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Spending Is Not Stimulus: Bigger Government Did Not Work for Bush, and It Will Not Work for Obama

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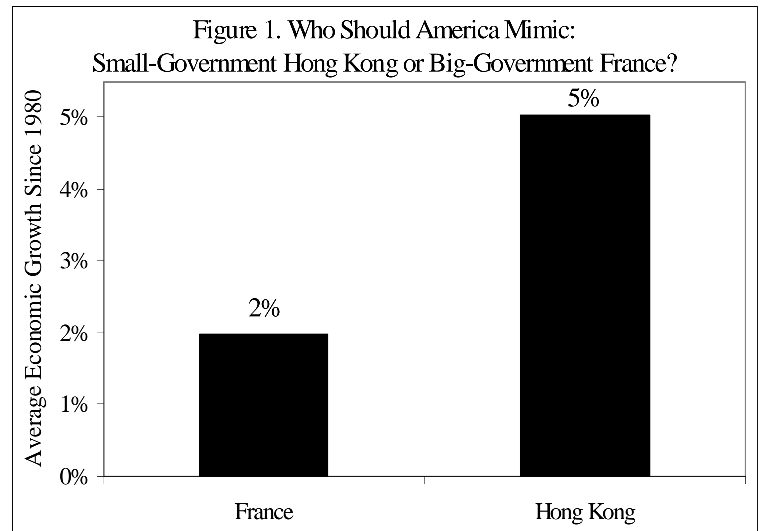
During the Bush years, so-called stimulus legislation based on "Keynesian" theory was enacted in both 2001 and 2008.[1] It was hoped that putting money in people's pockets would lead to more consumer spending and thus give the economy a positive jolt. Those episodes of Keynesian policy were ineffective, but that has not dimmed enthusiasm for the approach. The Obama economic team is pushing a similar approach, but on a much bigger scale—more than $800 billion of new spending and temporary tax cuts, a figure that climbs above $1 trillion when interest costs are included. And that may be just the starting point since the promise of additional spending has set off a feeding frenzy on Capitol Hill.

Doing more of a bad thing is not a recipe for growth. Government spending generally is a burden on the economy. Whether financed by debt or taxes, government spending requires a transfer of money from the productive sector of the economy. Moreover, most forms of government spending result in the misallocation of labor and capital, causing even further damage.

Although many factors influence economic performance, the negative impact of government spending is one reason small-government jurisdictions such as Hong Kong have higher growth rates than nations that have medium-sized government, such as the United States. The same principle explains in part why the United States enjoys faster average growth than a big-government country such as France. Figure 1 shows average economic growth rates in France and Hong Kong since 1980.

Ironically, John Maynard Keynes might not be a Keynesian if he were alive today. He certainly would not be a proponent of big government. In correspondence with another British economist, he agreed with the premise of "25 percent [of GDP] as the maximum tolerable proportion of taxation."[2] America is now well past that stage and a



Source: Author's calculations based on International Monetary Fund data.

further expansion of government will make the United States more like a stagnant, European-style welfare state.

The Case against Keynesian Theory

During the 1930s, Keynes and his disciples argued that the economy could be boosted if the government borrowed money and spent it. According to the theory, this new spending would put money in people's pockets, and the recipients of the funds would then spend the money and "prime the pump" as the money began circulating through the economy. The Keynesians also said that some tax cuts—particularly lump-sum rebates—could have the same impact since the purpose is to have the government borrow and somehow put the money in the hands of people who will spend it.

Keynesian theory suffers from a rather glaring logical fallacy. It overlooks the fact that, in the real world, government can't inject money into the economy without

first taking money out of the economy. Any money that the government puts in the economy's right pocket is money that is first removed from the economy's left pocket. There is no increase in what Keynesians refer to as aggregate demand since every dollar that is spent on a stimulus package is a dollar that the government first must borrow from private credit markets. Keynesianism doesn't boost national income, it merely redistributes it.

Keynesian Economics: A Track Record of Failure

Real-world evidence does not support the Keynesianism perspective. In his four years, Herbert Hoover increased taxes dramatically, including a boost in the top tax rate from 25 percent to 63 percent. He imposed harsh protectionist policies. He significantly increased intervention in private markets. Most importantly, at least from a Keynesian perspective, he boosted government spending by 47 percent in just four years. And he certainly had no problem financing that spending with debt. He entered office in 1929, when there was a surplus, and he left office in 1933 with a deficit of 4.5 percent of GDP.[3]

Unfortunately, other than being a bit more reasonable on trade, Roosevelt followed the same approach. The top tax was boosted to 79 percent and government intervention became more pervasive. Government spending, of course, skyrocketed—rising by 106 percent between 1933 and 1940. This big-government approach didn't work for Roosevelt any better than it did for Hoover. Unemployment remained very high, averaging more than 17 percent throughout the 1930s, and overall output did not get back to the 1929 level until World War II. According to recent research by economists at UCLA, New Deal policies extended the Depression by seven years.[4]

Other Keynesian episodes generated similarly dismal results, though fortunately never as bad as the Great Depression. Gerald Ford did a Keynesian stimulus focused on tax rebates in the mid-1970s. The economy did not improve. But why would it? After all, borrowing money from one group and redistributing it to another does nothing to increase economic output. As mentioned above, George W. Bush gave out so-called rebate checks in 2001 and 2008, yet there was no positive effect either time. And he certainly was a big spender, yet that didn't work either.

International evidence also undermines the case for Keynesianism. The clearest example may be Japan, which throughout the 1990s tried to use so-called stimulus packages in an effort to jump-start a stagnant economy. But the only thing that went up was Japan's national debt, which more than doubled during the decade and is now even far more than Italy's when measured as a share of GDP. The Japanese economy never recovered, and the 1990s are now known as the "lost decade" in Japan.

Conclusion

Many factors influence economic performance. Monetary policy, trade policy, taxation, labor markets, property rights, and competitive markets all have some impact on an economy's performance. But one of the key variables is government spending. Once government expands beyond the level of providing core public goods such as the rule of law, there tends to be an inverse relationship between the size of government and economic growth. This is why reducing the size and scope of government is one of the best ways to improve economic performance. Unfortunately, policy moved in the wrong direction during the Bush years, and proposals for so-called stimulus indicate a continuation of those failed policies during the Obama years.

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1. John Maynard Keynes, *The General Theory of Employment, Interest and Money* (Amherst, New York: Prometheus, 1997).
2. Vito Tanzi and Ludger Schuknecht, *Public Spending in the 20th Century: A Global Perspective* (Cambridge, England: Cambridge University Press, 2000).
3. Office of Management and Budget, *Budget of the United States Government, FY 2009, Historical Tables*, February 2008.
4. Lee E. Ohanian and Harold Cole, "New Deal Policies and the Persistence of the Great Depression: A General Equilibrium Analysis," *Journal of Political Economy* (forthcoming).