HOUSE COMMITTEE ON THE BUDGET
Chairman John Yarmuth

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Reexamining the Costs of Debt in an Era of Low Interest Rates

The federal debt as a share of the economy has more than tripled since 1980 and now sits at its highest level since just after World War II. However, many of the predicted negative consequences of rising debt have seemingly not come to pass. These developments have motivated economists to reassess the consequences of government debt while also drawing attention to alternative economic theories that consider the threats posed by deficits to be overstated. In a recent hearing, "Reexamining the Economic Costs of Debt," the House Budget Committee heard a wide range of perspectives on this growing debate and considered the implications for fiscal policymaking going forward.

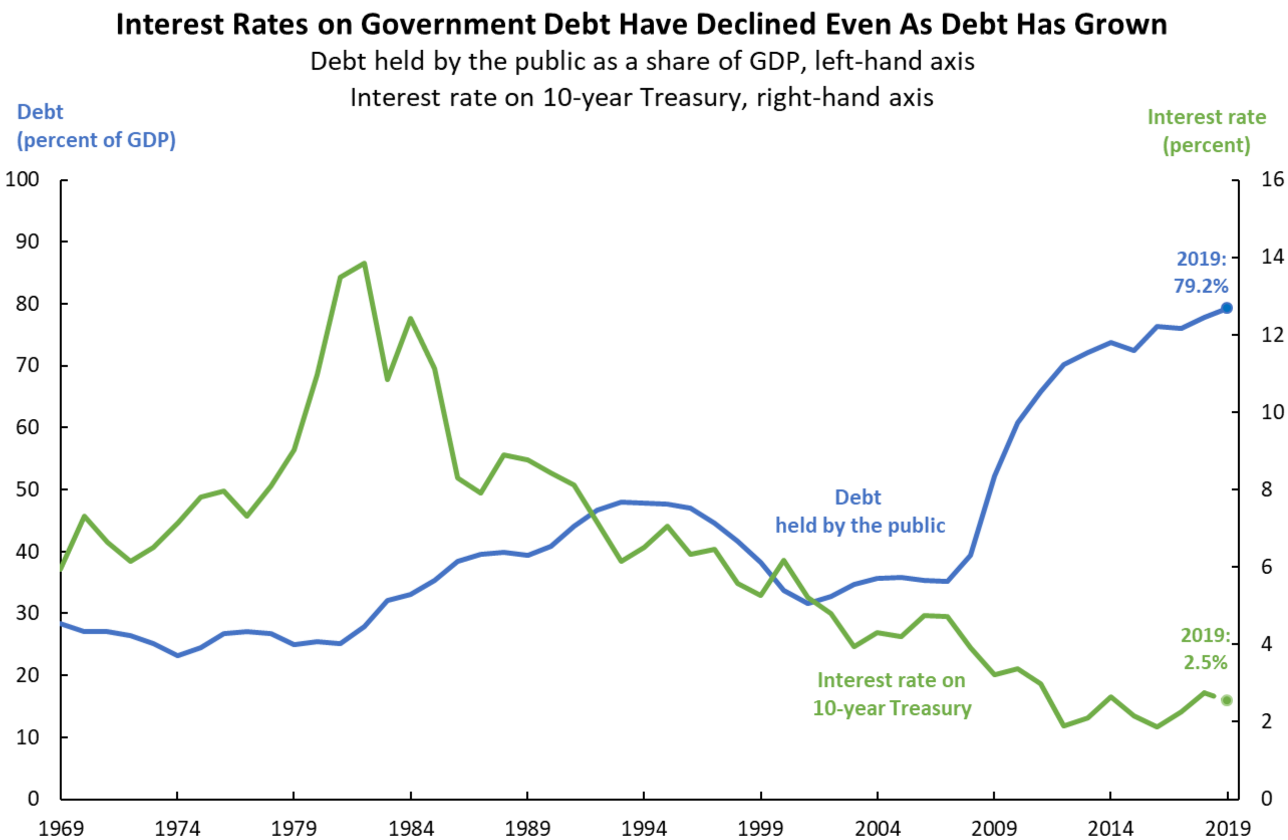
Debt Has Proven to Be Less Costly Than Conventional Wisdom Suggests

Textbook economic theories have long predicted that persistent budget deficits and rising government debt – particularly when the economy is operating close to full capacity – would raise interest rates, fuel inflation, and depress ("crowd out") private investment. Over time, these effects would lower economic output, slow growth, and leave future generations worse off. Some have also warned that high and rising debt could shake investor confidence to the point of triggering a catastrophic fiscal crisis, shutting the government out of credit markets and heightening the risk that it will default on its debt.

But over the last several decades, interest rates and inflation have steadily declined to record lows even as the debt has soared to near-record highs. Today, with publicly held debt at 79 percent of GDP, the United States pays a significantly lower interest rate on a 10-year loan than it did 20 years ago – when the government was running consecutive budget surpluses and the debt ratio was less than half of its current level. Critically, interest rates and inflation are expected to remain relatively low going forward, despite projections that debt will rise to unprecedented levels over the next 30 years. This divergence from long-held economic assumptions has led economists to reexamine the costs of debt in this new economic era.

"Low rates have three main implications for fiscal policy" — Drawing on his recent research, Dr. Olivier Blanchard, Senior Fellow at the Peterson Institute for International Economics and Professor of Economics Emeritus at MIT, explained that low interest rates have important consequences for government debt and fiscal policymaking. First, low rates reduce the fiscal costs of debt, whereby increases in the debt today require smaller offsets (whether through higher taxes or reduced spending) in the future. Second, there is less risk of a market-induced debt crisis: with rates projected to remain low, investors are clearly not concerned that the U.S.

government is at risk of defaulting on its debt. Finally, low interest rates may also lower debt's economic costs, such that high debt levels pose less harm to future economic growth. Taken together, these effects suggest that government debt in an era of persistently low interest rates may be less risky, less costly, and less cause for immediate concern than it has been in the past.



Source: Congressional Budget Office

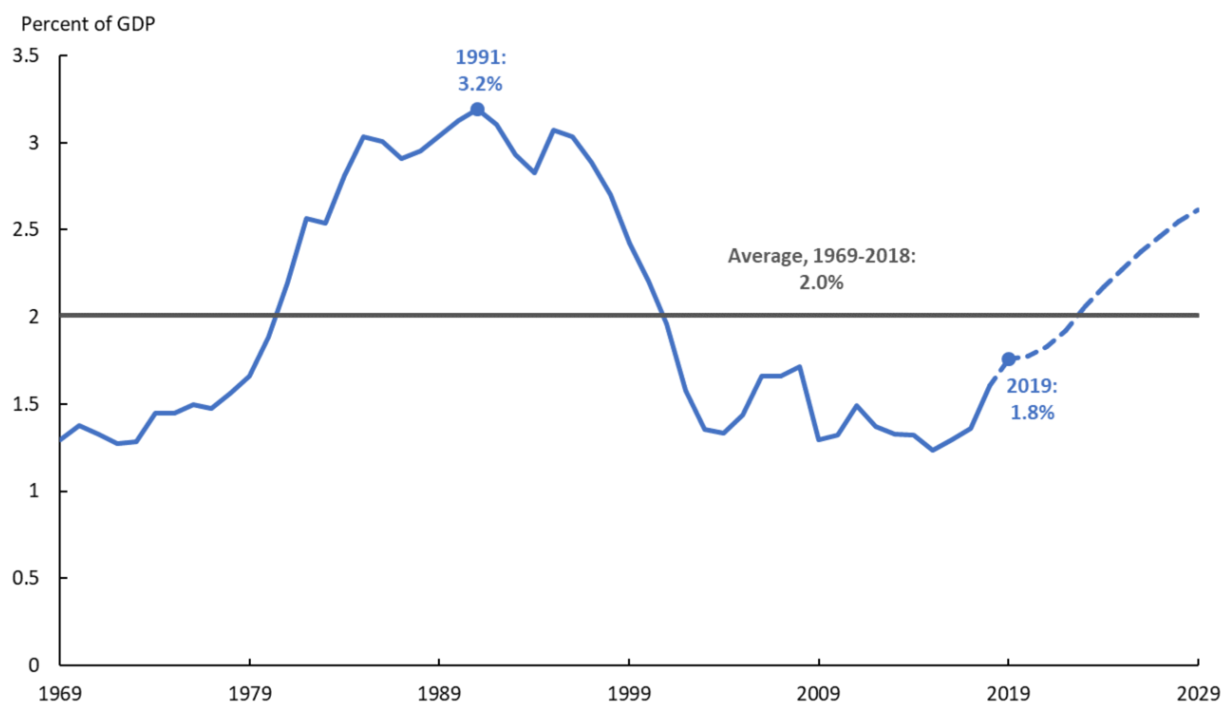
"The evidence provides a more nuanced, far less cramped understanding of the economic costs of budget deficits and the potential benefits from investing in people and places who have long needed the help" — Dr. Jared Bernstein, a Senior Fellow at the Center on Budget and Policy Priorities, argued that our recent economic experience, coupled with the research by Dr. Blanchard and other scholars, "suggests the need for policy makers to update widely held views about the impact of budget deficits on economies. There is, for example, little evidence to support the claim that budget deficits in expansions will necessarily lead to 'overheating' or upward pressure on interest rates. In fact, our current deficit is unusually high given the near-full capacity of the current economy, yet interest rates and inflation remain low." Given these facts, Dr. Bernstein concluded, "knee-jerk antipathy to budget deficits, and the austere policies such views often promote, is clearly both wrong-headed and outdated." These facts should also, when the costs of borrowing are cheap, "lead policy makers to willingly consider deficit-financed investments in growth-oriented public goods."

Deficits Still Matter

In a key point of consensus, all witnesses agreed that deficits and debt – and how we use them – matter. While evidence suggests that debt may be less costly than previously believed, witnesses cautioned that this does not imply that deficits should grow without restraint and that debt can rise indefinitely. Having a deeper and more realistic understanding of the kinds of risks debt poses, as well as a clear understanding of debt's benefits, would help policymakers promote more effective and responsible fiscal policy.

"New fiscal evidence does not relieve policymakers of any budget constraints, nor does it suggest that any desired spending should blithely go on the national credit card" — In his testimony, Dr. Bernstein laid out several reasons to keep the debt in check. One reason is simply "prudent risk management": interest rates could defy projections and increase sharply. This is a potentially painful risk given the size of our debt burden, which ensures that even small increases in interest rates can significantly change our fiscal position. Interest payments as a share of GDP are currently low relative to earlier periods, for example, but, even assuming low interest rates moving forward, they are still projected to rise.

Interest Payments As a Share of GDP Have Declined Since the 1990s...But Are Rising



Source: Congressional Budget Office

Second, persistent deficits increase spending on interest payments. Because much of our debt is held by foreigners, moreover, an increasingly large share of interest payments "leak out" of our economy and flow abroad. Dr. L. Randall Wray, Senior Scholar at the Levy Economics Institute and Professor of Economics at Bard College, shared this concern, noting that interest payments "are a very inefficient kind of spending. The first half of it is going abroad," and the other half that stays in the country "…doesn't tend to lead to economic growth."

Lastly, growing debt may feed policymakers' perception that they lack fiscal space, thereby feeding their reluctance to respond to future recessions. While policymakers should understand that they have sufficient budget capacity to fight downturns, they must also recognize that misperceptions about fiscal space can act as a real – and costly – constraint on policymaking.

"We have to continue to assume that debt, in the long run, has some effect on interest rates" — Dr. Blanchard underscored that while it is true in recent decades that interest rates have declined even as debt has soared, "To conclude from this that, therefore, there is no effect of debt on interest rates would be wrong. This would be mixing correlation and causality." Rather than conclude that the relationship between debt and interest rates was incorrect all along, he proposed that the relationship still exists but is being masked by other trends that are pushing interest rates down – a conclusion recent research supports.

Our Most Urgent Priority is Addressing Deficits in the Real Economy

The new evidence on debt makes clear that we are not facing an imminent debt crisis and suggests that reducing deficits is less urgent – even potentially counterproductive – in our current economic environment. But throughout the hearing, witnesses stressed that policymakers must better balance the risks and opportunities that debt presents by putting deficits to more productive uses. In particular, failing to tackle severe and persistent deficits in the real economy – such as in infrastructure, education, and health – is arguably more damaging to our economic and fiscal outlooks than the risks posed today by higher debt.

Committee members and witnesses identified two key challenges, climate change and potential labor market disruption from advances in artificial intelligence (A.I.), as especially important areas of investment in a rapidly changing world. Better targeting our fiscal policy and our use of deficits toward these kinds of investments – those that improve the livelihoods of American workers and families, bolster our environmental resilience, and foster a strong and dynamic economy – should be our priority.

"The tradeoff between debt stabilization and output stabilization has shifted in favor of output stabilization" — Dr. Blanchard argued that low interest rates – which lower the costs of debt but constrain the Federal Reserve's ability to stimulate the economy – suggest there should be less immediate emphasis on deficit reduction and more focus on using fiscal policy to support economic output. While careful to stress that deficits are high and would ideally be reduced unless used for productive investment, Dr. Blanchard explained that "even if the desirable level of debt is lower than the current level, it is still the case that low rates imply that fiscal consolidation is both less urgent and potentially more costly in terms of reduced output." Because deficit reduction would slow growth, and the Fed has limited room to offset these drags, deficit reduction "should be contingent on the strength of private demand." Dr. Blanchard advised that "this strategy might lead to further increases in the ratio of debt to GDP from the already fairly high levels, but I believe that it is acceptable risk, and that maintaining output is very, very important." As he concluded, "judicious use of deficits as a way of simultaneously sustaining demand and output in the short run and financing public investment and increasing output in the long appears today to be the best strategy."

"Good debt invests in people and places that need help. Bad debt does not" — While Dr. Bernstein said that we should reduce deficits as the economy approaches full employment, he stressed the importance of distinguishing between deficits that are used "to make necessary, productive investments" and those which add "to our already historically elevated debt for non-productive, or wasteful spending and/or tax cuts." As he argued, "there exists a deep, rich set of good debt investment opportunities" that policymakers should make today, from mitigating the impacts of climate change and upgrading our infrastructure, to reducing the cost of college, expanding health insurance coverage, bolstering education and skills training programs, and helping communities that have been left out of the recovery. Dr. Blanchard made a similar assessment, noting that "deficits, as they are now, are not used for the right purposes. There are a number of programs and measures which could increase growth, decrease inequality. It would be a much better use of these deficits than is currently the case."

"We have to factor in the cost of environmental damage from doing nothing. And if you simply look at your front page, those costs seem to be growing by the month" — Witnesses agreed that addressing climate change is among the most urgent challenges facing Congress today. While Republicans fixated on flawed cost estimates for plans like the Green New Deal, Dr. Bernstein stressed that "When you are contemplating the cost of the Green New Deal, or any other action against climate change, it is very important to factor in the costs of not doing anything about climate change. Those costs are becoming increasingly significant, and they must be netted out of whatever numbers we are throwing around." As he warned, "We can't make this a one-sided equation…to talk about this purely as an expense on businesses or something like that is to miss both the opportunity for game-changing investments, where, I believe, our country should play a role, and again, the costs of not doing enough."

Dr. Wray added that we have the technical know-how to address climate change, "So the question is can we release the resources from current uses, plus put unemployed resources to work to tackle climate change? And I think the answer is clearly yes." Dr. Blanchard agreed, arguing that "There is no question that we should be doing it, and partly finance it by tax and partly financing by debt. The part which would be financed by debt would be called, I think, by [Dr. Bernstein], good debt. This is debt to improve the future."

"We have to find jobs for these people, and we need to train them for jobs" — In response to a question from Chairman John Yarmuth (KY-03) on the impact of A.I. on jobs, Dr. Wray noted that over the last two centuries, technological advances have usually been a good thing for workers and "probably will continue to be a good thing." On the other hand, "We do need education, because robots are pretty good at taking away the jobs of the lower-skilled and lower-educated workers. They are some way off from taking away our jobs…but we need to worry about the people at the bottom end." Additionally, Dr. Blanchard argued that while past technological advances generally created more jobs than they displaced, "I think this time we are less sure. It may not, in which case we really have to think about everything we can do to help the people who may lose their jobs and not find one." As he concluded, "I think we have to be ready for these contingencies. They may cost money."

GOP Tax Law is the Poster Child for Bad Debt

In contrast to necessary and productive "good debt," panelists held up the 2017 GOP tax law as a key example of unjustified and wasteful deficit-financed policy. Two years since the law passed, it appears on track to increase the debt by even more than its initial $1.9 trillion price tag while research continues to show that it has had little impact on the economy beyond exacerbating income inequality.

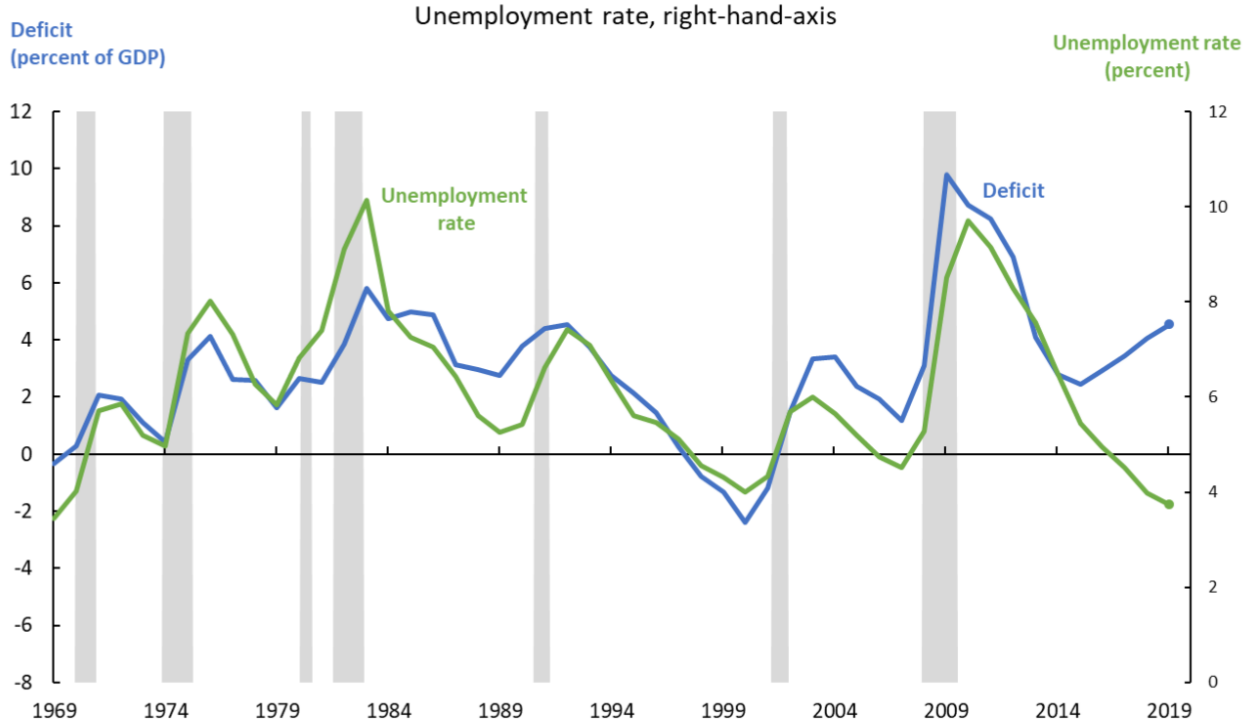
The fact that Republicans skyrocketed the deficit for this purpose – even as the number of Americans without health insurance increased in 2018 for the first time in a decade; air pollution worsened between 2016 and 2018, reversing a decades-long trend of cleaner air; and reading scores for children in 2019 declined from their levels in 2017 – makes clear the extent to which their fiscal priorities are misplaced. As Representative Steven Horsford (NV-04) observed, "the other side will view tax cuts for the very wealthy as investments. But when we talk about investing in resources and programs that we know will benefit our children and their future, somehow that is not something that is worth investing in."

"The 2017 tax cuts…are exhibit A in wasteful, inequitable debt accumulation" — Dr. Bernstein described how the GOP tax law showered most of its benefits on the wealthy and corporations, exacerbated our revenue shortfalls despite promises that it would pay for itself, and failed to provide a meaningful economic boost – making it a clear illustration of "inequitable, revenue-robbing, bad debt." Indeed, contrary to Republican claims that the tax law would "supercharge" the economy, projected growth remains at its pre-GOP tax law trend of 2 percent. Dr. Wray noted that this outcome is unsurprising: "The recent tax cuts were inefficient because the main beneficiaries were high-income earners. This raised the deficit without boosting growth."

"Once again, supply-side trickle-down fairy dust didn't work" — Witnesses also highlighted the particular wastefulness of the tax law's corporate provisions, which permanently slashed the corporate tax rate by 40 percent. This led corporate tax revenues to plummet by nearly one-third in the first year of the law – the largest year-over-year drop in corporate tax revenue outside of a recession since World War II. Despite this giveaway, Dr. Blanchard noted, we have not seen the investment boom Republicans promised: "Whatever the case for corporate tax rate reduction as boosting investment, I think the evidence so far is that it has not. And therefore, indeed, I think the money could have been spent much better." Dr. Bernstein added that "companies have spent almost three times as much on dividends and stock buybacks than they have on increased investment. If you actually look at the investment record, it is exhibit A against the argument that the tax cut was going to have these trickle-down effects that would generate faster investment, faster productivity, and then faster income growth."

Deficit is Unusually Large Relative to the Unemployment Rate

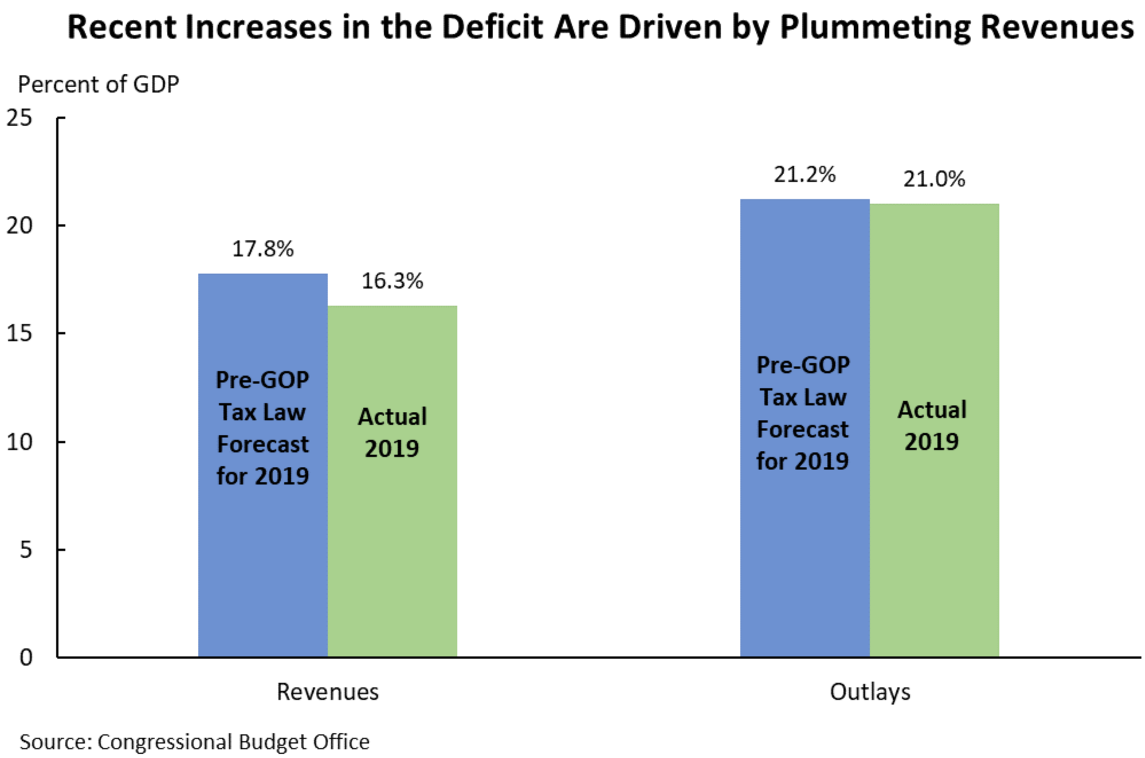
Deficit (+) as a share of GDP, left-hand axis
Unemployment rate, right-hand-axis



Source: Congressional Budget Office
Note: Gray bars denote recession.

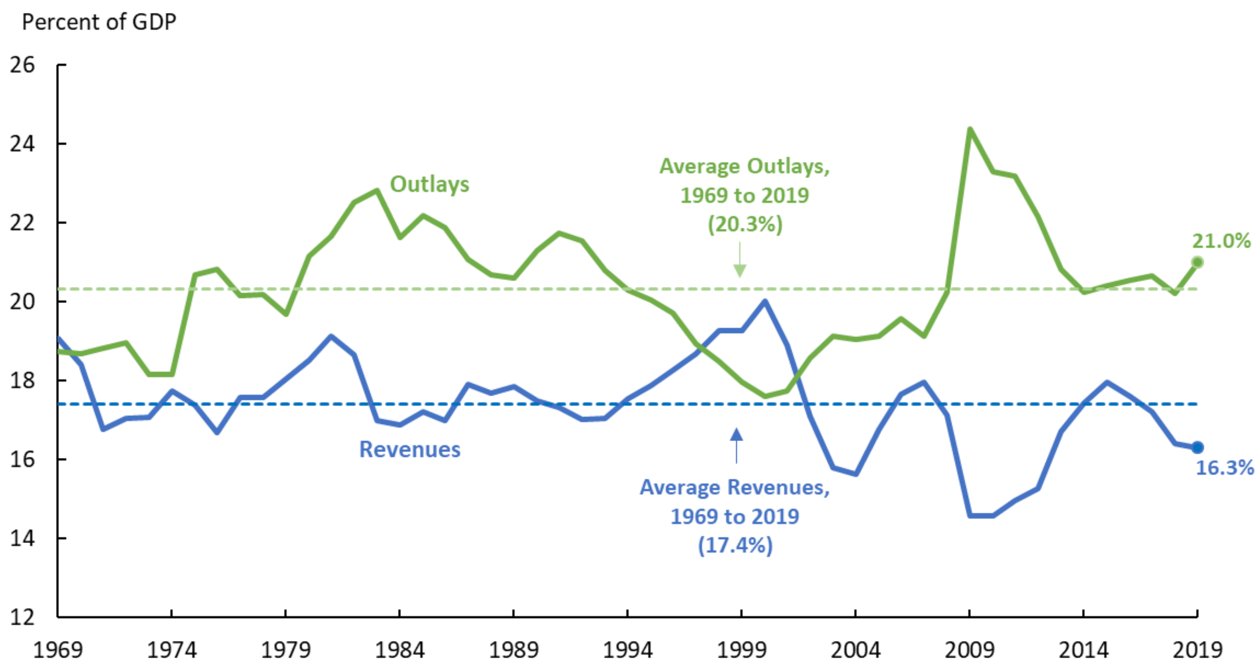
"The 2017 tax cut really broke down the connective tissue between a growing economy and ample revenues" — Dr. Bernstein stressed that the tax law's impact is even more destructive when considering that it dismantled a fundamental and well-established relationship in our economic history: as the economy grows, government revenues increase and deficits decline. Over the last half century, the deficit as a share of GDP has averaged 0 percent in years in which the unemployment rate has been below 4.5 percent. The deficit in fiscal year 2019, by contrast, was 4.6 percent of GDP even though unemployment averaged just 3.7 percent. In fact, the deficit in 2019 was at its highest level since 2012, when we were recovering from the Great Recession and unemployment was more than double its current rate.

Dr. Bernstein explained that these unusually high recent deficits are "clearly a function of lost revenue due to the tax cuts" – not, as Republicans repeatedly claim, out-of-control spending. Examining the Congressional Budget Office's (CBO) projections of spending and revenues before the tax law drives the point home. In fiscal year 2019, spending was about (and even slightly lower than) what CBO projected in June 2017, six months before the tax law. Revenues, by contrast, have come in significantly below projections. This revenue loss has driven deficits above what CBO forecast before the law, though we have precious little to show for it.



"As a share of GDP, we are collecting 16.3 percent in revenues in fiscal year 2019. That is a historical low point" — Dr. Bernstein also helped clarify Republicans' general confusion over government revenues, explaining that their oft-repeated argument that revenue in dollar terms are at historic highs "is probably true every quarter in our history, except when we are in recession. The relevant measure is as a share of GDP. This is not a partisan statement. This is a CBO view." Indeed, CBO shows that revenue as a share of the economy in 2019 declined from the previous year and was more than a full percentage point below the average level over the past 50 years, despite record-low unemployment. When compared to years in which the unemployment rate was below 5 percent, revenue as a share of the economy in 2019 was *two percentage points* below the historical average. Looking at the appropriate measure, Dr. Bernstein explained, makes clear that "it really doesn't make sense to cite revenue collections in the billions and hundreds of billions and argue that we are in some uniquely favorable space." To the contrary, CBO data plainly show that revenues today are unusually low, especially when considering the state of the economy.

Revenues Are Below Their Historical Average Despite An Expanding Economy



Source: Congressional Budget Office

Our Real Fiscal Challenge is Long Term

While the diminished costs of debt have made reducing deficits in the near term less urgent, over the next several decades the United States faces a growing structural shortfall between spending and revenues – one that historically low interest rates do not fundamentally change or allow us to avoid. As witnesses emphasized, this darkening long-term outlook is the result of predictable demographic trends and rising health care costs, as well as insufficient revenue. Returning our debt to a sustainable path over the long run will in part require addressing the gross revenue imbalance in our budget and ensuring that revenue rises commensurate with the needs of our aging population.

"Spending projections show that federal spending as a share of GDP is expected to rise not because of new programs but because of demographic and, [in regards to] health care, price pressures on existing programs" — CBO projects that the debt as a share of GDP will rise from 79 percent today to an unprecedented 144 percent by 2049, with spending on Social Security, Medicare and other health care programs, and net interest expected to outpace revenues and rise as a share of the economy. Dr. Bernstein underscored that this forecast is driven by America's aging population and rising health care costs – which increase spending on vital programs that support older Americans rather than spending on new policies or increasingly generous benefits. But Dr. Bernstein notes that this should not come as a surprise: “I wouldn’t characterize our spending...as exploding. I would characterize them as completely predictable.” The share of Americans aged 65 or older has increased from 12 percent of the population in 2004 to 16 percent today, and is projected to rise to 22 percent by 2049. In just the next 20 years, moreover, senior citizens will outnumber children for the first time in U.S. history. While witnesses emphasized that we can and must achieve budgetary savings by reducing health care costs, population aging will continue to put pressure on our budget. As Dr. Blanchard noted, “I do not think that mandatory spending can be decreased substantially. I think there are some savings to be made, but there are also more demands, because of aging.”

“Whether it is health care or retirement security through Social Security…these are clearly essential public goods. And we are not raising enough revenue to pay for them” — Dr. Bernstein advised that in addition to slowing the growth of health care costs, tackling our long-term fiscal challenge will require correcting the revenue imbalance in our budget. As he stated in his closing comments, “we really do have a revenue problem.” Indeed, though the nation’s over-65 population is nearly three times larger today than it was 50 years ago, we are taking in less revenue as a share of the economy today than we were then. This imbalance is projected to get worse as the population ages further. CBO estimates that government outlays in 2049 will be 28 percent of GDP – nearly 10 percentage points higher than outlays in 1969. But revenues in 2049 (19.5 percent) would be little higher than they were 80 years before (19.1 percent).

Dr. Bernstein underscored that addressing our revenue problem will require repairing the link between economic growth and higher revenue that was severed by the GOP tax law, but policymakers must also consider “tightening up” our tax system to address the accumulation of income and wealth at the top of the scale. At a minimum, reforming the capital gains and estate tax and funding the IRS “to close some of the tax avoidance gap that has cost us, literally, hundreds of billions per year.” Dr. Blanchard reached a similar conclusion, adding: “I very strongly suspect that the way to take care of deficits and reduce them over time” is through additional revenue. “I have no doubt that this is the case.”

“The goal should be sustainable growth, rising living standards, reduction of inequality, and not to achieve some arbitrary deficit or debt number” — More broadly, Dr. Wray underscored that our fiscal policy should be driven by our nation’s needs, rather than achieving a specific debt-to-GDP target as some Committee members proposed in the hearing. As he advised, “You should focus on the things that are important: employment, rising income, economic growth, rising productivity, meeting the challenges that face us in the future.” Dr. Blanchard agreed, noting that not only is there no “magic number” past which debt would trigger a fiscal crisis, we also “really do not have a good sense of what” an appropriate debt target would be.

Fiscal Policy Will Be Critical in the Next Recession

Beyond reshaping the economics of debt, the decline in interest rates over the last several decades also has an impact on the strength and efficacy of our recession-fighting toolkit. Witnesses agreed that fiscal policy – in particular, automatic stabilizer programs that do not require Congressional action to take effect – will be more important than ever in countering future downturns. As Dr. Blanchard concluded, “Fiscal policy must be ready to fight the next recession, when it comes.”

“Once at the lower bound, monetary policy cannot help. But fiscal policy can” — Dr. Blanchard pointed out that while low interest rates expand Congress’s fiscal space, they diminish the Fed’s monetary policy space, sharply limiting its ability to fight recessions. The Fed cut rates by more than 5 percentage points to near zero (the effective “lower bound”) in the wake of the Great Recession, but it has just one-third of that space today, heightening the risk that monetary policy will be constrained in future recessions. Consequently, Dr. Blanchard argued, “fiscal policy should be used more aggressively than in previous recessions. The cost of higher debt from such an aggressive response is likely to be much smaller than the output cost from a more limited response.” Dr. Bernstein agreed, warning that “were Congress to take insufficient action to offset a downturn, it would be a fateful mistake, one that would disproportionately harm those who are already economically vulnerable and who are least insulated from recessions.”

“The stabilizer functions of government spending have weakened” — Dr. Wray underscored the critical need to bolster the economy’s automatic stabilizers, the changes in spending and revenues that automatically kick in to dampen the ups and downs of the business cycle. When the economy is weak, more federal resources flow to people in need and tax collections are lower; when the economy is strong, fewer people are eligible for programs such as Medicaid, so spending on those programs declines, and government revenues rise. Dr. Wray noted that policy changes over the last several decades have weakened spending’s “countercyclical swing,” rendering stabilizers less effective and our economy less resilient. Dr. Blanchard provided a similar assessment, arguing that existing stabilizers “are too weak in the U.S. to do the job. Better ones focusing, for example, on larger payments to low-income households should be designed soon. This is an urgent matter.”

“The analogy that the government is like a family is extremely misguided” — Panelists also pushed back against the claim that government should approach budgeting as households do. As Dr. Bernstein stressed, the analogy actually gets it backwards: when families are tightening their belts, that is precisely when government must loosen its own to support the economy. “The idea that the federal government would contract when the private sector is contracting,” he argued, “is a recipe for austerity, more specifically for more pain for the people least insulated from the pain, the most economically vulnerable families.” Dr. Blanchard explained that government debt “plays a macro stabilization role that individual debt does not. So, when the government decreases its debt or has a large surplus, this has an adverse effect on the economy, which it has to take into account. This is irrelevant to you or me or any household.”

“The Obama stimulus package...had a profound change in trajectory in terms of jobs and unemployment rate” — Underscoring the GOP tax law’s failure to fundamentally change our economic trajectory, Congressman Bobby Scott (VA-03) pointed to the efficacy of the American Recovery and Reinvestment Act (ARRA) of 2009 as an example of responsible and effective deficit-financed policy. Passed without a single House Republican vote, ARRA helped counter the most devastating economic downturn since the Great Depression by deploying critical aid and relief to individuals, small businesses, and state and local governments. Research from a wide variety of sources – from CBO to private-sector analysts – confirm that ARRA succeeded in creating millions of jobs and boosting output when our country most needed it, thereby reversing the economy’s downward trajectory and laying the groundwork for the record-long 11-year expansion we enjoy today. Leading economists, moreover, overwhelmingly agree that not only did ARRA lower unemployment, but that its economic benefits outweighed its costs.

Toward A More Nuanced Understanding of Debt

Near the end of the hearing, Ranking Member Steve Womack (AR-03) recounted advice he received: “Don’t go into debt for things that are not an appreciating asset.” Democrats agree. Our economic experience over the last several decades makes clear that using debt to support critical investments in families, communities, and our environment – investments that improve current and future living standards and boost our long-term growth potential – are justified uses. So are fighting recessions and avoiding needless and destructive austerity traps. Tax cuts for the wealthy, however, are clearly not justified.

As we head into a new term, and the start of a new decade, Democrats remain committed to making smart and responsible investments in our nation’s future. As Chairman Yarmuth said, “At the end of the day, carrying debt still carries risks. But by investing strategically in responsible policies that reflect our nation's values, and by having a more sober and evidenced-based understanding of the costs of debt, we can lay the groundwork for a productive and dynamic 21st century economy.”