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The Economic Case for Limited Government

The burden of government spending in the United States has grown considerably since 2000, but this is just the calm before the storm. Thanks to unchecked entitlement programs, America is at risk of becoming an uncompetitive European-style welfare state. Total government spending already consumes about one-third of national economic output, with the federal government spending \$2 for every \$1 spent by state and local governments. If left unchecked, however, the federal government's budget will metastasize, growing from about 21 percent of GDP today to nearly 40 percent of national economic output after the baby-boom generation retires.

Instead of allowing government to grow, policy makers should focus on how best to shrink the public sector. Academic research clearly shows that government spending – once it reaches above the level needed to finance core responsibilities such as the rule of law – hinders economic growth by misallocating labor and capital. Indeed, there is even a well-established relationship, illustrated by the Rahn Curve, showing how larger levels of government spending are associated with slower growth and economic stagnation. Researchers do not agree on the precise number, but there is general agreement that the growth maximizing level of government is between 15 percent of GDP and 25 percent of GDP, far below current levels.

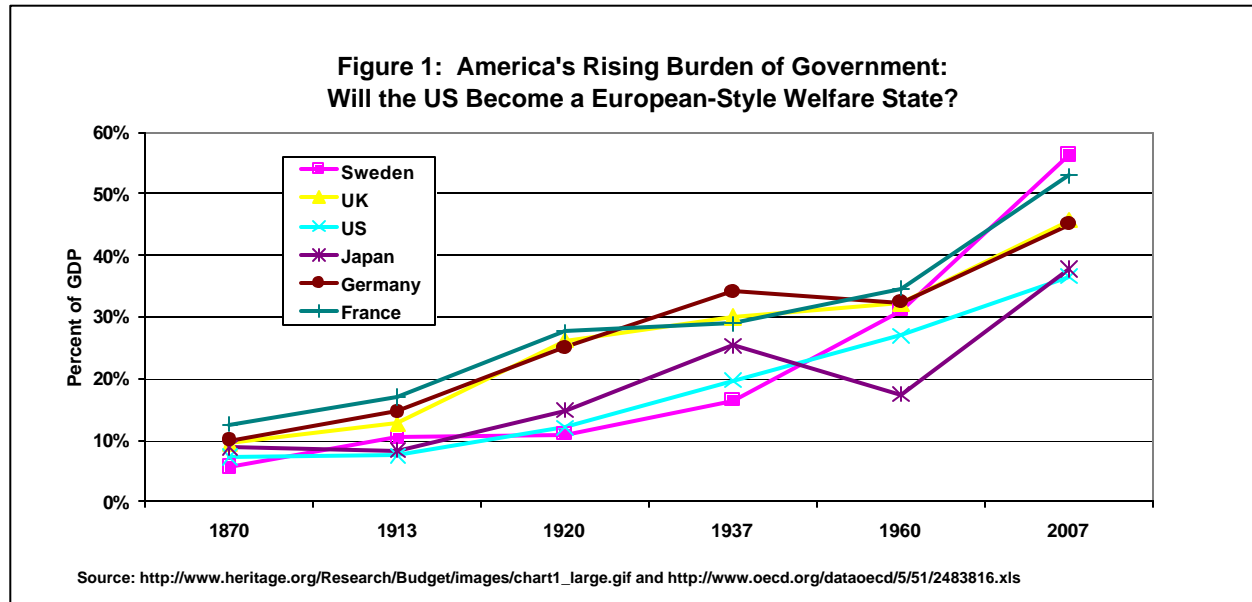
Most federal spending is unjustified. To cite just a few examples, the Departments of Energy, Education, Commerce, Housing and Urban Development, and Agriculture engage in activities that are not legitimate functions of the federal government. They should be shut down. A substantial share of federal spending is consumed by entitlement programs such as Social Security and Medicare. These programs should be shifted to the private sector. The transition may be lengthy, but the ultimate objective is more freedom and greater prosperity. This requires smaller government.

By Sven R Larson, Ph.D.

For much of its history, America had a tradition of limited government. And even though government has expanded dramatically in the past 70-plus years, America still has a relatively small public sector by international standards.¹ As a result of having a lower burden of government, taxes are less onerous and the standard of living is higher here than in most other nations - especially countries in highly-taxed Europe. But even America's government has become too large. Moreover, the United States is in jeopardy of becoming an uncompetitive,

¹ See Gwartney et al: The Size and Functions of Government and Economic Growth, Exhibit 1, Testimony before the Joint Economic Committee, U.S. Congress, April 1998. Available at: <http://www.house.gov./jec/growth/function/function.pdf>.

high-tax welfare state. As Figure 1 indicates, total government spending in the U.S. (including state and local government) is now above one third of GDP, more than three times its size (as a share of national output) as recently as 100 years ago. Moreover, government spending is projected to climb to European levels unless entitlement programs are reformed.²



Indeed, entitlement programs are substantially responsible for the expansion of the public sector that already has occurred. An entitlement program, in plain English, creates an unlimited obligation to dole out money to anyone who meets eligibility requirements. For the two biggest programs, Social Security and Medicare, age is the biggest criterion. For Medicaid, the third-biggest program, eligibility generally is based on income and assets.

As Table 1 shows, these so-called mandatory spending programs have come to dominate the federal budget. Rising entitlements mean a growing burden of government. The White House's Office of Management and Budget estimates that the federal budget will consume ever-larger shares of GDP until, by 2070, the federal budget devours about 40 percent of GDP.³ Theoretically, because of rising health care costs, the trend could continue until the private sector is entirely consumed by the government.

² Although the same trends are apparent, the OECD's methodology is slightly different than the federal government's methodology for measuring the aggregate burden of government. For figures from the Office of Management and Budget on total government spending as a share of GDP, see <http://www.whitehouse.gov/omb/budget/fy2008/sheets/hist15z3.xls>.

³ http://www.whitehouse.gov/omb/budgetcharts/2007_budget/current_trends.pdf.

Bigger government almost certainly imposes a high cost on economic performance. A major review of the academic literature published by the Heritage Foundation⁴ shows that limited government is more conducive to economic growth.

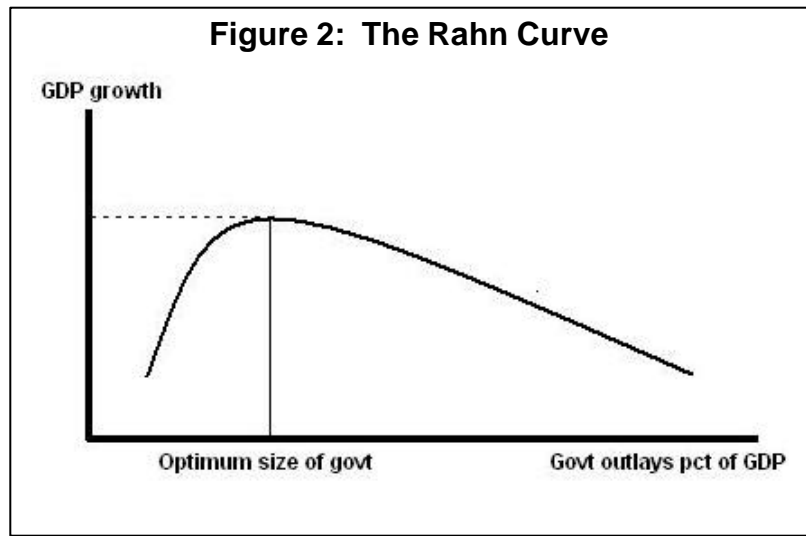
A particularly important point in the Heritage paper, written by Daniel Mitchell, is the “Rahn Curve,” which measures the relationship between different levels of government spending and economic performance. This curve was popularized by Richard Rahn, the former chief economist of the U.S. Chamber of Commerce,⁵ and defines a largely negative relationship between economic growth and the burden of government spending. As shown in Figure 2, the Rahn Curve’s message is that growth is maximized when government spending is modest – and presumably allocated for core public goods like protection of life, liberty and property – but that growth deteriorates when government expands beyond this limited level.

Table 1: Composition of Federal Outlays, Discretionary vs. Mandatory Spending

	Discretionary	Mandatory
1965	66.2%	33.8%
1970	62.4%	37.6%
1975	48.3%	51.7%
1980	48.7%	51.3%
1985	48.1%	51.9%
1990	44.4%	55.6%
1995	40.0%	60.0%
2000	37.4%	62.6%
2005	40.1%	59.9%

Source: Congressional Budget Office: Historical Budget Data, Table 5

The growth-maximizing point on the Rahn Curve is the subject of considerable research. Academic experts generally conclude that this point is somewhere between 15 percent of GDP



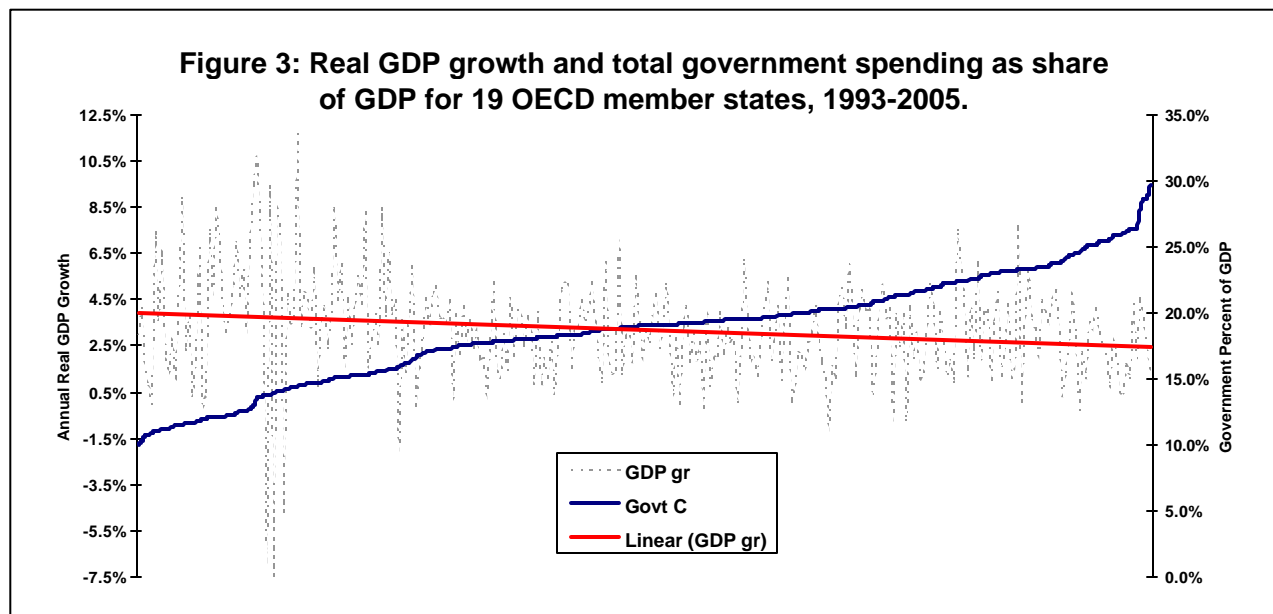
and 25 percent of GDP, though it is likely that these estimates are too high since the statistical studies are constrained by a lack of data for countries with limited governments. In the past, as shown in Figure 1, most nations in Europe and North America had modest levels of government, oftentimes only consuming only about 10 percent of GDP. Today, by contrast, even jurisdictions such as Hong Kong have governments that consume

4 Mitchell, Daniel J: The Impact of Government Spending on Economic Growth, Backgrounder #1831, March 15, 2005, The Heritage Foundation. Available at: <http://www.heritage.org/Research/Budget/bg1831.cfm>.

5 <http://www.ewtn.com/library/BUSINESS/ANTOUTWK.HTM>.

nearly 20 percent of GDP, and this influences the results of cross-country research. For all intents and purposes, today's research measures the downward-sloping portion of the Rahn Curve.

Not surprisingly, America is on the "wrong" side of the curve.⁶ Bluntly stated, government is too big and is hampering economic growth by consuming resources that could be more productively allocated by the private sector.⁷ Figure 3 sheds more light on the Rahn curve: using 1993-2002 data for OECD countries. The findings show that, as the government share of GDP rises, the growth of the economy slows. Interestingly, Figure 3 shows that government is too big in all countries and that higher spending leads to less growth in all cases. In other words, every nation is on the downward-sloping portion of the Rahn Curve.



To be sure, economic performance is not solely a function of fiscal policy. Trade policy, labor policy, regulatory policy, and monetary policy are just a few of the other important economic issues. But putting a limit on government spending surely is a necessary condition of a free and prosperous society. This is why spending limits rather than deficits limits are the key to sound fiscal policy. It is much more destructive for the economy to have a balanced budget when government spending is above 50 percent of GDP than it is to have a deficit when government spending is at or below, say, 30 percent of GDP.

⁶ Brimelow, Peter: Why the Deficit is the Wrong Number, Forbes Magazine, March 15, 1993.

⁷ http://hsgac.senate.gov/_files/102505Mitchell.pdf.

Prioritizing government spending and shrinking the size of the state

What would a limited government actually look like? One way to approach this hypothetical exercise is to compare today's government with the one America had 100 years ago.⁸ Total federal outlays for FY 2007 are projected to be \$2.784 trillion, with the Department of Health and Human Services topping the spending list with \$672.9 billion, followed by the Social Security Administration at \$625 billion and the Department of Defense at \$548.9 billion (see Table 2).

Table 2: Federal Government Budget Proposal, Fiscal Year 2007

<u>Departments and Agencies</u>	<u>Total Outlays \$million</u>
Agriculture	88,771
Commerce	6,191
Defense	548,915
Education	68,060
Energy	23,092
Health and human services	672,932
Homeland security	50,430
Housing and urban development	42,836
Interior	11,157
Justice	23,117
Labor	47,448
State	32,514
Transportation	63,775
Treasury	61,763
Veterans' affairs	72,327
Corps of engineers	7,578
EPA	8,038
NASA	16,143
National science foundation	5,860
SSA	625,021

Sources: White House, Office of Management and Budget.
<http://www.whitehouse.gov/omb/budget/fy2008/budget.html>

With GDP expected to reach \$13.5 trillion in 2007, the current federal budget almost surely is above the growth-maximizing point on the Rahn Curve. And when state and local government expenditures are added, total government spending in America greatly exceeds the growth-maximizing point of the Rahn curve.

When added together, federal, state and local government outlays exceed one third of GDP. Reducing the burden of government spending so that America is at the growth-maximizing point on the Rahn Curve would require cutting away about two trillion dollars worth of spending. This should, of course, be done at all levels of government, but the federal budget is a good place to start since the Constitution – as originally written – presumably does not give the federal government authority for many of its current activities.

Limited government has two purposes: individual freedom and economic prosperity. Individual economic freedom is instrumental to economic prosperity because it facilitates incentives for productive behavior. The federal budget therefore should be constrained only to those activities that protect life, liberty, and property.

Not many of the Departments and programs from Table 2 fulfill government's legitimate role of protecting life, liberty, and property. And even the Departments that are necessary almost surely are too big and operated inefficiently. But even if one assumes that government operates

⁸ <http://www.whitehouse.gov/omb/budget/fy2007/budget.html>. The discussion of the '07 budget is in no way an endorsement of it, either in its entirety or parts thereof. Nor is it an endorsement of any competing budget proposals in U.S. Congress. The discussion is meant exclusively as an experiment in limited government.

efficiently, only the departments and agencies listed in Table 2B are - at least theoretically - necessary for the protection of the life, liberty, and property of Americans.

Additionally, some limited functions of the Treasury and State departments belong under the realm a limited government. Deleting a whole range of foreign aid programs from the State department's budget reduces its budget to \$10.5bn, 36.6% of its actual budget for 2007. A similar operation with the Treasury department (including, for all intents and purposes, closing the Internal Revenue Service) reduces its budget by 98.6% to \$861 million.

Adding the downsized State and Treasury departments to Defense, Justice and Veterans' Affairs produces a limited federal government budget of \$706.1 billion (Table 2B). Almost three quarters of every dollar in the '07 budget has been excised, leaving a federal government that consumes barely 5 percent of GDP. This level is below the Rahn curve's growth-maximizing range (at least based on data-constrained academic research), but state and local governments

currently consume 11.5 percent of GDP⁹ and state and local policy makers might be expected to pick up some of the activities formerly handled by the federal government.

Table 2B: Hypothetical Federal Government Budget, FY 2007

Departments & Agencies	Total Outlays \$million
Defense	\$548,915
Justice	\$23,117
Veterans' affairs	\$72,327
Homeland security	\$50,430
State	\$10,491
Treasury	\$861
Total	\$706,141

Source: Table 2 & author's calculations

At the very least, total government outlays will consume a bit more than 16 percent of GDP - a good approximation of the growth-maximizing level of spending according to econometric estimates of the optimal size of government.¹⁰

This hypothetical exercise obviously sidesteps the challenge of how to get from here to there. Some programs could - and should - be immediately abolished. Others, such as

entitlements, would be phased-out as part of reforms such as personal retirement accounts. The purpose of this paper is to explain why the destination is desirable, not to provide a road map.

⁹ Budget of the United States Government, FY 2008, Historical Tables, February 2007. Available at <http://www.whitehouse.gov/omb/budget/fy2008/sheets/hist15z3.xls>.

¹⁰ The most compelling evidence is provided by: Peden, E.A., Productivity in the United States and Its Relationship to Government Activity: An Analysis of 57 Years, 1929-1986, Public Choice, Vol. 69 (1991), pp. 153-173. Some evidence in this direction is also found in: Folster, S. and Henrekson, M., Growth Effects of Government Expenditure and Taxation in Rich Countries, European Economic Review, Vol. 45, No. 8 (August 2001), pp. 1501-1520; and: Hansson, P. and Henrekson, M., A New Framework for Testing the Effect of Government Spending on Growth and Productivity, Public Choice, Vol. 81 (1994), pp. 381-401. Another study that indicates a top of the Rahn curve significantly below 20 percent of GNP is: Carlstrom, C T, and Gokhale, J, Government Consumption, Taxation and Economic Activity, Federal Reserve Bank of Cleveland Economic Review, 3rd Quarter, 1991.

Limited Government: An American Tradition

While a very small government would be a very unpopular notion in most parts of Washington, DC, it actually is very much part of America's history. Since the Great Depression the federal government has gradually expanded its spending beyond the constraints imposed by the Constitution. As Figure 1 illustrated, the burden of government spending used to be very modest.

Equally important, the federal government was just a minor part of overall government. For much of America's history, state and local governments overshadowed the federal government. Indeed, as recently as 1930, federal spending was just 3.4 percent of gross domestic product. Sadly, that quickly began to change. The burden of the federal government more than doubled by 1940, thanks in part to misguided policies during the Great Depression. It did not take long for federal spending to climb closer to 20 percent of GDP, though it has remained somewhat constant in recent decades. It is a great historic irony that government policy mistakes (such as tax rate increases, misguided monetary policy, and trade protectionism) have caused economic downturns, including the Great Depression, that have then been used as an excuse by those wanted bigger government, to greatly expand the size and scope of government.

A European Future?

As shown in this paper, the relationship between limited government and growth is reinforced by economic data, and that link is likely to become even stronger because of globalization. It is increasingly easy for labor and capital to cross national borders, so nations with bigger governments are likely to suffer even worse economic consequences.

Competition among nations already has generated very positive results. Top tax rates have dropped dramatically since 1980. Triggered by the tax rate reductions of Margaret Thatcher and Ronald Reagan, the average top tax rate on personal income in OECD nations has fallen by 25 percentage points. A similar story can be told for the corporate tax. The average corporate tax rate in the developed world has dropped by nearly 20 percentage points.

It remains to be seen, however, if nations will begin to compete more aggressively to reduce the burden of government spending.

Unfortunately, America seems more likely to move in the wrong direction. Table 3 indicates that in 2007 total government spending claimed almost 37 percent of America's national economic output. The good news is that this represents a slight decline since 1993 (though the burden of government was even smaller in 2000 and has climbed since that year). The bad news – at least from a competitiveness standpoint – is that other nations are moving in the right direction at a faster rate.

In several nations, government spending has dropped by more than 10 percentage points or more as a share of GDP. As a result, the average burden of government today in other developed nations is down to 43.5 percent of economic output, just 6.5 percentage points higher than the US level. In 1993, by contrast, the gap was 11.2 percentage points. While it certainly is good news that many nations are reducing the burden of government spending, this means America is

slowly losing an important economic advantage. Furthermore, in 1993 only a couple of countries had government spending burdens below that of the United States. In 2007 a larger group of nations enjoys spending burdens below the American level.

Conclusion

To promote growth and boost freedom, government should be a small fraction of its current size. The question is not what to do, but how to get there. The entire Social Security system should be privatized, for instance, and safety net programs operated at the state and local level. A privatization of Social Security would take several decades to accomplish and require political consensus and commitment paralleled only by the construction of the system itself. Similarly, replacing Medicare and Medicaid with private health insurance also take enduring effort and legislative dedication.

However, such obstacles should not lie in the way of a serious discussion of what it actually means – and takes – to limit the burden of government. Those who built Social Security, Medicare, Medicaid and other vast federal spending programs did so with dedication, commitment and patience. It took at least half-a-century for Social Security to mature into the full-scale program it is today. Rolling back government must – and can – demand similar amounts of dedication, commitment and patience.

This long-term trend in the American economy is a strong reason to take note of the Rahn Curve. As this paper has shown, the curve is not merely a theoretical construct, but contains tangible proof that the philosophy of limited government has a harsh economic reality to back it up. Small governments are more beneficial to growth than big governments.

Table 3: Government Spending as Share of Burden of Government in Western Nations

	1993	2007
Australia	38.6%	34.0%
Austria	56.0%	49.1%
Belgium	54.7%	48.7%
Canada	53.0%	39.6%
Denmark	60.6%	50.9%
Finland	64.8%	48.7%
France	54.4%	53.5%
Germany	48.2%	45.1%
Greece	52.0%	45.5%
Iceland	43.6%	44.6%
Ireland	44.6%	34.9%
Italy	57.7%	48.8%
Japan	34.2%	36.2%
Luxembourg	45.6%	42.8%
Netherlands	53.7%	45.9%
New Zealand	44.7%	40.7%
Norway	55.1%	42.0%
Portugal	47.8%	46.9%
South Korea	21.6%	29.8%
Spain	48.6%	37.8%
Sweden	72.4%	54.8%
Switzerland	34.7%	35.4%
U.K.	46.1%	45.3%
Non-US Average	49.2%	43.5%
U.S.	38.0%	36.9%

Source: OECD, Annual National Accounts Data, Gross Domestic Product and Government Final Consumption Expenditure. Current prices.

Dr. Sven R Larson served as a research fellow with the Center for Freedom and Prosperity Foundation.

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