

## HOW MUCH SHOULD THE GOVERNMENT SPEND?

Review of *Public Spending in the 20th Century*, by V. Tanzi and L. Schuknecht (2000), and *Efficiency, Equality and Public Policy with a Case for Higher Public Spending*, by Y.-K. Ng (2000).

The central public finance question facing any country is the appropriate size of its government. (Feldstein, 1997).

The last decade has witnessed increased questioning of government spending in many OECD countries. Economists and politicians who have advocated rolling back the welfare state have claimed that the size of spending programs is responsible for the decline in economic performance registered in many of these countries. Indeed, if one looks at actual and trend GDP growth rate as an example of performance, the 1990s have been characterized by a slow-down as compared with the previous decade in the majority of these countries.<sup>1</sup> However, is government spending the villain or the hero in this story?

To better understand the attack it might be useful to summarily review the analytical background of the debate on the role and the dimension of the public sector.

At the core of much neo-classical reasoning are the two fundamental theorems of welfare economics: under certain assumptions, an allocation of resources resulting from a competitive equilibrium is Pareto optimal since no agent can be made better off without someone being made worse off (first welfare theorem) and any Pareto optimum state can be sustained as a competitive equilibrium (second welfare theorem). When the assumptions are met there is no need for government intervention and the public sector is required only to provide the institutional and legal framework under which markets operate or redistribute income in a non-distortionary way. When the assumptions are not met the market fails and public intervention can yield Pareto improvements.

Market failures<sup>2</sup> can occur if: (1) the preferences of the households or the production technologies of the firms are non-convex, implying that the optimal choices are not unique<sup>3</sup>; (2) some economic agents are not price-takers; (3) externalities exist because of a lack of property rights or because there is jointness in production and/or consumption (including public goods); or (4) full information is not available to all agents, implying that some insurance markets may fail to exist. Moreover, the Pareto criterion is not itself free from criticism: it does not

*Note:* I would like to thank Lars Osberg for very helpful comments.

<sup>1</sup>For growth performance in OECD countries, see, among others, Scarpetta *et al.* (2000).

<sup>2</sup>For a clear discussion of the reported market failures see, among others, Boadway and Bruce (1984).

<sup>3</sup>Hence, there may exist some states that are Pareto optimal but cannot be achieved by a decentralized market process.

incorporate any concept of justice, and hence is compatible with any distribution of resources; there can exist an infinite set of Pareto optimal states and, at the same time, not all states can be ranked according to it.

Since market failures are more the norm than the exception in modern societies,<sup>4</sup> the question is then the following: “can we find a government which respects individual preferences for collective activities, is administratively efficient, and finally, capable of finding economically efficient allocation of social resources?” (Inman, 1987).

The two books of this review article, Tanzi and Schuknecht (henceforth TS) and Ng, enter onto the debate at this point. Ng is a more traditional public economics book that starts from the position that there is an agent, the government, that has as its objective to maximize the social welfare function, i.e. a mechanism able to aggregate individual preferences in order to determine the social ordering on attainable states, in the presence of market failures. Ng is concerned with the ultimate ethical foundation of public policy—that is, what public policy should ultimately aim at. While he discusses the problem of public spending, he is mainly concerned with more general and fundamental issues rather than specific items and complications of implementation and political feasibility. TS, on the other hand, deal primarily with the issue of the extent of public spending.

The two books are complementary. They overlap on the effort to determine the appropriate size of public spending, being in agreement that GDP alone is not a good guide to public policy, but they arrive at opposite conclusions on this issue. On the one hand, TS claim that it is possible to decrease public spending without much cost, or even with gains, in economic and social well-being. On the other hand Ng, even considering efficiency alone, argues that public spending has to increase since higher public spending is likely to be more welfare improving than private spending. Ng, unlike TS, includes a theoretical section of the foundation of public economics. TS, however, provide a unique source of data on public expenditure and indicators of economic performance.

Real world policy decisions in economics require the economist to go beyond Pareto optimality. If a decision on economic policy is to be taken on welfare grounds, it is necessary that interpersonal comparisons of utility must be made since there are, in practice, virtually no public policy decisions which do not generate some losses for some people. According to Ng, interpersonal comparison of cardinal utility is necessary for making social choice. There is, though, a long tradition in economics of regarding interpersonal cardinal utilities as impossible or meaningless and scientifically inadmissible. As Wicksteed (1933) and Robbins (1938) put it, each mind is inscrutable to any other mind, implying that interpersonal comparisons of utility are value judgments without any scientific status. Ng has argued elsewhere that interpersonal comparisons of utility are not value judgments but subjective judgments of facts and that economists are able to make those judgments of facts in areas closely related to their field of study (Ng, 1972).

<sup>4</sup>Future markets in commodities are rare and short term, returns to scale dominate large sectors, public goods and externalities are extremely common, merger mania rules the high technology sector, just to mention a few.

Ng claims that individual utilities are not only cardinal and interpersonally comparable but there are also practical ways to measure and compare utilities. He proposes to use: (1) the individual willingness to pay to obtain information on intensities of preferences; (2) the unweighted aggregate willingness to pay in making social choice; and (3) the appropriate redistribution of total purchasing power to address the issue of equity. In this way, cardinal utility and interpersonal comparisons are needed only for the decision on the appropriate redistribution of total purchasing power.

Using the unweighted willingness to pay as a measure of the preference intensity of any individual can be called, for brevity, the “a dollar is a dollar” principle. It treats a dollar of the rich in the same way as a dollar of the poor in order to lower disincentive effects because preferential treatment in government expenditure is an inefficient tool to achieve both equality and efficiency. Willingness to pay is, hence, unweighted while making social choice. Any desired degree of redistribution should be then achieved only through the tax/transfers system without adding any specific equality oriented measures, such as subsidizing goods consumed disproportionately by the poor or using distributional weights in cost-benefit analysis. However, subsidizing education and health care is still efficient since external effects are involved. In the same way, it is efficient to publicly provide pension schemes since many people tend to take inadequate care for the future or have excessive discount rates (Ng, 1992).

The principle “a dollar is a dollar” is not in itself in favor of more or less equality. Rather, for any degree of equality aimed at, it is more efficient, in the sense of Pareto, to achieve it by adopting the principle of a dollar is a dollar and using the appropriate degree of progressivity in the tax/transfer system.<sup>5</sup>

Ng’s proposal leaves the pursuit of equality to the general tax/transfer system, and means that cardinal utility and interpersonal comparisons are not needed except in determining the optimal tradeoff between efficiency and equality in the general tax/transfer system. He concludes that “the objective of new welfare economics in doing away with cardinal utility and interpersonal comparison may be said to be largely (but not completely) met.” Only on specific decisions where the individual’s willingness to pay cannot be used as a good reflection of welfare due to serious ignorance, irrationality or externalities, does one need to resort to interpersonal comparison of cardinal utility.

The adoption of the efficiency principle of a dollar is a dollar takes Ng to the conclusion that public spending is much lower than optimal. The argument is based on the fact that both environmental quality and research are global public goods that are under-funded by national governments and too long term for the horizons of current decision takers. In rich countries, what is important is not simply growth in GNP and the resulting higher consumption per head but how welfare-improving measures (environmental protection, scientific advances,

<sup>5</sup>Formally, for any alternative (designated A) using a system (designated a) of purely equality-oriented preferential treatment between the rich and the poor, there exists another alternative, B, which does not use preferential treatment, that makes no one worse off, achieves the same degree of equality (of real income, or utility) and raises more government revenue, which would be used to make everyone better off. Under alternative B, a more (than alternative A) progressive tax/transfer system (designated b) may have to be used.

etc.) can be increased. A pure increase in national product may be welfare-reducing since further increase in private consumption fails to increase happiness in affluent countries.

Easterly (1997), indeed, finds that world growth is more important than home country growth for many quality of life indicators. Quality of life is, hence, not influenced by a nation's economic growth—rather it depends more on scientific and technological advances at the world level. The latter is financed more by public spending than private consumption (Stiglitz, 1999 as reported by Ng). Thus, Ng argues that despite the costs (excess burden, administrative, compliance and policing costs) of raising public revenue, more public expenditures in the areas previously highlighted may be the most welfare improving policies.

Ng therefore concludes that “happiness could be increased by shifting resources from the largely competitive private consumption to items of public spending that benefit the whole world for a long time.”

However, TS reach opposite conclusions regarding public spending. The authors first document the growth of public spending in the industrialized countries for the period between 1870 and the present. Public spending did not increase at a constant rate over the years analyzed: between 1913 and 1960 the growth was still moderate while it boomed afterwards. This unprecedented growth was, according to the authors, caused by a change in the attitude toward the role of the government. During the 1950s, many started to think that government should provide protection against the risks of getting old, sick, becoming disabled or unemployed, or remaining illiterate since the government itself was perceived as being more efficient than the market in offering these goods and services. Furthermore, the United Nations Universal Declaration of Human Rights, ratified by Member states,<sup>6</sup> assigned governments the responsibility to protect the full range of human rights required for people to have a full, free, safe, secure and healthy life, implying that the basic necessities of life—work, food, housing, health care, education and culture—needed to be adequately and equitably available to everyone.

TS attempt to establish if there existed over time a relationship between higher public spending and higher social welfare. They assume that social welfare depends, positively, on the values of various socioeconomic indicators and changes in these indicators are taken as proxies for changes in social welfare.<sup>7</sup> TS provide evidence on both economic indicators (such as growth and per-capita income, unemployment, inflation, interest on public debt, savings) and social indicators (such as health, education, income distribution) and conclude that by 1960 these indicators had improved considerably—which is at least consistent with the claim that the increase in public spending was responsible for the reported improvement. In contrast, they argue that after 1960 progress in improving social and economic objectives slowed down considerably or even reversed in spite of a continuous large expansion in public spending in many countries. Hence, they

<sup>6</sup>Hence, states assumed obligations in international law to ensure the attainment of social and economic rights.

<sup>7</sup>TS approach is, hence, more macroeconomic than Ng since socioeconomic indicators can be thought of as an aggregate measure of individual happiness.

claim that growth in public spending after 1960 was less socially and economically productive than before.

In my opinion, the indicators used to evaluate the effects that public spending had on social welfare are not always appropriate and, actually, their usage could be misleading. As an example of this point, let's consider the pension system. This welfare state program was introduced to combat risks associated with old age—in particular, the risk of poverty in old age. If we look at its target there is clear evidence that in many countries it has been successful. Can we judge that success by looking at unemployment, interest and growth rates, per capita income, the literacy rate, or income distribution indicators estimated for the whole population?

Furthermore, the evidence provided for the causation from government spending to the economic and social indicators is not particularly convincing. There is no clear empirical evidence for a negative influence of government tax and expenditures on economic prosperity and growth. Many studies have indeed demonstrated that the finding of a negative association is not robust to reasonable alternative formulations (for a clear discussion and references see Slemrod, 1995). Studies that deal specifically with expenditure related to the welfare state, also do not provide any conclusive evidence on the relationship between the size of the welfare state and economic performance (for a comprehensive survey see Atkinson, 1999). There is also no evidence for a negative influence of government expenditure in developed countries on individual happiness, measured by social indicators.

The reform of public spending suggested by TS could be summarized by saying that what countries should aim at is a residual welfare state rather than an institutional one.<sup>8</sup> Looking at the traditional role of the state as identified by Musgrave (1959), TS argue that: (1) the allocative role of government could and should be much smaller than it has been in most countries (in their view, most public enterprises and provision of many services and even infrastructures can in principle be privatized); and (2) the redistributive role of government should be reduced.<sup>9</sup> TS believe that the risks associated with old age and illness could be handled by the private sector for much of the population. In their scenario, public budgetary resources would be used only to secure minimum standards and basic social services for those without the means to buy private insurance. Thus, the reduction in public spending and consequently in the level of taxation would leave more resources in private hands to use in ways that more directly improve individual welfare. The government should be limited to regulating and supervising the working of the market.<sup>10</sup>

<sup>8</sup>The difference between a residual and an institutional welfare state is contained in Barr (1998). A residual welfare state accords welfare a role only when market or family structure break down.

<sup>9</sup>Government can redistribute income not only by increasing expenditures but also by lowering taxes. Economically equivalent programs may, indeed, represent different levels of government involvement if the latter is measured only by public expenditures. For an example of this point, both France and the United States have policies to support families with dependent children, but while in France families receive a direct payment, in the United States families are granted a deduction from taxable income.

<sup>10</sup>Public opinion polls do not seem to find popular support for this position. Boeri *et al.* (2000), for example, have shown that the majority of citizens from France, Germany, Italy and Spain do not want to change the status quo size of pension and unemployment benefits, even in the light of high current taxes and contributions.

Is a residual welfare state desirable? Will the market be able to deliver on the promises of TS if the government simply regulates and supervises its working? Should public spending decrease or increase? Considering only efficiency TS and Ng reach opposite conclusions. Taking into account also equity, Atkinson (1999) has noted: “Social, demographic, and labor market changes may have called into question the economic feasibility of the welfare state. At the same time, to reduce welfare state spending by amounts like 2% of GDP could have major implications for family living standards. The effectiveness of the welfare state in achieving its redistributive objectives is certainly open to criticism but there can be little doubt about its importance in providing income support. There are major equity gains. Put bluntly, the rolling back of benefit coverage or reductions in benefit levels could hit hard some of the most disadvantaged members of our societies. Rolling back is not therefore to be undertaken lightly.”

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