The Public Sector in Perspective

CHAPTER 2

Depending on how we are affected personally by government and our general philosophical views about the roles of the public and private sectors, we have different and sometimes contradictory views about the public sector. Sometimes it is too big; sometimes it is too small. Often we do not think of the government at all, except when government intrudes in obvious ways. Federal income tax filing time in the United States is one of those intrusions, and it often leads one to say: "Government is too big; I pay too much in taxes." The 2010 oil spill resulting from the explosion of the BP deep well rig in the Gulf of Mexico is another dramatic occasion. It led many people to demand faster and more massive response from both federal and state governments.

One danger of generalizing about the size of the public sector of society is that any single generalization necessarily ignores important information. Although the statement "government is vast" may be valid, it fails to recognize the difficulties in determining what is and is not government or the fact that government is also small in some respects. This chapter describes the size and extent of the public sector, discusses the relative and absolute growth rates of government, and considers the general level of taxes and other revenue sources and the societal functions that these revenues support.

The chapter explores three main topics. The first is the relative sizes of the private and public sectors of society and the reasons for the growth of government. The second is the magnitude of government and the historical growth of local, state, and federal finances. The third section contrasts the purposes of government expenditures with the sources of revenue used by the three main levels of government in the United States.

RELATIVE SIZES OF THE PRIVATE AND PUBLIC SECTORS

Basic to all matters of public budgeting is the issue of the appropriate size of the public sector. This issue is inherently political, not only in the partisan sense but also in the sense that it involves fundamental policy questions about what government should and should not do, and what it can and cannot do. At stake are congeries of competing public and private wants and needs and competing philosophies of the role of the public sector in society. Many of the framers of the Constitution wanted to keep the central government small

to protect individual liberty. However, other early leaders, such as Alexander Hamilton, sought a more active role for the new government.[1]

Reasons for Growth

Value Questions

The issue of size relates to the values of freedom and social welfare. Keeping government small has been advocated as a means of protecting individuals from tyranny and stimulating individual independence and initiative. In contrast, critics charge that sometimes reliance on the private sector causes the underfinancing of public programs and the failure to confront major social problems.[2] Some people argue that the wave of corporate scandals that occurred in 2002 (Enron and WorldCom, for example) and the stock market volatility due in part to the behavior of large mortgage lending institutions later in the decade were in part caused by placing too much faith in an unfettered—or more precisely, deregulated—private sector. Debates over the rise of the welfare and warfare states have been especially acrimonious.

The U.S. political system, of course, is not structured in such a way that any single and overriding decision is made as to the size of this sector. The multiplicity of governments makes it virtually impossible to reach any single decision about overall governmental size. Decisions relevant to size are made in a political context within and between the executive and legislative branches and among the three major levels of government—local, state, and federal. Each set of decisions contributes to an ultimate resolution of the question, but a decision on the appropriate size really results from tallying many individual choices. And any time we decide to measure the size of the public sector, we are only capturing a snapshot at that point in time. Significant changes in public sector size occur over time, sometimes quite rapidly.

Government Responses

Why government expands has been the subject of extended debate.[3] One of the two main reasons is that government is "responsive" to the demands of society. Wagner's law, originally proposed in the 1880s, holds that economic development creates opportunities for new activities that government alone can perform.[4] The second reason is that government has a supposed propensity to grow. In this case, government grows as a result of empire building by government bureaucrats, supported by political leaders.[5] Among the numerous factors suggested as stimulating responses from government are the following:[6]

- *The need for collective goods.* Because defense, homeland security, disaster response, and some other programs benefit all citizens and cannot be handled readily by the private sector, the government becomes involved. When wars occur, governments grow in size. After the conflict, they tend to remain larger than during the prewar period. Education is another important collective good. Educated people tend to be more productive and increase the total wealth of the society, and the private sector cannot be relied on to provide an appropriate level of public education.

- *Demographic changes.* Increases in total population and in the numbers of newborns and the elderly stimulate the creation and expansion of government programs.
- *Changes in living patterns.* As people move from rural to urban areas, and then from cities to suburbia, demands for government services follow them. Governments must then provide more schools, roads, public utilities, and public safety.
- *Externalities.* Industrial firms, which are concerned mainly with making a profit, may pollute the air and water. Government is expected to control the social costs arising from these private actions.
- *Economic hardships.* Depressions and other negative economic situations stimulate the growth of government.
- *High-risk situations.* When risks are high, the private sector is unlikely to invest large quantities of resources, so government is called upon to support programs. Examples include the development of nuclear energy as a source of electrical power and the creation of the space program. Once the risks of certain aspects of space activity became manageable as a result of government intervention, commercial interests engaged in space research and moved into the launching of private vehicles and satellites.
- *Technological change.* With the advent of new technology, government has provided support, as in the case of roads and airports, to accommodate improved transportation modes and information highways, such as the Internet, and to regulate new industries, as in the case of railroads, radio, and television.

These reasons are helpful in explaining why government is necessary and why it has expanded over time. Proposals to expand or contract the scope of the public sector also reflect many political considerations. Principally, any proposal for the expansion of services that results in an increase in taxes is likely to have unfavorable political repercussions. Therefore, the size issue always relates to both government expenditures and revenues (taxes). Decision makers, no matter how crude or approximate their methods of calculating, attempt to weigh the merits of coping with the current situation with the available resources against the merits of recommending new programs that may alleviate problems but at the same time raise the ire of taxpayers. The success of the Tea Party movement in capturing enough seats in the U.S. House of Representatives in the 2010 congressional elections to unseat the Democratic Party control, in addition to the changeover in many state legislatures, may have in part reflected taxpayer uneasiness with the size of government.

Private and Public Sector Boundaries

Major problems are encountered when attempts are made to gauge the sizes of the public and private sectors and to distinguish between one government and another. Government has become so deeply involved in society that one may frequently have difficulty discerning what is not at least quasi-public. Moreover, governments have extensive relationships with each other, to the point where a discussion of any single government becomes meaningless without a discussion of its relationships with other governments.

Statistical data on government revenues and expenditures fail to reflect adequately the size of government. For instance, the entire political campaign process is clearly governmental in that substantial sums of money are spent to elect people to political offices. These funds are not recorded as government expenditures, but nonetheless are "governmental" in nature.[7] Federal Election Commission statistics show that spending in the 2008 presidential election exceeded $1.7 billion, more than four times the amount spent in the 2000 election.[8] Also, the size of government tends to be understated in cases where government activities require relatively little money and personnel but have a substantial impact on the private sector or other governments. This is especially true with respect to regulatory activities, such as the federal government's control of interstate commerce, occupational safety, and environmental health.

Nonexhaustive Expenditures

It can be misleading to rely exclusively on revenue and expenditure data for measuring size for another reason. Sometimes the assumption is made that all government expenditures represent a drain on the private economy. In fact, government expenditures can be nonexhaustive as well as exhaustive. Exhaustive expenditures occur when government consumes resources, such as facilities and manpower, that might otherwise have been used by the private sector. Nonexhaustive expenditures occur when government redistributes or transfers resources to components of the society instead of consuming them. Interest payments on the national debt, unemployment compensation, aid to the indigent, and old-age and retirement benefits are major examples of nonexhaustive government expenditures.

Another form of nonexhaustive expenditures is investment for the future, whether for capital facilities (see the chapters on capital assets and capital finance) or for services, as in education for children. Government aid to small businesses, support of research and development, and similar activities are forms of investment in future economic development. As a result of these kinds of expenditures, the cost of government is actually less than the total dollar figures reported in budgets. Money that is spent by governments will generate future revenue for both society and its governments.

Effects on the Private Sector

Government expenditures have specific effects on industries, occupations, geographic regions, and subpopulations. These effects are especially evident in the field of defense. During the Cold War, clusters of firms and their employees became highly dependent upon defense outlays, resulting in what President Eisenhower in 1961 decried as the military-industrial complex. The case could be made that a dangerous symbiotic relationship developed between the military, with its penchant for new weaponry, and corporations eager to supply such weaponry. Periodic scandals in defense contracting offer seeming confirmation of the fears expressed by President Eisenhower.

The effects of defense are particularly pronounced in regard to employment, despite the downsizing that has occurred since the end of the Cold War. In 2010, civilian employment in the Department of Defense accounted for just over 0.5% of the private sector labor force and more than one-fourth of the federal government's civilian labor force. In addition, in 2010 the federal government employed more than 1.4 million active duty armed

services personnel, including more than 1.1 million within the borders of the United States or its territories. Total military and civilian defense employment constituted 1.5% of total U.S. employment in 2010.[9] Those figures were almost unchanged from 2005, despite the continued buildup of the military during the heights of the Iraq and Afghanistan wars.

The effects of defense expenditures on the private economy also have been substantial. Defense expenditures account for a significant percentage of jobs in various industries. The creation of defense-related jobs entices people into educational programs that train them to develop the requisite skills. As a result, people are attracted to technical career fields that are dependent upon continued defense spending. These people suffer or flourish based on which policies prevail.

Geographic and Industry Effects

Military research, development, and procurement are of such great magnitude that many specific industries and corporations become quasi-public institutions. In 2009, the Department of Defense spent $327.4 billion in total contracts. Of this amount, $303.4 billion went to business firms in the United States. The remainder was provided to nonprofit or education institutions in the United States, intergovernmental contracts, or work done outside the United States.[10] Defense expenditures greatly influence the private sector—in firms that engage in shipbuilding, aircraft construction, and communications, to name just three examples—and the importance of defense expenditures on the private sector increases in periods of defense buildup. Besides providers of military equipment, such as Boeing, General Dynamics, General Electric, and General Motors, numerous consulting and research and development firms are dependent on military expenditures. Nondefense contracting firms are similarly dependent, with 60% to 80% of their revenues coming from government contracts. The role of contractors in Iraq and Afghanistan in performing what had historically been military functions, and in the massive reconstruction programs, received special attention from government watchdog agencies, such as the Government Accountability Office, as charges of poor oversight, waste, fraud, and simply an excessive reliance on contractors mounted.[11]

Employees of these varied private sector firms, judging from their length of service on government projects, are doing work that otherwise would be done (and, in many cases, used to be done) by career civil servants. One difference between these contractors and the civil servants they supplant is that the pay of managerial staff in these firms is often higher than that of similarly trained government employees. Professional salaries, such as for engineers and scientists, tend to be relatively equal, because government must meet private sector salaries to recruit and retain professionals. Another difference is that private sector employees do not constitute a permanent expense to the government. These workers are not protected by civil service laws and are ineligible for government pension benefits. Furthermore, when these workers' services are not needed, government has no obligation to them as it would to its own employees.

The geographic effects of defense expenditures are equally important because they are not uniformly distributed throughout the nation. In 2009, the Department of Defense spent $504 billion. Five states—Virginia, California, Texas, Florida, and Maryland—accounted for $192 billion, or about 38% of that total.[12] In addition to direct expenditures, the Department of Defense also spent $332 billion for procurement contracts and grants

in the same year. When payments to these various firms are totaled, the states of Virginia, California, Texas, Maryland, and Connecticut respectively rank as the top five locations of these recipients, accounting for 41% of all contracts and grants.[13]

Defense, while the most striking example of private dependence upon public outlays, is not the sole example. Highway construction also involves large sums of public money. The employees of construction firms specializing in bridge and highway construction are, in effect, government employees. The same is true for suppliers of road-building equipment. Much of the emphasis on job stimulation in the various federal programs adopted starting in 2008 was on highway construction projects that could start immediately and put people back to work (see the chapter on government and the economy). In addition, the 1990s and early 2000s saw a continued emphasis on contracting out as a means of producing public services. In 2005, 10.5 million individuals were employed under federal grants and contracts, up from 7 million in 1999.[14]

In some cases, the impact of government on an industry is greater as a result of what government does *not* do than what it *does* do. The federal government's choice not to tax interest paid on home mortgages (see the chapter on budgeting for revenues and taxes), for example, has a far greater effect on the housing industry than all federal expenditures for public housing and redevelopment.

The lack of clear-cut distinctions between the public and private sectors and between one government and another is evident in education. Elementary and secondary education is a function of local school districts, but about half the funds used by these districts come from state governments, with additional funds coming from the federal government and local sources of revenue, primarily property taxes. The states have a primary role in funding public higher education, with important federal support, especially in the form of student aid and research financing. Governments also selectively subsidize private colleges and universities. Private corporations also make important contributions to both public and private schools. In 2002, the U.S. Supreme Court ruled that it is constitutional for governments to use public funds to provide vouchers to parents whose children attend private or parochial schools.[15] Since that ruling, some states have adopted statutes permitting school vouchers, but most have not. In addition, the level of funding may understate the degree of federal involvement in elementary and secondary education. The federal government can, as a condition of the receipt of federal assistance, insist that state and local governments adopt policies they might otherwise have chosen not to adopt. The best recent example of this is the federal No Child Left Behind Act, which forced state and local governments to adopt specific accountability standards in the form of testing requirements in order to continue to receive federal funds.[16] Under the constitutionally provided federal system, the national government cannot directly compel states and localities to establish such standards, but the threat of the loss of federal funds is sufficient to encourage most to go along with the federal requirements. The Obama administration, while continuing to enforce the act, introduced measures in the reauthorizing legislation to allow states more flexibility, but reauthorization stalled in Congress. Stimulus programs to provide both additional funding and flexibility to states, such as the Race to the Top program in the American Recovery and Reinvestment Act of 2009, did give states more choice in designing their education programs, with the Obama administration using waivers to allow states to set their own standards.[17]

Subpopulation Effects

Taxes and expenditures affect different subpopulations in different ways. In the example given earlier of the federal government allowing income tax deductions for interest paid on home mortgages, the middle and upper classes benefit far more than lower-income groups, who are typically renters rather than homeowners. This tax expenditure—namely, the government's not taxing something that could be taxed—has a redistributional effect in favor of the middle and upper classes (see the chapter on budgeting for revenues and taxes).

Government actions also have important effects on generations, including those yet to be born. Taxing and spending policies can help or harm children (born and unborn) through health and education programs, the working-age population through transportation programs, and the elderly through government-sponsored nursing care and the like. Future generations benefit from government programs that encourage investment in economic development, but excessive debts that governments may accumulate may harm these same people in the future.

THE MAGNITUDE AND GROWTH OF GOVERNMENT

There are many ways to measure the magnitude of government, but measurements of dollars and people are generally the easiest. By focusing on revenues, expenditures, and numbers of employees, we can use comparable standards in contrasting governments with each other and with private organizations. These measures, then, are the main ones used in this section. While care has been taken in making these comparisons to obtain the most recent and accurate data possible, some of the data here must be considered approximate.[18]

Revenues

One approach to assessing the size of government is to compare many governments with each other, as well as with large private sector organizations. **Table 2–1** makes such comparisons, using revenues or receipts, which allows comparisons among private and public organizations.[19] Table 2–1 ranks the 25 largest governments and industrial corporations in the world, as measured by revenues. Thirteen of the 25 are governments, with the U.S. federal government ranked first. One U.S. state government, California, makes the list as the nineteenth largest organization in the world. Significantly, 12 of the world's 25 largest organizations are not governments but private sector corporations (all multinational), with Wal-Mart coming in as the ninth largest. The listing is replete with intriguing contrasts. For example, Austria's government budget is smaller than the budget of California, and both have budgets much smaller than Wal-Mart's.

Figure 2–1 shows central government revenue as a percentage of GDP for 2009 for Organization for Economic Cooperation and Development (OECD) countries, excluding five with no data for 2009. On that list, the United States ranks third from the bottom, probably surprising to most U.S. citizens. Note, however, that the figures are for central government revenues only. Many OECD countries are unitary states, so that all government revenues are central, whereas government in the United States, as noted in this chapter, includes substantial financial roles for state and local governments. Thus, comparing the

Table 2–1 Twenty-Five Largest Governments and Industrial Corporations in the World by Revenues, 2009

Rank	*Governments*	*Revenues (Billions of Dollars)*	*Private Corporations*
1	United States (Federal)	$2,105.05	
2	Germany (1)	$1,231.88	
3	France	$1,111.03	
4	Italy	$919.60	
5	Japan	$795.75	
6	United Kingdom	$747.50	
7	Spain	$448.55	
8	Canada	$421.42	
9		$408.21	Wal-Mart Stores
10		$285.13	Royal Dutch Shell
11		$284.65	Exxon Mobil
12		$246.14	BP
13	Korea	$213.24	
14		$204.11	Toyota Motor
15	Belgium	$203.64	
16		$202.20	Japan Post Holdings
17	Sweden	$188.33	
18		$187.52	Sinopec
19	California	$186.31	
20		$184.50	State Grid
21		$175.26	AXA
22		$165.50	China National Petroleum
23		$163.53	Chevron
24		$163.20	ING Group
25	Austria	$162.98	

Sources: Data from U.S. Council of Economic Advisers (2011). *Economic report of the president (p. 285).* Washington, DC: U.S. Government Printing Office; Bureau of the Census, U.S. Department of Commerce (2009). *State government finances 2009: summary table.* Retrieved March 28, 2011, from http://www.census.gov/govs/state/; CNN Money (2009). *Global 500.* Retrieved May 21, 2011, from http://money.cnn.com/magazines/fortune/global500/2010/full_list/; Organization for Economic Cooperation and Development (2010). *Revenue statistics: comparative tables.* Retrieved May 23, 2011, from http://www.oecd-ilibrary.org/taxation/data/revenue-statistics/comparative-tables_data-00262-en?isPartOf=/content/datacollection/ctpa-rev-data-en.

U.S. federal government only with countries that have no state and local governments is somewhat misleading. Adding state and local revenues to federal revenues and dividing by GDP moves the United States two more places up the list, but it is still near the bottom. One other observation is important, and that is that the revenue figures do not consider borrowing. U.S. expenditures as a percent of GDP are considerably higher—36%—than U.S. revenues (see the chapter on government and the economy for a discussion of deficits and debt). This difference is due to expenditures financed by borrowing.

A comparison of organizations only in the United States also demonstrates the significant size of the governmental sector. A list of the top 50 organizations (including corporations, the federal government, and state governments) in the United States includes seven state governments (see **Table 2–2**). These states, in order of appearance, are California, New

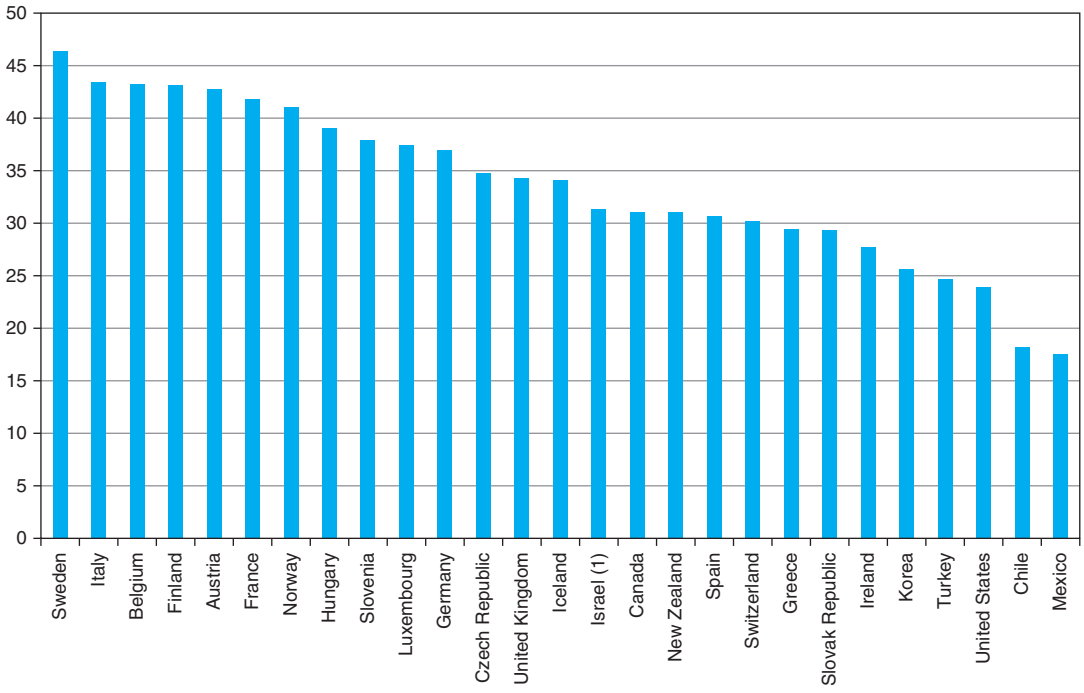

Figure 2–1 Central Government Revenue as a Percentage of GDP: Selected OECD Countries 2009.
Source: Data from Organization for Economic Cooperation and Development (2010). *Revenue statistics: comparative tables.* Retrieved October 12, 2011, from http://www.oecd-ilibrary.org/taxation/data/revenue-statistics/comparative-tables_data-00262-en?isPartOf=/content/datacollection/ctpa-rev-data-en

York, Texas, Florida, Pennsylvania, Illinois, and Ohio. If cities were included in the ranking, New York City would be 42nd on the list, just below Pennsylvania and above Illinois and Ohio.[20]

These statistics dramatically underscore the need for caution in generalizing about governments or private corporations. It is necessary to recognize the important differences in the functions of government and industry and the methods by which these organizations make decisions. Differences also abound within these two types of organizations. The services provided and methods of decision making are not identical in the governments of Japan, Germany, and the United Kingdom, nor are they the same in such private corporations as General Motors, IBM, and Wells Fargo. In contrast, using the standard of revenue size may provide more insights into the operations of organizations than simply classifying organizations as public or private, national or local, and so forth. Revenue is a key measure of the economic impact of an organization—revenue collected from the private sector by governments or sales by private companies (see the chapter on government and the economy). Though not all industrial firms are like General Motors, nor are all state governments like California's, all organizations of any given size, regardless of their private or public character, may exhibit some common traits, and all of a similar size represent similar proportions of the total economy. And many large private organizations in the United

Table 2–2 Fifty Largest U.S. Organizations by Revenues, 2009 (in Billions of Dollars)

1	United States (Federal)	$2105.05
2	Wal-Mart Stores	$408.21
3	Exxon Mobil	$284.65
4	California	$186.31
5	Chevron	$163.53
6	General Electric	$156.78
7	Bank of America Corp.	$150.45
8	ConocoPhillips	$139.52
9	New York (State)	$135.22
10	AT&T	$123.02
11	Ford Motor	$118.31
12	J.P. Morgan Chase & Co.	$115.63
13	Hewlett-Packard	$114.55
14	Berkshire Hathaway	$112.49
15	Citigroup	$108.79
16	McKesson	$108.70
17	Verizon Communications	$107.81
18	General Motors	$104.59
19	American International Group	$103.19
20	Cardinal Health	$99.61
21	CVS Caremark	$98.73
22	Wells Fargo	$98.64
23	International Business Machines	$95.76
24	Texas	$95.25
25	UnitedHealth Group	$87.14
26	Procter & Gamble	$79.70
27	Kroger	$76.73
28	AmerisourceBergen	$71.79
29	Costco Wholesale	$71.42
30	Valero Energy	$70.04
31	Archer Daniels Midland	$69.21
32	Boeing	$68.28
33	U.S. Postal Service	$68.09
34	Home Depot	$66.18
35	Target	$65.36
36	WellPoint	$65.03
37	Florida	$64.24
38	Walgreen	$63.34
39	Johnson & Johnson	$61.90
40	State Farm Insurance Cos.	$61.48
41	Pennsylvania	$60.73
42	Medco Health Solutions	$59.80
43	Microsoft	$58.44
44	Illinois	$55.58
45	Ohio	$54.44
46	United Technologies	$52.92
47	Dell	$52.90
48	Goldman Sachs Group	$51.67
49	Pfizer	$50.01
50	Best Buy	$49.69

Sources: CNN Money (2009). *Global 500-U.S. only*. Retrieved May 23, 2011, from http://money.cnn.com/magazines/fortune/global500/2010/countries/US.html; U.S. Council of Economic Advisers (2011). *Economic report of the president* (p. 285). Washington, DC: U.S. Government Printing Office; Bureau of the Census, U.S. Department of Commerce (2009). *State government finances 2009: summary table*. Retrieved March 28, 2011, from http://www.census.gov/govs/state/.

States received massive bailout funds during the most recent recession, such as General Motors, further blurring private versus public distinctions.

Although total revenues or expenditures are useful as approximate guides in measuring the size of government, these data need to be assessed in light of the varied capabilities of societies to support government. Unfortunately, reliable international data are often unavailable. Therefore, drawing useful comparisons among international organizations is difficult.

Even given these limitations, it is obvious that the U.S. economy is one of the most prosperous in the world. The high per capita GDP in the United States, $42,723 in 2010, has allowed for both big government and a large private sector.[21] While the size of federal, state, and local government as a proportion of GDP has grown—from about 31% in 2005 to 36% in 2010—the growth is not as dramatic as it might seem given the depth of the recession that started in 2007.[22] This figure, however, is misleading in regard to the size of the public sector in that just under half of the per capita expenditures go toward the purchase of goods and services—the other half is used for transfer payments and interest payments on debt.

Expenditures

Because early records on state and local finance are spotty, federal expenditure data must be used to obtain some overall perspective on the growth of government since the eighteenth century. **Table 2–3** shows federal spending from 1789 through 2010. During this period, expenditures rose from only $4.3 million in the first few years to almost $3.5 trillion annually in fiscal year 2010 (bear in mind that an important contributor to this difference is inflation).[23]

The twentieth century has seen important differences in the expenditure patterns of the federal government and those of state and local governments. Federal expenditures have fluctuated most, primarily because of war-related activities. The first year in which federal expenditures exceeded $1 billion was 1865, the peak year of the Civil War. Later, in response to World War I, federal expenditures jumped from $0.7 billion in 1916 to $18.5 billion in 1919, then dropped to $6.4 billion the following year. They also increased from $13.3 billion in 1941, the year the United States entered into World War II, to $92.7 billion in 1945, then declined just after the war. During the Korean War, expenditures rose from $42.6 billion in 1950 to $74.3 billion in 1953, and then dropped to $68.4 billion in 1955, after the war.[24]

In general, the past century has seen a pattern where federal expenditures have risen during wartime and then declined, but not to prewar levels, resulting in a cumulative increase over time. The Vietnam War era, however, departed from this pattern: federal expenditures rose both during and after the war. One of the reasons for the continued high spending from the 1960s onward was the creation and growth of large entitlement programs, such as Social Security, Medicare, and Medicaid. More recently, the Afghanistan and Iraq wars resulted in increases in federal spending as a proportion of GDP, as Table 2–3 shows, and a substantial increase in federal debt (see the chapter on government and the economy). The addition to the federal debt from the approximately $1.3 trillion in war-related expenditures over ten years accounted for about 25% of the increase in federal

Table 2–3 Federal Government Expenditures, Selected Years, 1789–2010 (Millions of Dollars)

1789–91	4	1885	260	1975	332,332
1800	11	1890	318	1980	590,947
1805	11	1895	356	1985	946,423
1810	8	1900	529	1990	1,253,198
1815	33	1905	567	1995	1,515,837
1820	18	1910	694	2000	1,789,216
1825	16	1915	746	2001	1,863,190
1830	15	1920	6,358	2002	2,011,153
1835	18	1925	2,924	2003	2,160,117
1840	24	1930	3,320	2004	2,293,006
1845	23	1935	6,412	2005	2,472,205
1850	40	1940	9,468	2006	2,655,100
1855	60	1945	92,712	2007	2,728,700
1860	63	1950	42,562	2008	2,982,500
1865	1,298	1955	68,444	2009	3,517,700
1870	310	1960	92,191	2010	3,455,800
1875	275	1965	118,228		
1880	268	1970	195,649		

Sources: Data from Bureau of the Census, U.S. Department of Commerce (1975). *Historical statistics of the United States: colonial times to 1970* (part 2, p. 1114). Washington, DC: U.S. Government Printing Office; U.S. Office of Management and Budget (2007). *Historical tables, budget of the United States government: fiscal year 2007* (pp. 53–54). Washington, DC: U.S. Government Printing Office; U.S. Congressional Budget Office (2011). *The budget and economic outlook: fiscal years 2011-2021* (pp. 54, 87). Washington, DC: U.S. Government Printing Office.

debt (see the chapter on government and the economy). The remainder is attributable to domestic, civilian programs, mainly the anti-recession measures.

State and local expenditures, in contrast, have fluctuated less. In 1902, state and local expenditures were $1.1 billion, and they have continued to grow steadily over the past 100 years, to $2.4 trillion in 2008, with no significant reductions during any period.[25]

Important shifts have occurred in the extent to which the nation relies on different levels of government. At the turn of the century, local governments were by far the biggest spenders, followed by the federal government and then the states. During the Great Depression, federal spending spurted above local expenditures, and the gap has continued to widen. As of 2008, federal expenditures stood at $3 trillion,[26] compared with $1.7 trillion for states and $1.6 trillion for local governments.[27] Caution should be exercised in interpreting these numbers, in that each includes intergovernmental transfers—namely, grants from one government to another. Total spending for all governments was $5.8 trillion in 2010, of which $3.7 trillion represented federal expenditures and $2.1 trillion represented state and local expenditures. (Note that data are not as readily available for local government finances, so when separating local from state, the data are not as current.) These last numbers take out the effect of intergovernmental transfers— $0.5 trillion. Therefore, taxes collected at the federal level (for example) but spent at the state or local level are counted as federal spending.[28]

One means of looking at the growth of government over time, while controlling for price changes, is to consider government expenditures as a percentage of GDP. **Figure 2–2** shows that, from 1926 to 2010, the cost of government rose from 12% to 36% of GDP. Increases first occurred in the 1930s due to the Great Depression, and World War II brought expenditures to an all-time high at about half of GDP. A sharp cutback followed in the postwar years, and expenditures dropped to a low of just under 20% by 1948. The Cold War and the Korean War occasioned another sharp increase in the early 1950s, and—after reductions in military spending in the late 1950s—the Great Society programs and the Vietnam War resulted in increased spending again during the 1960s; the spending has persisted since that time. Although there has been some year-to-year fluctuation, the percentage of GDP devoted to government remained relatively stable between 28% and 34% since 1970, rising to 36% in 2010 as a result of economic stimulus programs and defense spending.

Public Employment

Another way to measure the size and growth of government is to examine trends in the number of government employees. In 1816, there were fewer than 5,000 full- and part-time civilian employees in the federal service. Much more growth in public employment followed the Civil War. In 1871, there were more than 50,000 federal employees, and this number doubled to 100,000 by 1881. The period of fastest growth was from the Great Depression through World War II. In 1931, there were still only 610,000 employees, but by 1945—the peak of the wartime economy—the federal civilian workforce had climbed to

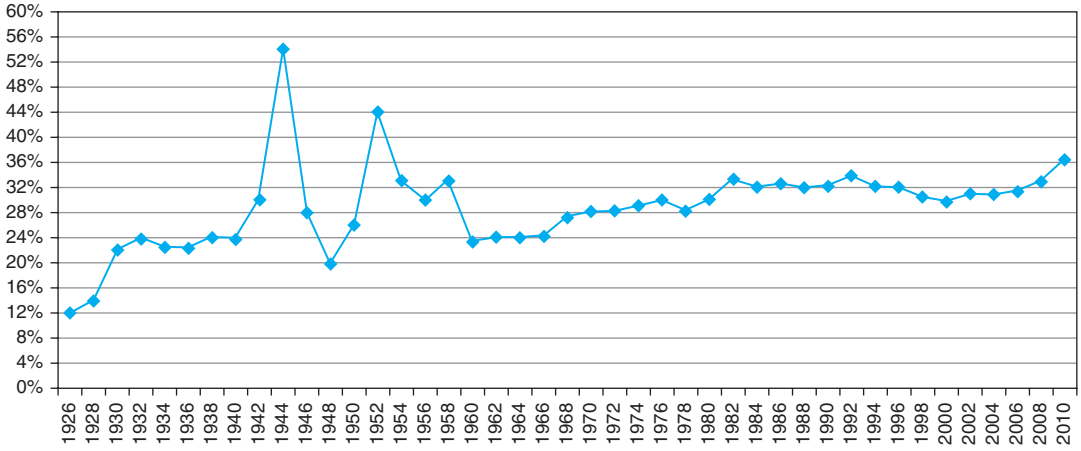

Figure 2–2 All Government Expenditures as a Percentage of Gross Domestic Product, 1926–2010.
Sources: Data from Bureau of Census, U.S. Department of Commerce (1969). *Historical statistics on governmental finances and employment* (pp.1, 36–37). Washington, DC: U.S. Government Printing Office; U.S. Council of Economic Advisers (2011). *Economic report of the president* (pp. 283, 287). Washington, DC: U.S. Government Printing Office.

nearly 4 million. Within a year, however, it was reduced to fewer than 3 million employees, and since then, only once (in 1950) has the federal workforce dropped below 2 million. Federal civilian personnel averaged approximately 3 million between 1970 and 2000, but decreased to about 2.7 million by 2005 and increased about 3% to 2.8 million by 2010.[29]

Although the size of the federal bureaucracy is extraordinarily large, the government's personnel are geographically dispersed. In 2009, California had 169,000 federal civilian employees, a figure equal to almost one-third of Wyoming's population. Federal employees (excludes military personnel) are also numerous in other states, including Virginia, with 147,000; Texas, with 140,000; and Maryland, with 124,000.[30] In the 1990s, such states became painfully aware of their dependence on federal employment as the government began to downsize the military, because about one of every three federal civilian jobs is in defense. Similar effects on states with high defense-related employment likely will occur as the post–Iraq and Afghanistan defense period budgets decline, relative to the total federal budget, assuming no major defense crisis occurs.

At the state and local levels, the number of employees has also increased. State employment grew from 3.8 million in 1980 to 4.4 million in 2009. In the same period, local employment increased from 9.6 million to 12.4 million.[31] However, both state and local employment had declined by 2010 with cutbacks in most categories of state and local employees. Significantly, the growth at the local level has been accompanied by a decline in the number of local governments. In 2007, there were more than 89,000 local governments, 29,000 fewer than five decades earlier. This decline is largely attributable to school district consolidation. Since 1972, the number of local governments has been increasing gradually, due mainly to increases in the number of special districts—that is, governments that typically provide a single service such as water provision or recreation services. There were more than 37,000 of these special district governments in 2007.[32]

SOURCES OF REVENUE AND PURPOSES OF GOVERNMENT EXPENDITURES

In general, government does not simply get money and spend it. Rather, governments obtain revenue from specific sources and spend it on specific public goods and services. The following discussion considers the relationships between income and outgo—that is, the ways in which revenue is generated and the purposes of government expenditures.

Federal Revenues and Expenditures

The federal government obtains revenues from several different sources. The major source of revenue for the federal government is the individual income tax. In fiscal year 2010, 42% of all federal revenues came from this source. Social insurance taxes (payroll taxes for Social Security and Medicare) accounted for another 40% of the total, a sharp increase from 35% in 2006. Adding in the almost 15% contributed by corporate income taxes, these three sources accounted for 91% of all federal revenues. This distribution represents a substantial shift from the early 1900s, when customs duties and excise taxes were the major

revenue sources. These sources now account for 4% of total federal revenues. **Table 2–4** shows a summary of federal revenues and expenditures.

There are two main types of federal spending: discretionary spending, which is provided for through the annual appropriations process, and mandatory spending, which is provided for through "permanent" law. Discretionary appropriations provide for most of the core functions of government, including the operations of major federal departments. This category accounted for about 39% of all federal spending in 2010, and just over half of this amount went for defense. This represents a substantial decline in the relative importance of discretionary spending from the 1970s. In 1973, 50% of expenditures were discretionary, and the figure was 65% in 1967.[33] Increased defense spending associated with military activities in Iraq and Afghanistan has increased the percentage of the budget accounted for by discretionary spending in recent years, reversing a trend of several decades. As recently as 2001, discretionary spending represented less than 35% of total federal spending.[34]

Mandatory spending (chiefly entitlements) accounted for about 55% of federal spending in 2010. This was a substantial increase in the proportion of the budget that went to mandatory spending since 1970, when the figure was 35%. The major single entitlement—36% of total mandatory spending—is Social Security. The health entitlements (Medicare and Medicaid) together make up another 41% of all mandatory spending. The expansion of mandatory spending since the mid-1960s (fueled by the federal role in health care costs and smaller "Great Society" programs of the Johnson administration) has increased the proportion of the federal budget devoted to mandatory spending.

Table 2–4 Federal Revenues and Expenditures, 2010 (Billions of Dollars)

Revenues			*Expenditures*		
Source	*Dollars (Billions)*	*Percent*	*Source*	*Dollars (Billions)*	*Percent*
Individual Income	899	41.6	Social Security	701	20.3
Corporate Income	191	8.8	Medicare	520	15.0
Social Insurance	865	40.0	Medicaid	273	7.9
Excise	67	3.1	Other Spending	600	17.4
Estate and Gift	19	0.9	Offsetting Receipts (3)	–184	–5.3
Total Taxes	**2,041**	**94.4**	**Total Mandatory**	**1,910**	**55.3**
Customs Duties	25	1.2	Defense	689	19.9
Federal Reserve	76	3.5	Nondefense	660	19.1
Miscellaneous	20	0.9	**Total Discretionary**	**1,349**	**39.0**
Total Receipts	**2,162**	**100.0**	**Net Interest**	**197**	**5.7**
			Total Outlays	**3,456**	**100.0**

Source: Modified from U.S. Congressional Budget Office (2011). *The budget and economic outlook: fiscal years 2011–2021* (pp. 54, 87). Washington, DC: U.S. Government Printing Office.

The other category of federal spending is net interest. The federal government's spending on interest has increased and decreased, depending on the federal government's reliance on deficit financing and on interest rates. In 2010, it was 6% of the budget. In 1995, that figure was 15%. The reason for the much lower interest percentage in 2010, with a much larger debt, is historically low, near zero, interest rates. The Congressional Budget Office projected net interest to grow again to 12% by 2021 as a result of deficits driven by stimulus programs and defense expenditures and expected interest rate increases.[35] Extreme partisan differences in the U.S. Congress have made compromise on sufficient expenditure decreases and/or revenue increases extraordinarily difficult.

State and Local Revenues and Expenditures

State and local revenues and expenditures are summarized in **Table 2–5**. The first thing to note about state revenues shown in the table is that nearly 28% comes from other governments, mostly from the federal government. Typically, insurance trust revenues, the majority of which are for employee retirement, have constituted a significant portion of revenues—more than 20% in 2007. However, unrealized gains and losses from security holdings such as for public employee retirement systems are accounted for as revenues, and 2008 included significant unrealized losses. As a result, insurance trust revenues in 2008 were only at 5%. Sales and gross receipts taxes account for 22% of state government revenue. States obtain another 17% from individual income taxes, and 18% comes from user charges, such as tuition at state universities. Not every state taps into each of the varied revenue sources that the states use. Some states have both a sales tax and an individual income tax. Others have only one or the other, and two states (Alaska and New Hampshire) have neither.

Local governments obtain one-third of their money from other governments and the rest mainly through property tax and other sources. Of all local revenue, 26% comes from property tax. A little over 21% is obtained from charges, miscellaneous general revenue, and utility fees. While some local governments have income and sales taxes, these sources contribute only about 7% of all local revenues in aggregate.

State and local expenditures also follow different patterns. Some expenditures that are important for the federal government are nonexistent in states and localities. For example, neither the states nor their local governments are responsible for defense, postal service, or space exploration. When looking at direct expenditures (that is, expenditures that are actually made directly by the government, as opposed to assistance provided to some other level), public welfare is the largest expense for states, with education spending (primarily for higher education) ranked second. Other significant areas of state expenditure include highways and corrections.

Education spending is by far the largest category of local expenditures. The 38% spent on education is more than three times the percentage that is devoted to the second-ranked category, utility expenditure. Other significant areas of expenditure include public safety (police and fire), hospitals, and highways.

Table 2–5 State and Local Revenues and Expenditures, 2007–2008 (in Millions of Dollars)

Source	*State and Local*	*State*	*State Percent*	*Local*	*Local Percent*
Total Revenue	2,660,475	1,619,128	100.0%	1,530,814	100.0%
General Revenue	2,425,778	1,513,904	93.5%	1,401,341	91.5%
General Revenue from Own Sources	1,944,398	1,067,795	65.9%	876,604	57.3%
Taxes	1,330,412	781,647	48.3%	548,765	35.8%
Property	409,686	12,691	0.8%	396,995	25.9%
Sales and Gross Receipts	448,689	358,522	22.1%	90,166	5.9%
Individual Income	304,627	278,373	17.2%	26,255	1.7%
Corporate Income	57,810	50,759	3.1%	7,051	0.5%
Motor Vehicle Licenses	21,344	19,719	1.2%	1,626	0.1%
Other Taxes	88,256	61,584	3.8%	26,673	1.7%
Charges and Miscellaneous	613,987	286,148	17.7%	327,839	21.4%
Utility Revenue	139,142	16,523	1.0%	122,620	8.0%
Liquor Store Revenue	7,243	6,128	0.4%	1114	0.1%
Insurance Trust Revenue	88,312	82,574	5.1%	5,738	0.4%
Intergovernmental Revenue	481,380	446,109	27.6%	524,738	34.3%
From Federal Government	481,380	423,150	26.1%	58,230	3.8%
From State Government				466,508	30.5%
Total Expenditures	2,838,836	1,733,862	100.0%	1,593,088	100.0%
Intergovernmental	4,761	477,085	27.5%	15,790	1.0%
Direct by Function	2,834,075	1,256,777	72.5%	1,577,298	99.0%
Direct General Expenditure	2,400,204	1,024,666	59.1%	1,375,539	86.3%
Capital Outlay	307,448	107,058	6.2%	200,390	12.6%
Other Direct General Expenditures	2,092,757	917,608	52.9%	1,175,149	73.8%
Education and Libraries	837,674	232,658	13.4%	605,017	38.0%

(continued)

Table 2–5 State and Local Revenues and Expenditures, 2007–2008 (in Millions of Dollars)

Source	*State and Local*	*State*	*State Percent*	*Local*	*Local Percent*
Public Welfare	404,624	354,048	20.4%	50,576	3.2%
Hospitals	128,853	51,938	3.0%	76,916	4.8%
Health	79,704	40,033	2.3%	39,671	2.5%
Social Insurance and Veterans' Services	5,172	5,155	0.3%		
Highways	153,515	90,645	5.2%	62,871	3.9%
Other Transportation	27,806	3,258	0.2%	24,550	1.5%
Police Protection	89,676	12,034	0.7%	77,642	4.9%
Fire Protection	39,683			39,683	2.5%
Corrections	72,904	47,239	2.7%	25,665	1.6%
Protective Inspection and Regulation	14,937	9,298	0.5%	3,766	0.2%
Natural Resources	29,917	19,942	1.2%	9,974	0.6%
Parks and Recreation	40,646	5,510	0.3%	35,136	2.2%
Housing and Community Development	50,974	10,857	0.6%	40,118	2.5%
Sewerage	46,679	1,273	0.1%	45,406	2.9%
Solid Waste Management	23,757	2,439	0.1%	21,318	1.3%
Governmental Administration	126,997	52,102	3.0%	74,895	4.7%
Interest on Debt	100,055	44,719	2.6%	55,336	3.5%
Other General	126,630	41,520	2.4%	85,110	5.3%
Utility Expenditures	193,353	26,073	1.5%	167,280	10.5%
Liquor Store	5,934	4,945	0.3%	989	0.1%
Insurance Trust	234,584	201,094	11.6%	33,490	2.1%

Source: Data from of the Census, U.S. Department of Commerce (2011). *State and local government finances summary: 2007–2008* (pp. 6–11). Retrieved October 16, 2011, from http://www2.census.gov/govs/estimate/08statesummaryreport.pdf.

SUMMARY

Government is indeed large. The growth pattern of the public sector has been upward, and drawing a definitive line today between the public and private sectors is virtually impossible. If present trends continue, government can be expected to become even larger, albeit at a slower rate, providing more services directly or ensuring the provision of services by regulating the private sector.

Governments in the United States differ in the types of revenue sources used and main areas of expenditure. The federal government relies primarily on personal and corporate income taxes and social insurance taxes. Federal expenditures are concentrated in defense, medical entitlements, and social insurance. States obtain almost one-fourth of their revenue from the federal government and the remainder largely from sales and individual income taxes. Their expenditures are concentrated in education, social services, and welfare. Local governments, in contrast, receive one-third of their funds from other governments and one-fourth from property taxes, while their most expensive function is education.

NOTES

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