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Why Government Spending Does Nothing for Jobs

By: Caroline Baum – June 20, 2013

While most economists and policy makers are focusing on the International Monetary Fund's epiphany on the perils of austerity, some researchers at the IMF have offered another take on the fiscal-policy debate. They found that less is more, even when it comes to the size and scope of government.

Such findings are hardly new. But you would never know it from the debate being waged on the op-ed pages of daily newspapers and on columnists' blogs. The impression one gets from reading them is that fiscal austerity is ill-advised while more government spending -- timely, targeted and temporary -- is a costless way to boost economic growth.

The authors of a June 2013 IMF working paper, "Does Public-Sector Employment Fully Crowd Out Private-Sector Employment?," answer in the affirmative. After examining data from both developing and advanced economies, Alberto Behar and Junghwan Mok find that a public-sector job comes at the expense of a private-sector job. In other words, paying someone to dig holes and fill them up doesn't reduceunemployment.

Today's proponents of increased government spending aren't necessarily arguing for hiring more government workers, whose ranks have been diminished over the last four years. They do want the federal government to provide some extra oomph to an economy that is barely eking out 2 percent growth four years after the recession ended.

Another dose of stimulus is both unnecessary and counterproductive in the medium and long term. There seems to be widespread agreement -- among academics and economists at the IMF, European Central Bank, World Bank and Organization for Economic Co-operation and Development, if not among the policy setters themselves -- that government spending has a sizeable negative impact on growth.

Say What?

What?, you say. That was my reaction, too, before I read some recent papers from those institutions referenced by Cato Institute Senior Fellow Daniel Mitchell on his blog. "There are lots of studies outlining the reasons government spending has a negative effect on growth," he said in a telephone interview.

For example, an overpaid civil service distorts the wage structure and has to be financed by higher taxes, he said. Or it bids up the price of labor in the private sector, which makes employers reluctant to hire.

Not all government spending is created equal. An ECB working paper found that public wages, interest payments, subsidies and government consumption had a negative effect on growth, while spending on education and health was a positive, enhancing the quality of the workforce and its productivity.

This shouldn't be hard to understand. Simple arithmetic will suffice. If the government wants to spend money, it has three means at its disposal: taxation, borrowing and inflation. The third is the province of the central bank, so let's deal with Nos. 1 and 2 first.

If the government takes a dollar from A in taxes to give to B, even Keynesians can understand that it's a wash in terms of aggregate demand. Yes, B may have a higher propensity to consume, but he also may be in no position to do it because of a prior debt binge. Viewed from the supply side -- from the disincentives they create to work, invest and save -- higher tax rates are a negative.

What about borrowing from A to give to B? Again, it's a wash because A would have done something else with his savings. Which brings us to what Mitchell says is the crux of the argument: What is the most efficient way to allocate labor and capital in an economy?

Anyone who has watched the videos of Internal Revenue Service employees learning line dancing at one of their taxpayer-funded retreats should get the correct answer on first try.
Strike Out

That doesn't mean government spending is never justified. Even Milton Friedman acknowledged that the Great Depression was one of those cases where it was. He stressed that, in general, the benefits accrue to the recipients of government largess, not the economy overall.

It was refreshing to learn that other academics have come around to the view that in the intermediate and long term, a larger government inhibits growth. The short run is still up for grabs. One of the reasons is the way government spending is accounted for in gross domestic product, according to Veronique de Rugy, a senior fellow at George Mason University's Mercatus Center in Arlington, Virginia.

As she explains it, if a private employer hires his deadbeat nephew and pays him $40,000 a year to do nothing, there will be no effect on GDP until he produces something. Alternatively, if the government hires the same deadbeat at the same salary, that spending will add, dollar for dollar, to GDP.

In the same way, cuts in government spending affect GDP on paper, even if there is no real-world effect. Often it takes time, but those resources are reallocated to the private sector, which uses them more efficiently.

Before you label me heartless, I should add that this discussion has been confined to the economic impact of government spending, not its moral obligation to help the truly needy, on which I am a sap.

Last but not least is inflation, or the creation of more money by the Federal Reserve. The Fed can do that on its own. It doesn't need to finance new government spending to

increase the money stock. What looks like stimulus from fiscal policy is really monetary accommodation, Friedman said.

That's strike three for government spending. It didn't stop the IMF from advising the U.S. to adopt a more "gradual and balanced approach" to fiscal consolidation, including repealing the automatic spending cuts. Maybe the IMF pooh-bahs should take a look at the work the staff is producing.