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Forget Keynes. Spending cuts don?t hurt the economy, they help it [1]

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In the run-up to the Comprehensive Spending Review this week, many have warned [3] against cutting spending because it will ?take money out of the economy?. This is a Keynesian fallacy that mistakes money for wealth ? in fact, what most people value is not money itself but the things that money can buy. Government spending merely reallocates wealth, to the detriment of long-term wealth creation.

The error is in seeing the government as being external to the economy, with spending coming as manna from heaven. In fact, government money does not come from nowhere ? barring simply printing money to pay for spending (which obviously does not increase actual wealth), government spending money can either come from taxes or borrowing.

In terms of taxes, the mistake should be obvious enough: if the government cuts spending and taxation in equal measure, there will not be money ?taken out? of the economy, just left in private hands. It may be true that the public is more likely to save its money than spend it, but these increased savings simply free up more money for private investors to borrow. If, as in the supposed "worst-case" scenario, people hoard money under their matresses, the buying-power of money remaining in circulation increases.

As for borrowing-funded spending, which the CSR will reduce, the story is similar. Government borrowing comes from private savings, crowding out private borrowers like entrepreneurs and investors. By diverting money away from businesses and entrepreneurs, who can use it to create commercially-valuable projects, wealth is squandered on projects that are unproductive such that only a government. If they were productive, why would it be necessary to tax people to pay for them in the first place? Again, this is not an argument against government spending *per se*, just the idea that this spending is economically stimulating.

Government spending can come from thin air in the form of inflation, from taxation, or from borrowing where it crowds out the private sector. None of these increase the stock of wealth in an economy ? they just reallocate it. The argument that cutting spending ?takes money out of the economy? is woolly thinking based on outdated fallacy, and it should be ignored in the coming weeks.

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[2] http://www.adamsmith.org/taxonomy/term/5809

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[4] http://disqus.com/?ref_noscript
[5] http://disqus.com