PREVENTING ANOTHER LOST DECADE:

WHY LARGE FEDERAL DEFICITS SHOULD BE WELCOMED, NOT FEARED, IN TODAY'S ECONOMY

ISSUE BRIEF BY **J.W. MASON** | DECEMBER 2020

INTRODUCTION

Our nation is facing once-in-a-generation challenges: a global pandemic that has devastated our economy and taken more than 300,000 lives in the US alone, the existential threat of climate change, and the growing threat of another deep recession. Crises of such magnitudes call for bold, ambitious programs that will require substantial new government spending.

Even as a legion of economists, Federal Reserve officials, and even former deficit hawks are urging Congress to spend trillions of dollars to combat the economic fallout from COVID-19, some people still ask: "Can the government really afford this?"

The simple answer is yes.

In our current economy, increased public spending and borrowing by the government is not a problem. Rather, large deficits are an important part of the solution—a desirable policy outcome that can not only prevent a collapse in business activity and prolonged joblessness now, but, in the longer term, create a healthier and more equitable economy that is better able to address the major challenges of our time.

At the same time, the risks traditionally associated with deficit spending are far lower than previously assumed. In an environment of depressed demand, there is no danger of inflation or of public spending crowding out investment. And today's low interest rates, which are likely to continue for the foreseeable future, mean there is no risk of debt spiraling out of control. The risks of not spending enough, on the other hand, are real, immediate, and substantial.

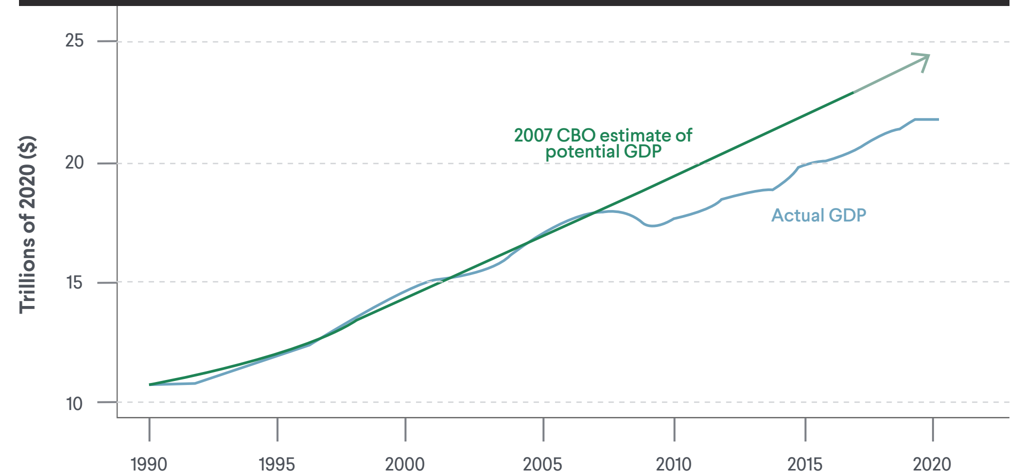
This issue brief explains why a higher price tag should now be seen as a feature, not a bug, of new public initiatives. It begins with an overview of current economic conditions, arguing that the central problem our economy faces is weak demand. This section draws on lessons from the Great Recession to explain the economic harms that come from inadequate government spending. Following that, the brief describes the many macroeconomic benefits of government spending: its ability to boost demand, "crowd in" private investment, and reduce inequality. Finally, the brief lays out common objections to government borrowing and explains why these objections do not apply in our current economy.

THE CENTRAL PROBLEM FACING THE ECONOMY TODAY IS TOO LITTLE SPENDING

The central issue for macroeconomic policy is balancing the amount of spending in the economy (demand) with the productive potential of the country's workers and businesses (supply). When demand exceeds supply, the result is rising inflation, accompanied by higher interest rates and eventually shortages of raw materials and other goods. When demand falls short of supply, the result is unemployment, falling wages, and even outright deflation. While neither of these dangers can ever be completely ignored, which one is a more urgent problem depends on the situation. Today, there is no question that too little spending is a far greater danger than too much spending.

Even before the pandemic, the US economy was struggling with a chronic shortfall of demand relative to supply. Compared with earlier periods, the period since 2000 has seen slower wage growth, slower productivity growth, and declining labor force participation, all signs of a weak labor market, while inflation and interest rates have been consistently low and declining over time. This has led economists to describe this as a period of "secular stagnation"—that is, a period when demand falls short of supply not just in recessions, but almost all of the time (Summers 2015). Notably, before the pandemic hit, the Federal Reserve was already cutting interest rates, indicating that they too saw the main danger facing the economy as too little spending.

FIGURE 1. ACTUAL VERSUS FORECAST GDP GROWTH SINCE 2007



Compared with forecasts from before the Great Recession of 2008—2009, the US economy was operating well below potential even before the pandemic. This suggests that larger federal deficits were already called for. Source: Congressional Budget Office, author's analysis.

We are now facing one of the most severe economic shocks in history. The first half of 2020 saw the fastest and deepest fall in GDP and employment on record. There are still more than 10 million fewer jobs than at the start of the year (US Bureau of Labor Statistics 2020a). Unlike the job losses of the spring, which were largely temporary layoffs, more than 3.7 million of today's job losses are expected to be permanent (US Bureau of Labor Statistics 2020c).

In the second quarter of 2020, according to the Bureau of Economic Analysis, GDP was a full 10 points below potential—the largest gap on record (US Bureau of Economic Analysis 2020d). While GDP did recover over the summer and fall, as of the third quarter it was still three points below potential, a gap previously seen only at the bottom of the deepest recessions. While the CARES Act and related stimulus measures limited the damage, it is now clear they were withdrawn well before the economy had fully recovered.

We may soon face a "double-dip" recession. Ominously, after falling for months, new unemployment claims began rising again in November (US Department of Labor 2020). After recovering strongly through the summer, consumer spending has stopped rising while still short of its level at the start of 2020 (US Bureau of Economic Analysis 2020b). The end of the federal stimulus and the deep spending cuts already underway at the state and local level are major negative shocks to demand in an economy that is already weak. And new waves of COVID-19 cases are triggering renewed restrictions on economic activity. In the absence of a major new stimulus, it is likely that output and employment will soon be falling steeply again, without ever recovering to pre-pandemic levels.

Since businesses depend on consumer spending, and consumers depend on wages from business, cuts to private spending can become a self-reinforcing downward spiral unless the government steps in to stop them. Just as the bursting of the real estate bubble and ensuing financial crisis set off such a downward spiral a decade ago, the COVID-19 crisis threatens to do so today.

The consequences of a weak economy go well beyond the immediate harms of lost jobs and incomes, and the useful goods and services not produced. A major lesson of the Great Recession of 2008—2009 is that a collapse in spending can have long-term effects, which last well beyond the end of the official recession itself. For workers, temporary job loss interrupts career paths, and long-term unemployment degrades skills and contributes to family breakup, ill health, and addiction, all of which harm future employment prospects and incur great personal costs. Between 2008 and 2012, labor force participation among prime-age adults fell by 2.5 points—equivalent to 3 million people dropping out of the workforce (US Bureau of Labor Statistics 2020). Participation rates had only just returned to their 2008 levels at the start of 2020. Studies have found that those who lost their jobs in the recession but remained in the workforce saw significantly lower wages even a decade later (Yagan 2017). And the weak labor markets of the recession and afterward led to slow wage growth across the board, especially for the lowest paid. Without an adequate stimulus today, we could be facing another lost decade for American workers.

For businesses, similarly, weak demand means less new investment. And that in turn leads to slower productivity growth. There is widespread agreement among economists today that the historically slow growth over the past decade reflects the lingering effects of the 2008 recession—a phenomenon economists call "hysteresis" (Summers and Fatás 2016). If, as seems increasingly clear, recessions can lead to lasting reductions in the economy's productive potential, then the costs of demand shortfalls may be even greater than previously believed (Benigno and Fornaro 2019).

Failing to act quickly against economic downturns means that much larger-scale action will be needed later on. When the government increases spending in a recession, that creates revenue for businesses and income for families. Their spending then creates more income, in a virtuous circle. This is why we speak of fiscal policy as "priming the pump"; once the flow of spending in the economy is restored, the government can safely step back. If the spring and early summer's stimulus spending, including full pandemic unemployment benefits, had been maintained through the fall, it's quite likely that private spending would have recovered quickly as soon as the pandemic was controlled. Unfortunately, the end of the stimulus—and the failure to support state and local governments—means that this is no longer likely to be the case. But a renewed stimulus can still stave off a deep downturn. Conversely, if we allow private spending to collapse, the eventual stimulus needed to bring the economy back to full employment will be much larger—another lesson of the Great Recession. Under these conditions, a myopic focus on "fiscal responsibility" can be self-defeating even on its own terms.

ROBUST GOVERNMENT SPENDING CAN STAVE OFF A RECESSION AND HELP NARROW INEQUALITY

Robust federal government spending is uniquely able to address our current economic challenges. Unlike households, the federal government does not face a financial constraint; a family that loses income cannot simply borrow more to make up the difference, but the government can. And unlike private businesses, the government can make its spending choices with an eye to their effect on the economy as a whole, not just on its own finances. In an economy facing a downward spiral of falling incomes and spending, only the government can step in and break the cycle. It is precisely because businesses and families need to cut spending when their income falls that the government needs to *raise* spending when its revenue falls.

Fiscal policy is the only reliable tool to boost demand and address the current economic freefall. In the past, aggressive monetary policy by the Fed might have been enough to stabilize the economy, but that tool is not available today. Interest rates are already so low that there is no room for the Fed to lower them further. And unconventional monetary policy like quantitative easing, while helpful, is an inadequate substitute. One Federal Reserve study of the effects of quantitative easing (conducted by a strong supporter of the policy) concluded that the nearly $2 trillion in asset purchases in 2009 and 2010 provided the equivalent of only a half-point decline in interest rates (Gagnon et al. 2010). Given that the Fed has historically cut rates by 5 points or more in even mild recessions, this is clearly not enough to stabilize demand. So it falls to the federal budget to maintain demand and prevent a deep downturn.

Government spending yields both immediate and long-term benefits. In the short term, higher government spending can kick off a virtuous cycle of consumer spending and business investment. Economists have extensively studied the effect of increased government spending on economic activity—what is known as the "fiscal multiplier." A review of studies suggests that in the US, when the economy is below full employment, each dollar of public spending generates at least $1.70 of increased production (Chodorow-Reich 2019). In other words, when the government buys a billion dollars' worth of new public services, we also get an additional 700 million dollars' worth of private consumption and investment, as the initial spending recirculates through the economy.

The Great Recession's economic dislocations and aftermath gave us a great deal of new evidence on the effectiveness of fiscal policy. Today, there is a near-consensus among economists that when the economy is operating below potential, each dollar of public spending more than pays for itself through higher growth. In a survey of leading economists by the University of Chicago's Booth School of Business, 97 percent agreed that the 2009 stimulus bill was effective in boosting output and lowering unemployment (University of Chicago 2014).

The immediate benefits of higher government spending in a depressed economy are more jobs and higher GDP. But there are longer-term benefits as well. Just as a deep recession can permanently drag down labor force participation, productivity, and wage growth, stimulus spending can have lasting benefits. When the economy is facing a demand shortfall, as it is today, and as it has been for much of the recent past, spending more money not only boosts output and employment while the spending takes place, but also boosts output and employment in the future—even after the spending has ended. For example, previously unemployed people who are drawn into the labor force and acquire new skills and work experience because of a government program will be more productive for the remainder of their working lives. New machines, buildings, and software created by business investment thanks to government stimulus continue to be useful even after the stimulus has ended. If it has even a modest effect on long-run growth, increased public spending can more than pay for itself.

Public spending can also have an important effect on income distribution and the balance of power between workers and employers. In a setting where jobs are scarce and workers abundant, workers have little bargaining power. Those in low-wage and low-skilled jobs—disproportionately Black and brown workers, women workers, and workers with the least education—are particularly vulnerable, since employers view them as replaceable or expendable. In contrast, when labor markets are tight, wages and working conditions improve. With few available workers and many job openings, employers must pay higher wages and offer more generous benefits to attract workers, even those in low-wage and low-skilled positions (Bivens and Zipperer 2018). We saw this clearly in the years before the pandemic; only once the unemployment rate fell below four percent did wages for low-paid workers begin to rise faster than for those at the top.

In the high-unemployment years after 2009, white workers' wages rose more rapidly than those of Black and brown workers, but when unemployment fell, this pattern reversed, with the gap between white workers and Black and brown workers shrinking after 2016 (Federal Reserve Bank of Atlanta 2020). In the pre-pandemic, high-pressure labor markets, wages for low-income Black households grew by 3.7 percent annually, more than four times the rate for low-income white households (CBPP 2019). Employers were less able to discriminate or impose requirements that limited their labor pool. In the past, it was often argued that the only way to equalize the distribution of income was through supply-side measures like job training. But today, it is widely understood that labor market conditions also play a critical role. By helping to create a tight labor market, government spending can be an equalizing mechanism that can raise wages and bargaining power for those at the bottom of the income distribution.

IN OUR CURRENT ECONOMY, DEFICIT SPENDING IS FAR LESS RISKY THAN PREVIOUSLY THOUGHT

The sections above outlined the myriad short- and long-term benefits of robust government spending, along with the likely economic harms of doing too little. However, what about the other side of the coin: the potential risks associated with excessive government borrowing?

Conventional economic theory typically cites four interrelated objections to increased deficits and debt. First, if total spending in the economy rises beyond its productive capacity, prices will begin to rise, meaning higher inflation. Second, too much spending in the economy may lead to a rise in interest rates, if the Fed believes that inflation will otherwise get unacceptably high. Third, via either higher prices or higher interest rates or a combination of the two, higher public spending will "crowd out" private spending, especially investment. Finally, government debt may compound or "snowball" over time, if high interest rates mean that existing debt grows faster than the economy. In this case, debt service payments may eventually crowd out other important spending. The following section explains why these concerns do not apply in today's economy.

1. **Government deficits lead to inflation only in an economy already at full employment.**

   Traditional economic dogma warns that deficit spending will lead to rising inflation. This is certainly possible when an economy has reached full potential. But it's important to understand that this kind of inflation only happens when demand exceeds supply, when there is "too much money chasing too few goods." As discussed above, our economy faces the opposite problem. We have a great deal of slack—that is, unused labor and capital. There are more workers than jobs available, and businesses are not producing at their full capacity.

   To get a sense of the scale of unused capacity in the US right now, consider that total employment as of October 2020 was 142 million, compared with 152 million at the start of the year. Assuming those people would still be working if jobs were available, that implies a true unemployment rate today of at least 10 percent, rather than the still-high official rate of 7 percent. Based on the experience of past recoveries, it would take at least five years of solid growth to get back to the labor-market conditions of a year ago.

   The large amount of slack in today's economy means that inflation is not a concern. In fact, most economists think that somewhat higher inflation would be a good thing today. This means that deficits are not a problem now, and that we will have plenty of warning before they become one. Until we have seen consistently above-trend growth and 2 percent inflation for a number of years, there is no reason to worry that deficits are too large.

2. **The interest rate on federal debt is set by the Federal Reserve.**

   To understand why rising interest rates are not a concern in our current economy, recall that interest rates on government debt are *fully controlled by the Fed*. While the Fed typically sets only the very shortest-term interest rates directly, interest rates on longer bonds depend on what market participants expect the Fed to do in the future. If, for example, a bank is willing to hold a 30-year Treasury bond at an interest rate of 1.5 percent (about where it is today), that means they are very confident that interest rates will remain low for many years to come.

Normally, market expectations are enough to allow the Fed to control longer-term interest rates. But if necessary, they can simply set long interest rates directly. During World War II, the Fed capped the interest rate on longer-term federal debt at 2.5 percent, a cap it had no trouble maintaining despite the massive scale of federal borrowing during the war (Toma 1992). While the Fed has not had to explicitly set rates for longer bonds in recent years, other central banks, including the Bank of Japan and the European Central Bank, have been able to set longer-term interest rates at whatever level they wanted, simply by announcing a target rate. Put simply, a central bank has unlimited funds at its disposal, so if it decides to buy a given asset (say a Treasury bond) at a certain price, there is no way for markets to set a different price. The only way interest rates on federal debt can rise is if the Fed wants them to rise.

The Fed chooses to raise or lower interest rates based on macroeconomic conditions. When the economy is overheating and the Fed is concerned about too-high inflation, it raises rates. When the economy is underperforming, as it currently is, the Fed lowers rates.

Given these criteria, it is extremely unlikely that the Fed would raise interest rates since inflation is not a concern. Indeed, at the most recent meeting of the Fed's governing body, the Federal Open Market Committee, the majority of members said they expected interest rates to remain below 2.5 percent for the indefinite future (Board of Governors of the Federal Reserve System 2020). As long as output is falling short of potential and inflation remains below target, we should not be worried about rising interest rates.

3. **When there is substantial slack in the economy, public spending does not compete with private investment.**

When the government competes with the private sector for a limited supply of financing, it can "crowd out" (discourage) private sector investment and slow the economy. In effect, if the government is using too much of the economy's productive resources, the private sector will be left with less. However, in an economy operating below potential, there is no scarcity of dollars available for lending. Businesses decide not to invest because they lack demand—not because they can't access credit. Indeed, in an underperforming economy, there is a glut of credit available for the private sector at extremely low costs. Under these circumstances, government borrowing does not compete with the private sector. Indeed, deficit spending spurs private sector investment that would otherwise not take place.

4. **Government debt can "snowball" or grow without lift, only if interest rates are higher than GDP growth rates, but today they are much lower.**

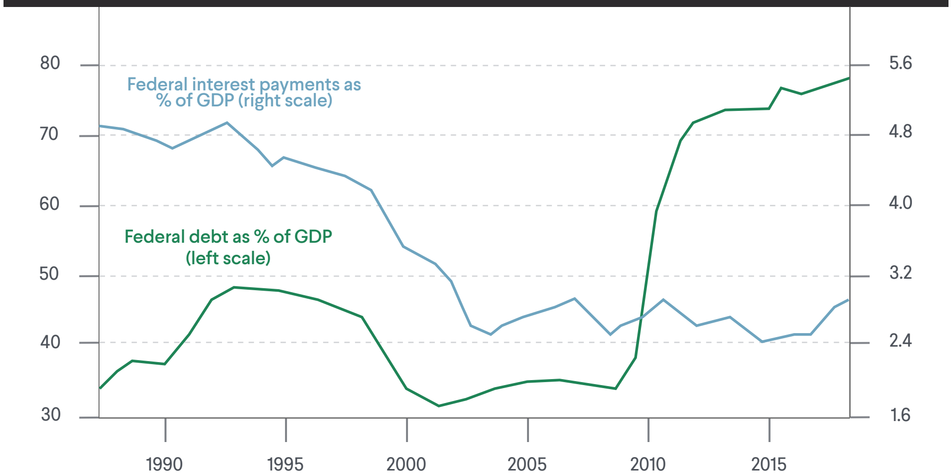
   A major concern about government borrowing is whether it is "sustainable"—that is, will the debt rise without limit and ultimately crowd out other important spending, or will it stabilize.

   The mathematics of debt sustainability are well-known and agreed on by all economists. Sustained deficits will cause debt to explode if and only if the interest rate on the debt is greater than the growth rate of GDP. In the 1980s and 1990s, when interest rates on federal debt were typically higher than growth rates, there was some basis for worries that sustained deficits could cause the debt burden to grow uncontrollably.

   But we live in a starkly different economy. Even during the relatively weak expansion of the 2010s, GDP grew at nearly 5 percent a year. With the average interest rate on federal debt now well below 1 percent, and with the Fed planning at most modest increases, this condition is not going to be met for the foreseeable future, so there is no way for debt to rise out of control (Board of Governors of the Federal Reserve System 2020). Indeed, thanks to the fall in interest rates in recent years, the CBO's forecast for federal debt later this decade is no higher than it was a few years ago, despite the massive deficits run in response to the pandemic (CBO 2019). In the low-interest environment we can expect for the foreseeable future, even if the government runs deficits forever, the debt-GDP ratio will stabilize on its own.

   Low interest rates also mean that we do not have to worry about debt service crowding out other spending. Debt service costs depend on both the level of debt and the interest rate on that debt. High debt with low interest rates is no more burdensome than low debt carrying high interest rates. The steady decline in interest rates over the past 40 years means that even though the debt-GDP ratio is close to its historic high, debt service costs have actually fallen. Today, federal interest payments total only around 2 percent of GDP—about half what they were in 1990, despite the fact that over the same period, debt has more than doubled relative to GDP (US Bureau of Economic Analysis 2020a).

FIGURE 2. FEDERAL DEBT AND INTEREST PAYMENTS, 1980-2020



While federal debt has risen relative to GDP over the past 30 years, the cost of servicing that debt has come down. That means that interest payments take up much less of the federal budget today than in decades past. Source: FRED, Federal Reserve Bank of St. Louis.

Low interest rates mean that we don't have to worry about debt snowballing or interest payments crowding out other forms of public spending; and when we take into account the effect of federal spending on GDP, higher borrowing can actually *reduce* the debt-GDP ratio. Yes, borrowing more raises the federal debt—but it may raise GDP by even more. In accordance with a Federal Reserve study, former Treasury Secretary Lawrence Summers and his colleagues have estimated that under current conditions, increasing debt-financed public spending by one percent of GDP would *reduce* the long-term debt-GDP ratio by as much as two points (Auerbach and Gorodnichenko 2017). Conversely, efforts to reduce deficits today may actually make the long-term burden of the debt greater, by holding back growth.

It's not wrong to think that excessive public deficits can create serious problems. They can! But it is wrong to focus on those problems today, when we are faced with the much more urgent problem created by deficits that are not large enough.

IN OUR CURRENT ECONOMY, GOVERNMENT SPENDING IS A FEATURE, NOT A BUG

In an economy facing chronic weak demand, inflation below target, and ultra-low interest rates, the fact that some proposed new public initiatives will lead to higher deficits should be counted as an additional benefit, not a cost. Investments in public health programs, education, universal childcare, clean energy, and affordable housing will all have major direct benefits, as they address immediate social needs. But beyond the specific problems these expenditures address, they will also have large macroeconomic benefits: pumping additional dollars through the economy, stabilizing demand, and preventing the COVID-19 crisis from turning into the COVID-19 depression. Over the longer term, debt-financed public spending on a large enough scale can put an end to secular stagnation and put the economy on a permanently higher growth path. And these benefits will come precisely because these programs add to the federal deficit.

This Doesn't Mean That Deficit Spending Is Always Sound Policy

The argument that government spending is "a feature, not a bug" does not mean that bigger deficits are always a good thing. There are several important caveats to the arguments presented here.

First, the argument that bigger deficits are desirable is based on current economic conditions—both the immediate COVID-19 crisis and the accompanying recession, and the longer-term problem of chronic stagnation. In the future, the US economy may again reach a situation of true full employment, with inflation a serious concern. As discussed earlier, there is good reason to think that it will take many years of strong growth to reach this point, and we will have ample warning before we get there. But we may reach it eventually—and sooner if we get adequate stimulus now. Once that point is reached, continued deficits will carry real costs in terms of higher inflation and crowding out of private spending. There are no absolute, universal rules for macroeconomic policy. Once the US is again enjoying consistently strong growth and steadily rising wages, the conversation will need to be quite different than it is today.

Second, even in conditions like today's, where larger deficits are desirable, we still need to be sure that the government spending is not doing more harm than good. Deficits incurred to finance tax cuts for the rich, for example, may not be costly from the increase in public debt, but they have major costs in exacerbating inequality. Similarly, spending on subsidies to fossil fuel companies, for example, may have modest macroeconomic benefits, but those are vastly outweighed by the social costs it imposes.

Finally, the arguments here are based on deficits within the scale the US has experienced historically. In both the COVID-19 pandemic and the 2008—2009 recession, federal deficits reached 10 percent of GDP without any adverse effects on inflation or interest rates. (In 1943, the deficits exceeded 25 percent of GDP, albeit in the context of a broad set of wartime regulations.) In neither case was there any difficulty in getting financial markets to absorb the increased debt. That doesn't imply, however, that the government could run deficits of any size whatsoever without creating serious disruptions in the financial system. Our argument is that as long as demand is weak and there are urgent public needs to be met, the government should continue running deficits as large as today's or somewhat larger. We don't claim that the government could run a deficit of 100 or 1,000 percent of GDP.

The United States desperately needs more of the services that only the public sector can provide, from public health to decarbonization to income redistribution. But just as much, the US economy needs the additional dollars that will come from spending on those services, as long as they are *not* offset by tax increases. To forego useful public spending because of fears it would add to the deficit is, in today's conditions, like firefighters refusing to turn their hoses on a blazing house fire because they are afraid of getting the house wet. Which is to say: It is a concern that is certainly valid in some times and places, but runs directly contrary to dealing with the immediate problem at hand.

The greatest fiscal danger we face today is not rising debt, but failing to address real, pressing needs because of a misplaced obsession with the government's budget balance. We cannot base our policy choices today on conditions of decades ago—times when, unlike today, inflation was a real problem and high interest rates meant that there was a danger of federal debt spiraling out of control.

In the conditions facing us today, and almost certainly for many years into the future, higher public deficits do not crowd out private spending, but crowd it in. They do not increase the burden of the debt but, more likely, reduce it by generating faster growth. They don't create a danger of inflation but stave off the danger of deflation. For a private business or family to cut back spending in response to hard times is reasonable. But for the government to do so only ensures that the hard times will be worse and last longer. Strange as it may sound, in today's economy, we need to accept that a big price tag on a public program is not an objection to it but a point in its favor.

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