To spend or not to spend, that is not the question.

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When John Maynard Keynes propounded his *General Theory of Employment, Interest and Money* in 1936, the world was in the throes of the Great Depression. Market forces had failed to do anything to revive the economy. Even Roosevelt's attempt at public works and subsidies were not having effect – partly because he was still trying to “balance the budget”. The fundamental point of Keynes' theory is that free markets do not necessarily result in full employment nor in the economy producing at potential GDP. When the economy slows and confidence gets eroded, the Government needs to step in with deficit spending to keep the wheels moving. With the starting of the Second World War in 1939 and with the US itself jumping into the fray in 1942, deficit spending was forced upon the Government and the economy. And while humanity suffered, the economy recovered. We are at a similar junction of a slowing (or very slowly recovering) global economy; and to my mind, what needs to be done is reasonably clear, if not straight-forward.

Don't attempt to balance the budget – right now

The current financial crisis has been complicated by the incredible debt overhang in several parts of the developed world. At a time when counter-cyclical deficit spending is most required, doom-sayers are predicting widespread sovereign defaults/devaluations preventing a rational discussion on fiscal policy. I am not arguing that it is alright to have so much sovereign debt (almost everywhere in excess of 50% of GDP, with the US approaching 100% and Japan already well beyond 200% of GDP). However, this is not the time to try and reduce this debt burden. The debate, so far, seems to be stuck at this level – whether deficits should be reduced or allowed to grow. To my mind, that question is moot at this time. The real question should be, if the Government is to spend borrowed money, where should it be spending it.

The point that most supporters of deficit spending seem to have missed is that you cannot keep running deficits perpetually and not care about the absolute debt burdens – not even the US which enjoys the right to print the reserve currency of the world. Like any sensible debtor, debt must be taken on to finance projects which can eventually pay off the debt as well as any accrued interest. In questions of public policy, the increased welfare of the people might sound like enough return on investment but the actual money does have to be returned to the lenders (especially if they are foreigners like China in the case of the US). Therefore, the question should be, when the Government invests in this or that project or programme, would it translate into increased revenues in the future to be able to pay down the debt taken on to finance that programme.

Do not get tempted to create long-term entitlements

In light of the above, it becomes evident that creation of long-term entitlements should not be the focus of deficit spending, especially when the balance sheets of Governments are already so strained. While the immediate effect of increased entitlements may have a beneficial effect on the economy, the problem with entitlements is that they are extremely hard to withdraw. The purpose of deficit spending, as we saw above, is to act as a counter-cyclical force to ensure that the economy does not settle into low-employment, low-production equilibrium. The flip side is that when the economy begins to recover, it should be possible to withdraw this counter-cyclical force. Entitlements, therefore, do not fit the bill.

The Social Security system in the US, though, is a good example of a counter-cyclical incentive. As the economy slows and employment drops, the social security spending automatically increases as jobless claims increase. Similarly, when the economy begins to grow again, jobless claims drop and social security spending drops. This works well. Medicare, on the other hand, does not seem to have this counter-cyclical nature and therefore would not qualify as a valid programme to support with borrowed money.

Focus on capital development projects which were ignored during boom-time

The free market economy, with its narrow self-interest, will often fail to build infrastructure that requires widespread coordination or to provide goods or services to those most in need of those things. For instance, when rural connectivity is poor or incomes are low, service providers shy away from investing in infrastructure that can service those poor areas. Through Government intervention, however, the seeds can be sown that eventually make it feasible and worthwhile for the private sector to supply services there, indeed make phenomenal profits. Case in point is the insistence of the Government of India that banks have at least 25% of their branches in rural areas. To begin with, this might be money loser. However, as these areas get better integrated into the banking system, they might participate in the national economy much more effectively. With an increased ability to pay for goods and services, these areas suddenly become attractive to the rest of the private sector. A virtuous cycle is set in motion.

The lesson is clear. The Government should focus tax incentives (and other subsidies) towards the creation of infrastructure that was heretofore ignored by the free markets. Transportation networks, communication networks, power delivery, banking, logistics etc. This infrastructure creation can stimulate altogether new activity, which might not have existed even during the previous up-cycle. Increased revenues from heightened activity and productivity could eventually pay off the for the subsidies and tax incentives provided.

Should the Government itself get into the business of building this infrastructure. I find it hard to agree. Even though it seems to be easier to do it oneself than to incentivize the private sector, the dangers of waste, delay and leakage are far too great in Government enterprises to merit serious consideration. The National Rural Employment Guarantee Scheme in India is one such example.

Ensure mechanisms of scaling back as private sector takes over

The last, and most often forgotten aspect is the necessity of the scaling back of deficit spending as the economy recovers. As the economy moves into recovery and then to the cyclical boom, the Government should strive to run a surplus to pay down the debt put on during the slowdown phase. The hand off to the private sector should be built into the project proposals so that future political bickering and strength is not required to do the needful. Entitlements, as discussed above, rarely allow for simple scale backs. Even temporary tax incentives are difficult to suspend although not as hard as entitlements.

In this context, the insistence of Republican lawmakers in the US that the deficit be reduced is sensible but badly timed. The deficit reduction should be back-loaded with little to no reduction currently. On the other hand, the spending itself should be refocused towards development projects instead of the creation and expansion of entitlements like Medicare, etc. Similar ideas apply to all countries struggling with this problem. The specific projects they undertake, of course, would depend on specific circumstances.

Conclusion

The markets work fine under normal circumstances and the role of the Government, at these times, should be that of an enforcer of the rule of law and a passive observer. When the economy slows and market failures become evident, the Government must act as a counter-cyclical force, with a longer term view which private individuals and corporations may not have. Programmes must be designed which stimulate the economy in the short run but also ensure an adequate return on investment to be able to pay down the borrowed money and the accrued interest. These programmes must also be designed with an ability to be scaled back as the economy gets back on track and free markets can run on their own strength. This is a complicated dance but, in my view, the only way to have stabler economies and societies.