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THE NEGATIVE CONSEQUENCES OF GOVERNMENT EXPENDITURE

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The U.S. national debt currently stands at 62 percent of GDP, its highest level since WWII.[1] Under plausible assumptions, this ratio will rise to at least 80 percent and possibly 185 percent of GDP by 2035 and continue increasing thereafter.[2] As the debt-ratio increases, the United States's creditors will demand higher and higher interest rates to continue financing this debt. This means ever-larger deficits and ultimately a U.S. default. The United States can try to avoid this fate by raising taxes, but that approach faces both political and economic obstacles. Raising taxes is rarely popular with either voters or politicians, especially in a weak economy. Both macroeconomic and microeconomic perspectives, moreover, suggest that taxes slow economic growth, thereby limiting the scope for revenue gains. If tax increases cannot restore fiscal balance, then the United States must slow the path of expenditure to avoid fiscal Armageddon.

RESEARCH FINDINGS

- Government expenditure has an impact on the economy. To understand this impact, we can look at two basic principles of government expenditure:

  - Government expenditure requires taxation. This can occur simultaneously with the expenditure, or in the future if governments borrow and run deficits. Alternatively, governments can print money to pay for expenditure; this generates future "taxes" in the form of inflation.[3]

  - Taxation does more than transfer purchasing power from taxpayers to the government; it also distorts the economic decisions of consumers and firms.[4] Taxes on wage and income discourage work relative to leisure; taxes on interest, dividends, and capital gains discourage saving relative to consumption. Taxes on corporate profits discourage investments that can generate these profits.

- In addition to the looming fiscal disaster at the federal level, state and local governments are struggling to fund their existing programs and face large tax increases or default on their debt and pension obligations. State and local expenditure raises fewer red flags than federal expenditure, but substantial components are excessive or unnecessary.

- Determining the ideal level of government expenditure is difficult, but just a few decades ago the U.S. was a productive economy with far lower expenditure. In the 1960s, for example, federal government expenditure was below 20 percent of GDP, and state and local expenditure was below 12 percent; this contrasts with roughly 25 percent and 15 percent now. The discussion here suggests that returning government expenditure to at least its pre-1970 level would help secure a stable economic future.

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1 Congressional Budget Office. "The Long-term Budget Outlook." June 2010.

2 Ibid

3 The inflation tax is the reduction in the value of money held by the public that occurs when a central bank prints more money, thereby giving itself a larger share of the overall stock of money.

4 Taxes do not distort economic decisions if they are ―lump-sum,‖ meaning the amount of tax does not depend on taxpayer behavior. A head tax of $10,000 per person, for example, would not change the return to working or saving, so it would not distort economic incentives. Lump-sum taxation is rare in practice.

OPPORTUNITIES FOR CHANGE

- The good news in this message is that from a fiscal perspective, the U.S. can have its cake and eat it too. By slashing expenditure, the country can improve economic efficiency and get the debt under control at the same time. Many people claim such cuts will have catastrophic effects on the weakest elements of society and harm vital government functions. The analysis of this study suggests this view is enormously off-target. Most entitlement spending goes to the middle class, and much other expenditure is hurting economic productivity, not helping. All this expenditure, of course, helps some interest group; that is why the expenditure persists. But for the economy overall, the net impact is negative.

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To view the complete study by Dr. Miron, please visit:
http://mercatus.org/publication/negative-consequences-government-expenditure.

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