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# Specialisation-based external economies, supply of primary factors and government size

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**Abstract**

This paper examines the impact of changes in the supply of primary factors on the size of government and welfare. Unlike the existing studies, this paper utilises a model where the presence of monopolistic in the intermediate good sector gives rise to specialisation-based external economies in the final good sector. The size of theses external economies affects the magnitude of most comparative static results presented in this paper. For example, it is shown that, in the presence of specialisation-based external economies, an increase in the supply of either primary factor (i.e., capital or labour) decreases the size of governments even if the private and public sectors were equally capital intensive. Due to the presence of specialisation-based external economies, an increase in the size of the country decreases the size of government. In addition, an increase in the size of the country leads to a larger increase in welfare as long as external economies are present.
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## 1. Introduction

An examination of the available data reveals that the size of government varies considerably across time and countries [see IMF (2003)]. Persson and Tabellini (2002) considered

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14 OECD countries. They report that the average government spending which used to be less than 10% before World War I increased to almost 30% in 1960 and reached almost 50% by mid 1990s.

A number of studies have examined the role and the size of government in market economies. Ram (1986) examined the relationship between the size of government and the growth of national income in a number of developed and developing countries. Ram has shown that government size has a positive effect on economic performance and growth. Karras (1996) attempted to estimate the productivity of government services and the optimal government size for a number of economies. Karras has shown that since 1960, government size has steadily increased in Africa and decreased in North America and South America. Karras has also shown that government sector is more productive when small. Rodrik (1998) has shown that there is a positive relationship between the extent of openness of an economy and the size of government. Alesina and Wacziarg (1998) have shown that government size is smaller in larger economies and that small countries tend to be more open to international trade. Persson and Tabellini (1994, 1999, 2000) have considered factors underlying the size of government.[1]

The size of government has been a concern in most industrialised economies due to significant budget deficits. The Asian financial crisis of 1997–1998 resulted in a push for reduction in the size of government in affected economies. The size of government is influenced by, among other things, the supply of capital and labour. The increasing push towards free trade and the formation of regional trading blocks is likely to result in further adjustments to the supply of labour and capital within an economy.

This paper focuses on the impact of changes in the supply of capital, labour and the size of the country on the size of government and welfare. Availability of quality social services in developed countries, such as health care and education, attract migrants seeking a better standard of living. Inflow of labour has implications for the size of government. It can be argued that the inflow of capital also affects the size of government. Most existing studies that explicitly include a government sector have not explored this link. In addition, these studies assume that perfect competition prevails in all sectors of the economy.[2] This paper examines the relationship between the size of government and the supply of primary factors in the presence of imperfect competition.

In order to examine the link between the government size and the supply of primary factors, this paper utilises a simple general equilibrium model of an economy that produces one final good and one public good. The final good is produced by means of capital, labour and a large number of varieties of an intermediate good. Varieties of the intermediate and the public good are produced by means of capital and labour. Perfect competition prevails

[1] A number of studies, for example Barro (1990), Barro and Sala-i-Martin (1992), Mourmouras and Lee (1999) and Turnovsky and Fisher (1995), have considered the role of government in economic growth. The main prediction of this literature is that increases in government spending are associated with higher long-run growth rates. However, some earlier studies such as Landau (1986) and Scully (1989) have found a negative relationship between government spending and economic growth.

[2] See Anwar and Zheng (2004) and references therein. Anwar (2003) has used a framework where, despite the presence of increasing returns to scale in one sector of the economy, perfect competition prevails in all industries. This paper highlights the role of external economies of scale arising from the presence of monopolistic competition in the intermediate good industry.

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