

Why Government Spending Does Not Stimulate Economic Growth

by Brian M. Riedl
Senior Fellow, The Heritage Foundation
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In a throwback to the 1930s and 1970s, some lawmakers are betting that America's economic ills can be cured by an extraordinary expansion of government. This tired approach has already failed repeatedly in the past year, in which Congress and the President:

- Increased total federal spending by 11 percent to nearly \$3 trillion
- Enacted \$333 billion in “emergency” spending
- Enacted \$105 billion in tax rebates
- Pushed the budget deficit to \$455 billion in the name of “stimulus”

Every one of these policies failed to increase economic growth. Now, in addition to passing a \$700 billion financial sector rescue package, federal lawmakers have decided to double down on these failed spending policies by proposing a \$300 billion economic stimulus bill.

Even though the last \$455 billion in Keynesian deficit spending failed to help the economy, lawmakers seem to have convinced themselves that the next \$300 billion will succeed. This is not the first time government expansions have failed to produce economic growth. Massive spending hikes in the 1930s, 1960s, and 1970s all failed to increase economic growth rates. Yet in the 1980s and 1990s - when the federal government shrank by one-fifth as a percentage of gross domestic product (GDP) - the U.S. economy enjoyed its greatest expansion to date.

Cross-national comparisons yield the same result. The U.S. government spends significantly less than the 15 pre-2004 European Union nations, and yet enjoys 40 percent larger per capita GDP, 50 percent faster economic growth rates, and a substantially lower unemployment rate.

When conventional economic wisdom repeatedly fails, it becomes necessary to revisit that conventional wisdom. Government spending fails to stimulate economic growth because every dollar Congress “injects” *into* the economy must first be taxed or borrowed *out of* the economy. Thus, government spending “stimulus” merely redistributes existing income, doing nothing to increase productivity or employment, and therefore nothing to create additional income. Even worse, many government expenditures weaken the private sector by directing resources toward less productive uses and thus impede income growth.

The Myth of Spending as “Stimulus”

Spending-stimulus advocates claim that government can “inject” new money into the economy, increasing demand and therefore production. This raises the obvious question: Where does the government acquire the money it pumps into the economy? Congress does not have a vault

of money waiting to be distributed: Therefore, every dollar Congress “injects” *into* the economy must first be taxed or borrowed *out of* the economy. No new spending power is created. It is merely redistributed from one group of people to another.

Spending-stimulus advocates typically respond that redistributing money from “savers” to “spenders” will lead to additional spending. That assumes that savers store their savings in their mattresses or elsewhere outside the economy. In reality, nearly all Americans either invest their savings by purchasing financial assets such as stocks and bonds (which finances business investment), or by purchasing non-financial assets such as real estate and collectibles, or they deposit it in banks (which quickly lend it to others to spend). The money is used regardless of whether people spend or save.

Government cannot create new purchasing power out of thin air. If Congress funds new spending with taxes, it is simply redistributing existing income. If Congress instead borrows the money from domestic investors, those investors will have that much less to invest or to spend in the private economy. If Congress borrows the money from foreigners, the balance of payments will adjust by equally reducing net exports, leaving GDP unchanged. Every dollar Congress spends must first come from somewhere else.

This does not mean that government spending has no economic impact at all. Government spending often alters the composition of total demand, such as increasing consumption at the expense of investment.

More importantly, government spending can alter *future* economic growth. Economic growth results from producing more goods and services (not from redistributing existing income), and that requires productivity growth and growth in the labor supply. A government’s impact on economic growth is, therefore, determined by its policies’ effect on labor productivity and labor supply.

Productivity growth requires increasing the amount of capital, either material or human, relative to the amount of labor employed. Productivity growth is facilitated by smoothly functioning markets indicating accurate price signals to which buyers and sellers, firms and workers can respond in flexible markets. Only in the rare instances where the private sector fails to provide these inputs in adequate amounts is government spending necessary.

For instance, government spending on education, job training, physical infrastructure, and research and development can increase long-term productivity rates - but only if government spending does not crowd out similar private spending, and only if government spends the money more competently than businesses, nonprofit organizations, and private citizens.

More specifically, government must secure a higher long-term return on its investment than taxpayers’ (or investors lending the government) requirements with the same funds. Historically, governments have rarely outperformed the private sector in generating productivity growth. In fact, most government spending has historically *reduced* productivity and long-term economic growth.

The Myth that Highway Spending Creates New Jobs

Nowhere is the government spending stimulus myth more widespread than in highway

spending. Congress is already rumbling to push billions in highway spending in the next stimulus package. Over the years, lawmakers have repeatedly supported their errant claim that highway spending is an immediate economic tonic by citing a Department of Transportation (DOT) study.

This study supposedly states that every \$1 billion spent on highways adds 47,576 new jobs to the economy. The problem: The DOT study made no such claim. It stated that spending \$1 billion on highways would *require* 47,576 workers (or more precisely, it would require 26,524 workers, who then spend their income elsewhere, supporting an additional 21,052 workers).

But before the government can spend \$1 billion hiring road builders and purchasing asphalt, it must first tax or borrow \$1 billion from other sectors of the economy - which would then lose a similar number of jobs. In other words, highway spending merely transfers jobs and income from one part of the economy to another.

As The Heritage Foundation's Ronald Utt has explained, "The only way that \$1 billion of new highway spending can create 47,576 new jobs is if the \$1 billion appears out of nowhere as if it were manna from heaven." The DOT report implicitly acknowledged this point by referring to the transportation jobs as "employment benefits" within the transportation sector, rather than as *new* jobs for the total economy.

An April 2008 DOT update to its previous study reduced the employment figure to 34,779 jobs supported by each \$1 billion spent on highways, and explicitly stated that the figure "refers to jobs *supported* by highway investments, not jobs *created*."

Similarly, a Congressional Research Service study calculated similar numbers as the DOT study, but cautioned:

"To the extent that financing new highways by reducing expenditures on other programs or by deficit finance and its impact on private consumption and investment, the net impact on the economy of highway construction in terms of both output and employment could be nullified or even negative." [*Highway Construction: Its Impact on the Economy*, David J. Cantor, Congressional Research Service, Report for Congress, No. 93-21E, January 6, 1993]

Not surprisingly, highway spending has a poor track record of stimulating the economy. The Emergency Jobs Appropriations Act of 1983 appropriated billions of dollars in highway spending (among other programs) in hopes of pushing the double-digit unemployment rate downward. Years later, an audit by the General Accounting Office (GAO, now the Government Accountability Office) found that highway spending generally failed to create a significant number of new jobs. [*Funds Spent Slowly, Few Jobs Created*, GAO/HRD-87-1, December 1986.]

The bottom line is that there is no reason to expect additional highway spending this year to boost short-term economic growth or create new jobs. As stated above, resulting improvements in the nation's infrastructure may increase *future* productivity and growth - once they are completed and in use. This is *not* the same as suggesting that the act of spending money on additional highway workers and asphalt is itself an immediate stimulant.

Even the hope of future productivity increases rest on the assumptions that politicians will allocate money to necessary highway projects (rather than pork), and that those future productivity benefits will outweigh the lost productivity from raising future tax rates to finance the project.

State Bailouts Merely Shift Money around

Congress is reportedly considering using stimulus funding to bail out states dealing with their own budget shortfalls. This makes little sense as a matter of macroeconomic policy. State spending does not suddenly become stimulative because it is funded by Washington instead of state governments. Either way, any spending “injected” into the economy must first be taxed or borrowed from the economy. It does not matter which level of government is doing the taxing, borrowing, or spending.

Furthermore, sending federal aid to states would not save taxpayers a dime because state taxpayers are also federal taxpayers. Increasing federal borrowing to keep state taxes from rising is like running up a Visa card balance to keep the Mastercard balance from rising. The overall costs do not change, only the address receiving the payment.

Governors typically respond that a federal bailout is preferable because it could be funded with deficits rather than new taxes - currently not an option for the 49 states, like Washington state, with balanced-budget requirements. But it is disingenuous for a state to require a balanced budget, and then demand that Washington bail it out of the consequences of its own overspending.

Congress already sends \$467 billion to state and local government every year - up 29% after inflation since 2000. This is well beyond what is needed to reimburse states for federal mandates. In fact, since 1996, Washington has imposed less than \$25 million per state in new unfunded mandates. (No Child Left Behind is neither unfunded nor mandated.)

State health, education, and transportation programs remain heavily subsidized by Washington. Commonsense says states should build up adequate rainy-day funds during booms to cushion the inevitable recessions. Instead, states keep responding to *temporary* revenue surges with new *permanent* spending programs.

All booms eventually end, and free-spending states left themselves utterly unprepared for the 2002–2003 economic slowdown. Yet instead of sufficiently paring back their bloated budgets, the states demanded and received a \$30 billion bailout from Washington in 2003. When government bails out irresponsible behavior, it only encourages more irresponsibility. And that is just what happened: After the 2003 bailout, states went right back to spending - with annual budget hikes averaging 7.2 percent over the next four years. Washington state increased permanent spending by a whopping 34% in four years.

Thus, another recession has brought another round of state bailout calls. How will states learn to budget responsibly if they know they can keep returning to the federal ATM?

The biggest losers from a federal bailout are the taxpayers who live in fiscally responsible states. They played by the rules and resisted extravagant new spending programs - and will be “rewarded” with higher taxes to bail out neighboring states that went on a spending spree they could not afford.

That is simply unfair. And it encourages responsible states to be less responsible next time - better to be the bailout recipient than the bailout payer. Congress should resist a bailout and instead instruct state governments to set priorities, make trade-offs and reduce their own unnecessary spending.

A Better Way

Government spending has an abysmal track record of stimulating the economy. However, these repeated failures have not stopped lawmakers from proposing and enacting a seemingly endless string of “stimulus” bills. Rather than redistributing money, lawmakers should focus on improving long-term productivity. This means reducing marginal tax rates to encourage working, saving, and investing. It also means promoting free trade, cutting unnecessary red tape and streamlining wasteful spending that all weaken the private sector’s ability to generate income and create wealth.

Finally, it means strengthening education - not just throwing money at it. Addressing long-term growth and productivity is more challenging than waving the magic wand of short-term “stimulus” spending - but a more productive economy will be better prepared to handle future economic downturns.

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