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The size of good government

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President Clinton declared this year that "the era of big government is over." Since Republicans have been arguing for years that government is too big, we now seem to have a bipartisan agreement to downsize government. The only remaining question is, how far should the U.S. government be downsized?

The short answer is the U.S. government ought to be no bigger than 60 to 80 percent of its current size to maximize economic growth and the social welfare. The budget proposals of both the Clinton administration and that of the Congressional Republicans implicitly recognized that the government is above the optimum size, and both would result in a relatively smaller government sector. However, neither the Democrats nor the Republicans have developed proposals to reach the optimum size of government, nor are they likely to in the near future.

In an attempt to answer the question "what is the optimum size of government" more exactly, I recently completed a study with Professors Harrison and Lynn Fox, sponsored by the Krieble Foundation, which analyzed the relationship between economic growth and the size of the central government sector in 57 countries for the period 1951-93. We included in our sample all of those countries that had reasonably reliable data for the period, and whose gross national product (GNP) was greater than $5 billion but not largely accounted for by oil exports. We used only central government expenditures data, because of the unreliability of data for local and regional government expenditures in many of the sample countries.

Given that in most countries, regional and local government spending accounts for 5 to 15 percent of GDP, our data seriously understates the true size of government. For instance, the U.S. federal government will spend 21 percent of GDP this year, and on average, state and local government spend another 12 percent for a total - net intergovernmental transfers - of about 33 percent.

We found that economic growth was maximized when central government spending, as a percent of gross domestic product (GDP), was between 10 percent and 15 percent. Beyond this point, economic growth rates consistently declined as the relative size of government grew larger. Other recent studies using only U.S. data also indicate that the U.S. government is considerably larger than optimum to maximize the general welfare. For instance, in a study prepared last year for the Joint Economic Committee by Ohio University, Professors Lowell Gallaway and Richard Vetter concluded that "the optimal level of federal government spending is about 17.6 percent of GDP." Professor Gerald Scully concluded in a study published by the National Center for Policy Analysis, that "in order to maximize economic growth, the average rate for federal, state and local taxes combined should be between 21.5 percent and 22.9 percent of gross national product." The Scully study implies a federal government sector of approximately 15 percent of GDP, and that state and local government on average is well above its optimal size.

There is no particular mystery as to why we have a larger than optimal government. The special interests pleading for specific government spending will always be more highly motivated than those advocating restraint. Government taxing and borrowing imposes significant extraction costs on the economy and reduces the incentives to work, save, and invest. Government spending programs rarely have the cost-control incentives that characterize competitive private sector businesses. Seldom are government programs subject to objective and rigorous cost benefit analysis.

Big government is a relatively new phenomenon, largely caused by the influence socialists and Keynesians who, unlike our founding fathers, saw government as a panacea rather than a danger. Historically, government spending had been a relatively small share of GDP in most countries. A recent study by the International Monetary Fund showed that in the most highly developed industrial countries, total government spending as a percentage of GDP rose from an average of 8.3 percent in 1870 to 47.2 percent in 1994. In 1929, total government spending in the United States was only 10 percent of GDP, and the federal government share was a minuscule 2.6 percent of GDP.

Now that the problems with big government are widely recognized, both political parties have produced proposals to reduce the government sector. During the presidential campaign, both the Clinton and Dole economic proposals called for a smaller federal government sector by 2001 - but not small enough. The respective figures were 19.2 percent of GDP for Clinton and 17.6 percent for Dole/Republican plan, with identical deficits. The Republican plan projected higher economic growth - as it should given its lower level of taxation, spending, and regulation - than the Clinton plan, but ironically, both plans appeared to understate the real growth that will occur when the size of the government burden is reduced.

Current budget negotiations are likely to boost the estimates of economic growth, because now both parties have a vested interest in higher growth estimates; allowing the Democrats to spend more money on their favorite programs, and allowing the Republicans to propose bigger tax cuts -while enabling both parties to claim they have proposed a balanced budget.

The emphasis needs to shift from the fixation on balancing the budget to focusing on economic growth. In reality, much of the political class resists pro-growth economic policies, because widespread affluence reduces people's dependency on those who provide handouts with other people's money. While we can now claim with confidence that a significant downsizing of the federal government will substantially increase economic growth, we also need to be aware that many politicians have a vested interest in keeping this good news away from the American people. Thus, not until responsible members of the media and business people are willing to do what is necessary to educate people will the politicians be forced to give us only that amount of government that does more good than harm.

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