The Crowding-Out Tipping Point: Increasing economic growth means shrinking government

By Foundation for Economic Education

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The size and scope of government in the United States today would have been beyond the imagination of the American founders. For more than a century after the Constitution's ratification, Americans took limits on government power seriously.

At the start of the 20th century, total government spending was less than 10 percent of GDP, with the majority of spending taking place at the state and local levels. In 1900, federal spending was a mere 2.8 percent of GDP compared to 21.1 percent in 2014. Meanwhile, state and local spending stood at 5 percent of GDP in 1900, but reached 11.5 percent in 2014. Overall government spending now stands at nearly 33 percent of GDP.

That tectonic shift is largely due to the growth of entitlements and the regulatory state. Nearly half of federal spending goes toward Social Security, Medicare, and Medicaid; government imposes huge regulatory costs on the private sector; and the higher taxes needed to finance big government erode economic incentives to work, save, and invest.

How big is too big?

There is a growing body of evidence that bigger government means slower growth of real GDP. Once the level of total government spending as a percentage of GDP reaches a tipping point, estimated to be from 15 percent to 25 percent of GDP, additional expansion crowds out private productive investment and slows economic growth. An overreaching government diminishes economic freedom and limits private exchange opportunities, restricting the range of choices open to individuals.

In a pioneering study of the link between government growth and national wealth, which appeared in the fall 1998 issue of the Cato Journal, economists James Gwartney, Randall Holcombe, and Robert Lawson found that a 10 percentage point increase in government spending as a percentage of GDP decreases real GDP growth by 1 percentage point. Thus, if government spending went from 25 percent of GDP to 35 percent, real GDP growth would slow over the longer term by a full percentage point. They also found that a 10 percentage point increase in the government's share of GDP lowered private investment by 1.6 percentage points.

Factors of growth

One of their study's key findings was that secure property rights — which includes a legal system that protects persons and property, enforces contracts, and limits the power of government by a just rule of law — play an important role in promoting economic growth.

The late Bernhard Heitger, an economist at the Kiel Institute for World Economics, more fully developed the positive relationship between property rights and economic growth in his pathbreaking article in the winter 2004 Cato Journal. In that article, Heitger distinguished between proximate and ultimate determinants of economic growth. The former are well known: additions to physical and human capital and technological progress (also known as "total factor productivity"). But Heitger was interested in the question of what drives capital accumulation and innovation. His answer: the structure of property rights and the associated incentives.

Conventional growth theory took private property rights and incentives as givens. Heitger rigorously showed that private property rights and the rule of law are the ultimate sources of economic growth and the wealth of nations. Well-defined private property rights improve efficiency and increase per capita income. In turn, as a nation grows richer, people demand stronger protection of their property rights, advancing institutional change.

Using data from an international cross-section of countries from 1975–95, Heitger found that "a doubling of the property rights index more than doubles per capita income" and that "more secure property rights significantly raise the accumulation of physical and human capital."

Bauer's foresight

That outcome would not have surprised Peter Bauer, a pioneer of development economics. He was critical of the simplistic idea that physical capital accumulation is the key determinant of economic growth. As early as 1957, in his classic Economic Analysis and Policy in Underdeveloped Countries, Bauer noted:

It is misleading to think of investment as the only or the principal determinant of development. Other factors and influences, such as institutional and political forces, the qualities and attitudes of the population, and the supply of complementary resources, are often equally important or even more important.

In the same book, Bauer also anticipated modern endogenous growth theory, stating: "It is more meaningful to say that capital is created in the process of development, rather than that development is a function of capital." What mattered to Bauer, and to other classical liberals, in the process of development was freedom — namely, the freedom to pursue one's happiness without government interference except to protect life, liberty, and property. (See James A. Dorn, "Economic Development and Freedom: The Legacy of Peter Bauer.")

In that sense, Bauer argued that "the principal objective and criterion of economic development" is "the extension of the range of choice, that is, an increase in the range of effective alternatives open to people." Free markets — resting on effective private property rights — and free people are thus the ultimate determinants of economic growth. When government expands beyond its core functions, it undermines the primacy of property, diminishes the principle of freedom, and erodes the wealth of nations.

The United States falls

The loss of economic freedom in the United States is revealed in the annual Economic Freedom of the World Report, published by the Fraser Institute along with the Cato Institute and a number of global think tanks. In 2000, the United States was the second most economically free country in the world, based on data from 1998. Today it is ranked 12th, based on 2012 data.

To move up the freedom ladder, the United States needs to change the climate of ideas and recognize the importance of private property rights and the rule of law. A legal framework that safeguards persons and property means incentivizing individuals to take responsibility for their actions and allowing people to learn from their mistakes. It means cutting back the size and scope of government and not bailing out businesses.

The nature of government is coercion; the nature of the market is consent. The "great constitutional charter" that George Washington referred to in his first inaugural address (April 30, 1789) was intended to bind Congress to the powers enumerated in Article 1, Section 8 of the Constitution. Thomas Jefferson reiterated Washington's admonition by stating in his first inaugural address (March 4, 1801): "The sum of good government" is "a wise and frugal government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned."

Wise and frugal

The challenge for the 114th Congress is to return to "a wise and frugal government." A first step would be to understand the detrimental effects of expanding government power on economic liberties — especially on private property rights. If history has taught us anything, it is that the size and scope of government matter, both for freedom and prosperity.

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