



Dow Jones Reprints: This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit www.djreprints.com

See a sample reprint in PDF format.

Order a reprint of this article now

THE WALL STREET JOURNAL

WSJ.com

OPINION | JANUARY 22, 2009

Government Spending Is No Free Lunch

Now the Democrats are peddling voodoo economics.

By ROBERT J. BARRO

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 Opinion Journal Widget

Download Opinion Journal's widget and link to the most important editorials and op-eds of the day from your blog or Web page.

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.

In Today's Opinion Journal

REVIEW & OUTLOOK

[Obama and Guantanamo](#)

[Geithner's Tax Code](#)

[Silencing Islam's Critics](#)

TODAY'S COLUMNISTS

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

Wonder Land: Obama at History's 'Hinge Point'
– Daniel Henninger

individuals and businesses making the decisions.

COMMENTARY

Bush Was Right When It Mattered Most
– Karl Rove

A 'Bad' Bank Can Solve Our Problems
– David Roche

Conservatives Have Answered Obama's Call
– Arthur C. Brooks

Zimbabwe Could Use Some U.S. Attention
– Roger Bate

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.

Mr. Barro is an economics professor at Harvard University and a senior fellow at Stanford University's Hoover Institution.

Please add your comments to the [Opinion Journal forum](#).

Printed in The Wall Street Journal, page A17

Copyright 2009 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our [Subscriber Agreement](#) and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com

Philip Lowe backs government spending but warns against the Reserve Bank creating money, saying "there is no free lunch". Government must do what it can to limit the damage to the fabric of our society and to people's lives that is caused by a long spell of unemployment caused by the Covid-19 crisis, RBA chief Philip Lowe says. Photograph: Joel Carrett/AAP. Government must do what it can to limit the damage to the fabric of our society and to people's lives that is caused by a long spell of unemployment caused by the Covid-19 crisis, RBA chief Philip Lowe says. Photograph: Joel Carrett/AAP Recent data on public spending also shows that governments around the world often rely on the private sector to produce and manage goods and services. In the first period, until the First World War, spending was generally low. In the US, for example, total government expenditure accounted for less than 2% of national income until 1916. These low levels of public spending were just enough for governments to be concerned with basic functions, such as maintaining order and enforcing property rights. In the second period, between 1915-1945, public spending was generally volatile, particularly for countries that were more heavily involved in the First and Second World Wars. "The reality, though, is there is no free lunch. The tab always has to be paid and it is paid out of taxes and government revenues in one form or another." Dr Lowe explained that if the central bank bought government bonds it would have to credit the government's bank account held with the RBA and then pay interest on the government's money held there like any bank would. "It certainly is possible for the central bank to change when and how the spending is paid for, but it is not possible to put aside the government's budget constraint permanently." Government spending tends to be unproductive and perpetually funded with debt. The cumulative effect of the obsession to increase GDP with deficit spending is shown below. As a percentage of GDP, federal debt has tripled over the past 40 years. More recently, deficit spending exploded higher in the wake of the Great Recession of 2008-09.