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Intelligent Investment Management

The Trouble With Government Spending

Adapted from an essay originally published in Muhlenkamp Memorandum *Issue 40, October 1996. (The original essay is available on our website.) Ron offers his own perspective on taxes, federal spending, and their effects on the economy.*

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.

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 and Medicare (FICA), federal withholding, 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. The following table shows the W-2 numbers for someone making a gross income of $45,000.00 per year in 2011. The table also shows the amounts paid by the employer for FICA, various unemployment taxes, health care insurance, and so on. As you can see, for the employee to take home $38,066.00 it costs the employer $81,679.66. Specifically, for my son to take home $1.00 it costs me (his employer) $2.15. So he must produce $2.35. The 20 cents is my return for hiring him. (In fact, the average profit-to-payroll in the U.S. economy is 10%–11 percent.)

Employment Costs for 2011 (W-2 Filing: Married, Two Children)

Employee's Deductions		
Gross Wage	$	45,000.00
FICA	$	2,542.50
• Social Security (4.2%)[1]		
• Medicare (1.45%)		
Federal Withholding (4 exemptions)	$	2,472.00
PA State Withholding	$	1,381.50
PA State Unemployment	$	36.00
Local Services Tax	$	52.00
Local Earned Income Tax	$	450.00
Employee's Take-Home Pay	**$**	**38,066.00**

Employer's Costs		
Gross Wage	$	45,000.00
FICA	$	3,442.50
• Social Security (6.2%)		
• Medicare (1.45%)		
Health Insurance	$	21,717.00
PA State Unemployment	$	214.16
Federal Unemployment	$	56.00
Employee's Cost to Company	**$**	**70,429.66**
Pension/Profit Sharing Contribution[2]	$	11,250.00
Employee's Cost to Company	**$**	**81,679.66**

[1] *For 2011 only, employees will pay 4.2% of their wage earnings for the Social Security tax, instead of the normal 6.2% rate. Employers still pay the full 6.2% rate.*

[2] *Based on the maximum allowable contribution by law: 25% of gross wages.*

If the employee doesn't produce $2.35, he/she won't have a job. So the way to encourage job creation is to allow the employer to keep the dime (10% of $1.00). If you tax away the dime, you tax away the job. In the 1970s, we taxed away the dime, (inflation raised income taxes, and the government raised Social Security taxes) and businesspeople quit hiring.

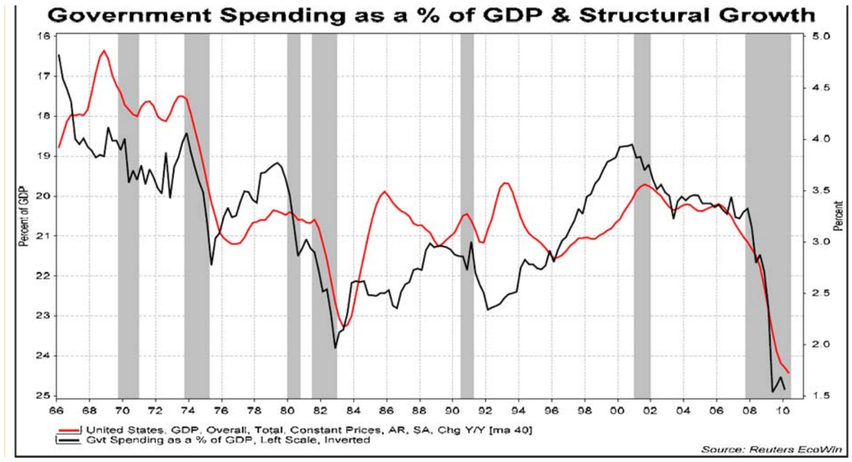
Although Ronald Reagan didn't cut federal spending, he did cut tax rates, encouraging us all to earn more money (and incidentally to pay more taxes). So the question becomes, "What rules give people the greater incentive to produce and earn more—and to spend more effectively?" I have observed the following:

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 (non-governmental) market because when the government gets involved, work incentives decrease, and spending becomes less efficient.

We recently received a chart from our friends at GaveKal Research. It shows the following correlation: As government spending as a percentage of GDP goes up, economic growth goes down, lending support to my argument. Note that the left scale of the chart is inverted.



Source: GaveKal Research. Used with permission.

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. The figure from GaveKal Research demonstrates my point.

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. Thirty years later, these questions are still alive and well.