Why Government Spending Hinders Economic Growth

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Key Premises of Eurasian Growth Paradox

- East European nations experienced strong growth in the 1990s due to market liberalization.
- CIS nations have experienced strong growth more recently due to reductions in the burden of government.
- EU membership is a mixed blessing.
- Perhaps some evidence for convergence, but only if the right policies are in place.
Issues to Contemplate

- Why are the Baltic countries different?
- How reliable are economic statistics?
- Would long-run data tell a different story?
- Why do per capita output numbers seemingly tell a different story?
OECD Per Capita GDP Statistics

Source: Angus Maddison, Historical Statistics for the World Economy
World Bank Gross Nat’l Income Statistics

Source: World Bank, Gross National Income Per Capita
Underground Economy is Large

Source: Friedrich Schneider, Shadow Economies and Corruption All Over the World: What Do We Really Know?
Government Spending and Growth

- If government spending is zero, presumably there will be very little economic growth because enforcing contracts, protecting property, and developing an infrastructure would be very difficult. Some government spending is necessary to uphold the rule of law.

- Government spending reduces growth, however, when the public sector becomes too large, leading to punitive tax rates and misallocation of labor and capital.
The “Rahn Curve”

There is a “Rahn Curve” relationship between government spending and economic growth similar to the “Laffer Curve” relationship between tax rates and tax revenue.
Empirical Estimates of the Rahn Curve

- Academic studies generally find that the growth-maximizing level of government is 17 percent-23 percent, though a European Central Bank study put the figure as high as 30 percent.
- Every single western nation – and every single transition nation – spends above the growth-maximizing level in these studies.
- Because of data limitations, the actual growth-maximizing level of spending presumably is lower than shown in the studies.
Burden of Government Used to be Small

Source: Tanzi and Schuknecht, "Reforming Government: An Overview of Recent Experience,"
Why Big Government Hurts Growth

- The Extraction Cost: The federal government cannot spend money without first taking that money from someone else. All of the options used to finance government spending have adverse consequences.

- The Displacement Cost: Government Spending Displaces Private Sector Activity. Every dollar that the government spends necessarily means that there is one less dollar in the productive sector of the economy.
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- The Negative Multiplier Cost: Government Spending Finances Harmful Intervention. Many regulatory agencies have relatively small budgets, but they impose large costs on the economy’s productive sector.

- The Behavioral Subsidy Cost: Many government programs subsidize economically undesirable decisions. Welfare programs encourage people to choose leisure over work. Unemployment insurance programs provide an incentive to stay unemployed.
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- The Behavioral Penalty Cost: Government programs discourage economically desirable decisions. The incentive to save has been undermined by government programs that subsidize retirement, housing, and education.

- The Market Distortion Cost: Government programs interfere with competitive markets. In both health care and education, government efforts to reduce out-of-pocket expenses have resulted in higher prices because of “third-party payer” issue.
Why Big Government Hurts Growth

The Inefficiency Cost: Government Spending is a Less Effective Way of Delivering Services. A voucher system would yield better education for less money. Privatized airports and postal service would be more efficient.

The Inertia Cost: Government programs inhibit innovation. Lacking a profit motive, bureaucracies do not seek better ways of achieving goals. This can create huge costs, as demonstrated by America’s old welfare system.
What Should Government Do?

There are certain core functions of government - including national defense, legal system, and public safety.

These core functions create conditions that encourage people to create wealth and improve their living standards.

These core functions preserve and enhance liberty so people can enjoy freedom.
Limited Government Makes Good Tax Policy More Feasible

- Tax Income at one low rate, ideally no more than 20 percent.
- Define the tax base correctly, taxing Income only one time.
- Tax all income alike, since neutrality ensures economic criteria rather than tax provisions determine resource allocation.
- Tax only income earned inside national borders, the common-sense notion of territorial taxation.
Fiscal Competitiveness

- Today’s global economy makes good economic policy much more important.
- Capital and labor (“brain drain”) are migrating to the United States.
- This is another reason why a lower burden of government is helping the U.S. grow faster and create more jobs than the EU.
- Ireland is another success story.
- Jurisdictional competition is a powerful force for economic liberalization, one that should be celebrated rather than persecuted.
More on Competitiveness

OECD economists have written that “the ability to choose the location of economic activity offsets shortcomings in government budgeting processes, limiting a tendency to spend and tax excessively.”

Gary Becker observed that “…competition among nations tends to produce a race to the top rather than to the bottom by limiting the ability of powerful and voracious groups and politicians in each nation to impose their will at the expense of the interests of the vast majority of their populations.”
Conclusion

Very few – if any – nations have inadequate levels of government.

Every nation in the Eurasian Growth Paradox paper has too much government spending according to Rahn Curve research.

The Eurasian Growth Paradox paper shows the economic benefits of climbing the right side of the Rahn Curve – somewhat akin to Laffer Curve research showing the benefit of lowering tax rates when they are so high that government loses revenue.