Chapter 13

OPTIMAL SIZE OF THE GOVERNMENT

The concept of optimal size of government, like the concept of optimal city size, is not very meaningful. A government or city with the “optimal size” means nothing if it does not function well because it is ill-structured. On the other hand, if all the government functions are taken up by the government to the optimal degree and the people in charge are well organized, the problem has been solved and there is no need to talk about the optimal size of the government.

1. INTRODUCTION

All societies need a government. A number of important functions have to be taken up by governments because the private sector is not in the position to do the job fairly or properly. These include the maintenance of law and order, fostering a favorable macroeconomic environment for the private sector to operate (“macroeconomic risk management”), setting up and running a social security system that provides a safety net for those hit by misfortunes, ensuring the provision of infrastructure and those services which may be under-provided if left entirely to the market. In the Introduction to this book, I have maintained that any government that satisfies the needs of society by delivering these needed goods and services can be said to be a substantive democracy. In this chapter, I argue that if a government takes up those tasks that it can do better than the private sector can, and if it performs these tasks at a scale that is optimal, then the size of the government will be optimal. The size of the government should not be considered a public choice parameter because having achieved the “optimal size” means nothing if the government is not doing its jobs properly.
2. BENEFIT-COST ANALYSIS AND BUDGET BALANCE

These days the financial markets expect governments to balance their budgets. Whether we like it or not, a government that runs an ongoing deficit is seen to be fiscally imprudent. Even though theoretically an ongoing fiscal deficit can be part of a long-run equilibrium and a growing economy could service an ongoing fiscal deficit indefinitely if the debt-servicing cost is a fixed percentage of the GDP, the financial markets will grow nervous. Largely reflecting the widespread belief that prudent governments should balance their budgets, while Europe prepared for the monetary union, the Maastricht Treaty required that the fiscal deficit of any member country should be no bigger than 3 per cent of the GDP. In a similar spirit, the Basic Law of the Hong Kong Special Administrative Region stipulated that the SAR government would adopt a policy of balanced budget, and that the government “should spend no more than its revenue.” However, the revenue of the government is not fixed. We can raise more revenue or less revenue. The edict of spending no more than the revenue does not really specify how much to spend and how much to raise. Ultimately, however, efficiency dictates that the government should spend the money if the benefit of the spending is larger than the cost. So long as the benefit justifies the cost, it makes sense to raise that extra revenue and to facilitate that extra spending.

To put it simply, under the balanced budget requirement a government can be bigger or smaller. Given the size of the GDP, if the government gets bigger, the private sector gets smaller. With resources available to the private sector being smaller, the real interest rate tends to go higher. But this does not mean that a smaller government is always better than a bigger government. Any government has to justify its size by looking at each policy variable. When each policy variable is set right, the government is optimal. There is no need to worry about the optimal size of the government.

3. LAWS

Just like everything else, the introduction of laws and regulations involve costs and benefits, and it is the consideration of these costs and benefits that should determine whether a specific law is to be introduced. The costs include the costs of legislation, the costs of compliance, and the costs of enforcement. These costs include both economic and social costs. To further the public interest, any law that brings more benefits than costs should be enacted; any law that brings more harm than good should not be. In