GOVERNMENT – How Big is Too Big?

"There are four ways to spend money. First, you can spend your own money on yourself. Second, you can spend your money on somebody else. Third, you can spend somebody else's money on yourself. Fourth, you can spend somebody else's money on somebody else.

When you spend your money on yourself, you care about the price as well as quality.

When you spend your money on somebody else, you don't care that much about the quality, but you are still very careful about the price, because it is your money.

When you spend somebody else's money on yourself, you want the best quality, but you don't care that much about the price, because it is not your money.

Finally, when you spend somebody else's money on somebody else, you are not that concerned about the price or quality. And that's government. And that's close to 40% of our national income."

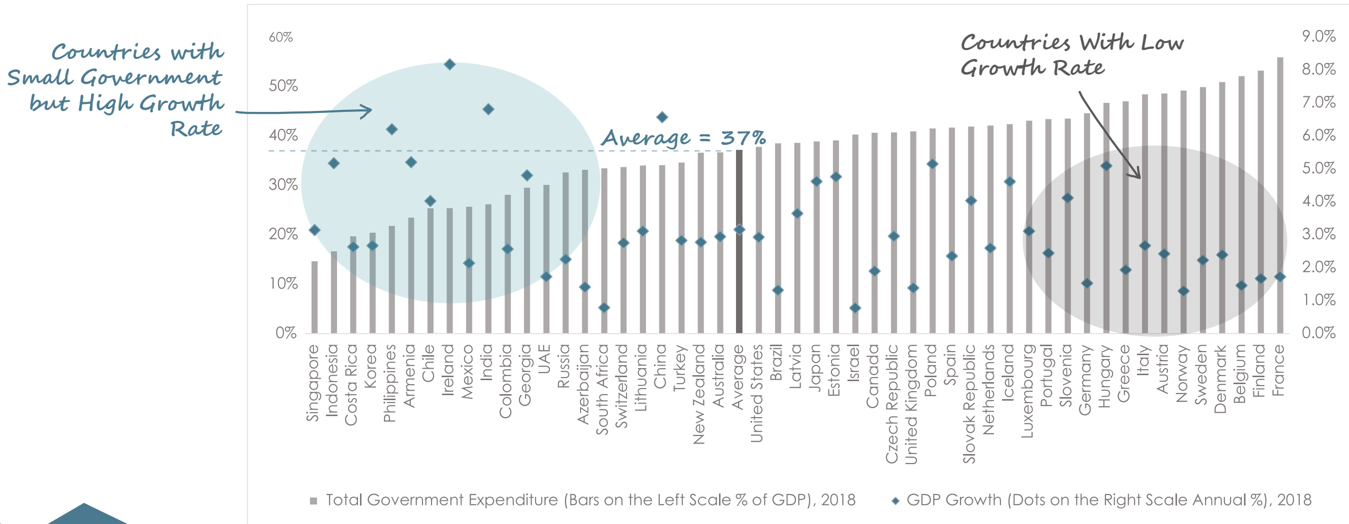
Milton Friedman[1]

Although optimal government size is still a hotly debated topic, and although government spending as a share of the overall economy can vary over time, most research and elementary common sense indicate that government spending should have a minimum and a maximum.

Chart 1 below shows total government spending, as a share of total national income, for a selected group of countries. As of 2018, the average of all these countries was at around 37%. By the end of 2020 this average will be closer to 45%, because of COVID.

Points on the chart indicate that governments which permanently spend more than 40% of GDP (France, Finland, Belgium...) eventually harm economic growth[2].

Chart 1: Large Governments Eventually Suffocate Growth



Source: IMF, World Bank

1 *"The 4 Ways to Spend Money by Milton Friedman"*. URL: link (retrieved: 23.06.20.) Milton Friedman (July 1912 – November 2006) – an American economist who received the 1976 Nobel Prize in Economics.

2 Lots of academic research supports this argument. See, for example, How "big" should government be? By António Afonso, Ludger Schuknecht, EconPol Working Paper March 2019.

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Chart 2 below shows that richer and more productive countries choose to have larger governments, regardless of country's population size.

When analysing government size and expenditure across countries, it is important to distinguish between six somewhat confusing indicators and notions.

First, government spending numbers are often understated. For example, economies with federal and regional governments – the US, Canada, Russia – may often include only federal government spending. It is important to compare Total Government Expenditures, including total defence spending.

Second, in countries such as Russia and China, with lots of government-owned companies, often called "State Owned Enterprises" or simply SOE, expenditures by SOEs are often excluded. This means Russian and Chinese government expenditures are much larger than captured by official statistics, because of huge SOEs.

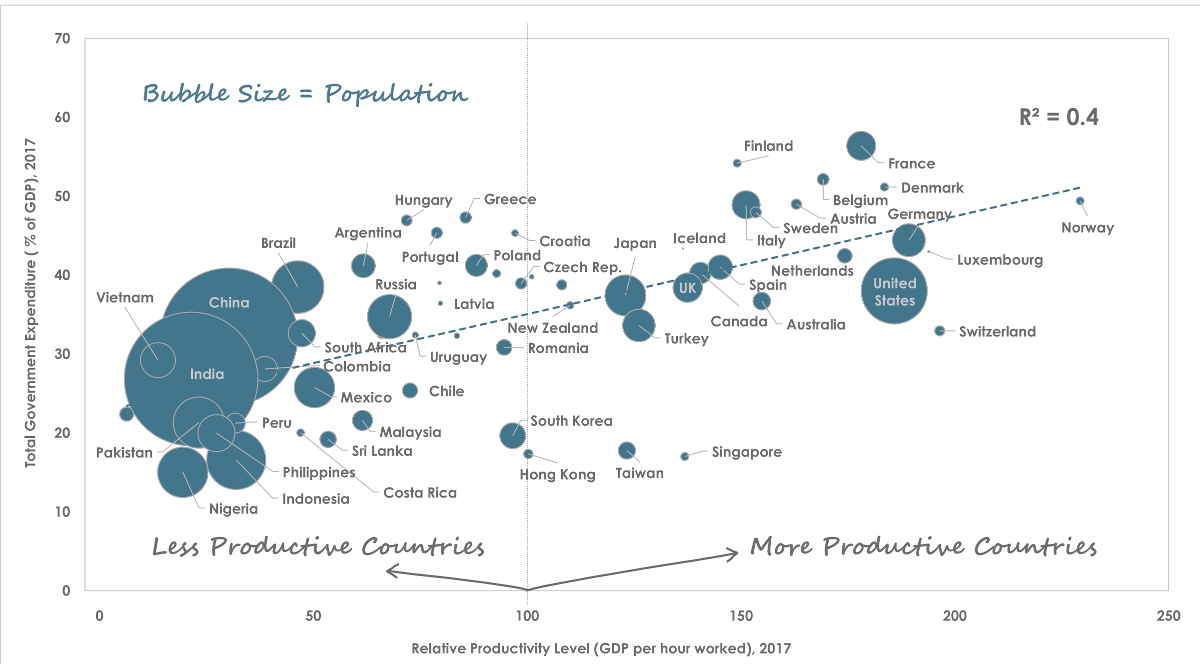
Third, when comparing tax rates across countries, it is important to look at the aggregate tax rate – federal and regional income taxes, social benefit taxes, property taxes, sales taxes, municipal taxes and so on. Tax rates are unreliable indicators of total government income or size. As an example, if we compared Russia's flat personal income tax rate of 13% with South Korea's average income tax rate of around 37%, we could erroneously conclude that Russia's government income and therefore expenditure is lower than Korea's.

Fourth, government expenditure can sometimes rise sharply, as it has this year, because of COVID. This is a positive phenomenon, required to keep economic activity afloat. The key, however, is to distinguish between temporary and permanent increases in government spending.

Fifth, people often conflate government expenditure with government debt. For example, South Korea's government debt to GDP ratio is at around 40%, more than double Russia's 17%. However, Korea's government expenditure is at around 20% of GDP whereas Russia's is at around 38% (Chart 1). If we adjust Russia's government spending number, as argued in our second point above, it would be even higher, because of government controlled corporations (SOEs).

Consistently large government spending will inflict much more damage on the economy than large amounts of government debt. We will discuss the topic of debt – government debt in particular – in one of our next reports.

Chart 2: More Productive Countries Choose Bigger Governments



Source: Our World in Data

Sixth, the overall government size and presence in an economy also depends on the complexity of the legal system. Governments can produce too many rules and regulations. Governments can be above the law or not accountable to their people. Table 1 (page 4) shows World Justice Report's Rule of Law Index for 2020[3]. This index consists of eight indicators. The first indicator – Constrains on Government Powers – measures citizens' control over their government.

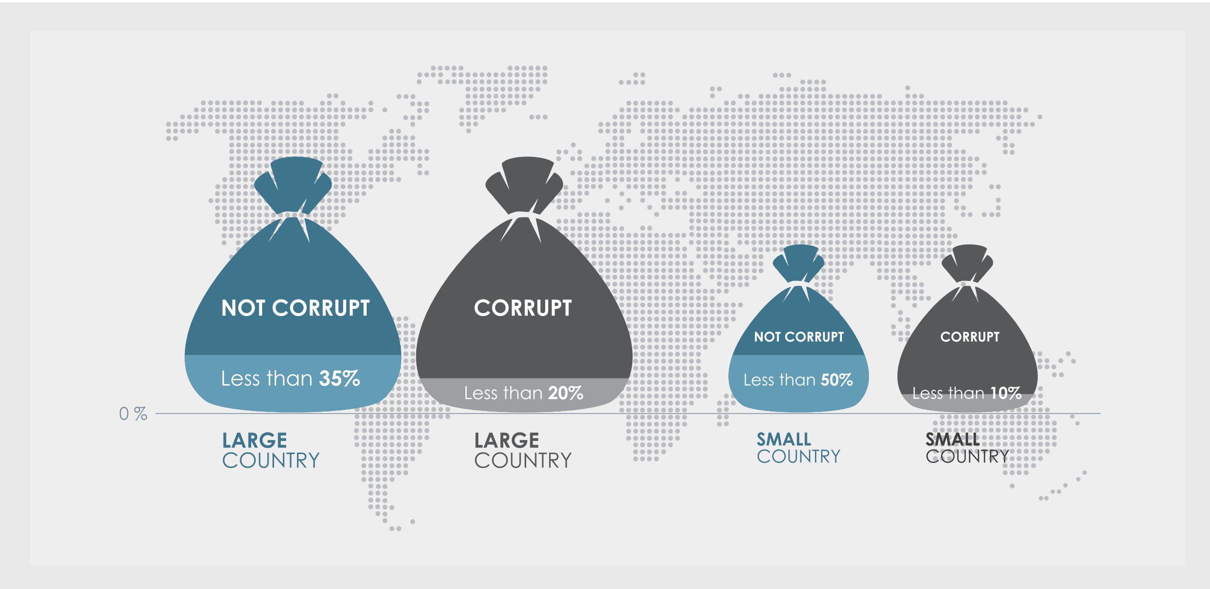
We have created a framework, shown in Diagram 1 below, to help us think how big a government should be in a given country. Our diagram has four options. For small and non-corrupt countries, such as Cyprus, Slovenia, Montenegro, Armenia, Georgia, to name a few, governments can and should take on more risk to jumpstart economic development. They can do this through PPP[4] projects, by taking on contingent rather than direct liabilities. We will discuss these in greater detail in one of our future reports.

For small and corrupt countries, government size should be kept to a bear minimum because people at the helm of such governments simply steal and transfer government funds to their personal offshore accounts. International and multinational institutions helping small countries should insist on limiting government expenditure. Local populations should elect political parties advocating small government.

Government expenditure is especially hard to control in big and complex countries because they have more inertia. Countries such as Denmark or Finland should not be used as universal examples of big government and economic welfare. What works in small countries, without major ethnic, racial or religious divides, doesn't necessarily work in large countries.

Large and noncorrupt countries, such as the US or Canada, should still limit their total government expenditure to below 35% of GDP because of spending inertia discussed above. Moreover, recent research[5] indicates that in large countries citizens are less involved in elections and politics in general, as they don't believe their voice makes a difference[6]. Harvard university's political scientist Pippa Norris calls this phenomenon a "democratic deficit."

Diagram 1: Optimal Government Size (shown as % of GDP)



3 The Rule of Law Index is a global study and the accompanying ranking of countries around the world in terms of their legal environment, which is based on universal principles of the rule of law. It is calculated according to the methodology of the international non-governmental organization The World Justice Project, based on a combination of publicly available statistics and the results of a global expert survey.

4 Private Public Partnerships will be discussed in greater detail in one of our next reports.

5 Gerring, John, Veenendaal, Wouter. *Population and politics: the impact of scale.* Cambridge, United Kingdom; New York, NY: Cambridge University Press, 2020.

6 Norris, Pippa. *Democratic deficit: critical citizens revisited.* Cambridge: Cambridge University Press, 2011.

Table1: World Justice Project Rule of Law Index 2020

COUNTRY	WJP Rule of Law Index: Overall Score	Factor 1: Constraints on Government Powers	Factor 2: Absence of Corruption	Factor 3: Open Government	Factor 4: Fundamental Rights	Factor 5: Order and Securit	Factor 6: Regulatory Enforcement	Factor 7: Civil Justice	Factor 8: Criminal Justice
Denmark	0.90	0.94	0.95	0.88	0.92	0.93	0.90	0.86	0.83
Norway	0.89	0.94	0.94	0.89	0.91	0.93	0.87	0.85	0.83
Finland	0.87	0.92	0.89	0.86	0.91	0.91	0.86	0.81	0.83
Sweden	0.86	0.87	0.91	0.86	0.87	0.92	0.84	0.82	0.80
Netherlands	0.84	0.86	0.88	0.82	0.84	0.85	0.85	0.85	0.76
Germany	0.84	0.85	0.82	0.79	0.85	0.89	0.85	0.85	0.79
Austria	0.82	0.85	0.82	0.71	0.85	0.90	0.84	0.77	0.80
Canada	0.81	0.84	0.83	0.81	0.82	0.91	0.81	0.70	0.74
Estonia	0.81	0.83	0.79	0.81	0.82	0.89	0.79	0.80	0.71
Singapore	0.79	0.67	0.91	0.64	0.68	0.93	0.87	0.82	0.79
United Kingdom	0.79	0.82	0.82	0.79	0.79	0.84	0.81	0.71	0.72
Belgium	0.79	0.83	0.80	0.76	0.84	0.81	0.80	0.76	0.71
Japan	0.78	0.71	0.82	0.68	0.77	0.92	0.79	0.79	0.76
Republic of Korea	0.73	0.72	0.67	0.71	0.73	0.84	0.72	0.76	0.71
Czech Republic	0.73	0.73	0.65	0.67	0.79	0.90	0.71	0.69	0.71
Spain	0.73	0.74	0.73	0.71	0.79	0.82	0.70	0.67	0.67
France	0.73	0.73	0.74	0.78	0.73	0.75	0.76	0.71	0.62
United States	0.72	0.71	0.74	0.78	0.72	0.81	0.71	0.62	0.63
Portugal	0.70	0.78	0.72	0.66	0.78	0.79	0.62	0.68	0.59
Slovenia	0.69	0.65	0.66	0.65	0.75	0.89	0.65	0.66	0.56
Chile	0.67	0.72	0.69	0.71	0.72	0.67	0.64	0.63	0.56
Italy	0.66	0.71	0.63	0.63	0.73	0.75	0.61	0.56	0.64
Poland	0.66	0.58	0.73	0.60	0.64	0.86	0.62	0.63	0.60
United Arab Emirates	0.65	0.56	0.80	0.36	0.46	0.91	0.73	0.68	0.67
Croatia	0.61	0.58	0.58	0.61	0.67	0.85	0.56	0.57	0.51
Georgia	0.60	0.55	0.68	0.57	0.61	0.79	0.57	0.53	0.52
Malaysia	0.58	0.58	0.60	0.42	0.52	0.79	0.57	0.63	0.56
Indonesia	0.53	0.68	0.39	0.55	0.52	0.68	0.55	0.46	0.39
Hungary	0.53	0.40	0.51	0.46	0.58	0.89	0.47	0.45	0.47
Kazakhstan	0.52	0.42	0.49	0.46	0.46	0.78	0.51	0.62	0.46
Brazil	0.52	0.53	0.45	0.61	0.51	0.64	0.51	0.54	0.34
India	0.51	0.61	0.42	0.61	0.51	0.59	0.49	0.45	0.40
Serbia	0.50	0.39	0.44	0.47	0.57	0.77	0.48	0.51	0.40
Vietnam	0.49	0.45	0.42	0.46	0.46	0.77	0.45	0.46	0.46
China	0.48	0.32	0.53	0.43	0.29	0.78	0.49	0.53	0.45
Russian Federation	0.47	0.36	0.43	0.49	0.44	0.66	0.49	0.54	0.31
Lebanon	0.45	0.50	0.36	0.40	0.50	0.66	0.45	0.42	0.35
Mexico	0.44	0.46	0.27	0.60	0.52	0.53	0.45	0.39	0.30
Turkey	0.43	0.30	0.47	0.42	0.32	0.69	0.41	0.44	0.38
Venezuela, RB	0.27	0.17	0.31	0.28	0.31	0.48	0.20	0.27	0.13

More Rule of Law

Less Rule of Law

Shows how much control people have over their government

Source: https://worldjusticeproject.org/

Conclusion

"People are not free unless government is limited. There's a clear cause and effect here that is as neat and predictable as a law of physics: As government expands, liberty contracts."

***Ronald Reagan, 40th President of the United States*[7]**

Political thinkers like Plato and Aristotle preferred smaller countries, like city-states, because they believed people could be more involved in governance and therefore smaller states would be more accountable, reasonable and virtuous.

The 18th century French judge, philosopher and political thinker Montesquieu continued Plato's and Aristotle's line of argument, and campaigned for smaller states, but in the end they all lost to American political philosophers such as James Madison, who argued that, bigger states are more diverse and less likely to be controlled by specific interest groups.

The trouble is that if government becomes too big – in total expenditure or in too many lobbied rules & regulations – James Madison's argument falls apart, simply because government bureaucrats and lobbyists become the ultimate "interest group" which Madison wanted to avoid.

Milton Friedman told us that nobody is going to spend somebody else's money as carefully as he would spend his own. This is a fundamental principal of human nature. Government bureaucrats spending taxpayers' money are no exception to this logic. Continuously excessive government expenditure dampens economic growth, erodes trust within societies, reduces productivity and limits people's freedom.

Our Diagram 1 should answer the question posed at the beginning of this paper: **How Big is Too Big?**

David Tavadian, CFA
Founding Partner

7 President Ronald Reagan's Farewell Address to the Nation from the oval office, January 11, 1989.

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