

# PUBLIC POLICY SOURCES

Number 13

## Canadian Public Spending: The Case for Smaller More Efficient Government

William Mackness

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## Executive Summary

- This paper examines the economic impact of the massive transfers of national resources from the private sector to the government sector that were common among most industrial countries in the post-World War II period. In Canada for example, the size of the government sector, measured as a proportion of the national economy, increased by nearly  $2\frac{1}{2}$  times between the end of World War II and the early 1990s; that is from 22 to 52 percent of Gross Domestic Product (GDP).
- Mandatory resource transfers of this magnitude would be expected to have a significant impact on overall economic performance. Presumably, that is why they were made. The record indicates, however, that intended performance changes were generally not achieved or were other than those intended.
- We assess the adverse impact of oversized government independently from the efficiency and effectiveness of individual programs. The distinction is important because big government is a size problem, not a management problem. The critical weakness of oversized government is the costs and disincentive effects of having the government sector appropriating something in the order of 50 percent of everything being produced in the national economy. It is paying for big government programs, not managing them, that is the Achilles heel of big government.
- The evidence from Canada and abroad is persuasive to the effect that the size of the government sector, relative to the size of the economy supporting it, is indeed of serious consequence to trend rates of economic growth and associated living standards.
- This paper arrives at two principal conclusions. First, while big government holds out an engaging promise of progress, enlightenment and compassion, it simply does not deliver in practice. Second, in addition to not delivering on the plus side, oversized government inexorably produces high taxes, slow growth and high unemployment. The very close association observed between big government and high unemployment across the industrial economies is as striking as it is lamentable.
- It is our premise that, if big government were accomplishing its objectives, there should be something to show for the immense sums being expended. In particular, countries like Canada, which have vastly expanded the public sector over the last generation, should be posting measurably better performance compared to countries that have kept the government sector and related overheads relatively small. The record is otherwise. Big government countries simply do not produce measurably superior performance compared to smaller government countries, and on the three key measures—taxes, economic growth, and employment—the performance of big government countries is significantly poorer.
- Expansion of the government sector, like other economic activity, becomes subject to diminishing returns and rising overheads. These realities determine that there is an optimum or maximum efficient size for the government sector, just as there is for other sectors of the economy. Accordingly, unrestrained expansion of the government sector is not a viable option. The size of government really matters, particularly when it moves materially above or below optimum size.
- Empirical analysis across a wide range of countries indicates that the government sector reaches an optimum or maximum efficient

size when total government outlays account for something the area of 20 to 30 percent of GDP. A broad range, but far below the 45 percent of GDP level prevailing in Canada today.

- An important goal of big government has been improvement in the circumstances of lower income Canadians. However, the weight of evidence suggests that the circumstances of lower income Canadians have actually deteriorated over the last generation. The total income share of the lowest quintile income group is about unchanged over the last 30 years, but the quality of that income has changed. In particular, earned income has fallen and while dependence on transfers has increased.
- There has been a major increase in crime experienced across the western industrial countries over the last generation. It is interesting to note that this major lapse in the capacity of government to deliver on one of its most important core responsibilities occurred at the same time that most countries were greatly increasing the resources available to government.
- Based on our examination of the evidence at home and abroad, we propose the reestablishment of smaller more efficient government in Canada. Our proposal calls for a budget constraint on government limiting total government outlays to 30 percent of GDP.
- To reduce the size of the government sector we propose a multi-year program of expenditure restraint, tax relief and debt elimination. Projections based on our preferred adjustment strategy indicate that the adjustment process could be completed in about 15 years. Benefits to the economy would be substantial including an increased trend rate of economic growth, lower taxes and reduced unemployment, throughout the adjustment period and beyond.
- Our adjustment strategy generates annual fiscal surpluses averaging about 4.5 percent of GDP, which are then allocated to a combination of debt reduction (to reduce interest costs) and tax relief (to stimulate the economy).
- The adjustment process targets a zero level of net debt. Zero net debt eliminates interest costs allowing all of the government sector's 30 percent share of GDP to be spent on valuable program spending, rather than being diverted to debt service. With limited government, it is important that the government's share of GDP be available in its entirety to meet core program spending obligations. That is what taxpayers are paying taxes for.
- Achieving a 30 percent of GDP target for the size of government will require a 15.4 percentage points of GDP reduction in government spending. Fully 8.8 percentage points of the required spending reduction is provided by the elimination of interest costs (under our proposal's zero net debt target). Accordingly, only 6.7 percentage points of GDP reduction will have to come from reduced program spending. This prospective reduction compares to a reduction in program spending of 8.3 percentage points of GDP already achieved over the past 5 years. Prospective spending cuts are thus smaller than those cuts already effected over the last five years.
- Because of the lengthy period of downsizing required, permanent tax relief is essential to maintain a vigorous economy. Over the course of the adjustment, taxes fall from 46 to 30 percent of GDP, the equivalent of a general tax reduction of more than one third.
- The final section of the paper presents an historic and analytical review of the evolution of public spending in Canada from 1926 to 1996.

## Introduction

### The size of government and its impact on the economy

This *Public Policy Source* reviews the consequences of the exceptional rise in government spending in Canada that was sustained from World War I through the early 1990s. Our interest is in the economic impact and other consequences of the size of the government sector relative to the national economy supporting it. To gain a broad perspective, we examine the evidence at home and abroad.

The size of government has not been a prominent issue in public policy, because of other pressing distractions in public finance. In Canada, public finances have been in such disarray over the last generation that debate on fiscal matters has centred principally on regaining control of runaway government spending and putting a lid on the explosive growth of public debt. In this environment of financial overextension and impending crisis, inquiry into the size of government has largely been ignored. Today, the threat of imminent fiscal crisis is largely behind us. It is time to move on, and examine the effect of the size of government on economic progress and living standards.

Beginning in the 1960s, Canadian public policy embraced big government and markedly accelerated the ongoing growth of public spending relative to the economy. By the early 1990s, the public sector represented more than half of total national output. Taking on such an immense increase in government overheads was a big gamble for a small trading nation, and particularly so because Canada's principal trading partners did not take on comparable increases. There has been a remarkable lack of interest in this watershed change in Canada's economic and financial structure. What limited debate there has been has

tended to polarise ideologically with the left championing "more" government and the right promoting "less" government. Adding to this general lack of focus, neither side has chosen to clarify the matter by specifying a rationale for determining an appropriate, or welfare-maximising, size of government.

With fiscal balance having been achieved in Ottawa and in most of the provinces, and the prospect of sizeable surpluses in sight, there is good reason to begin to focus on the size of government. This paper will argue that the size of government relative to the economy matters because it has a critical, cumulative influence on long-term economic growth and living standards. In this connection, we also argue that the allocation of prospective fiscal surpluses should be determined with particular reference to the need to establish a government sector of optimal size.

### The case for smaller more efficient government

Based on our examination of Canadian circumstances, and in light of evidence from abroad, we conclude that the government sector in Canada has been expanded well beyond an efficient size. In particular we note that Canada has indeed prospered when the government sector was contained below 30 percent of the GDP. We are persuaded that the country can do so again, aided by the efficiency gains flowing from the re-establishment of a smaller more efficient government sector.

Below, we outline a proposal for the re-establishment of a smaller more efficient government in Canada. Our proposal would reduce the size of the government sector to 30 percent of GDP from about 45 percent today and a peak in excess of 50 percent of GDP in 1992. The adjust-



ment required is substantial, but the process is feasible over 15 years. Considerable benefits will accumulate over the adjustment period and aid in our proposal's successful completion. Our analysis indicates that the re-introduction of smaller, more efficient government will raise the trend

rate of economic growth, lower the rate of unemployment and provide for lower, more internationally competitive tax rates.

## Public Finance and Canadian Circumstances

### Why the size of government matters

Government creates value for society only to the extent that public spending creates benefits greater than the offsetting costs and disincentives of taxes and other measures required to finance the government sector. At relatively low levels of taxation, market distortions and disincentive effects are small compared to the manifold benefits flowing from the introduction of core government services such as security, communications and rule of law.

However, as government grows, the marginal or incremental benefit of more government spending falls and the offsetting incremental costs of higher taxes rise. Falling marginal benefits and rising marginal costs determine that expansion of the government sector is constrained by an optimum or maximum efficient size. As the size of government is expanded beyond maximum efficient size, increasing damage will be done to the economy. Beyond maximum efficient size, the benefits of more government spending are less than their cost, and the associated net loss rises exponentially because the growth of benefits is decelerating while costs are accelerating. It is worth noting that, if the maximum efficient size constraint did not exist, it would be feasible to expand government endlessly on a soviet-type model.

Expansion of government beyond maximum efficient size has serious adverse consequences for economic growth and living standards. Oversized government requires punitive levels of taxation and other measures that produce market distortions, inefficiencies and disincentives. Additionally, excessive government overheads actually produce perverse, non-market incentives for counterproductive economic behaviour. As a consequence, the economic potential and long-term growth path of the economy is reduced by an oversized government sector. Over time, reductions in the trend rate of economic growth produce large, cumulative reductions in living standards below what would have been achieved in the absence of the ongoing drag placed on the economy by oversized government.

When the government sector has expanded beyond the optimal size, as is the case in Canada today, there is a great opportunity for public policy to generate large, permanent increases in living standards simply by reducing the size of government. In the first 30 years following World War II, the Canadian economy recorded an average, annual compound growth rate of 5.0 per cent measured in inflation-adjusted terms. In the next 20 years until 1996, the trend rate of growth fell to 2.6 per cent. If trend rate growth had only been one percentage point higher over this latter 20-year period, annual output and living standards would be higher than they are today by fully 22.0 per cent. On this basis, output per capita in the

Canadian economy in 1996 would have been \$32,482 rather than the \$26,625 actually recorded.

## The fiscal dimensions of big government in Canada

Government spending as a percent of GDP rose from 15 percent in 1926 to a 1992 peak of 52 percent, and subsequently declined to 46 percent in 1996. Beginning in the 1960s, when Canada first embraced a European-style commitment to big government, there was a distinct acceleration in the rate of permanent transfer of economic activity from private sector to government sector. From 1926 to 1966, an average of 3.6 percent of GDP was shifted from the private sector to the government sector each decade. From 1966 to the 1992 peak in government size, the pace of transfer from private to public sector increased sharply to an average of 8.5 percent of GDP being transferred each decade.

The very rapid, post-1966 rate of transfer from private to public control, which expanded the government sector to a peak of 52 percent of GDP in 1992, was clearly unsustainable. Had the transfer continued at this pace for another generation, the government sector in Canada would have exceeded 75 percent of GDP by 2022.

While ruling out an unsustainable Soviet-sized government sector, Canada still has the option of maintaining a very large government sector in the range of 50 percent of GDP, but only at the cost of reduced output growth and living standards. As discussed below, lagging productivity and the loss of competitiveness in Canada due to oversized government bites particularly hard because such a large proportion of our trade is with two of the world's most competitive, low-tax countries

Canada's experiment with big government has not produced the superior economic and social returns anticipated by its authors. It has, however, produced legacies that will adversely affect

the country for years to come including high taxes, high unemployment, massive public debt, and even more massive unfunded liabilities in over-extended social programs. Our examination and the research of others indicate that the combination of reduced economic growth, lack of results in social policy and the high cost of big government make a persuasive argument for containing the size of the government sector. In contrast to the unrealised benefits of big government, restraining the government at an economically efficient level offers the prospect of measurable benefits, namely strengthened economic growth, reduced unemployment, lower taxes, and improved living standards and social conditions.

The Canadian experience with big government is quite in line with the experience of other countries. Research indicates that expansion of the government sector beyond the 20-30 percent of GDP range produces ongoing economic under performance and little or no identifiable improvement in social conditions. It is the early days of this debate, but the evidence suggests that the most efficient, cost-effective size of government for Canada is in the range of 20 to 30 percent of GDP.

We also note a complete absence of research indicating that a big government structure in the area of 50 percent of GDP is positive, or even neutral, with respect to economic growth and living standards. Accordingly, we are moved to the conclusion that oversized government poses a serious threat to Canadian interests and should be replaced with a smaller more efficient government sector.

## Regaining the Fiscal Initiative—Allocating Prospective Fiscal Surpluses

Following the recession and fiscal crisis of the early 1990s, governments in Canada, with the ac-

tive encouragement of their creditors and credit rating agencies, belatedly began to embrace fiscal restraint in earnest. In the four years from 1988 to 1992, the size of the government sector rose from 44 to 52 percent of GDP. Something had to be done. The fiscal crisis was about to move out of control.

In the next four years, tax increases and some spending restraint made fiscal balance a reality or a realistic prospect in most jurisdictions and reduced the size of the government sector from 52 to 46 percent of GDP. However, taxes remain at record high levels, public debt exceeds 100 percent of GDP and the burden of public sector debt service is immense, currently amounting to nearly 9 percent of GDP, or about 20 percent of total government revenue.

The Alberta government has held what was styled a growth summit to solicit views of Alberta citizens about how fiscal surpluses in that province should be disposed of. Subsequently, debt reduction was made a top priority in Alberta. The Alberta summit had the great virtue of reminding electors that there is a connection between the disposition of fiscal surpluses and future prosperity. In fact, the decisions Canadians make during the next few years regarding fiscal surpluses will affect the size of government, and the rate of future economic progress.

The manner in which prospective fiscal surpluses are allocated will have an important influence on the size of the government sector. Therefore, a determination of the correct or optimal size of the government sector relative to the economy is necessary before a rational policy can be developed for allocating fiscal surpluses. The most apparent risk is that when the government sector is already beyond an efficient size, allocating fiscal surpluses to more program spending will compound the problem of oversized government.

Determining the appropriate size for the government sector is the critical first step in producing an internally consistent fiscal policy. Thereafter, the broad outlines of fiscal policy, and the appropriate allocation of fiscal surpluses, come together in a quite straightforward way. Depending on the current size of the government sector, there are three broad fiscal alternatives. First, if the government sector is too small, surpluses should be used to enrich core government programs, and taxes raised as necessary to sustain a higher level of public spending without endangering the budget balance. Second, if the government sector is at an optimum size, then the surpluses ought to be used entirely to retire outstanding debt. Once a zero net debt position has been established, taxes should be lowered to bring revenues in line with expenditures. Third, if the government sector is too large, surpluses should be dedicated to the elimination of debt in conjunction with other efforts to reduce the ongoing cost of oversized government. Where the government sector is substantially beyond efficient size, tax reductions should accompany debt reductions to stimulate economic growth and thereby ease the course of ongoing debt reduction and spending cuts.

As described below, the government sector in Canada is far too large relative to the economic base supporting it. Accordingly, our proposal for the restoration of a smaller more efficient government is based on the third alternative outlined above. Specifically, spending is capped at current levels until growth of the economy reduces government spending to 30 percent of GDP from about 45 percent today. Thereafter, spending is increased in line with economic growth to maintain the government sector share of the economy at 30 percent of GDP. Spending restraint and revenue growth from a growing economy will generate fiscal surpluses averaging 4.5 percent of GDP, which are then allocated to debt retirement and tax relief. Our projections indicate that this adjustment process can be completed in about 15



years and would leave Canada better positioned economically and financially than it has been since the 1960s. Our proposal is described in more detail below.

### Getting the most from public spending—program spending versus interest costs

The existence of an optimal or maximum efficient size of government has serious ramifications for deficit finance and associated public debt accumulation. When total government spending is limited, public spending devoted to debt service reduces directly the amount of funds remaining available for government program spending. It is on this account that our proposal for the re-introduction of smaller more efficient government establishes a zero net debt target.

Recognising that public spending is both valuable and limited, there is no justification for ongoing recourse to deficit finance. Deficit finance inexorably produces debt and ongoing debt service charges that directly reduces public funds available for constructive purposes. Debt reduction is an important policy option for increasing ongoing program spending without increasing the overall size of government. For a heavily indebted country like Canada, debt reduction can cut interest costs and permanently release a sizeable proportion of government revenues that can then be applied to further debt elimination or tax reduction as appropriate.

Today, Canadian public debt interest costs amount to about 9 percent of GDP and represent an ongoing government expense of something in the order of \$75 billion annually. Debt retirement as a policy option for Canada offers the opportunity for a major reduction in excessive government sector spending without reducing program spending. Additionally, the interest cost savings provided by debt elimination would provide for an average tax cut of about 20 percent. The poten-

tial here is quite large and needs to be examined carefully.

Another way to view the debt retirement issue is to examine the consequences of keeping existing debt in place and cutting other spending to reduce the overall size of government to a maximum of say 30 percent of GDP. In these circumstances, program spending would have to be driven to only about 21 percent of GDP leaving an additional 9 percent available for debt service. By comparison, reducing net debt to zero allows for program spending at 30 rather than only 21 percent of GDP. It is on this account that a zero net debt target is a key element in our proposal to re-introduce smaller more efficient government in Canada.

Robson and Scarth (1997) propose a federal net debt to GDP ratio of 20 percent compared to 70 percent today, principally because a lower level of debt would be a lesser threat to the economy in the event of economic or financial upset. Their analysis does not assume any constraint on the size of government so that a debt level of manageable size is acceptable. It is our limit on the size of the government sector that recommends a zero net debt structure as described above.

Others argue that the national debt should be left in place indefinitely, and that rising output should be relied upon to reduce the size of the debt relative to GDP. Such proposals are deficient on two counts. First, relying on economic growth to reduce the size of a fixed level of government debt relative to the economy is a very slow process. Reducing the debt to GDP ratio from 107 percent today to 50 percent would take more than 15 years and reaching 25 percent would take more than 30 years. In the meantime, the economy would continue to support the deadweight of massive public debt charges for decades, and economic growth would be adversely affected. Second, it is problematical whether popular support could be maintained for a strategy delivering

such meagre results over such a long adjustment period.

Moreover, in economic and financial affairs gradualist strategies such as the one above almost never work. Serious problems are so little affected by gradualist strategies that they tend to be overtaken by market-driven events not originally contemplated. For example, gradualist strategies to reign in double-digit money growth in the mid-to-late 1970s were an abject failure and brought the country to near-Latin American inflation rates

before serious monetary restraint measures were finally adopted. Similarly, gradualist fiscal strategies cobbled together in Ottawa from the late 1970s to the early 1990s were designed to meet current needs with borrowing rather than taxes and the hope that stronger economic growth in the future would provide for an eventual re-establishment of fiscal balance. In the event, these blue-sky fiscal schemes were singularly unsuccessful and were finally swept away on a tide of rising debt and compounding interest charges.

## The Case for Cost-effective Government

### Big government in Canada—the strategy and the record

The size of government in Canada expanded much in line with other industrial countries after World War II, rising from about 22 percent of GDP in the late 1940s to about 30 percent by the mid-1960s. Thereafter, the country embarked on a European-style commitment to big government. Measured against the total economy, public spending reached a peak level of 52 percent of GDP in 1992. Although most major countries experienced comparable government sector expansion, Canada's two largest trading partners, the United States and Japan, were exceptions to the rule and today still have comparatively small public sectors at 33 and 36 percent of GDP respectively.

Notwithstanding the immense expansion of the government sector in Canada over the last generation, the size of government and its relationship to economic progress and related social conditions has received remarkably little attention. Generally, analysis and debate regarding Canada's fiscal structure have focused on individual programs and particular tax and financial

strategies, presumably because these have been seen as more consequential than the question of the size of government itself. However, recent research indicates otherwise; namely, that the size of government has a substantial influence on the trend rate of economic growth, living standards and social conditions.

Although the literature on the size of government question is not large, findings are consistent and persuasive to the effect that excessive expansion of the government sector both reduces the trend rate of economic growth, and produces little or no measurable improvement in social indicators. For recent estimates of the impact of large government on economic performance in Canada, and for a review of the literature on size of government, readers are referred to Emes and Samida (forthcoming).

Having much higher government overheads and taxes relative to our principal trading partners adversely affects Canada's productivity, international competitiveness and the exchange value of the currency. Canadian policy makers often take comfort in the fact that Canadian economic particulars tend to be in line with OECD averages.

However, Canada does not compete with an average of OECD countries. More than 90 percent of Canadian trade is with the United States and Japan, countries which have the lowest government overhead and tax levels among the principal industrial countries.

By virtue of supporting government overheads proportionately about 40 percent larger than those supported by our principal trading partners adversely affects productivity and makes the Canadian economy less competitive internationally. Over the last 20 years, there has been a secular decline in the exchange rate that has amount to more than 30 percent. We believe that a lack of international competitiveness springing from excessive government overheads is a principal underlying cause of Canada's chronic exchange rate weakness.

The size of Canada's government sector was last in the area of 30 percent of GDP in 1966. Sustained expansion over the next generation increased government to a peak of more than 50 percent of the economy by the early 1990s. Expanding the take of government to more than half of everything being produced in the national economy begs the question; what have been the costs and benefits of this immense expansion of the government sector at the expense of the private sector?

We examine below the record and results of Canada's experiment with big government over the last 30 years. The salient feature is that the introduction of big government in Canada has come at very high cost. Principal costs include high taxes, overextended social programs, vast government indebtedness and, for the first time in history, levels of unemployment nationally that are nearly twice those prevailing in the rest of North America. Beyond these immense costs, big government has delivered little or no identifiable improvement in economic and social conditions beyond what would have been provided by a

smaller more efficient government fiscal structure.

Table 1 displays changes in principal government spending categories between 1966 and 1996. The 16.5 percentage points, or 50 percent, increase in the size of the government sector relative to the economy is almost entirely accounted for by increased transfers to persons and debt interest. The strategy, if one can call it that, looks simply to have been an uncritical commitment to the welfare state, and to the political convenience of deficit finance. If there was a more sophisticated strategy, it is not apparent.

The record shows that, beyond the commitment to the welfare state and deficit finance, other spending priorities changed little. As displayed in table 1, of the total rise of 16.5 percentage points of GDP in government sector share between 1966 and 1996, fully 14.9 percentage points were accounted for by increased transfer payments to individuals and increased debt interest. Goods and services spending did increase by 3.6 percentage points over the period, but this was largely offset by a fall of 2.3 percentage points in investment spending. Other spending changes were inconsequential.

If the immense investment in big government had actually produced stronger economic growth and lower unemployment, the big government initiative might have been self-financing, but it was not. The absence of any economic or social return on the investment in big government presented a serious financial problem; who pays for the new government largesse? Canada's answer was a heavy reliance on deficit finance which was politically more attractive than actually paying for government largesse with appropriately higher taxes. It was a fateful choice, and the country now carries one of the world's largest public debt burdens to highlight the error.

Rather than putting the immense costs of big government to the political test of higher taxes, successive Canadian governments chose to temporise and borrow. The strategy was to borrow today, and trust in deficit-financed economic momentum to deliver future growth and prosperity with which to service accumulated borrowings. Lenders and credit rating agencies went along with this for years, but a crisis of confidence finally developed in the early 1990s, first for provincial borrowers and then for the federal government. Faced with the threat of imminent financial crisis, governments finally hauled their fiscal structures into line, but the mountain of debt remains. This whole dreadful episode has provided a very expensive lesson in elementary finance and the dynamics of compound interest.

### Government size and unemployment—G7 countries

In general, among small, medium and large size governments, there appears little systematic difference in respect to absolute or relative perform-

ance across a wide range of economic and social indicators. There are, however, three very notable exceptions: taxes, economic growth and unemployment. In these three critical dimensions small governments tend to do significantly better than large governments without the debilitating costs and impositions associated with oversized government.

The modern relationship between big government and high unemployment is quite apparent in table 2. For example, among the G7 countries the two smaller government countries (United States and Japan) posted 1996 unemployment rates of 3.4 and 5.4 percent compared to the two largest government countries (Italy and France) which posted unemployment rates of 12.0 and 12.4 percent. In fact, the very close relationship between size of government and level of unemployment among all the G7 countries is quite striking.

In contrast to present circumstances, the G7 countries had much smaller government sectors and

**Table 1: Government Expenditures 1966 and 1996**  
(Percentage share of GDP)

	Share of GDP		Change	Share of Total		Change
Expenditures	1966	1996	1966-1996	1966	1996	1966-1996
Goods and services	15.0	18.6	+3.6	50.6	40.4	-10.2
Transfer payments	<b>7.3</b>	<b>16.0</b>	<b>+8.7</b>	24.8	34.6	+9.8
To persons	5.8	14.2	+8.4	19.7	30.8	+11.1
Subsidies to business	1.0	1.1	+0.1	3.5	2.4	-1.1
Capital assistance to business	0.1	0.4	+0.3	0.5	0.8	+0.3
To non-residents	0.3	0.3	0.0	1.0	0.7	-0.3
Interest on the public debt	<b>2.9</b>	<b>9.4</b>	<b>+6.5</b>	9.8	20.4	+10.6
Investment	4.4	2.1	-2.3	14.9	4.6	-10.3
<b>Total</b>	<b>29.6</b>	<b>46.1</b>	<b>+16.5</b>	<b>100.0</b>	<b>100.0</b>	<b>0.0</b>

Source: Statistics Canada, *National Income and Expenditure Accounts*, cat. 13-001.

**Table 2: Size of Government and Unemployment—  
G7 Countries**

Country	1996		1966	
	Gov't Size (% GDP)	U Rate <sup>1</sup> (%)	Gov't Size (% GDP)	U Rate <sup>1</sup> (%)
United States	32.7	5.4	29.1	3.6
Japan	36.2	3.4	n/a	1.3
United Kingdom	41.8	8.2	33.6	2.2
Canada	44.7	9.7	30.1	3.3
Germany	48.8	8.9	38.5	0.2
Italy	52.7	12.0	34.3	5.7
France	54.8	12.4	39.0	1.8
Average G-7	39.3	6.8	31.6	2.6

<sup>1</sup>Standardized unemployment rates.

Source: OECD, *Economic Outlook*, Dec. 1997.

much lower unemployment in the mid-1960s. Additionally, the relationship between the size of government and unemployment appears to have been less systematic in the earlier, smaller government era than it is today. In any event, big government and high unemployment are closely associated today and it is on this modern circumstance that we focus our attention. We examine in particular the influence of big government on taxation levels and labour market flexibility. Additionally, we examine the disincentives and dependency inherent in the large-scale recourse to income redistribution typically adopted by big government.

Three key factors appear to lie behind the high rates of unemployment associated with modern big government. First, the punitive tax and regulatory burdens associated with big government adversely affects output, labour market flexibility and employment. Second, big government raises costs and reduces efficiency by forcing economic

activity out of the private sector into the government sector. Universally, the production and delivery of goods and services under government monopoly is inefficient and expensive compared to delivery via private sector free markets. Third, generous government transfer programs, which are the common currency of big government countries, carry disincentives and the moral hazard of dependency regardless of how well designed and well intentioned they may be.

Without exception, big government overheads require high taxes, but direct measurement of tax burdens and tax incidence is complicated and to a degree is subject to misrepresentation. Deficit finance, off balance-sheet financing and pay-as-you-go social programs all have the capacity

to keep cash taxes somewhat below current spending levels, but not for long. At the bottom line, big government requires high taxes.

Among G7 countries (see table 3), the two largest government countries, Italy and France, have high top marginal tax rates (51 and 67 percent), high consumption tax rates (15 and 19 percent) and high social security tax rates (13 and 19 percent). The smaller government countries generally have substantially lower tax rates. The tax consequences of big government are unavoidable, namely high taxes across the board on income, consumption and payrolls. (It is on this account that the Government of Canada has been unable to honour electoral commitments to get rid of the goods and services tax (GST) and is so reluctant to reduce clearly excessive, job-killing payroll taxes.)

Top marginal tax rates are very important to the economic process because they bear directly on



Table 3: Tax measures—G7 Countries 1991/1992

G7 Countries	Marginal Tax Wedges (Percent) <sup>1</sup>	High Income Marginal Tax Rate (Percent) <sup>2</sup>	Top Marginal Tax Rate (Percent)	Consumption Tax Rate (Percent)	Social Security Tax Rate (Percent)
United States	38.5	29.9	40-47	5.3	7.0
Japan	22.2	28.1	65	6.1	9.4
United Kingdom	50.4	40.0	40	17.1	6.3
Canada	55.1	51.7	44-54	12.4	6.0
Germany	63.8	n/a	57	18.6	15.0
Italy	62.0	41.1	67	15.4	13.3
France	66.1	22.5	51	19.0	19.4

<sup>1</sup>OECD estimate published in *The OECD Jobs Study*. Measures after tax income of an average production worker as a percent of gross income plus employer paid payroll taxes.

<sup>2</sup>Marginal tax rate paid by one earner couple with two children earning 200 percent of the average production worker wage.

Sources: OECD (1994), *The OECD Jobs Study: Evidence and Explanations* (Paris: OECD, 1997); *Revenue Statistics 1965-1996*; J. Gwartney and R. Lawson, *Economic Freedom of the World 1997, Annual Report*, The Fraser Institute, Vancouver; United Nations, *Human Development Report 1997* (Oxford: OUP, 1997), p. 13.

that segment of the population best able to save and invest, and thereby to create jobs. Additionally, top marginal rates are levied on those best able to remove their wealth or themselves from high-tax jurisdictions. It is difficult, however, to measure and compare directly the incidence and effects of top marginal tax rates among countries principally because of complicated, politically-inspired exemptions and thresholds. To overcome these limitations the OECD and the UN studies cited below have prepared various estimates of actual or effective marginal tax rates bearing on major segments of the labour force. Two of these measures, the marginal tax wedge statistic and high-income marginal tax rate, are displayed in table 3.

The UN *Human Development Report 1997* estimates high-income marginal tax rates for production workers in the G7 countries. These high-income marginal tax rates apply to a one-earner couple with two children and an income twice the average production worker income. The

rates are generally below the top marginal rate, but in most of the larger government countries these rates are still quite high, even for better paid production workers. Overall, the influence of the size of government on the level of high-income marginal tax rates is quite apparent. (The rate for France is an exception reflecting special preferential rates for child rearing couples.)

Marginal tax rates on income do not account for the considerable additional tax burden of consumption and payroll taxes. These latter taxes are particularly onerous for workers in big government countries. To get a more comprehensive measure of the total marginal tax burden bearing on taxpayers the OECD *Jobs Study* has calculated a marginal tax wedge statistic. This statistic, which is presented in table 3, measures the marginal tax burden of all forms of taxation levied on an average production worker. It is a telling statistic, and very illustrative of the impact of big government on tax rates.

The marginal tax wedge is calculated as the tax gap between the after-tax purchasing power of an average production worker compared to the total wage and payroll tax cost to an employer of employing the worker. The gap is taxes; payroll taxes paid by the employer plus income, payroll, consumption and social security taxes paid by the worker. The OECD estimates indicate that for each dollar expended on employing a new worker in big government countries more than 60 cents goes to taxes and less than 40 cents goes to the worker. The 60 percent marginal tax wedge in the big government countries compares to a wedge of less than 40 percent in the small government countries. The wedge in Canada at 55 percent is not much below the highest tax jurisdictions.

In a major study of industrial country labour markets (*The OECD Jobs Study* 1994), the principal cause of high and persistent unemployment in OECD countries was identified as "... an inability of OECD countries to adapt rapidly and innovatively to a world of rapid structural change...". In addition to labour market rigidity, the study also identified high levels of taxation as a serious impediment to full employment. However, the study did not identify or examine the size of government as a critical factor in producing high taxes, labour market rigidity or high unemployment. The study was simply silent on the size of government question, possibly reflecting a lack of interest in the subject on the part of big government member countries. In any event, we believe it important to examine the influence of government size in the determination of taxation levels, labour market flexibility and the level of unemployment.

In general, labour market flexibility declines as the size of government increases (see table 4). One also observes that big government countries tend to have large, unionised public and quasi-public sectors that enjoy considerable insulation from market forces. These large, non-market sectors

create a momentum for dispute resolution by regulation, arbitration and litigation rather than the more flexible market-driven solutions common to more open competitive markets. Labour market rigidities are further compounded by dependency-inducing transfer payments which are common to big government. As noted in *The OECD Jobs Study*, generalised labour market inflexibility reduces the ability of an economy to adjust to external shocks and is reflected in reduced output and higher levels of unemployment.

In coping with market-driven shifts in terms of trade, which are so common to modern global markets, labour market flexibility is absolutely critical to maintaining output and employment levels. Conversely, countries with inflexible labour markets experience rising unemployment when commodity prices, exchange rates or other terms of trade shift against the economy or particular industries. The data displayed in table 4 certainly indicate that, among G 7 countries, the extent of unionisation and the rate of unemployment are higher in big government countries compared to smaller government countries. Taken together, the evidence is persuasive that big government contributes to labour market inflexibility and higher levels of unemployment than under a more flexible smaller government fiscal structure.

Overall, we are persuaded that the heavy tax burden of big government stands as a substantial impediment to economic growth and job creation. Additionally, labour market rigidities and dependency-inducing transfer payments common to big government countries compound the adverse impact of high taxes on the rate of unemployment.

### Government size and income distribution in Canada

An important goal associated with social programs in Canada has been the redistribution of

**Table 4: Government Size, Union Density, and Unemployment in 1990**

G7 Countries	Size of Government (Percent of GDP)	Union Density (Percent Members/ Labour Force)	Unemployment Rate (Percent)
United States	36.6	15.6	5.5
Japan	32.3	25.4	2.1
United Kingdom	42.3	39.1	6.9
Canada	47.8	35.8	8.1
Germany	45.1	32.9	6.2
Italy	53.6	38.8	10.3
France	49.9	9.8 <sup>a</sup>	8.9

<sup>a</sup>Union membership is low in France, but negotiated union agreements are applied to more than 90 percent of the labour force by agreement or by statute. In practice, France is a highly “unionized” country.

Sources: OECD (1994), *The OECD Jobs Study: Evidence and Explanations*, Paris; J. Gwartney and R. Lawson, *Economic Freedom of the World 1997 Annual Report*, The Fraser Institute, Vancouver.

income from upper to lower income Canadians as a means to reduce poverty and dependence. Our interest is in whether or not expansion of government programs over the last thirty years has been accompanied by improved circumstances for lower income Canadians.

Table 5 compares the pre-tax income distribution of 1965 with that of 1995, and on a post-tax basis between 1971 (earliest data available) and 1995. Readers will note that the 1995 after-tax income share of the lowest income quintile compared to pre-tax share is improved by one percentage point, from 4.7 to 5.7 percent. However, it is important to recognise that even this modest improvement in post-tax income share is not related or attributable to expansion of the government sector.

**Table 5: Income Distribution in Canada—Selected Years (Share of Total, Percent)**

	Pre-tax Income		After Tax Income	
	1965	1995	1971	1995
Lowest Quintile	4.4	4.7	4.2	5.7
Second Quintile	11.8	10.2	11.5	11.5
Middle Quintile	18.0	16.4	18.2	17.2
Fourth Quintile	24.5	24.5	25.0	24.5
Highest Quintile	41.4	44.1	41.1	41.1

Note: Total income, all units, families and unattached individuals. After tax data available only from 1971.

Source: Statistics Canada, cat. 13-207, *Income Distributions by Size in Canada*; and Statistics Canada, cat. 13-210, *Income After Tax, Distributions by Size in Canada*.

Tax structures favouring lower income groups are independent of the size of government. Namely, such redistribution via the tax system is equally feasible with small or large government and, therefore, should not be credited to big government. To the extent that more government spending were able to improve the incomes of lower income Canadians, such improvement would show up in pre-tax income. Accordingly, the impact of big government on income distribution is best measured in terms of pre-tax income distributions, which is the measure we employ in the analysis below.

While the pre-tax income share of the lowest quintile increased very

modestly from 4.4 percent to 4.7 percent between 1965 and 1995, the income share of the highest quintile also increased, and by much more, from 41.4 percent to 44.1 percent. Broadly measured, the income share of the bottom 40 percent actually fell over the period, from 16.2 to 14.9 percent, while that of the top 40 percent rose from 65.9 to 68.6 percent.

Available evidence indicates that the modest improvement in pre-tax income share of the lowest quintile was more than accounted for by increased transfers, and not by higher earned income and greater independence. Data from 1980 (earliest data available) to 1995 records an 8.9 percent decline in real income before transfers for the lowest quintile income group. Over the same period, transfers increased by 29.4 percent producing a net increase of 10.9 percent in total real

income of the lowest quintile. Falling earned income of the lowest income quintile being offset by rising government transfers reflects increased dependency and significant policy failure.

Independence or self-sufficiency as measured by the percent of income earned before transfers is displayed in the top panel of table 6. All income groups experienced a decline in independence because of the large and widespread rise in transfers. However, the sizeable decline in independence of the two lowest income quintiles is remarkable at a time when immense efforts were under way to improve the circumstances and independence of lower income groups.

Dependency measured as the percent of transfers in total income is displayed in the lower section of table 6. Steady increases in already high levels of dependency among lower income Canadians were recorded over the 1980 to 1995 period. Transfers accounted for 60.4 percent total real income of the lowest quintile in 1995 compared to 51.8 percent in 1980. Dependency also rose sharply in the second lowest income quintile, from 21.6 to 34.8 percent.

Overall, it is quite apparent that the circumstances of the lowest income quintile actually deteriorated through falling earned income and rising dependence on transfers over the 1980 to 1995 period. Accordingly, based on the 1980-95 data, it is probable that the very modest improvement in lowest quintile income share between 1965 and 1995 was more than accounted for by increased transfers. Based on this evidence, we would submit that the public policy objective of higher earned

Table 6: Average Income Share by Quintiles (Earned Income as a Percent of Total Income, 1995 Dollars)			
Before Transfers (independence measure)	1980	1995	Change 1980 to 1995
Lowest Quintile	48.2	39.6	-8.6
Second Quintile	78.4	65.2	-13.2
Middle Quintile	89.9	82.8	-7.1
Fourth Quintile	94.7	90.5	-4.2
Highest Quintile	97.2	95.9	-1.3
Transfers (dependence measure)	1980	1995	Change 1980 to 1995
Lowest Quintile	51.8	60.4	+8.6
Second Quintile	21.6	34.8	+13.2
Middle Quintile	10.1	17.2	+7.1
Fourth Quintile	5.3	9.5	+4.2
Highest Quintile	2.8	4.1	+1.3
Source: Statistics Canada, <i>Income Distributions by Size in Canada</i> , cat. 13-207; and <i>Income After Tax, Distributions by Size in Canada</i> , cat. 13-210.			

income and less dependence on transfers for the lowest income quintile was not met.

### The role of income redistribution in big government countries

Transfer payments are central to big government operations everywhere. Table 7 displays government spending in the G7 countries broken down between transfer payments and other government spending, which is comprised of goods, services and investment spending. The relationship between size of government and the level of transfer spending appears quite closely related to the size of government. The two smallest government countries support transfer payments amounting to only 12 to 14 percent of GDP. The two largest government countries support staggering levels of transfer payments amounting to 28 to 29 percent of GDP, about twice the level of transfers supported by small government countries.

Comparing columns two and four in table 7 indicates that there is no apparent systematic relationship between size of government and conventional, non-transfer-payment government spending. Note in particular that both the two-smallest and the two-largest government sector countries record very similar levels of non-transfer payment spending. All seven countries record conventional government spending within a relatively narrow range, 23 to 31 percent of GDP compared to a range of 12 to 29 percent for transfer payments.

In practice, transfer payments are big government commitments to improve the circumstances of identifiable groups. Conventional government spending does not produce immediate, specific

**Table 7: Transfer Payments and Other Government Spending in the G7 Countries in 1995 (Percent of GDP)**

Country	Total Government Spending	Transfer Payments	Other Spending
United States	36.7	13.9	22.8
Japan	36.7	12.2	24.5
United Kingdom	45.3	17.7	27.6
Canada	48.2	17.7	30.5
Germany	50.6	21.6	29.0
Italy	51.9	29.3	22.6
France	54.3	27.9	26.4
Source: J. Gwartney and R. Lawson, <i>Economic Freedom of the World, 1997 Annual Report</i> , The Fraser Institute, Vancouver.			

and identifiable results by way of improving the circumstances of target groups. Transfers, on the other hand, produce immediate, immediate income or other benefits. Accordingly, transfer payments have become an important means of maintaining support for big government through the provision of income or other identifiable benefits to target groups. Political attractions aside, the economics of income redistribution are quite unsatisfactory. Income redistribution initiatives tend to be expensive, expansive and ultimately counter productive. First, income redistribution is expensive because it is difficult to identify and target the needy, or the worthy, with precision. Accordingly, redistribution schemes are open to cheating and subject to political pressure for ever-wider application. Second, income redistribution is counterproductive because it creates work disincentives. As discussed above, evidence in Canada suggests that income redistribution to the lowest income quintile over the last generation has increased dependency while simultaneously reducing work effort.

Despite serious drawbacks, income redistribution will likely remain a major element in the op-



eration of big government because it can deliver politically where conventional government spending cannot. The political advantage of being able to deliver income and other benefits to target groups on a timely and fully identified basis is considerable. As a testament to the staying power of income redistribution schemes in Canada, the Atlantic region has been a victim of massive government transfers for decades despite the obvious moral hazard and compelling evidence of the damage being done.

### Security of persons and property under big government

Security of persons and property is among the most important responsibilities of government. There has been a large, generalised increase in crime rates since the early 1960s across the western industrial countries. (Demographic factors contributed to some of the increase in crime rates, but beyond these influences the rise in crime rates has been very large and wide spread across the western industrial countries.) The rise was sharpest until the early 1980s, modestly higher over the next decade and followed by a modest decline since the early 1990s. Setting aside the complexities of crime rate statistics, the compelling development has been the inability of governments of any size to contain the vast increase in crime rates recorded over the last generation. The Canadian data presented below is representative of developments in other western industrial economies.

The massive rise in crime rates recorded over the last generation has been a sign of failure for Canada, and indeed for all of the western industrial countries. Such a large and widespread lapse in the capacity of western governments to maintain high standards of peace and security is regrettable. That it should have developed alongside a massive increase

in government sector resources in most countries makes the crime explosion even more disconcerting. It is interesting to note that the failure of governments to limit the crime explosion did not stand in the way of an ongoing massive increase of new resources being delivered to most governments. In fact, the rising crime rate probably assisted governments in gaining more resources on the implicit assumption that more resources for government would somehow reduce or contain the rise in crime.

In retrospect, society's approval of the post-1960 expansion of the government sector in Canada and elsewhere was not sufficiently critical and demanding of results in the key areas of government responsibility. As we observe elsewhere in this paper, it is results rather than vision and public policy planning skills that should determine public sector resource allocation. Governments unable to control massive increases in crime rates or discharge other core responsibilities are poor candidates for even more money. Against this backdrop, there is a case for a more transparent and critical appraisal of public-sector performance and resource allocations. Where public policy is clearly deficient, other arrangements have to be considered, particularly market-determined or market-assisted alternatives.

Table 8: Police Reported Crime in Canada  
(Rate and Incidents per 100,000 Population)

	Total	Violent Crime	Property Crime	Other Crime
1996	8,758	973	5,192	2,593
1991	10,309	1,056	6,141	3,113
1981	8,708	652	5,741	2,315
1965	3,199	299	2,019	809
Ratio 1996/1965	2.7	3.3	2.3	2.9
Source: Statistics Canada, <i>Canadian Crime Statistics</i> , cat. 85-205.				

## Measuring the return on public expenditures—Canada and abroad

We present below an examination of the record of economic and social achievements of six selected G7 countries. The countries chosen, United States and Japan, United Kingdom and Canada, Italy and France, are representative of countries with small, medium and large government sectors. In important instances such as economic growth, taxes and unemployment, the evidence indicates that expansion of the government sector has not met its objectives and has made circumstances worse.

Taken together, the evidence suggests that the costs of big government exceed the benefits. Specifically, outstanding economic and social outcomes have not been achieved in big government countries relative to small government countries. This failure to deliver results must be contrasted with the vast increases in government generated overhead imposed on big government countries over the last generation. Measured against results in Canada and other big government countries, there is simply no evidence of economic and social improvement on a scale that would warrant the costs and impositions associated with vast expansion of the government sector.

We examine below evidence of the impact of the expansion of the government sector on economic and social performance indicators in Canada and abroad. Our premise is that the large costs involved in a major expansion of the public sector can only be justified if they produce significant additional benefits. If the costs of big government fail to produce a measurable net benefit, they leave society poorer than it would have been had the resources appropriated by government been left under the control of those who produced them.

The measures and comparisons reviewed here are not precise, and comparisons made interna-

tionally are that much more difficult again. Accordingly, our approach is to rely on the weight of evidence, or lack of the same, in evaluating the costs and benefits of big government. Measurement difficulties aside, the immense costs and dislocations associated with public sector appropriation of half or more of total national output are real and unmistakable. Given the high costs of big government, it is appropriate to identify associated benefits, if any. An absence of clear evidence of significant benefits being generated by the added costs of big government destroys the case for big government, at least from the perspective of those who are paying for it.

Accordingly, we look for evidence of improvements in economic and social circumstances that could reasonably be attributed to big government and thereby be counted as offsetting the considerable costs and impositions of big government. If big government does add value, there should be some measurable evidence of improved performance in the economic and social indicators in big government countries as compared with small government countries.

Taken together, the economic and social indicators reviewed below provide no case for big government. Of critical importance, the weight of evidence indicates that small governments actually produce better results on key measures including economic growth, unemployment and taxes. On other economic and social indicators, beyond the output, employment and tax measures noted above, the evidence is that small government countries produce results comparable to big government countries without the debilitating costs of big government.

Looking forward, the critical factor is economic growth. Over extended periods of time, even small increases or decreases in the underlying rate of economic growth have a profound impact on future output and living standards. Small governments deliver more rapid, long-term eco-

economic growth and are thereby able to raise living standards faster than a larger government could.

### Economic and social performance indicators—G7 countries

Table 9 presents a number of economic performance indicators. Where possible, we make historical comparisons, but historic data is not available for all of the indicators. We compare performance among six G7 countries, two with relatively small governments (the U.S. and Japan), two with medium-sized governments (the U.K. and Canada), and two with large governments (Italy and France).

The economic growth trends of the G 7 countries displayed in table 9 are representative of the relationship between government size and trend rates of economic growth across both the advanced and newly industrialised countries. Using G7 countries as a reference, trend rates of economic growth in the post-1966, big-government era are measurably more rapid in small government countries compared to big government countries, both on a total economy and per capita basis. As discussed in an earlier section, the slower economic growth trends in big government countries are accompanied by higher rates of unemployment.

Without exception, big government countries are high tax countries as a direct consequence of their high spending levels. In North America and Japan, high-income marginal tax rates are closely tied to size of government, below 30 percent in the US and Japan and above 50 percent in Canada. In Europe, the link between big government and high-income marginal tax rates is mixed depending on exemption structures and the degree of reliance on sales and payroll taxes. Regardless of how taxes are collected, however, big government universally requires high taxes. In this connection, small government countries score better than big government countries on measures of

economic freedom, principally because they have lower tax and regulatory burdens.

While taxes are tied to the size of government, public indebtedness clearly is not. The lack of a systematic relationship between government size and public indebtedness indicates that the choice to finance big government with borrowing rather than higher taxes is more a political than a financial choice. Labour force structure as measured in terms of participation rate and number of discouraged workers also appears unrelated to size of government. Although not captured by the measures in table 9, big government tends to produce labour market rigidities that restrict economic growth and raise unemployment as has been discussed above. Saving and investment do not appear to be closely related to government size. However, measurement in both of these areas is difficult and even more so in respect to international comparisons. Finally, consumer price inflation also looks to be unrelated to government size.

Overall, it appears that economic freedom, non-punitive tax rates, economic growth and unemployment are all favourably influenced by small government. These small government benefits are delivered without the considerable additional cost of big government. In other areas such as labour force structure, saving, investment and price inflation, big government countries appear to perform no differently than small government countries. In these areas, the high costs of big government are wasteful because they do not deliver measurable benefits beyond those available with small government.

Table 10 sets out a number of social indicators for the countries discussed above. If big government overheads are improving social conditions, it simply does not show in the social indicators reported by the UN and the OECD. There are differences in the indicators among countries, but the differences are unrelated to the size of govern-

Table 9: Economic Performance Indicators—Selected OECD Countries

	US	Japan	UK	Canada	Italy	France
Size of Government, Total Outlays as Percent of GDP						
1966	29.1	19.3 <sup>a</sup>	35.4	30.1	34.3	38.5
1996	32.7	36.2	41.8	44.7	52.7	54.8
Change 1966 to 1996	+4.2	+16.9	+6.5	+14.6	+18.4	+16.3
Real GDP Growth , Compound Annual (percent)						
1960-1973	3.9	9.6	5.4	4.8	5.3	5.4
1989-1994	2.1	2.1	0.8	1.1	1.0	1.2
Real Per-Capita GDP Growth , Compound Annual (percent)						
1960-1973	2.6	8.3	3.6	3.6	4.6	4.3
1989-1994	1.1	1.8	0.4	-0.2	0.8	0.6
Taxes and Economic Freedom, 1995						
Marginal Tax Rate, 1995 <sup>c</sup>	29.9	28.1	40.0	51.7	41.1	22.5
Economic Freedom Rating, 1995 <sup>b</sup>	7.9	6.7	7.3	6.9	5.5	6.1
Unemployment Rate (percent, standardized)						
1966	3.6	1.3	2.2	3.3	5.7	1.8
1996	5.4	3.4	8.2	9.7	12.0	12.4
Country Indebtedness, Debt/GDP (1995 estimate) (percent)	52	11	39	74	109	35
Labour Force (percent)						
Participation Rate: 1996	77.0	77.1	75.3	75.9	58.8	67.0
Discouraged Workers: 1993	0.9	2.2	0.6	0.9	2.6	0.2
Saving and Investment (percent of GDP)						
Saving: 1966	20.3	32.6	19.6	23.9	22.8	25.8
Saving: 1995	15.8	30.8	14.3	17.1	20.6	19.8
Investment: 1966	18.5	30.4	18.5	24.5	18.8	23.7
Investment: 1995	17.6	28.5	15.1	17.5	17.0	18.0
Consumer Price Inflation (percent change)						
1966	2.9	5.1	3.9	3.7	2.0	2.7
1996	2.9	0.1	2.4	1.6	3.8	2.0

<sup>a</sup>For Japan, 1970 data (1966 not available).<sup>b</sup>Rating is out of a maximum of 10, *Economic Freedom of the World 1997* published by The Fraser Institute et al.<sup>c</sup>One earner couple, two children, 200 percent of average production worker's salary.Sources: J. Gwartney and R. Lawson, *Economic Freedom of the World, Annual Report 1997*, The Fraser Institute, Vancouver; *United Nations Human Development Report 1997*; *Historical Statistics 1960-1994*, OECD Economic Outlook, June and December 1997, and December 1985; *OECD Economic Surveys*, 1997.

Table 10: Social Performance Indicators—Selected OECD Countries

	US	Japan	UK	Canada	Italy	France
UN Human Development Rank, 1994	4	7	15	1	21	2
Life Expectancy at birth, 1960	70	68	71	71	71	70
Life Expectancy at birth, 1994	76.2	79.8	76.7	79	77.8	78.7
Infant Mortality/1,000 live births, 1994	8.5 <sup>a</sup>	4.2	6.2	6.8 <sup>b</sup>	7.3 <sup>b</sup>	6.1
Prisoners/100,000 persons, 1993	n/a	n/a	92	45	89	86
Suicides/100,000 persons, 1989-93	25	33	n/a	29	16 <sup>a</sup>	43
Doctors/1,000 persons, 1994	2.5 <sup>b</sup>	1.8	1.5 <sup>b</sup>	2.2	1.7	2.9
Divorces/1,000 persons, 1987-91	48	22	42	43	8	39
Adult Literacy Rate (Percent), 1994	99	99	99	99	98	99
<sup>a</sup> 1992 data. <sup>b</sup> 1993 data. Sources: <i>United Nations Human Development Report</i> , 1997 and 1990 editions; <i>OECD Historical Statistics 1960-1994</i> , 1996 edition; <i>OECD Economic Outlook</i> , June 1997 and December 1985; <i>OECD Economic Surveys</i> , 1997.						

ment. In general, the social indicators presented here suggest that factors other than size of government are instrumental in shaping social conditions. Family, tradition, religion and cultural values appear to be more important than size of government in influencing social conditions.

Of the social performance indicators presented in table 10, even the number of doctors appears to be unrelated to government size, with big government countries having about the same number of doctors relative to population as small government countries. Countries with small governments generally achieved good rankings in the United Nations measure of human development. However, of the six countries examined, the two biggest government countries received the poorest (Italy) and the second best (France) human development ranking. Overall, the size of government appears to be unrelated to UN human development measures.

Further reflecting the lack of a systematic relationship between government size and social per-

formance, the two small government countries have both the highest (Japan) and lowest (U.S.) life expectancy at birth, and the highest (U.S.) and lowest (Japan) infant mortality. The two largest government countries recorded the highest (France) and lowest (Italy) number of suicides per 100,000 population. As well, the two mid-sized government countries had both the highest (U.K.) and lowest (Canada) number of prisoners per 100,000 population in 1993. Overall, social indicator measures do not appear to be much influenced by size of government.

### A budget constraint for government—30 percent of GDP

A number of studies (see below, and the bibliography) have examined the relationship between size of government and various economic and social performance indicators for a wide variety of countries. Generally, these studies indicate progressively more adverse consequences when the government sector is expanded beyond an effi-



cient size, variously estimated in the range of 20 to 30 percent of GDP. We note in particular that none of the published research on size of government points to any net benefit associated with large-scale expansion of the public sector. In fact, the evidence suggests that the expansion of government beyond 20 to 30 percent of GDP range produces increasing under performance.

Scully (1991) examined 103 countries with respect to the impact of taxation on economic growth. His models estimated that economic growth was maximised when total tax revenue was limited to 19.3 percent of GDP. As taxes rise beyond this level, the trend rate of economic growth declines and approaches a zero rate when taxes reach 45 percent of GDP. Peden (1991) examined the influence of government size on productivity growth in the United States from 1888 to 1986. His analysis indicates that productivity growth increases with expansion of the government sector until the size of government reaches about 17 percent of GDP. He attributes the slowdown in US productivity growth in the 1970s and 1980s to a dramatic increase in the size of the government sector that rose from 17 percent of GDP at the end of World War II to 35 percent in 1986. He concludes that to raise the rate of productivity growth back to its historic trend the size of government would have to be reduced.

Grossman (1988) examined the impact of the absolute and relative size of government on economic growth in the United States over the 1929–1992 period. He found that, measured against absolute size, the benefits of increasing government size are offset by associated costs. With respect to increasing the size of government relative to the size of the economy, he found a significant net negative impact on economic growth.

International Monetary Fund and World Trade Organisation economists Tanzi and Schuknecht (1995, 1997), have collaborated on studies examining the growth of government in industrialised

countries and concluded that there is considerable scope for reducing the size of the state, and associated overheads, without compromising economic and social well-being. This conclusion is based on two key observations:

- Most important social and economic gains can be, and indeed have been in the past, achieved with drastically lower levels of public spending than prevail today among most industrial countries.
- Government spending in excess of 30% of GDP produces little or no improvement in economic performance or social conditions compared to the record of small government countries which contain the size of the government sector to the area of 30 percent of GDP or less.

Tanzi and Schuknecht recognise the important, government-supported improvement in social indicators that was recorded between the late 19<sup>th</sup> century and mid-20<sup>th</sup> century. Impressive gains were associated with expansion of the government sector from about 10 to 30 percent of GDP. They argue, however, that continued expansion of government in big government countries post-1960 involved considerable cost and produced little or no measurable improvement in economic performance or social indicators. The Tanzi-Schuknecht results are consistent with Canadian experience.

The record in Canada certainly indicates that an approximate 50 percent increase in the size of the public sector over the last 30 years has simply not produced the results anticipated. Worse still, excessive government overheads have almost certainly retarded improvements in living standards as a direct consequence of costs associated with such a massive expansion of the public sector. Research at The Fraser Institute (see Emes and Samida, forthcoming) indicates that the sharp drop in the trend rate of economic growth re-

corded over the last 30 years in Canada is related to excessive expansion of the government sector. Below-potential output growth over the last generation has cumulated to produce current output levels well below what could have been achieved with a smaller more efficient government sector.

Econometric models developed by Scully and adapted for Canada by The Fraser Institute esti-

mate the growth-maximising size of government in Canada at about 30 percent of GDP (see Emes and Samida, forthcoming). These models also indicate that Canadian output levels in 1995 would have been more than 50 percent above the levels actually recorded, if the size of government had been contained at the 30 percent of GDP level since the mid-1960s.

## Policy Proposal

### A 30 percent proposal for Canada

Overall, the evidence in Canada, and from abroad, is persuasive to the effect that the size of the government sector relative to the economy supporting it is of serious consequence to the trend rate of economic growth and living standards. None of the research available indicates that the influence of big government is either neutral or positive. Rather, those who have examined the question have all produced results consistent with the proposition that expansion of the government sector beyond the range of 20 to 30 percent of GDP has serious, adverse consequences for economic growth and living standards.

Reducing government overheads in Canada to about 30 percent of GDP offers the prospect of improved economic performance. Specifically, the introduction of smaller more efficient government would increase the trend rate of economic growth, lower the rate of unemployment and accommodate lower and more competitive tax rates. These important benefits of a smaller more efficient government sector would be achieved with the country continuing to produce comparable performance on other principal economic and social measures. Measured against the performance record of big government in Canada over the

last generation, there is little or no risk in returning to a smaller more efficient government sector.

Accordingly, we propose that public policy in Canada be directed toward re-establishing a smaller more efficient government sector. The size of the government sector, currently estimated at about 45 percent of GDP, would be reduced to about 30 percent of GDP. We estimate that this downsizing process would take something in the order of 15 years. Over such an extended transition period, the benefits of reducing the size of government would be subject to empirical verification. Compared to the massive and uncritical expansion of the public sector over the last generation, ours is a modest proposal. We advocate an incremental, closely monitored transition to smaller and more efficient government.

In the same way that free trade and privatisation have been tested and accepted on their merits around the globe, redirecting resources out of the government sector and back into the private sector as we propose would be subject to a similar evaluation on its merits, namely results achieved. Results, or conversely the lack of them, really do make a difference. For example, the current federal government fought two national elections in opposition to free trade. Today that same government is an international champion of free trade,

presumably on the basis of actual trade performance achieved under free trade.

Our proposal aims to reduce the size of the government sector to 30 percent of GDP via a co-ordinated program of spending control, tax relief and debt elimination. As we have described above, a limitation on the size of government recommends a zero level of net public debt. A zero net debt target is not restrictive; it still leaves governments considerable financial latitude. Governments in Canada normally hold something in the order of \$300 billion of financial assets, which means that an equivalent amount of debt liabilities can be assumed leaving net debt at zero. With net debt at zero, government interests payments net of receipts move to about zero. Establishing a zero net debt structure allows taxes to be reduced by the amount formerly paid in interest. The relief here would be substantial; interest payments on government debt currently consume about 20 percent of total revenues. For these reasons, debt elimination is central to our proposal.

We are also persuaded that parallel tax relief will be essential to a successful program of restructuring and transition to a smaller government sector. Viewed narrowly, tax cuts slow debt elimination and retard the transition process. However, without tax cuts to offset ongoing spending cuts, economic growth will be slowed or reversed and the move to smaller government truncated or abandoned. Tax cuts are also necessary to contain the size of surplus being generated. In our projection the average size of surplus is 4.5 percent of GDP and the maximum in any year is 6.9 percent.

The transition process will be lengthy and will require continued economic growth. We note that the Canadian tax burden today is at a record level, 46.3 percent of GDP (1997), and imposes some of the highest personal tax rates applied in any of the advanced industrial countries. Two points stand out. First, reducing today's excessive taxation levels is necessary to provide economic

stimulation and continued strong economic growth through a lengthy period of transition. Second, popular and political support for government downsizing will benefit from clear evidence of the connection between smaller government and lower taxes.

The multi-year projections presented below are not advanced as precise measurements. However, our assumptions and methodology are realistic and broadly indicative of the opportunity and challenge presented by a decision to re-establish a smaller and more efficient government sector in Canada. Our objective is to sketch the key elements of a viable transition program and to provide an indication of the time required to re-establish a government sector limited to 30 percent of GDP.

Our view in this matter is generally optimistic, and we would caution against exaggerating the difficulty of coping successfully with excessive public debt and oversized government. Other countries, the United Kingdom, New Zealand and Ireland, have successfully undertaken major government downsizing. The greater risk is doing nothing and hoping that the problems of debt and oversized government will somehow cure themselves. We also believe that, in economic and financial matters, markets and individual initiative deliver results superior to non-market systems of political and bureaucratic determination. On this account, we anticipate that the ongoing process of resource transfer from the government sector to the private sector will improve underlying economic performance, and thereby develop an internal momentum reinforcing the adjustment process.

### Projection: preferred adjustment strategy

We have run a number of projections of alternative strategies to move to a smaller government structure. Our projections are based on the most

current, historically-revised data. These recently released data go back only to 1961 on a consistent, historically-revised basis. Accordingly, our historical review remains based on pre-revision data, which is the only consistent data set stretching from 1926 to 1996. There are differences between the revised and unrevised data series, but these differences have no material affect on the analysis and conclusions advanced here.

(The economic and financial assumptions used in the projection of our preferred adjustment strategy are outlined at the end of this section.)

Our preferred adjustment strategy is to cap total government spending at existing levels while revenue growth from a growing economy produces fiscal surpluses to be applied to debt elimination and tax relief. Some considerable progress has already been made on the spending side, but there has been no tax relief to date. As a percent of GDP, total government outlays have declined from a 1992 peak of 54.3 to 45.4 percent in 1997 while total revenues have remained unchanged at a record 46.3 percent of GDP.

Total government spending has increased only 2.6 percent over the last 5 years. Thanks to high taxes and economic growth, government revenues have risen 22.5 percent over the same period. A record post-war deficit of 8.0 percent of GDP in 1992 has been turned into a modest surplus in 1997, the first consolidated government sector surplus in more than 20 years. The challenge going forward will be to keep the private sector of the economy expanding vigorously to utilise resources being released by an ongoing downsizing of the government sector.

Under our preferred adjustment process, surpluses rise to 6 percent of GDP in about three years and are then maintained at the 6 to 7 percent level for the duration of the transition period. The speed of the transition process is critically influenced by the allocation of surpluses between tax

reduction and debt retirement. In general, the greater the tax relief, the longer is the transition process. However, without substantial tax relief, today's record tax burden will slow or reverse economic growth and retard or truncate the adjustment process.

With a view to providing economic stimulus and thereby expediting the adjustment process, we chose to allocate surpluses one-third to tax reduction and two-thirds to debt retirement. This allocation provides substantial cumulative tax relief and facilitates completion of the transition process in 15 years as outlined below. An even allocation of surpluses between tax relief and debt retirement would increase the transition period to about 25 years.

As displayed in table 11, the size of the government sector relative to the economy has been substantially reduced over the last five years, from a 1992 peak of 54.3 percent to 45.4 percent last year. This 8.9 percentage point reduction has been almost entirely accounted for by a decline in program spending. Interest charges declined only marginally as a percent of GDP. (In fact, ongoing deficits actually increased the debt to GDP ratio substantially, from 89 to 106 percent. The interest burden has been contained, but only thanks to lower interest rates. Had interest rates remained unchanged the interest burden would have risen over the period.) When the interest burden remains static, or nearly so, the entire burden of government sector downsizing must be born by program spending. It is on this account that minimising the impact of government downsizing on program spending requires a zero net debt target.

There has been no tax relief over the post-1992 period of government sector downsizing. Keeping revenue growth in place and containing spending was effective in bringing government revenues and spending into line and eliminating the deficit. Arguably, earlier and more determined spending restraint, in combination with tax relief,

could have eased and expedited the adjustment. In any event, with revenues and expenditures now brought into alignment and sizeable surpluses readily available, a more balanced program of spending cuts and tax reductions is required.

As indicated in table 11, achieving a 30 percent of GDP target for the size of government will require a further 15.4 percentage points of GDP reduction in government spending. However, because our proposal includes debt elimination to a zero net debt level, fully 8.8 percentage points of the required spending reduction is provided by the elimination of interest costs. This leaves only a further 6.7 percentage points of GDP reduction to be made up by reduced program spending. This additional 6.7 point reduction in required program spending compares to a reduction of 8.3 percentage points of GDP already achieved over the last 5 years. Those who are worried about the transition to a smaller, more efficient government should note that fiscal re-

straint already completed is larger than the restraint necessary to achieve our final objective.

The cumulative tax cut provided under our proposal lowers government revenue from 46.3 to 30.0 percent of GDP, which represents an average tax cut of 35 percent over the 1997 to 2012 adjustment period. The average tax cut over the first five years is 10 percent, 15 percent in the next five years and 10 percent in the last five years. We anticipate that tax cuts of this magnitude will increase domestic productivity and international competitiveness to the considerable benefit of the economy. Of particular importance, large cuts in payroll taxes could greatly assist in the job creation process.

Our economic growth projections were built up from projections of labour force growth, unemployment declines, productivity growth and inflation. Over the first five years, the labour force is projected to grow 1.4 percent per year and the unemployment rate to fall by 0.5 percent per year to produce an annual employment increase of 1.9

Table 11: A Smaller Government for Canada—Adjustment Projection (Percent of GDP)

	Total Revenue	Total Expenditure	Program Spending	Interest Costs	Debt-to-GDP Ratio (%)
History: From Peak Size of Government					
1992 Peak	46.3	54.3	45.0	9.3	89
1997 Base Year	46.3	45.4	36.7	8.8	106
Change 1992-1997	0.0	-8.9	-8.3	-0.5	+17
Projected Transition					
2002 Year 5	43.5	35.2	30.3	4.9	73
2007 Year 10	36.0	30.0	27.7	2.3	29
2012 Year 15	32.3	30.0	29.8	0.2	2
Adjustment Completed					
2013	30.0	30.0	30.0	0.0	0.0
Change 1997-2013	-16.3	-15.4	-6.7	-8.8	-106



percent per year. Productivity is projected to grow at 1.75 percent per year and inflation at 1.5 percent. In combination, these projections produce an annual 5.2 growth in GDP. Assuming a revenue elasticity of 1.01, total revenues grow at 6.3 percent per year.

The ability to reduce unemployment from 9.2 percent in 1997 to 5.0 percent in 2005 provides for an important, temporary addition to output and revenue growth of about 0.5 percent per year for the first half of the adjustment period. Productivity growth is projected to increase modestly from 2002 forward, from 1.75 to 2.25 percent per year reflecting a stronger underlying economy due to the transfer of resources from the government sector to the private sector. In the middle years of the adjustment period, the economic growth rate increases modestly principally on this account, from 5.2 to 5.6 percent. After 2006, the economic growth rate falls back to 5.2 percent, principally because the gains from lowering unemployment disappear when the unemployment rate stabi-

lises at 5.0 percent in 2006. A revenue elasticity of 1.01 is applied over the entire period.

Government spending is held level in nominal terms at current levels until ongoing economic growth reduces it to 30 percent of GDP, which we estimate will occur in 2004. Thereafter, government spending is increased at the same rate as the general economy in order to maintain a 30 percent government share of the economy. Surpluses in the 6 to 7 percent of GDP range are allocated one third to tax cuts and two thirds to debt reduction until 2004 when revenues have fallen to 36 percent of GDP. Thereafter, tax cuts are progressively reduced to keep total revenues from falling below 36 percent of GDP. In the last five years, tax cuts are quite small and nearly all of the 6 percent of GDP surplus is devoted to debt elimination. When net debt has been reduced to zero in 2013 a final tax cut reduces revenues to 30 percent of GDP. In practice, a smoother transition would be appropriate, but for the purposes of projection the big final drop is adequate.

## Historical Overview—The Government Sector in Canada

This section examines the evolution of Canada's fiscal structure over the last 70 years. Our examination and commentary focuses on four selected years: 1926, 1946, 1966 and 1996. Tables 12 and 13 below and charts in the Chart Compendium display various measures of expenditure and revenue.

### 1926—The Earliest Date With Comprehensive National Accounts Data

We start our historical review in 1926, the earliest period for which comprehensive National Accounts data are available for the economy and the consolidated government sector. In 1926, government sector expenditures and revenues both

stood at 15 percent of GDP, but they were on their way to respective peaks of 52 and 43 percent of GDP in 1992. Over the 1926 to 1996 period, the share of total government spending allocated to each of three of government's four principal spending categories was significantly reduced to accommodate an exceptional expansion of the fourth spending category, transfer payments. This massive increase in government transfer payment spending is a principal reflection and legacy of the country's post-1960 embrace of big government and the welfare state. (See Figure 5.)

Current expenditure on goods and services was the largest component of government spending in 1926, accounting for 48 percent of the total. This

component has declined, but remains the largest principal spending category, accounting for 40 percent of total spending in 1996. Interest payments on the public debt fell from 29 to 20 percent of total spending over the period. Investment spending has also declined, from 13 to 5 percent of total spending. Reflecting the introduction of big government and the welfare state, the share of transfer payments in government spending increased from 10 to 35 percent of total government spending over the 1926 to 1996 period. Indicative of a landmark shift in priorities, transfer payments were the only principal component of government spending to increase its share of total spending over the entire 1926 to 1996 period (see Figure 5.)

Expansion of the government sector between 1926 and 1996 was financed principally by taxes on income, particularly taxes on personal income, which have risen spectacularly. Taxes on personal income alone rose from one to 20 percent of GDP over the period. Taxes on corporate and investment income rose, but only from 2 to 8 percent of GDP. Indirect taxes (including the GST/BST) were very stable throughout the period in the range of 12 to 13 percent of GDP. As a direct consequence of government sector expansion, taxes on income are very high in absolute terms and relative to tax overheads being carried by our principal trading partners. The taxation of income now stands as a major economic and competitive impediment to saving and investment, and to the output and productivity growth that spring therefrom (see Figure 4.)

The growing influence of Keynesian economics, and the apparent success of government participation in and management of the economy during the war and in the early post-war period, led to an increasing economic and political acceptance of big government during the 1960s. Electors were generally agreeable to more government intervention and spending, but they had no taste for higher taxes. Runaway government

spending was increasingly being underwritten by deficit finance. By the mid 1970s, even the semblance of fiscal prudence had been abandoned, first in Ottawa and later among the provinces. The basic strategy was to defer on tax increases as a matter of political convenience, borrow now, and hope that somehow good luck and the passage of time would deliver stronger economic growth and more adequate revenues in the future.

It was a vain hope. By 1992, Canada's government debt exceeded 100 percent of GDP, a level of fiscal over-extension exceeded only by Italy among the principal industrial countries. There was an unmistakable air of impending fiscal crisis. Something had to be done. Finally, the fiscal authorities began, for the first time in a generation, to take determined and effective action, first in the provinces and later in Ottawa. Government revenues and expenditures were finally being hauled into line, as they should have been more than a decade earlier.

Canada's belated conversion to fiscal restraint meant a close call for the nation. It came just in advance of an impending, full-blown financial crisis and was no doubt inspired by this mounting financial and political threat. Canada dodged the bullet, but the country has accumulated one of the most excessive government debt structures among the industrial countries as well as vast unfunded liabilities in overextended, pay-as-you-go social programs. With fiscal balance largely re-established today, the great fiscal challenges in the future will revolve around dealing with accumulated debt, under funded social programs and an oversized government sector.

Loss of fiscal integrity, if only from the 1970s to the early 1990s, has cost the country dearly by way of slow economic growth, high unemployment and high taxes. Government net lending, or the level of government surplus/deficit, recorded a surplus of 1 percent of GDP in 1926. Setting

**Table 12: Government Expenditures and Revenues—Selected Years  
(Percent Share of GDP)**

	Share of GDP				Change			
Expenditures	1926	1946	1966	1996	1926-46	1946-66	1966-96	1926-96
Goods and services	7.3	13.6	15.0	18.6	+6.3	+1.4	+3.6	+11.3
Transfer payments	1.6	11.9	7.3	16.0	+10.3	-4.6	+8.7	+14.4
To persons	1.4	9.1	5.8	14.2	+7.7	-3.3	+8.4	+12.8
To business	0.0	1.9	1.1	1.5	+1.9	-0.8	+0.4	+1.5
To non-residents	0.1	0.9	0.3	0.3	+0.8	-0.6	0.0	+0.2
Interest on the public debt	4.3	4.6	2.9	9.4	+0.3	-1.7	+6.5	+5.1
Investment	2.0	0.8	4.4	2.1	-1.2	+3.6	-2.3	+0.1
<b>Total</b>	<b>15.1</b>	<b>30.8</b>	<b>29.6</b>	<b>46.1</b>	<b>+15.7</b>	<b>-1.2</b>	<b>+16.5</b>	<b>+31.0</b>
Revenues	1926	1946	1966	1996	1926-46	1946-66	1966-96	1926-96
Direct taxes	1.6	13.1	13.0	23.2	+11.5	-0.1	+10.2	+21.6
Persons	1.0	7.4	9.0	20.2	+6.4	+1.6	+11.2	+19.2
Corporations	0.6	5.4	3.7	2.7	+4.8	-1.7	-1.0	+2.1
Non-residents	0.0	0.2	0.3	0.3	+0.2	+0.1	0.0	+0.3
Indirect taxes	11.7	13.2	13.3	13.4	+1.5	+0.1	+0.1	+1.7
Transfers from persons	0.3	0.3	0.6	0.6	0.0	+0.3	0.0	+0.3
Investment income	1.4	2.2	1.9	5.7	+0.8	-0.3	+3.8	+4.3
<b>Total</b>	<b>15.1</b>	<b>28.7</b>	<b>28.8</b>	<b>42.9</b>	<b>+13.6</b>	<b>+0.1</b>	<b>+14.1</b>	<b>+27.8</b>
Source: Statistics Canada, <i>National Income and Expenditure Accounts</i> , cat. 13-001.								

aside the temporary impact of the depression and World War II, Canada established one of the soundest post-war fiscal regimes among the industrial countries, and maintained that distinction up to the 1970s. Beginning in the mid-1970s, all of this changed. Fifteen years of unrestrained government spending, heavily supported by deficit finance, moved Canada from being a model of fiscal rectitude to the unenviable dis-

inction of being one of the world's most heavily indebted and fiscally overextended countries (see Figure 2.)

Canada's abandonment of fiscal responsibility in the 1960s was quite out of character, but the associated financial consequences were in no way mitigated on this account. Fortunately, serious action was finally taken beginning in the early

1990s and since that time considerable progress has been made in re-establishing responsible fiscal practice. However, fiscal improvements to date have been narrowly focused toward re-establishment of revenue and expenditure balance. Beyond such cash flow improvements, however, very serious fiscal problems of a balance sheet character remain including debilitating levels of public debt, vast unfunded liabilities in social programs and a government sector that is much too large relative to the economy supporting it.

Today's public sector balance sheet problems are the predictable consequences of Canada's ill-advised and unsuccessful experiment with big government and deficit finance. These fundamental problems are not about to disappear any time soon; rather, they are going to be the next big public policy challenge facing the country. Indeed, the country's success, or otherwise, in dealing with the interrelated issues of debt, unfunded liabilities and over-sized government will importantly influence future prosperity.

In summary, the balance sheet constraint of too much debt and too much government places an ongoing drag on the economy, and that drag can be expected to continue until the debt and government size matters have been rectified. In 1926, interest on the public debt stood at 4 percent of GDP, reflecting the considerable burden of railroad debt and World War I debt. Setting aside the vagaries of the depression of the 1930s and World War II, prudent fiscal management in the years following the war saw debt interest fall to 2.5 percent of GDP by the late 1950s and stay below the 3 percent of GDP level until the 1970s. Beginning in the mid-1970s, a sustained run up in debt levels and interest rates more than doubled the burden of public debt interest by the 1990s where it remains today at about 9 percent of GDP. It is instructive to note that debt interest relative to GDP is twice as high today as it was at the World War II peak in 1946 (see Figure 11.)

## 1946 cum 1948—Facing the Future After the Strains of Depression and War

Growth in government expenditure over the 20 years between 1926 and the end-of-war peak in 1946 was the most rapid of all the periods studied. Total government expenditure relative to the economy doubled from 15 to 31 percent of GDP. However, an ensuing transition to a peacetime economy saw the government sector decline to 21 percent of GDP by 1948. Although considerably reduced from its wartime peak, the post-war government sector of the economy was larger than the 1926 benchmark by about one third. This newly enlarged government sector was destined to increase again by about one half to reach 30 percent of GDP by the mid-1960s.

The rise in public expenditure relative to the economy from 15 percent of GDP in 1926 to 21 percent in peacetime 1948 was driven primarily by a rapid expansion of government transfer payments, and to a lesser extent by higher goods and services spending. Transfer payments increased from 1.6 to 6.1 percent of GDP over the period. Goods and services spending rose from 7.3 to 9.1 percent of GDP. The principal source of new revenue over the 1926 to 1948 period was increased taxation on income. Combined personal and corporate tax revenues rose from 1.6 to 10.5 percent of GDP while all other revenues combined were about unchanged at 14 percent of GDP (see Tables 12 and 13, and Figures 9 through 16).

Canadian governments of this era were firmly committed to fiscal responsibility. Immediately following the war, government finances were moved into substantial surplus. The cumulative government sector surplus over the 1947 to 1953 period amounted to 20 percent of GDP. Thanks to these surpluses, debt was reduced and interest costs fell from a wartime peak of 4.6 percent of GDP in 1946 to 2.4 percent in 1953. Contrary to conventional Keynesian analysis, running surpluses was no impediment to the economy. The

economy recorded an annual compound growth rate of 5.2 percent in real terms over the seven-year period of post-war surplus finance and debt reduction.

The bitter legacy of the great depression, the success of wartime spending and finance, and the growing influence of Keynesian economics all combined to produce a major permanent increase in post-war government spending compared to pre-war levels. During World War II, real, or inflation adjusted, government spending rose by a staggering 260 percent and then declined in transition to peacetime circumstances, but the decline was only 53 percent. The post-war reduction in government spending was completed in 1948 and left real government spending 68 percent above the 1939 level, again measured in real, or inflation adjusted, terms.

Comparisons of pre- and post-war government spending relative to the economy are complicated by the influence of the depression, which savaged the private sector in the 1930s and thereby “exaggerated” the size of the government sector. The basic post-war policy choice was to keep about one half of the wartime increase in government revenues in place to finance higher levels of traditional government spending on goods, services and capital investment as wartime spending fell. Government transfer payment spending relative to the economy changed little in total between the war and 1966. However, important changes in the composition of transfer spending were under way as discussed in sections below.

Total government expenditure, which stood at about 21 percent of GDP in the late 1930s, mushroomed to a wartime peak of 50 percent in 1944. By 1948, government outlays were back to 21 percent of GDP, but this share was out of a much larger economy. Measured in real terms, the economy of the late 1940s was about 75 percent larger than the depression economy of the late 1930s. Revenue comparisons are similarly af-

ected. Total government revenues, as a percent of GDP, stood at 18 percent in 1939, rose to a peak level of 29 percent in 1945 and fell to a post-war low of 23 percent by the late 1940s.

### 1966—The Last Year with Government at or Below 30 Percent of GDP

The size of the public sector in 1966 was 30 percent of GDP compared to a wartime high of 50 percent in 1944 and a post-war peacetime level of about 22 percent established in the late 1940s. Measured against the new post-war government spending levels, the size of the government sector increased markedly between the late 1940s and mid-1960s, from 22 to 30 percent of GDP. The bulk of this increase was accounted for by increases in conventional goods and services expenditure, which rose from 9 to 15 percent of GDP. Total transfer payments increased only marginally in this early post-war period, from 6 to 7 percent of GDP, but as we note below the composition of these payments changed setting the stage for a massive expansion in future years. Other spending changes between the war and the mid-1960s were not consequential.

The early post-war period up to the mid-1960s was characterised by sound and responsible fiscal policy. Immediately following the war, the government sector ran sizeable fiscal surpluses. Thanks to generally sound fiscal management, government debt interest charges were reduced from a 1946 peak of 4.6 percent of GDP to less than 3 percent by 1950 and were kept below this level until 1966. We would argue that post-war debt reduction should have had an even higher priority, but sub-three percent debt charges still compare very favourably with public debt overheads in recent years in the order of 9 percent of GDP.

The 1960s marked major turning point in the composition of expanding of government spending. Transfer payments rather than conventional



goods, services and investment spending began moving to the forefront. Total transfer spending, which had been little changed since the war, began to increase sharply relative to conventional government spending. As a percent of GDP, government transfer spending rose from 7 to 16 percent of GDP between 1966 and 1996 compared to only a minor rise from 19 to 21 percent in conventional government spending on goods, services and capital investment.

The new and expanded transfer programs introduced after the war did not increase total transfer spending as they were offset by declining war-related transfers, which fell from 2.0 percent of GDP in 1947 to 0.6 percent by 1951. These savings were redirected in large measure to new and expanded federal transfer programs. By far the most important new program was Old Age Security (OAS), which was introduced in 1952 and by 1966 amounted to 1.5 percent of GDP, on its way to 2.7 percent in 1996. By 1957, OAS payments had become the largest federal transfer program to persons and today these transfers share the largest program distinction with CPP/QPP.

Other important transfer programs introduced in the twenty years before 1966 included prairie farm assistance 1947, Canada Council grants 1957, assistance to immigrants 1957, grants to universities 1957, payments to western grain producers 1958, scholarship research grants 1963 and grants to native peoples 1965. New programs continued to be introduced after 1966 – occupational training payments 1967, grants in support of international development assistance 1970, grants to national organisations 1971, local initiatives 1972.

Beyond these newly introduced principal federal transfer programs, spending on smaller miscellaneous transfer programs was negligible at less than one tenth of one percent of GDP from the end of the war on into the 1970s. But, beginning in the late 1970s, miscellaneous transfer programs

increased sharply on top of principal program increases reaching 1.3 percent of GDP by 1996. This latter increase in small transfer programs was indicative of Ottawa's growing commitment to economic and social management via income redistribution through transfer spending (see Figures 20 and 21 and Table 13.)

The level and structure of tax revenues were very little changed between 1946 and 1966. Net lending, or fiscal balance, was slightly positive in 1966 indicating a modest fiscal surplus. Overall, Canada's fiscal condition was very sound up to the mid-1960s. However, an impending 50 percent increase in the government sector, and massive recourse to deficit finance was destined to do immense damage to the fiscal structure and economy over the next 25 years. The mid-1960s were the lull before the storm from which we are currently trying to disentangle ourselves from (see Table 12 and Figure 2.)

### 1996—Addressing Oversized Government

Beginning in the mid-1960s, a serious commitment to big government saw government expenditures increase from 30 percent of GDP to a peak of 52 percent in 1992. Subsequently, fiscal disarray and a threat of financial crisis saw a return to more responsible fiscal management and an associated reduction in the size of the government sector to 46 percent of GDP by 1996. Nearly all of the 16 percentage point increase in government share of the economy between 1966 and 1996 was accounted for by an 8 point jump in transfers to persons and a 7 point jump in debt interest. Current expenditure on goods and services increased from 15 to 19 percent of GDP, but was offset by a fall from 4 to 2 percent of GDP in investment spending. Other spending shifts were minor.

The great expansion in government spending post 1966 was remarkably narrowly based. It was almost entirely composed of transfer-funded so-

Table 13: Transfers to Persons—1966 and 1995 (Percent Share of GDP and Total)

	Share of GDP		Change	Share of Total		Change
	1966	1995	1966-95	1966	1995	1966-95
Federal Transfers						
Family and youth allowances	0.94	0.00	-0.94	24.4	0.1	-24.3
Military pensions and allowances	0.44	0.17	-0.27	11.4	1.8	9.6
Unemployment insurance benefits	0.46	1.66	+1.20	11.9	17.2	+5.3
Pensions government employees	0.19	0.56	+0.37	5.0	5.9	+0.9
Old age security	1.54	2.66	+1.12	40.0	27.6	-12.6
Canada Council grants	0.01	0.01	0.0	0.3	0.1	-0.2
Scholarships and research grants	0.08	0.09	+0.1	2.1	0.9	-1.2
Grants to universities	0.09	0.02	-0.7	2.3	0.2	-2.1
Grants to native peoples	0.04	0.46	+0.42	0.9	4.8	+3.9
Miscellaneous	0.05	1.34	+1.29	1.2	13.8	+12.6
CPP/QPP	0.0	2.66	+2.66	0.0	27.9	+27.9
<b>Total Federal</b>	<b>3.86</b>	<b>9.64</b>	<b>+5.78</b>	<b>100.0</b>	<b>100.0</b>	<b>0.0</b>
Provincial						
Direct relief	0.22	1.35	+1.13	12.2	30.5	+18.3
Old age and blind pensions	0.16	0.05	-0.11	8.6	1.1	-7.5
Mothers' and disabled allowances	0.18	0.06	-0.12	9.6	1.3	-8.3
Workers' compensation	0.24	0.50	+0.26	13.3	11.2	-2.1
Government employee pensions	0.07	0.18	+0.11	3.7	4.0	+0.3
Grants, post-secondary education	0.50	0.80	+0.30	27.5	18.1	-9.4
Miscellaneous	0.45	0.50	+1.05	25.0	33.7	+8.77
<b>Total Provincial</b>	<b>1.82</b>	<b>4.43</b>	<b>+2.61</b>	<b>100.0</b>	<b>100.0</b>	<b>0.0</b>
Local						
Direct relief	0.14	0.49	+0.35	87.3	98.1	+10.8
Grants, charitable organisations	0.02	0.01	-0.1	12.7	1.9	-10.8
<b>Total Local</b>	<b>0.16</b>	<b>0.50</b>	<b>+0.34</b>	<b>100.0</b>	<b>100.0</b>	<b>0.0</b>
<b>Total All Governments</b>	<b>5.84</b>	<b>14.56</b>	<b>+8.72</b>	<b>100.0</b>	<b>100.0</b>	<b>0.0</b>

Source: Statistics Canada, *National Income and Expenditure Accounts*, cat. 13-001.

cial programs as opposed to conventional government spending. At the federal level, virtually all of the spending increases occurred in three programs: old age security, CPP/QPP, employment insurance. At the provincial level, spending growth was concentrated on welfare, post secondary education and workers compensation. (See Table 13.) In this context, the large increase recorded in debt interest was really not new, stand-alone spending; rather, increased interest costs merely reflected a political decision to finance much of the new social spending with borrowing rather than taxes. So, in this sense, virtually the entire rise in government spending was actually driven by new social spending on a relatively small number of transfer programs.

Government revenues rose from 29 to 43 percent of GDP between 1966 and 1996. This 14 percentage points of GDP rise in revenues was almost entirely accounted for by a massive rise in personal income tax, from 9 to 20 percent of GDP! There are consequences to this type of spend-and-tax policy. Canada must now compete with its principal trading partners, the United States and Japan, while carrying the competitive disadvantage of much higher taxes. Canada's high tax levels are particularly debilitating, precisely because our principal trading partners are the two lowest-tax countries among the G7 countries. Measured over the entire 1926 to 1996 period, nearly all of the expansion of the government sector has been financed by increased taxation of income (see Table 12.)

To offset Canada's tax-induced decline in competitiveness, the markets have been producing an offsetting secular decline in the exchange value of our currency. This is a risky business. Competitors will tire of supporting Canadian tax-and-spend policies by accepting ongoing, and thinly-disguised, competitive devaluation of the Canadian currency. Free trade and open access to the US market are not carved in stone. To be competi-

tive over the longer term, Canada must maintain tax and regulatory overheads at levels competitive with those of its major competitors.

As we describe in "A Thirty-Percent Proposal for Canada" above, the challenge of re-establishing a smaller and more efficient government sector is a serious, but somewhat lesser, hurdle than it might appear at first glance. We estimate that the size of the government sector has already fallen to about 45 percent of GDP. Viewing the necessary adjustment arithmetically, the required 15-percentage points of GDP reduction in total government spending from 45 to 30 percent of GDP exaggerates the size of the adjustment actually required in conventional government spending. By retiring the outstanding debt, ongoing interest charges can be eliminated reducing public spending without reducing program spending.

Our proposal focuses on a co-ordinated program of spending restraint, debt reduction, and tax relief calculated to move net debt and associated interest costs to zero within about 15 years. Of the 15 percent of GDP reduction required in total government spending, about 9 percent can be realised by debt retirement and the elimination of associated debt service costs. Accordingly, with an orderly reduction of outstanding debt over 15 years, program spending would have to be reduced by only about a further 6 percentage points of GDP from today's levels.

This discussion throws the consequences of maintaining high levels of government debt into sharp relief. With government size constrained, available program spending is reduced by the amount of debt service charges. Under our proposal, to reach a 30 percent of GDP target with debt and interest costs remaining at current levels, program spending would have to be cut by 15 rather than only 6 percentage points of GDP. It is against this reality that our proposal focuses on the importance of reducing net debt to zero.

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