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Reduce the Size of Government

by Garrett Wozniak

Last week, the House of Representatives failed to pass legislation increasing the cigarette tax, the alcohol tax and the licensing fee for alcohol sales. The reaction to this and the flurry of conversation on the nearly two dozen introduced or proposed tax increases should, hopefully, inspire policy makers to consider how non-government sector (private and non-profit) entities face a changing economy.

To illustrate that consideration, suppose John, a local businessman, decides to open up a hardware store. After one year, his store is doing well, so he hires additional staff. Unfortunately, half-way through year two, the economy takes a downturn and John realizes that he now has too many employees: he is not bringing in enough money to meet costs and make a profit.

At first, he is unwilling to lay-off employees and raises his prices. He thinks that increasing the prices will generate more revenue. Arithmetically, this should do the trick, right? If John sells 100 screwdrivers now at $1 a piece, and he raises his price to $2, he would instantly double his revenue! Economically, however, this simple math isn't sufficient to realize the full impact increased prices will have on John's business.

Shortly after raising prices, the store's revenues decline and the business is in worse shape than before. The increased prices induce customers to frequent competing stores with lower prices; they go where they can get the same good for less money. Why pay $2 for a screwdriver when the store in Maryland has them for $1.50?

Learning from this lesson, John decided to reduce his prices to their original levels and opted to lay off some excess workers. Without the excess workers, he quickly built his business back to his pre-price increase level and was balancing his operating costs with his revenues.

Relating this story to the public sector, when a school has X number of students, it will have Y number of teachers. If X decreases, Y will decrease too because there aren't enough students to warrant the same number of teachers. This concept must apply to government as a whole. When revenues are at one level, the state can employ a certain number of people. However, if revenues decline, the state needs to reduce the number of workers it hires.

Returning to the same example of John's hardware store, as revenues go down, spending (payroll) needs to be cut. When the opposite situation is true and revenues increase (equivalent to increased sales at the hardware store) the state should not increase staffing. Why? Because while the increase in revenue for the hardware store equates to more business, increased revenues to the state means more money from productive private and personal sectors of the economy – not that the state is doing more business or offering more or better services.

The similarities between a private business and a government continue when looking at spending. Wrongly, the state increases prices (taxes) to meet desired spending levels. But this gets things entirely backwards. In business, the hardware store owner doesn't say "I want to pay $100,000 to run my business, so I'll sell 50,000 hammers at exactly $2 per hammer!" Instead, he estimates his revenue and plans accordingly - spending enough to provide good customer service and make a profit. If he sees revenue dropping and hammer sales decreasing sharply, he doesn't continue purchasing more hammers from his supplier simply because he originally wanted to sell 50,000 of them. Even worse, with decreased sales, raising prices would be pure madness: higher prices are even less likely to increase sales. The state, by refusing to consider layoffs for workers while insisting on raising taxes, is missing the bigger picture of what must be done when money is tight.

In business, the way you get ahead is by making a better product, cutting costs, slashing your prices or some combination of all of these strategies. In government, there is no "getting ahead." There is simply spending the revenue that comes in and, in Delaware at any rate, raising taxes when there is a revenue shortage. Layoffs and spending cuts seem the last option, if an option at all.

A key question that is not asked enough of private sector firms is, "How did these top firms gain their dominance in the first place?" They supply a better product that customers prefer. In the market, nobody holds a gun to consumers – nothing is compulsory; profits are earned by satisfying customers. In the state, taxes are generated by a thriving economy. Individuals and businesses are compelled to pay, even if the firm (the government) isn't doing a "bang up" job. What the state of Delaware can learn from private business is that by being a high quality state that offers a good product (i.e. a great business environment, stellar schools or a tax structure that allows individuals to keep more of their hard-earned money) the revenues can increase. And this can be done without raising taxes.

A clear distinction when making linkages between the private sector and public sector is that private operations are cost-cutting and innovative, while the government sector is often over-budget and stagnant, differences that occur because of the incentives (or lack thereof) faced in each respective sector of the economy. Entrepreneurs must satisfy their customers directly, -- John cannot force his hammers on unwilling consumers; (remember, these exchanges are not compulsory); government agencies, however, get their money via taxes levied by the General Assembly, who does with it what they will. The customer in this case, the taxpayer, faces a far more circuitous route in the connection overseeing how his tax money is spent.

To quote Arthur Laffer, "The different incentives also shed light on the relative frugality of the private sector. If an entrepreneur figures out a way to cut costs without sacrificing the quality of his product, he pockets the savings. Naturally this arrangement leads him to rack his brains, experimenting with different techniques in order to shave pennies here and there from his operation. Nothing of the kind happens in the public sector. Here, if a program manager comes in $10,000 under budget, he certainly can't buy his wife a diamond necklace – that would be embezzlement of public funds! So the incentive is for every manager to spend every last dime allocated by the legislature, lest his budget be reduced in the following year."

The simple point is: we need to rethink how we pursue government spending and re-prioritize the numbers we use so that we can start anew. In doing so, remember the following from economist John Maynard Keynes:

> *"Nor should the argument seem strange that taxation may be so high as to defeat its object, and that, given sufficient time to gather the fruits, a reduction of taxation will run a better chance than an increase of balancing the budget. For to take the opposite view today is to resemble a manufacturer who, running at a loss, decides to raise his price, and when his declining sales increase the loss, wrapping himself in the rectitude of plain arithmetic, decides that prudence requires him to raise the price still more—and who, when at last his account is balanced with nought on both sides, is still found righteously declaring that it would have been the act of a gambler to reduce the price when you were already making a loss" (John Maynard Keynes, "The Collected Writings of John Maynard Keynes," London: Macmillan Cambridge University Press, 1972.)*

Garrett Wozniak is Policy Director for the Caesar Rodney Institute's Community Advisory Board.

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