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RESEARCH SUMMARY

The Trouble with Keynesian Stimulus Spending

For more than 70 years, a strand of Keynesian economic thought—the belief that economic growth can be achieved through increased, short-term government spending—has maintained that the cure for economic depressions is a matter of simple arithmetic. Economist Paul Krugman argues that the government can use a multiplier formula to calculate the amount by which to increase spending. Moreover, Keynesians assert that even wasteful government spending can be desirable, since any spending is better than nothing.

In "The Trouble with Keynesian Stimulus Spending," Tony Caporale and Marc Poitras disagree with this assertion. This simple Keynesian approach fails to account for several significant sources of cost. Besides the cost of waste inherent in government spending, financing the spending requires taxation, which entails an excess burden, the reduction in output resulting from workers' reduced incentive to work. Furthermore, the employment of even previously idle resources involves lost opportunities to invest in alternative uses of these resources.

BACKGROUND

Economist Kevin Murphy made one of the first attempts to challenge this Keynesian way of thinking using a formal benefit-cost analysis. Murphy identified three main sources of costs:

- The inefficiency of government: the possibility that the public receives less than full value for each dollar spent by the government.
- The relative value of idle resources: the sacrifices associated with employing resources that could have been employed differently.
- The excess burden of taxation required to pay for the spending.

On the basis of his analysis, Murphy concluded that stimulus purchases by the government are unlikely to add value to the economy.

A similar but more detailed benefit-cost analysis subsequently suggested that government purchases, at least during a deep recession, could create positive value. The problem with this analysis was that the only costs the model considered were the negative effects of taxation.

STUDY DESIGN

Caporale and Poitras's study subjects the Keynesian stimulus spending method to a benefit-cost test that expands on Murphy's model: it accounts for waste, the value of workers' time, wear and tear on capital, and the deadweight loss of taxation. It relaxes Murphy's constraint that the multiplier can be no greater than one. This model was calibrated by surveying the published estimates of key parameters, including the Keynesian fiscal multiplier.

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RESULTS

The benefit-cost test yields two important insights into Keynesian spending programs:

- Waste and other costs can negate the benefits of stimulus spending, even in an ideal Keynesian situation (a deep recession with 0 percent interest rates). Even for an efficient spending package that is free of waste, the net wealth created amounts to only about one-quarter of the measured increase in GDP.
- Pressuring the government to perform while "the economy is reeling" will result in the government not spending wisely. To generate wealth from spending packages, the government must limit waste and provide services that the public values. This means the government would need to invest a lot of time coming up with an efficient plan, by which point the economy could already be on the rebound.

CONCLUSION FOR POLICYMAKERS

It is wrong to say that "spending is spending" or that any spending is better than nothing. How the government spends stimulus money does matter. The government should spend taxpayer money carefully on projects that offer real value to the public. There is no justification for spending for spending's sake, even during a deep recession.