Joint Economic Committee Republicans
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Government Spending and Economic Growth

Executive Summary

Economic growth is created over the long run by a labor force which possesses the incentive to work and produce, and by entrepreneurs who have incentives to invest in capital stock. Through excessive spending, the government negatively affects the long-run economic growth rate of a free economy. Government spending reduces labor force participation, increases unemployment, and reduces productivity.

Labor Force.

- Government spending reduces labor-force participation by creating disincentives to work.
- Government spending makes labor markets more rigid by hampering the efficient flow of workers from declining industries to expanding industries.

Productivity.

- Government spending reduces productivity growth rates by inhibiting innovation and capital accumulation.
- Government spending reduces productivity as resources are withdrawn from the private sector and placed in the unproductive public sector.

Capital Accumulation.

- Government spending increases interest rates which decrease private investment.
- Government spending creates uncertainty that reduces the return of long-term investments.

Rent-Seeking

- Government spending creates opportunities for rent-seekers to waste resources to curry political favor.
- Rent-seeking distorts economic markets, reduces economic growth, and destroys the free market ethic.

Jim Saxton
Vice-Chairman
Joint Economic
Committee

Government Spending and Economic Growth

"The Federal Government has too often intruded into decisions on the allocation of resources. Such intrusions have caused inefficiencies in the workings of the economy, misallocation of resources, uncertainty, and instability.

Joint Committee on Taxation, 1981

"The medium-term goals...in each Economic report shall include interim numerical goals for... reducing the share of the Nation's gross national product accounted for by Federal outlays to 21 per centum or less by 1981, and to 20 per centum or less by 1983. . .

Employment Act of 1946, as Amended

Introduction

Economic growth, the increase in the quality and quantity of goods and services, is the result of hundreds of thousands of entrepreneurs hiring more workers, introducing technological innovations, and improving worker productivity. Entrepreneurs expand businesses and hire more workers when they think that they can make profits. Likewise, they introduce technological advances or invest in new machines when they perceive that they will receive a return on the expenses paid for machines and research and development.

Workers offer their labor when they perceive that the benefits of work are better than the benefits of leisure. Policy makers must remember that businesses expand when they expect future profits and reductions in workers' take-home pay slows the growth in the total number of hours worked. Through excessive spending, the government negatively affects the long-run growth in the output of goods by reducing business profits and workers' take-home pay. As Table 1 and Table 2 show, the government is increasing its take of resources from the private sector. This increase in expenditures is slowing the growth of the economy. Unless we stop the future expansion of government spending the problem will exacerbate.

Government Spending Levels
(1987 Dollars)

	1959	1993
Real Gov't Spending	515.2	1765.5
Real GDP	1930.5	5132.0
Fixed Investment	282.8	805.5
Gov't Spending/GDP (%)	26.6	34.4

Source: *Economic Report of the President, 1994*

Government Spending

To ensure well-functioning markets, government must expend resources to enforce contracts, provide national security, and protect against criminals. Increased government expenditures, above this minimal level, have a diminishing effect on the growth of the economy. At some level of spending, the impact of government expenditures on the production of goods and services is negative. Excessive government spending makes everybody poorer. However, it is important where the government spends tax dollars. Public investment on roads, ports, and bridges compliments private investment to improve economic productivity, though economic growth suffers when government diverts funds that could be more profitably used to hire workers or buy new machines.

Real Growth Rate

	1959-75	1976-93	1959-93
Gov't Spending	4.7%	2.9%	3.7%
GDP	3.3%	2.5%	2.9%
Productivity	2.5%	1.1%	1.8%
Fixed Investment	3.0%	2.9%	2.4%

Source: *Economic Report of the President, 1994*

In the debate over the negative effects of high tax rates and the near obsession with the budget deficit, the negative effects of government expenditure have been ignored. Resources, taken from citizens and consumed by the state, are not available for private investment or consumption regardless of how government expenditures are financed. In the short-term, if the government grabs more resources from citizens, citizens can pay the additional burden from savings or foreigners can invest in the United States without changes in private consumption or investment. However, in the long-run, increased government expenditure reduces private investment and consumption. **The economy cannot grow without increased private investment and consumption.**

Sources of Economic Growth

Economists identify several factors that contribute to economic growth, such as growth in the number of workers, the number of plants and equipment, or economic productivity. For the standard of living to rise, the productivity of workers must rise. To satisfy the demands of the populace, the U.S. economy needs growth in economic productivity. Productivity increases with technological improvements and business investment. Labor productivity rises as workers produce more output in the same time frame, or the same output in less time. We can identify the negative impact of government expenditure on each source of economic growth.

Growth of the Labor Force

For the economy as a whole, there are three possible ways that the labor supply may grow, 1) the working-age population may grow, 2) immigration may increase, or 3) the proportion of workers to non-workers may rise. Government expenditures reduce the take-home pay of workers which discourages immigration and causes some people to leave the workforce, thus affecting immigration and the proportion of workers to non-workers.

If governments finance expenditures through payroll taxes, workers will receive lower take-home pay while employers must pay more for labor. Employer wage costs are higher than the wage received by the employee. The wedge between employer costs and employee wages will make low-productivity workers, the young, poor, and elderly, too expensive for employers. The wedge created by payroll taxes acts like the minimum wage to decrease youth employment. Low-productivity workers may become discouraged and join the welfare rolls which further exacerbates the problem of government spending.

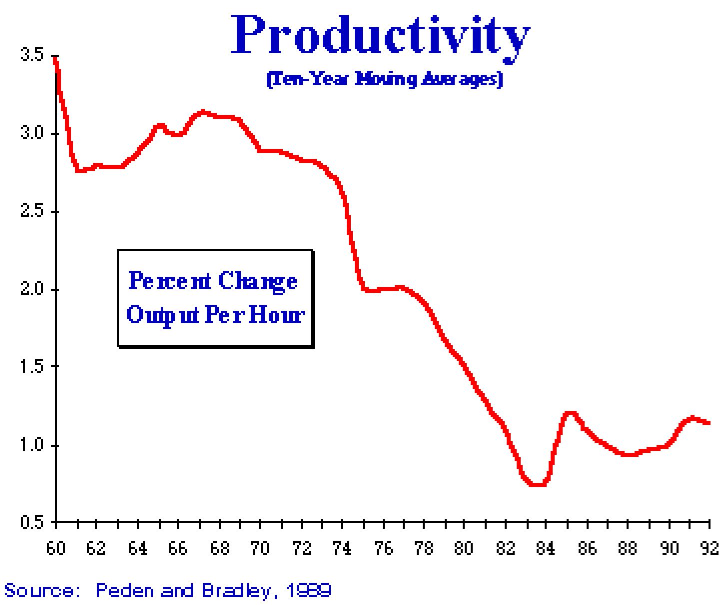
Second, empirical observation shows that increases in government expenditure mean that more workers are employed in the public sector relative to the private sector than would otherwise be. The bureaucratic rules and rigidities of the public sector hamper the ability of the labor market to function. A properly-functioning labor market will allow a flow of workers from declining ventures to successful ventures. Private markets permit a smoother transition among various job market opportunities which reduces unemployment. Lower unemployment increases the economic growth rate.

Third, tax policies affect the proportion of workers to non-workers. A study by two Brookings Institution scholars, Barry Bosworth and Gary Burtless estimated that working-aged men worked 5.2 percent more hours and work-aged women worked 8.8 percent more hours due to the Reagan administration's tax cuts. Overall the proportion of workers to the total population rose from 63.8 percent in 1980 to 66.4 percent in 1990.

High marginal tax rates impose particular burdens upon highly skilled workers. Doctors, lawyers, and professors left the United Kingdom for other countries due to high-tax rates at home. Entrepreneurs are also affected. Fewer people will takes risks if the government confiscates a large share of the gains from successful ventures.

Productivity

Government expenditure impacts on productivity are more damaging than their impacts on the supply of workers. The standard of living cannot rise unless the same number of workers produce more goods and services. For economic growth to match the post-war U.S. trend, productivity must rise. Currently, productivity has fallen well below the post-war trend (see figure below)[1].



Worker productivity improves when businesses employ better techniques, better technology, more machines and equipment per worker, or increase the education and training of workers. The free market provides the impetus, in the form of higher profits, for firms to upgrade technologies and techniques and for workers to acquire more job skills. These free market forces are absent when economic decisions are constrained, or controlled, by government. Another way government spending hurts productivity is by destroying private savings. Private savings are crucial to improve technologies and to invest in plants and equipment.

Contributions to Increasing Labor Productivity,
1929-1982

Contributor	Percentage Contributed (%)
Capital	25
Advances in Knowledge	36
Improved Resource Allocation	10
Education per Worker	18
Economies of Scale	12
TOTAL	100

Source: OECD, 1992

Growth in Plants and Equipment

"Our country would be far better off with a federal budget of $1 trillion and a deficit of $300 billion than with a fully balanced budget of $2 trillion.

Milton Friedman[2], 1995

The growth of plant and equipment, or capital investment, is negatively impacted by government spending. Simply put, government spending "crowds out" private investment. When government uses resources, there are fewer resources for private purposes. Temporarily, government spending and private investment can be complementary. Government's grab for resources can be met through reduction in savings or capital inflows from abroad. In the long-run, private investment must fall as government increases spending.

Government may invest the resources it controls in productive areas, but political forces are less likely than private markets to allocate resources where the returns are the highest. The state invests resources where the political demands are greatest not where the profit opportunities are large. Government spending also can raise interest rates. Higher interest rates discourage private sector investment because it ends up costing the investor more over the long run. As interest rates rise, the returns to investment fall. Capital projects that made economic sense at lower interest rates are no longer viable. All these effects serve to lower the long-term growth rate of the capital stock.

Rent-Seeking

Economic growth is adversely impacted when the government imposes itself through spending and regulations. As more resources are channeled through the political process, the opportunities for rent-seeking increase. Rent-seeking is the manipulation of the political process for personal gain. Individuals, or special interests, attempt to create government-sanctioned monopolies or impose costs upon other people without those people receiving the full, or any, benefit from the action. Rent-seekers expend government resources to capture these monopoly gains. The resources expended on rent-seeking are a net loss to society.

As the state grows, it provides increasing opportunities for transfers of rents. It also increases the profitability of rent-seeking. Expanding the opportunity for rent-seeking increases waste and permanently lowers the growth rate of the economy. The productivity of rent-seeking activity is zero, or negative, for the economy because rent-seeking reduces potential economic output.

Conclusion

Some government spending is crucial for a well-functioning economy. However, currently the United States and most developed countries' governments spend excessively which reduces economic growth.[3] In other words, as governments divert resources away from private entrepreneurs, jobs, investment, and productivity decline which ultimately slows down the economy.

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Notes

1. Peden, Edgar A. and Bradley, Michael D. 1989 "Government Size, Productivity, and Economic Growth: The Post-War Experience." *Public Choice.* 61: 229-245.

2. Friedman, Milton "Balanced Budget: Amendment Must Put Limit on Taxes." *Wall Street Journal*. January 4, 1995.

3. Hong Kong remains an exception with government spending only eleven percent of GDP.