Q: Does government spending stimulate the economy?

A: Economists hold two different views on whether government spending is an effective way to stimulate the economy. According to one view, purchases by the government cause a chain reaction of spending. That is, when the government buys $1 worth of goods and services, people who receive that $1 will save some of the money and spend the rest, and so on. This theory suggests that the “government spending multiplier” is greater than 1, meaning that the government’s spending of $1 leads to an increase in gross domestic product (GDP) of more than $1.

The other view suggests that government spending may “crowd out” economic activity in the private sector. For example, government spending might be used to hire workers who would otherwise be employed in the private sector. As another example, if the government pays for its purchases by issuing debt, that debt could lead to a reduction in private investment (due to an increase in interest rates). In this case, the $1 increase in government spending leads to an increase in GDP of less than $1 because of the decline in private investment. Therefore, the government spending multiplier is less than 1.

My research focuses on disentangling these two conflicting views. One way to do this is by looking at changes in defense spending, which are caused by international geopolitical factors rather than short-term economic concerns. In a recent paper, my research analyst Rodrigo Guerrero and I examined the impact of defense spending on the U.S. economy in the post-World War II period.¹ Our results suggest that the multiplier is less than 1, meaning that the government spending causes some crowding out of private economic activity. In particular, we found that an additional $1 in defense spending leads to a reduction of about 50 cents from some other part of the economy.

Of course, economists also want to know if government spending is effective at stimulating the economy during a recession. To that end, I have studied the effects of the American Recovery and Reinvestment Act of 2009, with a primary focus on employment. My general finding is that the government was able to create jobs but at a fairly expensive cost. For example, in one study I worked on, I found that creating a job lasting one year cost the government about $100,000, whereas the median compensation for a U.S. worker was roughly $40,000.²

The overall takeaway from my research is that government spending does not seem to be a very cost-effective way to stimulate the economy and create jobs. However, economists have a lot more to learn on this topic.