

TOPIC 1
**THE RISE (AND RISE)
OF THE FISCAL STATE**



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- When and how has the fiscal state state grown? (Data)
 - Size of the state
 - Composition of spending
 - Stylized facts about the history of government spending
- Why does government grow? (theory)
 - Relentless forces of development
 - Democracy and the demand for redistribution
 - Bureaucracy and excessive government
 - Ideology and the zeitgeist
- A closer look at South Africa
- What is the relationship between the size of government and economic growth?
- Concluding thoughts

READINGS

*** Hindriks, Jean, and Gareth D. Myles. 2013. 'Chapter 5 Theories of the public sector' in Intermediate Public Economics. 2nd ed. Cambridge, MA: MIT Press:

Hindriks, Jean, and Gareth D. Myles. 2013. 'Chapter 4 Public Sector Statistics' in Intermediate Public Economics. 2nd ed. Cambridge, MA: MIT Press:

Lindert, Peter H. 2004. Chapter 1 'Patterns and Puzzles' and Chapter 2 'Findings'. In Growing Public: Volume 1, the Story: Social Spending and Economic Growth since the Eighteenth Century. Cambridge University Press.

Black, P., Siebrits, K. and Van der Merwe, T. 2015. *Public expenditure and growth*. Chapter 7 in Black, P. A., Estian Calitz, Tjaart J. Steenekamp. 2015. Public Economics. Sixth edition.

Bonus reading!:

Foley, Duncan K. 1978. 'State Expenditure from a Marxist Perspective'. Journal of Public Economics 9 (2): 221–238.

TOPIC COMMENTARY

"Should South Africa increase the size of the state in response to the coronavirus pandemic or not?"

The deadline is Friday 7 August at 9am.

1000 words, typed in Microsoft Word, emailed to michael.sachs@wits.ac.za

When and how did the fiscal state grow?

“A leading French economist of the time, Paul Leroy-Beaulieu (1888), addressing the question of the proper share of taxes in the economy, suggested that a share of **5 - 6 percent** was moderate while a share beyond 12 percent had to be considered ‘exorbitant’ and would damage the growth prospects of the economy”

Tanzi and Schuknecht (2000) p5

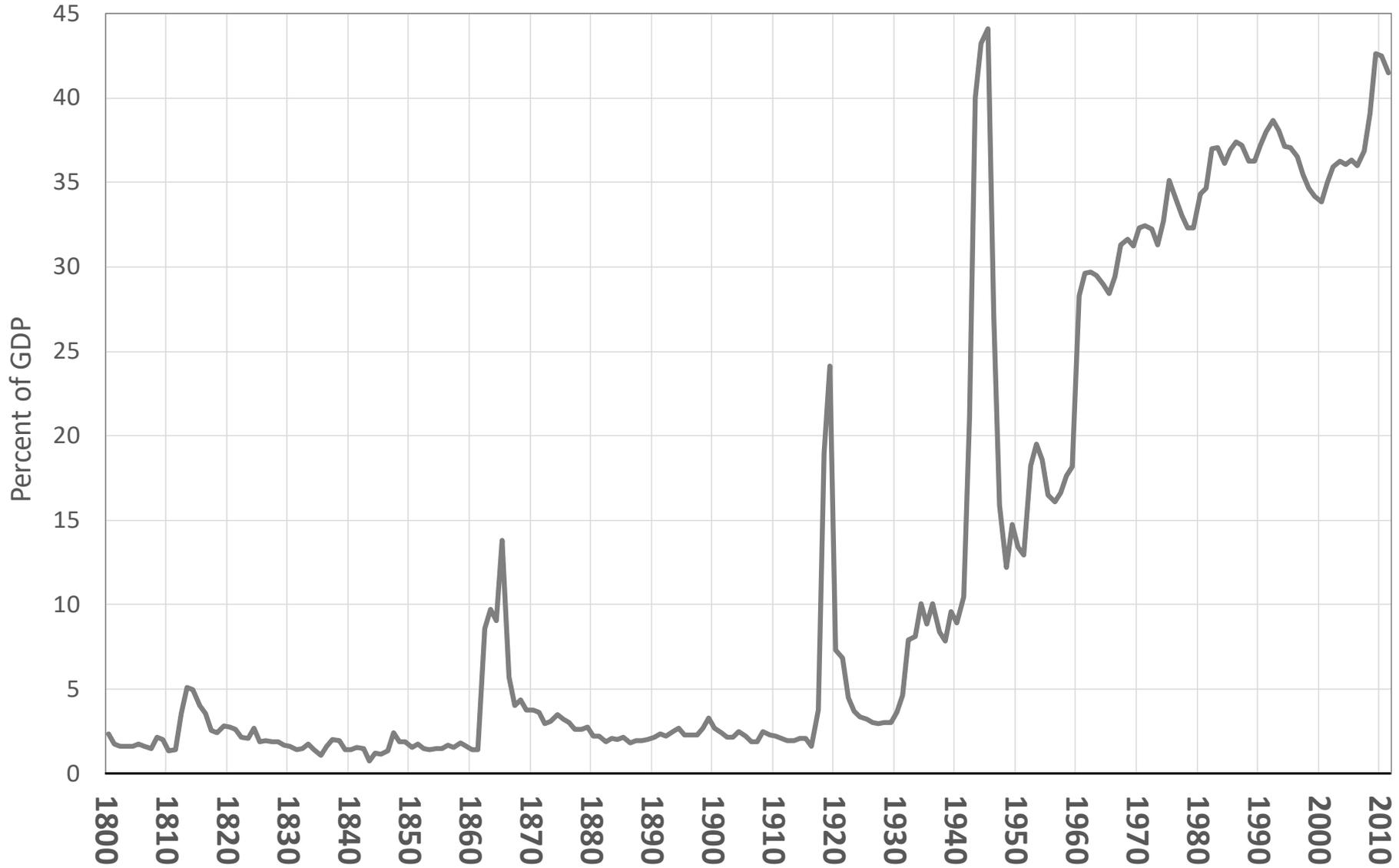
Colin Clark published an article in Economic Journal in 1945 arguing that a tax share of national income above **25 percent** was inflationary and therefore unsustainable. In his capacity as editor of the journal, John Maynard Keynes wrote to Clark: “In Great Britain after the war I should guess that your figure of 25 per cent as the maximum tolerable proportion of taxation may be exceedingly near to the truth. I should not be surprised at all if we did not find further confirmation in our post-war experience of your empirical law.”

Kirchner (2011) p15

By 1980, public expenditure exceeded **50 percent** of GDP in Belgium, the Netherlands, and Sweden. No industrial country kept public expenditure below **30 percent** of GDP and only Japan, Spain, Switzerland and the United States stayed close to this level.

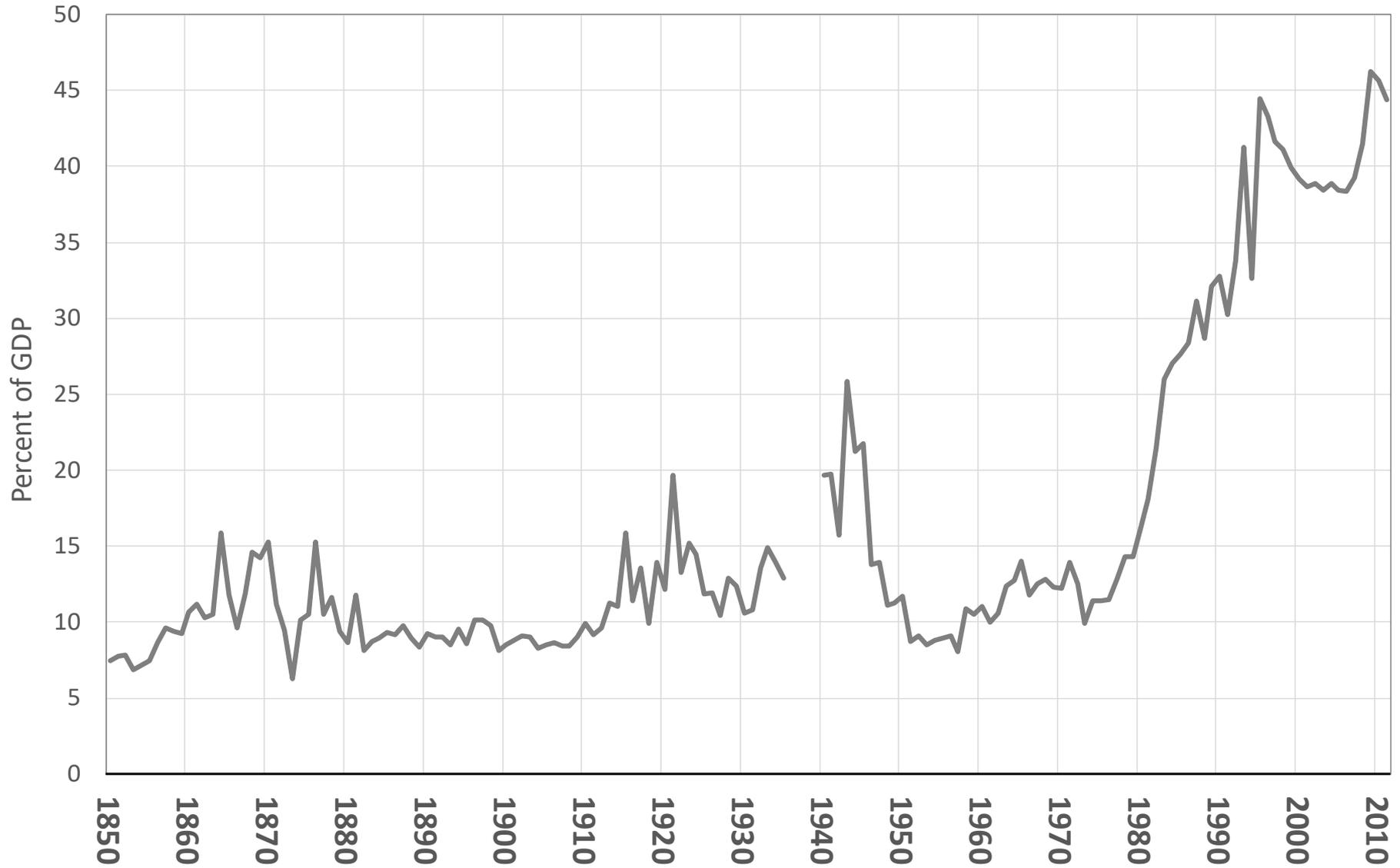
Tanzi and Schuknecht (2000) p16

USA Government spending as a share of GDP



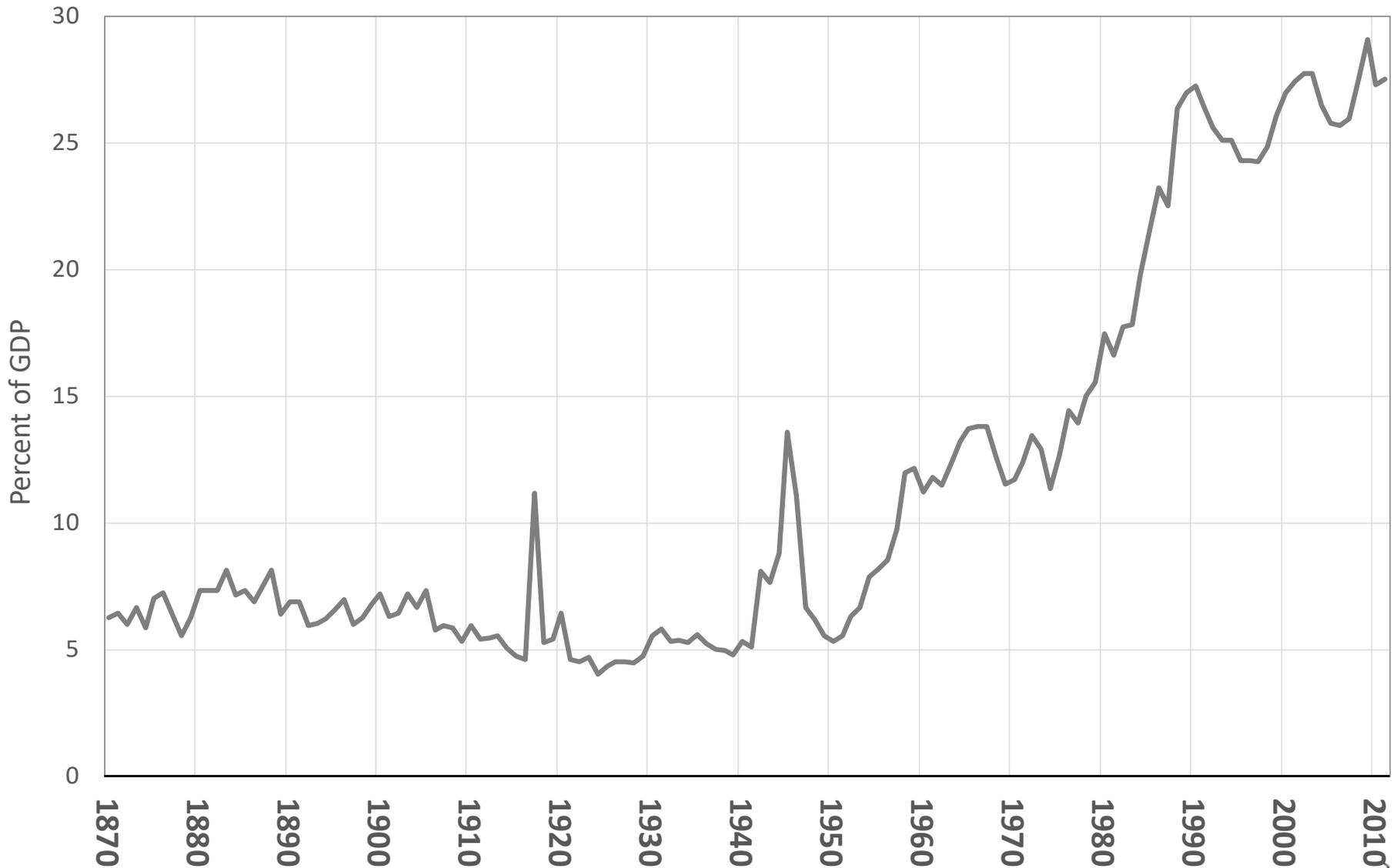
Source data : Mauro et al (2013)

Spain Government spending as a share of GDP



Source data : Mauro et al (2013)

India Government spending as a share of GDP



Source data : Mauro et al (2013)

South Africa Government spending as a share of GDP



Source data : Mauro et al (2013)



Government spending and GDP per capita

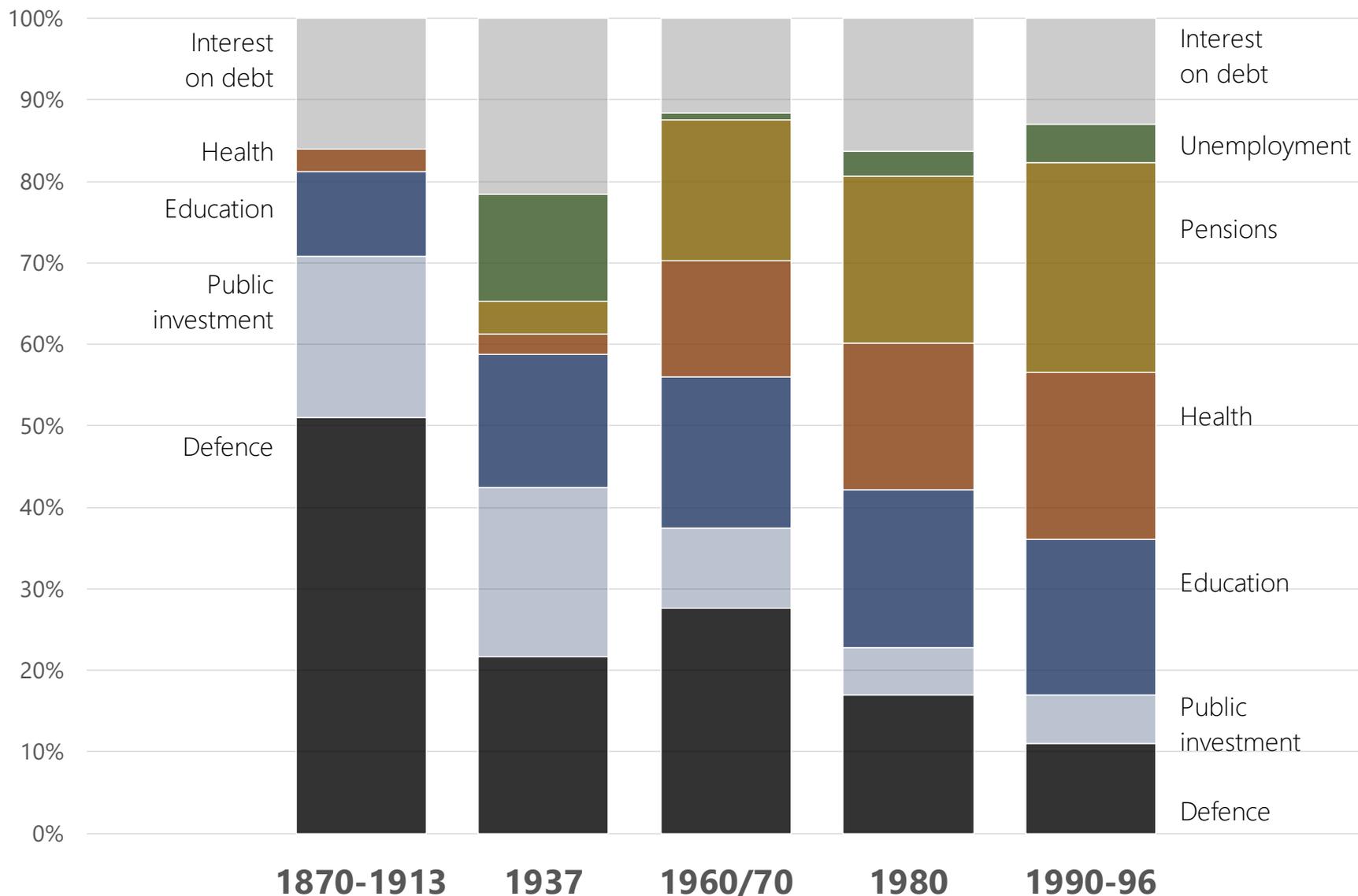
10

	1850	1900	1930	1960	1980	1990	2010
UK	10.3	10.8	18.7	33.1	47.6	41.1	50.6
	2 858	5 608	7 301	12 000	20 593	24 002	35 116
USA	1.6	2.7	3.6	28.3	34.3	37.2	42.5
	2 825	6 252	9 490	18 058	29 613	36 982	49 267
Japan		1.0	2.9	18.4	33.5	30.1	39.8
	910	1 575	2 471	5 185	20 408	26 341	35 477
Sweden	5.1	7.2	8.7	24.4	41.0	38.0	52.9
	1 446	3 438	5 291	11 391	20 491	26 364	42 043
India		7.2	5.5	11.2	17.5	27.2	27.3
		1 131	1 545	1 403	1 143	1 283	4 353
RSA			18.8	16.7	21.8	28.7	33.0
	1 362	1 951	2 942	5 802	8 871	7 866	11 288

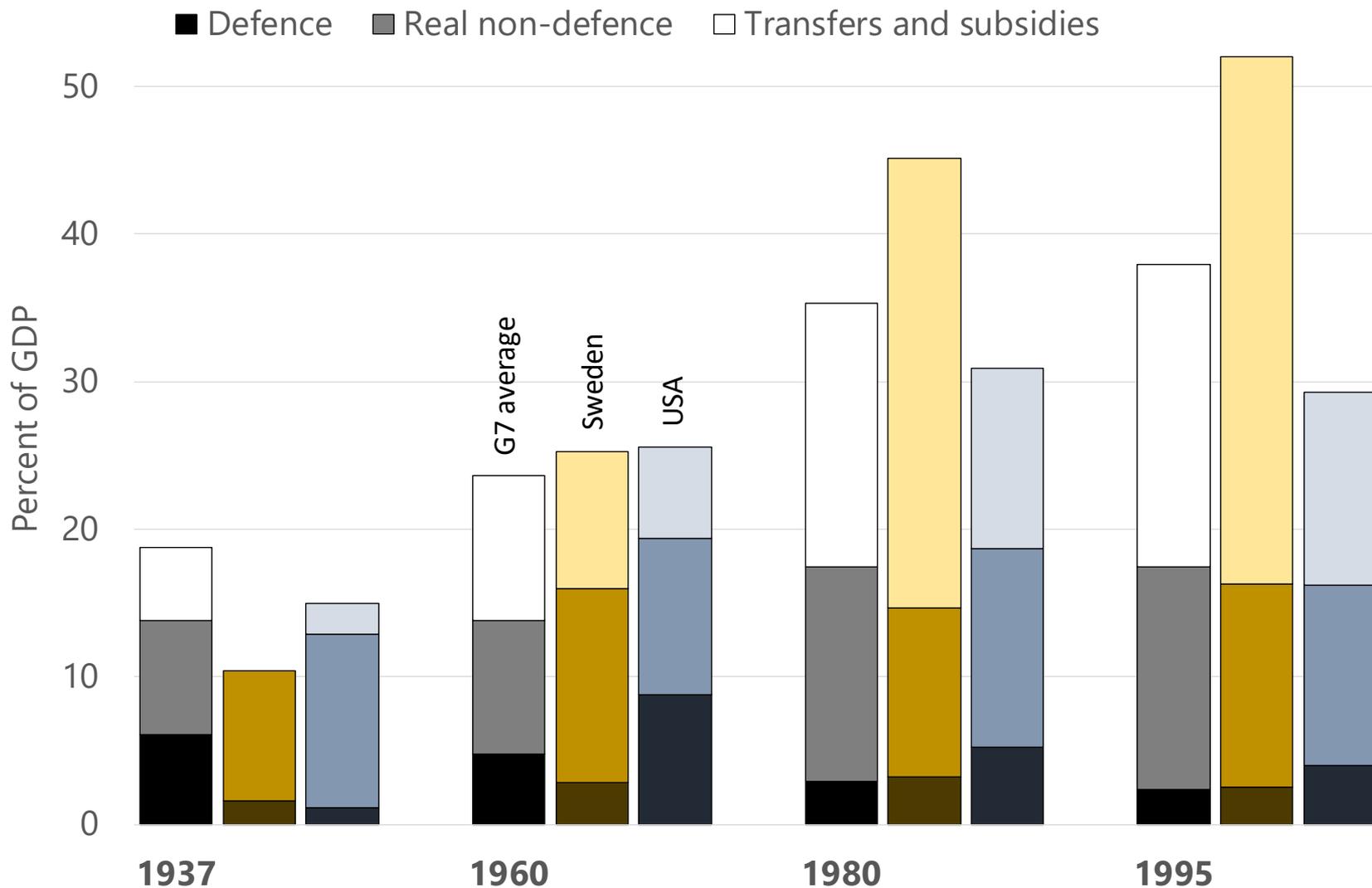
Sources: Government spending as a share of GDP (IMF/Mauro et al 2013), Maddison Project Database, version 2018. Bolt, Jutta, Robert Inklaar, Herman de Jong and Jan Luiten van Zanden (2018), Real GDP per capita in 2011US\$



United Kingdom Composition of spending (% of functions covered)



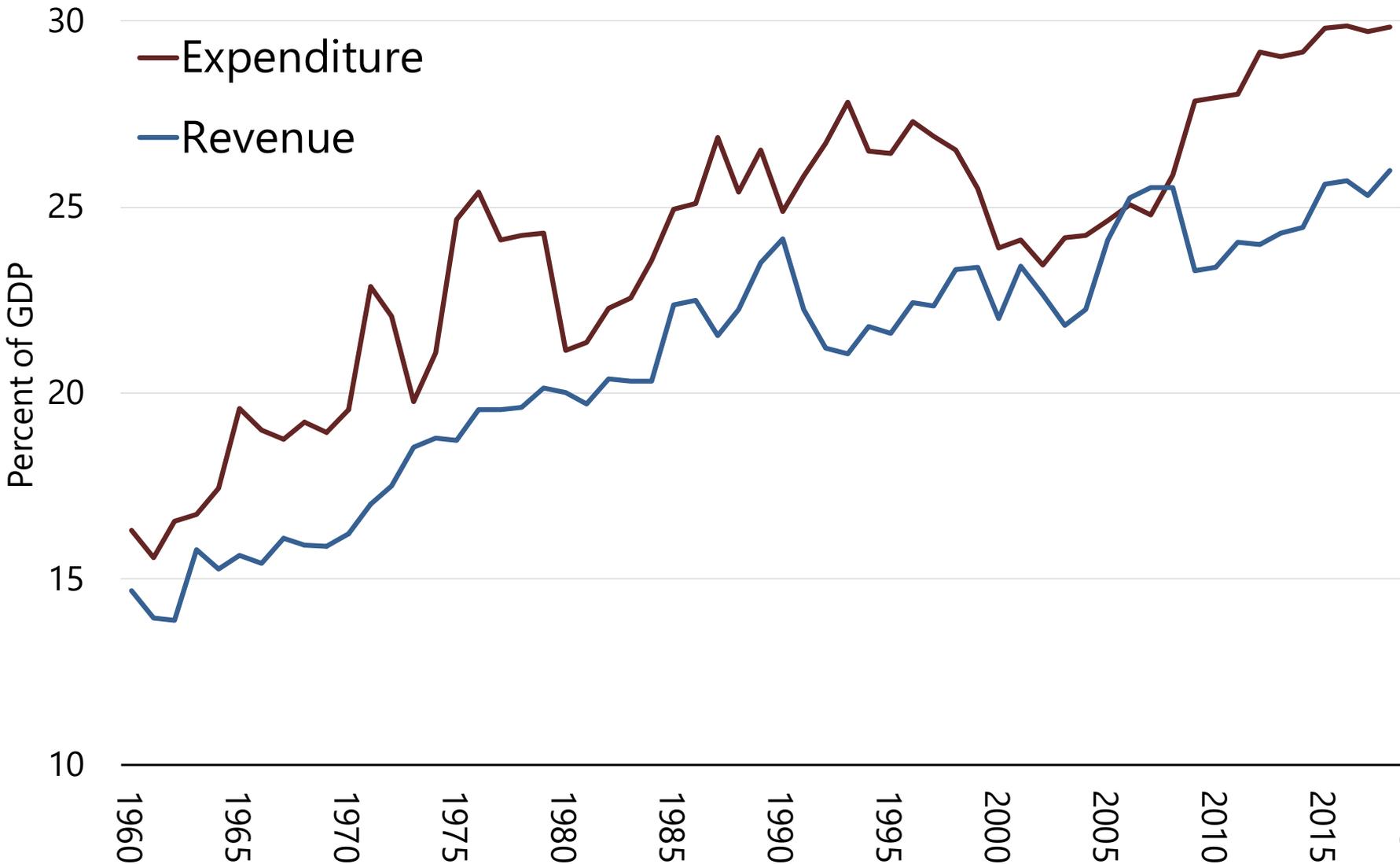
Source data: Tanzi and Schuknecht (2000) Various tables in chapter 2. (NB does not include all expenditure, dates vary by function)



Source data: Tanzi and Schuknecht (2000) Tables II.1, II.3 and II.4.
 NB :There is no data on Sweden's transfers and subsidies in 1937.

A closer look at South Africa

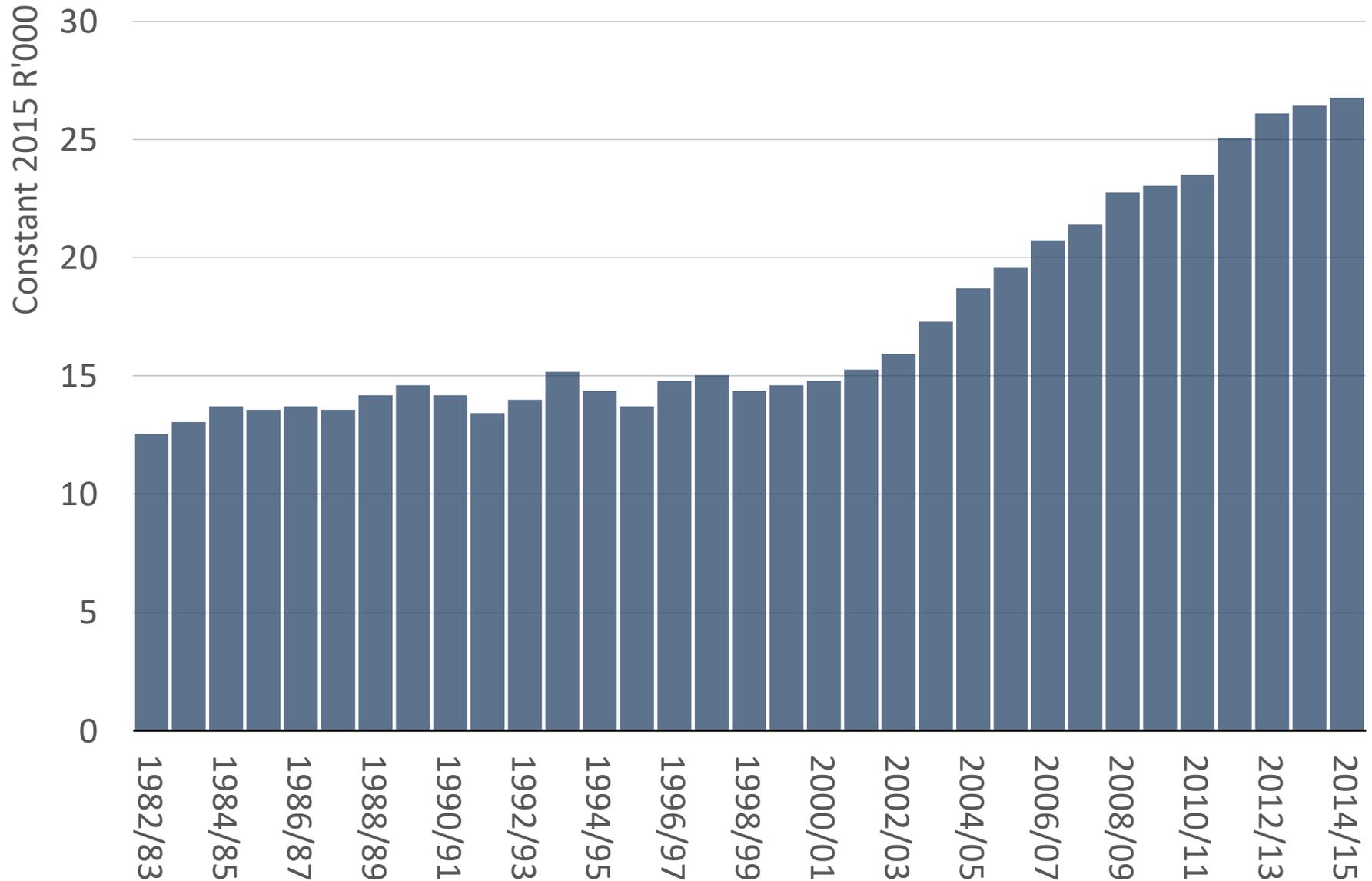
Size of Government: National government revenue and expenditure



Source: SARB



General government spending per capita since 1982



Function	1983/84	1993/94	2005/06	2015/16
Social services	37.8%	43.8%	45.8%	48.2%
Education	17.1%	18.3%	18.4%	18.8%
Health	9.9%	8.9%	9.7%	11.4%
Social protection	6.2%	13.0%	13.8%	13.4%
Housing and community amenities	4.6%	3.5%	4.0%	4.6%
Security	18.6%	14.6%	15.5%	12.8%
Public order and safety	5.7%	8.0%	10.4%	9.9%
Defence	12.9%	6.5%	5.1%	2.9%
Economic affairs	17.3%	12.4%	8.9%	11.2%
General public services	10.3%	14.2%	16.4%	16.1%
Debt service cost	14.3%	13.5%	9.8%	8.5%
Recreation, culture and religion	1.6%	1.5%	2.8%	2.4%
Environmental protection			0.7%	0.8%

What theories explain the growth of government?

1. The most developed economies have the highest government spending as a share of GDP.
2. The rise of government has been general
3. Increase in spending has been on social policy and redistributive transfers
4. Interventions began as classic public goods (defence and public infrastructure)
5. State spending is now dominated by spending to correct inequality and market efficiency failures that relate to information, risk and externalities.
6. Social services are growing as a share of GDP (whether provided publicly or privately)
7. The “neo-liberal” age slowed state expansion, but the size, extent and complexity of state functions continues to grow.
8. Compared to other developing countries, South Africa has a high level of government spending, and this dates back over half a century.

Technical

1. Rising per capita incomes with public expenditure having an income elasticity of greater than unity
2. Redistribution of income, raising the median relative to the mean
3. Decrease in (perceived) tax burden of the median voter, which may result from changes in fiscal structure or increased fiscal illusion;
4. Decrease in relative price of public sector output

Political

5. Increase in population, where rising costs and low degree of "publicness"
6. Extension of the franchise and increased participation of lower income groups
7. Expansion of interest group activity (e.g. formation of trade associations pressing for aid to industry)
8. Changing ideology of political parties, and shifts in the sources of financial support

Bureaucratic

9. The aim of government agencies to expand provision, coupled with incomplete control by the legislature;
10. Increasing cost of administrative hierarchies

Class and interest groups

11. The transfer of power to the working class, and the expansion of redistributive expenditure
12. The need for government intervention to secure the conditions for profitable accumulation of capital

- “Inherent in the technological structure of [economic services] are forces working almost unavoidably for progressive and cumulative increases in the real costs incurred in supply them. As a consequence, efforts to offset these cost increases, while they may succeed temporarily, in the long run are merely palliatives which can have no significant effect on the underlying trends”
- **Sector 1: Constant productivity sector (“non-progressive”)**
 - The labour activity itself is the product – i.e. the quality of the product is judged directly by the rate of labour input per hour
 - Examples: Teaching, live performance, retail, marketing, professional services, municipal government, restaurants, and leisure time activity
 - These activities which by their very nature permit only sporadic increases in labour productivity
- **Sector 2: Rising productivity sector (“progressive”)**
 - Labour is primarily an instrument, an input required in production
 - Example: Manufacturing
 - Innovation, capital accumulation, and economies scale result in rising labour productivity.

- Assume that
 - a) Labour is the only input in production
 - b) Wages are equalised between the two sectors (i.e. labour mobility between the two sectors)
 - c) Money wages rise in line with productivity growth in the progressive sector
 - d) The constant productivity sector produces output that is highly price inelastic, or highly income elastic

- Propositions:
 1. The relative cost per unit of output in sector 1 rises without limit
 2. If demand for the outputs of sector 1 are not highly inelastic, there is a tendency for these outputs to decline and perhaps ultimately vanish
 3. If the ratio of the outputs of the two sectors is held constant the labour force must be progressively transferred to sector 1 and the amount of labour in the other sector will approach zero
 4. An attempt to achieve balanced growth in a world of unbalanced productivity must lead to a declining rate of growth relative to the rate of growth of the labour force

“There are some economic forces so powerful that they constantly break through all barriers erected for their suppression...”

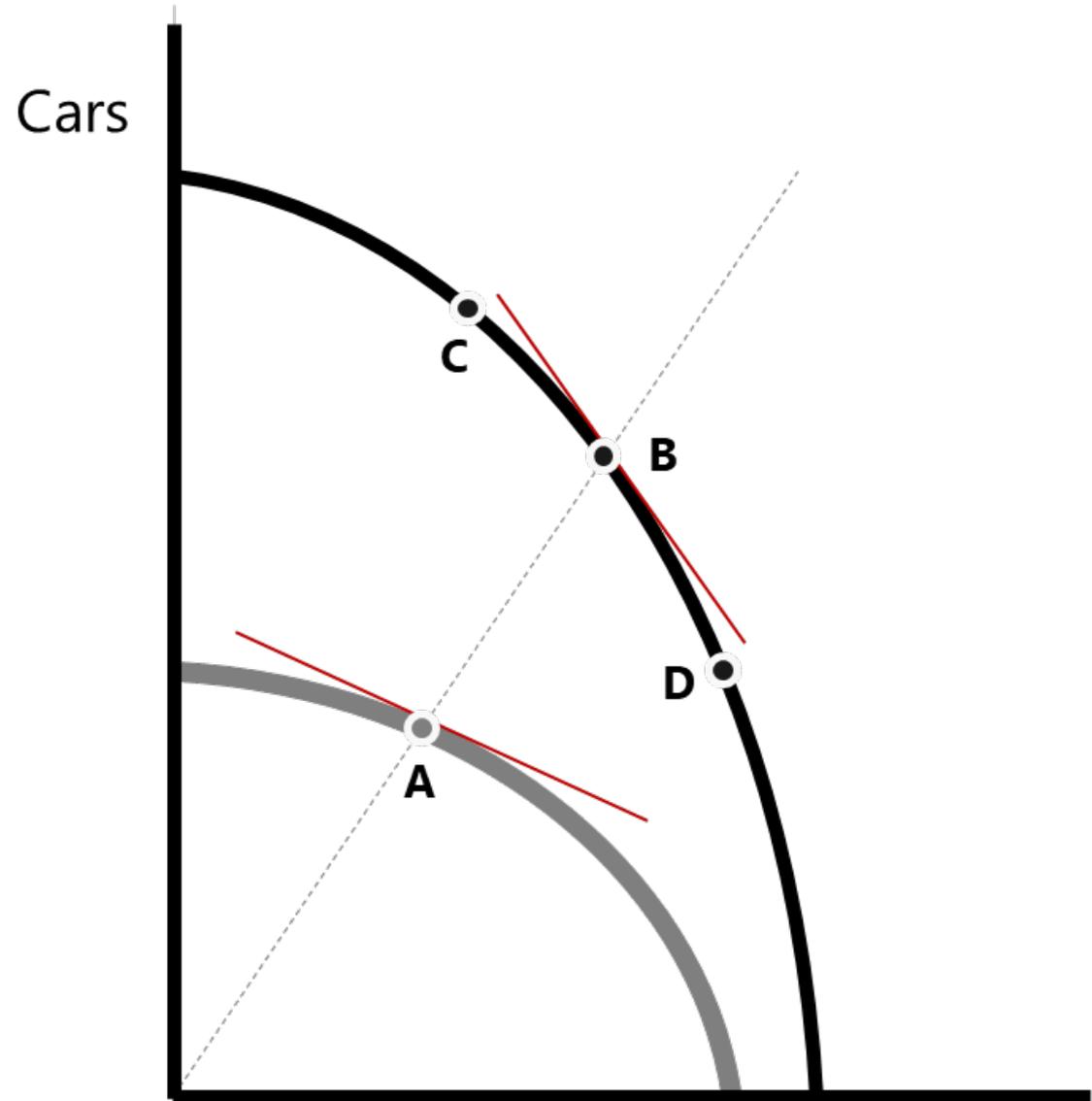
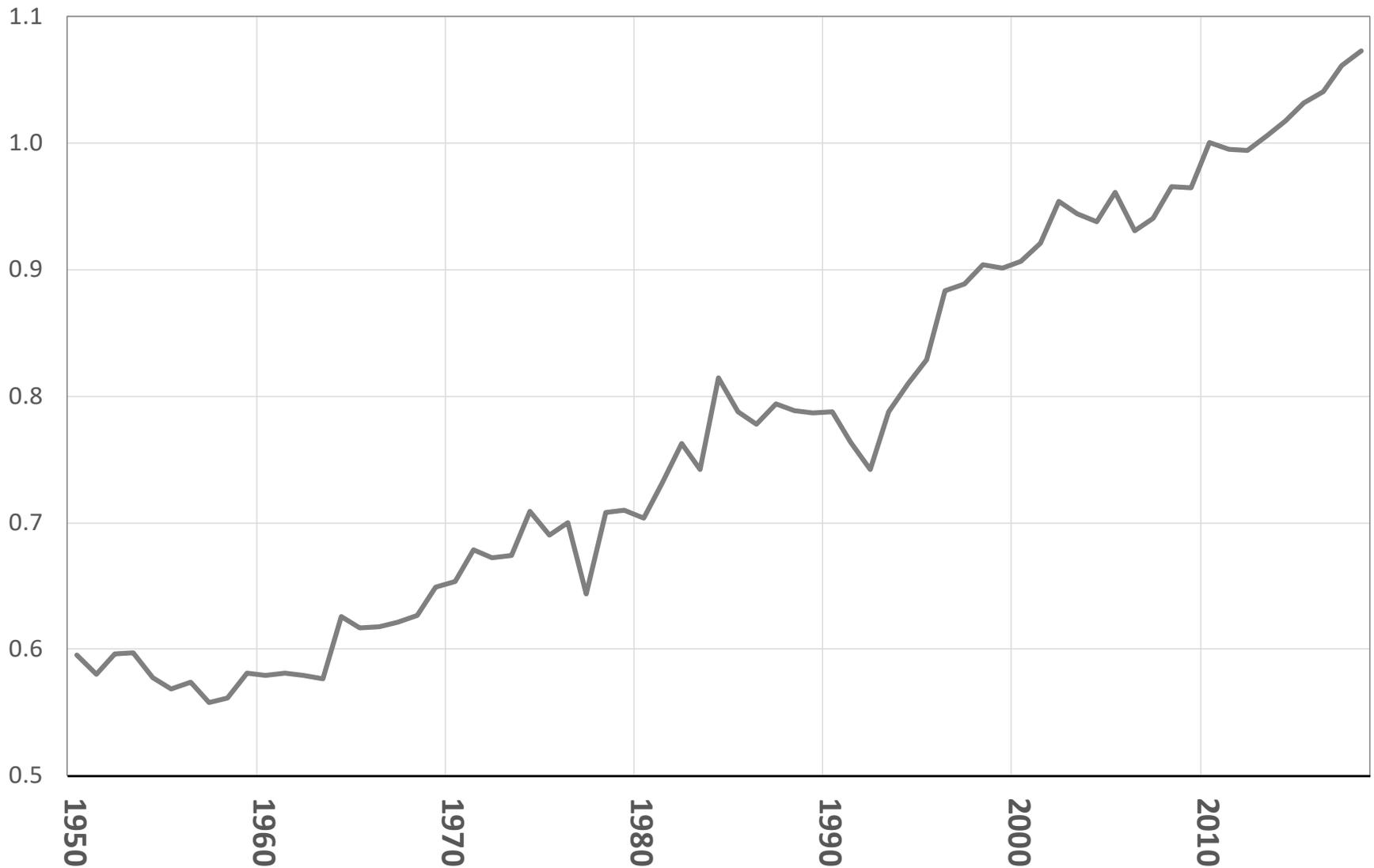


Figure is sourced from Helland, E. and Tabarrok, A. (2019)

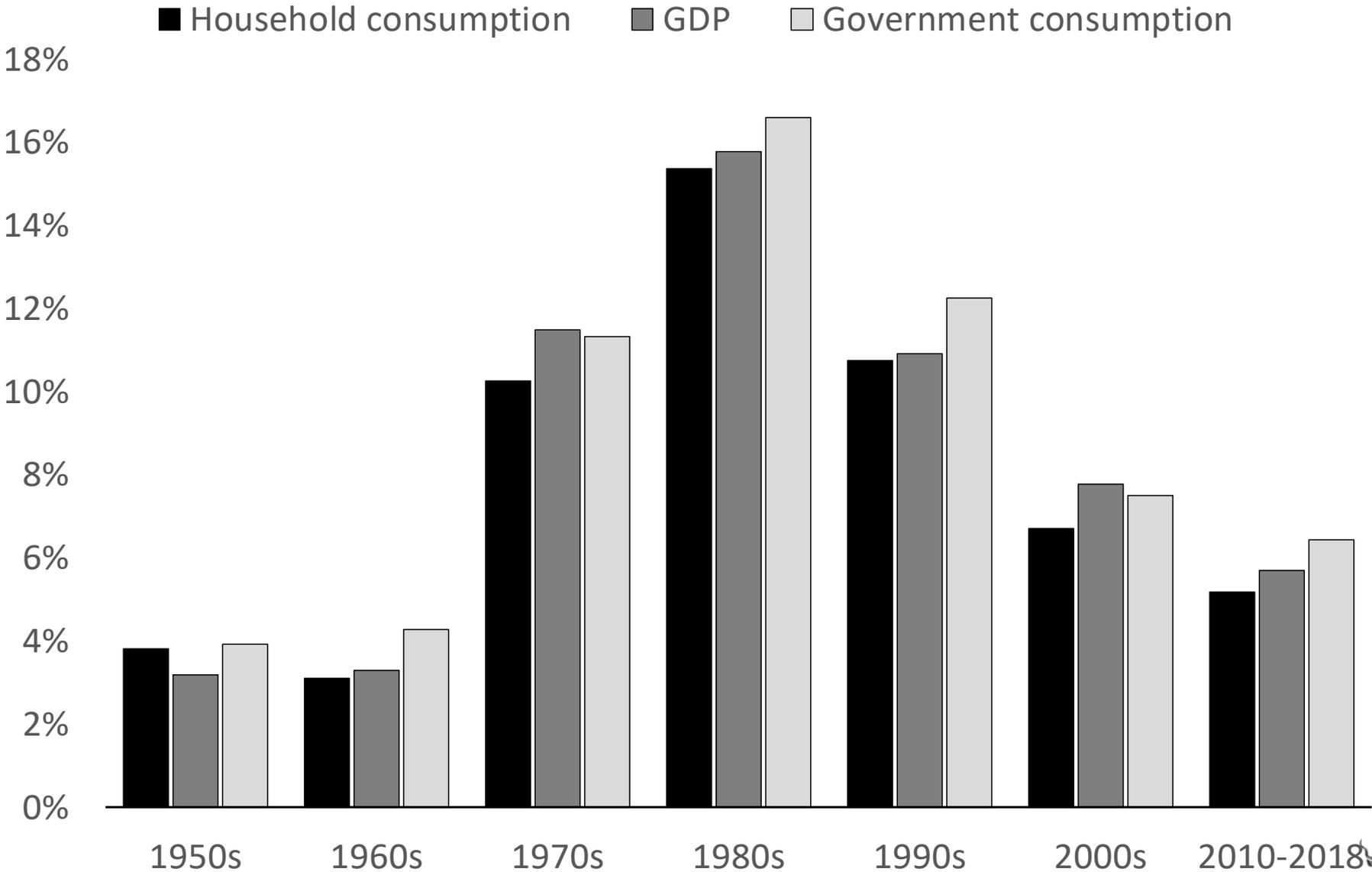
South Africa: Ratio of Public to Household Consumption Deflator



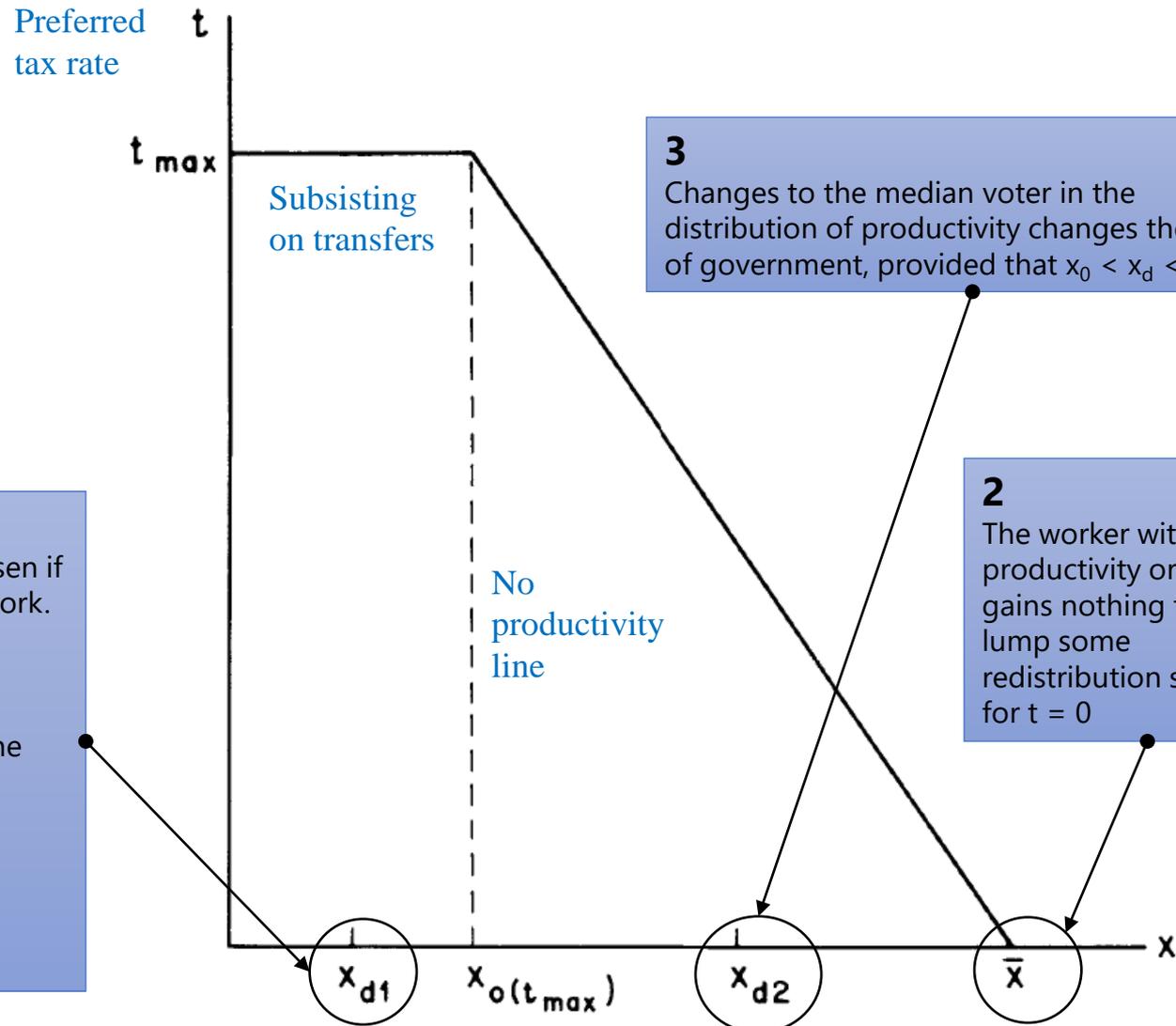
Source data: South African Reserve Bank



Change in deflator: Average for the Decade



- Context
 - The post war rise in redistributive spending
 - Extension of the franchise in the U.S. following the civil rights movement of the 1960s
- Differs from the public choice literature where “taxpayers are portrayed as the prey sought by many predators who conspire to raise taxes relative to income by diffusing costs and concentrating benefits” (i.e. Buchanan, Niskanen and Hayek)
- Instead returns to “the earlier tradition of de Tocqueville (1835) who associated the size of government, measured by taxes and spending, with two factors: the spread of the franchise and the distribution of wealth (property)”
- Income distribution is skewed to the right, so the mean income lies above the median income.
- The median voter is decisive, so extensions of the franchise to include more voters below mean income increases votes for redistribution and, thus, increases this measure of the size of government.
- The problem with this version of the de Tocqueville hypothesis is that ... nothing limits the amount of redistribution or prevents the decisive voter from equalizing incomes.
- In a general equilibrium, higher taxes and redistribution reduce the incentive to work and thereby lower earned income. Once we take account of incentives, there is a limit to the size of government.



1
 The maximum tax rate is chosen if the decisive voter does not work.
 Any tax rate higher than t_{max} reduces aggregate earned income, tax collections and the amount available for redistribution.
 Therefore t_{max} maximizes consumption for the decisive voter

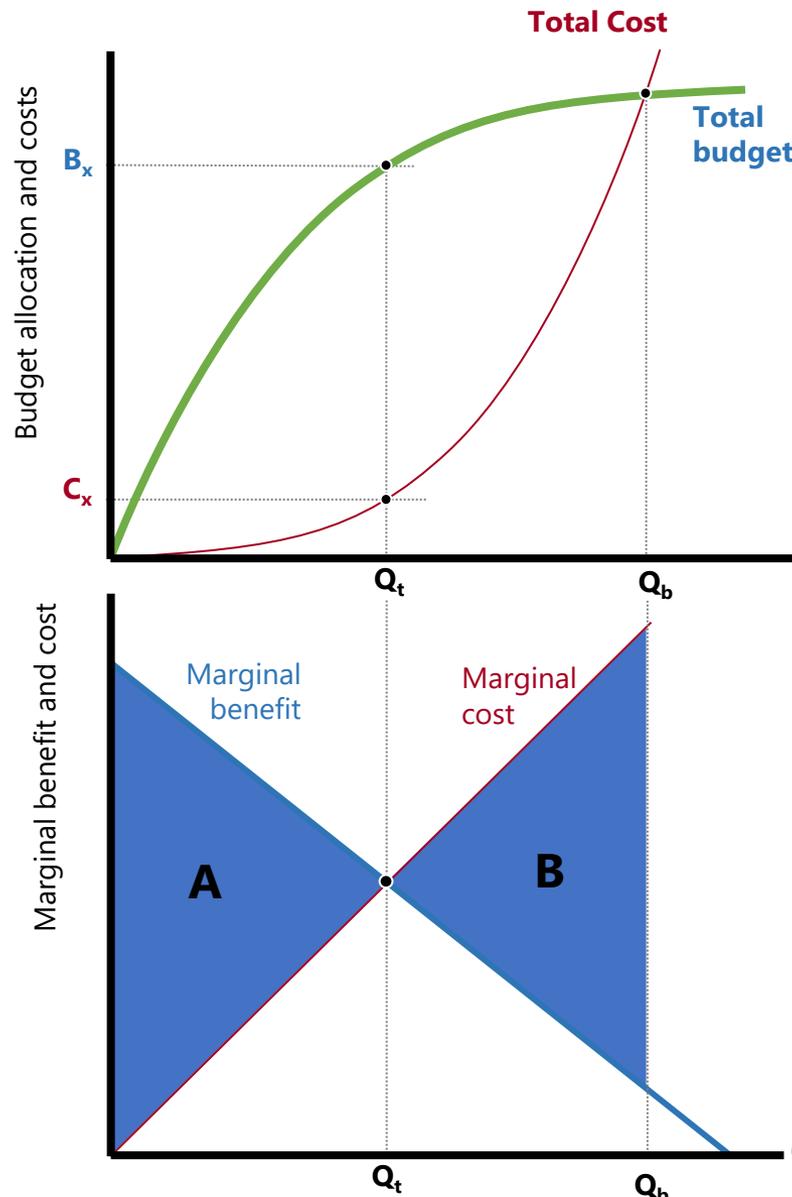
3
 Changes to the median voter in the distribution of productivity changes the size of government, provided that $x_0 < x_d < \bar{x}$

2
 The worker with average productivity or above gains nothing from lump some redistribution so votes for $t = 0$

Productivity ranking \longrightarrow

- Context
 - 1950s and 1960s: Naivety on state effectiveness based on an engineering approach to public policy (PPB/CBA) and idealistic views of state objectives
 - 1970s: rising inflation, global disorder, evidence of government failure and the beginning of conservative resurgence in US politics
- Public choice literature challenges the consensus
- Government also has an objective function, in a context of
 - Monopoly provision with no threat of entry
 - Imperfect measurement of outputs: gauging efficiency is costly
 - Personnel have tenure and so there is not mechanism for translating competition into efficiency gains.

- A theory of the maximizing bureaucrat
- Government is divided into bureaus, who compete for budget funds
- The bureaucrat's utility is a function of salary, prestige, power, reputation and control over patronage resources: proxied by the size of the bureau's budget
- There is a principle-agent problem with asymmetric information:
 - The budget is observable but the true output of the bureau is not – so the total budget is equated with total benefit.
 - Only the bureau-head knows the true costs of provision
- The taxpayer would maximize the budget subject to the cost function, thereby optimizing social benefit.
- The bureaucrat maximizes the budget subject only to the constraint: costs \leq budget.
- The bureaucrat's maximization implies a much higher level of provision than the taxpayer would choose
- This is repeat across a multitude of bureaus, resulting in a government that is much bigger than optimal.



- There has been a remarkable growth in public spending, and this has been a general phenomenon across all industrialized countries, despite considerable institutional differences.
- However the growth in public spending is not caused by inevitable forces that made it imperative
- It is explained by:
 - Changing perceptions, beliefs, views and theories of policy makers and academic economists
 - The extent of institutional restraints on spending, particularly constitutions and the law)
 - Events (such as war and economic depression)
- The dramatic increase in public spending the century up to 1960 clearly improved welfare, but since then the increase in public spending has not been associated with an corresponding improvement in welfare.
- Smaller states and newly industrialised countries show that the same levels of welfare can be attained with lower levels of public spending.
- Determined governments could have resisted the growth of expenditure (since it was not the result of ineluctable forces) and can act now to reduce it.
- Therefore, the future is likely to see a smaller state as views shift closer to realities and the lessons of efficient states are learned.

Era	Ideas	Events, Institutions	State
19th C Smith Ricardo	Dominance of laissez-faire Public goods and the importance of public education	Constitutional restraints on large state	Small government limited to allocation of public goods Law, order, external security Education and infrastructure
Late 19th Early 20th Marx Wagner Schmöller	Redistribution of wealth as a legitimate objective of govt (but continued laissez-faire limits size of govt)	Socialist movements WW1 and ratchet effect	Pensions and social protection for the working class Universal primary education
Interwar Keynes	“The End of Laissez-Faire”	Depression WWII	Expansionary spending (new deal etc) Military build up to WWII
Post-war Musgrave Keynes Gailbraith	Stabilisation (Keynesian consensus) Allocation: Theory of market failure Redistribution: Popularity of socialism Engineering approach to public policy (PPB/CBA) Naïve perceptions of the state effectiveness and romantic view of state objectives	Easing constitutional restraints and acceptance of social rights Democracy, interest groups and bureaucratic elites Rapid urbanisation	Stabilisation (aggregate demand Allocation (health, secondary and tertiary education, social insurance) Redistribution (accounting for the bulk of rising expenditure)
1970/80s Buchanan Friedman	Shortcomings in underlying theoretical models became evident Empirical studies show disincentive effects Positive models of state objectives (public choice theory)	Experience of government failure in stabilisation and efficiency Thatcher, Reagan Central bank independence and fiscal rules	Attempt to slow growth of state, improve efficiency But tyranny of past commitments, influence of interest groups limits progress

Type	Causal mechanisms	E.g.
Developmental	Demography, technology, productivity, geography, urbanisation	
	Rising incomes	Wagner (1895)
	Needs of capital and accumulation	Marx (e.g. Foley, 1978)
	Productivity and prices	Baumol (1967)
	Globalisation	Rodrik (1998)
	Ratchet effects	Wiseman and Peacock (1961)
Demand driven	Citizens-over-state	
	Demand for redistribution	Meltzer and Richard (1980)
	Models of democratic choice/log-rolling	
	Female labour force participation	Cavalcanti and Tavares (2011)
Supply driven	State-against-citizens, predatory elites	
	The stationary bandit	Olsen (1993)
	Government as a revenue maximiser	Buchanan (1977)
	Bureaucracy and excessive government	Niskanen (1974)
	Dominance of distributional coalitions	Olsen (1965)
Zeitgeist	Ideas and ideology	Tanzi and Schuknecht (2000)
	Various critiques of SA govt.	

Conclusions

- It is usually assumed that higher spending must be traded off with economic efficiency and growth.
- But Lindert claims there is a “free-lunch puzzle”
 - Neither simple raw correlations nor a careful weighing of the evidence shows any clear negative affect of redistribution on growth”
 - There is apparently no negative feedback from social programmes to productivity levels or productivity growth.
 - The net national costs of social transfers, and the taxes that finance them, are essentially zero. So nations with higher welfare spending enjoy a free lunch.
- The solution: governments with higher social spending:
 - Use more regressive, less distortionary taxation to finance progressive redistribution
 - Prioritises social investments that complement productivity growth:
 - Are more open economies with lower import barriers and competitive markets
 - Use universalism rather than strict means testing
 - Have high levels of democratic accountability, which limits inefficiency and corruption
 - As budgets growth the consequences of design failure also rise, and welfare-states have invested more heavily in avoiding mistakes.

- The modern capitalist economy is everywhere a “mixed economy”.
- There is little indication that private provision of social policy is more efficient than public provision
- Economic models and econometric testing can offer insights but will never resolve the issue of the size and appropriate role of the state – it is about complex evolution in a society of conflicting interests, not simple causality.
- I like Lindert’s formulation:
 - “The increasing role of social spending in our lives has been linked to three other great social transformations: the transition to fuller democracy, the demographic transition toward fewer births and longer life, and the onset of sustained economic growth.
 - Social spending's share of national product derives its permanence from the likely permanence (we hope) of these three great transformations – that is, of democracy, of human longevity, and of prosperity”
- Today, government’s role in stabilisation, allocation and redistribution has become more significant.
- The future is perhaps slower growth, rising inequality, aging populations, increasing dominance of (social) services in income and pressing fiscal constraints
- Reducing the size of the state is not feasible in South Africa.
- Instead we need to ask how to realize Lindert's free lunch.

