

**Joint Economic Committee Republicans**  
**July 1996**

## **The Impact of the Welfare State on Small Business and the American Entrepreneur**

### **Executive Summary**

This is the fourth in a series of Joint Economic Committee (JEC) studies I have commissioned on the effects of the modern Welfare State on various aspects of the American economy and society. This study focuses on the impact of excessive government activity on small business and entrepreneurs.

This series of JEC studies has consistently found that a level of federal spending in excess of about 17.5 percent is associated with slower economic and income growth, and higher rates of poverty. This new JEC study explores the impact of excessive government on the nerve center of a market economy -- small business and entrepreneurs.

The study documents how excessive government overburdens small business and entrepreneurs under mounds of taxation and red tape. Because of their pivotal role in a market economy, the hampering of small business and entrepreneurs not only directly limits their ability to produce, but also exerts a serious drag on economic growth throughout the entire economy.

Furthermore, the costs of complying with government regulation tends to impose disproportionate costs on small business relative to big business. This results from the fact that for a small business, the cost of complying with a government regulation tends to be higher relative to the size of its assets, workforce, or output. In the case of small business, regulatory costs tend to be spread over a relatively smaller output, meaning that their cost per unit is higher than average.

The study also finds that taxes can also play an important role undermining small business output and employment growth. Together, higher taxes and over-regulation can be a devastating combination. The study notes that this excessive burden of taxes and regulations derailed the "small business express" underlying much of the prosperity of the 1980s.

Excessive federal spending and taxation undermines the vitality of private firms and reduces economic growth. According to the findings of this study, a \$100 billion reduction in federal spending growth would boost economic growth by \$35-38 billion annually. This lost economic output translates into slower growth in worker compensation and lower living standards over time.

I am pleased to make this study available to Congress and the public, and hope it contributes to an informed discussion of economic issues.

Jim Saxton  
Vice-Chairman  
Joint Economic Committee  
July 1996

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# **The Impact of the Welfare State on Small Business and the American Entrepreneur**

by Lowell Gallaway and Richard Vedder

The most significant economic question of the twentieth century has been, "Can a nation spend itself into affluence?" Put differently, that question translates into, "Does the demand for goods and services (represented by "spending") create its own supply?" During the middle half of the century, the answer provided by the conventional wisdom, both economic and political, was an affirmative. However, as the twentieth century is winding down, increasingly it is being realized that we cannot "spend" ourselves rich, especially through the device of government spending. Instead, we are rediscovering the idea that the only path to economic well-being is through the supply-side of the economy. In short, if it is economic abundance we want, we must produce ourselves rich.

In the three previous studies in this series, the implications of increased Federal Government spending for the health of the American economy have been explored. The conclusions of the three reports have been quite consistent. Beyond some critical level of Federal Government spending as a percentage of Gross Domestic Product (GDP), additional spending is counterproductive. It inhibits the ability of the American economy to produce goods and services. That critical level of spending is about 17.5 percent of GDP, about twenty percent less than current levels of Federal outlays.

## **I. The Role of the Entrepreneur**

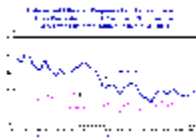
In this, the fourth such report, we turn to an exploration of how Federal Government activity affects the actions of those who are center stage in the organization of the production of commodities, entrepreneurs and the business organizations they command. It is in the entrepreneurial sector that the critical economic decisions are made -- what to produce and what and how much of various inputs to employ in the process. In so doing, entrepreneurs must forecast the potential demand for their products and future prices of the inputs they require. This is a risky undertaking. Risky is the appropriate word. Entrepreneurs are people who take chances, who expose themselves to the possibility of failure.

### **The Entrepreneur and Profits**

But what is the measure of lack of success in these endeavors? Nothing more than the so-called "bottom-line" - profits - whatever is left over after the output has been sold and expenses paid, including taxes.

Profits, particularly in the corporate sector, have become an important issue very recently. Secretary of Labor Robert Reich has focused on them as an explanation for the sluggish growth (or, in some cases, actual decline) in the earnings of workers in the United States. The basic implication of the Secretary's claims is that increases in corporate profits mean decreases in earnings. This view of the world is a redistributionist one that attempts to use corporate profits as an excuse for the behavior of earnings.[1]

To buttress this position, the claim is often made that profits are at nearly all time record high levels. This is an interesting assertion. When corporate profits, either before tax or after tax, are expressed as a percentage of the cost of producing output and compared over time, almost the opposite seems to be true. This is indicated in Figure 1, which graphically displays measures of corporate profitability during the post-World War II era. Clearly, there is a downward trend in corporate profits as a share of the cost of output.



[Click here to see Figure 1.](#)

## Profits and Federal Government Spending

Given the already documented longer term slowing of economic growth that we have attributed to excessive Federal spending, the decline in the corporate profit share of national income could well be another manifestation of the fiscal drag imposed by an out-sized Federal Government. As a first step in exploring this possibility, we examine the statistical linkage between corporate profits and the percentage rate of change in GDP in the United States. The results are shown in Panel A of Table 1. They indicate the presence of a strong **positive** relationship between the corporate profit share of the cost of producing output and GDP growth.

Next, we turn to the statistical linkage between corporate profits and the percentage growth in the average productivity of labor. The results are provided in Panel B of Table 1. They, too, indicate a statistically significant **positive** relationship between the profit share of income and growth in labor productivity. Since labor earnings are very closely associated with productivity levels,[2] this implies that workers' earnings and the profit share of income are also positively associated, both being the product of a similar set of factors.

[Click here to see Table 1.](#)

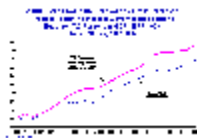
The association between the corporate profit component of income and the average output of labor is an important one. It provides the connection between corporate profits, growth in GDP, and the impact of excessive Federal Government spending. In the second report of this series, the impact of Federal Government spending on the average product of labor was documented, with the conclusion being that Federal spending that exceeds 17.42 percent of GDP has a negative effect on the productivity of labor.

In that report, we picked up the story of productivity change beginning in 1973. We will do the same here, assuming that Federal spending is set at the critical level of the mid-seventeen percent range and held there through 1994. Based on this assumption, we then create a hypothetical average productivity of labor data series and, from it, calculate hypothetical percentage rates of change in average productivity.

Once this has been done, the difference between the hypothetical and actual rates of change in labor productivity can be translated into an impact on Gross Domestic Product by doing, in order, the following:

1. Multiply each year's rate of productivity change difference by 0.5387 (the regression coefficient reported in Panel B, Table 1). This produces a hypothetical **change** in the corporate profit share of income data series.
2. Using the results of step #1, calculate a hypothetical corporate profit share of national income for each year.
3. Calculate the difference between the hypothetical and actual corporate profit shares.
4. Multiply this difference by 1.2108 (the regression coefficient from Panel A of Table 1). This produces a hypothetical change in the rate of growth in GDP data series.
5. Using the result of step #4, calculate a hypothetical GDP series based on the assumption that Federal Government spending is maintained in the mid-seventeen percent of GDP range.

Figure 2 shows the behavior of both the actual and hypothetical GDP series (indexed so that 1973 = 100) over the years 1973-1994. As the magnitude of Federal spending departs further and further from the optimal, subsequent to 1973, the actual level of GDP falls below the hypothetical by greater and greater amounts through 1982. At that point, hypothetical GDP was 14 percent greater than the observed level. Following 1982, the gap drops to about nine percent for the years 1984-1988, but then begins to rise, averaging about 12 percent during the period 1988-1994. Currently, it stands at about ten percent.



[Click here to see Figure 2.](#)

## The Impact of Federal Spending Restraint

In our earlier studies, we evaluated the impact of restraining Federal Government spending by \$100 billion. From the second of these, we know that \$100 billion of spending restraint would produce an increase of the average productivity of labor of 0.8 percent. Tracking the effect of this through the corporate profit share of income and the rate of growth in GDP (using the

regression coefficients from Table 1) yields an estimated increase in GDP of 0.52 percent.[3] At 1994 levels of real GDP, this amounts to about \$35 billion, quite consistent with our earlier estimate of a \$38 billion increase in GDP that would result from \$100 billion of spending restraint.

## How Government Inhibits Entrepreneurship

So much for the technical side of the relationship between Federal Government spending and the actions of entrepreneurs. We now will explore some of the specifics of how the overburden of government inhibits the capacity to function of those who organize the process of production. The very sense of the word entrepreneur is that it describes persons of imagination and energy who are willing to take risks in the hope of making profits. Success in these endeavors turns on their being able to institute new and different ways of combining inputs to generate the goods and services that a nation and its people desire.

Constraints on the freedom of people to be entrepreneurial interfere with this mechanism and reduce the total level of national output. This is where government enters the picture. In a prescient fashion, Alexis de Tocqueville saw the future of the modern state as one in which government "covers the surface of society with a network of small complicated rules, minute and uniform, through which the most original minds and the most energetic characters cannot penetrate, to rise above the crowd. The will of man is not shattered, bent and guided; men are seldom forced by it to act, but they are constantly refrained from acting. Such a power does not destroy, but it prevents existence; it . . . compresses, enervates, extinguishes . . ."[4] In short, it dampens the entrepreneurial spirit. It drags the economy down, slowing its rate of growth.

## The Special Case of Small Business

To be sure, the entrepreneurial types have the capacity to respond and adjust to the various government rules and regulations they encounter. However, this can be done only at some cost and, ultimately, it is these costs which apply the brakes to the system. A classic illustration of this is provided by some of the experience of the small business sector of the American economy in recent years. We begin by pointing out that small businesses are a major source of jobs, especially new ones, in the American economy. It is large businesses that **downsize** their labor force. Small businesses create jobs and grow in size.

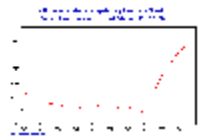
To put this issue in perspective, consider the pattern of job growth in the United States since 1973. Between 1973 and 1981, both years containing a business cycle peak, 15,323,000 additional jobs were created.[5] At the same time, the civilian non-institutionalized, working-age population grew by 23,034,000. Thus, 0.67 jobs were added for every additional person considered available to work. See Table 2 for details. Move on to the period 1981-1989.[6] In this interval, 16,945,000 additional jobs were created, not that much different from the 1973-1981 period. However, the working-age population grew by only 16,263,000 between 1981 and 1989, meaning that 1.04 additional jobs were available per person added to the working-age population. After 1989, things are fairly similar to the 1973-1981 period. Between 1989 and 1995, the working age population grew by 12,191,000 and employment increased by 7,558,000.

This translates into an increase of 0.62 jobs per addition to the civilian non-institutional population aged 16 and over.

[Click here to see Table 2.](#)

Why the differences in the rates of job creation in these periods? The answer lies in changes over time in the costs per worker associated with the burden of government regulations affecting typical small business enterprises. A 1992 Joint Economic Committee minority staff study documented the nature of fluctuations in the cost of government regulations during the years 1982-1992.[7] Figure 3 displays those changes in a graphic fashion. Through 1989, the real cost of government mandates and regulations fell by about eight percent. This is almost exactly the interval in which the remarkable job growth of the 1980s took place. However, between 1989 and 1992, they rose by slightly more than one-third, prompting the following conclusion:[8]

"A combination of government mandates, regulations, and taxes significantly altered the potential profitability of small business firms subsequent to 1989. In the process, the great job creation machine that fueled the economic boom of the 1980s was derailed, contributing very substantially to the lower rates of growth in employment, total output, and wage rates in the American economy."



[Click here to see Figure 3.](#)

Given that firms that employ fewer than 100 employees account for more than half of total employment in the United States, the link between the pattern of variation in the costs created by the impact of government regulations on small business and both the acceleration of job growth in the 1980s and its slowing in the 1990s is obvious. The bottom line in this respect is clear. Anything that destroys the profitability of small business enterprises ultimately lowers overall living standards and erodes the economic vitality of the United States.

Exacerbating the impact of regulation on the small business entrepreneur is the fact that, on average, regulatory burdens are greater the smaller the business enterprise. Thomas Hopkins estimates that, in 1992, the regulatory burden per worker in businesses employing 500 or more employees was \$2,921. For enterprises with 20 to 499 workers, however, it was \$5,195; and for firms with fewer than 20 employees, \$5,545.[9] See Figure 4.



[Click here to see Figure 4.](#)

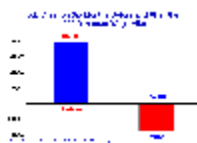
## The Minimum Wage Controversy

One of the major factors in the post-1989 increase in the regulatory burden borne by small businesses was the minimum wage increases that took place in April, 1990, and April, 1991. The minimum wage is a hoary example of government's mandating a particular private economic decision, in this case the wage rate that many employers must pay to certain workers.

Much of the rhetoric associated with advocacy of minimum wage increases focuses on **doing something for the poor**. Ironically, though, the recent historic record indicates that very little good has resulted from minimum wage increases, at least for the poor. This is not that surprising. To begin, very few of the poor of working age have full-time jobs (only 9.2 percent). Slightly more than another thirty percent work part-time, but almost three-fifths do not work at all.<sup>[10]</sup> The truth is most people who earn the minimum wage are not poor. A majority of minimum wage workers are either young persons living in nonpoor families or they are second or third earners in a household -- not the primary breadwinner. Many come from relatively prosperous middle-class families.<sup>[11]</sup>

Evidence confirming the lack of impact of minimum-wage increases on levels of poverty is readily available. After a series of minimum wage increases beginning in 1974, when the basic rate was increased from \$1.60 to \$2.00 an hour, and ending in 1981 with a rate of \$3.35, the poverty rate climbed from 11.1 percent of the population to 14.0 percent. From then until 1990, there were no further increases. The poverty rate? It fell to 12.8 percent. Subsequent to the 1990 and 1991 increases, which took the rate to \$4.25 an hour, the poverty rate climbed to as high as 14.5 percent.

A likely explanation for the **increase** in the poverty rate following rises in the minimum wage is the employment (or unemployment) effects arising from the higher labor costs produced by a heightened minimum wage. The sequence of minimum wage changes that began in 1974 followed a six-year hiatus in which there had been no change. The first rise took place on May 1, 1974, and almost immediately the unemployment rate began to rise. From the very low five percent range during the early months of 1974, the unemployment rate surged to the 7.8 percent level by the end of the year. Another increase took place on January 1, 1975, and the unemployment rate continued to climb. For all of 1975, it averaged 8.5 percent, compared to 5.6 percent for 1974.



[Click here to see Figure 5.](#)

An accident, perhaps? We think not. A similar situation occurred in 1990, when, after a period in which the minimum wage had not increased since 1981, it was raised by more than 10 percent on April 1, 1990. In the six months prior to that change, 802,000 additional jobs had been created. In the six months following, 352,000 jobs were lost. See Figure 5. There are other examples of the same phenomenon at work, one being during the Great Depression of the 1930s. (See Box 1)

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## Box 1

### Minimum Wages in the Great Depression

A powerful example of the impact of the minimum wage comes from the pre-Fair Labor Standards Act portion of the 1930s. In fact, instead of describing the early 1930s as the Great Depression, we could describe them as a period of high wages and low employment.<sup>[1]</sup> Much of the public policy analysis of the time focused on the importance of maintaining purchasing power by keeping wage rates high.<sup>[2]</sup> Herbert Hoover argued vigorously against any reduction in money wages at the outset of the Great Depression. At the conclusion of its renowned "first hundred days," Franklin Roosevelt's New Deal made a strong commitment to the same principle. The National Industrial Recovery Act, passed in June 1933, required that a minimum wage be included in any industrial code. As it evolved, the actual minimum wage was generally about 40 cents an hour.<sup>[3]</sup> This was remarkable, since a 40 cent-an-hour **minimum** wage represented more than 90 percent of the **average** hourly wage.<sup>[4]</sup> The impact on wage rates was dramatic, driving them upward by almost 20 percent in the last half of 1933.<sup>[5]</sup> The timing of this surge was unfortunate. From March to July, the unemployment rate had fallen by a full 5 percentage points, indicating that an economic recovery had begun.<sup>[6]</sup>

These data understate the impact of the codes on employment. In addition to the minimum wage provisions, the codes contained maximum hours requirements. They generally were set at 40 hours per week, below the average work week of the time.<sup>[7]</sup> Consequently, as unemployment rates stopped declining, the average work week fell by 13 percent between June and December 1933.<sup>[8]</sup> Over the next 15 months, unemployment rose slightly, standing at 23.5 percent in October 1934. The following year saw a slight improvement, but unemployment still measured nearly 22 percent in October 1935. By this time, the National Industrial Recovery Act had passed from the scene, having been declared unconstitutional earlier in the year by the Supreme Court. In the absence of the Act's minimum wage provisions, employment conditions improved dramatically. By May of 1937, the unemployment rate had fallen to almost 12 percent. Again, all the evidence points to the same conclusion: If we introduce a wage shock in the form of a hike in the minimum wage, unemployment rises; if we allow the minimum wage to fall from the effects of inflation or court rulings, unemployment falls.<sup>[9]</sup>

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### Notes

1. For a fuller description of the nature and character of the Great Depression in America, see our **Out of Work: Unemployment and Government in Twentieth Century America** (New York: Holmes and Meier, 1993) and Murray Rothbard, **America's Great Depression** (Kansas City: Sheed and Ward, 1963).

2. Herbert Hoover had a particular fascination with this notion. See our **Out of Work**, pp. 89-97. for details.

3. As the industry codes under the National Recovery Administration were approved, the agreed-upon minimum wages clustered about the 40-cent figure. They were not uniform, though. There often were special, i. e., lower, minimums for women and Southern workers. The key features of 109 different approved codes are described in



"Summary of Permanent Codes Adopted Under National Industrial Recovery Act Up to November 8, 1933," **Monthly Labor Review**, December 1933, pp. 1333-1343.

4. The estimate of average hourly earnings in the United States for June 1933 is 43.5 cents. **Monthly Labor Review**, September 1933, p. 728.

5. By December 1933, the average hourly wage had risen by 19.3 percent from the previous June and stood at 51.9 cents. The driving up of average wage rates by the introduction of the 1933 minimum wage is recognized in the economics literature. See Paul A. Samuelson and Robert M. Solow, "Analytic Aspects of Anti-Inflation Policy," **American Economic Review**, May 1960, pp. 177-194; and Michael M. Weinstein, **The Great Depression Revisited**, Karl Brunner, ed. (Boston: Martinus Nijhoff, 1981), or Weinstein's **Recovery and Redistribution Under the National Industrial Recovery Act, 1933-1936** (New York: Elsevier, 1980).

6. The monthly estimates of unemployment rates are taken from our **Out of Work**, Table 5.1, p. 77. The accompanying text explains how the estimates were derived.

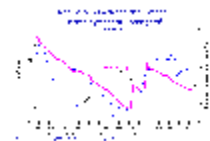
7. An examination of the approved codes described in the December 1933 issue of the **Monthly Labor Review** reveals a very broad agreement on the 40 hour figure.

8. In June 1933 the average workweek was estimated to be 43.3 hours. By December, it was down to 37.7 hours. See, respectively, **Monthly Labor Review**, September 1933, p. 728, and **Monthly Labor Review**, March 1934, p. 798.

9. The subsequent rise in unemployment in late 1937 and 1938 reflected a wage shock of another sort, largely resulting from the implementation of the National Labor Relations Act, the Social Security Act, and other 1935 legislation that passed constitutional muster in 1937. See our **Out of Work**, chapter 7.

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An additional consideration in the case of the minimum wage is the distribution of its employment effects. They are borne disproportionately by particular groups in the economy. Figure 6 shows the relationship between the minimum wage rate (in 1994 dollars throughout) and the **excess unemployment** of teenagers. Excess unemployment is simply the difference between the unemployment rate for teenagers and the overall unemployment rate for the economy.[12] The correspondence between the two data series is striking.[13] Higher minimum wages increase the gap between the teenage and overall unemployment rates.



[Click here to see Figure 6.](#)

### **A Special Mandate: The Davis-Bacon Act**

Very significantly, the same relationship holds between the real minimum wage rate and the overall unemployment rate for non-whites. This is consistent with a growing body of evidence that indicates that the employment effects of government intervention in labor markets are disproportionately concentrated among non-whites.[14] A special case in point is the impact of the Davis-Bacon Act. The Davis-Bacon legislation was enacted in 1931 and requires the paying of **prevailing** wage rates on Federally funded construction projects. Historically, prevailing wage

rates have been defined in terms of the trade-union wage scales that exist in an area. Thus, the ultimate impact of Davis-Bacon is the equivalent of a minimum wage rate, a high one to be sure, for a certain class of construction workers. In a recent analysis of the impact of the Davis-Bacon legislation on non-white unemployment, we found that, since 1930 (before Davis-Bacon), the difference between black and white unemployment in the construction industry has increased from 1.2 percentage points to about five percentage points in 1990.(See Box 2)

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## Box 2

### The Personal Side of Davis-Bacon

Often, minority workers lack job skills simply because they have been denied on-the-job training. Being inexperienced, they are relatively less productive, perhaps performing ten dollars an hour worth of services instead of the twenty dollars provided highly experienced workers. Black contractors **wanting** to hire blacks simply cannot afford to do so, since worker productivity is far below the very high minimum wage set by Davis-Bacon.

To illustrate, Art Pearson, a black man who began his career as an electrician in 1956, later starting his own contracting business says, "The Davis-Bacon Act puts me between a rock and a hard place . . . I would like to be able to hire workers and pay them different rates, based on how good they are. I would pay some people more than what is currently the prevailing wage rate, and others less, depending on how good they are . . . I would also want to have some workers cross over, do some electrician work, some laborer work, some other work . . . The Davis-Bacon Act prevents me from doing any of this."[\[1\]](#)

In a similar vein, the President of the Bay Area Black Contractors Association, Chris Albert, tells a story about a young high school graduate who begged him for a job working as an electrician on a public housing project. Albert said, "I can't hire you because . . . I can't afford to hire another trainee," since he had to pay Davis-Bacon wages. The young man returned saying he would work below prevailing wages, saying he wanted to end a life of dealing in drugs. Albert reluctantly said, "No," and two days later the young man was shot to death.

While on the subject of public housing projects, some of the strongest support for repealing Davis-Bacon comes from minority residents in public housing projects, who would like to have maintenance work performed at modest wages by their own residents, a move that would achieve three objectives. First, it would provide them income. Second, it would teach work skills and discipline. Third, it would improve the quality of their housing. A resident of the Abbottsford project in Philadelphia, Dorothy Harrell, notes that, "Even though our residents would be happy to perform unskilled and semi-skilled work for \$8 or \$10 an hour, the Davis-Bacon Act forces the contractors to pay the prevailing wage . . . A general laborer's wage right now is \$25.65 . . ." Major renovation of the over half-century old facilities is soon to begin, but it is likely that the residents who live there cannot join in the construction project despite the many advantages of allowing their participation.

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## Notes

1. We are indebted to the Institute for Justice for providing us with these quotes from various people regarding how they perceive the Davis-Bacon legislation.

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## II. Regulatory Effects in General

Our findings with respect to the impact of wage-setting activities of the Federal Government can be generalized to all Federal regulatory activity. Higher governmentally mandated wage rates increase the costs to employers of hiring workers. The same is true of other government regulations. In effect, the costs implicit in their implementation can be viewed as a tax on the hiring of resource inputs. The magnitude of these costs, or implicit taxes, at the Federal level is immense and growing. Table 3 provides data in this regard.



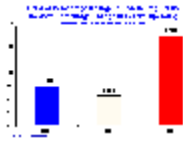
[Click here to see Table 3.](#)

These costs are more than just implicit taxes. They also represent spending that is under the effective control of government. What government regulatory mandates do is disguise the true size of the government's role in the economy. If we added the regulatory burden attributable to the Federal Government to actual Federal spending, the Federal share of GDP would rise to almost one-third.

A very significant aspect of the regulatory cost of the Federal Government is a marked change in its growth compared to increases in actual Federal spending. Over the periods 1977-1981 and 1981-1989 the costs of Federal regulation, as estimated by Hopkins and Robert Genetski, rose at about half the rate at which Federal spending grew. However, in the five years following 1989, Federal regulatory costs grew at a significantly **faster** pace than Federal spending.[15] See Table 3 and Figure 7. Increasingly, it seems, the Federal impact on the American economy is becoming more heavily weighted in the direction of regulations and mandates.

Why the increase in the relative importance of regulations and mandates? Very simple: they differ from the more normal approach to government activity by substituting constraints on the way in which private individuals or companies conduct their affairs for the direct collection of tax revenues that are then distributed by government agencies to finance social programs. This approach has some appealing features for legislators. Faced with rising public resentment about the level of taxation and the very size of government, it is becoming more difficult for elected representatives to use the conventional tax and spend approach to expand government programs beyond their present levels. By mandating how other people spend their money, though, they can

accomplish the same thing with no apparent increase in the size of government or the burden of taxation.



[Click here to see Figure 7.](#)

Of course, this is an illusion. As we have already discussed, regulations and mandates impose burdens that represent **hidden** taxes in the American economy, taxes that become additional costs to business enterprises. There are a limited number of ways in which businesses can respond to such cost increases. Either they can raise prices, reduce other costs, such as wages, or do some combination of these things. For example, in 1991, a substantial part of the adjustment was made through reductions in profits. Before-tax profits for nonfinancial corporate businesses as a percentage of the total gross domestic product they produce, fell to lower levels than all but three other years since 1946.[16]

The significance of low profits is profound. They are a leading indicator of the movement of the unemployment rate. Lower corporate profits this year portend higher unemployment rates in future years. The precise quantitative relationship is shown by the regression results reported in Table 4.[17]

[Click here to see Table 4.](#)

The linkage between movements in profits and unemployment is a simple one. For example, say the government requires a design change in a product, such as automobiles. Either the company will have to change its level of usage of labor and capital or buy more inputs from other businesses to satisfy the new mandate. Unless any additional costs are passed on to consumers in the form of higher prices, profits will be squeezed. In the short term, profits, being merely what is left over after all the other bills have been paid, will adjust freely to reflect the impact of any new government regulations. In the longer term, though, businesses will seek to rearrange their affairs in a way that will move the level of profits back towards normal. If this cannot be done, the ultimate adjustment is to simply close the doors and cease operation. The longer term adjustment usually takes the form of reducing employee compensation by some combination of lowering money wage rates or employing fewer workers, thus the connection between the level of profitability this year and unemployment rates in subsequent years.

Of course, it might appear that many of these mandates and regulations will increase the real incomes of workers. However, that will not be the case. The nature of the longer term adjustment that characterizes labor markets in America is such that these additional costs of doing business will be shifted ultimately to workers through a reduction in their real wage rate, either by businesses raising prices or slowing the rate of growth in money wages. There is no **free lunch**

that government can hand out to workers. In the end, at best, employees will simply exchange one form of compensation for another, irregardless of their preferences in this respect.

Worse yet for workers, they are likely to bear the brunt of the costs of mandates and regulations that do not directly enhance employee compensation. More and more, people are realizing that the costs of achieving many so-called **social goals** that have become popular is quite expensive in terms of jobs that may be lost. Of course, workers have the option of saving those jobs by accepting lower rates of pay, or by agreeing to forego any wage increases while the prices of the goods and services they buy increase. Either way, they pay the bill by suffering a loss of real income.[18]

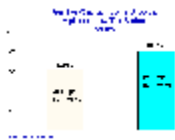
Therein lies the ultimate problem with regulations and mandates. The shifting of their costs to workers is subtle and goes largely unrecognized. However, the end result is likely to prove unpopular and, when it does, it becomes the rallying point for a new set of government initiatives designed to deal with the problem of a lack of growth in real wages. In short, the unwanted consequences of one set of government interventions become the rationale for another round of the same thing. Unfortunately, this may go on almost in perpetuity. (See Box 3)

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### Box 3

#### The Experience of the States

The major theme of this series of reports is that high levels of Federal Government spending reduce the volume of economic activity. A possible criticism of this finding is that it is based on time-series data and, therefore, could represent nothing more than a statistical artifact. However, there is an alternative source of information that does not have the characteristics of time series information and its associated possible statistical problems, namely, data for the various states. These can be used in a cross-section fashion to explore the relationship between size of government and economic activity.



[Click here to see Figure.](#)

Much research has been done along the lines of exploring the impact of state government on economic growth, with the emphasis being on levels of taxation rather than spending.[1] However, since almost all states have balanced budget requirements, taxes and spending are almost synonymous. This body of research has created a "new" conventional wisdom that emphasizes the debilitating effect of high state taxes on state economic growth. This has replaced an earlier consensus which held that taxes didn't matter in this regard. A very recent Joint Economic Committee Staff Report presents technical and graphic evidence that is remarkably consistent with the argument that we have been making at the Federal level. The data contained in that report show that the 25 low-tax states, measured by an average of state and local taxes per \$1,000 of personal income in fiscal years 1965 and 1992, had a real per-capita income growth

rate between 1965 and 1993 that was 32 percent greater than the growth rate for the 25 high-tax states. See Figure B-1. This is quite consistent with our findings with respect to the relationship between current levels of Federal spending and economic performance.

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## Notes

1. Some examples of these newer studies are Robert J. Genetski and Young D. Chin, "The Impact of State and Local Income Taxes on Economic Growth" (Chicago: Harris Bank, November 3, 1978); Richard K. Vedder, **State and Local Government Economic Development Strategies: A Supply Side Perspective**, Staff Study, Joint Economic Committee, Congress of the U.S. (Washington, DC: Government Printing Office, 1981); L. Jay Harris, "The effect of State and Local Taxes on Economic Growth: A Time Series-Cross-Section Approach," **Review of Economics and Statistics**, November 1985; Victor Canto and Robert Webb, "The Effect of State Fiscal Policy on State Relative Economic Performance," **Southern Economic Journal** July 1987; and Alaaeddin Mofidi and Joe A. Stone, "Do State and Local Taxes Affect Economic Growth," **Review of Economics and Statistics**, November 1990. This literature is summarized in Richard K. Vedder, **State and Local Taxation and Economic Growth: Lessons for Federal Tax Reform**, Joint Economic Committee Staff Report (Washington, DC: Government Printing Office, 1995).

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## III. Conclusions

In this study, we have demonstrated the following:

1. An oversized Federal Government, defined as one which spends more than about 17.5 percent of GDP, has contributed to a significant decline in the corporate profit share of national output.
2. The fall in corporate profitability has had the effect of reducing the rate of economic growth in the United States. As of 1994, this had led to GDP being approximately ten percent less than it otherwise would have been.
3. Federal spending restraint of \$100 billion dollars would increase current GDP by an amount that is quite consistent with our earlier estimate of \$38 billion.
4. The dollar volume of the cost of Federal Government regulations and mandates has been increasing more rapidly relative to Federal spending since 1989.
5. Small businesses bear a disproportionate share of the cost of Federal Government regulations and mandates.
6. The costs of regulations and mandates leads to inefficiencies in the production of goods and services that are translated into lower levels of national income, compensation of workers, and/or employment.

Collectively, these findings present another perspective with respect to the impact of Federal Government spending that is in excess of the threshold spending level beyond which additional government expenditures are counterproductive in terms of economic growth.

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**NOTE:** This paper is the fourth in a series of studies on the impact of the welfare state. The other three papers are entitled *The Impact of the Welfare State on the American Economy* (December 1995), *The Impact of the Welfare State on Workers* (March 1996), and *The Impact of the Welfare State on America's Children* (May 1996).

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## Endnotes

1. In the second report in this series, **The Impact of the Welfare State on Workers**, March 1996, we analyzed the validity of this notion and found it to be an inappropriate paradigm for explaining the relationship between corporate profits and the earnings of workers.
2. This is demonstrated in **The Impact of the Welfare State on Workers, op. cit.**
3. This is obtained by multiplying the increase in productivity of 0.8 percent by 0.5387 to obtain the increase in the corporate share of output. This is then multiplied by 1.2108 to produce the percentage change in GDP. The values 0.5387 and 1.2108 are the regression coefficients reported in Table 1.
4. Alexis de Tocqueville, **Democracy in America**, Vol. II, Book IV, Chapter 6, p. 319.
5. The employment numbers used here are taken from the monthly Current Population Survey used by the Bureau of Labor Statistics to estimate labor force characteristics.
6. 1989 is not quite a business cycle peak, but it probably represents peak conditions more appropriately than 1990.
7. Lowell Gallaway and Gary Anderson, **Derailing the Small Business Job Express**, Joint Economic Committee Minority Staff Study, November 7, 1962; reprinted (with revisions) as "The Impact of Recent Regulations on Small Business Job Creation," **Journal of Regulation and Social Cost**, March 1993, pp. 27-61.
8. **Derailing ... , op. cit.**, p. 28.
9. These data are reported in Thomas Hopkins' **Regulatory Costs in Profile**, Policy Study, Center for the Study of American Business, forthcoming.
10. U. S. Bureau of the Census, **Poverty in the United States: 1992**, Current Population Reports, P-60 (Washington, DC: Government Printing Office, 1993).

11. Based on Current Population Survey data. See **The Low-Wage Workforce** (Washington, DC: Employment Policies Institute Foundation, 1994), especially Tables 2, 6, and 10.

12. The use of alternative statistical techniques (e. g., regression analysis) confirms the finding, and the relationship is highly significant in a statistical sense.

13. The question of the impact of minimum wages has become a controversial one very recently. David Card and Alan Krueger have been the primary contributors to an attempt to discredit the conventional wisdom that increasing minimum wages has negative effects on employment. See their **Myth and Measurement: The New Economics of the Minimum Wage** (Princeton, NJ: Princeton University Press, 1995) and "Minimum Wages and Employment: A Case Study of the Fast-Food Industry in New Jersey and Pennsylvania," **American Economic Review**, September 1994, pp. 772-193. There are a number of studies that contradict the Card-Krueger position and serious questions have been raised about the reliability of some of their data sources. See, *inter alia*, David Neumark and William Wachser (responding to an earlier Card-Krueger paper), "Employment Effects of Minimum and Subminimum Wage Panel Data on State Minimum Wage Laws," **Industrial and Labor Relations Review**, October 1992, pp. 55-81.

14. Richard Vedder and Lowell Gallaway, "Racial Differences in Unemployment, 1890-1990," **Journal of Economic History**, September 1992, pp. 696-702. For other discussion of this issue, see Edna Bonacich, "Advanced Capitalism and Black/White Race Relations in the United States: A Split Labor Market Interpretation," *American Sociological Review*, February 1976, pp. 34-51; Robert Higgs, **Competition and Coercion: Blacks in the American Economy, 1865-1914** (New York: Cambridge University Press, 1977); and Gerald D. Jaynes, "The Labor Market Status of Black Americans, 1939-1985," **Journal of Economic Perspectives**, Fall 1990, pp. 9-24.

15. For these calculations, we use National Income and Product Account (NIPA) estimates of Federal spending so that our data are for calendar years in both cases. The data on the dollar cost of Federal regulations are reported in **Cost of Government Day** (Washington, DC: Americans for Tax Reform, 1996), p. 16. The total volume of regulatory costs includes Hopkins' estimates, obtained from **Profiles of Regulatory Costs**, available from the U.S. Small Business Administration, plus Genetski's estimate of \$20 billion a year in regulatory costs attributable to the Americans with Disabilities Act (ADA).

16. Those three years are 1980-1982.

17. This relationship is quite consistent with one we report in our book, **Out of Work: Unemployment and Government in Twentieth Century America** (New York: Holmes and Meier, 1993). There, we related unemployment to what we call the adjusted real wage rate. In most aspects, this measure is the obverse of the corporate profit share of output.

18. As a general proposition, we estimate that about 85 percent of any tax on employment, either explicit or implicit, will be shifted to workers in the form of reduced compensation. The remainder of the adjustment will take place on the employment side of labor markets. See our **Concealed Costs: The Real Impact of the Administration's Health Care Plan on the Economy** (Washington, DC: American Legislative Exchange Council, 1994), pp. 13-17.