeze the old florist in place by paying her landlord, her bank, and her workers indefinitely.

Similarly, authorities should not offer grants or subsidized loans so that distressed large businesses like airlines and hotel chains can retain their employees. These businesses will keep excess employees only as long as they get the subsidies. It will be far cheaper for the government to support laid-off workers through unemployment insurance than to pay employers to retain them indefinitely when their work has clearly disappeared.

Large corporations that need money to stay afloat can borrow from markets, made buoyant by central banks. If they are so indebted that no one will lend to them, they can restructure their debts in bankruptcy and get a fresh start.

In some situations, however, firms may be unable to deal with market forces unaided. In economically disadvantaged communities, where a few small hard-to-restart businesses are vital to community life, support is desirable for both economic and social reasons. Similarly, while markets treat large firms reasonably, mid-size firms may find it harder to get funding even when viable. If an economically viable firm, employing 100 workers, closes because it has had no revenue over much of the year, its specialized workers will be dispersed, its equipment will be sold in liquidation, and the norms and routines that enable it to function will be lost forever. Even if its exit leaves a big economic hole, a start-up would not easily step in and fill it.

But here, too, public support should not be a free lunch. Wherever possible, the government should ensure that existing capital, whether from bondholders or stockholders, absorbs a fair share of the losses before government support kicks in and the burden passes to future generations.

Finally, wherever possible, we should boost investment in the young as partial compensation for the debts we are leaving them. For example, we must spend to reopen public schools safely, and ensure the necessary facilities for students whose only option is distance learning.

Government spending is necessary today. But just because sovereign-debt markets have not yet reacted adversely to extremely high levels of borrowing and spending, we must not – for our children's sake – throw caution to the wind.

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