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## THE NEGATIVE CONSEQUENCES OF GOVERNMENT EXPENDITURE

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**T**HE U.S. NATIONAL debt currently stands at 62 percent of GDP—its highest level since WWII.<sup>1</sup> Under plausible assumptions, this ratio will rise to at least 80 percent and possibly 185 percent of GDP by 2035 and continue increasing thereafter.<sup>2</sup> As the debt ratio increases, the country's creditors will demand higher and higher interest rates to continue financing this debt. This means even larger deficits and ultimately a U.S. default.

Both macroeconomic and microeconomic perspectives suggest that tax increases cannot address the debt problem because higher taxes mean slower economic growth, reducing the scope for increased tax revenue.<sup>3</sup> If tax increases cannot restore fiscal balance, the United States must slow the path of expenditure, starting with reforming entitlement spending, to avoid fiscal Armageddon. Expenditure cuts can simultaneously improve fiscal balance while enhancing economic growth.

### THE PROBLEM

DEBT RELATIVE TO GDP has trended strongly upwards over time. Debt rose during the Great Depression, when spending grew under the New Deal, and since the early 1970s, as both Great Depression programs (Social Security) and Great Society programs (Medicare, Medicaid) expanded.

Over the 1940–2009 period, most of the growth in debt came from entitlement programs (see Figure 1). Government health expenditure rose from almost nothing in the mid-1960s to roughly 5 percent of GDP in 2009. Similarly, government retirement expenditure rose from almost nothing in the 1940s to roughly 5 percent of GDP in 2009. The other components of federal expenditure, while larger than before WWI, have been relatively stable. Military spending, for example, increased during the Bush years but is still modest compared to the post-WWII period.<sup>4</sup> Entitlement spending is expected

to raise the debt even more going forward.<sup>5</sup> The implications of these facts are that the U.S. fiscal situation is not sustainable and the United States must reign in entitlement spending, especially for health care.

## CURRENT SPENDING LEVELS ARE TOO HIGH

GOVERNMENTS SPEND TAX revenue in two ways: by transferring revenue to particular subgroups of the population or by purchasing goods and services that are then used to produce some kind of output. This expenditure comes with serious costs. Taxes and transfers distort decisions about work and savings. Government production crowds out private activity, which is usually more efficient.

### Medicaid and Medicare

THE USUAL JUSTIFICATIONS for Medicaid and Medicare rely on both efficiency and equity arguments. One efficiency claim is that private health-insurance markets do not function properly because of adverse selection, the tendency of people with poor health to buy more insurance.<sup>6</sup> A second efficiency claim is that private markets do not provide insurance against the misfortune of being born with “bad genes,” yet behind a veil of ignorance most people would purchase insurance against such bad luck by accepting lower consumption overall.<sup>7</sup> The equity argument asserts that everyone should receive adequate medical care regardless of ability to pay.

The adverse selection argument is unconvincing since insurers can identify bad health risks via appropriate medical tests or can include conditions that address any lack of information in their contracts. The veil of ignorance argument is more convincing, but it only implies that people would buy some insurance against bad health, not unrestricted access to all medical care. The veil-of-ignorance argument also more suggests subsidizing insurance for the poor, not equalizing health insurance outcomes for everyone.

Government health insurance generates negative efficiency effects. Medicare encourages early retirement and discourages saving for medical expenses.<sup>8</sup> Medicaid, like any transfer program conditioned on low income, discourages work effort.<sup>9</sup> Because these programs have only modest deductibles and co-payments, they encourage overutilization of health care, driving up costs for both citizens and the government. As government expenditure mounts, the budgetary pressure leads to price controls and rationing, which distorts choices in health-care markets.

The implication of these concerns is that government provision of health insurance must balance the goal of protecting the most vulnerable against the adverse side effects of such provision. This suggests a defensible role for Medicaid, but not Medicare or the Patient Protection and Affordable Care Act. Alternatively, Medicaid plus a scaled-back version of

Medicare that incorporates higher co-pays and deductibles along with a higher age of eligibility would achieve the most defensible goals of government health insurance with fewer negative side effects.

### Social Security

THE USUAL JUSTIFICATION for Social Security is that some people outlive their earnings abilities and fail to save adequately for retirement. Without government support, therefore, these people might be destitute in old age, and society might wish to prevent or alleviate such suffering via old-age benefits.

This argument assumes that the current beneficiaries of Social Security would not have saved anything at all, but in the absence of Social Security, many who now receive benefits would have saved more during their working lives or could receive help from families or private charities. The argument that current beneficiaries would be destitute without government support also assumes that current beneficiaries do not have substantial savings. This may be true for some beneficiaries but certainly not for all. A simple means test could be applied to the distribution of benefits to reduce payments to those who do not need the support of Social Security.

In addition, Social Security has adverse effects on the size of the economic pie. In the presence of Social Security, some people choose an earlier retirement age, which means they leave the labor force when the extra income they could produce is greater than the value they place on the extra leisure. This leaves society with less output because individuals face a distorted tradeoff between labor and leisure.<sup>10</sup>

A scaled-back system could provide the most crucial benefits of Social Security with fewer negative impacts. One approach to reform is a higher age of eligibility since life expectancy has increased by 10 to 14 years since Social Security’s inception.<sup>11</sup> A different approach would index benefits to the price level rather than to the wage rate. Under wage indexation, recipients get real benefits that increase with economic growth. Under price-level indexation, real benefits would remain constant.

### Other Expenditure

MEDICAID AND MEDICARE are the fastest-growing parts of federal expenditure,<sup>12</sup> so any serious attempt to tackle the debt must address these components. Other expenditures, however, also have negative effects that plausibly outweigh their positive effects. These include subsidies, such as those received by farmers,<sup>13</sup> and earmarks, which are targeted expenditures on small, localized projects that have questionable societal benefit.

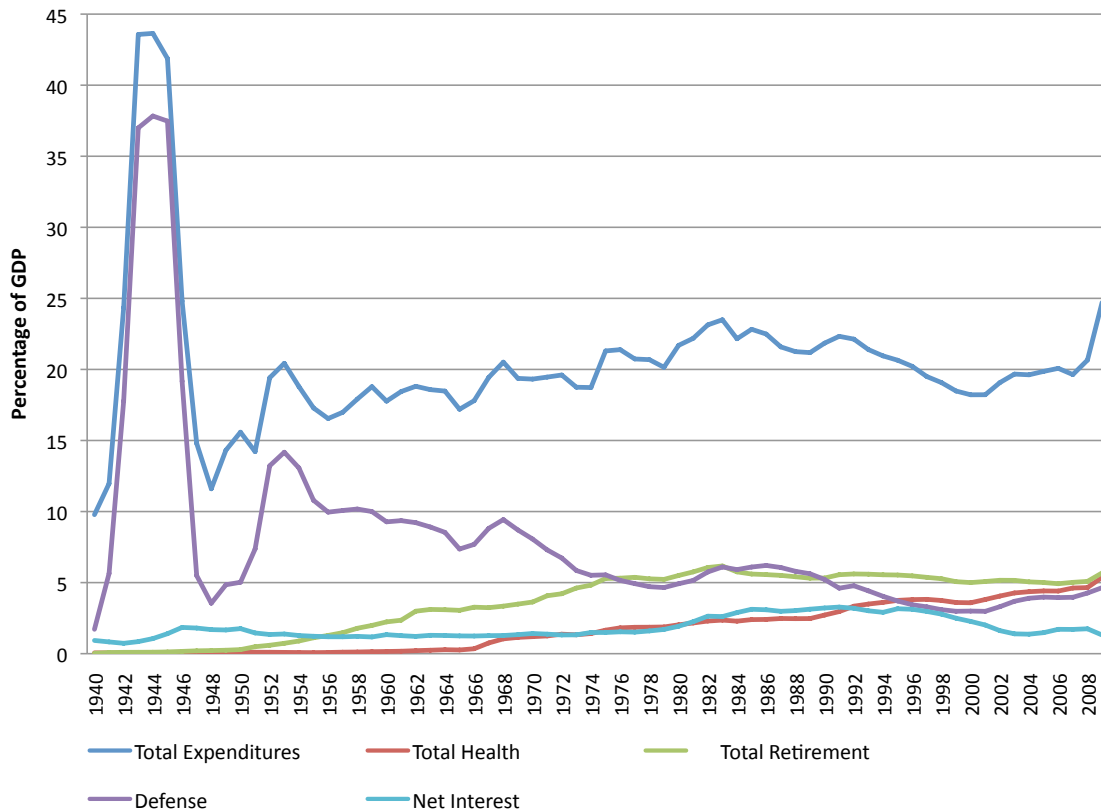
Similarly, while federal expenditure is on a much worse path than state and local expenditure, much of state and local

spending is excessive as well. Education expenditure could be reduced substantially by adopting vouchers in place of public schools, colleges, and universities.<sup>14</sup> All state and local spending could be reduced by shrinking excessive employee compensation packages.

## CONCLUSION

LARGE CHUNKS OF current expenditure are counterproductive and fail to accomplish reasonable policy goals. Determining the ideal level of government expenditure is difficult, but just a few decades ago the United States was a productive economy with far lower expenditure. In the 1960s, for example, federal government expenditure was below 20 percent of GDP, and state and local expenditure was below 12 percent; this contrasts with roughly 25 percent and 15 percent now. The good news is that, from a fiscal perspective, the United States can have its cake and eat it too. By slashing expenditure, the country can simultaneously improve economic efficiency and get the debt under control.

FIGURE 1: EXPENDITURES AS A PERCENTAGE OF GDP



Source: Office of Management and Budget (OMB), "Historical Tables," <http://www.whitehouse.gov/omb/budget/Historicals/>.

## ENDNOTES

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3. Dan Miller and William MacReynolds, "Economic Update: Tax Policy, Economic Growth and American Families," Joint Economic Committee, July 20, 1995, <http://www.house.gov/jec/growth/taxpol/taxpol.htm>.
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10. A different potential negative of Social Security is reduced national savings, but the welfare implication of this reduced savings is theoretically ambiguous. Existing evidence, moreover, does not support a strong conclusion about the magnitude of any impact; see Martin Feldstein and Jeffrey B. Liebman "Social Security" (NBER Working Paper No. 8451, National Bureau of Economic Research, 2001).
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