Commentary: When recessions or depressions hit, fiscal policy can determine future

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Does government spending help or hurt our economy?

Most goods and services are more efficiently produced by the private sector, but there are many “public goods” that the private sector fails to provide well but are nonetheless important to both the economy and society. These public goods may include roads, ports, bridges, schools, the military, courts, the police, fire fighters, bank auditors, cloud seeders, and even a social safety net. If the benefit to us all 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 are not always run that well by the politicians who manage them, nonetheless 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) with no functioning government, and the now deceased Soviet Union with no functioning private sector. Economic development is most successful somewhere in between.

In addition, the overall level of government spending may matter for the rest of the economy. Fifty years ago, macroeconomists thought the effect was clearly positive. When government spent more, this led to higher incomes for those who provided those goods and services, and in turn they would spend more on goods and services provided by others. Tax cuts provided a similar, if smaller, effect.

Economists are now more skeptical. 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 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 instead the deficit is financed with lending from the central bank, new money is created, with inflation the result if money supply grows faster than the money demanded by the needs of the real economy. If the deficit if 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 which 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 sometimes extraordinary things happen, and private markets can function badly. Balancing the government’s budget in such times can make things much worse. In good times, then, 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 from spiraling ever downward.

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