

Can We Spend Our Way Out of a Recession?  
The View from a Skeptic

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Recessions are surely bad things to be avoided. And one hopes that government policy makers take the appropriate steps to do so. Lately we have been hearing from a lot of folks, both inside and outside of Washington, about the importance of increased deficit spending by the government to pull the economy out of its doldrums. We are told of the near unanimity of economists that share this view. However, this is one economist who does not. And let me assure you, despite what you may read, that there are plenty of respectable economists who join me in my skepticism. Everyone shares the view that it is important to get the economy out of recession. The disagreement is on the means to accomplish it. Frankly, present policy plans cause me a good deal of consternation, with proposals to ramp up spending and deficits to such levels that leave me wondering whether the “cure” is worse than the disease.

Much of our present economic problems can be traced, to a substantial degree, to the difficulties in the housing, mortgage, and financial markets. The realization that a lot of bad mortgage debt was written sent mortgage-backed securities south, followed by other financial instruments, and leaving in their trail lower housing prices, looming foreclosures, and shaky financial firms. Individuals and firms need to do a lot of adjusting of their spending, saving, and investment patterns in the face of the new realities, yet there is still a great deal of uncertainty to be resolved about what those new realities in fact are.

Thus, it is not surprising that households are being cautious and reducing consumption. Reduced consumption generally leads to more saving, which ends up being loaned to firms to make investments. But firms are presently unsure of what to invest in due to the uncertainty they face, so investment spending is stagnant. Thus, we have reduced production and employment.

Many policy makers come forward with the old idea that government should step in to fill the void by purchasing more goods and services. The intent is to raise consumption, which will generate employment for people employed in making the goods and services that government acquires. It sounds pretty simple and straightforward. And it really is pretty straightforward but you need to hear, as Paul Harvey says, the rest of the story.

Here’s the rest of the story, part one. The present proposals are for deficit spending, which means the government sells bonds (borrows the money) for its purchases. But someone buys the bonds, which reduces their ability to purchase goods and services. It is extremely unlikely that bond purchases won’t come without reduced

consumption by bond buyers. Thus, there is increased consumption by the government, but reduced consumption by the public. The net effect is likely to be small, meaning very little new production and employment.

The rest of the story, part two, is that we need to be concerned about what the government does with the money it is proposing to spend. There is lots of talk of roads, bridges, internet connectivity, and assorted green projects. Most sound pretty good, but which ones actually are good and which *are* just pork? It's not really helpful to employ people to produce things that nobody values . . . might as well just hand out money in that case. A decided advantage of the private sector spending is that for projects to be successful, you have to end up with something people will pay for. This makes it much more likely that only good projects are funded. Government does not have such sharp incentives. Thus, it is virtually inevitable that more government spending projects means more pork.

And the levels of spending increases being discussed are massive. Sometimes government budget numbers are thrown out so fast and furious that it's hard to wrap one's brain around it. But let me toss out a couple that I think are quite telling. Almost every year for the past forty years, federal government spending has hovered around 20% of GDP. That's a lot . . . one of every five dollars we earn end up being spent by the feds. The Congressional Budget Office just estimated that in fiscal 2009, the federal government will spend 25% of GDP. Instead of one in five, Washington will be deciding how one in every four dollars is spent. (See [http://www.cbo.gov/ftpdocs/99xx/doc9958/01-08-Outlook\\_Testimony.pdf](http://www.cbo.gov/ftpdocs/99xx/doc9958/01-08-Outlook_Testimony.pdf).) Federal borrowing is projected to increase by a factor of 2.6 from \$455 billion to \$1.2 trillion. As a percent of GDP, the deficit is forecast to be 8.3% . . . a number not seen since the winding down of World War II in 1946. Do we really want government running this much of our economy?

I'm not trying to scare anyone that the end of the world is near, but just that this level of government involvement in the economy is not desirable and certainly is not a cure-all for recessions. So where do we turn?

Most importantly, the private sector needs to reinvigorate. As noted above, private sector activity is inhibited by present uncertainties. But ramped up deficit spending does nothing to resolve this. Though government cannot wave a magic wand and resolve all uncertainty, it can reduce the uncertainty that it generates itself. Here are some steps to do so.

Resolve the use of TARP funds and other bailout money. While my own preference is for government to facilitate expedited renegotiation of loans, restructurings, and bankruptcies, that battle is lost. But at least the "rules" for TARP and bailout funds can be made clear, the funds expended, and that be the end of it. If not, another teetering industry will wonder if it should hang on for the next round of bailout funds or get on with life and make the appropriate adjustments. All the mysteries surrounding TARP and the next bailout target just add uncertainty and impede the economy's adjustments.

The Federal Reserve has made it clear that it will step in and make monetary injections to try to stimulate the economy. That's all well and good, but this has raised the fear of future inflation, again leading to private sector uncertainty and hesitancy to invest and spend. The Fed needs to make it clear that it is committed to soak up the liquidity it has injected so that it will head off any serious inflation.

Large increases in deficit spending can itself add to uncertainty. After all, the borrowing that raises the deficit has to be paid back someday. How will that be done? Such a large deficit is not a confidence builder. Thus, beyond the safety net spending that emerges in a recession (e.g., unemployment compensation, food stamps), we need to get beyond the idea that heavy government spending is the answer.