Mainstream Keynesian economics is facing its last hurrah. The global fiscal stimulus championed last year by the Obama administration is coming undone, repudiated by the same Group of 20 that endorsed it last year. Now, against a backdrop of a widening sovereign debt crisis, we need to abandon short-term thinking in favour of the long-term investments needed for sustained recovery.

Keynesian stimulus was premised on four dubious propositions: that it was needed to prevent a global depression; that a short-run fiscal boost would jump-start the economy; that “shovel-ready projects” could combine short-term cyclical and long-term structural agendas; and, last, that the rapid rise of public debt occasioned by stimulus need not be a concern. That these ideas were so widely accepted was a testament to the perennial political attractiveness of tax cuts and spending increases.

In fact, the ubiquitous references last year to the Great Depression were glib; the policymakers had panicked. Adroit central banking could and would prevent depression. The hastily assembled stimulus packages were a throwback to naive Keynesianism. The relevant fact was that the US, UK, Ireland, Spain, Greece and others had over-borrowed for a decade, so a decline in consumption after 2007 was not an anomaly to be fought but an adjustment to be accepted.

Certain counter-cyclical spending is vital on social grounds. But stimulus measures such as temporary tax cuts for households or car scrappage schemes were dispiriting wastes of scarce time and money. They reflected a hope that a temporary fiscal bridge would carry us back to consumption and housing-led growth – a dubious proposition since the old “normal” had been financially unsustainable.

The talk of a green recovery, in which the fall in consumer spending would be offset by investments in sustainable energy, made sense and still does. Yet it was quickly undermined by the politicians’ insistence on “shovel-ready” projects. The shift to sustainable energy systems is a vital but long-term task. It could never be a short-term jobs programme. Maybe in China there are shovel-ready projects of sufficient scale, but not in the US.

Taking office in January 2009, President Barack Obama inherited the largest peacetime budget deficit in US history. By increasing it further, he made it his rather than his predecessor’s. He and his advisers ignored one of the key insights of modern macroeconomics: that the result of fiscal policy depends not only on current taxes and spending but also on their expected trajectories in the future.

The US was not in a credible position to raise an already enormous deficit “temporarily” because the prospect for future deficit cutting was and remains extremely clouded. America has absolutely no consensus on how to restore budget balance, as it is trapped between a federal government that provides too few public investments and services and a public that is almost maniacal in its opposition to tax rises. One cannot build a credible long-term fiscal policy by starting off in the wrong direction, with larger rather than smaller deficits.

Now we face a world economy with weak aggregate demand in the US and Europe, bulging budget deficits, sovereign debt downgrading and consumers unwilling to borrow. Governments are fighting for
market credibility via draconian cuts in spending. This too is the wrong approach. We should avoid a simplistic austerity to follow the simplistic stimulus of last year. Here are some suggested guidelines.

First, governments should work within a medium-term budget framework of five years, and within a decade-long strategy on economic transformation. Deficit cutting should start now, not later, to achieve manageable debt-to-GDP ratios before 2015.

Second, governments should explain, and the public should learn, that there is little that economic policy can do to create high-quality jobs in the short term. Good jobs result from good education, cutting-edge technology, reliable infrastructure and adequate outlays of private capital, and thus are the outcome of years of sustained public and private investments. Governments need actively to promote post-secondary education.

Third, governments must of course also ensure social safety nets: income support for the poor, universal access to basic healthcare and education, a scaling up of job training programmes and promotion of higher education.

Fourth, governments should steer their economies towards needed long-term structural transformation. External-deficit countries such as the US and UK will need to promote exports over the next few years, while all countries must promote clean energy and new transport infrastructure.

Fifth, governments and the public should insist that the rich pay more in income and wealth taxes – indeed, a lot more. The upward re-distribution of the past 25 years has made our economies into extravagant playgrounds for the super-wealthy. Politicians of both the mainstream left and right in the US and UK have fawned over those who pay their campaign bills in return for low taxation. Even playgrounds should collect tolls – when it is billionaires in the sandpit.

We need, in sum, to reset our macroeconomic timetables. There are no short-term miracles, only the threat of more bubbles if we pursue economic illusions. To rebuild our economies, the watchword must be investment rather than stimulus.

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