

Government Spending Is No Free Lunch

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Multiplier effect

- Team Obama: effect of government spending on economic output is greater than one, 1.5
- If it is 1.0, then an increase by one unit in government purchases would lead to an increase by one unit of GDP
- In other words, as government purchase increases, private consumption and investment will be the same

Explanation

- 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, then, in addition to the free airplane or bridge, we also have more goods and services left over to raise private consumption or investment.

A simple Keynesian model

- The simple Keynesian model implicitly assumes that the government is better than the private market at marshaling idle resources to produce useful stuff
- The private market is somehow unable to figure any of this out. In other words, **there is something wrong with the price system**

What is wrong?

- John Maynard Keynes: wages and prices that were stuck at excessive levels
- Not a good explanation, but economists have not come up with explanations, such as incomplete information, for multipliers above one.

A multiplier of zero

- 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
- A cost-benefit analysis of public projects

- World War II: **the multiplier was 0.8**
- The main declines were in private investment, nonmilitary parts of government purchases, and net exports – personal consumer expenditure changed little
- there was a dampener, rather than a multiplier
- The multiplier associated with peacetime government purchases is about **zero**

What should be done?

- Focus on incentives for people and businesses to invest, produce and work
- For example: Reduce 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”
- Avoid massive public-works programs that do not pass muster from the perspective of cost-benefit analysis