

The Myth of Fiscal Stimulus

By Robert Genetski

Whenever an economy is performing poorly, policymakers tend to recommend “fiscal stimulus” to get it back on track. Fiscal stimulus usually refers to policies that involve some combination of increases in government spending and tax cuts. The idea behind fiscal stimulus is to place more money in people’s pockets to encourage them to spend it and thereby boost business activity. However, the idea behind fiscal stimulus is basically flawed. Too often, what passes for “fiscal stimulus” actually has a depressing effect on the economy.

The problem with most calls for fiscal stimulus is that the proponents assume that it will increase current dollar spending. However, current dollar spending depends primarily on monetary policy. If monetary policy is restrictive, spending will slow. If monetary policy is expansive, spending will increase.

Efforts to boost spending in the economy by increasing government spending will actually tend to depress economic activity. There are two reasons this is so. First, when the government spends money it must first take that money out of the private sector. It does this by issuing debt to borrow the money it will spend. The “stimulus” from additional government spending simply involves taking money away from those who buy government bonds and giving it to someone else. It’s important to understand that the money for more government spending has to come from somewhere (unless you believe in the good fairy). Taking money from one group and giving it to another provides no net increase in spending. Any stimulus to spending from those receiving the money is offset by additional restraint from those who provide it.

The reason that increases in government spending tend to depress the economy is because government spending tends to be less efficient than spending in the private economy. When resources are used inefficiently it has a depressing effect on real economic activity.

In terms of tax changes, the same reasoning applies. Tax cuts do not stimulate an economy by increasing spending. As with increases in government spending, the money to pay for tax cuts simply comes from one group and goes to another. The stimulus provided by tax cuts occurs because such cuts have the potential to increase productivity. Lower marginal tax rates (taxes on additional income) increase the rewards associated with productive behavior. This tends to produce greater efficiency and more goods and services for the same amount of effort. Hence, lowering marginal tax rates stimulates the supply of goods and services to the economy.

As with government spending, tax rebates do nothing to stimulate economic activity. They simply involve taking money from one group (bondholders) to give to another (those receiving the rebates). Since the money goes directly to the recipients instead of through government programs, tax rebates tend to be less depressing than increases in government spending. Among the most destructive tax cuts are those that target particular areas, such as investment tax credits. By taking funds from the private sector and redirecting them to areas politicians believe are important, tax credits not only shift funds from one group to another, they also provide incentives to shift from more productive free market uses of resources to less productive politically directed uses.

Some economists claim that fiscal stimulus (increases in government spending or tax cuts) will have a greater effect on boosting spending if it is funded by an increase in the money supply as opposed to taking funds away from bondholders. While it’s true that increases in the money supply will boost spending, for the reasons stated above, there is no additional boost to spending from fiscal stimulus.

It should be pointed out that while there is no good theoretical reason for increases in government spending to increase demand, there is some evidence that suggests such spending has a temporary impact on the economy in the immediate period when it occurs. However, the evidence also suggests that any positive impact is completely offset in subsequent periods.

It's unfortunate that the only lesson many students remember from their economic courses—that deficits stimulate the economy—is a lesson worth forgetting.