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Why Government Spending Does Not Stimulate Economic Growth

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In a throwback to the 1930s and 1970s, Democratic 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; and
- 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, 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.

Talking Points

- Washington has already spent hundreds of billions of dollars on economic stimulus bills that have failed to revive the economy. There is no reason to believe the next one will succeed.
- Government spending cannot be stimulative because every dollar that government spending "injects" into the economy must first be taxed or borrowed out of the economy. Rather than create new purchasing power, these policies merely redistribute existing purchasing power.
- Claims that a Department of Transportation study proved that highway spending creates jobs are based on a misreading of the study.
- Economic growth requires increasing the productivity of American workers. Lower marginal tax rates encourage productivity by increasing incentives to work, save, and invest.
- Tax rebates do not help the economy because they are government grants that are not based on encouraging productivity.

This paper, in its entirety, can be found at:
www.heritage.org/Research/Budget/bg2208.cfm

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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.[1]

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 federal 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.[2]

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

1. This originally appeared in Daniel J. Mitchell, "The Impact of Government Spending on Economic Growth," Heritage Foundation *Backgrounder* No. 1831, March 15, 2005, at *http://www.heritage.org/research/budget/bg1831.cfm*. The EU–15 consists of the 15 member states of the European Union before the 2004 enlargement: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.
2. The Federal Reserve could fund new spending by printing new money, which would only create inflation.

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.

Even when government spending improves economic growth rates on balance, it is necessary to differentiate between immediate versus future effects. There is no immediate stimulus from government spending, since that money had to be removed from another part of the economy. However, a productivity investment may aid *future* economic growth, once it has been fully completed and is being used by the American workforce. For example, spending on energy itself does not improve economic growth, yet the eventual existence of a completed, well-functioning energy system can. Those economic impacts can take years, or even decades, to occur.

Most government spending has historically *reduced* productivity and long-term economic growth due to: [3]

1. **Taxes.** Most government spending is financed by taxes, and high tax rates reduce incentives to work, save, and invest—resulting in a less motivated workforce as well as less business investment in new capital and technology. Few government expenditures raise productivity enough to offset the productivity lost due to taxes;
2. **Incentives.** Social spending often reduces incentives for productivity by subsidizing leisure and unemployment. Combined with taxes, it is clear that taxing Peter to subsidize Paul reduces both of their incentives to be productive, since productivity no longer determines one's income;
3. **Displacement.** Every dollar spent by politicians means one dollar less to be allocated based on market forces within the more productive private sector. For example, rather than allowing the market to allocate investments, politicians seize that money and earmark it for favored organizations with little regard for improvements to economic efficiency; and
4. **Inefficiencies.** Government provision of housing, education, and postal operations are often much less efficient than the private sector. Government also distorts existing health care and education markets by promoting third-party payers, resulting in over-consumption and insensitivity to prices and outcomes. Another example of inefficiency is when politicians earmark highway money for wasteful pork projects rather than expanding highway capacity where it is most needed.

Mountains of academic studies show how government expansions reduce economic growth:[4]

- *Public Finance Review* reported that "higher total government expenditure, no matter how financed, is associated with a lower growth rate of real per capita gross state product."[5]
- The *Quarterly Journal of Economics* reported that "the ratio of real government consumption expenditure to real GDP had a negative association with growth and investment," and "growth is inversely related to the share of government consumption in GDP, but insignificantly related to the share of public investment."[6]
- A *Journal of Macroeconomics* study discovered that "the coefficient of the additive terms of the government-size variable indicates that a 1% increase in government size decreases the rate of economic growth by 0.143%."[7]
- *Public Choice* reported that "a one percent increase in government spending as a percent of

3. This list was influenced by Daniel J. Mitchell, "The Impact of Government Spending on Economic Growth."
4. These studies were originally cited in *ibid*. Many more studies can be found in the supplemental appendix to that paper, at *http://www.heritage.org/Research/Budget/bg1831_suppl.cfm*.
5. S. M. Miller and F. S. Russek, "Fiscal Structures and Economic Growth at the State and Local Level," *Public Finance Review*, Vol. 25, No. 2 (March 1997).
6. Robert J. Barro, "Economic Growth in a Cross Section of Countries," *Quarterly Journal of Economics*, Vol. 106, No. 2 (May 1991), p. 407.

GDP (from, say, 30 to 31%) would raise the unemployment rate by approximately .36 of one percent (from, say, 8 to 8.36 percent)."[8]

Economic growth is driven by individuals and entrepreneurs operating in free markets, not by Washington spending and regulations. The outdated idea that transferring spending power from the private sector to Washington will expand the economy has been thoroughly discredited, yet lawmakers continue to return to this strategy. The U.S. economy has soared highest when the federal government was shrinking, and it has stagnated at times of government expansion. This experience has been paralleled in Europe, where government expansions have been followed by economic decline. A strong private sector provides the nation with strong economic growth and benefits for all Americans.

Three Applications of the Spending Fallacy

The myth of government spending stimulus is often found in debates over tax rebates (which function similar to government spending), highway spending, and federal bailouts of states.

1) Why Tax Rebates Do Not Stimulate

The debate on taxes and economic growth is also clouded with confusion. By asserting that tax cuts spur economic growth by "putting spending money in people's pockets," many tax cutters commit the same fallacy as do government spenders. Similar to government spending, the money for tax cuts does not fall from the sky. It comes out of investment and net exports if financed by budget deficits or government spending if offset by spending cuts.

However, the right tax cuts can add substantially to productivity. As stated above, economic growth requires that businesses produce increasing amounts of goods and services, and that requires consistent business investment and a growing, productive workforce. Yet high marginal tax rates—defined as the tax on the next dollar earned—create a disincentive to engage in those activities. Reducing marginal tax rates on businesses and workers will increase incentives to work, save, and invest. These incentives encourage more business investment, a more productive workforce by raising the after-tax returns to education, and more work effort, all of which add to the economy's long-term capacity for growth.

Thus, not all tax cuts are created equal. The economic impact of a tax cut is measured by the extent to which it alters behavior to encourage productivity.

Tax rebates fail to increase economic growth because they are not associated with productivity or work effort. No new income is created because no one is required work, save, or invest more to receive a rebate. In that sense, rebates are economically indistinguishable from government spending programs that write each American a check. In fact, the federal government treats rebate checks as a "social benefit payment to persons."[9] They represent another feeble attempt to create new purchasing power out of thin air.

Consider the 2001 tax rebates. Washington borrowed billions from the capital markets, and then mailed it to Americans in the form of $600 checks. Rather than encourage income creation, Congress merely transferred existing income from investors to consumers. Predictably, the following quarter saw consumer spending growth surge from 1.4 percent to 7.0 percent, and gross private domestic investment spending drop correspondingly by 22.7 percent[10] The overall economy grew at a meager 1.6 percent that quarter, and remained stagnant through 2001 and much of 2002.

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7. James S. Guseh, "Government Size and Economic Growth in Developing Countries: A Political-Economy Framework," *Journal of Macroeconomics*, Vol. 19, No. 1 (Winter 1997), pp. 175–192.
8. Burton Abrams, "The Effect of Government Size on the Unemployment Rate," *Public Choice*, Vol. 99 (June 1999), pp. 3–4.
9. Frequently Asked Questions, Bureau of Economic Analysis, Department of Commerce, at *http://faq.bea.gov/cgi-bin/bea.cfg/php/enduser/std_adp.php?p_faqid=490* (November 7, 2008).
10. These growth rates are annualized. See U.S. Commerce Department, Bureau of Economic Analysis, NIPA Tables, Table 1.1.1, at *http://www.bea.gov/bea/dn/nipaweb/SelectTable.asp* (November 7, 2008). Consumption and investment spending changed by similar dollar amounts, but because investment spending begins at a lower base figure, its percentage change is larger.

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It was not until the 2003 tax cuts—which cut tax rates for workers and investors— that the economy finally and immediately began a robust recovery. In the previous 18 months, business investment had plummeted, the stock market had dropped 18 percent, and the economy had lost 616,000 jobs. In the 18 months following the 2003 tax rate reductions, business investment surged, the stock market leaped 32 percent, and Americans created 307,000 new jobs (followed by 5 million jobs in the next seven quarters).[11] Overall economic growth rates doubled.[12]

Marginal tax rates were reduced throughout the 1920s, 1960s, and 1980s. In all three decades, investment increased, and higher economic growth followed. Real GDP increased by 59 percent from 1921 to 1929, by 42 percent from 1961 to 1968, and by 31 percent from 1982 to 1989.[13]

Yet in a triumph of hope over experience, lawmakers embraced tax rebates over rate reductions again in early 2008. While the economic data are still coming in, it is clear that once again the rebates failed to support economic growth. There is no reason to expect another round of tax rebates to be any more effective.[14]

2) Highway Spending: The Myth of the 47,576 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.[15]

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."[16] 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.

11. U.S. Commerce Department, Bureau of Economic Analysis, NIPA Tables, Table 1.1.1; Yahoo Finance, "S&P 500 Index," at *http://www.finance.yahoo.com/q/hp?s=%5EGSPC* (November 7, 2008); and U.S. Department of Labor, Bureau of Labor Statistics, "Employment, Hours, and Earnings from the Current Employment Statistics Survey (National)."
12. For more on the Bush tax cuts, see Brian M. Riedl, "Ten Myths About the Bush Tax Cuts," Heritage Foundation *Backgrounder* No. 2001, January 29, 2007, at *http://www.heritage.org/Research/Taxes/bg2001.cfm*.
13. See Daniel J. Mitchell, "Lowering Marginal Tax Rates: The Key to Pro-Growth Tax Relief," Heritage Foundation *Backgrounder* No. 1443, May 22, 2001, at *http;//www.heritage.org/Research/Taxes/BG1443.cfm*.
14. Because pro-growth tax cuts are not designed simply to "put money in people's pockets," their proponents do not focus on whether recipients are rich or poor. Tax relief policies should be designed to maximize long-run economic growth, which in turn raises incomes across the board. Thus, raising marginal tax rates on "the wealthy" to finance tax rebates from low-income families may satisfy a redistributive agenda, but it would also reduce economic growth and eventually lower incomes across the board. It is better for everyone to reduce tax rates across the board and encourage all Americans to work, save, and invest.
15. Much of this analysis originally appeared in Ronald D. Utt, "More Transportation Spending: False Promises of Prosperity and Job Creation," Heritage Foundation *Backgrounder* No. 2121, April 2, 2008, at *http://www.heritage.org/Research/budget/bg2121.cfm*.
16. *Ibid.*

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*."[17] 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.[18]

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.[19] 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 then pork), and that those future productivity benefits will outweigh the lost productivity from raising future tax rates to finance the project.[20]

3) 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 with balanced-budget requirements. But nobody forced these states to enact balanced-budget requirements, which they are free to repeal. It is disingenuous for a state to enact a balanced-budget amendment, and then demand that Washington bail it out of the consequences of its own policy.

Congress already sends $467 billion to state and local government every year—up 29 percent after inflation since 2000.[21] 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

17. "Employment Impacts of Highway Infrastructure Investment," Department of Transportation, Federal Highway Administration, April 7, 2008. (Emphasis in original.) Report no longer appears on DOT Web site. Contact author for original PDF file.
18. David J. Cantor, "Highway Construction: Its Impact on the Economy," Congressional Research Service *Report for Congress* No. 93–21E, January 6, 1993.
19. U.S. General Accounting Office, *Emergency Jobs Act of 1983: Funds Spent Slowly, Few Jobs Created*, GAO/HRD–87–1, December 1986, at *http://archive.gao.gov/f0102/132063.pdf* (November 7, 2008).
20. Alternatively, the project could be financed by borrowing. However, long-term economic growth requires that the government obtain a higher return on its investment than the private sector would have with those funds.

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mandates. (No Child Left Behind is neither unfunded nor mandated.)[22] State health, education, and transportation programs remain heavily subsidized by Washington.

Because states are so dependent on income tax revenues—which are volatile—common sense says to build rainy-day funds during booms to cushion the inevitable recessions. Instead, states keep responding to *temporary* revenue surges with new *permanent* spending programs. Between 1994 and 2001, states flush with new revenues shunned rainy-day funds and instead expanded their general fund budgets by 6.2 percent annually.[23]

All booms eventually end, and these 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.[24] Rainy-day funds were expanded, although not nearly by enough. 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 unnecessary spending. States that insist on deficit spending should reform their own balanced-budget laws rather than demand that Washington borrow for them. Finally, any federal aid to state governments should come in the form of loans to be repaid in full, with interest, within three years.

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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21. U.S. Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009* (Washington, D.C.: U.S. Government Printing Office, 2008), p. 113, Table 8.3, at *http://www.whitehouse.gov/omb/budget/fy2009/pdf/spec.pdf* (November 7, 2008).
22. U.S. Congressional Budget Office, "A Review of CBO's Activities in 2007 Under the Unfunded Mandates Reform Act," March 2008, Appendix C, pp. 55–56, at *http://www.cbo.gov/ftpdocs/90xx/doc9068/03-31-UMRA.pdf* (November 7, 2008).
23. National Association of State Budget Officers, "Fiscal Survey of the States," June 2008, p. 4 at *http://www.nasbo.org/Publications/PDFs/Fiscal%20Survey%20of%20the%20States%20June%202008.pdf* (November 7, 2008).
24. *Ibid.*