The latest economic research demonstrates why concerns about federal budget deficits and U.S. debt levels are overblown

April 2021 **By Shaun Harrison**

Overview

A growing number of economists are reconsidering long-held views about the appropriate level of public borrowing and the consequences of federal budget deficits and debt on U.S. economic growth and well-being. Their cutting-edge research suggests that previous concerns about deficits and debt, such as increases in inflation and interest rates that affect U.S. Treasury bonds, are overblown.

Instead, the available evidence indicates that the United States boasts substantial fiscal capacity to make needed public investments that could power a more broad-based and sustained economic recovery and support more equitable long-term growth. And the current low-interest-rate environment is one in which federal budget deficits should be embraced as an appropriate and necessary tool to support a faster and more equitable recovery.

This issue brief highlights select studies in this line of new economic research. I first examine the role of fiscal policy in promoting economic recovery. I then review studies that examine the implications of low interest rates on deficit spending.

Key economic terms and definitions discussed in this issue brief

An **interest rate** is the percentage lenders charge on the amount of money borrowed from them. In other words, it is the cost of borrowing money. As part of the Federal Reserve Board's dual mandate to stabilize prices and reach maximum employment, the Fed raises and lowers its benchmark federal funds rate in response to prevailing economic conditions.

A **nominal interest rate** is an interest rate before taking inflation into account. The **real interest rate**, in contrast, adjusts for inflation and is calculated by subtracting the inflation rate from the nominal interest rate. This helps determine spending power over time.

The **debt-to-Gross Domestic Product ratio** is the ratio between a country's sovereign debt and its total output. It has traditionally been used to indicate whether a country's level of debt is sustainable. Emerging views consider this metric less important because it does not indicate the actual cost of debt, since it does not take interest rates into account. The cost to service debt and pay it off has fallen dramatically since 2000 due to the widespread fall in interest rates.

Fiscal policy and economic recovery

"Fiscal Stimulus and Fiscal Sustainability"

By Alan J. Auerbach and Yuriy Gorodnichenko
University of California, Berkeley

Alan Auerbach and Yuriy Gorodnichenko examine the effects of changes in government spending, such as fiscal stimulus, on public debt and overall fiscal sustainability. They find that expansionary fiscal stimulus are not followed by persistent increases in debt-to-GDP ratios or borrowing costs, especially in a weak economy. Instead, fiscal stimulus in a weak economy can improve fiscal sustainability and the ability to respond to future recessions.

"Debt and deficits in the coronavirus recovery"

By Josh Bivens
Economic Policy Institute

Josh Bivens argues that the U.S. economy during the coronavirus recession is constrained by limited demand and not by limited supply. An economy is constrained by limited demand when there are people who are willing to work but are unemployed because firms do not expect enough paying customers to justify putting more resources into hiring. Conversely, an economy is constrained by limited supply when there is full employment, and any increase in demand does not result in greater output because all potential workers are already hired. Instead, an increase in demand will lead to an increase in prices. In a demand-constrained economy, higher debt does not reduce growth because there are not enough increases in inflation and interest rates as a result of that debt to hamper growth. Instead, higher deficits are a useful tool for providing fiscal relief during recessions and promoting economic recoveries.

"Preventing Another Lost Decade: Why Large Federal Deficits Should Be Welcomed, Not Feared, in Today's Economy"

By J.W. Mason
Roosevelt Institute

J.W. Mason argues that the U.S. economy's central problem is weak demand—that is, there is not enough spending in the economy. Signs of weak demand include falling wages, slow productivity growth, and declining labor force participation. Public spending initiatives are a necessary tool to address this problem because they lead to more jobs and more growth, which, in turn, lead to more consumer spending and more business investment. All of this boosts demand.

In his view, the tepid economic recovery after the Great Recession of 2007–2009 demonstrates that limiting government spending during a crisis causes lasting harmful effects on the U.S. economy. Instead, robust government spending delivers significant macroeconomic benefits, including boosting demand, spurring private investment, and reducing inequality. Mason argues that concerns about the federal budget deficit—including potential increases in inflation and interest rates crowding out private investment—and runaway debt increases are not applicable to the current economic situation in the United States.

"The Way Out of America's Zero-Sum Thinking on Race and Wealth"

By Heather C. McGhee
Demos

In an essay adapted from her new book, titled *The Sum of Us: What Racism Costs Everyone and How We Can Prosper Together*, Heather McGhee examines the role of racism in fiscal policy. She demonstrates that White support for government spending was drastically reduced with the advent of the Civil Rights movement. This was a moment in which White Americans saw Black activists demanding the same economic guarantees afforded to White Americans.

White racial resentment against Black people continues to fuel a disapproval of government spending today. White people who exhibit low racial resentment against Black people are 60 percentage points more likely to support increased government spending than are those with high racial resentment. McGhee argues that the ideological backdrop for this dynamic is a zero-sum narrative between "makers and takers" or "taxpayers and freeloaders." She concludes that policymakers can help overturn this harmful narrative by directly addressing the roots of systemic racism and encouraging investments that improve the lives of all people in the United States.

"The Inequitable Effects of Raising the Retirement Age on Blacks and Low-Wage Workers"

By Kyle Moore, Teresa Ghilarducci, and Anthony Webb
The New School

Kyle Moore (now at the Economic Policy Institute), Teresa Ghilarducci, and Anthony Webb investigate the racially disparate consequences of the policy proposal to push the Social Security full retirement age to 70 years old and beyond. The authors find that doing so would present a harmful choice to workers: retire as planned or work longer. In the first choice, to retire as planned, monthly benefits would be cut because workers would no longer meet the age requirement for full benefits. This would penalize Black people and low-wage earners disproportionately because overall, Black people and low-wage earners rely more heavily on Social Security for post-retirement income than non-Black people and high-wage earners. The second choice, to work longer, is inequitable because Black people and low-wage earners generally have a higher-than-average mortality rate due to disparities in health care and other structural factors. Fiscal policy choices that address the deficit simply through spending cuts instead of pathways for raising revenue will further structural racial inequities. The authors instead propose strengthening Social Security to increase the benefits of low lifetime earners and expanding retirement plan coverage to supplement Social Security.

Deficits in an era of low interest rates

"Public Debt and Low Interest Rates"

By Olivier Blanchard
Peterson Institute for International Economics

Olivier Blanchard documents that most interest rate forecasts project that benchmark rates will remain below growth rates for a long time, and historically, this has been the rule rather than the exception. On average, since 1950, nominal interest rates have been lower than nominal growth rates—an economic relationship that implies the federal government can consistently run and repay a budget deficit without increasing the debt-to-GDP ratio or risking a fiscal crisis.

Interest rates were consistently below the growth rate until the disinflation of the early 1980s. During this period, the Federal Reserve raised interest rates substantially to counteract high levels of inflation, which had the secondary effect of slowing economic growth. Since then, both nominal interest rates and nominal growth rates have declined, with interest rates declining faster than growth, even before the 2007 financial crisis. Blanchard argues that this empirical regularity suggests that the fiscal and welfare costs of debt may be small and, importantly, are smaller than has generally been assumed in public debates about fiscal policy.

"The Federal Fisc"

By Karen Dynan and Douglas Elmendorf
Harvard Kennedy School

Karen Dynan and Douglas Elmendorf explain that reducing the federal budget deficit is not as urgent as was previously thought because of low interest rates. The lower interest rates prevalent today mean that debt will compound more slowly than it would have in the past. Low interest rates also suggest that investors are not concerned about the possibility that the debt will not be honored. And they argue that it is unlikely investors might try to sell their holdings in large quantities. Overall, the danger of high interest rates is not great because they could rise considerably from current levels and still remain below long-term averages.

"Federal Budget Policy with an Aging Population and Persistently Low Interest Rates"

By Douglas W. Elmendorf and Louise M. Sheiner
Harvard Kennedy School and The Brookings Institution

Douglas Elmendorf and Louise Sheiner examine the roles of an aging U.S population and low interest rates in setting appropriate U.S. budget policy. They argue that an aging population suggests higher national savings would be desirable, while consistently low interest rates suggest higher deficits and debt would be desirable. An aging population can drive up federal health costs while simultaneously reducing the number of workers and therefore per capita Gross Domestic Product. This dynamic is projected to raise the federal budget deficit significantly, yet persistently low interest rates indicate that debt will accumulate more slowly.

Over time, however, Elmendorf and Sheiner argue that increasing the federal deficit would consequently have the effect of eventually raising interest rates. An increase in interest rates would then allow the Federal Reserve to the cut rates during a future recession. They conclude that while deficit-reducing policy changes will eventually be appropriate, policymakers do not need to implement them immediately. Over the next decade, policymakers should aim to increase federal investment while enacting changes that reduce the deficit in later years.

"A Reconsideration of Fiscal Policy in the Era of Low Interest Rates"

By Jason Furman and Lawrence H. Summers
Harvard Kennedy School

Jason Furman and Lawrence Summers document a secular, long-term decline in real interest rates despite large buildups of government debt. They note, for example, that U.S. 10-year indexed bond yields declined by more than 4 percentage points between 2000 and early 2020, even as projected debt levels sharply increased. They argue that this decline in real interest rates reflects changes in economic fundamentals—such as increased inequality—and should motivate a reconsideration of fiscal policy.

Furman and Summers identify three implications of this decline in interest rates. First, fiscal policy will need to play a more important role in addressing economic downturns because there will be less room for interest rate reductions. This includes automatic recession insurance—for example automatic stabilizers such as Unemployment Insurance benefits, nutritional assistance, and across-the-board cash transfers that trigger on when a recession hits—in order to quickly provide assistance and hasten recovery efforts. Second, they argue that past concerns about federal budget deficits crowding out private investment no longer apply with the same force, and traditional measures of fiscal sustainability have less relevance. Finally, they argue policymakers should consider how fiscal investments are being put to use in the U.S. economy when deciding whether to make debt-financed investments, since those investments can pay for themselves in certain circumstances.

"Austerity is Bad Economics: Why U.S. Fiscal Conservativism Does Not Hold"

By Marokey Sawo
The Groundwork Collaborative

Marokey Sawo addresses four common arguments made by critics of deficit spending. First, critics argue that higher deficits lead to inflation. Consistent with other research literature, she finds inflation has been low and trending downward for the past 40 years regardless of the size of the deficit. Second, critics argue that higher deficits crowd-out private investment by pushing up interest rates. Sawo shows that the deficit and interest rates have no long-term relationship with each other, and there is therefore little reason to believe deficits will increase interest rates to the point of decreasing private-sector investment. Third, critics argue higher deficits increase the risk of a fiscal crisis because investors will supposedly become unwilling to hold public debt and require higher interest rates to compensate for the “additional risk” of solvency. Regarding this point, there is also a lack of empirical evidence for these concerns because interest rates have been on a downward trend even as debt has increased. Finally, critics argue higher deficits reduce economic growth. Sawo demonstrates that previous claims about increased deficits constraining economic growth have been thoroughly debunked by economists on methodological and theoretical grounds. As a concrete example, she notes that economic expansion failed to materialize in European countries that adopted austerity policies. In sum, the four arguments made by critics of deficit spending lack empirical support.

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