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THE OPTIMUM SIZE OF GOVERNMENTAL UNITS

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Is Cayman too small to be a successful independent country? What is the optimal size of government units? How much of the economy should government own or control? Mankind has made amazing technological and economic progress in the last 300 years, but very little progress in improving governmental systems in the last 3,000 years. Since the Athenian experiments with democracy 2,500 years ago, there have been hardly any advances in finding answers to basic questions about how much or how little democracy is best.

The Scottish Enlightenment of the 17th and 18th centuries largely set the terms of political debate for the Anglosphere, beginning with the basic proposition that some government is necessary to protect person and property, and ensure liberty. During the 20th century, virtually every form and size of government that could be imagined was tried in practice, most often with disastrous results. But the good news is that there is substantial empirical evidence of what works and what doesn't.

According to the IMF, World Bank, and CIA – Qatar, Luxembourg, Brunei, Kuwait, Norway, UAE, Liechtenstein, Macau, Bermuda, Isle of Man, Monaco, Saint Maarten, San Marino and Jersey – all have higher per capita incomes than the U.S. But they are either petro-states or micro-states (with populations of less than a million) who prosper by largely engaging in tax and regulatory arbitrage. There are three political jurisdictions – Switzerland, Hong Kong and Singapore – with multimillion populations and highly diversified economies that are not resource rich but have real per capita incomes (on purchasing power parity basis) greater than the U.S. What can we learn from these successes? The enclosed table details some of their characteristics. Cayman has been added as an example of a successful micro-state, which succeeds in part by having a portion of its economy engaged in legal tax and regulatory arbitrage opportunities resulting from American and European inefficiencies.

It is apparent that it is not necessary for a country to have a large population to be prosperous. The U.S. is the only country in the world with a population of more than 100 million that enjoys a high per capita income. It is also apparent that countries do not need a large government sector to have high per capita incomes. This observation reinforces the findings of many studies that as government spending begins to exceed roughly a quarter of GDP, economic growth rates tend to slow. Most countries are well over that level, with the EU countries having government sectors exceeding 40 percent of GDP (France is 55 percent), which may explain the income stagnation. Maximum individual tax rates of more than 20 percent and corporate tax rates of more than 15 percent are not necessary for fiscal soundness and are a drag on economic growth. Cayman and some other jurisdictions show that consumption taxes can make income taxation unnecessary.

COMPARISONS OF SUCCESSFUL JURISDICTIONS

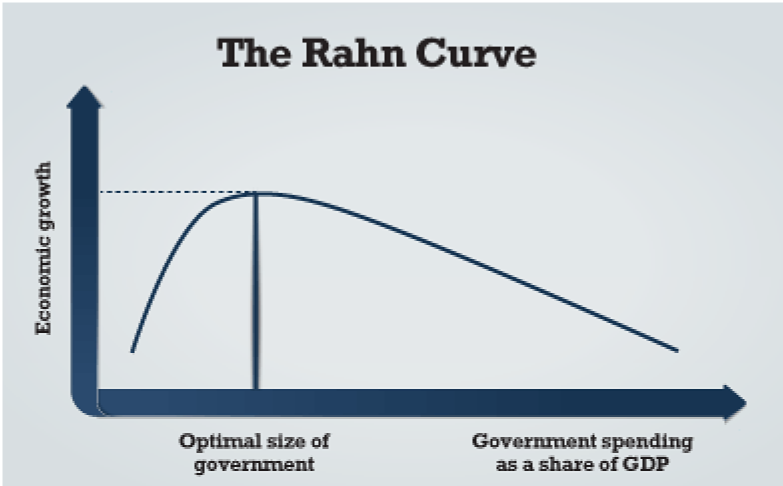
	USA	Switzerland	Hong Kong	Singapore	Cayman
Population, millions	324.5	8.3	7.4	5.5	0.06
Per Capita Income, PPP basis, International $ (IMF)	55,805	58,551	56,701	85,253	55,808
Government Spending as % of GDP (IMF)	38.0	33.7	18.5	17.1	18.1
Index of Economic Freedom, rank*	11	4	1	2	N.A. (10)****
Human Freedom Index, rank**	20	2	1	43	N.A. (9)****
Life Expectancy, years (WHO)	79.3	83.4	82.7	83.1	82.3
Individual Tax Rate, maximum %	39.6-55.5	23-45	15	22	00.0
Corporate Tax Rate, maximum %	35-43	18	16.5	17	00.0
World Happiness Report, rank***	13	2	75	22	N.A. (23)

* Co-Published by the Heritage Foundation and Wall Street Journal, 2016

** Co-Published by the Cato Institute, the Fraser Institute, and the Liberales Institut at the Friedrich Naumann Foundation for Freedom, 2016

*** Published by the U.N. Sustainable Development Solutions Network, 2016

**** U.K data used as data for Cayman is not available



Back in the 1980s, when I was the chief economist for the United States Chamber of Commerce, we were in the midst of preparing some testimony on the relative economic performance of countries. Looking at the data, it appeared to me that there might be an inverse relationship with the size of government as a percentage of GDP and economic growth. That is, as the government sector in any economy grew larger, economic growth slowed and at some point became negative. I asked two of the economists on our staff, Cesar Conda and William Orzechowski, to take a closer look at the data – which was very limited at the time – and we concluded that there was a negative relationship once government exceeded roughly a quarter of GDP. A couple years later, Gerald Scully of the University of Texas, Robert Barro of Harvard University, independently using much more data and a more sophisticated analysis, found the same negative relationship between government growth as a share of GDP and economic growth. In 1993, Harrison Fox and I did a more detailed study, which again supported the finding of the earlier studies – that when government spending exceeded 25 percent of GDP, measurable reductions in the rate of growth begin to appear. (Peter Brimelow wrote an extensive article "Why the Deficit is the Wrong Number" in the March 15, 1993 issue of Forbes magazine, reporting on our study with the enclosed curve).

In the years since, many other studies by researchers around the world have looked at the same relationship. Critics of the concept claim that a number of the studies show that the negative relationship between spending and growth may not be particularly robust, and there are major definitional and quality problems with data from many countries.

In 2009, two economists, Dimitar Chobanov and Adriana Mladenova from the Institute of Market economics in Bulgaria, concluded in their extensive study of the issue: "The evidence indicates that the optimum size of government, e.g. the share of overall government spending that maximizes economic growth, is no greater than 25% of GDP (at a 95% confidence level) based on data from OECD countries. In addition, the evidence indicates that the optimum level of government consumption on final goods and services as a share of GDP is 10.4% based on panel data of 81 countries. However, due to model and data limitations, it is probable that the results are biased upwards, and the true 'optimum' government level is even smaller than the existing empirical study indicates."

Dan Mitchell of the Cato Institute has argued for a number of years that the "growth-maximizing size of government is probably far lower than 25 percent of economic output." He argues, based on his extensive review of many studies and substantial empirical evidence, that: "Spending on core public goods (rule of law, courts, etc.) generally are associated with better economic performance; Spending on physical and human capital (infrastructure and education) can be productive, though governments often do a poor job based on a money-to-outcomes basis: Most government spending, though, is for transfers and consumption, and these are areas where the economic effects are overwhelmingly negative."

Economic freedom and protection of basic civil liberties is highly correlated with real per capita income and with life expectancy. Full democracy is also unnecessary to have high per capita incomes. The degree of democracy in Hong Kong is very limited, but civil liberties are for the most part still protected, as part of the 50-year (two systems) agreement with the U.K. Cayman has a very high degree of democracy in all matters except for defense, foreign policy and the final appellant court.

Switzerland has arguably the best overall economic and political governance system in the world. Each member of the National Council, the lower House of the Federal Assembly of Switzerland, represents approximately 40,000 people, not much larger than the 33,000 people represented by each member of the U.S. Congress in 1792. Each U.S. House of Representatives member now represents almost a three quarters of a million people. Virginia now has roughly the same population as Switzerland, but each member of the Virginia House of Delegates (the oldest continuous legislative body in the new world) now represents about 100,000 people. Each member of the British Parliament also represents about 100,000 people, while in its overseas territory of Cayman, each local member of the Assembly represents only about 4,000 people. In Singapore, there are about 55,000 citizens for each representative in the Legislative Assembly. Does democracy tend to break down if there are too many citizens per representative? Is the European Union too centralized to function well? Will Britain be better off economically and will civil liberties of its citizens be better protected because of Brexit?

Other than defense, are there any advantages to living in a large state over a small one? And if we went to a world with many more small states, how could they defend themselves?
Large centralized states with large government sectors get mired down in many layers of bureaucracy for which democracy is no cure, but part of the problem. The U.S. and Switzerland are both constitutional federal republics, where considerable power is delegated to the subunits of government – in the U.S. states and localities, and in Switzerland cantons and communes.

The Swiss have done a better job than the U.S. at devolving government to the lowest possible level and thus ensuring considerable competition between government units. Most traditional functions of government, such as police, fire, schools, local roads, land use, etc., can be carried out perfectly well at the local level, as the Swiss have shown. The Swiss communes (towns) raise most of their own taxes, which stay in the commune – thus avoiding the bureaucratic toll charge that occurs when tax money is sent to a larger unit of government and the locals have to plead to get some of it back. The national government in Bern has far fewer direct functions than most national governments, and constraints on its growth are provided by both spending and debt limitation provisions, and the double veto provisions of the Swiss direct democracy provisions. Major issues must be settled by a referendum, on such matters as immigration policy and whether to have a national minimum wage, etc. A major act must not only be approved by a direct vote by a majority of the people, but also by a majority of the cantons. Referendums must be limited to single issues, and those that involve significant expense must also define where the revenue to pay for the measure is to come from.

The Swiss system was designed to be cumbersome, because the founders wanted to make sure that the time required for a major change would be greater than the passions of the moment. As a Swiss friend once said to me, “By the time we Swiss can get around to taking an action, other countries have already proved it to be a bad idea, so we don’t bother.” The Swiss also benefit from considerable tax and regulatory competition between the cantons. After 800 years of trial and error and the occasional civil war, the Swiss have figured out how to have a government that protects civil liberties but allows for considerable experimentation and choice on economic and social issues at the local level. They do not have access to the sea nor much in the way of natural resources, yet they have a very high level of prosperity and happiness, and a very stable government – despite considerable language and religious differences. The secret is local control where the people do feel they have some influence on the government unit that most affects them.

One of the ironies is that the writers of the U.S. Constitution incorporated lessons from the Swiss experience. Then in 1848, the Swiss created a new constitution to a large extent based on the U.S. Constitution. Over the years, the Swiss have amended their constitution many more times than has the U.S., but they stuck much more faithfully to what was actually written, rather than allow the courts to water down the document through “judicial review” as has been done in the U.S.

Can features of the Swiss governmental system be adopted by other countries, including very large countries like the U.S? My argument is, yes. There is nothing inherently unique about the Swiss people. For many years, they have had large numbers of immigrants, but the Swiss have been successful in getting most of them to adopt Swiss values.

In the U.S., people are increasingly dissatisfied with the federal government in Washington, but tend to be more satisfied with their state and particularly local governments. The U.S. Constitution gives very few powers to the Federal government – and as the 10th Amendment to the Constitution reads: “The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.” So there is not only no prohibition of a

massive devolution of power to the states and localities, it would be very much in line with the thinking of the American Founders.
The U.S. and other countries could also adopt the direct democracy provisions, including the double majority – again a direct vote of all of the people and then a vote by the state legislatures with the requirement that a majority of the states concur. The Swiss-style single issue and its attendant funding should be made part of any reform package.

As in the U.S., people throughout the world are becoming increasingly hostile to big bureaucratic governments that stifle liberty and economic potential. The Swiss and even smaller states with smaller government sectors have proved that big states and big government have no inherent advantage, and, if anything, quite the opposite. Those larger countries that are not federal republics, such as the U.K and France, could devolve powers to regional and local jurisdictions so that the people would again feel more like they are masters of their own destinies. Legislative districts ought to be small enough so the people might actually know and meet their representatives (and who ought to be part of the most important level of government).

Small states could enter into alliances with larger states for national defense; but this would need to be a two-way street, whereby members of the alliance all agree, as part of the condition of being a member of the alliance, to contribute the same share of GDP and pro-rata manpower to the effort. Treaties and other international agreements should be made part of the referendum process so that organizations like the OECD would not be able to impose minimum global tax rates without the consent of the people in each jurisdiction.

The problem of political governance, including the optimum size of governmental units, is not hopeless; in fact, it is just the opposite. The Swiss and other nations have shown what works. There is no reason why all cannot enjoy a high degree of personal liberty, economic freedom, and live in a community that provides whatever level of government benefits, under the control of that community, its citizens desire.

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