The Flawed Economics of the PAYGO Rule

Our nation is faced with once-in-a-generation challenges—including devastating climate change, crumbling infrastructure, and crippling household debt—that can only be addressed by bold, progressive policies, many of which require significant government spending.[1] A major impediment to meeting these challenges is the "pay as you go" (PAYGO) rule. The PAYGO rule is a congressional budget rule that requires any legislation that raises spending on entitlement programs or cuts taxes to be offset with either tax increases or spending cuts elsewhere in the budget.[2]

Many opponents of PAYGO note that the procedural requirements impede effective policymaking by holding critical investments hostage to budgetary constraints. Getting policymakers to agree to offsets, especially for ambitious programs, is politically challenging, if not impossible.

Less discussed are the macroeconomic concerns with PAYGO. From an economic perspective, PAYGO is problematic because it perpetuates a reflexively anti-deficit worldview that is analytically flawed and ultimately harmful for the economy. Specifically, we argue that:

- The PAYGO rule perpetuates a flawed and overly rigid view of deficit spending; and
- This flawed understanding of deficit spending leads policymakers to overestimate the risks of non-offset spending and understate its benefits in the current economic climate.

The PAYGO rule reflects a flawed view of deficit spending

Underpinning the PAYGO rule is the premise that deficits are universally bad and to be avoided at all costs. This simplistic viewpoint is wrong. **Deficits are not always good or always bad**. Deficit spending comes with both risks and benefits, which can only be evaluated against the backdrop of the current economy. When the economy is booming and inflation is high, it makes sense to restrain deficit spending because of the elevated risks of interest rates spiking. But during downturns or sustained periods of economic weakness, when the risks of inflation are low, more deficit-financed government spending may be useful.

The ideology undergirding the PAYGO rule is problematic because it doesn't allow for these distinctions. It takes no account of the current state of the business cycle or the broader economy. It is a one-size-fits-

[1] For further discussion on the case for more public spending, see Roosevelt's "Why Spending Money on Ambitious New Programs Is a Feature—Not a Bug—in Today's Economy" factsheet.

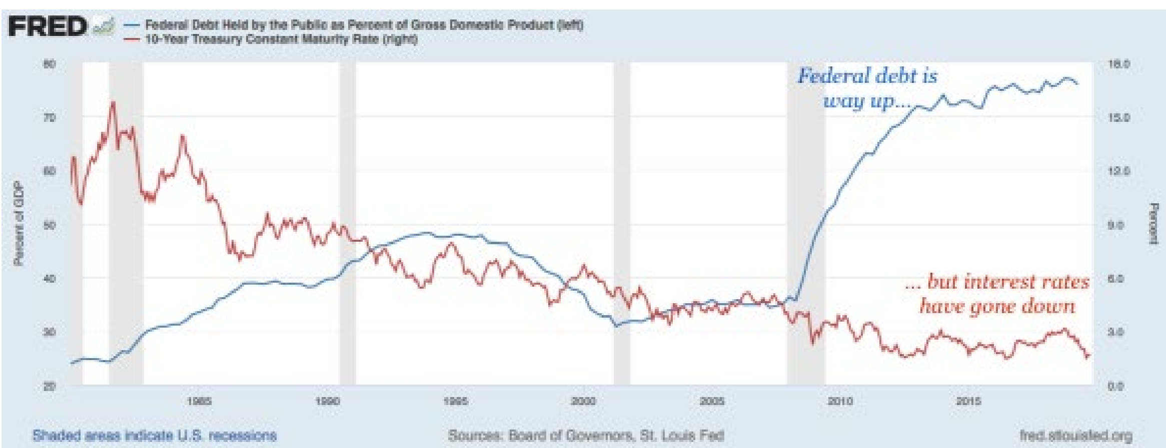
[2] The PAYGO rule is different from statutory PAYGO. Statutory PAYGO stipulates that any legislation enacted during a session of Congress that increases the projected debt for the following year would trigger a "sequestration," or an across-the-board spending reduction of non-exempt mandatory programs to offset this increase in the deficit.

all rule that assumes that higher debt is always costly. Taken to its logical conclusion, it militates against deploying expansionary fiscal policy, even when doing so would help stabilize markets or grow the economy.

The PAYGO rule results in policy choices that overestimate the risks of non-offset spending and understate its benefits in our current economy

The textbook reason to oppose federal deficits is that they push up interest rates, fuel inflation, crowd out productive business investment, and lead to unsustainable debt in the long term. These problems are most likely to happen when the economy is at full employment and starved of savings and when inflation and interest rates are high.

We live in a very different economy, where low interest rates and low inflation rates are, as Federal Reserve Chairman Jerome Powell has put it, “the new normal.” Even as deficits rise, interest rates on 10-year Treasury bonds recently reached their lowest point since the federal government existed. Far from overheating, the economy is operating persistently below potential. Despite low unemployment rates, there are clear signs of continued weakness in the labor market, including a depressed labor force participation rate among prime-age workers and a failure of wage growth to take off, as it would in an economy where labor was genuinely scarce. It is clear that aggregate demand—i.e., total spending by households, businesses, and governments—has consistently fallen short of what is needed to reach full employment.



In this context, the normally cited “costs” of deficits are hardly a concern. Yet, because of the reflexive, anti-deficit sentiment epitomized in PAYGO, policymakers are fearful of deficit spending.

At the same time, the worldview underlying PAYGO often leads to policy choices that discount the economic value of more government borrowing. It has been widely understood since Keynes’s era that when the economy is suffering from a lack of demand, larger deficits can be desirable, since they help stimulate demand in our economy. Increased spending generates more jobs to the unemployed, who in return have more dollars to spend in the economy. Ideally, government spending kicks off a virtuous cycle of consumer spending and business investment, resulting in a bigger increase in GDP than the initial injection of funds. The best time to raise spending is in a slump, while the best time to raise taxes is in a boom. There is no economic basis for insisting that they must move together, as the PAYGO rule does.

The PAYGO perspective also overlooks how debt-financed government spending can help rebalance power in the economy toward those most vulnerable. During periods of weak demand, when jobs are sparse, workers (especially those earning low wages) have little bargaining power. In contrast, when labor markets are tight, employers must pay higher wages and offer more generous benefits to attract workers, even those in low-wage positions. Thus, in helping to stimulate the economy and create a tight labor market, debt-financed government spending can be an equalizing mechanism that can raise bargaining power (and thus wages, for example) for those at the bottom of the income distribution.

Conclusion

PAYGO is a misguided approach to deficits and debt that overlooks the actual needs of today's economy.

It perpetuates the flawed view that "we cannot afford more government debt," which is based on outdated analyses that ignores the economic realities of our time. The last decade of weak growth and wage stagnation have made it abundantly clear that more expansionary fiscal policy is needed—not just in rare emergencies but much of the time. Yet the ideological underpinnings of PAYGO make it harder for policymakers to deploy expansionary fiscal policy, even when the economy desperately needs more demand. **In short, the PAYGO rule creates an unnecessary obstacle to economically sound budgeting.**

This fact sheet was prepared for the Congressional Progressive Caucus Center by the Roosevelt Institute. It builds off of work by Roosevelt Institute Fellow JW Mason. For more information, see **"Fiscal Rules for the 21st Century: How to Pay for the Public Sector."**