How to tell when deficit spending crosses a line

By Stephanie Kelton
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When I was the chief economist to the Democrats on the Senate Budget Committee in 2015-2016, I attended a number of hearings, all called by its chairman, Republican Senator Mike Enzi of Wyoming. He would invariably open with prepared remarks that included his observation that deficits are evidence of "chronic overspending."

Democrats just as invariably would attack Republicans like Enzi for voting for the December 2017 tax cut, calling it was a boon for the rich that produced a "shortfall" that inflated the deficit. But as I have written, the impact of the tax cuts on the deficit is not the issue Democrats should be emphasizing. Instead, we should be focused on the substance of Enzi's argument itself.

Since the government's budget deficit is, by definition, the difference between what it spends and what it collects in the form of taxes and other payments to itself, it may seem reasonable to call it "overspending" when the government spends more than it takes in. But it's not.

As every economist knows, inflation — not a budget deficit — is the tell-tale sign of an economy that is under pressure from excessive spending. If prices aren't accelerating, you don't have an inflation problem. And if you don't have an inflation problem, you don't have a spending problem.

The claim that deficits are a sign of overspending is just one myth distorting the national debate about the deficits. Liberals as well as conservatives have argued that the trillion-dollar deficits the U.S. is projected to run, beginning as early as 2022, are putting America on a dangerous and unsustainable path. Distinguished economists on both the left and the right have warned that a debt crisis is coming, and that we should act sooner rather than later to deal with our looming budget problems.

Both sides have this wrong. This is not a trivial complaint. Myths and misunderstandings about budget deficits distract from the many legitimate challenges facing our country and leave us poorer than we could otherwise be.

In a series of columns, I'm going to look at five myths about the U.S. budget. Where do the myths come from, who benefits from them and how can we fix our thinking? The arguments will build on one another, so don't assume I've failed to deal with something important until the series is complete.

What will emerge, if you stick with me, is a call for a new way of thinking about budgetary discipline, one that replaces the conventional notion of a financial budget constraint with a real resource constraint centered on maintaining the value of the currency. Along the way, I'll aim to clear up some misconceptions and misrepresentations about modern monetary theory, which is the basis for this new view of government deficits.

Let's start with the Mike Enzi myth.

Every economy has its own internal "speed limit." There are only so many workers, machines, factories, raw materials and so on that can be brought online to produce our economy's goods and services. This our "potential GDP."

In a depressed economy, say, the U.S. economy of 2008-2009, there are plenty of idle workers and businesses that are producing well below their full capacity. In that environment, the government can easily expand its deficit, spending more money into the economy, without risking an inflation problem.

It was the perfect (missed) opportunity to put a trillion dollars into projects modernizing and rebuilding the nation's infrastructure. Millions

of people were out of work, including many builders and contractors who lost construction jobs after the housing bubble collapsed.

Depressed conditions meant that the government could have spent a trillion dollars without raising a single tax. It would not have been inflationary. But as things tighten up, and the slack dissipates, the economy moves to a fuller utilization of its resources.

We almost never make it all the way to maximum velocity — we did during the mobilization for World War II — and we're almost surely not there now. That day could come. And when it does, you don't get to spend so freely.

What does that mean in the current environment? I have no doubt that we could add several billion dollars to current spending without risking an inflation problem. The economy is big enough, and still has enough slack, to handle a modest increase in federal spending with ease.

But what if we wanted to add tens of billions, say, for free college or hundreds of billions for a federal job guarantee? Does the economy have the resource capacity to safely absorb that much new spending, or would it wreak havoc as we strain our productive capacity, running out of workers, raw materials and the like?

The answer is, you can't know until you do the analysis. A program like a federal job guarantee would involve hiring 15 million or so people and paying them $15 an hour plus benefits, including health care. It would cost around $350 billion a year.

That might sound like too much to spend in the current environment. Maybe it isn't. In fact, research suggests that it could be done with minimal inflationary consequences, since the program boosts overall growth and because some of the new spending is offset by lower spending in other categories of the budget — for example, on unemployment compensation, food stamps, Medicaid and so on.

Now, if you tried to tie all of these jobs to a Green New Deal that aims to spend trillions, transforming the entire U.S. economy into a fossil-free zone in a matter of 10 years, then all bets are off. There is almost certainly no way to avoid an inflationary meltdown without careful planning and at least some offsets to make room for a WWII-style mobilization to combat climate change.

Anyone thinking seriously about how to pull off something like this in the modern era should go back and read John Maynard Keynes' 1940 book, "How to Pay for the War." You might assume, judging by the title, that Keynes was laying out a prescriptive plan to raise the money that would be needed to fight and win the war. That wasn't it at all.

The book was a careful exposition of what it would take to transform the economy away from one that was oriented around production for consumers to one that was oriented around production for the war effort. It was a book about how to carefully reorient industries and occupations in a way that would minimize dislocations and inflationary pressures.

If we're going to war against climate change — a war that will touch almost every part of the U.S. economy: energy, housing, transportation, agriculture and so on — something like this will need to be done to manage the inflation risk along the way. The financing is the easy part. The hard part is managing the inevitable upheaval through the transition.

Deficit spending is not a blank check. But before explaining more about how the government can make its choices, I need to rebut another misconception about deficits. It's the most pernicious one of all: the myth that the government's budget is just like a household budget.

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