

FISCAL RULES FOR THE 21ST CENTURY: HOW TO PAY FOR THE PUBLIC SECTOR

ISSUE BRIEF BY **J.W. MASON** | MARCH 2019

Introduction

From unaffordable housing, to lack of access to higher education and health care, to extreme income and wealth inequality, to the existential crisis of climate change, the US faces many urgent problems that call for a larger, more active public sector. Any proposal for a substantially expanded public sector will, however, raise an inevitable question: How do we pay for it?

This question combines two different issues: First, how will the spending be financed? That is, what mix of higher taxes, new debt, and other sources of funds will balance the additional spending by the government? And second, where will the real resources for the new spending come from? That is, will directing more labor, capital, and other productive resources toward public purposes crowd out other uses, cause inflation, or otherwise run up against supply limitations? For most businesses and households, only the first question matters, since their own spending is so minute relative to the economy as a whole. For the public sector, however, both questions must be answered—and it is the second constraint (real resources) that ultimately provides the harder limit on new public spending.

The US government’s unique advantages, both in financing and in mobilizing real resources, mean that the question of “How do we pay for it?” is, when properly considered, more often an argument for an expanded public sector rather than against it. But the confused state of current discussions of government budgets, dominated by an obsession with balanced budgets, low taxes, and hard limits on public debt as ends in themselves, has obscured the real issues at stake. As a result, concerns about “how to pay for it” lead to a misdirected focus on non-problems of public finance, which can derail essential public initiatives—the stimulus in the wake of the 2008 recession, for example, and efforts to deal with climate change today—and lead to half-hearted, ineffectual solutions to our real problems.

The question of “How do we pay for it?” is an argument for the public sector rather than against it.



Here, I suggest nine principles that should guide any discussion of how to pay for increased public spending in the 21st century. One is a general point about what it means to “pay for” spending, two through four are on real resource constraints, five and six are on debt, and seven through nine are on taxes. I discuss each principle briefly here and at more length below.

1. Financing and real resource constraints are two different questions. We need to clearly distinguish between the questions of financing and of real resources. Government spending does have to be financed, in the sense that total money payments must equal total money receipts. This does not mean, however, that the government faces the same kind of budget constraints as a household or a business. With its capacity both to levy taxes and to issue the world’s safest, most in-demand debt, the federal government can always generate the money income it needs to finance its spending. The more fundamental limit on public spending is the real resources constraint. While the government can always generate money, public projects will still be limited by the labor, capital, technology, and other real resources available in the economy.

2. When the economy is operating below potential, there is no real cost to increased public spending. Turning to the real resources side, there is good reason to think that the economy is still operating well short of any reasonable measure of full employment or potential output. Therefore, an expansion of the public sector does not require withdrawing resources from the private sector. Instead, it will involve mobilizing labor and other resources that are currently idle. (Notably, this includes entrepreneurial capabilities; we see more innovation and new businesses formation when demand is strong.) This means that there need not be any crowding-out of private activity. Given the personal and social costs of unemployment, under these conditions the real resources used by the public sector should be seen as a benefit rather than a cost.

3. We need to remember that there will be recessions and weak recoveries in the future. An assessment of real resource constraints should not be made simply in light of today’s relatively strong labor markets, but upon the average conditions we expect to hold in the future. It is nearly certain that there will be a recession in the next few years, and based on historical experience, it is likely that it will be followed by an extended period of high unemployment. So even if, contrary to the previous point, we believe that the economy is operating at full capacity today, it is nearly certain that it will be below it for much of the future, strengthening the case for a higher level of public spending.

4. We should not be afraid to run the economy hot. Even if an expansion of the public sector is large enough to use up the remaining slack and push up against supply constraints, this carries important benefits as well as costs. Only if the economy is allowed to run hot for an extended period will wages rise fast enough for workers to recover the share of income they have lost over the past 15 years. And if the economy is allowed to overheat a bit in good times, that will make it



easier to avoid the extended periods of weak demand that we have repeatedly experienced since the 1980s. For instance, if the Federal Reserve (the Fed) is able to raise rates more in good times, it will have more space to cut them in downturns.

5. Any discussion of public debt must consider the fact of interest rates below growth rates. This means that, even on orthodox theory, a substantial increase in public spending can be safely financed by new borrowing. While economists disagree about what kinds of limits might exist for public debt in the abstract, there is little question that the US currently shows none of the signs of high public debt leading to economic costs. Low long-term interest rates, in particular, mean that even large deficits imply only modest increases in the debt-GDP ratio. And there is no danger that higher deficits could lead to a “snowball” effect where the debt-GDP ratio rises without limit. This makes increased borrowing safer and less costly than in the high-interest years of the 1980s and 1990s.

6. Higher public debt has benefits that offset costs. Today, there is good reason to think that a higher debt ratio has macroeconomic benefits that counterbalance or even outweigh whatever costs it creates. US Treasury debt is an important asset for the domestic financial system and for the rest of the world, where the dollar serves as the global currency. Indeed, there is good reason to think that financial markets would function better if the federal debt were higher, not lower.

7. Higher taxes may be desirable for their own sake. There are a number of taxes—especially on carbon and on concentrations of income and wealth—that are socially beneficial, regardless of their value for financing public spending. To the extent that we want to raise these taxes in any case in order to discourage carbon-intensive activities and to level the income distribution, there is no additional cost for using the revenue to finance increased public expenditure.

8. We should not be afraid to talk about broad-based tax increases. The US tax burden, as opposed to statutory rates, is lower than in almost any other developed country. There is ample room to raise taxes to finance public spending, if it is politically and economically desirable to do so.

9. Higher public spending can pay for itself. To the extent that higher public spending leads to faster growth, this will automatically increase tax revenue. Higher GDP growth also makes any given level of debt less burdensome. Therefore, it is not unreasonable to think that higher spending will, in part, pay for itself. While these kinds of arguments have been discredited by their use in the so-called supply-side economics on the right, we should be clear that the flaw there was not the logic of the argument but in the claim that their preferred policies would in fact generate higher growth.

I discuss each of these points in more detail below.



In General:

1. Government expenditure does need to be financed, but the fundamental constraint on public spending is the real resources available in the economy.

People often compare the government budget to a household or business, but this is fundamentally misleading. Unlike any other economic unit, governments don't depend on voluntary market transactions for income, but they can compel payments through the power to tax. Furthermore, the US federal government produces the money with which payments are made, and it issues the global currency used for international transactions and foreign exchange reserves by the rest of the world. For all of these reasons, the US debt is the safest, most liquid asset in the world, meaning that the US government borrows on the most favorable possible terms. It is still the case, of course, that any increase in spending implies an equal increase in some mix of taxes and new borrowing, and the optimal mix is a question that deserves serious attention. But for the US government, unlike almost any other entity, simply getting the money is never a concern.

On the other hand, because the federal government is so large relative to the economy, there is a question—unlike in the case of households and private businesses—of whether there is enough unused labor and capital in the economy to produce the goods and services that the government wants to buy. If not, then public spending will, in one way or another, “crowd out” private spending. And higher public spending is likely to face supply constraints in the form of rising inflation, shortages or bottlenecks, a rising trade deficit, and other signs that the economy cannot produce as much as the federal government is attempting to buy. The problem of supply constraints is real, even if—as discussed below—there is reason to think that the US is currently operating well below the limit of its productive capacity. The critical thing is that the real resource problem should not be confused with the financing problem. For a private business, the question of “Will we be able to get the labor, machines, etc. that we need?” is equivalent to the question of “Where will we get the money?” For the federal government, the two questions are distinct.

The critical thing is that the real resource problem should not be confused with the financing problem.

Though we should seriously examine how much new borrowing the government should undertake, given its likely effects on financial markets, and the incentive and distributional effects of raising revenue, these are not the main factors in deciding whether a given program of increased public expenditure is feasible. In past periods of sharp expansions in the public sector—as during major wars—the federal government's spending has never been limited by



its ability to raise money. It has, however, required measures to deal with the possibility of an overheating economy. Taxes may be important for this purpose, since they reduce private demand, freeing up resources for public purposes. But direct public programs to relieve specific supply constraints (e.g., investment in strategic raw materials, training programs for important skills or specialties), price controls, or, in extreme cases, direct allocation of key inputs may be important as well. In the case of a major expansion of higher education or health care, it does make sense to ask whether there are sufficient additional skilled teachers or health care professionals. It does not make sense to ask whether the government can “afford” it.

Real Resource Constraints:

2. Despite the fact that the official unemployment rate is low, there is considerable evidence that the economy is still operating below potential.

Conventional wisdom says that because the official unemployment measure is today below 4 percent—which is quite low by historical standards—there is no significant slack in the economy. This would mean that the labor and other resources required for an expansion of the public sector would have to be withdrawn from the private sector somehow, whether by higher taxes that discourage private spending, higher prices, or more direct controls. There are good reasons to doubt this, however.

In the first place, today’s labor force participation rate¹ remains well below historical levels—63 percent, compared with 67 percent in the late 1990s. That represents approximately 10 million adults neither working nor seeking work. While some of this decline reflects an aging population, this is not the whole story—even among “prime-age” (24 to 54) adults, the fraction in the labor force² is well below its level in the late 1990s or even the late 2000s. It seems clear that much of this represents the ongoing effects of the exceptionally weak labor market of the recession and immediately following years. A recent Roosevelt Institute study³ suggested that at most about half of the decline in labor force participation can be explained by demographic factors—a similar finding to those of studies by the Council of Economic Advisors⁴ and the Levy

¹ Federal Reserve Bank of St. Louis and US Office of Management and Budget. 2019. “Civilian Labor Force Participation Rate.” Retrieved from FRED, Federal Reserve Bank of St. Louis. <https://fred.stlouisfed.org/graph/?g=mnUA>. Note: The data information was organized monthly for the 30 years from January 1, 1990 to February 1, 2019.

² Federal Reserve Bank of St. Louis and US Office of Management and Budget. 2019. “Civilian Labor Force Participation Rate: 25 to 54 Years.” Retrieved from FRED, Federal Reserve Bank of St. Louis. <https://fred.stlouisfed.org/graph/?g=ncOe>. Note: The data information was organized monthly for the 30 years from January 1, 1990 to February 1, 2019.

³ Mason, J.W. 2017. “What Recovery? The Case for Continued Expansionary Policy at the Fed.” Roosevelt Institute. <http://rooseveltinstitute.org/wp-content/uploads/2017/07/Monetary-Policy-Report.pdf>.

⁴ Furman, Jason. 2015. “Trends in Labor Force Participation.” Council of Economic Advisors. https://obamawhitehouse.archives.gov/sites/default/files/docs/20150806_labor_force_participation_retirement_research_consortium.pdf.



Institute.⁵ It's notable that the relatively strong labor market of the past couple of years has seen an uptick in labor force participation, suggesting that people who dropped out in previous years are returning to the labor market now that more jobs are available. This implies that, despite the low official unemployment rate, a program of expanded public employment could mobilize currently underutilized labor, rather than bidding workers away from private businesses.

There is also sign of unused capacity on the business side. The Bureau of Economic Analysis (BEA)'s standard measure of capacity utilization⁶ shows lower values than in the previous two expansions. Productivity growth and the formation rate of new businesses are also quite low, suggesting that productivity-boosting investment and innovation are still being held back by lack of demand. Low interest rates and inflation rates are also a sign of weak demand; in a truly hot economy, we would see prices rising as more and more sectors found themselves unable to increase production in line with desired purchases.

Despite the low official unemployment rate, a program of expanded public employment could mobilize currently underutilized labor, rather than bidding workers away from private businesses.

The most obvious sign that the economy is not yet facing supply constraints is the fact that inflation remains subdued. Open any macroeconomics textbook and you will find that high or rising inflation is the key sign of an overheating economy, where spending is running ahead of the capacity to produce. Until and unless prices begin to rise, it is hard to argue that the economy lacks the real resources to support additional public spending.

Another important sign that the economy is far from potential is the weak wage growth in the current expansion. Labor's share of income⁷ remains well below that of a decade ago, and even further below the share in the year 2000. This implies that, despite official statistics showing a low unemployment rate and high job-vacancy rate, labor is still abundant enough for workers' bargaining position to be relatively weak vis a vis their employers. The only way⁸ to return labor's

⁵ Dantas, Flavia, and L. Randall Wray. 2017. "Full Employment: Are We There Yet?" Levy Economics Institute. <http://www.levyinstitute.org/publications/full-employment-are-we-there-yet>.

⁶ Federal Reserve Bank of St. Louis and US Office of Management and Budget. 2019. "Capacity Utilization: Total Industry." FRED, Federal Reserve Bank of St. Louis. <https://fred.stlouisfed.org/graph/?g=ncOk>. Note: The data information was organized monthly for the 30 years from January 1, 1990 to February 1, 2019.

⁷ Federal Reserve Bank of St. Louis and US Office of Management and Budget. 2019. "Share of Labor Compensation in GDP at Current National Price for United States." FRED, Federal Reserve Bank of St. Louis. <https://fred.stlouisfed.org/graph/?g=ncOp>. Note: The data information was organized monthly for the 34 years from January 1, 1980 to January 1, 2014.

⁸ Bivens, Josh. 2019. "The Fed Shouldn't Give Up on Restoring Labor's Share of Income—and Measure It Correctly." Economic Policy Institute. <https://www.epi.org/blog/the-fed-shouldnt-give-up-on-restoring-labors-share-of-income-and-measure-it-correctly/>.



share to its 1990's levels is for the US to experience a sustained period of "overfull" employment, with wage gains regularly outpacing productivity. We are still far from that today. Nominal wages for nonsupervisory workers are up just 8.5 percent⁹ over the past 3 years—an average growth rate of less than 3 percent per year, significantly less than during the already weak 2000's expansion and much less than in the 1990s. Until wages begin rising significantly faster, there is no credible case that output is limited by a lack of labor. As Minneapolis Fed President Neel Kashkari puts it: "Businesses love to say ... it's this historic worker shortage. Well, show me the money."¹⁰

3. When we think about real resource constraints going forward, we shouldn't just think about the state of the economy today. We should think about what it may be in a few years—and the experience of the past 50 years suggests that we are much more likely to face a problem of inadequate aggregate demand and unemployment than overheating and inflation.

A program to decarbonize the economy or to provide genuinely universal access to health care or free higher education represents an ongoing commitment by the federal government, implying higher spending over many years or indefinitely. So, when we think about real resource constraints, we have to think about the state of the economy over a number of years, not just today.

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The textbook assumption is that the economy normally operates somewhere near its full potential, with random deviations above and below it. This assumption does not fit the experience of the past 50 years, and it is unlikely to fit better going forward. A fundamental macroeconomic fact about the US economy today is that it far more often finds itself with too little demand than too much.

There are good reasons to think the official measures understate the true degree of slack in the economy. But even if we take the official statistics at face value, we will see that in recent business cycles the economy spends much of its time well below potential. Each of the past three recessions has been followed by long "jobless recoveries" in which unemployment remained well above the Fed's target (the "NAIRU," or non-accelerating inflation rate of unemployment) for

⁹ Federal Reserve Bank of St. Louis and US Office of Management and Budget. 2019. "Share of Labor Compensation in GDP at Current National Prices for United States." FRED, Federal Reserve Bank of St. Louis. <https://fred.stlouisfed.org/graph/?q=ncOp>. Note: The data information was organized monthly for the 34 years from January 1, 1980 to January 1, 2014.

¹⁰ Smialek, Jeanna. 2019. "America's Job Market Is Defying Employer Labor Shortage Reports." Bloomberg, March 6, 2019. <https://www.bloomberg.com/news/articles/2019-03-06/america-s-job-market-is-defying-employer-labor-shortage-reports>.



four, five, or in the most recent cycle seven years after the end of the formal recession. Taking the official statistics¹¹ at face value, since 1980, there have been 192 months when the unemployment rate was more than one point above the NAIRU, and only 18 months when it was more than one point below. Given that record, we shouldn't evaluate the desired level of public spending on the assumption that the risks of overshooting and undershooting potential are about equal. Since 1980, the state of economy has been far more likely to call for more demand than for less.

CIVILIAN UNEMPLOYMENT RATE-NATURAL RATE OF UNEMPLOYMENT (LONG TERM)

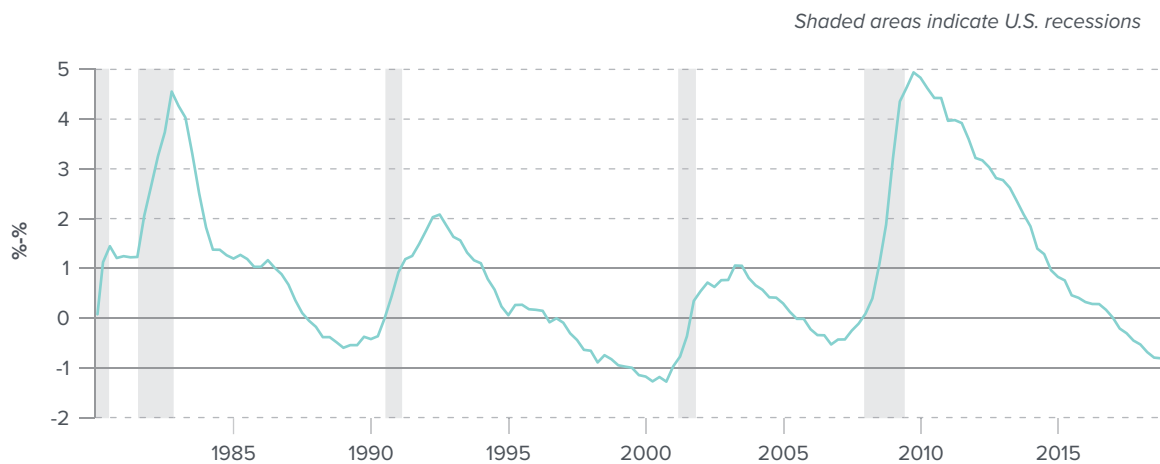


FIGURE 1 Source: BLS, CBO

The fact that we had a catastrophic recession just a decade ago—and are guaranteed to have more recessions in the future—should play a central role in discussions of the appropriate scale and scope of public spending. Instead, too much of the discussion still focuses on the experience of the 1970s. Yet there has been no similar episode of overheating in the past 50 years—while periods of weak and high unemployment have been, as we all know, quite common. In assessing the risks of getting the level of public spending wrong, we need to update our views on the risks of erring on each side.

The stimulus bill of 2009 was hampered by a lack of “shovel-ready” public projects. This is a strong argument for laying out an expansive public spending program now.

¹¹ Federal Reserve Bank of St. Louis and US Office of Management and Budget. 2019. “Civilian Unemployment Rate-Natural Rate of Unemployment (Long-Term). FRED, Federal Reserve Bank of St. Louis. <https://fred.stlouisfed.org/graph/?g=ncNJ>. Note: The data information was organized monthly for the 38 years from January 1, 1980 to January 1, 2018.



The asymmetric macroeconomic risks facing us are well-illustrated by the experience of the past 10 years. Even after the official end of the recession in 2009, growth has been quite slow—output today is about 12 percent below what was forecast before the recession (forecasts that were consistent with long-term trends up until then.) A recent paper¹² by the San Francisco Fed suggests that almost all the gap between growth over the past decade and the pre-2008 trend can be explained by the financial crisis and ensuing collapse in demand. (A similar argument was made in the Roosevelt report *What Recovery?*) Conventional monetary policy was unable to offset the effects of the crisis, at least in part because the short-term interest rate was stuck at zero—the familiar problem of the zero lower bound. The result of this was trillions of dollars of lost output and millions of people suffering years of unemployment and poverty. It’s worth recalling, also, that the stimulus bill of 2009 was hampered by a lack of “shovel-ready” public projects. This is a strong argument for laying out an expansive public spending program now, before it becomes macroeconomically urgent in the next recession.

4. Allowing demand to push up against supply constraints (i.e., to let the economy “run hot”) would, within limits, have significant benefits. There is a strong case of higher public spending on macroeconomic grounds, even apart from the specific activities we would like the government to carry out.

An economy where demand is persistently running ahead of potential output is sometimes called a high-pressure economy. While macroeconomic policymakers have often seen this as something to avoid, there are in fact good reasons to welcome it.

The most immediate effects of demand pushing against the limits of aggregate supply would be faster wage growth, perhaps higher inflation and, presumably, a higher interest rate set by the Fed. These outcomes are sometimes seen as a problem; from the point of view of macroeconomic stability, however, they would be a benefit. Higher wages would to some extent be passed on to higher prices. But recent experience suggests that a large part of faster wage growth would instead lead to faster productivity growth and a higher share of wages in national income. Productivity growth is faster in a high-pressure economy as more productive enterprises bid scarce labor away from less productive ones, and as businesses find ways to substitute technology for labor. Strong demand also favors investment and new business formation, with further benefits for productivity growth. A higher wage share, meanwhile, is the automatic result of wage growth outpacing productivity growth and inflation—which is a necessary condition for workers to recover the share of income they have lost to capital over the past two decades.

¹² Barnichon, Regis, Christian Matthes, and Alexander Ziegenbein. 2018. “The Financial Crisis at 10: Will We Ever Recover?” FRBSF Economic Letter. <https://www.frbsf.org/economic-research/publications/economic-letter/2018/august/financial-crisis-at-10-years-will-we-ever-recover/>.



Meanwhile, a proportionate increase in inflation and interest rates would not affect the sustainability of government debt. But it would extend the space for the Fed to cut rates during a recession. This is another case where economic policy discussion is only beginning to take on board the lessons of the Great Recession: Recessions at the zero lower bound are extremely destructive. Even by the standard measures of potential output (which almost certainly understates the gap), the shortfall between output and potential over 2008 and 2015 came to a cumulative 25 percent of GDP¹³, or approximately \$5 trillion. The cumulative excess unemployment was on the order of 15 points. That is an enormous amount of useful goods and services unproduced, and an enormous number of people whose productive capabilities were left to decay. Going forward, a very high weight should be put on avoiding similar macroeconomic disasters.

As long as we rely on the interest rate set by the Fed as the primary tool of macroeconomic management, there's great danger when the normal, default setting of that rate gets close to zero. In recent decades, even moderate recessions have seen the Fed cut interest rates by at least 5 points. Today, rates are normalizing well below that level. That means that we will once again be up against the zero lower bound when the next recession hits. (For a broader discussion of the limits of conventional monetary policy, see the Roosevelt report *A New Direction for the Federal Reserve*.¹⁴) The only way to avoid this is to use fiscal policy much more aggressively—both in crises themselves but also, and even more importantly, in normal times. Having the normal, default setting of fiscal policy be much more expansionary than it currently is, will mean that both the average state of the economy will be closer to full employment and the Fed would have more space to cut interest rates when demand does fall short.

The recession and slow recovery saw an enormous amount of useful goods and services unproduced, and an enormous number of people whose productive capabilities were left to decay. Going forward, a very high weight should be put on avoiding similar macroeconomic disasters.

¹³ Federal Reserve Bank of St. Louis and US Office of Management and Budget. 2019. "Gross Domestic Product/ Nominal Potential Gross Domestic Product." FRED, Federal Reserve Bank of St. Louis. <https://fred.stlouisfed.org/graph?g=ncOB>. Note: The data information was organized annually for the 28 years from January 1, 1990 to January 1, 2018.

¹⁴ Mason, J.W., and Mike Konczal. 2017. "A New Direction for the Federal Reserve: Expanding the Monetary Policy Toolkit." <http://rooseveltinstitute.org/wp-content/uploads/2017/11/Monetary-Policy-Toolkit-Report-1.pdf>.



Government Debt:

5. What matters is not debt in isolation, but the debt-GDP ratio. It is much easier to stabilize this ratio when interest rates on government debt are lower than GDP growth rates, as they are today.

Historically, the main concern about government borrowing was whether it was “sustainable”—that is, whether the debt was on a path to stabilize as a share of GDP or whether it would rise without limit without some policy change. This made sense in a world where average interest rates on government were higher than the growth rate of GDP. Under those conditions, it is possible for government debt to “snowball,” or rise without limit as a share of GDP, unless a deficit in one year is made up for with a higher surplus in a later year. In the 1980s and 1990s, interest rates were indeed higher than growth rates, so keeping the debt-GDP ratio on a stable path required the government to avoid too much new borrowing. For the past 15 years, however, GDP growth has consistently been higher than the average interest rate on government debt—a return to the situation that prevailed over much of the 20th century. In this low-interest world, the debt ratio is much more stable. When interest rates are lower than growth rates, then after a period of high deficits the debt-GDP ratio will return to its previous path on its own, without any need to “pay for” the deficits through subsequent surpluses. After World War II, for instance, the US government (as well as the government of UK) never paid down its wartime debt; it simply grew out of it.

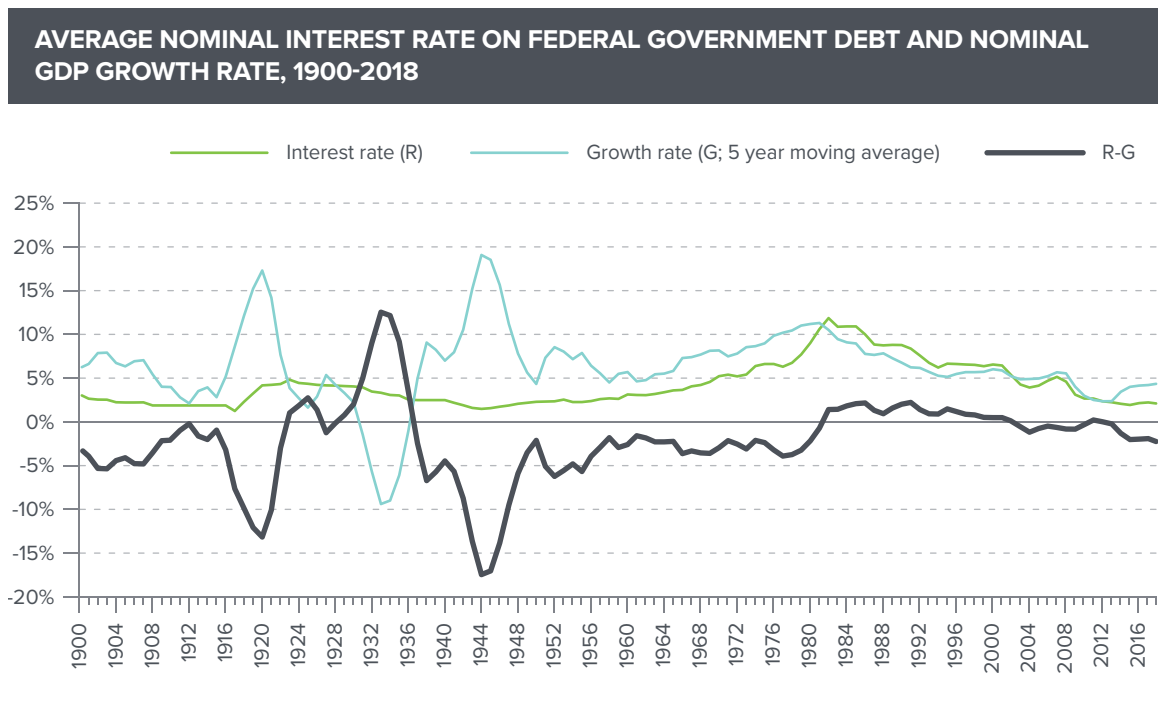


FIGURE 2 Center for Budget and Policy Priorities



Today, the 10-year Treasury bond is trading¹⁵ at 2.7 percent, and the 30-year at 3 percent. GDP growth over the past decade, meanwhile, has averaged around 4 percent—quite low by historical standards, but still well above the interest rates. The low rates on government debt today reflect not just the policy of the Fed, but also the judgement of bond market participants; holding a 30-year bond at 3 percent is in effect a bet that interest rates will not rise much above this over the next 30 years. (The fact that 30- and 10-year rates are quite close is further evidence that market participants don't expect rates to rise, since any interest rate increase would imply larger capital losses on longer bonds.) Given these low rates, there is no basis for worries about the sustainability of the debt. And there is no sense in which increased borrowing today will have to be “paid for” down the road.

Stabilizing the debt ratio when interest rates are higher than growth rates is like rolling a boulder along the crest of a ridge. If it goes off course a little, it is going to get further and further off course until you make an extra effort to push it back on track. Stabilizing the debt ratio when interest rates are lower than growth rates is like rolling a boulder along the trough of a valley. If it slightly goes off course, it will come back on its own. If you veer off toward one side, you don't have to make any effort to correct course—you can just keep pushing steadily.

It is important that public officials realize that when they say that we can't meet crucial social needs because of the need to hold down public debt, they are simply repeating folk wisdom. This is no longer the view of leading economists.

The implications of low interest rates for public debt have been widely noted by economists. Former International Monetary Fund (IMF) Chief Economist Olivier Blanchard presented a widely discussed paper¹⁶ at this year's American Economic Association meetings, arguing that in a world of low interest rates, the costs of high government debt are much lower than many economists had previously believed. “Put bluntly,” he says, “public borrowing may have no fiscal cost.” Former Treasury Secretary Lawrence Summers and former Council of Economic Advisors Chair Jason Furman recently made a similar argument in an article in *Foreign Affairs*¹⁷ subtitled, “Why Washington Should End Its Debt Obsession.” But

¹⁵ Federal Reserve Bank of St. Louis and US Office of Management and Budget. 2019. “10-Year Treasury Constant Maturity Rate v. 30-Year Treasury Constant Maturity Rate.” FRED, Federal Reserve Bank of St. Louis. <https://fred.stlouisfed.org/graph/?g=ncmv>. Note: The data information was organized monthly for 57 years from February 2, 1962 to March 28, 2019.

¹⁶ Blanchard, Olivier. 2018. “Public Debt and Low Interest Rates.” *American Economic Review*, 109(4), 1197-1229. doi: 10.1257/aer.109.4.1197. https://www.aeaweb.org/aea/2019conference/program/pdf/14020_paper_etZgfbDr.pdf.

¹⁷ Furman, Jason, and Lawrence H. Summers. 2019. “Who's Afraid of Budget Deficits?” *Foreign Affairs*, March/April 2019. <https://www.foreignaffairs.com/articles/2019-01-27/whos-afraid-budget-deficits?cid=soc-tw-rdr>.

while an increasing number of policy-oriented macroeconomists agree that the dangers of public debt have been greatly exaggerated, this new consensus has not yet reached many policymakers. It is important that public officials realize that when they say that we can't meet crucial social needs because of the need to hold down public debt, they are simply repeating folk wisdom. This is no longer the view of leading economists.

6. There is reason to think that financial stability would be enhanced by higher government debt.

With growth rates above interest rates, there is no possibility of the debt rising uncontrollably. But large deficits, if sustained, would still raise the debt-GDP ratio. There is no reason to panic about this.

The US debt-GDP ratio is currently around 75 percent, up from 35 percent in the mid-2000s. Before the Great Recession, many commentators would have predicted that doubling the debt-GDP ratio in a decade would have dramatic, if not catastrophic, consequences—skyrocketing inflation, a massive spike in interest rates, a collapse in the value of the dollar, to name a few. None of this has occurred. Inflation and interest rates remain well below their levels of a decade ago, and during the 2008-2009 financial crisis—when the federal debt was rising rapidly—the dollar actually gained value, as frightened investors fled to the relative safety of US assets. As historian Adam Tooze notes in his new history¹⁸ of the financial crisis and its aftermath, the US had “the wrong crisis” in 2008-2009: a crisis of irresponsible borrowing by the private sector, not by the government. The weak recovery that followed, Tooze argues, had much to do with policymakers continuing to worry about the crisis that they had expected—one caused by excessive public debt—rather than the one we actually had, where public debt was instead part of the solution.

Historically, the current debt-GDP ratio¹⁹ of 75 percent is high but not unprecedented. US federal government debt reached 120 percent at the end of World War II. Japan's public debt currently stands at 250 percent of GDP. In neither of these cases, nor in other episodes of extremely high debt ratios in developed countries, have we seen the negative macroeconomic effects that high debt ratios are supposed to lead to. (Developing countries are a different story, especially when they borrow in a foreign currency.) Japan, with the world's highest debt-GDP ratio, continues to struggle with deflation and an exchange rate that is arguably too strong for its manufacturers to export successfully—exactly the opposite

¹⁸ Tooze, Adam. 2018. *Crashed: How a Decade of Financial Crises Changed the World*. New York: Penguin Random House LLP.

¹⁹ Federal Reserve Bank of St. Louis and US Office of Management and Budget. 2019. “Federal Debt Held by the Public as Percentage of Gross Domestic.” FRED, Federal Reserve Bank of St. Louis. <https://fred.stlouisfed.org/series/FYFGDQ188S>. Note: The data information was organized quarterly for 48 years from January 1, 1970 to July 1, 2018.



of the problems that high debt is supposed to create. (Japan's growth has been low, but this is a natural result of slow population growth; over the past 25 years, real per capita GDP growth²⁰ in Japan has been almost exactly the same as in the US.) A well-known paper²¹ of a decade ago, which argues²² that a debt ratio of 90 percent is a kind of tipping point at which debt begins to have a strongly negative effect on growth, is one²³ of the most thoroughly demolished²⁴ pieces of economics in recent history. Even Kenneth Rogoff, one of the paper's co-authors, recently repudiated its conclusions in a column²⁵ titled, "Never Mind the Debt."

There is even an argument that increased federal debt might not only be relatively costless but even beneficial, since it would help stabilize the financial system. Many economists have described²⁶ the fundamental challenge facing the economy in the years after 2008 as a "safe asset shortage." And it is clear that one of the major forces behind the development of the mortgage-backed security market was the desire—by both domestic financial institutions and foreign investors—to hold more ultra-safe, AAA-grade debt than the federal government was issuing. The senior tranches of mortgage-backed securities were supposed to provide the same safety and liquidity as federal debt—but they failed to do so spectacularly, with consequences we are still seeing to this day.

Along with the problem of zero lower bound discussed earlier, this suggests that the recession of 2008-2009 might have been less destructive if the federal debt had been *higher* before the crisis broke out. In addition, a great deal of demand for federal debt comes from the dollar's role as the world's currency. In most of the world outside the US, central banks hold their foreign-exchange reserves mainly in the form of dollars.²⁷ This means that the growth of international trade and financial flows create a steadily growing demand for safe,

²⁰ Federal Reserve Bank of St. Louis and US Office of Management and Budget. 2019. "Constant GDP per capita for Japan v. Constant GDP per capita for the United States." FRED, Federal Reserve Bank of St. Louis. <https://fred.stlouisfed.org/graph/?g=ncn6>. Note: The data information was organized yearly for 17 years from January 31, 2000 to January 1, 2017.

²¹ Cassidy, John. 2013. "The Reinhart and Rogoff Controversy: A Summing Up." The New Yorker, April 26, 2013. <https://www.newyorker.com/news/john-cassidy/the-reinhart-and-rogoff-controversy-a-summing-up>.

²² Reinhart, Carmen M., and Kenneth S. Rogoff. 2011. "Growth in a Time of Debt." (Working Paper 15639). National Bureau of Economic Research. <https://www.nber.org/papers/w15639.pdf>.

²³ Herndon, Thomas, Michael Ash, and Robert Pollin. 2013. "Does High Public Debt Consistently Stifle Economic Growth? A Critique of Reinhart and Rogoff." Cambridge Journal Of Economics, 38(2), 257-279. doi: 10.1093/cje/bet075. https://www.peri.umass.edu/fileadmin/pdf/working_papers/working_papers_301-350/WP322.pdf.

²⁴ Konczal, Mike. 2013. "Researchers Finally Replicated Reinhart-Rogoff, and There Are Serious Problems." Roosevelt Institute. <http://rooseveltinstitute.org/researchers-finally-replicated-reinhart-rogoff-and-there-are-serious-problems/>.

²⁵ Rogoff, Kenneth. 2019. "Never Mind the Debt: If There's a Hard Brexit, Britain Will Have to Splash the Cash." The Sunday Times, February 3, 2019. https://scholar.harvard.edu/files/rogoff/files/the_sunday_times_february_3_2019_rogoff.pdf.

²⁶ Caballero, Ricardo J., Emmanuel Farhi, and Pierre-Olivier Gourinchas 2017. "The Safe Assets Shortage Conundrum." Journal Of Economic Perspectives, 31(3), 29-46. doi: 10.1257/jep.31.3.29. <https://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.31.3.29>.

²⁷ International Monetary Fund. 2019. "IMF Data Access to Macroeconomic & Financial Data, Currency Composition of Official Foreign Exchange Reserve (COFER)." <http://data.imf.org/?sk=E6A5F467-C14B-4AA8-9F6D-5A09EC4E62A4>. Note: The data information was done for one year from Q4 of 2017 up to Q4 of 2018.



liquid dollar assets—what former Fed Chair Ben Bernanke famously called²⁸ the “global savings glut.” In other words, the rest of the world is desperate to lend to the United States. Rather than perversely insist on keeping federal debt down, it would make more sense to give the rest of the world the dollar liquidity it demands while simultaneously financing an expanded public sector. (This argument is developed at more length in the essay “Dealing with the Trade Deficit,” in the Roosevelt report *Untamed*.²⁹)

Taxes:

7. Some tax increases are desirable in themselves.

There are good reasons to think that the US could easily support a much higher level of government debt, and even that increased federal debt might be macroeconomically beneficial rather than harmful. But this doesn’t mean that we don’t want higher taxes. Some tax increases are desirable for their own sake. Raising these taxes can also finance increased public expenditure, even if that is not the main reason to raise them.

There is a long tradition in economics of support for “Pigouvian taxes”—taxes on activities with negative externalities (i.e., activities that impose costs on the rest of society). Traditional examples include taxes on polluting industries or on goods with negative impacts on public health, such as alcohol and tobacco. A natural extension of this is taxes on carbon. While carbon taxes are not, in themselves, a sufficient solution to the problem of climate change, they are likely to be one part of it. Even a modest carbon tax of \$50 per ton could raise around 0.75 percent of GDP; more aggressive taxes would of course raise more. A financial-transactions tax (FTT) is also easily justified on Pigouvian grounds, given the immense costs imposed on society by financial instability and crises. An FTT of 0.5 percent on stock and bond transactions and 0.05 percent on derivatives would probably raise³⁰ over 1 percent of GDP, depending on how much it reduced trading volumes.

Taxes on the highest levels of income and wealth and inheritances, while less often discussed in these terms, can also be seen as justified by the social harms caused by the concentration of income and wealth. Sen. Elizabeth Warren (D-MA)’s proposed wealth tax is estimated³¹ to raise

²⁸ Bernanke, Ben. S. 2005. “The Global Saving Glut and the U.S. Current Account Deficit.” Federal Reserve Board. <https://www.federalreserve.gov/boarddocs/speeches/2005/200503102/>.

²⁹ Abernathy, Nell, Mike Konczal, and Katy Milani. 2016. “Untamed: How to Check Corporate, Financial, and Monopoly Power.” Roosevelt Institute. <http://rooseveltinstitute.org/untamed-how-check-corporate-financial-and-monopoly-power/>.

³⁰ Fremstad, Anders, and Mark Paul. 2017. “The Impact of a Carbon Tax on Inequality.” Retrieved March 28, 2019. <https://markpaulcon.files.wordpress.com/2018/01/fremstad-paul-the-impact-of-a-carbon-tax-on-inequality.pdf>.

³¹ Saez, Emmanuel, and Gabriel Zucman. (n.d.). University of California, Berkeley [Letter written January 18, 2019 to Sen. Elizabeth Warren (D-MA)]. <http://gabriel-zucman.eu/files/saez-zucman-wealthtax-warren.pdf>.



on the order of 1 percent of GDP, or \$200 billion per year; a 70-percent tax on incomes over \$10 million, as proposed³² by Rep. Alexandria Ocasio-Cortez (D-NY), might raise half this. Together, these taxes would finance a substantial expansion of the public sector. More importantly, they would help safeguard democracy against the outsized power of the wealthiest and foster a more inclusive, egalitarian society.

When the government raises taxes to combat social ills, one option is to use the revenue to reduce other, regressive or economically counterproductive, taxes, or, as some have suggested with a carbon tax, to distribute the revenue as a social dividend. But to the extent that we think that higher debt is economically or politically undesirable, it would also be natural to use these new revenues to finance an expanded public sector.

8. US taxes are currently among the lowest among rich countries.

If for whatever reason an expanded public sector does call for broader-based tax increases, this shouldn't be a deterrent. Even before the most recent federal tax cuts, the United States was the most lightly taxed of large rich countries. As of 2017,³³ taxes for all levels of government—federal, state, and local—totaled only 27 percent of GDP in the US, compared with an average of 34 percent for the Organization for Economic Cooperation and Development (OECD) countries as a group. Among the rich countries, only Ireland, a notorious tax haven, sees a smaller fraction of GDP collected in taxes. In France and several Scandinavian countries, taxes total more than 45 percent of GDP. Thus, even if single-payer health insurance—new spending on the order of 10 percent of GDP—is entirely financed with taxes, that would bring the United States only a bit above the OECD average, to around the current level of Germany or the Netherlands.

We should not assume that even a substantial increase in public spending would call for an increase in broad-based taxes. As discussed above, there is no reason to doubt that the US has the capacity to issue more debt, and some spending can also be financed by taxes adopted for redistributive or other non-revenue purposes. As discussed in the next point, to the extent that higher public spending generates faster growth, this will automatically finance some or perhaps all of it. And at present there is no reason to think that higher spending would require higher taxes to reduce demand in an overheating economy. Nonetheless, it is likely that with a sufficiently large increase in public spending, a point would be reached where it was desirable to finance some of it with broad-based, though still progressive, tax increases. This should not be a deterrent to increased public spending—the US government has a great deal of space to tax more as well as to borrow more.

³² Yglesias, Matthew. 2019. "Alexandria Ocasio-Cortez Is Floating a 70 Percent Top Tax Rate—Here's the Research That Backs Her Up." Vox, January 1, 2019. <https://www.vox.com/policy-and-politics/2019/1/4/18168431/alexandria-ocasio-cortez-70-percent>.

³³ Organization for Economic Cooperative Development. 2019. "Revenue Statistics-OECD Countries: Comparative Tables." <https://stats.oecd.org/Index.aspx?DataSetCode=REV>. Note: The data information is organized yearly from 1965 to 2017 according to country.



OTAL TAX REVENUE AS SHARE OF GDP, 2017

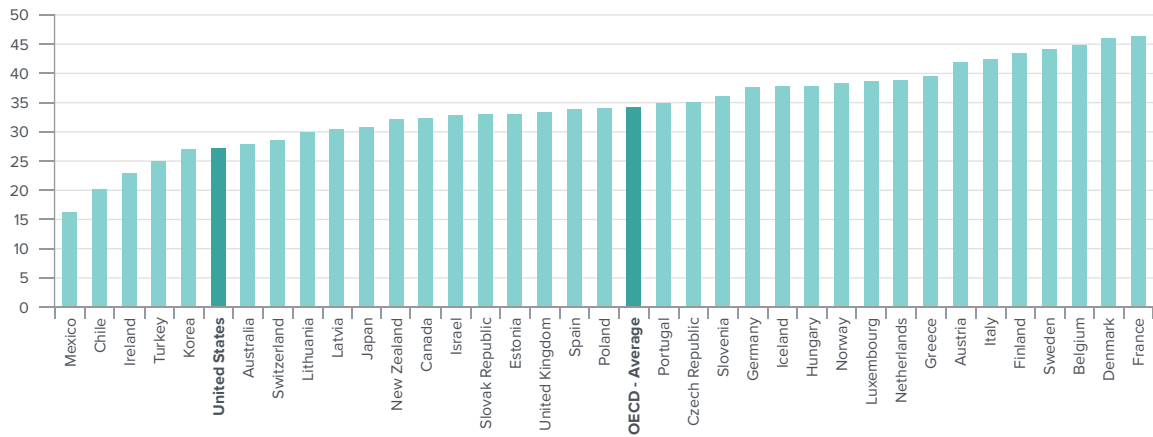


FIGURE 3 Data for Japan and Australia is from 2016. Source: OECD

9. If increased public spending leads to faster growth, this can fully pay for the spending.

We often assume that more borrowing will lead to a higher debt-GDP ratio, but if the borrowing boosts demand and growth, this need not be the case. First, if public borrowing raises GDP, this increases the denominator of the debt-GDP ratio, offsetting the higher debt in the numerator. Second, tax revenue automatically rises with GDP, reducing the need to pass tax increases. Together, these two effects mean that if higher public spending has a sustained effect on GDP—even a small one—it is quite possible for it to fully pay for itself, in the sense that even without any new tax increases the debt ratio will not rise.

In the past, this argument has been associated with so-called supply-side economics, which favored a program of tax cuts for the rich and for corporations. These trickle-down promises have been disappointed—because the promised growth failed to materialize. Today, however, an increasing number of economists from across the spectrum believe that depressed demand can have lasting costs for growth, and conversely, that demand-boosting public expenditure can have permanent benefits. If this idea, called “hysteresis,” is correct, it is quite possible for increased public spending to partly or even fully pay for itself.

Among economists³⁴, the past decade has seen an increasing interest in hysteresis—persistent effects of shifts in aggregate demand on the economy’s productive potential.³⁵ Researchers

³⁴ Fatás, Antonio, and Lawrence H. Summers. 2016. “Hysteresis and Fiscal Policy During the Global Crisis.” Vox CEPR Policy Portal. <https://voxeu.org/article/hysteresis-and-fiscal-policy-during-global-crisis>.

³⁵ Ball, Lawrence. 2009. “Hysteresis in Unemployment Old and New Evidence.” (Working Paper 14818), National Bureau of Economic Research. <https://www.nber.org/papers/w14818.pdf>.

at several Federal Reserve Bank research departments have published research³⁶ arguing for a substantial role for hysteresis in the slow growth of the past decade. The implications of hysteresis for macroeconomic policy and public debt have been explored in a series of papers by Lawrence Summers and various coauthors. They show that with even a modest degree of hysteresis, it is quite possible³⁷ for a fiscal stimulus to pay for itself. For example, if the fiscal multiplier is 1.5 (a common estimate in empirical studies) and just one-tenth of demand-induced changes in output are persistent, then an increase in public spending could pay for itself if the interest rate was as much as 10 points above the growth rate.

The converse case is painfully obvious in countries like Greece, where years of fiscal surpluses won through painful austerity have left the debt-GDP ratio higher than before, because of their depressing effects on growth. There is an important lesson here about the potentially self-defeating nature of rigid ideas about fiscal responsibility.

Conclusion

The critical point linking all these arguments is that the public sector not only has unique advantages in providing many goods and services, but it also has unique advantages in paying for them. With its power to tax, its status as a safe borrower, and its long horizons, the federal government can raise funds on more favorable terms than any private sector entity. Unlike private actors, it can also consider the social impact of its financing decisions. Additionally, a progressive tax code can discourage socially costly activities and raise revenue. And borrowing can stimulate demand and help moderate future recessions, and it can be a source of finance for public programs.

The bottom line is that if there are urgent problems that we want the federal government to solve, the “how to pay for it” question does not give us any reason not to do so. The federal government has plenty of room to tax more and plenty of room to borrow more, and the US economy has plenty of unused productive capacity. As John Maynard Keynes said 75 years ago: “Anything we can actually do, we can afford.”³⁸

³⁶ Acharya, Sushant, Julian Bengui, Keshav Dogra, and Shu Lin Wee. 2016. “Slow Recoveries and Unemployment Traps: Monetary Policy in a Time of Hysteresis.” (Staff Report, No.831). Federal Reserve Bank of New York. https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr831.pdf.

³⁷ Delong, J. Bradford, and Lawrence H. Summers. 2012. “Fiscal Policy in a Depressed Economy.” *Brookings Papers On Economic Activity*, 2012(1), 233-297. doi: 10.1353/eca.2012.0000. <https://www.brookings.edu/bpea-articles/fiscal-policy-in-a-depressed-economy/>.

³⁸ Moggridge, Donald. 1980. *The Collected Writings of JM Keynes, Vol. 27: Activities 1940-1946. Shaping the Post-War World: Employment and Commodities*. London: Macmillan.



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