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The Optimum Government

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If you knew economic growth and new job creation begin to slow when total government spending is larger than about 25 percent of the economy, and you knew total government spending in the United States is about 36 percent of gross domestic product (GDP), would you propose policies to make government larger or smaller to create more jobs and boost economic growth?

Over the last few decades, many economists have done studies on the "optimum" size of government. A new study just completed shows the optimum size of government is less than 25 percent of GDP.

Optimum is defined as that point just before government becomes so large as to reduce the rate of economic growth and job creation. Governments are created to protect people and property. A government too small to establish the rule of law and protect people and their property from both foreign and domestic enemies is less than optimal.

The American Founding Fathers also believed government had public health functions (as contrasted with spending on private health), such as draining swamps where malaria-infected mosquitos thrived; and some public works functions (e.g. building and

maintaining roads, and ensuring basic education - but not necessarily state-operated schools).

The American Founding Fathers also understood that government could easily become too large, which would diminish the liberties of the people and discourage them from engaging in productive activity. The socialist utopians were in denial of the basics of human nature, which scholars like Adam Smith and the American Founders well understood.

Nevertheless, countless socialist schemes to enlarge the size of government have been sold to naive people. After two centuries of experimentation and the unnecessary loss of hundreds of millions of human lives, most of mankind now understands that pure socialism leads to tyranny and economic stagnation.

The question remains: Between the extremes of virtually no government and a pure communist state, how much government is necessary and desirable, and when does it become a drag on both liberty and economic well-being?

Economists have tried to quantify the question by looking at the experience of countries (and economic/political entities) over time as the size of their government grew or contracted, and by making comparisons of governments of various sizes. Most studies measure the size of government as a share of GDP (realizing it is an imperfect measure because it does not measure counterproductive regulation, restrictions on liberty and other factors, but is a reasonable approximation).

Wise observers have well understood that free markets and uncontrolled prices do a far better job in allocating resources (labor and productive investment) than politicians, who tend to resort to deciding what they believe is best for other people and, of course, rewarding their friends.

Most of the studies of the optimum size of government made by reputable scholars in recent decades have indicated that total government spending (federal plus state plus local) should be no lower than 17 percent, nor larger than about 30 percent of GDP. In a just completed paper, economists at the Institute for Market Economics in Sofia, Bulgaria, have provided new estimates of the optimum size of government, using standard models, with the latest data from a broader spectrum of countries than had been previously available. Their conclusion is that there is a 95 percent probability that the optimal size of government is less than 25 percent of GDP.

Because most governments are - and have been for many years - larger than the optimal, there are insufficient data to give a point estimate as to the best size, other than it is less than 25 percent. Other studies have shown small-population homogeneous countries, such as Finland, may have slightly higher optimal government sizes than heterogeneous countries, such as Switzerland and the United States.

The ramifications of this study and previous ones are important for the current debate going on in the United States and many other countries, about having the government spend more to "stimulate" the economy - i.e. create jobs and increase growth rates.

Rather than increasing the size of government, the empirical evidence shows that sharply reducing taxes, regulations, and government spending down to at least 25 percent of GDP would do the most to spur economic growth and create more jobs over the long run.

There is virtually no empirical evidence - in the United States or anywhere else - to support the belief of economists of the Keynesian school that a big increase in government spending will make matters better, rather than worse. Economists of the Austrian school have, in general, supported smaller government as a way to achieve higher levels of both prosperity and individual freedom, and the empirical evidence shows them to be correct.

In the United States, periods of rapid economic growth, such as 1983-89 and 1992-99, have been associated with a reduction in the total size of government. During the 1970s and much of the last decade, total (federal, state and local) government spending grew to a post-World War II record (36 percent), and these periods were associated with lower economic growth. In recent decades, many European countries have greatly increased government spending as a percentage of GDP, and as a result most of them experienced lower growth rates and much higher rates of unemployment than the United States.

Those members of Congress and parliamentarians in other countries who vote for a "stimulus package" that increases the size of government will be voting for slower economic recovery and higher rates of unemployment over the long run, based on both solid empirical evidence and theory.

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