The Growth of Government

Empirics

The government of every developed nation has grown over the last 200 years

(Table taken from page 503 – at back of handout)

Key facts about the growth……

In 1800, the U.S. govt. (all levels) accounted for less than 2% of GNP
1870 – 7.3%
1913 – 7.5%
1920 – 12.1%
1937 – 19.7%
1960 – 27%
1980 – 31.4%
1990 – 32.8%
1996 – 32.4%

Note – these numbers understate actual growth in government
Why? Two effects – regulation and tax distribution

Tax Distribution

What if the government taxes all workers, and then transfers some of the money (say $1,000 to each person with a child under the age of 18? If society has 50 million children, that is an increase of 50 billion dollars to the size of the govt.

What if, instead, each person can deduct $1,000 from their taxes for each child?

Taxes, and how they are levied, have large distributive connotations. Government can "spend money" by never collecting it from favored groups. So Govt. "indirect" transfers can be large

- And often are, precisely because *they don't appear on the books*

See Table 21.3 (page 505) for calculated full transfers….. (at back of handout)

What does this imply about government tax policies?

Compared to the “leviathan” hypothesis

Regulation

Safety belts, Airbags

The cost of cars over time……

Government does not have to always spend money, it can change spending through regulation. Again, how does one count the cost of a car? Government has Grown. Note however, that the growth has slowed dramatically, or in some cases stopped or reversed itself, since 1980.

Explanations for the Growth of Government

An empirical test of
G = Pg + Y + Z

Where
G = government,
Pg = Price of Public Goods
Y = Income
Z = exogenous taste variables.

Z could have gone up for three plausible reasons

The ratchet effect – Wars cause G to rise, afterwards people find they like the higher G now that they have lived with it.

G as Insurance. People view the role of government as insurance, in order to protect from risk. They want G to rise to protect them from variance in Y

Population Density. As population density increases, demand for G rises

Y, Income effects

Possibly, G is a superior good. In that case, as Income goes up, people will demand more G relative to other goods.

- Empirically, this seems to have some justification…
  - Environmentalism seems very highly correlated with Y
    - Both across countries, and within countries
    - Why this is so is still debated….
      - Environmentalism and rent seeking….
        - Archer Daniels Midland
        - EU and Frankenfoods
- Other issues, however, dispute that G as a whole is a superior good
  - State level data from Federal systems
    - U.S. state governments have grown little since 1900

Note we may have a specification error – if urbanization leads to and increase in Y, than what causes demand for G to rise, a taste for urbanization, or rising income?

Pg, Price effects

If demand for govt. goods is elastic, and Pg has fallen relative to Pp, (Price private goods), then we may switch towards purchasing government goods if the substitution effect is high enough. Very few economists really believe this (the govt. has become more efficient relative to the rest of society?).

The Baumol Effect. Technology improves efficiency in the industrial sector. But most of what government provides is services, where productivity growth has been much less. So the relative price of "government goods" has increased. If the demand for government is inelastic, then we would expect to spend more on it to get the same level of goods….

Empirically, a great deal of work has been done on the Baumol effect.
Government productivity growth lags that of private industry
It also lags that of private service providers
(Buchanen – is this a cause of government growth, or a problem with it)
But this lag probably doesn't explain everything….
Public sector wages have increased relative to private sector wages
The monopolist arguments – if wages are going up (for no reason)
Could not productivity be going down for the same reason?

Can we assume that the rising cost of expanded government is due to exogenous reasons?
Couldn't the rising per unit cost of government be because government is larger?

Most economists who study the issue think the Baumol effect exists, but that it does not account for all of the growth of government.

The Baumol effect does not seem capable of explaining transfers……..

The Growth of Government II

A Differing ways to look at things……

Two conceptual frameworks – the individual over the state, or the state over the individual….

1) The government provides public goods and eliminates externalities
2) The government transfers wealth
3) The government responds to interest groups

Vs

4) The bureaucracy expands the government by offering lump sum goods
5) The government expands spending at the behest of politicians (fisc. Illusion)
6) The government expands spending based on the elasticity of taxes…

Government has expanded because we want it too….

1) The government provides public goods and eliminates externalities

In this view, the government is benign, or helpful. Thus, if government has expanded, it is a good thing, since governments do good things. So either the cost of doing good things has risen (a change in relative price), tastes have changed, or the demand for government is a superior good.

Pros – Many people believe (or want to believe) it
Government does do most public goods
The tragedy of the commons exists, (environment, externalities)
Urbanization implies truth to this as well….
Cons – public good provision still creates redistribution
The costs of government have risen, not output…
People don't all say they want more public goods…
And much of what govt. does has nothing to do with public goods..

2) The government transfers wealth

In this view, the government is about wealth redistribution. As society grows, it redistributes more and more wealth. This could be for the insurance reasons already explained. But it could be for other reasons as well. Empirically, democratic government was quite regressive for much of history. So why has the franchise expanded?

Pros -- Governments do much wealth transfer today (entitlements in the U.S.)

Many people believe it should,

Cons -- While government may do transfers, the question of why comes up

Why has demand for transfers increased?

How did the franchise get expanded?

Does the government as insurance model really make sense?

3) The government responds to interest groups.

This is the rent seeking view of government. Note that in this view, the government is still responding in part to voters. Example: Tullock and roads … under majority rule, government will expand beyond what it would reach under unanimity, or dictatorship.

(review Tullock road example)

Note, the Tullock example does not explain why the transfers are done inefficiently…

Also, countervailing interest groups exist, why has govt grown? (example: environmentalists)

Pros – Governments do seem responsive to interest groups

The Olsen model of interest group formation….

Cons – This seems a hard thing to measure.

Models based on Illusion………

4) The bureaucracy expands by offering lumps of goods

This is the Niskannen model. Bureaucracies can fool people. Niskannen's base model is static, but it can be made dynamic. As the bureaucracy expands, it becomes larger, and less transparent. Thus, it becomes easier to fool people…

Pros – The bureaucracy has expanded (but see below)

The complexity of tasks has increased, in many cases greatly

Many bureaucracies do seem to oversupply goods

All bureaucracies seek to act as monopolists…

Cons – has the bureaucracy actually expanded?

Measured by outputs, inputs, people, or funding….

If outputs have declined, could it be due to the complexity of tasks?

If demand for G rises, wouldn't the law of d. returns kick in cetera parabis?

5) Fiscal illusion – the politicians did it

Government grows because it can successfully hide taxes. Rationally ignorant voters can be systematically tricked into paying higher taxes. Things that make this so include

- The complexity of the tax system
- Renters vs. owners of property
- Built in progressivity of the tax system (non-legislated)
- The difficulties of future evaluation of tax burdens (ricardian equivalence)
- The flypaper effect (skip for now)

This assumes that voters can be tricked in various ways to pay taxes. The weak version suggests it occurs for a while, a strong version says they can be tricked continuously.

This explains growth after WW II, and to a lesser extant tax revolts in the U.S. and Europe… (but see ratchet effect)

Pros – uses standard economic assumptions (information asymmetries)

Seems to explain how the tax system has actually been created

Cons – tax revolts suggest it is only partially correct

How ignorant of taxes are people actually?

Causality, if people can't trace the taxes, couldn't that be rent seeking?

6) Tax Elasticity – technology did it

This model is similar to 5, but it assumes that NOBODY can stop the government from taxing. So in the past, SOMETHING did. What? An inability to tax efficiently. See Douglass North, the "new institutional economics school".