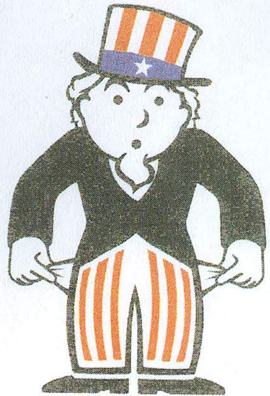
the DEFICIT MYTH



Modern Monetary Theory and the Birth of the People's Economy

STEPHANIE KELTON

Introduction

Bumper Sticker Shock

> It ain't what you know that gets you into trouble. It's what you know for sure that just ain't so.
>
> —MARK TWAIN

I remember when I saw a bumper sticker on the back of a Mercedes SUV in 2008 while I made my one-hour commute from Lawrence, Kansas, to my job teaching economics at the University of Missouri in Kansas City. It featured a man, standing slightly hunched, with his pants pockets turned inside out. His face bore a hardened, serious look. He wore red-and-white striped pants, a dark-blue jacket, and a top hat adorned with stars. It was Uncle Sam. Like the driver with this bumper sticker, many people have come to believe that our government is flat broke and that its budget is unable to tackle the most important issues of our time.

Whether the policy debate is health care, infrastructure, education, or climate change, the same question inevitably arises: But how are you going to pay for it? This bumper sticker captured a real frustration and anxiety that exists over our nation's fiscal affairs, particularly with the size of the federal deficit. Based on how politicians across parties

have railed against the deficit, it's understandable why anyone would get enraged when thinking about our government behaving imprudently. After all, if we as individuals behaved the way the government behaves, we'd soon be bankrupted just like the image of a destitute Uncle Sam.

But what if the federal budget is fundamentally different than your household budget? What if I showed you that the deficit bogeyman isn't real? What if I could convince you that we can have an economy that puts people and planet first? That finding the money to do this is not the problem?

Copernicus and the scientists who followed him changed our understanding of the cosmos, showing that the earth revolves around the sun and not the other way around. A similar breakthrough is needed for how we understand the deficit and its relationship to the economy. When it comes to increasing our public well-being, we have far more options than we realize, but we desperately need to see through the myths that have been holding us back.

This book uses the lens of Modern Monetary Theory (MMT), of which I have been a leading proponent, to explain this Copernican shift. The main arguments that I present apply to any monetary sovereign—countries like the US, the UK, Japan, Australia, Canada, and others—where the government is the monopoly issuer of a fiat currency.[1] MMT changes how we view our politics and economics by showing that in almost all instances federal deficits are good for the economy. They are necessary. And the way we have thought about them and treated them is often incomplete or inaccurate. Rather than chasing after the misguided goal of a balanced budget we should be pursuing the promise of harnessing what MMT calls our public money, or sovereign currency, to balance the economy so that prosperity is broadly shared and not concentrated in fewer and fewer hands.

The taxpayer, according to the conventional view, is at the center of the monetary universe because of the belief that the government has no money of its own. Therefore, the only money available to fund

the government must ultimately come from people like us. MMT radically changes our understanding by recognizing that it is the currency issuer—the federal government itself—not the taxpayer, that finances all government expenditures. Taxes are important for other reasons that I will explain in this book. But the idea that taxes pay for what the government spends is pure fantasy.

I was skeptical when I first encountered these ideas. In fact, I resisted them. During my early training as a professional economist, I sought to refute MMT's claims through intense research about our government's fiscal and monetary operations. By the time I developed this into my first, published, peer-reviewed academic paper, I realized that my prior understanding had been wrong. The core idea behind MMT may have initially appeared outlandish, but it proved to be descriptively accurate. In one sense, MMT is a nonpartisan lens that describes how our monetary system actually works. Its explanatory power doesn't depend on ideology or political party. Rather, MMT clarifies what is economically possible and thus shifts the terrain of policy debates that get hamstrung over questions of financial feasibility. MMT focuses on the broader economic and social impacts of a proposed policy change rather than its narrow budgetary impact. John Maynard Keynes's contemporary, Abba P. Lerner, was a champion of this approach, which he dubbed *functional finance*. The idea was to judge policy by the way it worked or functioned. Does it control inflation, sustain full employment, and bring about a more equitable distribution of income and wealth? The particular number that falls out of the budget box each year was (and is) quite beside the point.

Do I believe the solution to all our problems is to simply spend more money? No, of course not. Just because there are no *financial* constraints on the federal budget doesn't mean there aren't *real* limits to what the government can (and should) do. Every economy has its own internal speed limit, regulated by the availability of our *real productive resources*—the state of technology and the quantity and quality

of its land, workers, factories, machines, and other materials. If the government tries to spend too much into an economy that's already running at full speed, inflation will accelerate. There are limits. However, the limits are not in our government's ability to spend money, or in the deficit, but in inflationary pressures and resources within the real economy. MMT distinguishes the real limits from delusional and unnecessary self-imposed constraints.

You've probably already seen MMT's central insights in action. I saw them up close when I worked in the US Senate. Whenever the topic of Social Security comes up, or when someone in Congress wants to put more money into education or health care, there's a lot of talk about how everything must be "paid for" to avoid adding to the federal deficit. But have you noticed this never seems to be a problem when it comes to expanding the defense budget, bailing out banks, or giving huge tax breaks to the wealthiest Americans, even when these measures significantly raise the deficit? As long as the votes are there, the federal government can always fund its priorities. That's how it works. Deficits didn't stop Franklin Delano Roosevelt from implementing the New Deal in the 1930s. They didn't dissuade John F. Kennedy from landing a man on the moon. And they never once stopped Congress from going to war.

That's because Congress has the power of the purse. If it really wants to accomplish something, the money can always be made available. If lawmakers wanted to, they could advance legislation—today—aimed at raising living standards and delivering the public investments in education, technology, and resilient infrastructure that are critical for our long-term prosperity. Spending or not spending is a political decision. Obviously, the economic ramifications of any bill should be thoroughly considered. But spending should never be constrained by arbitrary budget targets or a blind allegiance to so-called sound finance.

I DON'T THINK it's a coincidence that I ended up seeing the Uncle Sam bumper sticker when I did in November of 2008. The outmoded beliefs about the government running out of money gained traction during the financial crisis that same year. Our nation was in the midst of the worst economic downturn since the Great Depression. It did feel as though we, as a country, were going broke, along with a good chunk of the rest of the world. What started as a disruption in the subprime mortgage market had spilled over into global financial markets and morphed into a full-blown economic meltdown that cost millions of Americans their jobs, their homes, and their businesses.[2] Eight hundred thousand Americans lost their jobs that November alone. Millions applied for unemployment insurance, food stamps, Medicaid, and other forms of public assistance. With the economy sliding deeply into recession, tax receipts fell off a cliff and spending to support the unemployed rose sharply, pushing the deficit to a record $779 billion. There was panic all around.

Proponents of MMT, myself included, saw this as an opportunity to offer bold policy ideas to the incoming Obama administration. We urged Congress to enact a robust stimulus, calling for a payroll tax holiday, additional aid for state and local governments, and a federal job guarantee.

By January 16, 2009, America's four largest financial institutions had lost half their value, and the labor market was hemorrhaging hundreds of thousands of jobs a month. Just like FDR, President Obama took the oath of office on January 20 at a time of historic urgency. Within thirty days, he had signed a $787 billion economic stimulus package into law. Some of his close advisers had pushed for substantially more, insisting that a minimum of $1.3 trillion would be needed to avoid a protracted recession. Others balked at anything ending in "trillion." In the end, Obama lost his nerve.

Why? Because he was basically a conservative when it came to fiscal policy. He was surrounded by people giving him different numbers, and he decided to err on the side of caution, picking a number

toward the lower end of what was presented to him. Christina Romer, his chair of the Council of Economic Advisers, understood that a crisis of this magnitude could not be handled with the more modest $787 billion intervention. She made the case for an ambitious trillion-plus stimulus, saying, "Well, Mr. President, this is your 'holy-shit moment.' It's worse than we thought."[3] She had run the numbers, and she concluded that a package as large as $1.8 trillion might be required to combat the worsening recession. But that option was nixed by Lawrence Summers, the Harvard economist and former treasury secretary who became Obama's chief economic adviser. Summers might have preferred a bigger stimulus, but he worried that asking Congress for anything close to $1 trillion would provoke ridicule, saying that "the public wouldn't stand for it, and it would never get through Congress."[4] David Axelrod, who would go on to become senior adviser to the president, agreed, worrying that anything over a trillion would create "sticker shock" in Congress and with the American people.

The $787 billion that Congress ultimately authorized included money to help state and local governments cope with the downturn, funding for infrastructure and green investment projects, and substantial tax breaks to encourage private sector consumption and investment. It all helped, but not nearly enough. The economy shrank, and as the deficit climbed to more than $1.4 trillion, President Obama faced questions about the rising tide of red ink. On May 23, 2009, he appeared in an interview on C-SPAN. The show's host, Steve Scully, asked, "At what point do we run out of money?"[5] The president responded, "Well, we are out of money now." And there it was. The president had just reinforced what the driver with the Uncle Sam bumper sticker suspected all along. The United States was broke.

The Great Recession, which lasted from December 2007 to June 2009, left permanent scars on communities and families across the United States and beyond. It took more than six years for the US labor market to recover all 8.7 million jobs that were lost between December 2007 and early 2010.[6] Millions struggled for a year or longer before

finding employment. Many never did. And some who were fortunate enough to find work often had to settle for part-time employment or take jobs that paid substantially less than they had been earning. Meanwhile, the foreclosure crisis swallowed $8 trillion in housing wealth, and an estimated 6.3 million people—including 2.1 million children—were pushed into poverty between 2007 and 2009.[7]

Congress could and should have done more, but the deficit myth had taken hold. By January 2010, with the unemployment rate at a staggering 9.8 percent, President Obama was already moving in the opposite direction. That month, in his State of the Union address, he committed to a reversal of fiscal stimulus, telling the nation, "Families across the country are tightening their belts and making tough decisions. The federal government should do the same." What followed was a sustained period of self-inflicted harm.

The Federal Reserve Bank of San Francisco (FRBSF) estimates that the financial crisis and the lackluster recovery robbed the US economy of up to 7 percent of its output potential from 2008 to 2018. Think of this as a measure of all of the goods and services (and income) we could have produced over that decade but didn't because we failed to do enough to support our economy by protecting jobs and keeping people in their homes. By not getting the policy response right, we set the stage for a slow and weak recovery that harmed our communities and translated into trillions of dollars in foregone prosperity for our economy. According to the FRBSF, the decade of subpar economic growth cost every man, woman, and child in America the equivalent of $70,000.

Why didn't we make better policy? You might think the answer is that our two-party system has become so divided that Congress was just incapable of doing the right thing, even when confronted with a national calamity that threatened the security of average Americans and big corporations alike. And there is certainly some truth to that. In 2010, Senate majority leader Mitch McConnell boasted openly that "the single most important thing we want to achieve is for President

Obama to be a one-term president." But party politics weren't the only obstacle. The politics of deficit hysteria, embraced by both sides for decades, served as an even bigger impediment.

Bigger deficits would have enabled a faster and stronger recovery, protecting millions of families and avoiding trillions in economic losses. But no one with any real power fought for bigger deficits. Not President Obama, not most of his senior advisers, not even the most progressive members of the House and Senate. Why? Did everyone really believe that the government had run out of money? Or were they just afraid of offending the sensibilities of voters like the one who placed that bumper sticker on her Mercedes?

We can't use deficits to solve problems if we continue to think of the deficit itself as a problem. Right now, about half of Americans (48 percent) say that reducing federal budget deficits should be a top priority for the president and Congress. This book aims to drive the number of people who believe the deficit is a problem closer to zero. It won't be easy. To get there, we're going to have to carefully unravel the myths and misunderstandings that have shaped our public discourse.

THE FIRST SIX chapters of the book dispel the deficit myths that have hobbled us as a country. To begin, I tackle the idea that the federal government should budget like a household. Perhaps no myth is more pernicious. The truth is, the federal government is nothing like a household or a private business. That's because Uncle Sam has something the rest of us don't—the power to issue the US dollar. Uncle Sam doesn't need to come up with dollars before he can spend. The rest of us do. Uncle Sam can't face mounting bills he can't afford to pay. The rest of us might. Uncle Sam will never go broke. The rest of us could. When governments try to manage their budgets like households, they miss out on the opportunity to harness the power of their sovereign currencies to substantially improve life for their people. We

will show how MMT demonstrates that the federal government is not dependent on revenue from taxes or borrowing to finance its spending and that the most important constraint on government spending is inflation.

The second myth is that deficits are evidence of overspending. It's an easy conclusion to reach because we've all heard politicians lament deficits as proof that the government is "living beyond its means." That's a mistake. It is true that a deficit is recorded on the government's books whenever it spends more than it taxes. But that's only half the story. MMT paints the rest of the picture using some simple accounting logic. Suppose the government spends $100 into the economy but collects just $90 in taxes. The difference is known as the *government deficit*. But there's another way to look at that difference. Uncle Sam's deficit creates a *surplus* for someone else. That's because the government's minus $10 is always matched by a plus $10 in some other part of the economy. The problem is that policy makers are looking at the picture with one eye shut. They see the budget deficit, but they're missing the matching surplus on the other side. And since many Americans are missing it, too, they end up applauding efforts to balance the budget, even though it could mean taking money out of their pockets. It is possible for the government to spend too much. Deficits can be too big. But evidence of overspending is inflation, and most of the time deficits are too small, not too big.

The third myth is that deficits will burden the next generation. Politicians love to trot out this myth, proclaiming that by running deficits we are ruining the lives of our children and grandchildren, saddling them with crippling debt that they will eventually have to repay. One of the most influential perpetrators of this myth was Ronald Reagan. But even Senator Bernie Sanders has echoed Reagan, saying, "I am concerned about the debt. It's not something we should be leaving to our kids and our grandchildren."[8]

While this rhetoric is powerful, its economic logic is not. History bears this out. As a share of gross domestic product (GDP), the national

debt was at its highest—120 percent—in the period immediately following the Second World War. Yet, this was the same period during which the middle class was built, real median family income soared, and the next generation enjoyed a higher standard of living without the added burden of higher tax rates. The reality is that government deficits don't force financial burdens forward onto future populations. Increasing the deficit doesn't make future generations poorer, and reducing deficits won't make them any richer.

The fourth myth we'll tackle is the notion that deficits are harmful because they crowd out private investment and undermine long-term growth. This myth is mostly circulated by mainstream economists and policy wonks who should know better. It relies on the faulty assumption that in order to finance its deficits the government must compete with other borrowers for access to a limited supply of savings. Here, the idea is that government deficits eat up some of the dollars that would otherwise have been invested in private sector endeavors that promote long-term prosperity. We will see why the reverse is true—fiscal deficits actually increase private savings—and can easily crowd-in private investment.

The fifth myth is that deficits make the United States dependent on foreigners. This myth would have us believe that countries like China and Japan have enormous leverage over us because they hold large quantities of US debt. We will see this is a fiction that politicians wittingly or unwittingly propagate, often as an excuse to ignore social programs in desperate need of funding. Sometimes this myth has used the metaphor of irresponsibly taking out a foreign credit card. This misses the fact that the dollars aren't originating from China. They're coming from the US. We're not really borrowing from China so much as we're supplying China with dollars and then allowing them to trade those dollars in for a safe, interest-bearing asset called a US Treasury. There is absolutely nothing risky or pernicious about this. If we wanted to, we could pay off the debt immediately with a simple

keystroke. Mortgaging our future is yet one more instance of not understanding—or willfully misconstruing for political purposes—how sovereign currencies actually work.

The sixth myth we'll consider is that entitlements are propelling us toward a long-term fiscal crisis. Social Security, Medicare, and Medicaid are the supposed culprits. I will show you why this way of thinking is wrong. There is absolutely no good reason for Social Security benefits, for example, to ever face cuts. Our government will always be able to meet future obligations because it can never run out of money. Instead of arguing over the monetary cost of these programs, lawmakers should be fighting about whose policies stand the best chance of meeting the needs of our entire population. The money can always be there. The question is, What will that money buy? Changing demographics and the impacts of climate change are real challenges that could put stress on available resources. We need to make sure that we're doing everything we can to manage our real resources and develop more sustainable methods of production as the baby boom generation ages out of the workforce. But when it comes to paying out benefits, we can always afford to keep our promises to current retirees and to the generations that will follow them.

After we fully examine the faulty thinking underlying these six myths and counter them with solid evidence, we will consider the deficits that do matter. The real crises that we're facing have nothing to do with the federal deficit or entitlements. The fact that 21 percent of all children in the United States live in poverty—that's a crisis. The fact that our infrastructure is graded at a D+ is a crisis. The fact that inequality today stands at levels last seen during America's Gilded Age is a crisis. The fact that the typical American worker has seen virtually no real wage growth since the 1970s is a crisis. The fact that forty-four million Americans are saddled with $1.7 trillion in student loan debt is a crisis. And the fact that we ultimately won't be able to "afford" anything at all if we end up exacerbating climate change

and destroying the life on this planet is perhaps the biggest crisis of them all.

These are real crises. The national deficit is not a crisis.

THE CRIME OF the tax bill signed by President Trump in 2017 is not that it added to the deficit but that it used the deficit to provide help to those who needed it least. It has widened inequality, putting more political and economic power into the hands of the few. MMT understands that building a better economy isn't contingent on raising enough revenue to pay for the things we want. We can, and must, tax the rich. But not because we can't afford to do anything without them. We should tax billionaires to rebalance the distribution of wealth and income and to protect the health of our democracy. But we don't need to crack open their piggy banks to eradicate poverty or to have the federal job guarantee with a living wage that Coretta Scott King fought for. We already have the tools we need. Feigning dependence on those with incredible wealth sends the wrong message, making them appear more vital to our cause than they actually are. That's not to suggest that deficits don't matter, so we can throw caution to the wind and simply spend, spend, spend. The economic framework that I'm advocating for is asking for *more fiscal responsibility* from the federal government, not less. We just need to redefine what it means to budget our resources responsibly. Our misconceptions about the deficit leave us with so much waste and untapped potential within our current economy.

MMT gives us the power to imagine a new politics and a new economy. It challenges the status quo *across the political spectrum* with sound economics, and that is why it is generating so much interest around the world from policy makers, academics, central bankers, finance ministers, activists, and ordinary people. MMT's lens enables

us to see that another kind of society is possible, one in which we can afford to invest in health care, education, and resilient infrastructure. In contrast to narratives of scarcity, MMT promotes a narrative of opportunity. Once we overcome the myths and accept that federal deficits are actually good for the economy, we can pursue fiscal policies that prioritize human need and public interest. We have nothing to lose but our self-imposed constraints.

The United States is the wealthiest country in the history of the world. But even when Americans were at their poorest during the Great Depression, we managed to establish Social Security and the minimum wage, electrify rural communities, provide federal housing loans, and fund a massive jobs program. Like Dorothy and her companions in *The Wizard of Oz*, we need to see through the myths and remember once again that we've had the power all along.

As this book was going to press, the COVID-19 virus hit with full force, giving us a vivid, real-world demonstration of the power of the MMT way of thinking. Entire industries are shutting down. Job losses are mounting, and there is the potential for an economic collapse that could put unemployment on par with the percentages last seen during the Great Depression. Congress has already committed more than $1 trillion to fight the health pandemic and the unfolding economic crisis. Much more will be needed.

The federal deficit, which was expected to top $1 trillion before the virus became a threat, will likely skyrocket beyond $3 trillion in the months ahead. If history is any lesson, anxiety over rising budget deficits will lead to pressure to reduce fiscal support in order to wrestle deficits lower. That would be an unmitigated disaster. Right now, and in the months ahead, the most fiscally responsible way to manage the crisis is with higher deficit spending.

The next year will be incredibly difficult for all of us. We will live with a heightened state of anxiety until the virus is contained and a

vaccine is widely available. Many of us will experience social and economic hardship. There is enough to worry about without piling on additional concerns over our nation's fiscal situation. This is as good a moment as any to learn some important lessons about where money comes from and why the federal government—and only the federal government—can step up and save the economy.

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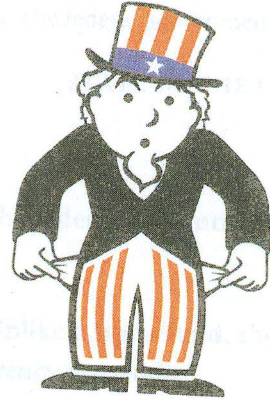
DEFICIT MYTH



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