

# POLITICAL ECONOMY





NEW

SZÉCHENYI PLAN

# POLITICAL ECONOMY

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Course Material Developed by Department of Economics,

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# POLITICAL ECONOMY

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# POLITICAL ECONOMY

Week 13

Applications.

The size of government and economic performance

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# The U.S. government has grown

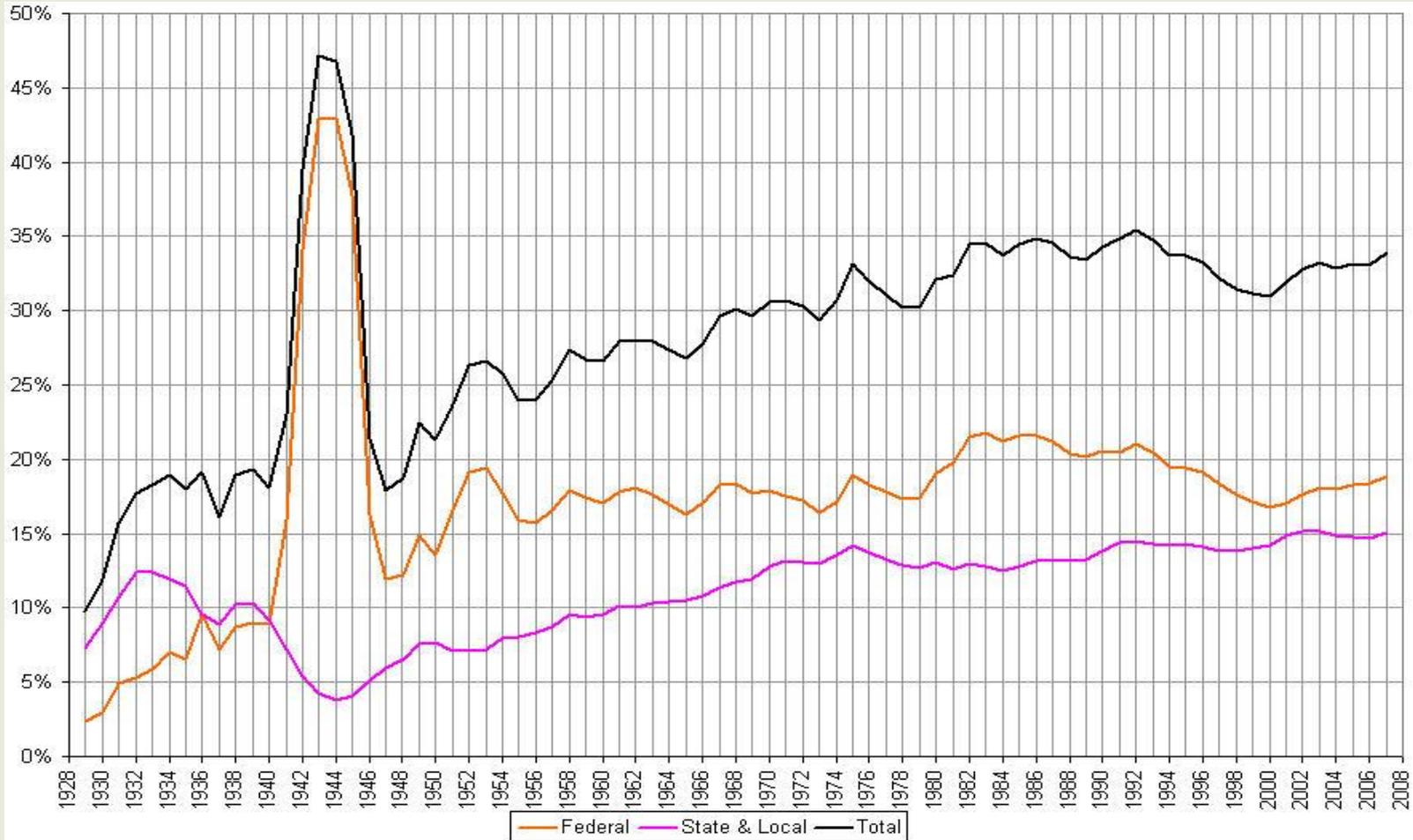


Table 3.2 from the BEA's National Income & Product Account tables

# Government has grown everywhere

Table 21.2. *Growth of general government expenditure, 1870–1996 (percent of GDP)*

	About 1870	Pre– Post– World War I		Pre– Post– World War II				
		1913	1920	1937	1960	1980	1990	1996
<b>General government for all years</b>								
Australia	18.3	16.5	19.3	14.8	21.2	34.1	34.9	35.9
Austria	10.5	17.0	14.7	20.6	35.7	48.1	38.6	51.6
Canada	–	–	16.7	25.0	28.6	38.8	46.0	44.7
France	12.6	17.0	27.6	29.0	34.6	46.1	49.8	55.0
Germany	10.0	14.8	25.0	34.1	32.4	47.9	45.1	49.1
Italy	13.7	17.1	30.1	31.1	30.1	42.1	53.4	52.7
Ireland	–	–	18.8	25.5	28.0	48.9	41.2	42.0
Japan	8.8	8.3	14.8	25.4	17.5	32.0	31.3	35.9
New Zealand	–	–	24.6	25.3	26.9	38.1	41.3	34.7
Norway	5.9	9.3	16.0	11.8	29.9	43.8	54.9	49.2
Sweden	5.7	10.4	10.9	16.5	31.0	60.1	59.1	64.2
Switzerland	16.5	14.0	17.0	24.1	17.2	32.8	33.5	39.4
United Kingdom	9.4	12.7	26.2	30.0	32.2	43.0	39.9	43.0
United States	7.3	7.5	12.1	19.7	27.0	31.4	32.8	32.4
<i>Average</i>	10.8	13.1	19.6	23.8	28.0	41.9	43.0	45.0
<b>Central government for 1870–1937, general government thereafter</b>								
Belgium	–	13.8	22.1	21.8	30.3	57.8	54.3	52.9
Netherlands	9.1	9.0	13.5	19.0	33.7	55.8	54.1	49.3
Spain	–	11.0	8.3	13.2	18.8	32.2	42.0	43.7
<i>Average</i>	9.1	11.3	14.6	18.0	27.6	48.6	50.1	48.6
<b>Total average</b>	<b>10.7</b>	<b>12.7</b>	<b>18.7</b>	<b>22.8</b>	<b>27.9</b>	<b>43.1</b>	<b>44.8</b>	<b>45.6</b>

Source: Tanzi and Schuknecht (2000, Table 1.1).

# Why?

- What caused the increase in the relative size of government over the past two centuries?
- What caused the growth of government to accelerate after World War II?
- What has caused the size of government, as measured by its full fiscal impact, to stop growing and in some cases to decline in the last few years?
- What explains the large disparities in the sizes of the government sectors across countries?
- Methodological caveat: one big consequence need not be caused by one big cause!

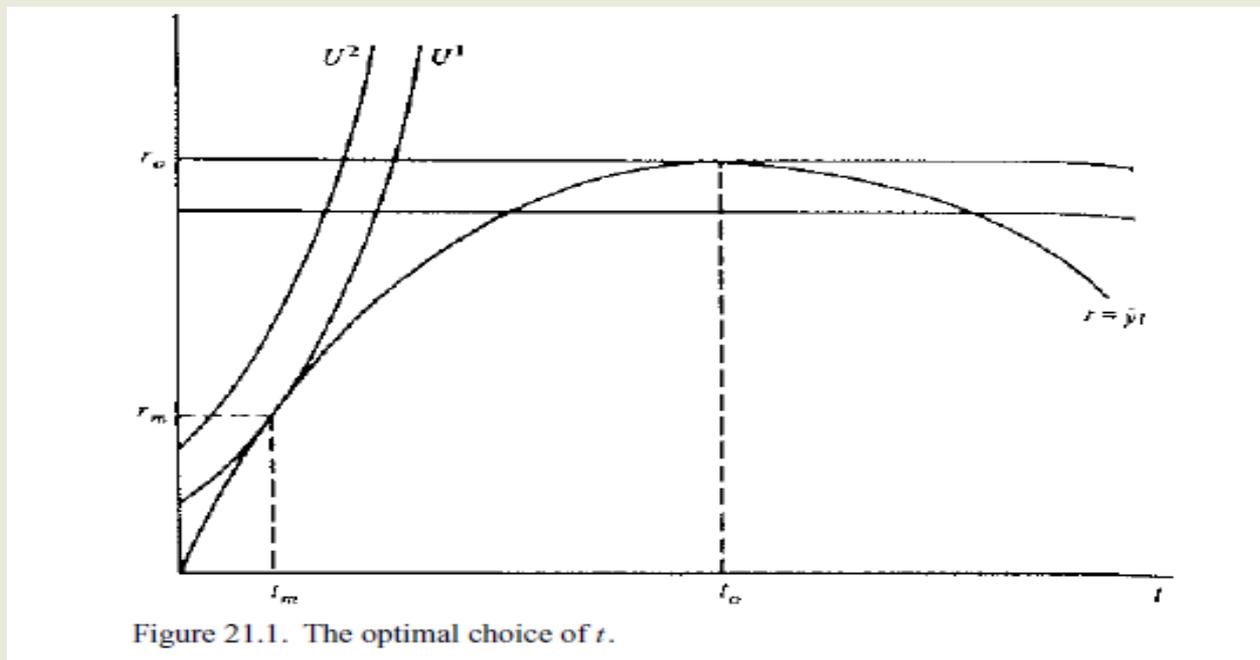
# The government as a public good provider

$$\ln G = a + \alpha \ln P_g + \beta \ln Y_m + \gamma \ln Z + \mu. \quad (21.1)$$

- The median voter has a demand for public goods, which depends on
- "taste variables" ( $Z$ ): aversion to market-generated risk, or population density,
- income ( $Y_m$ ),
- and the relative prices of government services ( $P_g$ ): the Baumol effect

# The government as a redistributor

- Government, to a large extent, is about redistribution
- Meltzer and Richard (Mueller 21.2.2.1)



# The government as a redistributor

- Maybe left-of-center parties redistribute more and become more popular.
- Maybe the middle class has more affinity for the working class.
- Maybe more equal interest groups generate more competition for the favors of politicians.
- But: redistribution happens to favor not just the poor!
- What is our story for extending the franchise?  
Cf. Acemoglu's paper studied in Economic History class!

# The government as a venue for interest group deals

- Link between majority voting and redistribution.
- But many dislike taxes, they might vote to bring tax burdens down.
- The net effect on the increase in the size of government is hard to predict.
- A general, vague, claim that the transaction costs government is there to bring down increase.

# Government as a toy of bureaucracies

- Does the Niskanen story explain the growth of government?
- OK, bureaucracy likes to grow. But why do politicians let it grow?
- Maybe by the sheer participation of bureaucrats in politics.
- Maybe a bigger government means more informational asymmetry: fiscal illusions.

# Fiscal illusions

Fiscal illusions: maybe people do not realize how government grows.

- A tax burden is more difficult to judge the more complex the tax structure.
- Renters are less able to judge their share of property taxes in the community than are homeowners.
- Built-in tax increases because of the progressivity of the tax structure are less clearly perceived than are legislated changes, making elastic tax structures more conducive to government growth than are inelastic structures.
- The implicit future tax burdens inherent in the issuance of debt are more difficult to evaluate than are equivalent current taxes;
- the “flypaper” effect.

# Government as Leviathan

- Brennan and Buchanan (1980):  
government grows as large as can be supported by extracting tax revenue
  - Industrialization, urbanization
  - Introduction of IT

# Conclusions

- There is no one explanatory story.
- Supply-side effects do matter>
  - Federal vs. unitary states
  - Direct vs. representative municipal government in Swiss communities
- We have not addressed yet the question whether a bigger government is "good" or "bad".

# Government size and economic performance

# Effects of a large state

- Most are not (just) economic:
  - Positive
    - less uncertainty,
    - less inequality,
    - Pride in the outputs of state-financed projects
  - Negative
    - economic freedom may be curtailed
- But economic effects do matter

# Possible economic effects of state size

- Welfare loss from higher taxes
- Black market
  - Distortions
  - Loss of revenue
  - Misleading information for policy formulation
  - Rule of law weakens
- Corruption
- Productivity loss

# State size and economic growth

- Hypothesis: inverted U
- What about the effect level of development?
- Surprising but robust empirical findings: bigger government has a **positive** effect on growth! Or, rather, the *correlation* is such. Establishing causality is tricky.

# Government activity and the economic decline of nations

Olson's rent seeking – sclerosis hypothesis:  
the activity of interest groups retards the speed at which the production possibility frontier moves outward as a result of the normal growth process. Interest groups tend to be democratic in varying degrees and thus are slow to reach decisions. They are therefore slow to respond to change, and impede the speed with which the organizations that they affect can react to or implement changes. The consequence is that “*distributional coalitions [i.e. interest groups] slow down a society's capacity to adopt new technologies and to reallocate resources in response to changing conditions and thereby reduce the rate of economic growth.*”

# What have we learnt?

# Fields covered

1. Intro + "PE – the label" + Impossibility theorem
2. Public choice in direct and representative democracies: voting, parties competing, etc.
3. The paradox of voting
4. Rent-seeking
5. Bureaucracy
6. Dictatorship

# Fields covered

7. Applications: macroeconomics and political competition
8. Applications: lobbying
9. Applications: the size of the state

# Insights

- The market and the state have a lot of interactions.
- Normative recommendations about boundaries between the state and the marketplace require understanding how both work.
- The state is not an actor, but a wide field (like the marketplace), *in which* actors act.
- Political/institutional rules matter.
- The methodological approach of economics: explicit models generating hypotheses and rigorous statistical testing is quite useful in understanding politics, too.

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Thank You for using this teaching material.

We welcome any questions, critical notes or comments we can use to improve it.

Comments are to be sent to our email address listed at our homepage,

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