The Trouble with Government Spending

This essay was originally published in Muhlenkamp Memorandum *Issue 40, October 1996. It was a presidential election year. Bob Dole and Jack Kemp were running on the Republican ticket against incumbents Bill Clinton and Al Gore. As in any election year, there was much discussion of taxes and government spending. But the discussion often dissolved into political attacks and sound bites instead of furthering any true understanding of the underlying economic issues. So in this essay, Ron offers his own perspective on taxes, federal spending, and their effects on the economy.*

When Bob Dole won the Republican nomination for president, it looked like a victory for the "old guard" Republicans, à la George H. W. Bush, and a defeat for the "growth" Republicans of Ronald Reagan. The argument within the party appeared to be over for this election cycle. Then Bob Dole proposed a 15% cut in income tax rates and named Jack Kemp as his running mate. This decision seemed to resolve the argument (within the Republican Party) in favor of growth and smaller government. Based on this, I had renewed hope that the presidential campaign would focus on the benefits of a smaller federal government. I believe this argument needs to be put directly before the American people. But, so far, I have been disappointed in the presentation of the argument. So I will attempt to make the argument myself. The argument has two parts. The first part focuses on who is better able to spend our money, the federal government or individual citizens. The second part of the argument focuses on how to best generate more money to be spent by the citizenry and by the federal government.

Who Is Better Able to Spend Our Money?

In 1980, I spent an afternoon with my old college roommate, Mike, and his wife, Cindy. Cindy and I got into an argument that Mike finally summed up (and thankfully ended) with, "Ron, you believe that the average person, dumb as he may be, is better at making his/her own decisions and spending his/her own money than a highly educated, well-meaning person in Washington, D.C., can do it for him?" I said, "Absolutely!" He continued, "Cindy, you believe that an intelligent, highly educated, well-meaning person in Washington, D.C., can spend the average person's money better than that person can do it for himself." She said, "That's right!" I can't summarize the argument any better than Mike did.

President Clinton's healthcare plan was based on his belief that the politicians in Washington, D.C., could spend our money better than we can. On his four-day train trip to the convention in Chicago, he proposed $8 billion a year in new government spending based on this same belief. Bob Dole now says, "We believe/trust the American people are capable of spending their own money a whole lot better than politicians can." (Yes, this is a change from his votes and actions in years past!) So the question is: who do you believe is more capable of spending your money? I believe the issue from an economics standpoint is more a matter of incentive than it is of knowledge. Individuals are most capable of spending their own money regardless of knowledge, because when individuals spend their own money, they have better incentive to earn more money. Let me explain.

How Do We Best Generate More Money to Spend?

The trouble with government spending is that the government doesn't have any money. Every dollar spent by the government must be raised—either through taxes or through borrowing. We've heard a lot about the borrowing to cover the federal deficit, but we don't hear much about the taxes. For most of us, we only see the taxes that are on our annual tax return and our W-2 forms. The W-2 lists our gross pay along with deductions for Social Security (FICA) and state and local taxes. But this is only part of the story.

The other part is the taxes paid by the employer, which the employee never sees. Figure 6.21 shows the W-2 numbers for someone making a gross income of $36,000 per year. The table also shows the amounts paid by the employer for FICA, various unemployment taxes, health care, and so on. As you can see, for the employee to take home $28,521 it costs the employer $43,128. Specifically, for my son to take home $1.00 it costs me (his employer) $1.51. So he must produce $1.56. The 5 cents is my return for hiring him. (In fact, the average profit to payroll in the U.S. economy is 5%–6%.)

If the employee doesn't produce $1.56, he/she won't have a job. So the way to encourage job creation is to allow the employer to keep the nickel. If you tax away the nickel, you tax away the job. In the 1970s, we taxed away the nickel (inflation raised income taxes, and the government raised Social Security taxes) and businesspeople quit hiring.

Figure 6.21 Employment Costs (W2 Filing: Married, Two Children), January 1996

Employee's Deduction		Employer's Costs	
Gross Wage[1]	$36,000.00	Gross Wages[1]	$36,000.00
FICA (Social Security & Medicare)	$2,754.00	FICA (Social Security & Medicare)	2,754.00
Federal Withholding (0 Exemptions)	3,696.00	Health Insurance	4,207.32
State Withholding	1,008.00	Unemployment Taxes (Federal & State)	167.52
PA State Unemployment	10.80		
Occupational Tax	10.00	Employee's Cost to Company	$43,128.84
Employee's Take Home Pay	$28,521.20		

[1] Based on the U.S. median income.

Although Ronald Reagan didn't cut federal spending, he did cut tax rates, encouraging us all to earn more money (and incidentally to pay more taxes). So the question becomes, "What rules give people the greater incentive to produce and earn more—and to spend more effectively?" I have observed the following:

People have three working speeds:

- They work for someone who can't/won't fire them, typically the government.
- They work for someone who can fire them, typically a business.
- They work for themselves.

People have four spending modes:

- Spend their own money (money they've earned) on themselves (private economy).
- Spend money they've earned on someone else (private charity).
- Spend someone else's money on themselves (see the Senate office building).
- Spend someone else's money on someone else (government programs).

Based on the above, I would suggest that personal and national wealth production only occurs in the private (nongovernmental) market because when the government gets involved, work incentives decrease and spending becomes less efficient.

The most obvious example of this is in food production and farm policy. The consumer is quite willing to pay for food, and therefore to pay farmers to grow food. Only government would pay farmers to not grow food. By giving incentives to not produce goods and services, the government actively lowers the total wealth of the nation.

Summary

So what's the problem with government spending? It moves resources from the private sector (slowing the economy and decreasing employment) into the government sector where work incentive is poor and spending is inefficient. It assumes a well-meaning individual in Washington can spend our money better than we can, but government spending has none of the incentive effects that drive the economy. Which is more likely to get you to work overtime: the thought of a nice house, car, or vacation, or the thought of paying more in taxes so the government can buy another ship or build another bridge?

Editor's Note

We've updated the employment costs table (see Figure 6.22). You'll notice several changes from the original. First, the median income has increased from $36,000 in 1996 to $40,000 in 2006. We've also added pension and profit-sharing contributions under employer's costs. These were not included in the original essay, but they constitute a significant portion of employer costs after the first year of employment, so they are included here. And though they are benefits to the employee (just as health insurance is), they are not part of the employee's take-home pay and therefore not apparent to most employees.

The updated table shows that the costs of employment have risen since 1996. In 1996, for an employee to take home $1.00 in pay it cost the employer $1.83, so the employee had to earn $1.92 (remember, the employer wants his 5%). In 2006, for the employee to take home $1.00 in pay it costs the employer $2.12 so the employee has to earn $2.23. The change from 1996 to 2006 is partly due to taxes, and partly due to healthcare costs.

Figure 6.22 Employment Costs (W-2 Filing: Married, Two Children), Updated

Employee's Deduction	**January 1996**	**January 2006**
Gross Wage[1]	$36,000.00	$40,000.00
FICA and Medicare	$2,754.00	$3,060.00
Federal Withholding (0 Exemptions)	3,696.00	$4,056.00
State Withholding	1,008.00	$1,228.00
PA State Unemployment	10.80	$36.00
Occupational Tax	10.00	$10.00
Employee's Take Home Pay	$28,521.20	$31,610.00
Employer's Costs		
Gross Wages[1]	$36,000.00	$40,000.00
FICA (Social Security & Medicare)	2,754.00	$3,060.00
Health Insurance	4,207.32	$13,765.20
Unemployment Taxes	167.52	$266.94
Pension Contribution [2]	3,600.00	$4,000.00
Profit Sharing Contribution [3]	5,400.00	$6,000.00
Employee's Cost to Company	$52,128.84	$67,092.14

1 Based on the U.S. median income.
2 Based on the maximum allowable by law: 10% of gross wages.
3 Based on the maximum allowable by law: 15% of gross wages.

If we want our economy to grow, and we want to reduce unemployment, we need to keep the cost of employment low. We need to allow the workers to keep enough of what they earn that they will continue to work to their full potential. We need to allow the employers to keep enough of their profits that they will create new jobs. More jobs mean more income, which means more income tax revenues (even at lower rates). Therefore, keeping employment costs low not only grows the economy and reduces unemployment, it also generates more revenue for the government.

Every four years the discussion of taxes and government spending comes into the spotlight as the Democratic and Republican parties vie for our votes. That means that we, the voters, get to tell the politicians who we think is better able to spend our money, and how we think our economy can best generate more money to spend. These questions are still alive and well.