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THE CASE FOR GOOD DEFICITS

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Deficit spending is the right medicine for what ails the economy now

NEWS FROM EPI

EMBARGOED UNTIL 12:00 AM, Wednesday, January 6, 2010

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As Congress and the President continue to grapple with how to reinvigorate the labor market and the economy, a familiar chorus of voices has begun warning against the dangers of any actions that would raise the national deficit further. That chorus is, according to economist Josh Bivens, sorely out of tune with the facts and the challenges presented by today's economic conditions.

In **"Budgeting for Recovery: The Need to Increase the Federal Deficit to Revive a Weak Economy,"** published today by the Economic Policy Institute, Bivens explores the arithmetic, economics, and history of federal budget deficits. Bivens makes the case that the effect of deficits depends crucially on whether or not the economy is ailing or healthy. In an ailing economy with idle workers and factories, larger deficits provide the spending that is necessary to ensure a robust recovery.

"The notion that all deficits are bad is a simplistic political idea that flies in the face of sound economic theory and economic history," said Bivens. "In an ailing economy deficit spending is an essential tool for getting the economy off life support and back to health. When the economy is stronger, and private and personal spending have resumed normal levels, it's appropriate and desirable for the government to scale back. But right now the greatest danger regarding deficits is that they will be too *small* to provide the public relief and investments the economy needs."

Bivens then examines the economic relationships between federal budget deficits and interest rates, inflation, international indebtedness, and generational equity. In the process he shows that the deficit hawks' fears of adverse effects in all these areas are misplaced in this economy because they do not differentiate between the effects of growing deficits in healthy versus ailing economies. For example:

- In a healthy economy, where private firms and households are borrowing money to spend and invest, rising deficits can put upward pressure on interest rates as government begins competing with the private sector for sources of lending. But when firms and households clamp down on new borrowing and spending, government borrowing does not compete with the private sector and no interest rate spikes are on the horizon.
- Similarly, when the private sector starts spending less, there is no risk that raising the deficit will set off rising inflation. Further, Bivens argues moderate rise in inflation would actually be a good thing, as it could help erode the debt burden that is keeping business and household spending low.

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- Bivens also notes that rising budget deficits in the past two years have *not* relied on foreign investors for financing. Consequently, claims that the efficacy of using deficits to fight the recession depends on the willingness of foreigners to lend to the U.S. are false,
- Finally, Bivens also refutes the hawks' claims that today's budget deficits will unfairly burden future generations. He shows that, to the contrary, wise *public* investments made now to jumpstart a recovery and build the infrastructure to support a health economy going forward will benefit future generation while not crowding out any *private* investments that may benefit future generations. Rather than leaving the next generation an economy scarred by an unnecessarily long, lingering recession, he argues that the right kind of spending now is needed to lay the foundation for a healthy economy for generations to come.

Bivens offers a step-by-step guide to the composition and sources of both current-year and projected deficits. He concludes that much of the growth of current-year deficits can be traced back directly to two sources: first, the large and poorly targeted tax cuts, which reduced revenues without producing enough economic lift and job creation to pay for the losses; and, second, the recession itself, which drove down revenues as millions of people lost their jobs and drove up safety net spending. He notes that, the spending under the Recovery Act was relatively small – only about one-quarter as much as the losses generated by the recession itself. Bivens argues that the best thing to do for the economy would be more of the kind of spending and policies that would boost the economy and stem further losses from a protracted recession and sluggish recovery.

He concludes, "For too long, Beltway conventional wisdom has held that growing federal budget deficits are always and everywhere bad for the economy. This view is not buttressed by economic theory or history, and it is deeply dangerous if it threatens the prospects for aggressive policy actions to spark a genuine economic recovery."

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