
The Opposite of Austerity

By Robert Shiller *Wed, Mar 20, 2013*

The respected Yale economist argues that temporarily higher taxes and higher spending is a better path to recovery than permanently lower taxes and lower spending.



With much of the global economy apparently trapped in a long and painful austerity-induced slump, it is time to admit that the trap is entirely of our own making. We have constructed it from unfortunate habits of thought about how to handle spiraling public debt.

People developed these habits on the basis of the experiences of their families and friends: when in debt trouble, one must cut spending and pass through a period of austerity until the burden (debt relative to income) is reduced. That means no meals out for a while, no new cars, and no new clothes. It seems like common sense – even moral virtue – to respond this way.

But, while that approach to debt works well for a single household in trouble, it does not work well for an entire economy, for the spending cuts only worsen the problem. This is the paradox of thrift: belt-tightening causes people to lose their jobs, because other people are not buying what they produce, so their debt burden rises rather than falls.

There is a way out of this trap, but only if we tilt the discussion about how to lower the debt/GDP ratio away from austerity – higher taxes and lower spending – toward debt-friendly stimulus: increasing taxes even more and *raising* government expenditure in the same proportion. That way, the debt/GDP ratio declines because the denominator (economic output) increases, not because the numerator (the total the government has borrowed) declines.

This kind of enlightened stimulus runs into strong prejudices. For starters, people tend to think of taxes as a loathsome infringement on their freedom, as if petty bureaucrats will inevitably squander the increased revenue on useless and ineffective government employees and programs. But the additional work done does not necessarily involve only government employees, and citizens can have some voice in how the expenditure is directed.

People also believe that tax increases cannot realistically be purely *temporary* expedients in an economic crisis, and that they must be regarded as an opening wedge that should be avoided at all costs. History shows, however, that tax increases, if expressly designated as temporary, are indeed reversed later. That is what happens after major wars, for example.

We need to consider such issues in trying to understand why, for example, Italian voters last month rejected the sober economist Mario Monti, who forced austerity on them, notably by raising property taxes.

Italians are in the habit of thinking that tax increases necessarily go only to paying off rich investors, rather than to paying for government services like better roads and schools.

Keynesian stimulus policy is habitually described as *deficit* spending, not tax-financed spending. Stimulus by tax cuts might almost seem to be built on deception, for its effect on consumption and investment expenditure seems to require individuals to forget that they will be taxed later for public spending today, when the government repays the debt with interest. If individuals were rational and well informed, they might conclude that they should not spend more, despite tax cuts, since the cuts are not real.

We do not need to rely on such tricks to stimulate the economy and reduce the ratio of debt to income. The fundamental economic problem that currently troubles much of the world is insufficient demand. Businesses are not investing enough in new plants and equipment, or adding jobs, largely because people are not spending enough – or are not expected to spend enough in the future – to keep the economy going at full tilt.

Debt-friendly stimulus might be regarded as nothing more than a *collective* decision by all of us to spend more to jump-start the economy. It has nothing to do with taking on debt or tricking people about future taxes. If left to individual decisions, people would not spend more on consumption, but maybe we can vote for a government that will compel us all to do that collectively, thereby creating enough demand to put the economy on an even keel in short order.

Simply put, Keynesian stimulus does not necessarily entail more government debt, as popular discourse seems continually to assume. Rather, stimulus is about collective decisions to get aggregate spending back on track. Because it is a collective decision, the spending naturally involves different kinds of consumption than we would make individually – say, better highways, rather than more dinners out. But that should be okay, especially if we all have jobs.

Balanced-budget stimulus was first advocated in the early 1940's by William Salant, an economist in President Franklin Roosevelt's administration, and by Paul Samuelson, then a young economics professor at the Massachusetts Institute of Technology. They argued that, because any government stimulus implies higher taxes sooner or later, the increase might as well come immediately. For the average person, the higher taxes do not mean lower after-tax income, because the stimulus will have the immediate effect of raising incomes. And no one is deceived.

Many believe that balanced-budget stimulus – tax increases at a time of economic distress – is politically impossible. After all, French President François Hollande retreated under immense political pressure from his campaign promises to implement debt-friendly stimulus. But, given the shortage of good alternatives, we must not assume that bad habits of thought can never be broken, and we should keep the possibility of more enlightened policy constantly in mind.

Some form of debt-friendly stimulus might ultimately appeal to voters if they could be convinced that raising taxes does not necessarily mean hardship or increased centralization of decision-making. If and when people understand that it means the same average level of take-home pay after taxes, plus the benefits of more jobs and of the products of additional government expenditure (such as new highways),

they may well wonder why they ever tried stimulus any other way.

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