"But How Do We Pay for It?" Why Spending Money on Ambitious New Programs Is a Feature—Not a Bug—in Today's Economy

Our nation is faced with once-in-a-generation challenges—widespread inequality, alarming climate change, crumbling infrastructure, and crippling household debt, among others—that can only be addressed with bold, progressive policies, many of which require significant government spending. Although some policymakers and candidates have proposed such policies, they often get pushback from skeptics asking, *"Can the government really afford these programs?"*

The simple answer is yes. Given our current economic conditions, increased public spending and borrowing by the government is not a problem to be explained away; in fact, it is a desirable feature of policymaking that can both help our economy reach its full potential and enable policymakers to overcome today's challenges.

A growing number of economists are challenging the conventional economic wisdom that higher government spending, especially when financed through debt, is harmful for the economy. The idea that "we cannot afford more government debt," if it's needed to meet national priorities, is based on outdated analyses that ignores the economic realities of our time.

Despite headline numbers suggesting some indicators of a "good economy," we are currently experiencing a long-term economic slump, reflected in persistently low interest rates and inflation as well as weak demand. A recession might very well loom on the horizon. In this economic climate, the risks of deficit spending are far lower than previously assumed, while the benefits may be much greater. Low interest rates mean little risk of out-of-control debt or inflation. Meanwhile, more government spending offers the specific benefits of stimulating demand, spurring business investment, and even moderating future recessions.

In short, our current economy stands only to benefit from increased public spending. Therefore, it should be seen as a feature—not a bug—of future economic policymaking.

In Our Current Economy, Deficit Spending Is Far Less Risky Than Previously Thought

Today, the fundamental macroeconomic problem we face is that weak demand—i.e., total spending by households, businesses, and governments—consistently falls short of what is needed to reach full employment, or when all people who can or want to work are employed. This underperformance, sometimes referred to as secular stagnation, is reflected in persistently low interest rates and inflation, a dearth of private investment, depressed labor force participation rates, and long "jobless recoveries."

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In an economy facing secular stagnation, there is always a great deal of slack—that is, unused labor or capital. We currently have more workers than jobs available, and businesses are not producing at their full capacity. In this context, the typically cited dangers of deficit spending—skyrocketing inflation, a dragging economy, runaway federal debt—are unlikely to occur because:

- **The inflation rate is low and unlikely to rise.** Traditional economic dogma warns that deficit spending will lead to runaway inflation. However, inflation happens when demand exceeds supply, or there is "too much money chasing too few goods." As noted above, our current economy faces the opposite problem. We have excess slack due to insufficient demand relative to what the economy is capable of producing. The inflation rate, 1.7 percent as of August 2019, has been below target for the past 20 years. And rather than increasing, this rate has been declining compared to the previous two years. For the foreseeable future, higher inflation seems unlikely; and if it did materialize, somewhat higher inflation would be a good thing in today's conditions, since more inflation would encourage consumers and businesses to spend sooner, thus boosting economic growth.
- **With ample capital available for both government and private borrowing, "crowd-out" is unlikely.** Economists have warned that deficit spending can harm the economy through "crowd-out," or when the government competes with the private sector for a limited supply of financing. This can discourage private sector investment and slow the economy. However, in an economy operating below potential, businesses decide not to invest because they lack demand—not because they can't access credit—so there is no scarcity of dollars available for lending. 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.
- **The rate of economic growth is outpacing the rates we pay to borrow money, which means there is no risk of runaway debt.** A major concern about government borrowing is whether it is "sustainable"—that is, will the debt rise without limit or will it stabilize as a share of gross domestic product (GDP). In situations where average interest rates are higher than the growth rate of GDP (such as during the 1980s and 1990s), government debt can 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. For the last 25 years, however, interest rates have been lower than growth rates. The long-term decline in interest rates are due to structural factors—including slowing population growth and the rising weight of high-saving Asian countries in the world economy—that are unlikely to reverse any time soon. This means that our capacity to pay for public programs, investments, and other initiatives is continually growing faster than the rate we pay to borrow the money. When the interest rate is below the GDP growth rate, as is true today, the debt ratio will stabilize on its own—i.e., deficits do not have to be offset with surpluses. As many leading economists have begun to recognize, this reality makes many of the concerns with debt sustainability obsolete.

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In an Underperforming Economy, Government Spending Can Help the Economy Reach Its Full Potential

Running an economy below potential comes with real costs. At the macroeconomic level, there are the opportunity costs of unproduced goods and underutilized labor. For instance, the recession and slow recovery saw an enormous amount of useful goods and services go unproduced, and an enormous number of unemployed people held productive capabilities that were left to decay. In fact, the shortfall between output and potential between 2008 and 2015 came to approximately $5 trillion. A chronically underperforming economy also leads to stagnating wages and declining labor conditions. In the longer term, persistent unemployment can cause people to lose skills, eroding our long-term potential.

Robust government spending is uniquely able to address these challenges because:

- **Government spending stimulates the economy by boosting demand.** Increased government spending benefits the economy in the short term by spurring demand and creating a multiplier effect. For instance, if government spending provides jobs to the unemployed, then the newly hired individuals will have more income to spend, resulting in a further increase in aggregate demand (e.g., construction workers employed by the government will increase their own spending on food and transportation, causing other sectors in the economy to benefit). Furthermore, as the economy improves, the outlook for businesses also improves; this can spur increased investment, a phenomenon known as "crowding in." 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.
- **Monetary policy alone cannot address secular stagnation.** The Federal Reserve (the Fed) has historically attempted to overcome economic downturns by lowering interest rates, predicated on the idea that this will encourage spending and investment. There is good reason to doubt that this alone cannot stabilize the economy today. Interest rates are already so low that there is little room for the Fed to maneuver before they hit zero. Since the policy interest rate cannot be set below zero, there is a limit to what the Fed can do. In this environment, we must also deploy fiscal tools to jumpstart a weakening economy, and more government spending shouldn't be underutilized.
- **In the longer term, an initial infusion of funds can set the economy on a positive growth trajectory, with lasting effects even after the spending has ended.** Persistent effects of government stimulus or austerity are referred to as "hysteresis." This means that spending more money today not only boosts output and employment while the spending takes place, but it also boosts output and employment in the future—even after the spending has ended. For instance, 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.

- **Spending by the government can rebalance the power in the economy and tilt it toward those most vulnerable.** During periods of weak demand, when jobs are sparse and workers abundant, workers have little bargaining power. Those in low-wage and low-skilled jobs—disproportionately minority, female, and least educated people—are particularly vulnerable, since they are viewed as replaceable or expendable. In contrast, when labor markets are tight, employee wages and working conditions improve. With more jobs than available workers, employers must pay higher wages and offer more generous benefits to attract workers, even those in low-wage and low-skilled positions. We have seen this clearly in recent years; only since the unemployment rate has fallen below 4 percent have wages for low-paid workers begun to rise faster than those at the top. In tight labor markets, employers are also less inclined to discriminate or impose requirements or credentials that unnecessarily limit their labor pool. Thus, in 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.

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 deficits are irrelevant. Rather, our assessment of deficits is based on current economic conditions of chronic underperformance, which the federal government is best suited to address. In other times and places, where inflation is a major problem or where interest rates are high, there is a better case for keeping the government budget balanced. Though we do not expect these conditions to return to the US in the foreseeable future, the economics of government deficits will have to be revisited if they do.

We also do not believe that taxes are irrelevant. Our conclusions about the effects of federal borrowing refer to increased spending of up to 3, 4, or even 5 percent of GDP—enough to pay for most-prominent expansions of the public sector. A health care program along the lines of Medicare for All, however, would involve increased federal spending of as much as 10 percent of GDP, and, because we cannot be confident about the economic effects of deficits on this scale, would probably necessitate tax increases.

In addition, regardless of whether they are needed to finance public spending, certain taxes also have an important social role to play in reining in extreme concentrations of income and wealth and discouraging socially costly behavior, such as carbon emissions or wealth hoarding.

Finally, even if more government spending imposes little economic cost, it's still important that the spending is for things that are useful rather than harmful. Deficits incurred to finance tax cuts for the rich, for example, may not have great costs 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 are vastly outweighed by the great social costs they impose.

In Our Current Economy, Government Spending Is a Feature—Not a Bug

The greatest fiscal danger we face today is failing to address real, pressing needs because of a mindless and flawed obsession with the government's budget balance. We cannot afford to base our policy choices today on conditions of decades ago—a time when inflation was a real problem and high interest rates meant that there was a danger of federal debt spiraling out of control. The economics of our current economy are clear: The government can and should pay for bold, progressive policies and programs. Increased public spending and borrowing by the government is not a problem to be explained away; in fact, it is a desirable feature of policymaking that will help our economy reach its full potential and equip policymakers to overcome today's challenges.

This fact sheet builds off work by a range of Roosevelt Institute experts, including fellows JW Mason and Mike Konzcal. For more information, see *Fiscal Rules for the 21st Century: How to Pay for the Public Sector*.

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