

### 3. Does country size matter for public sector size?

It has been shown in the previous theoretical chapter that country size should play a role in determining public sector size. In the presence of diseconomies of scale for at least a few publicly provided goods, smaller countries should exhibit larger public sectors than larger countries. Chapter 3 is designed to test whether this theoretical expectation is met empirically. We employ multiple regressions for a large set of countries, different proxies for country size, and also test for the dynamics of the relationship between country size and public sector size or government size.<sup>28</sup>

Even though the list of possible determinants of government size appears quite comprehensive<sup>29</sup>, a major and intuitive one has long been neglected, maybe just because of its obviousness. Only recently, the importance of public goods and its effects on government size was re-considered and analyzed by Alesina and Spolaore (1997) in a theoretical model of optimal country size and by Alesina and Wacziarg (1997, 1998) in an econometric model. All these contributions suggest that country size and government size should be negatively related, and they provide a straightforward rationale for such a relationship. Small countries face

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<sup>28</sup> The two terms «public sector size» and «government size» are interchangeable. We decided to use the shorter and more common term «government size» henceforth, but we refer to the whole public sector, excluding only state-owned enterprises.

<sup>29</sup> Considerable efforts have been devoted to detecting and analyzing economic as well as political determinants of public sector size or government size. Some of the important arguments appeared under the heading of «determinants of budget deficits», but they can – *mutatis mutandis* – also be applied to the question of government size. De Haan and Sturm (1994) summarize the early literature on political and institutional determinants of fiscal policy and government size. They distinguish between four different strands of the literature, which is devoted to detecting and analyzing these determinants. Volkerink (1999) adds a few more possible determinants. Table A.2 in the Appendix provides an overview of these classes of models and lists the main contributions.