The Washington Times

May 11, 1995
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Cutting the government to size

Conventional wisdom holds that the truth is usually in the middle. But when the middle is in the space between two erroneous extremes, the truth is probably somewhere else entirely.

Case in point: the growing debate over the income tax and possible alternatives. The macroeconomic statist approach - the legacy of Karl Marx, John Maynard Keynes and assorted other socialists and do-gooders - is now discredited. Few seriously hold that the state has unlimited potential to do good, and should be funded accordingly. But the microeconomic statist approach, in its unthinking acceptance of the notion that alternative taxes should bring in at least as much revenue as the income tax, is also flawed. For the fundamental question is not how to raise money for the state, but what is the right size government to enable maximum economic welfare. For 30 years after World War II, it was conventional wisdom that increasing the size of government would lead to higher levels of prosperity. However, by the 1970s, it was evident that the macroeconomic statist model wasn't working. In much of Western Europe and the United States, capital formation and growth rates fell and unemployment increased. By the 1980s, it was also evident that the economies of some Southeast Asian nations with small governmental sectors (such as Singapore, Taiwan and South Korea) were growing at much higher rates than had previously been thought possible.

Economists thus began looking at the relationship between government size and economic growth. In 1986, economists of the U.S. Chamber of Commerce (myself included) analyzed this relationship for 22 countries. We found that slowdowns in growth rates were significantly correlated with growth in the government share of GDP. Our best estimate was that government maximized economic growth when it was between 15 percent and 25 percent of GNP. Since then, many more studies have confirmed our work.

It should not be surprising that there is an optimal size for government. Government needs to spend enough to assure a fair and predictable system of justice, national defense and basic public health and education, and to enforce contracts. However, all government spending entails extracting wealth from the private sector, either by taxing or borrowing. Eventually, they crowd out private sector investment, reducing productivity, capital formation, and growth.

High tax rates reduce incentives to work, save and invest, and involve ever-increasing collection and compliance costs. Also public spending is less efficient than private because it often misallocates resources and lowers incentives for cost-controls. Government spending programs also tend to develop their own constituencies, and generate political pressures to increase spending that have nothing to do with the general welfare. Benefits concentrate in certain groups, while costs diffuse throughout the population. When these benefits take the form of income redistribution rather than, say, defense or capital spending, negative effects are especially severe.

So, for the United States, the right size government (at all levels) is no more than 25 percent of GDP, and perhaps considerably less. About two-thirds of this necessary reduction, from the current 33 percent to 25 percent of GDP, should come from relative reductions in federal spending. This will require elimination of most counter-productive spending programs, and changing Social Security and Medicare into genuine annuity and insurance programs. And, a new tax system that is less intrusive and less biased against work, saving and investment needs to be designed.

The country may be edging toward serious consideration of such a simple but profound change. The first evidence is that people are finally willing to start thinking about it in various academic and think tank seminars. But the real test is likely to be the election of 1996 and whether a correctly sized government - and what it entails - becomes part of a national political debate.

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