SPECIAL TOPIC 1

Government Spending and Taxation

FOCUS

- How has government spending per person changed historically in the United States?
- How has the composition of government spending changed in recent decades?
- Do taxes measure the cost of government?
- Do the rich pay their fair share of taxes? Do they pay less now than they did a couple of decades ago?
- How does the size of government in the United States compare with other countries?
- How has the share of the population paying taxes and receiving various types of transfer benefits changed in recent years? How is this likely to influence the fiscal future of the United States?

[A] wise and frugal government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government....

—Thomas Jefferson[1]

I'm proud to be paying taxes in the United States. The only thing is—I could be just as proud for half the money.

—Comedian Arthur Godfrey

[1]Thomas Jefferson, First Inaugural Address (March 4, 1801).

In Chapters 5 and 6, we analyzed the economic role of government and the operation of the political process. We learned that whereas the political process and markets are alternative ways of organizing the economy, a sound legal system, secure property rights, and stable monetary regime are vitally important for the efficient operation of markets. We also noted that there may be advantages of using government to provide certain classes of goods that are difficult to supply efficiently through markets. However, as public-choice analysis indicates, the political process is not a corrective device. Even democratic representative government will often lead to the adoption of counterproductive programs. This feature will take a closer look at government in the United States and will provide additional details with regard to its spending, taxing, and borrowing.

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GOVERNMENT EXPENDITURES

As we noted in Chapter 6, total government spending (federal, state, and local) sums to almost 40 percent of the U.S. economy. The size of government has grown substantially over the past 80 years. Measured as a share of GDP, total government spending rose from less than 10 percent in 1930 to a little more than 30 percent in 1980 and nearly 40 percent in 2010. Approximately three-fifths of the spending by government now takes place at the federal level. Federal expenditures on just four things—(1) income transfers (including Social Security and other income-security programs), (2) health care, (3) national defense, and (4) net interest on the national debt—accounted for 88 percent of federal spending in 2010. (See Chapter 6, Exhibit 2.) This means that expenditures on everything else—the federal courts, national parks, highways, education, job training, agriculture, energy, natural resources, federal law enforcement, and numerous other programs—were less than 12 percent of the federal budget. Major spending categories at the state and local level include education, public welfare and health, transportation and highways, utilities, and law enforcement.

FEDERAL SPENDING PER PERSON, 1792–2010

Article 1, Section 8, of the U.S. Constitution outlined a limited set of functions that the federal government was authorized to perform. These included the authority to raise up an army and navy, establish a system of weights and measures, issue patents and copyrights, operate the post office, and regulate the value of money that it issued. Beyond this, the federal government was not authorized to do much else. The founders of the United States were skeptical of governmental powers, and they sought to limit those powers, particularly those at the federal level. (See the quotation by Thomas Jefferson at the beginning of this feature.)

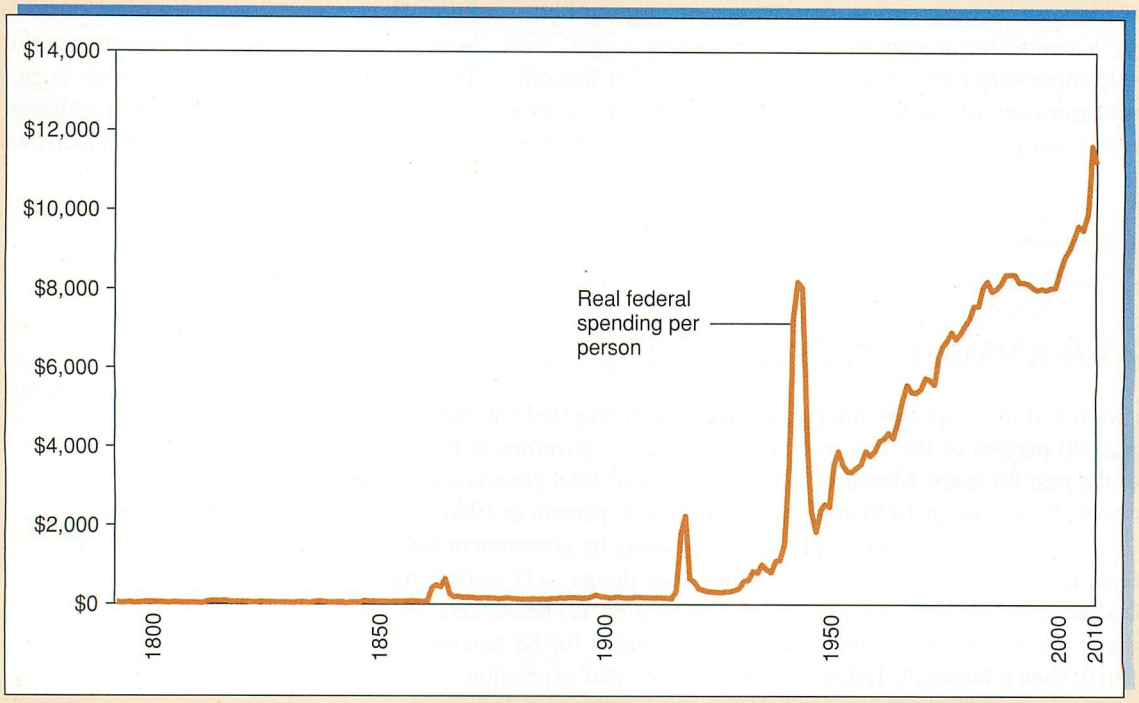
During the United States' first 125 years, the constitutional limitations worked pretty much as planned; the economic role of the federal government was quite limited, and its expenditures were modest. In the nineteenth century, except during times of war, most government expenditures were undertaken at the state and local level. The federal government spent funds on national defense and transportation (roads and canals) but not much else.

Exhibit 1 presents data on real federal spending per person (measured in terms of the purchasing power of the dollar in 2010). Just before the Civil War, real federal expenditures were $60 per person, not much different than the $50 figure of 1800. Federal spending per person rose sharply during the Civil War, but it soon receded and remained in a range between $125 and $200 throughout the 1870–1916 period. Thus, before World War I, federal expenditures per person were low and the growth of government was modest.

Exhibit 1

Real Federal Expenditure per Capita: 1792–2010

Real federal spending per person (measured in 2010 dollars) was generally less than $50 before the Civil War, and it ranged from $125 to $200 throughout the 1870–1916 period. However, beginning with the spending buildup for World War I in 1917, real federal spending per person soared, reaching $11,194 in 2010—almost 80 times the level of 1916.



Source: U.S. Census Bureau, *Historical Statistics of the United States* (Washington, DC: U.S. Dept. of Commerce, U.S. Bureau of the Census, 1975); and *Economic Report of the President* (Washington, DC: U.S. Government Printing Office, 2011).

Beginning with the World War I spending of 1917, however, the situation changed dramatically. Federal spending remained well above the prewar levels during the 1920s and rose rapidly during the 1930s. It soared during World War II, and after receding at the end of the war, federal spending continued to grow rapidly throughout the 1950–1990 period. After a brief reduction during the 1990s, per capita real federal spending is once again on the upswing. Whereas per capita federal spending fell by 4.6 percent during the 1990s, it increased by 40 percent during 2000–2010. In 2010, it amounted to $11,194, roughly 80 times the $142 figure of 1916. The additional government expenditures came with a cost. On average, Americans paid more federal taxes in one week during 2010 than during the entire year in 1916. Based on current budget projections, the federal tax burden will continue to grow.

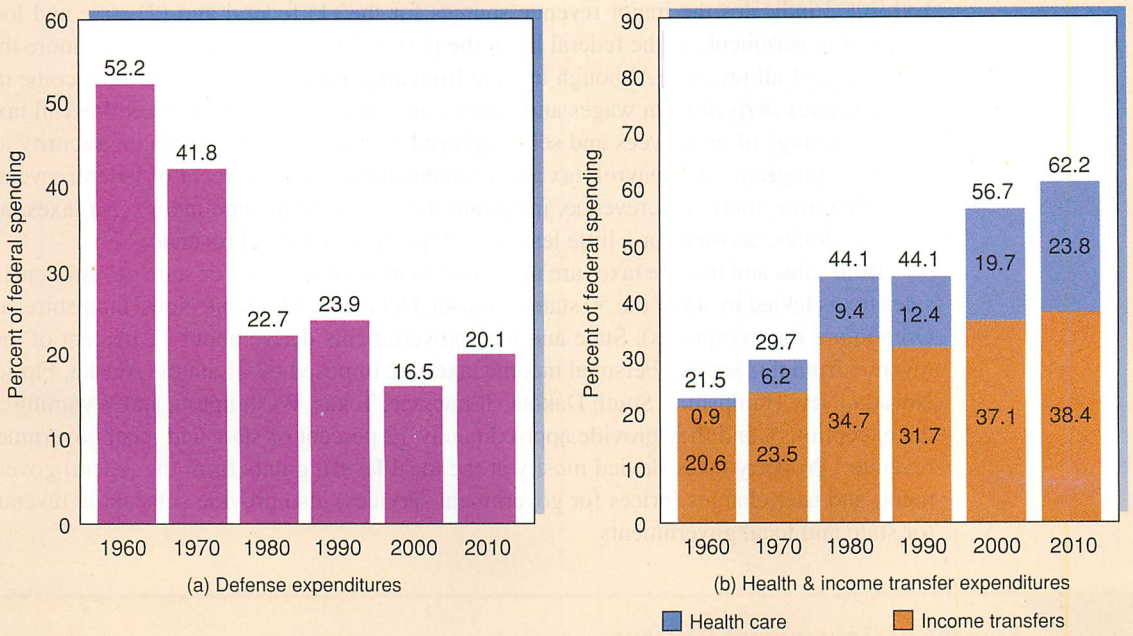
Not only has federal spending grown rapidly, but also there has been a dramatic shift in the composition of that spending. Since 1960, spending on defense has fallen as both a share of the budget and as a share of the economy, whereas expenditures on health care, transfer payments, and subsidies have soared.

As **Exhibit 2** illustrates, defense expenditures constituted more than half (52.2 percent) of federal spending in 1960. By 2000, defense spending was only 16.5 percent of the federal budget. Largely because of the wars in Iraq and Afghanistan, defense spending has expanded during the past decade, reaching 20.1 percent of the federal budget in 2010. Government expenditures on income transfers (including Social Security and other transfer

Exhibit 2

The Changing Composition of Federal Spending

In 2010, national defense expenditures accounted for 20.1 percent of the federal budget, down from 52.2 percent in 1960. In contrast, spending on income transfers and health care rose from 21.5 percent of the federal budget in 1960 to 62.2 percent in 2010.



Source: Economic Report of the President (Washington, DC: U.S. Government Printing Office, 2011).

programs) and health care (primarily Medicare and Medicaid) have soared during the past half century. As Exhibit 2 shows, income transfers and health care expenditures rose from 21.5 percent of the federal budget in 1960 to 62.2 percent in 2010.

Thus, there has been a dramatic change in the composition of federal spending during the last five decades. In contrast with earlier times, national defense is no longer the primary focus of the federal government. In essence, the federal government has become an entity that taxes working-age Americans in order to provide income transfers and health care benefits primarily for senior citizens. Furthermore, spending on the elderly is almost certain to increase as the baby-boomers move into the retirement phase of life during the next two decades.

TAXES AND THE FINANCE OF GOVERNMENT

Government expenditures must be financed through taxes, user charges, or borrowing.[2] Borrowing is simply another name for future taxes that will have to be levied to pay the interest on the borrowed funds. Thus, it affects the timing but not the level of taxes. In the United States, taxes are by far the largest source of government revenue. The power to tax sets governments apart from private businesses. Of course, a private business can put whatever price tag it wishes on its products, but no private business can force you to buy its

[2]In addition to user charges, taxes, and borrowing, the operations of government might be financed by printing money. But this is also a type of tax (it is sometimes called an "inflation tax") on those who hold money balances.

goods. With its power to tax, a government can force citizens to pay, whether or not they receive something of value in return. As government expenditures have increased, so, too, have taxes. Taxes now take approximately one-third of the income generated by Americans.

TYPES OF TAXES

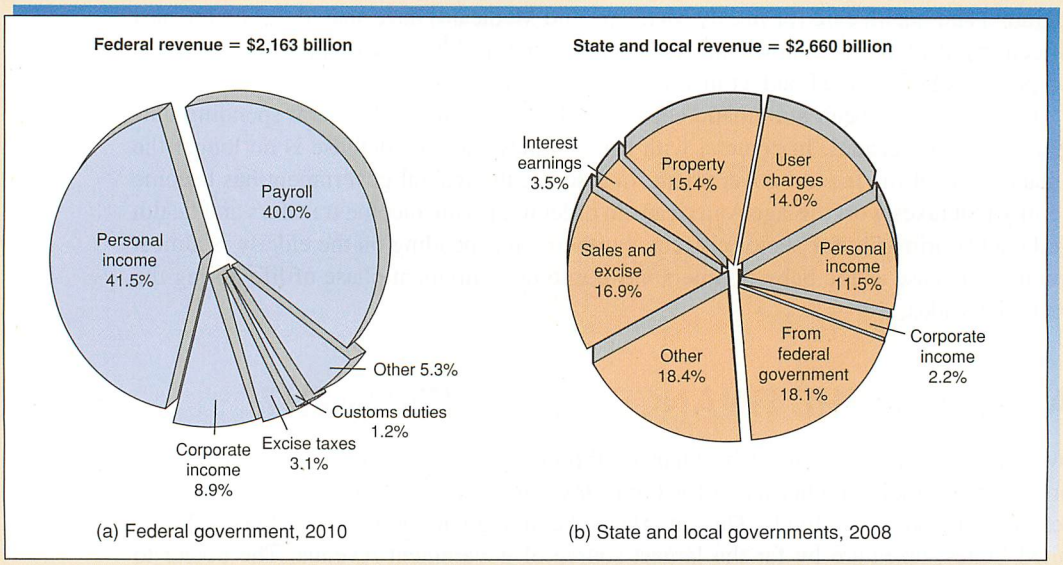
Exhibit 3 indicates the major revenue sources for the (1) federal and (2) state and local levels of government. At the federal level, the personal income tax accounts for more than 40 percent of all revenue. Although income from all sources is covered by the income tax, only earnings derived from wages and salaries are subject to the payroll tax. Payroll taxes on the earnings of employees and self-employed workers finance the Social Security and Medicare programs. The payroll tax also accounts for about 40 percent of federal revenue. The remaining sources of revenue, including the corporate income tax, excise taxes, and customs duties, account for a little less than 20 percent of federal revenue.

Both sales and income taxes are important sources of revenue for state governments. A sales tax is levied by 45 of the 50 states (Alaska, Delaware, Montana, New Hampshire, and Oregon are the exceptions). State and local governments derive about 17 percent of their revenue from this source. Personal income taxes are imposed by 41 states (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming are the exceptions), and they provide approximately 12 percent of state and local government revenue.[3] Property taxes (levied mostly at the local level), grants from the federal government, and user charges (prices for government services) also provide substantial revenues for state and local governments.

Exhibit 3

Sources of Government Revenue

The major sources of government revenue are shown here. More than 40 percent of federal revenues are derived from the personal income tax. The share of federal revenue derived from the payroll tax is only slightly less. The major revenue sources of state and local governments are sales and excise taxes, personal income taxes, user charges, grants from the federal government, and property taxes.



Source: Economic Report of the President (Washington, DC: Government Printing Office, 2011) and State and Local Government Finances (2008), www.census.gov.

[3]New Hampshire and Tennessee have limited income taxes that only tax income derived from dividend and interest (so wage income is not subject to the personal income tax).

TAXES AND THE COST OF GOVERNMENT

There are no free lunches. Regardless of how they are financed, activities undertaken by the government are costly. When governments purchase resources and other goods and services to provide missiles, education, highways, health care, and other goods, the resources used by the government will be unavailable to produce goods and services in the private sector. As a result, private-sector output will be lower. This reduction in private-sector output is an opportunity cost of government. Furthermore, this cost will be present whether government activities are financed by taxes or borrowing.

Moreover, a tax dollar extracted from an individual or a business ends up costing the private economy much more than just one dollar. There are two main reasons why this is the case. ***First, the collection of taxes is costly.*** The administration, enforcement, and compliance of tax legislation require a sizable volume of resources, including the labor services of many highly skilled experts. The IRS itself employs more than 100,000 people. In addition, an army of bookkeepers, tax accountants, and lawyers is involved in the collection process. According to the Office of Management and Budget, each year individuals and businesses spend more than 6.6 billion hours (the equivalent of 3.3 million full-time year-round workers) keeping records, filling out forms, and learning the tax rules and other elements of the tax-compliance process.[4] More than half of U.S. families now retain tax-preparation firms like H&R Block and Jackson Hewitt to help them file the required forms and comply with the complex rules. Businesses spend roughly $5 billion each year in tax-consulting fees to the four largest accounting firms, to say nothing of the fees paid to other accounting, law, and consulting firms. In total, the resources involved amount to between 3 percent and 4 percent of national income (or 12 to 15 percent of the revenues collected). If these resources were not tied up with the tax-collection process, they could be employed producing goods and services for consumption.

Second, taxes impose an additional burden on the economy because they eliminate some productive exchanges (and cause people to undertake some counterproductive activities). As we noted in Chapter 4, economists refer to this as an *excess burden* (or *deadweight loss*) because it imposes a burden over and above the tax revenue transferred to the government. It results because taxes distort incentives. When buyers pay more and sellers receive less due to the payment of a tax, trade and the production of output become less attractive and decline. Individuals will spend less time on productive (but taxed) market activities and more time on tax avoidance and untaxed activities such as leisure. Research indicates that these deadweight losses add between 9 percent and 16 percent to the cost of taxation.[5] This means that $1 in taxes paid to the government imposes a cost of somewhere between $1.20 and $1.30 on the economy. Thus, the cost of a $100-million government program financed with taxes is really somewhere between $120 million and $130 million. As a result, the government's supply of goods and services generally costs the economy a good bit more than either the size of the tax bill or the level of government spending implies.

When considering the cost of taxation, it is also important to recognize that all taxes are paid by people. Politicians often speak of imposing taxes on "business" as if part of the tax burden could be transferred from individuals to a nonperson (business). This is not the case. Business taxes, like all other taxes, are paid by individuals. A corporation or business firm might write the check to the government, but it merely collects the money from someone else—from its customers in the form of higher prices, its employees in the form of lower wages, or its stockholders in the form of lower dividends—and transfers the money to the government.

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[4]Office of Management and Budget, *Information Collection Budget of the United States Government,* and Tax Foundation *Special Brief,* by Arthur Hall (March 1996).

[5]The classic article on this topic is Edgar K. Browning, "The Marginal Cost of Public Funds," *Journal of Political Economy* 84, no. 2 (April 1976): 283–98.

HOW HAS THE STRUCTURE OF THE PERSONAL INCOME TAX CHANGED?

The personal income tax is the largest single source of revenue for the federal government. The rate structure of the income tax is progressive; taxpayers with larger incomes face higher tax rates. During the past half century, the structure of the rates has been modified several times. In the early 1960s, there were 24 marginal tax brackets ranging from a low of 20 percent to a high of 91 percent. The Kennedy–Johnson tax cut reduced the lowest marginal rate to 14 percent and the top rate to 70 percent. The rate reductions during the Reagan years cut the top marginal rate initially to 50 percent in 1981 and later to approximately 30 percent during the period 1986–1988. During the 1990s, the top rate was increased to 39.6 percent, but the tax reductions during the administration of George W. Bush rolled back the top rate to 35 percent. These cuts were scheduled to expire at the end of 2010 but were extended for two more years.

Thus, since the late 1980s, Americans with the highest incomes have paid sharply lower top marginal tax rates—rates in the 30- to 40-percent range, compared to top rates of 91 percent in the early 1960s and 70 percent before 1981. These reductions in the top rate make it tempting to jump to the conclusion that high-income Americans are now getting a free ride—that they now shoulder a smaller share of the personal income tax burden than in the past. But such a conclusion would be fallacious.

Exhibit 4 presents the Internal Revenue Service data on the share of the personal income tax paid by various classes of high-income taxpayers, as well as those in the bottom half of the income distribution, for the years 1963, 1980, 1990, and 2008. These data show that the share of the personal income tax paid by high-income Americans has increased substantially since 1963, and the increase has been particularly sharp since 1980. For example, the top 1 percent of earners paid 38.0 percent of the personal income tax in 2008, up from 19.1 percent in 1980 and 18.3 percent in 1963. The top 10 percent of income recipients paid 69.9 percent of the personal income tax in 2008, compared to 49.3 percent in 1980 and 47 percent in 1963. At the same time,

Exhibit 4

Share of Federal Income Taxes Paid by Various Groups, 1963–2008

Even though marginal tax rates have been reduced substantially during the past three decades, upper-income Americans pay a much larger share of the federal income tax today than was previously the case. In 2008, the richest 1 percent of Americans paid 38.0 percent of the federal income tax, up from 18.3 percent in 1963 and 19.1 percent in 1980. The 5 percent of Americans with the highest incomes paid more than half of the personal income tax, whereas the entire bottom half of the income distribution (the bottom 50 percent) paid only 2.7 percent of the total.

	Share of Total Federal Personal Income Tax Paid			
Income Group	1963	1980	1990	2008
Top 1%	18.3%	19.1%	25.1%	38.0%
Top 5%	35.6%	36.8%	43.6%	58.7%
Top 10%	47.0%	49.3%	55.4%	69.9%
Top 25%	68.8%	73.0%	77.0%	86.3%
Top 50%	89.6%	93.0%	94.2%	97.3%
Bottom 50%	10.4%	7.1%	5.8%	2.7%

Source: Internal Revenue Service (also available online at the Tax Foundation's Web site: www.taxfoundation.org/).

the share of the personal income tax paid by the bottom half of the income recipients has steadily fallen from 10.4 percent of the total in 1963 to 7.1 percent in 1980 and 2.7 percent in 2008.

What is going on here? How can one explain the fact that high-income Americans are now paying more of the personal income tax even though their rates are now sharply lower than those in effect before 1981? Two major factors provide the answer. First, when marginal rates are cut by a similar percentage, the "incentive effects" are much greater in the top tax brackets. For example, when the top rate was cut from 91 percent to 70 percent during the Kennedy–Johnson years, high-income taxpayers in this bracket got to keep $30 out of every $100 of additional earnings after the tax cut, compared to only $9 before the rates were reduced. Thus, their incentive to earn additional income increased by a whopping 233 percent (30 minus 9 divided by 9)! Conversely, the rate reduction in the lowest tax bracket from 20 percent to 14 percent meant that the low-income taxpayers in this bracket now got to keep $86 of each additional hundred dollars that they earned compared to $80 before the tax cut. Their incentive to earn increased by a modest 7.5 percent (86 minus 80 divided by 80). Because the rate reductions increased the incentive to earn by much larger amounts in the top tax (and therefore highest-income) brackets, the income base on which high-income Americans were taxed expanded substantially as their rates were reduced. As a result, the tax revenues collected from them declined only modestly. In the very highest brackets, the rate reductions actually increased the revenues collected from high-income Americans. (See Laffer curve analysis of Chapter 4.) In contrast, the incentive effects were much weaker in the lower tax brackets and, as a result, rate reductions led to approximately proportional reductions in revenues collected from low- and middle-income taxpayers. This combination of incentive effects shifts the share of taxes paid toward those with higher incomes, the pattern observed in Exhibit 4.

Second, both the standard deduction and personal exemption have been increased substantially during the last couple of decades. This means that Americans are now able to earn more income before they face any tax liability. In 2008, for example, 36.3 percent (approximately 52 million returns) of those filing an income tax return either had zero tax liability or actually received funds from the IRS as the result of the **Earned Income Tax Credit**. This change in the structure of the personal income tax explains why people in the bottom half of income now pay such a small percentage of the personal income tax: 2.7 percent in 2008 compared to 10.4 percent in 1963.[6]

Earned Income Tax Credit
A provision of the tax code that provides a credit or rebate to people with low earnings (income from work activities). The credit is eventually phased out if the recipient's earnings increase.

INCOME LEVELS AND OVERALL TAX PAYMENTS

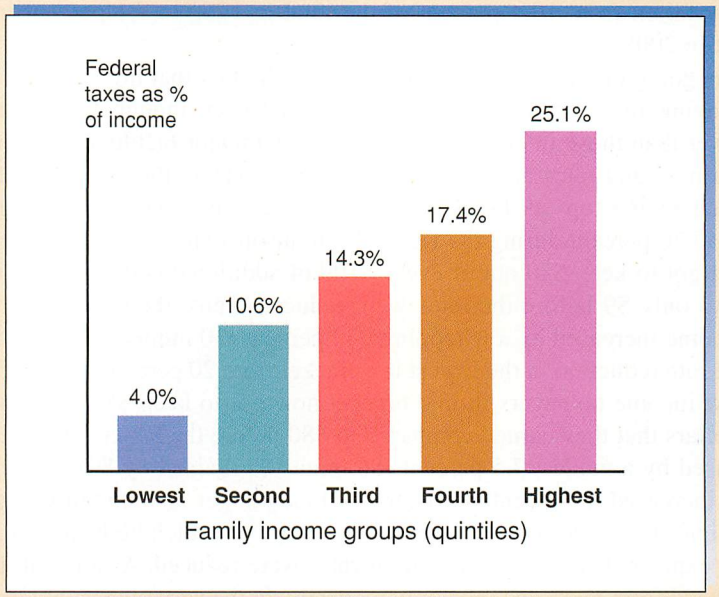
In addition to the personal income tax, the federal government also derives sizable revenues from payroll, corporate income, and excise taxes. How is the overall burden of federal taxes allocated among the various income groups? **Exhibit 5** presents Congressional Budget Office estimates for the average amount of federal taxes paid in 2007 according to income. On average, the top quintile (20 percent) of earners are estimated to pay 25.1 percent of their income in federal taxes. The average federal tax rate for the quintile with the next-highest level of income falls to 17.4 percent, and the average tax rate continues to fall as income declines. The average tax rate of the bottom quintile is 4.0 percent, about one-sixth of the average rate for the top quintile of earners. Clearly, the federal tax system is highly progressive, meaning that it takes a larger share of the income of those with higher incomes than from those with lower income levels.

[6]The data of Exhibit 4 consider only the tax liability of taxpayers. They do not reflect the payments from IRS to taxpayers as the result of the Earned Income Tax Credit, which was established in the mid-1980s. If these payments to taxpayers were taken into consideration, the net taxes paid by the bottom half of income recipients would have been less than 1 percent. Thus, the data of Exhibit 4 actually understate the reduction in the net share of taxes paid by the bottom half of income recipients during the last two decades.

Exhibit 5

Total Federal Taxes as a Share of Income, 2007

Federal taxes are highly progressive. In 2007, federal taxes took 25.1 percent of the income generated by the top quintile (20 percent) of earners, compared to 14.3 percent from the middle-income quintile and 4.0 percent from the lowest quintile of earners.



Source: Congressional Budget Office, Average Federal Tax Rates in 2007, June 2010. Total federal taxes include income, payroll, and excise taxes.

SIZE OF GOVERNMENT: A CROSS-COUNTRY COMPARISON

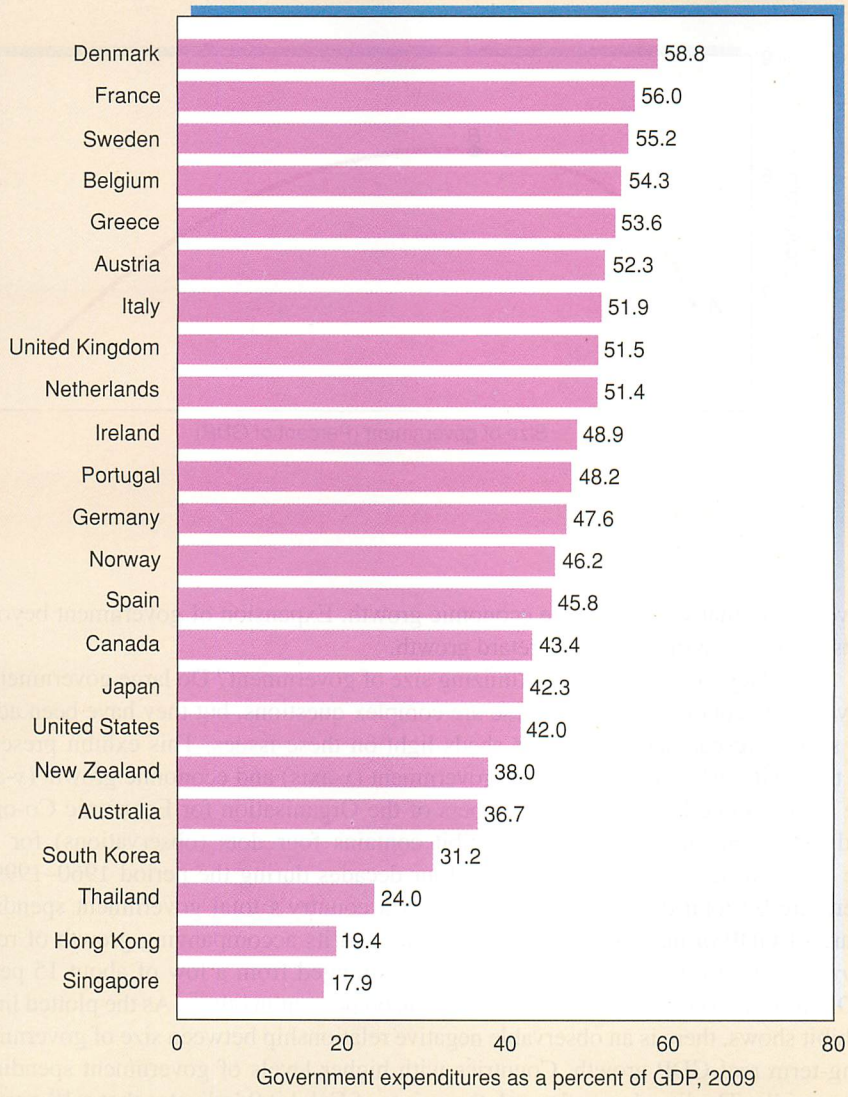
There is substantial variation in the size of government across countries. As **Exhibit 6** illustrates, the relative size of government in most other high-income industrial countries is greater than that of the United States. In 2009, government spending summed to more than 50 percent of the economies of Denmark, France, Sweden, Belgium, Greece, Austria, Italy, United Kingdom, and Netherlands. Government spending as a share of the economy in Japan and Canada was similar to that of the United States, about 42 percent. Interestingly, the size of government was substantially smaller in South Korea, Singapore, Thailand, and Hong Kong—four Asian nations that have achieved rapid growth and substantial increases in living standards during the last four decades.

HOW DOES THE SIZE OF GOVERNMENT AFFECT ECONOMIC GROWTH?

Throughout this text, we have analyzed how governments influence the efficiency of resource use and the growth of income. It is clear that a legal environment that protects people and their property and provides for the impartial enforcement of contracts is vitally important. So, too, is a monetary and regulatory environment that provides the foundation for the smooth operation of markets. As we discussed in Chapter 5, there are also a few goods—economists call them *public goods*—that may be difficult to provide through markets. National defense, roads, and flood-control projects provide examples. Because they generate joint benefits and it is difficult to limit their availability to paying customers, sometimes they can be provided more efficiently through government. But public goods are rare, and the market can often devise reasonably efficient methods of dealing with them. If resources are going to be allocated efficiently, government spending on provision of public goods will generally be only a small share of the economy.

As governments expand beyond these core functions, however, the beneficial effects wane and eventually become negative as government moves into areas ill suited for political

Exhibit 6



Source: International Monetary Fund, *Government Finance Statistics Yearbook* (2010). (The data for New Zealand are for 2007.)

The Size of Governments—An International Comparison

The size of governments varies substantially across countries. In Sweden, government spending sums to more than 50 percent of the economy, compared to 42.0 percent in the United States and 20 percent or less in Hong Kong and Singapore.

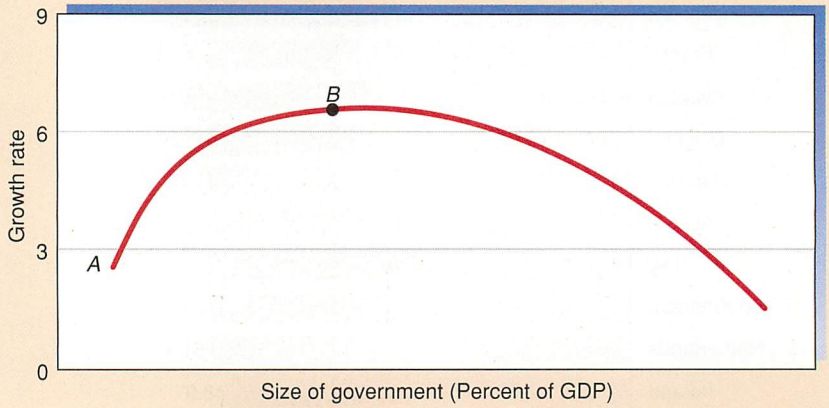
action and in which the political process works poorly. Thus, expansion of government activities beyond a certain point will eventually exert a negative impact on the economy. Exhibit 7 illustrates the implications with regard to the expected relationship between the size of government and economic growth, *assuming that governments undertake activities based on their rate of return.* As the size of government, measured on the horizontal axis, expands from zero (complete anarchy), initially the growth rate of the economy—measured on the vertical axis—increases. The *A* to *B* range of the curve illustrates this situation. As government continues to grow as a share of the economy, expenditures are channeled into less-productive (and later counterproductive) activities, causing the rate of economic growth to diminish and eventually to decline. The range of the curve beyond *B* illustrates this point.[7] Thus, our analysis indicates that there is a set of activities and size of

[7]In the real world, governments may not undertake activities based on their rate of return and comparative advantage. Many governments that are small relative to the size of the economy fail to focus on the core activities that are likely to enhance economic growth. Thus, one would expect that the relationship between size of government and economic growth will be a loose one.

Exhibit 7

Economic Growth Curve and Government Size

If a government undertakes activities in the order of their productivity, its expenditures will promote economic growth (the growth rate will move from *A* to *B*). Additional expenditures, however, will eventually retard growth (the growth rate will move along the curve to the right of *B*).



government that will maximize economic growth. Expansion of government beyond (and outside of) these functions will retard growth.

How large is the growth-maximizing size of government? Do large governments actually retard economic growth? These are complex questions, but they have been addressed by several researchers. **Exhibit 8** sheds light on these issues. This exhibit presents data on the relationship between size of government (*x*-axis) and economic growth (*y*-axis) for the twenty-three long-standing members of the Organisation for Economic Co-operation and Development (OECD). The exhibit contains four dots (observations) for each of the 23 countries—one for each of the four decades during the period 1960–1999. Thus, there are 92 total dots. Each dot represents a country's total government spending as a share of GDP *at the beginning of the decade* and its accompanying growth of real GDP *during that decade*. Government expenditures ranged from a low of about 15 percent of GDP in some countries to a high of more than 60 percent in others. As the plotted line in the exhibit shows, there is an observable negative relationship between size of government and long-term real GDP growth. Countries with higher levels of government spending grew less rapidly. The line drawn through the points of Exhibit 9 indicates that a 10-percentage-point increase in government expenditures as a share of GDP leads to approximately a 1-percentage-point reduction in economic growth.[8]

Time series data for specific countries have also been used to investigate the link between size of government and growth. Edgar Peden estimates that for the United States, the "maximum productivity growth occurs when government expenditures represent about 20% of GDP." Gerald Scully estimates that the growth-maximizing size of government (combined federal, state, and local) is between 21.5 percent and 22.9 percent of the economy. Although the methodology of these studies differs, they do have one thing in common: They indicate that in the ranges observed, high levels of government spending tend to retard economic growth.[9] They also indicate that the size and scope of most governments around the world are larger than the size that would maximize the income growth of their citizens. Moreover, the estimates imply that the recent expansion in the size of the government sector in the United States is likely to reduce the growth of income in the years immediately ahead.

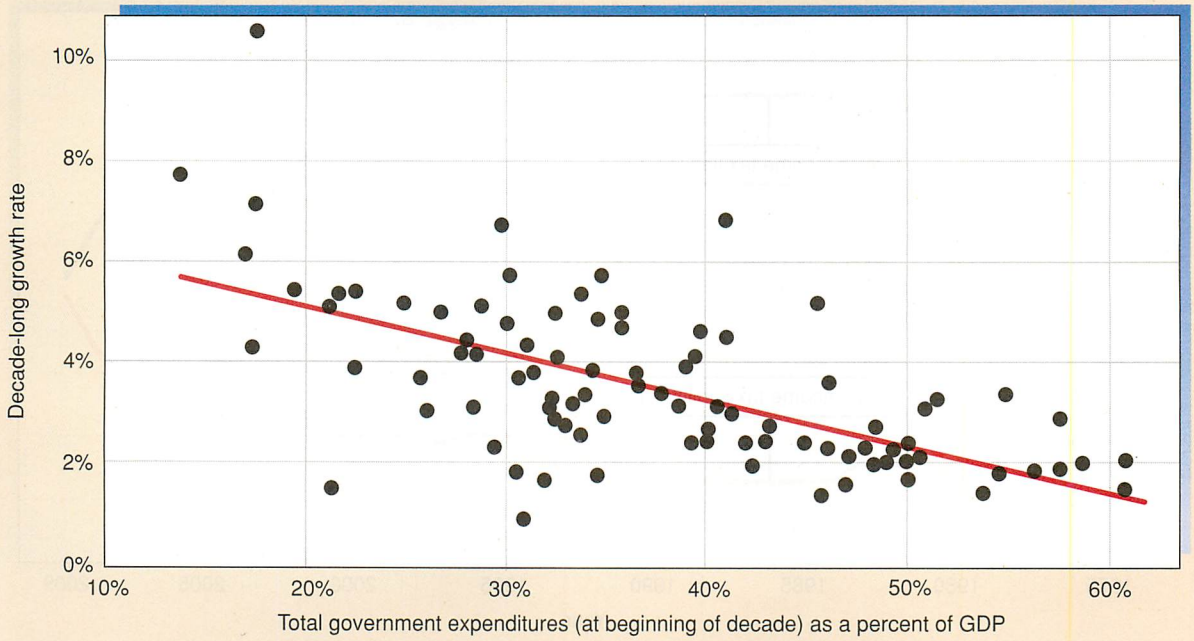
[8]For additional information on the relationship between size of government and growth, see James Gwartney, Robert Lawson, and Randall Holcombe, "The Scope of Government and the Wealth of Nations," *The Cato Journal* (Fall 1998): 163–90.

[9]See Edgar Peden, "Productivity in the United States and Its Relationship to Government Activity: An Analysis of 57 Years, 1929–1986," *Public Choice* 69 (1991): 153–73; and Gerald Scully, *What Is the Optimal Size of Government in the United States?* (Dallas, TX: National Center for Policy Analysis, 1994).

Exhibit 8

Government Spending and Economic Growth Among the Twenty-Three OECD Countries: 1960–1999

Here we show the relationship between size of government and the growth of real GDP for the 23 longtime OECD members during each decade since 1960. The data indicate that a 10-percent increase in government expenditures as a share of GDP reduces the annual rate of growth by approximately 1 percent. The data also imply that the size of government in these countries is beyond the range that maximizes economic growth.



Source: OECD, *OECD Economic Outlook* (various issues), and the World Bank, *World Development Indicators*, CD-ROM, 2001.

EXPENDITURES, TAXES, DEBT FINANCE, AND DEMOCRACY

Exhibit 9 presents data on the percent of persons age 18 and older with and without a personal income tax liability. During the quarter of a century before 2000, the share of Americans paying income taxes fluctuated within a narrow range between 66 percent and 71 percent. However, the share paying income taxes has declined sharply during the past decade. Since 2003, 60 percent or less has had an income tax liability. In 2009, only 51 percent of Americans paid any federal income tax.

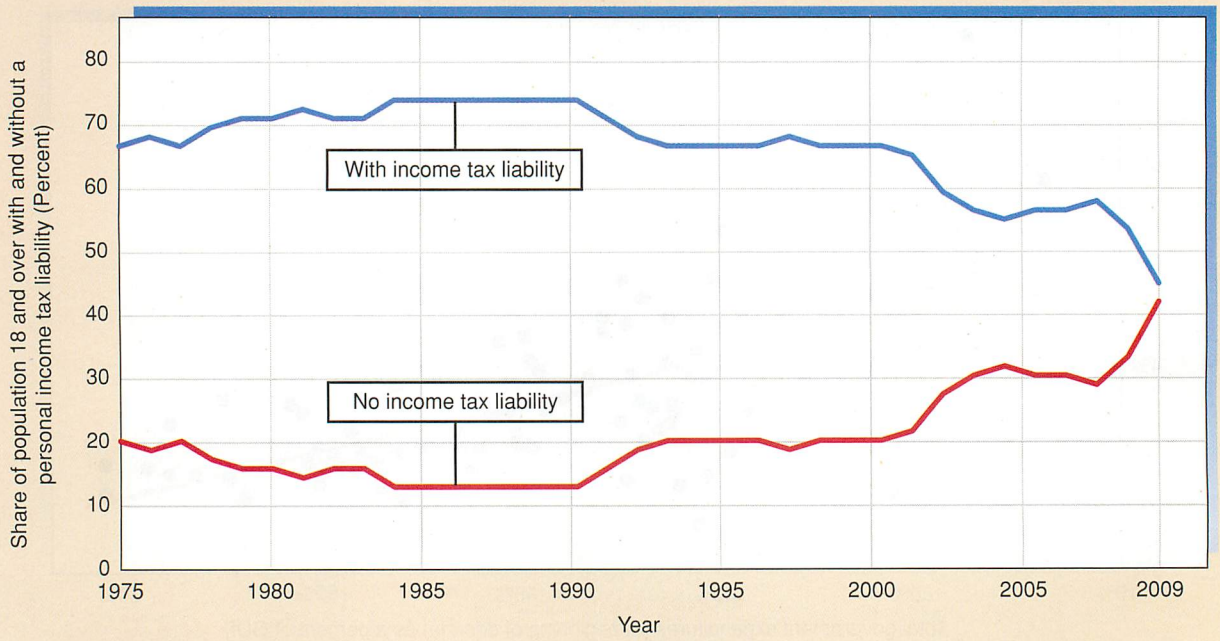
On the other hand, the percent of the population paying no income tax has risen sharply. Throughout 1975–2000, approximately one-third of Americans had no income tax liability. But the legislation passed under the administration of George W. Bush increased the "no tax" income threshold and doubled the child tax credit. These changes eliminated the income tax liability of many Americans. By 2009, nearly half of the population (49 percent) paid no income taxes. While many without an income tax liability are responsible for payroll taxes, the payroll tax is directed toward only two programs: Social Security and Medicare. Thus, payroll taxes do not contribute to the finance of government in other areas.

While the share of people paying taxes has declined in recent years, the share benefiting from transfers has been relatively constant. However, a little more than half of American families derive income from transfer programs. As **Exhibit 10** shows, the percent of families receiving transfers from at least one program fell from 54.1 in 1991 to 49.5 percent in 2000,

Exhibit 9

Share of Population 18 and Older with and without a Personal Income Tax Liability

The percent of the population age 18 and older with and without a personal income tax liability is shown here. Note how the share paying income taxes fluctuated between 66 percent and 71 percent throughout 1975–2000. Since 2003, however, 60 percent or less have had an income tax liability, and the share plunged to 51 percent in 2009. Over the same period, the share with no income tax liability rose from one-third of the adult population during 1975–2000 to nearly one-half in 2009.



Source: Internal Revenue Service and *Economic Report of the President* (various issues). The number of persons with an income tax liability was derived by summing (1) the joint returns with a tax liability times two and (2) the number of individual returns with a tax liability. This figure was then divided by the population age 18 and older to derive the percentage of the 18 and older population with a tax liability.

but the figure has risen during the past decade, reaching 52.9 percent in 2009. When income from government employment is included, approximately three-fifths of all families benefit from government spending. In 2009, 62.3 percent of families derived income from either transfer programs or government employment. If the people employed by businesses with government contracts and those receiving subsidies (for example, the producers of ethanol, sugar and several other agricultural products, and wind and solar energy) were also included, the share of Americans heavily dependent on government would be even larger.

What are the implications of these patterns of tax payments and government spending? People who are not paying taxes have little reason to resist increases in government spending because they are not paying for them. In fact, they have every incentive to pressure politicians for more government services and transfers because someone else will be covering their cost. Similarly, people who are dependent on government spending for a sizable share of their income will be more supportive of government spending than those who derive their income from private-sector activities.

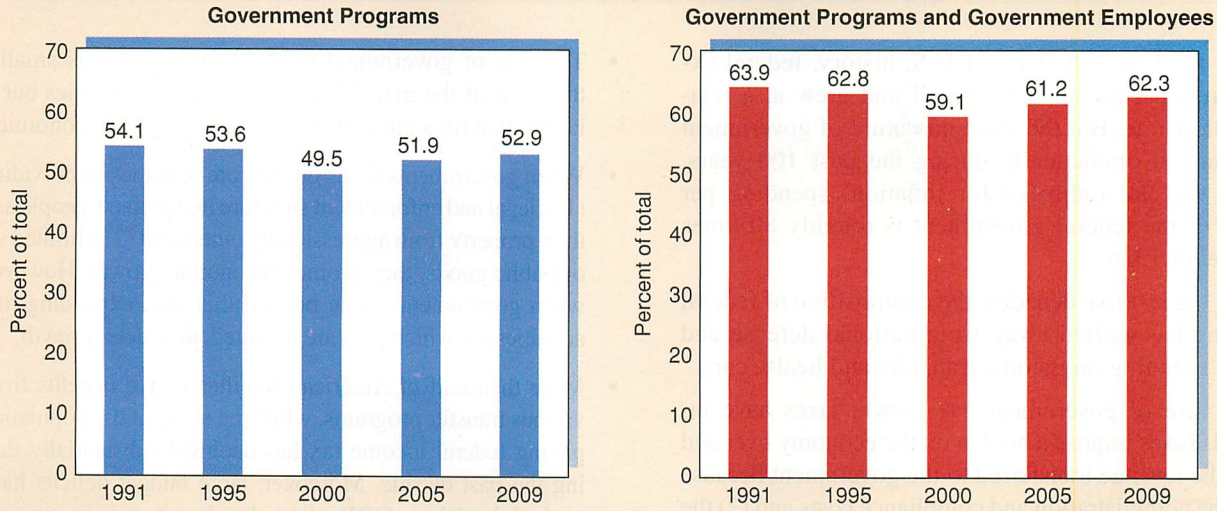
Debt financing is also related to the observed pattern of taxing and spending. Borrowing makes it possible for politicians to provide voters with current benefits without having to impose a parallel visible cost in the form of higher taxes. This enables elected officials to increase the number of people dependent on government spending without having to increase current taxes.

To a large degree, the modern democratic political process has become a game in which politicians seek to use the fiscal powers of government to assemble a political

Share of Families Deriving Income from Government, 1991–2009

Exhibit 10

More than half of American families derive income from transfer programs. The percent of families receiving transfers from at least one program fell from 54.1 in 1991 to 49.5 percent in 2000, but the figure has risen during the past decade, reaching 52.9 percent in 2009. When income from government employment is also included, more than three-fifths (62.3 percent) of American families now derive income from the government.



Source: These figures were derived from the Current Population Survey data. The following income transfers were included: Medicare, Medicaid, food stamps, unemployment compensation, school lunch program, housing subsidies, Social Security, and welfare.

majority. Is this a dangerous trend that may undermine democracy and lead to fiscal collapse? Eighteenth-century Scottish philosopher Alexander Tytler warned of this possibility:

A democracy cannot exist as a permanent form of government. It can only exist until the voters discover that they can vote themselves largesse from the public treasury. From that moment on, the majority always votes for the candidates promising the most benefits from the public treasury with the result that a democracy always collapses over loose fiscal policy.[10]

Is Tytler correct? Are the spending, taxing, and debt financing policies of the United States taking the country down a dangerous path? We do not know the answer to this question, but there are some troubling signs.

Measured as a share of GDP, total government expenditures are now about 7 percentage points higher than during the 1990s. During 2009 and 2010, the federal government financed approximately 40 percent of its expenditures by borrowing. The huge deficits of recent years have pushed the federal debt to nearly 100 percent of GDP, a level not seen since the aftermath of World War II. Moreover, the unfunded future benefits promised to senior citizens under the Social Security and Medicare programs are another form of debt, and these liabilities are three times the size of the official national debt. As the baby-boomers move into the retirement phase of life during the next decade, if Social Security and Medicare are not reformed, then spending on these programs will far outstrip the revenues for their finance.

Several members of the European Union (EU), including Greece, Portugal, Italy, and Spain, now confront exceedingly high debt levels and prior commitments to voters that make it difficult for them to reduce government spending. To date, other EU countries with marginally stronger government finances have been willing to provide emergency loans and other assistance. But this is not a long-run solution. The United States appears to be

[10]Some attribute this statement to Lord Thomas Macaulay. The author cannot be verified with certainty. For additional information on this topic, see Loren Collins, "The Truth About Tytler" at www.lorencollins.net/tytler.html.

headed down the same path. There are steps that could be taken, but special interest politics and the myopic nature of the political process may make them untenable. We are in the midst of an interesting, though unattractive, experiment in political economy as Western democracies face troubled fiscal waters in the years immediately ahead.

KEY POINTS

- During the first 125 years of U.S. history, federal expenditures per person were small and grew at a relatively slow rate. But the size and nature of government has changed dramatically during the past 100 years. Today, the real (adjusted for inflation) spending per person of the federal government is roughly 80 times the level of 1916.
- During the last five decades, the composition of federal spending has shifted away from national defense and toward spending on income transfers and health care.
- As the size of government has grown, taxes have increased. Taxes impose a burden on the economy over and above the revenue transferred to the government because of (1) the administration and compliance costs and (2) the deadweight losses that accompany taxation.
- Overall, the federal tax system of the United States is highly progressive. Taxes as a percentage of income are approximately six times greater for the top quintile (20 percent) of families than for the bottom quintile.
- The size of government of the United States is smaller than that of the major Western European countries but is larger than for a number of high-growth Asian economies.
- When governments focus on the core activities of providing (1) a legal and enforcement structure that protects people and their property from aggression by others and (2) a limited set of public goods, they promote economic growth. However, when governments grow beyond this size, expanding into activities for which they are ill suited, they deter growth.
- More than half of American families derive benefits from various transfer programs, while the share of the population paying federal income tax has declined substantially during the past decade. Moreover, large budget deficits have pushed the debt to GDP ratio to levels not seen since the aftermath of World War II. These factors, along with upward pressure on expenditures for Social Security and Medicare as the baby-boomers retire, will make it very difficult to control federal finances. Thus, the United States confronts a troublesome fiscal future in the years immediately ahead.

CRITICAL ANALYSIS QUESTIONS

1. *How do taxes influence the efficiency of resource use? How much does it cost for the government to raise an additional dollar (or $1 billion) of tax revenue?
2. During the past five decades, there has been a shift in the composition of the federal budget toward more spending on income transfers and health care and a smaller share for national defense. Does economics indicate that this change will help Americans achieve higher living standards? Discuss.
3. Because the structure of the personal income tax is progressive, a larger share of income is taxed at higher rates as real income increases. Therefore, economic growth automatically results in higher taxes unless offsetting legislative action is taken. Do you think this is an attractive feature of the current tax system? Why or why not?
4. Compared with the situation before 1981, the marginal tax rates imposed on individuals and families with high incomes are now lower. What was the top marginal personal income tax rate in 1980? What is the top rate now? Are you in favor of or opposed to the lower marginal rates? Why?
5. *As the result of changes during the last two decades, the bottom half of income recipients now pay little or no personal income tax. Rather than paying taxes, many of them now receive payments back from the IRS as the result of the Earned Income Tax Credit and Child Tax Credit programs. Do you think the increase in the number of people who pay no taxes will affect the efficiency of the political process? Why or why not?
6. How have the size and functions of government changed during the last two centuries? Did the framers of the U.S. Constitution seek to limit the size of the federal government? If so, how?
7. Can democracy survive if a majority of the citizenry pay little or nothing in taxes while benefiting directly from a higher level of government spending? Why or why not? Discuss.

*Asterisk denotes questions for which answers are given in Appendix B.