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No Need to Panic about U.S. Government Deficits

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The Great Recession and its immediate aftermath has created the largest federal government deficits, by far, that the United States has experienced since the end of World War II.[1] The deficit jumped from slightly more than 1 percent of GDP in 2007 to 10 percent in 2009, 9 percent in 2010, and just under 9 percent in 2011. To put these figures in perspective, the U.S. federal deficit exceeded 5 percent of GDP only twice since World War II (5.9 percent in 1983 and 5.0 percent in 1985). These figures have stimulated loud anti-deficit rhetoric about fiscal irresponsibility from politicians, pundits, and some economists. In addition, serious commentators who seem sincere about their desire to "do the right thing" argue that we must significantly cut spending *and* raise taxes to avoid burdening our children and grandchildren with mountains of public debt.

It is hardly surprising that all this rhetoric has led to a sense of panic about deficits among the U.S. population. In 2011, mainstream political discussion largely converged on the idea that the deficit must be cut *now*. Any thought of further fiscal stimulus to address the perniciously stagnant labor market recovery from the Great Recession seems off the political table. Deficit fears have compromised even the most basic countercyclical fiscal policies, such as extended unemployment insurance. In stark contrast to the broad message of this volume, the political right, and even a share of so-called moderates in the U.S. Democratic Party, claim that the deficit demonstrates the failure of Keynesian policy and they are pushing for lower government spending as a way to boost private investment and

[1] This chapter is an extensively revised version of a keynote address presented at the conference "The World Economy in Crisis – The Return of Keynesianism?" Berlin, October 31, 2009 that appears in the conference volume Dullien et al. (2010).

business confidence by taking "seriously the debt that is threatening our job creators."[2]

In this chapter, we argue that these fiscal fears are largely without merit, and they constrain fiscal policy from doing what it needs to do: continuing to support and even grow demand as the U.S. economy struggles after the recession. Through the lens of basic Keynesian macroeconomics, we present the case for aggressive fiscal policy and associated large deficits as a critical part of the appropriate policy response to the Great Recession. In short, we argue that the government has the power to affect aggregate demand through taxation and spending ("fiscal policy"), and that the constraints on fiscal policy that politicians and talking heads often emphasize stem not from the government's inability to spend, but from a desire to reduce or eliminate government provision of certain public programs. Our argument is that the political debate over *how to spend* money (meaning, ultimately, how the real resources in our economy are allocated) should be determined independently of the important and unique role the government can and must play in regulating aggregate demand. If we restrict the government from adjusting fiscal policy as necessary to boost demand, we are doing it either because we do not believe that the government can be effective in that capacity, or because we are afraid of the consequences of the government determining fiscal policy – especially spending – without limitation. However, it is important to recognize that the only limitation is a political one, one we choose, and that the government has flexibility to regulate demand in ways that can be palatable across political lines and can prevent the waste created by unemployed resources.

An organizing theme of this volume, reflected in every chapter, is that the proximate source of the Great Recession was inadequate demand, the causes of which are discussed throughout this book. Historic declines of both consumer spending and residential construction, magnified by declining business investment, combined to create a massive negative "demand shock" that has idled resources well into the fourth year since the recession began. The increase in the federal deficit, created mostly by automatic stabilizers (falling tax revenues and rising entitlements – primarily unemployment insurance and Medicaid), but assisted by non-trivial discretionary stimulus (most prominently the American Recovery and Reinvestment Act of 2009), played a central role in containing the demand freefall of late 2008 and early 2009. The near consensus among politicians, along with

[2] The quotation comes from Texas Republican representative Jeb Hensarling, *New York Times*, "War of Ideas on U.S. Budget Overshadows Job Struggle," June 4, 2011, page B1.

the views of a large segment of the economics profession, however, is that fiscal policy had done what it needed to do by early 2011. This perspective has two components. First, recovery has begun and since recoveries since World War II tend to "gain traction" as they proceed, the time has arrived to dial back policy support. Second, even if the economy could benefit from further demand stimulus, the size of the deficit and the associated rise in outstanding federal debt makes any further fiscal stimulus infeasible, or at least highly undesirable. The latter concern is reflected in commentary peppered with phrases like "we're broke."

We reject both pieces of this conventional wisdom. Much of the discussion in other chapters in this volume explains why recovery of the economic processes that generate growing demand faces a greater challenge than at any time since the 1930s. Mainstream predictions that automatic economic mechanisms will assure adequate demand to purchase full-employment output over a relatively short period of time have theoretical problems discussed elsewhere in this book (see Chapter 1, in particular). As a practical matter, the sluggishness of the two years of recovery following the trough of the Great Recession implies that, theoretical debates aside, demand *is not* growing fast enough. If, as we believe, private demand growth will be inadequate to sustain a robust recovery well into the future, resources will remain inefficiently idle without further demand support from the public sector. As also discussed in Chapter 1, conventional monetary policy is unlikely to do the job. Further fiscal demand stimulus could have an important effect, but any expansionary tax or spending policies will raise the deficit. If deficit fears force fiscal austerity, we believe economic performance will suffer.

We criticize the mainstream view that government budget constraints and the unsustainable size of fiscal deficits severely limit what can be done in the aftermath of the Great Recession. We argue that conventional fears of fiscal stimulus when resources are underutilized arise from a misunderstanding of both the size of the deficit/debt problems and their economic consequences. We also develop ideas about how aggregate fiscal stimulus affects micro distribution and allocation outcomes. These concerns, such as the worry that deficits crowd out private investment or that today's deficits impose unacceptable burdens on future taxpayers, are central to the fear of deficits that pervades both current mainstream economic thinking and the associated public uneasiness with fiscal stimulus. This chapter shows that such fears are largely misguided in situations like the aftermath of the Great Recession.

We conclude with a proposal for a much more active role for national governments in creating demand growth that leads to a different perspective

on fiscal deficits than that widely expressed in modern political discussions and most textbook economic analysis. This approach, however, should not be a blank check for any government project that a vote-seeking politician can dream up in the name of demand stimulus. There are also reasonable concerns about long-term fiscal balance should the economy approach full employment of its resources. We propose the need for a set of institutional structures to channel government activity in directions that shore up demand, enhance productivity, and promote a decent society that exploits the opportunity for high material living standards achieved by modern capitalism.

1. Fiscal Stimulus: Where Does the Money Come From?

Even those who appreciate that low demand is the source of stagnation often fear that an aggressive fiscal solution cannot work, especially beyond a year or two, because it requires current borrowing and therefore threatens the welfare of future generations.[3] The usual question is some version of: How can countries *afford* stimulus when their economies are so weak? A careful response to this question provides useful perspective on how increased spending today, by any agent, private or public, impacts the welfare of future generations.

Where does the money come from to finance economic stimulus? The typical answer to this question often draws on simple analogies between government borrowing and a representative household's budget. If a family borrows today to consume beyond current income, implicitly taken as given, then its members must consume less of their income in the future to pay off the loan. So, the argument goes, borrowing today must put a burden on the future. From this perspective, borrowed money for current spending stimulus appears to come from somebody in the future.

The Keynesian response to the misleading household analogy is obvious: for the economy as a whole, current incomes are not given independently of current spending. If there are unemployed resources today, a rise in current spending brings these resources into use. This more intensive use of resources raises incomes today. In the aggregate, where does the money come from to finance stimulus? *Stimulus itself creates income.* Alternatively,

[3] Here is typical rhetoric, in this case from Representative John Boehner of Ohio (statement on new federal deficit projections, August 25, 2009): "the Democrats' out-of-control spending binge is burying our children and grandchildren under a mountain of unsustainable debt. … Democrats … spent taxpayer dollars with reckless abandon all year … putting all the sacrifice on future generations."

think about this point in terms of real resources. If stimulus today mobilizes idle labor and productive capacity, then stimulus creates a net gain for society. It is the employment of these resources that is the source of new income, and that new income finances the stimulus.

Although this point contrasts strongly with the typical political discussion of fiscal stimulus, a moment's reflection makes it rather obvious. Effective stimulus today does not borrow real resources from the future in any sense. If a rise in today's spending leads to more economic activity today, that activity does not "steal" labor from the future. Nor does it prevent productive capacity from being used in the future. Rather, stimulus today employs resources that would otherwise sit idle. Although more intensive use of capital today may lead the capital stock to depreciate somewhat more quickly, the least of our worries in the aftermath of the Great Recession is excessive wear and tear on our underutilized capital. In a period of idle resources, more production today has negligible impact on future production opportunities.

One naturally thinks of government stimulus in this context. Nothing in the preceding discussion, however, changes if stimulus arises from fresh acts of private spending. Private spending creates income. Additional private spending today when resources are underutilized does not, in the aggregate, borrow real resources from the future. Nevertheless, private spenders will necessarily have a more narrow perspective on stimulus-creating activity than the government. Private agents cannot avoid the private-opportunity cost of a fresh act of current spending: if they spend today on good X, they have less for good Y, now or at some future date. The fact that my spending today creates an equivalent amount of income and relaxes the budget constraint for someone else today does not enter my current spending choices. Private spenders do not care that they create income for others or mobilize idle resources. Therefore, if the system relies on privately motivated spending to employ its resources, we must confront an inherent problem: the private benefit of spending acts that increase resource use by others are not part of the private spender's calculation about his or her appropriate level of spending. It is this externality problem that creates an opportunity for government action to raise social welfare. We discuss how the government can meet this responsibility later in this chapter, but first we need to consider some indirect effects of demand stimulus that have an intertemporal dimension, and also give rise to conventional fears about the future consequences of policies that raise current demand.

2. What Burden Does Today's Borrowing Impose on Future Citizens?

Suppose new spending is financed with a rise in borrowing. How does the apparent burden of future debt service created by the new borrowing reconcile with the argument that greater spending today, and the production it stimulates, does not borrow real resources from the future? We must address two issues with debt-financed spending, the direct effect of future debt service and possible indirect, or crowding out, effects from widespread concern that more borrowing will increase interest rates.

Conventional wisdom takes as obvious that the future cost of borrowing today is the debt service on the loan, financed in the case of government borrowing by future taxes. Simple accounting demonstrates that these tax liabilities are imposed on future generations, and almost every commentator on these issues starts from this point to criticize government borrowing. What is hardly ever recognized, and is certainly not emphasized, however, is that current borrowing also creates a new *asset* for future generations. The debt service paid from future liability holders to future asset holders constitutes an *intra-* (not *inter-*) generational transfer payment, and it imposes no *net* burden on future generations as the result of stimulus-creating borrowing today. This result reconciles the observation that employing idle resources today does not directly take away resources from future production with the obvious need to service debt created today with future payments. Those debt-service payments are not a net burden on future agents, but rather a redistribution of income among them.

Do the transfer payments arising from debt service make a difference to the agents involved? Do they affect how we should understand the benefits and costs of economic stimulus financed by borrowing? The answer is likely yes, but ignoring the asset side of the generational transfer, as the simple representative household analogy does, is not the right approach. Indeed, a different analogy better illuminates the issue. Consider the standard argument in favor of free international trade. Most economists argue that free trade raises social welfare because it allows each country to specialize in what it is relatively better at producing (the country's comparative advantage). When everyone does what they do best, the combined output of the two countries is higher than it would be if they each produced everything for themselves, so everyone could be better off. Sensible analysts recognize, however, that any practical attempt to realize these net benefits will likely have complicated distributional effects. Even if society as a whole is

more productive, there could be some losers. Nonetheless, the comparative advantage argument usually proceeds to recommend that we need, first, to exploit basic gains from trade to maximize aggregate welfare and, second, design institutions to mitigate possible distribution effects for some agents. The story for Keynesian stimulus is analogous. The primary benefit arises from bringing idle resources into use and creating new income, a net social gain at times when many resources are underutilized. Future distribution effects should be considered, and we do so later in this chapter, but they should not divert us from the primary objective.

This perspective shows that the future tax liabilities arising from new government debt creates no direct *aggregate* burden on future generations. This result is fully consistent with the government budget constraint. Much of mainstream economic analysis recognizes this point implicitly because most economists (unlike politicians and the popular press) do not identify the future tax burden of current government borrowing as the primary cost of deficits. Rather, economists worry that current deficits, by increasing the demand for loanable funds, raise interest rates and therefore increase the cost of capital to business, which crowds out private investment.

Keynesian theory provides several responses to this worry. As long as there are unemployed resources, it is logically inconsistent to argue that the demand for and supply of loanable funds determine real interest rates. The problem, known since Keynes wrote chapter 14 of the *General Theory*, is that the supply of saving is not independent of spending. An increase in the demand for funds increases spending. As we discussed previously, additional spending creates additional income when there are unemployed resources, and additional income creates additional saving. The equilibrium condition between borrowing and lending is established by income adjustment, not interest rate adjustment (see Fazzari 1994–95 for further discussion). This condition implies that the deficit, in a sense, *finances itself*. Other things equal, a fresh act of spending – public or private – financed by borrowing will continue to boost income through the multiplier process until new saving rises to exactly equal the injection of borrowing.[4] There is, therefore, no upward pressure

[4] Here is a little more detailed intuition. Suppose someone borrows $100 and spends it at a store owned by person A. Then, A's income rises by $100. If A saves the entire $100, the multiplier process ends after one round and saving has risen by the amount of borrowing. Alternatively, suppose A spends half of his new income by purchasing something from B for $50. A's saving then rises by just $50, but now B has an additional $50 of income. Should B save all of this new income, the multiplier process ends and total new saving of A and B offset the additional $100 in fresh borrowing. If B spends part of the new income, however, then the process continues. The multiplier continues to operate until the entire initial injection of $100 leaks into saving by someone.

on interest rates as the result of an excess demand for loans because there is never any effective excess demand for loans. The logic of this argument is not difficult to understand, but it can appear counterintuitive. How can it be that an increase in borrowing does not raise interest rates? The answer is that higher borrowing leads to higher spending, higher income, and higher saving. The increase in saving matches the rise in borrowing (i.e., the supply of loanable funds expands to meet the new, higher demand for these funds) so that interest rates (the *price* of loanable funds) need not increase.

Indeed, in spite of the widespread fear that government deficits affect interest rates, systematic empirical evidence for such an effect is thin at best. Anecdotally, recent major swings in U.S. fiscal policy do not justify any robust link between deficits and interest rates. In the late 1990s, President Clinton trumpeted the first U.S. fiscal surpluses in decades, but interest rates rose. In the first years of George W. Bush's presidency, the federal budget changed quickly from a modest surplus to a large deficit, a very large historical shift when measured relative to GDP. Interest rates fell. As the Great Recession unfolded, the U.S. deficit-GDP ratio increased to levels not seen since World War II. Again, interest rates fell. Interest rates in these periods of major fiscal changes seem to be driven by monetary policy, not government deficits or surpluses. Chapter 10 by Baker in this volume reviews this evidence in detail.[5]

Indeed, it seems that deficits are more likely to *raise* private investment in a recession than to crowd out private spending. Business investment collapsed during the Great Recession and has recovered only modestly. Venture capital funding, an important source of financing for new technology, dried up.[6] These effects of the Great Recession have tangible costs for future generations of workers and consumers, who will likely face a more poorly equipped economy. Effective stimulus to limit such damage and hasten recovery will likely lead to more capital, better technology, and a more productive future.

These observations lead to another question: how much will a given injection of government stimulus actually increase the deficit? The typical intuition is that a dollar of spending or a dollar of tax cuts raises the deficit

[5] In addition, see Galbraith (2005) for an accessible review of systematic econometric evidence that casts doubt on the link between deficits and interest rates over longer horizons.

[6] *Business Week* reports that U.S. venture capital funding in the first three quarters of 2009 fell to $12 ~~trillion~~ trillion from $22 ~~trillion~~ trillion in the same period of 2008. The article also reports on numerous cuts to R&D and engineering spending by global firms ("The GDP Mirage" from "Mandel on Economics" by Michael Mandel and Peter Coy, October 29, 2009).

by a dollar. Yet when stimulus creates income, it also creates income tax revenues. To fix ideas, consider a simple idealized closed economy in which people spend all that they receive in disposable income, but leakages from the spending stream are the result of a proportional income tax. In this case, a dollar of debt-financed stimulus in the form of new spending or a tax cut must generate enough income so that tax revenues rise to *completely offset* the effect on the deficit. This result follows from the previous discussion that deficits are self-financing: a demand injection must raise income until endogenous leakages equal the size of the initial injection. If the saving effects are zero by assumption, tax revenues – the only remaining source of leakages in a closed economy – must rise by the full amount of the initial stimulus once the multiplier process converges to equilibrium. In reality, most people save some of their marginal income, and the economy is not closed so that some consumption spending leaks into imports. It follows that higher government spending holding tax rates constant will raise the conventionally measured deficit. However, the effect is likely to be substantially less than dollar-for-dollar.[7]

Again, this analysis assumes that resources are not fully employed so that demand stimulus can create real income. In Chapter 6 of this book we argue that the proximate constraint on U.S. output for most of the quarter century leading up to the Great Recession was demand, not supply. The collapse in 2008 and 2009 followed by an anemic recovery in output, but a rather surprising rise in labor productivity, makes it even more obvious that the economy had excess resources in early 2011, and will have excess resources for years to come. Whereas the practical design of a fiscal stimulus must pay attention to possible bottlenecks and supply constraints (see Tcherneva in the next chapter of this volume), we should not underestimate the flexibility of the labor market to guide flows of unemployed workers into expanding sectors. Stimulus spending on highway construction, for example, most likely could effectively absorb unemployed home builders.

From a conventional perspective, the conclusion of this section is surprising. The typical worries about government deficits, higher interest rates, investment crowding out, and economic burdens imposed on "our children

[7] Paul Krugman's *New York Times* blog, September 29, 2009, identifies this effect and proposes that endogenous increases in taxes generate about 40 cents of new government revenue for each dollar of stimulus spending. With a very simple model and rough estimates of how much U.S. tax revenues rose in the recent expansion (including federal, state, and local revenues), we estimate that the effect could be larger, 50 cents to 70 cents for each dollar of stimulus. Import effects would reduce this figure, but induced investment-accelerator effects make it larger.

and grandchildren" are, in general, profoundly misguided. However, as noted earlier, deficit spending can create distribution effects, and we must consider the economics of these effects to completely assess the social impact of fiscal stimulus and higher government deficits.

3. The Distribution Effects of Fiscal Stimulus

Concerns that debt-financed fiscal stimulus imposes a *net* burden on future generations are misplaced. Government debt created today as a by-product of fiscal stimulus transfers a tax liability to the future, but it also transfers an asset. Thus, future debt-service payments go from one group of future agents (taxpayers) to another group of future agents (bondholders). There is no net burden on future agents, but these transfers do affect the *distribution* of claims on future output. These distributional effects may have economic consequences that we explore in this section.

Claims that the U.S. government cannot afford further fiscal stimulus because of current levels of outstanding debt or the current size of federal deficits, if they are to have any basis, must relate to the magnitude of the future transfer payments to bondholders. How large are these potential transfers? The most obvious variable to consider is the real interest rate. In the United States, inflation-adjusted government bond yields have averaged less than 2 percentage points.[8] The 2009 U.S. federal deficit hit 10 percent of GDP. It declined modestly to just below 9 percent in 2010 and is projected by the Congressional Budget Office to decline further to 3.1 percent of GDP by 2016. Suppose that instead of this slow reduction, the federal deficit returned to 10 percent of GDP in 2012 and remained at this elevated level through 2016. Then, as a first approximation, future real debt-service transfers from five more years of historically massive deficits would initially be 10 percent of GDP times five years times a 2 percent real interest rate which equals *just 1 percent of GDP*. Note that this scenario implies massive *additional* fiscal stimulus relative to the baseline projections – well more than 4 *trillion* dollars.[9] Should this policy, along with other factors, put

[8] The real yield on ten-year inflation-adjusted U.S. Treasury Securities (TIPS) averaged 1.96% from 2003 through 2009. This figure likely overstates the average real debt service cost because the average maturity of U.S. federal debt is likely to be substantially less than ten years. The average maturity of U.S. debt was about four years according to a Reuters report ("Treasury Plans to Shift to Longer Debt Maturities," November 4, 2009). The same report indicates that the historical average for maturity has been five years.

[9] This figure is calculated as follows. The baseline projections from the CBO, as of January 2011, project budget deficits that sum to 21% of GDP over 2012 to 2016. The counterfactual

the economy back on a robust growth path, this share of GDP devoted to marginal debt service will decline over time. As a kind of premium for the effective income and employment insurance provided by a stimulus policy of this exceptional magnitude, this figure seems small. Remember that it is a *transfer* in the aggregate, not a net social cost.

In addition, the size of this transfer is mitigated by two factors, perhaps significantly. First, as argued previously, effective stimulus will not just return the economy to a predetermined growth path. It will likely affect the long-run path of the economy. It is easy to imagine that effective policy, by raising investment, the development of technology, and enhancing the skills of a more fully employed labor force, could increase potential output by an amount that exceeds the entire transfer figure. Second, as discussed previously, stimulus creates income and tax revenues. Therefore, $4 trillion-plus of stimulus in a weak economy will not raise the national debt by the same amount. This effect could easily cut the one percent of GDP debt service figure in half.

These points notwithstanding, even small transfers have distributional effects. Who are the taxpayers and bondholders on both ends of these transfers? We begin by considering transfers resulting from bond sales to domestic citizens. On average, most taxes are paid and most saving is done by high-income individuals. In the United States, the top quintile of income earners paid approximately 82 percent of the income taxes in 2007, and the top quintile accounts for 70 percent or more of saving.[10] To the extent that domestic citizens purchase new government bonds and income tax payments are the primary source of revenue to service this debt, the transfers created by government debt will take place largely among the affluent, at least if these historical patterns continue to hold.[11]

There is another mitigating factor especially relevant to high-income households. Profits and capital gains income are highly procyclical. Effective

policy proposed in the text would raise this sum to 50% of GDP. Nominal GDP is roughly $15 trillion. Multiply $15 trillion by 29% (50% less 21%) to obtain $4.35 trillion.

[10] Tax data are from 2007 and the top quintile figure is interpolated from data from taxes for the top 10% and top 25%. Saving data is based on Federal Reserve Flow of Funds and Survey of Consumer Finance. The top quintile accounted for 74% of aggregate saving from 1989:4 to 1998:4. The skewness of saving is even more striking from 1999:1 through 2009:2, a period during which the top 20% accounts for more than 80% of saving. This is because the middle quintiles of U.S. households had negative saving in many of the recent years.

[11] In the 2011 U.S. political environment, however, one could argue that the effect of higher debt service costs could be to raise payroll taxes, or lower safety net entitlement spending.

policy to combat deep recessions and speed recoveries will support profits and asset markets, the benefits of which are highly skewed toward the wealthy. It makes good political theater for well-off households to complain about high taxes, but modestly higher tax rates to service government debt – much of which will be recycled back to the same group as interest payments – is a small price to pay for effective stimulus that enhances economic growth, creates profits, and supports asset prices.

A more politically potent fear of future transfers, and one that animates many criticisms of fiscal deficits in recent years, comes from the possibility that foreigners buy bonds created by the government deficit. If this is the case, then the wealth created by the bonds is owned in part by foreigners, and the future debt-service transfer goes from domestic taxpayers to foreign citizens. In the United States, foreigners own just under half of the federal debt held by the public (2009 data). Of course, the point that debt service is analogous to a transfer payment applies equally whether the recipient is domestic or foreign. One might ask why the presence of an international border makes any more difference than a city or state border. Yet, there is concern about the distribution of political power reflected by foreign holding of domestic assets, foreign transfers may affect exchange rates and trade, and foreigners do not pay domestic taxes on the interest income created by government debt service. (See Blecker's Chapter 8 for more discussion of these issues.)

Consider the case for the United States. The capital surplus from the foreign purchase of U.S. government bonds corresponds to a current account deficit. As such, with foreign financing of deficits the United States can absorb more output, in the form of consumption, investment, and government spending on goods and services, than it produces. The inflow of goods could be viewed as a current benefit, but at the cost of forcing a current account surplus, and corresponding outflow of goods and services in the future. In this sense, foreign debt financing might seem to create a net burden on future U.S. citizens. The future trade surplus, should it ever come to pass, however, also would be a source of future demand that could be beneficial if, as previously argued, insufficient demand is likely to remain a persistent source of underperformance for the aggregate economy (see Galbraith 2005 for further discussion of this point). More broadly, should foreigners become less willing to accumulate assets denominated in the domestic currency (something that seems to inspire fear in the United States), the most obvious result would be depreciation of the domestic currency. The result would be an increase in domestic demand, which would almost certainly be welcome.

This issue must be put in the appropriate quantitative perspective. The recent example suggests that massive deficits for several years create only modest debt-service transfers. Half or more of these transfers remain within domestic borders. If the foreign debt eventually leads to a current account surplus, the extra demand created by higher exports and lower imports is likely to stimulate the domestic economy. It would seem unreasonable to forego the net gains from bringing idle resources into use because of a *possibility* of what is, at most, a small cost to the domestic economy because of foreign debt service, when what costs there are will likely be born in large part by those with the greatest ability to pay who benefit indirectly from stimulus policy in other ways.

In summary, it is difficult to imagine why the transfer payments discussed in this section should be a barrier to effective fiscal stimulus when there is substantial economic slack. Consider the following thought experiment. Suppose that the multiplier is 1.5, a value consistent with empirical evidence on the general effect of government stimulus, that could well be larger in a deep recession. As previously discussed, also assume that each dollar of stimulus generates enough new income so that tax revenues rise by fifty cents. Thus, the deficit from a dollar of stimulus is just fifty cents. If we treat the fifty-cent increase in debt as a "cost," the benefit-cost ratio is 1.5 to 0.5, that is, 300 percent! Yet even this favorable outcome understates the case for stimulus for at least two reasons. First, the fifty-cent increase in debt is not a net social cost, it is a transfer payment. Second, investment, technological development, infrastructure, and human capital will likely rise because the stimulus creates a more productive economy in the future, so the benefit of the deficit-finance stimulus is understated.

4. Fiscal Stimulus after the Great Recession

Several chapters in this volume argue that the Great Recession likely marks the end of an era in which debt-financed consumer spending generates substantial demand growth. There is no obvious source of private demand to replace the consumer engine that powered the economy for nearly a quarter century. The case for government-led demand stimulus going forward is strong. Given the limits on conventional monetary policy discussed in the introduction of this book and Chapter 9 by Epstein, this stimulus needs to include a heavy dose of fiscal expansion. Despite conventional fears, we argue here that such fiscal stimulus is entirely feasible. Typical views of fiscal responsibility discussed in the press and political debates, often motivated by comparing the finances of national governments to budgets of individual

households, are misguided in an economy with idle resources. The case for aggressive fiscal policy recognizes that the need for such action is not just a temporary response to a rare event, but likely an ongoing responsibility, a conclusion developed in more detail in Chapter 12 by Tcherneva.

Misunderstanding of these points impedes effective policy making. The ongoing debate in the United States over health care policy provides a useful example. One gets the impression that even supporters of a larger government role in providing health care for U.S. citizens believe that policy options are constrained by rising deficits. People who make this argument seem to be saying that they would support a larger program if the economy were at full employment, but in the current slump the government deficit implies that we "can't afford" the better policy. This approach seems necessary from the perspective of an isolated household that must tighten its belt when faced with the threat or reality of unemployment. However, our perspective implies that, for a national economy, the logic is backwards. The presence of unemployed resources makes the aftermath of the Great Recession a *better* time to pursue a major public program that passes a microeconomic cost/benefit test: the society benefits from the program, and the demand created by the program creates jobs and income by mobilizing idle resources. Worries about the deficit and national debt impose false constraints.

In addition to the need for fiscal stimulus, the analysis here offers some insight into whether demand stimulus should be implemented via higher government spending or tax cuts. It has become close to conventional wisdom that tax cuts are relatively ineffective as demand stimulus because the recipients will spend a relatively small fraction of such cuts, especially when tax cuts are explicitly temporary. In contrast, government spending on goods or services adds directly to demand. We accept this basic logic, but we must also recognize that government spending does not just provide demand stimulus, it also *allocates resources* to specific activities through a bureaucratic process. The allocation of funds distributed by tax cuts, however, is determined by personal choices and market processes.[12]

We propose the following framework as a possible way to address both economic and political considerations in the design of effective fiscal stimulus. Government projects should be justified on cost/benefit grounds, with opportunity costs measured at full employment; that is, costs that assume resources allocated to government activities have a productive alternative use in the private sector. One could reasonably argue that this method

[12] Of course, the political process must still determine *who* receives a tax cut.

overstates costs when the economy has idle resources. However, if government projects are pursued as stimulus that would not pass a cost/benefit test with the economy at full employment, the policy structure faces two political problems. First, critics will assert that these projects will not disappear once stimulus is no longer needed, and therefore, they could waste resources eventually. Second, critics who do not understand the logic of demand stimulus, or have other political/ideological motives to defeat the program, will complain that projects waste resources now. Supporters of demand-stimulus policy need the strongest possible cost/benefit rationale for the particular activities they propose to succeed in today's ideologically charged political environment.

In the aftermath of the Great Recession there are, most likely, not enough public projects meeting these criteria to get the economy onto a path approaching full employment.[13] A related problem arises from time lags required to initiate large public works. For these reasons, we believe that tax cuts should remain in the policy toolbox. The analysis in this chapter offers some response to the standard criticism that tax cuts are relatively ineffective because recipients will save a large proportion of them. First, U.S. tax rebate plans in recent years almost always provided a one-time and relatively small payment. If permanent tax cuts would be more effective in boosting demand, why has recent policy tied at least one arm behind its back by repeatedly offering temporary rebates? The obvious answer is concern about the deficit. The discussion here points out, however, that the costs of deficits are typically exaggerated. Furthermore, if tax cuts effectively create spending, they will also create new income and higher tax revenues so that their impact on the fiscal deficit will likely be substantially smaller than it appears in the political discussion of these policies. The perspectives developed in this book also lead to the conclusion that the need for demand stimulus is not likely to be just temporary. With no obvious source of demand growth in coming years to replace the U.S. consumer juggernaut, one can make a strong case for tax cuts with no expiration if both policy makers and the public learn to understand the effectiveness of government deficits in periods of underutilized resources.

Of course, the economy will sustain the most demand-stimulus bang for the tax cut buck if the dollars flow to those who will spend the most.

[13] Chapter 12 in this volume by Tcherneva criticizes the idea that generalized demand stimulus can ever effectively generate full employment. We accept the thrust of Tcherneva's analysis. That said, the problem of underutilized resources is so large in the aftermath of the Great Recession that we argue generalized-demand stimulus is an important complement for the more targeted employment programs that Tcherneva proposes.

Republicans managed to cut taxes substantially, and permanently, at various points in the past several decades. However, the distribution of the benefits from these cuts provided inefficient stimulus since so many of the dollars went to the well-to-do. A per-head or per-household reduction in taxes, refundable to those with low taxes, would be much more effective.

Ultimately the decision of how the government allocates *any* spending or tax cut is a political question, a question of how our country will allocate its real resources in the public domain and how the tax burden will be distributed across different parts of the society. This question will be determined by the voters through their elected representatives. We argue that these questions of allocation should be determined without unnecessary concerns about deficits and independently of decisions about the magnitude of a fiscal stimulus necessary to regulate demand and target full employment.

The kind of fiscal stimulus we propose is not a silver bullet. There are deeper structural problems. Most obviously, stagnant real-wage growth in the United States has destroyed a virtuous circle from the post–World War II era in which higher productivity led to higher wages and higher wages created consumer demand as an engine of growth (see Chapters 2 and 7 by Palley and Setterfield in this volume). Policies to restore faster wage growth across the income distribution are likely necessary for a sustainable recovery. In addition, the healthy growth of private demand depends fundamentally on a financial system that distributes credit to households and firms without inflating asset-price bubbles (Kregel, Chapter 4, and Wray, Chapter 3). In this environment, monetary policy can contribute to stabilization and growth more effectively than it did during the consumer era of recent decades (Epstein, Chapter 9). This chapter argues, however, that an aggressive fiscal policy should be a central part of the solution, calibrated to the needs of the economy not just for a few quarters, but for years to come.

When the economy recovers to a reasonable approximation of the full use of resources, it makes sense to have a tax system that funds the level of public spending chosen through a (hopefully) effective political process. Minsky (1986) proposes that the federal budget should be balanced at full employment to avoid inflationary pressure. In many countries, for example, rising health care costs might justify higher taxes at full employment to avoid inflationary deficits. Perhaps the realities of politics force discussions of fiscal austerity even at times like the aftermath of the Great Recession, well before anything approximating anyone's concept of full employment can be reached. However, if some taxes go up to create a credible expectation that the country can "live within its means" once it reaches full employ-

ment, then there should be offsetting increases in demand stimulus that persist as long as unemployment continues to plague our society.

It is important to recognize that the U.S. federal government cannot run out of dollars to spend as it sees fit, because it has the unique ability to create dollars. This is not to say that the government has access to limitless resources, but to say that – as demonstrated in war times – it has tremendous access to resources as a result of its unlimited access to dollars. Again, the point is not that the government can commandeer any and all goods and services it wants without social impact, but rather to say that the true constraint on the ability of the government to spend is precisely the political will to absorb the consequences of those impacts and *not* the possibility of running out of money.[14]

The aftermath of the Great Recession is not the time for tight fiscal policy. The fear of government deficits that has already constrained fiscal policy in the United States and has grabbed hold of much of the rest of the world, is greatly exaggerated. This panic and its political reverberations are supported by neither theory nor evidence. The perspectives developed throughout this volume imply that the need for large fiscal deficits will likely be with us for an extended period. False constraints, often based on misunderstanding, should not prevent governments in the United States and elsewhere from taking actions that have great potential to mitigate, if not reverse, the human consequences of the most severe economic disruptions in several generations.

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[14] See Wray (1998) for an introduction to the Modern Money Theory (MMT), a comprehensive theory of the way that money works in sovereign countries.