Will infrastructure spending cure slow economic growth?

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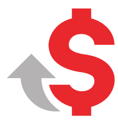
One of the few areas where Democrats and Republicans agreed during the campaign was on the need for more infrastructure investment. In doing so, politicians finally endorsed what many economists have recommended for some time—using increased government spending (i.e., fiscal stimulus) to reinforce the Federal Reserve's use of monetary policy in the fight against sluggish economic growth.



Added government spending will generate more economic growth

The critical question is how much growth each dollar of new spending will generate. When we look closely at what additional stimulus can accomplish, there are reasons to believe it may not be as effective as many people hope.

Although the presidential campaign was not overly long on details, president-elect Donald Trump has suggested he would spend close to $1 trillion on infrastructure. Washington typically targets 10-year horizons, so we will assume that program would add roughly $100 billion of spending each year. Given the current size of the economy, $100 billion of new spending should add 0.5% of nominal (i.e., no adjustment for inflation) growth to the U.S. economy. Using third-quarter numbers to illustrate, the added spending would have made the reported growth of 2.8% close to 3.3%. Putting that in perspective, the average nominal growth of the U.S. economy from 1980 until just before the last recession was 6.2%. Thus, new infrastructure spending would help, but it would not get us markedly closer to the average historical rate of growth.

Bear in mind, too, that for the economy to receive the full benefit of the $275 billion investment there can be no offsetting spending cuts in other areas. For example, cutting the entitlement programs to do more infrastructure spending would generate no additional economic growth.

Additional problems to watch for

Funding the stimulus package by raising tax revenue could also be problematic. If tax increases discourage consumer or business spending, the economic gain from the stimulus spending could be largely nullified. Only if additional taxes were raised from cash that would not be spent on other things would the extra government spending be expected to realize its full short-term growth potential. Even then, some would argue that higher taxes would reduce economic growth over the long run.

Ideally, major spending programs should generate a multiple of the initial stimulus value by encouraging businesses that receive government contracts to hire new employees or expand their operations. Particularly when an economy is ready to emerge from recession, fiscal spending can help to prime the pump for higher levels of economic growth.

Unfortunately, that may not work well under the current conditions, where the economy is weighed down by broad oversupply. When economies are saturated with an oversupply of goods and services, increased demand can be satisfied without significant investment in new productive capacity. Goods can be drawn out of existing inventory. Labor can be performed with existing staff and facilities. Under conditions of oversupply, economic growth rises with the initial government contracts, but the spending wave dies out shortly after the initial round rather than rippling through the economy in successive waves of spending.

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A globalized economy also poses some unique challenges for a U.S. economic stimulus package, as some of the benefits may go to overseas suppliers. The government can insist that prime contractors be domestic businesses, but beyond that, spending can be difficult to control. While the majority of any government stimulus should accrue to the domestic economy, that goal becomes harder to achieve as our economy becomes more global.

For the same reason, however, the United States may also benefit directly or indirectly from overseas fiscal stimulus. Lethargic growth has plagued most major economies of the world. With signs that monetary policy is losing its effectiveness, global policymakers are increasingly considering infrastructure and other spending programs of their own. Some U.S. suppliers may benefit directly from that spending, although most countries will try to focus the majority of the spending in their own economies.

Indirectly, the U.S. economy could benefit if improved growth overseas reduces the gap between growth here and abroad. Weakness overseas has been one reason the dollar has been strong against foreign currencies. A strong dollar, in turn, makes it harder for U.S. exporters to compete in global markets. Additional strength overseas could therefore help reduce pressure on the dollar and make it easier for U.S. exporters to compete for international trade.

Bottom line, added government spending should help to improve domestic economic growth. The question is, by how much? It clearly offers no magic cure. The stimulus would be large enough that some firms and industries could certainly benefit, but the broader economic effects would probably be comparatively limited.