



Government Spending and Taxation

Full Length Text — Part: 6 Chapter: 1
Micro Only Text — Part: 4 Chapter: 1
Macro Only Text — Part: 5 Chapter: 1


To Accompany "Economics: Private and Public Choice 12th ed."
James Gwartney, Richard Stroup, Russell Sobel, & David Macpherson
Slides authored and animated by:
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Government Expenditures


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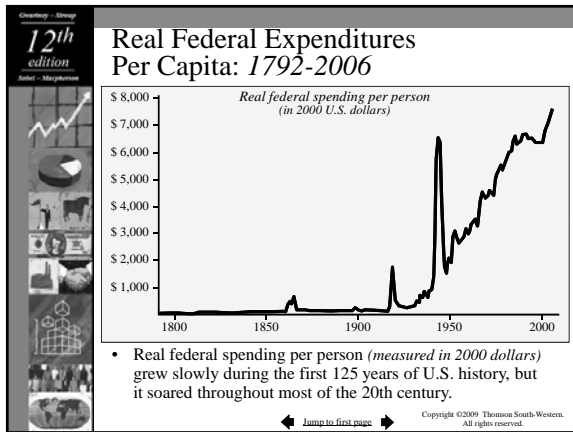


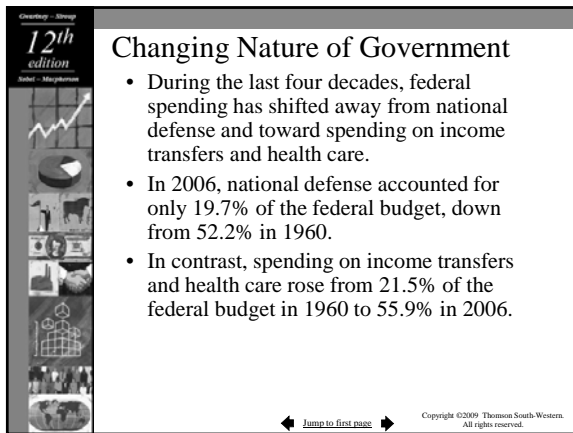
Growth of Government

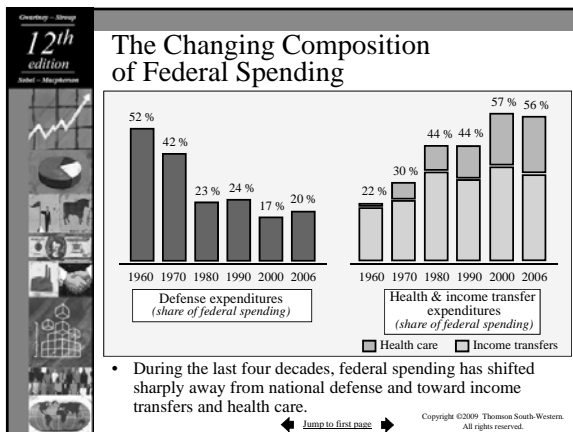
- During the first 125 years of U.S. history, federal expenditures per person were small and they grew at a relatively slow rate. *(See following slide)*
- In contrast, federal spending soared throughout most of the 20th century. In 2006, real federal spending per person was roughly 70 times the level of 1916.
- During the 1990s per capita real federal spending was relatively constant. In fact, it declined slightly during the decade.
- Since 2000, per capita real federal spending has once again been increasing rapidly.

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Taxes and the Finance of Government

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Taxes and Other Revenue Sources

- Governments are financed by taxes, user charges, and borrowing.
 - Borrowing implies higher future taxes.
- The power to tax is a distinguishing characteristic of government.
- The major sources of federal revenue are the personal income tax (*accounted for 43.4% of federal revenue in 2006*) and the payroll tax (*accounted for 34.8% of the total in 2006*).
- Major revenue sources at the state and local level are sales and excise taxes, personal income taxes, user charges, and grants from the federal government.

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Sources of Government Revenue

Category	Percentage
Personal income	43.4%
Payroll	34.8%
Corporate income	14.7%
Other	3.0%
Excise duties	1.0%
Customs	3.1%

Federal government revenue 2006 -- \$ 2,407 billion

Category	Percentage
Property	13.3%
Sales & excise	13.2%
Other	21.3%
From Federal government	17.4%
User charges	19.3%
Personal income	9.5%
Corporate income	1.7%

State & local government revenue 2005 -- \$ 2,523 billion

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Taxes and the Cost of Government

- A dollar of taxation costs the economy more than a dollar because:
 - It is costly to administer, enforce, and comply with tax legislation.
 - Taxes distort incentives and eliminate productive exchanges (*and cause people to undertake some counterproductive activities*).
 - Economists refer to this as the “dead weight loss” of taxation.

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How Has the Structure of the Personal Income Tax Changed?

- The share of the income tax paid by high-income taxpayers has risen during the past 40 years – especially since 1980. (*This is demonstrated graphically on the next slide.*)
- Why has the share paid by those with high-incomes risen?
 - The decline in marginal tax rates has created greater “incentive effects” for high-income tax payers to earn taxable income.
 - The standard deduction and personal exemption have increased substantially over the past two decades.

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Share of Federal Income Taxes Paid By Various Income Groups

Income group	Share of total federal personal income tax paid			
	1963	1980	1990	2004
Top 1%	18.3 %	19.1 %	25.1 %	36.9 %
Top 5%	35.6 %	36.8 %	43.6 %	57.1 %
Top 10%	47.0 %	49.3 %	55.4 %	68.2 %
Top 25%	68.8 %	73.0 %	77.0 %	84.9 %
Top 50%	89.6 %	93.0 %	94.2 %	96.7 %
Bottom 50%	10.4 %	7.1 %	5.8 %	3.3 %

- Upper-income Americans pay the bulk of the federal income tax and the share they pay has risen during the last 4 decades.

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Total Federal Taxes As a Share of Income, 2004

Federal taxes as a share of income (%)

Family income groups (quintiles)	Federal taxes as a share of income (%)
Lowest	4.5%
Second	10.0%
Third	13.9%
Fourth	17.2%
Highest	25.1%

- Here we show the payment of federal taxes as a share of income for each income quintile.
- Note the overall federal tax structure is highly *progressive*.

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Does the Growth of Income Benefit the Federal Government?

- Federal personal income tax brackets are indexed for inflation, but no adjustments are made for increases in real income.
- Under the current progressive tax structure, the growth of real income will increase federal revenues as a share of total income if no offsetting action is taken.

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Size of Government: U.S. versus Other Countries

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Size of Government: *U.S. Versus Other Countries*

- The size of government in the U.S. is smaller than that of Japan and the major Western European countries, but larger than for a number of high-growth Asian economies. (See the following slide.)

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Size of Government: *An International Comparison*

Government expenditures as a share of GDP, 2005

Sweden	55.4 %
Denmark	55.2 %
France	53.8 %
Belgium	50.0 %
Austria	49.9 %
Italy	48.2 %
Portugal	47.8 %
Germany	46.8 %
Greece	46.7 %
Netherlands	45.5 %
United Kingdom	44.6 %
Norway	42.6 %
Canada	39.9 %
Spain	38.5 %
Japan	36.9 %
New Zealand	36.5 %
United States	36.4 %
Australia	34.6 %
Ireland	34.1 %
South Korea	22.6 %
Hong Kong	20.1 %
Thailand	19.4 %
Singapore	17.1 %

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The Size of Government and Economic Growth

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The Size of Government and Economic Growth

- The core functions of government such as a sound legal system, access to money of stable value, and provision of public goods that are difficult to provide through markets will promote economic growth and help citizens achieve high income levels.
- But when government expands beyond these core functions and into areas for which it is ill-suited, it will retard economic growth.

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Size of Government – Growth Curve

- If governments undertake activities in the order of their productivity, the growth of government will initially promote economic growth (move from A to B).
- At some point, however, continued expansion of government will retard growth (moves beyond B).

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Govt Spending and Economic Growth

- The relationship between the size of government at the beginning of the decade and the growth rate of real GDP for each decade during the 1960-2000 period is shown below.
- An increase in government spending of 10% (as a share of GDP) reduces annual growth by about 1%.

Source: OECD, OECD Economic Outlook (various issues) and The World Bank, World Development Indicators, 2001, CD-ROM.
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The Future of Government Spending in the United States

- A major share of U.S. government spending (e.g. *Social Security & Medicare*) is directed towards the elderly.
- As the baby-boom generation begins to retire around 2010, federal expenditures are almost certain to grow as a share of the economy.
- In turn, the higher level of government spending is likely to slow the growth rate of the economy.

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Questions for Thought:

1. A century ago, federal taxes and spending per person were substantially lower than today. How would the U.S. economy be affected if the federal government was, for example, one-third its current size? What programs would you favor cutting?
2. Because the structure of the personal income tax is progressive, more income is taxed at higher rates as income grows. Therefore, economic growth automatically results in higher taxes. Do you think this is an attractive feature of the current tax system?

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Questions for Thought:

3. The marginal tax rates imposed on those with high incomes are now substantially lower than in 1980. Would you like to see higher tax rates imposed on high income Americans?
Do you think higher rates would increase the tax revenues collected from high-income Americans?
4. "Real federal spending per person grew slowly under the Reagan Administration during the 1980s, but it increased rapidly under the Clinton administration in the 1990s."
-- Is this statement *true*?

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Questions for Thought:

5. Are the following statements *true or false*?

- a. During the first 125 years of U.S. history, federal expenditures per person were small and they grew at a relatively slow rate.
- b. In 2006, real federal spending per person was about 70 times its level of 1916.

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**End
Special Topic 1**

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