Does government spending help or hurt our economy?

Most goods and services are more efficiently produced by private firms. However, there are many “public goods” that the private sector fails to provide well, but are important to both the economy and society. These public goods may include roads, ports, bridges, schools, national defense, courts, police, firefighters, bank auditors, cloud seeders, and even a social safety net. If the benefit to us is greater than the cost, then it makes sense for government to ensure these public goods are available. Government can either buy these goods from the private sector or provide them directly. Even though government agencies may not always be run well by the politicians who manage them, economies that don’t deliver these public goods fail to prosper.

Most economists think of the relationship between the size of government and the growth of the economy as an inverted-U. At the extremes, you have Somalia or Haiti without a functional government, and the now-deceased Soviet Union that had no functioning private sector. Economic development is most successful somewhere in between. Compared to other developed countries, our government is relatively small. While the political left and right squabble over whether the optimal level is more or less than our current amount, others try to look at what the statistical evidence tells us.

When looking at the overall level of government spending, macroeconomists once thought the effect was clearly positive. They theorized that when government spent more, those who provided these goods and services made more money, and in turn, they would spend more on goods and services provided by others. Tax cuts provided a similar, if smaller, effect.

Economists today are now more skeptical. Many claim that government spending often “crowds out” private spending, especially when unemployment rates are low and markets are functioning reasonably well. If government gets its spending money from taxpayers, then private households have less for their own consumption, and so the public goods need to be worth it. If government still spends while cutting taxes, then it has to cover the deficit by borrowing from capital markets, leaving less for the private sector. This increases real interest rates and reduces private investment.

If the deficit is instead financed with lending from the central bank, new money is created, resulting in inflation if the money supply grows faster than the money demanded by the needs of the real economy. If the deficit is financed by borrowing from abroad, then exports fall instead, as every dollar a foreigner lends us is a dollar they do not spend on our goods. That borrowing is why we have a huge trade deficit, and it won’t turn around until we start paying back what we owe.

Good policy, then, means taxing ourselves enough to pay for the public goods that we think benefit us. In the long run, the overall deficit should be no more than enough to finance a small increase in money supply that just meets the demands of a growing economy.

But extraordinary things happen sometimes, and private markets can function badly. Balancing the government’s budget in such times can make things much worse. In good times, government should save with budget surpluses, and pay down its debt. In bad times like these, we can then more easily borrow to keep providing those public goods, and keep spending in the private sector to keep from spiraling ever downward.

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