Economic Growth and the Public Sector: Evidence from the States

Executive Summary

In May 2006, the Ohio General Assembly adopted a state spending limitation that represents an official endorsement of a highly restrictive fiscal policy that curbs public services with the expectation of fostering greater economic growth. What evidence exists to support this expectation? This study compares trends in inflation-adjusted, per capita gross state product (GSP) over the 1990 to 2004 period among all fifty states in order to analyze the relationship between public sector growth and private sector economic performance. We perform separate analyses for each half of the period due to a time series break in the 1997 GSP data. Our main findings are:

- There is no evidence of a tradeoff between the size of states' public sectors and private sector growth. Across all states, the average state and local government share of total GSP showed a positive association with private sector GSP growth per capita in the 1990-1997 period, and no association in the 1997-2004 period.

- There is no evidence of a tradeoff between public sector growth rates and private sector growth. Across all states, increases in state and local government GSP per capita showed a positive association with changes in private output in both the 1990-1997 and 1997-2004 periods.

- States with expanding public sectors experienced more rapid private sector growth, on average, than did states that reduced their public sectors. This result occurred in both the 1990-1997 and 1997-2004 periods. States with expanding public sectors had private sector growth, on average, of 19.6 percent in the earlier period and 16.9 percent in the latter period. States with shrinking public sectors had private sector growth, on average, of 11.6 percent in the earlier period and 11.7 percent in the latter period.

- Ohio's private sector grew faster than its public sector over the 1990 to 2004 period. This trend occurred even in the latter half of the time period, when the state experienced a recession and a weak recovery. From 1997 to 2004, Ohio's state and local government GSP per capita increased by 6.4 percent, while private sector GSP per capita increased by 10.5 percent. As a consequence, the public sector's share of Ohio's economy declined over time.

These results have important implications for state fiscal policy. Ohio will not receive economic rewards for arbitrarily restraining its public sector, nor will our economy be punished if the state budget exceeds the new 3.5 percent annual spending limit. Cutting back on essential public services will not stimulate economic growth. Policy debates should not juxtapose the needs of Ohio's residents for education, transportation, health care, and law enforcement with private sector economic performance. In order to have a meaningful discussion about our future, we must break the grip of this false dichotomy.

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