

Government Spending Is No Free Lunch

Robert J. Barro. [Wall Street Journal](#). (Eastern edition). New York, N.Y.: [Jan 22, 2009](#). pg. A.17

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Back in the 1980s, many commentators ridiculed as voodoo economics the extreme supply-side view that across-the-board cuts in income-tax rates might raise overall tax revenues. Now we have the extreme demand-side view that the so-called "multiplier" effect of government spending on economic output is greater than one - Team Obama is reportedly using a number around 1.5.

To think about what this means, first assume that the multiplier was 1.0. In this case, an increase by one unit in government purchases and, thereby, in the aggregate demand for goods would lead to an increase by one unit in real gross domestic product (GDP). Thus, the added public goods are essentially free to society. If the government buys another airplane or bridge, the economy's total output expands by enough to create the airplane or bridge without requiring a cut in anyone's consumption or investment.

The explanation for this magic is that idle resources -- unemployed labor and capital -- are put to work to produce the added goods and services.

If the multiplier is greater than 1.0, as is apparently assumed by Team Obama, the process is even more wonderful. In this case, real GDP rises by more than the increase in government purchases. Thus, in addition to the free airplane or bridge, we also have more goods and services left over to raise private consumption or investment. In this scenario, the added government spending is a good idea even if the bridge goes to nowhere, or if public employees are just filling useless holes. Of course, if this mechanism is genuine, one might ask why the government should stop with only \$1 trillion of added purchases.

What's the flaw? The theory (a simple Keynesian macroeconomic model) implicitly assumes that the government is better than the private market at marshaling idle resources to produce useful stuff. Unemployed labor and capital can be utilized at essentially zero social cost, but the private market is somehow unable to figure any of this out. In other words, there is something wrong with the price system.

John Maynard Keynes thought that the problem lay with wages and prices that were stuck at excessive levels. But this problem could be readily fixed by expansionary monetary policy, enough of which will mean that wages and prices do not have to fall. So, something deeper must be involved -- but economists have not come up with explanations, such as incomplete information, for multipliers above one.

A much more plausible starting point is a multiplier of zero. In this case, the GDP is given, and a rise in government purchases requires an equal fall in the total of other parts of GDP -- consumption, investment and net exports. In other words, the social cost of one unit of additional government purchases is one.

This approach is the one usually applied to cost-benefit analyses of public projects. In particular, the value of the project (counting, say, the whole flow of future benefits from a bridge or a road) has to justify the social cost. I think this perspective, not the supposed macroeconomic benefits from fiscal stimulus, is the right one to apply to the many new and expanded government programs that we are likely to see this year and next.

What do the data show about multipliers? Because it is not easy to separate movements in government purchases from overall business fluctuations, the best evidence comes from large changes in military purchases that are driven by shifts in war and peace. A particularly good experiment is the massive expansion of U.S. defense expenditures during World War II. The usual Keynesian view is that the World War II fiscal expansion provided the stimulus that finally got us out of the Great Depression. Thus, I think that most macroeconomists would regard this case as a fair one for seeing whether a large multiplier ever exists.

I have estimated that World War II raised U.S. defense expenditures by \$540 billion (1996 dollars) per year at the peak in 1943-44, amounting to 44% of real GDP. I also estimated that the war raised real GDP by \$430 billion per year in 1943-44. Thus, the multiplier was 0.8 (430/540). The other way to put this is that the war lowered components of GDP aside from military purchases. The main declines were in private investment, nonmilitary parts of government purchases, and net exports -- personal consumer expenditure changed little. Wartime production siphoned off resources from other economic uses -- there was a dampener, rather than a multiplier.

We can consider similarly three other U.S. wartime experiences -- World War I, the Korean War, and the Vietnam War -- although the magnitudes of the added defense expenditures were much smaller in comparison to GDP. Combining the evidence with that of World War II (which gets a lot of the weight because the added government spending is so large in that case) yields an overall estimate of the multiplier of 0.8 -- the same value as before. (These estimates were published last year in my book, "Macroeconomics, a Modern Approach.")

There are reasons to believe that the war-based multiplier of 0.8 substantially overstates the multiplier that applies to peacetime government purchases. For one thing, people would expect the added wartime outlays to be partly temporary (so that consumer demand would not fall a lot). Second, the use of the military draft in wartime has a direct, coercive effect on total employment. Finally, the U.S. economy was already growing rapidly after 1933 (aside from the 1938 recession), and it is probably unfair to ascribe all of the rapid GDP growth from 1941 to 1945 to the added military outlays. In any event, when I attempted to estimate directly the multiplier associated with peacetime government purchases, I got a number insignificantly different from zero.

As we all know, we are in the middle of what will likely be the worst U.S. economic contraction since the 1930s. In this context and from the history of the Great Depression, I can understand various attempts to prop up the financial system. These efforts, akin to avoiding bank runs in prior periods, recognize that the social consequences of credit-market decisions extend well beyond the individuals and businesses making the decisions.

But, in terms of fiscal-stimulus proposals, it would be unfortunate if the best Team Obama can offer is an unvarnished version of Keynes's 1936 "General Theory of Employment, Interest and Money." The financial crisis and possible depression do not invalidate everything we have learned about macroeconomics since 1936.

Much more focus should be on incentives for people and businesses to invest, produce and work. On the tax side, we should avoid programs that throw money at people and emphasize instead reductions in marginal income-tax rates -- especially where these rates are already high and fall on capital income. Eliminating the federal corporate income tax would be brilliant. On the spending side, the main point is that we should not be considering massive public-works programs that do not pass muster from the perspective of cost-benefit analysis. Just as in the 1980s, when extreme supply-side views on tax cuts were unjustified, it is wrong now to think that added government spending is free.

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