



Does the Economy Need More Spending Now?

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In a recent *Wall Street Journal* opinion article, Alan Blinder suggested the economy needs more spending now and recommended tax cuts and more public spending (i.e., larger federal deficits).¹ Blinder suggests that “reducing the budget deficit probably hurts growth in the short run but helps it in the long run.” This essay discusses some potential short- and long-run effects of increased deficit spending and suggests the case for additional deficit spending is weak because the short-run effect on output is uncertain and temporary, while the long-run effect on economic growth is negative.

Additional deficit spending need not increase output for two reasons. First, increased deficit spending increases the supply of bonds, which reduces bond prices and increases real bond yields. Higher real bond yields reduce consumption and investment spending. Consequently, additional deficit spending can crowd out private spending, so the net increase in demand would be less than the increase in the deficit.

Second, deficit spending may not affect private spending because of Ricardian equivalence, named after the classical economist, David Ricardo. The basic premise is that current tax cuts must be paid for with future tax increases in order to repay the additional debt incurred today. Consequently, people save the additional income arising from the tax cut rather than spending it. Thus, there is no change in household spending in response to the current tax cut. For either of these reasons, the response of total output to the increased deficit will be zero or very small.

In addition to concerns about the extent to which deficit spending crowds out private spending is the fact that any increase in output is temporary: Increased deficit spending can have no permanent effect on output. In short, government debt cannot be considered net wealth by all U.S. households. If it could be, then we could all become infinitely wealthy simply by incurring an infinite amount of debt. Just as with fiat money, you cannot simply print your way to long-run prosperity.

Assessing the benefits of additional deficit spending is further complicated by the likelihood that deficit spending

reduces economic growth. Additional deficit spending reduces economic growth by crowding out capital investment. A smaller stock of capital means less future output. This is an intergenerational transfer: People today get more output, while those in the future get less. It seems likely that such a loss of future output could easily swamp any (temporary) increase in current output. Future output gains associated with a larger capital stock accrue over a long period of time, while the increased output associated with additional deficit spending is short-lived.²

Economic growth requires more labor, more and better capital, and up-to-date technology—what might be collectively referred to as *social infrastructure*—to support entrepreneurship and efficient markets. It is hardly surprising that periods of more-rapid economic growth include invention, innovation, new methods of production (e.g., the assembly line, robotics), and entrepreneurship.

Some economists and policymakers argue the negative effect on growth can be offset if the deficit spending is used to improve the infrastructure—roads, bridges, and so forth—because such capital spending increases productivity. This conjecture is at odds with experience: Japan has spent massive amounts on infrastructure with no noticeable effect on economic growth, while China is building new cities with few inhabitants. Infrastructure spending can facilitate economic growth, but only when it is driven by economic forces. However, the crowding out of productive private capital by additional deficit spending on unproductive public capital will do nothing to stimulate economic growth.

The previous analysis suggests why it is difficult to make the case for additional deficit spending. The positive effect on output is problematic and temporary, while the negative effect on economic growth is long-lived. Hence, if one believes that the effect of additional deficit spending on output is temporary and potentially capable of reducing economic growth, it is hard to argue for additional deficit spending. Blinder acknowledges both these points, but nevertheless suggests that additional deficit spending is desirable. Perhaps he really does not believe increased spending has a negative effect on growth. I mention this because in noting that the short-run output is demand-determined, Blinder writes

The big question is how much of the economy's productive capacity is used. And that depends on the strength of demand—the willingness of businesses, consumers, foreign customers, and governments to buy what American businesses are able to produce. When demand falls short of supply, deficit reduction *hampers economic growth* by reducing demand even further.

An analogy to private companies works here. Firms grow their capacity by building capital, hiring more workers, innovating and improving the efficiency of their operations. But if customers don't show up, all that effort may go for naught. (emphasis added)

This sounds quite different from saying the effect of additional deficit spending on output is temporary and has a negative effect on economic growth. Indeed, Blinder seems to suggest that by increasing demand now, firms will invest more in capital, innovate more, and improve efficiency—all of which should spur economic growth. The idea that more will be produced if more is demanded is easy to understand. The belief that additional deficit spending will somehow cure the current problems—an unusually slow rate of output growth and an unusually high rate of unemployment—by stimulating innovation and capital spending is not.

I believe a better understanding of the role of supply in both the short and long runs is needed. Most output is produced before it is sold. Many products are produced before the producer knows there will be sufficient demand or the public knows they really want it. For example, consider the continued demand for electricity, automobiles, computers, and smart phones—the list is endless. Economic growth requires more labor, more and better capital, and up-to-date technology—what might be collectively referred to as *social infrastructure*—to support entrepreneurship and efficient markets. It is hardly surprising that periods of more-rapid economic growth include invention, innovation, new methods of production (e.g., the assembly line, robotics), and entrepreneurship.

Strong economic growth generates higher levels of income—wages, rents, interest, and profits. Consequently, it is not surprising that periods of rapid growth are also accompanied by high demand. The fact that output can be conveniently decomposed by those who purchased it—the public (consumption), firms (investment), governments, and foreigners (net exports)—does not necessarily mean that output can be increased by government actions designed to increase any of these components. ■

Notes

¹ Blinder, Alan S. "The Economy Needs More Spending Now." *Wall Street Journal*, July 8, 2013, p. A17.

² For details on how this calculation is made in the context of determining the optimal rate of inflation, see Thornton, Daniel L. "The Costs and Benefits of Price Stability: An Assessment of Howitt's Rule." *Federal Reserve Bank of St. Louis Review*, March/April 1996, 78(2), pp. 23-38; <http://research.stlouisfed.org/publications/review/96/03/9603dt.pdf>.