

Can Small Governments Secure Economic and Social Well-Being?

VITO TANZI AND LUDGER SCHUKNECHT

The appropriate role and size of government has been debated amongst economists since the period of classical economics and *laissez-faire* in the nineteenth century. However, economic thinking and policies have changed considerably over the past century. Public spending began to increase as two world wars expanded the revenue bases, as social security systems began to develop, and as public spending programs were introduced during and after the Great Depression. The period after World War II witnessed much faith in the ability of governments to improve people's economic and social well-being through higher spending. The result was an unprecedented growth—especially in the 1960s and 1970s—in public expenditure in most industrialized countries.

In more recent years, however, scepticism has grown about what governments can, in fact, do to alleviate social and economic problems. Publications by those studying public choice and political economy

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provided theoretical and empirical reasons for this scepticism; Margaret Thatcher and Ronald Reagan exploited this scepticism to promote their political objectives. While the more ideological debate of the early 1980s has given way to a more reasoned assessment of the size and efficiency of government activity, “lean” governments and “balanced” (or near balanced) budgets have once again become popular.¹

What have been the driving forces for this re-assessment of the role of government? Economic thinking changed as theoretical models and empirical evidence put into doubt the possible benefits to be achieved from an activist state. The experiences of some newly industrialized countries with very small public sectors and rapid growth contrasted visibly with growing public spending and debt, rising real interest rates, and slow growth in many industrialized countries. Aging populations and their impact upon spending on public health and pensions began to add a sense of urgency to the mounting fiscal problems. Globalization and growing competition for international capital have made countries with large public sectors and high taxes less attractive to international investors. All these factors have increased the pressure upon governments to become smaller and more efficient, and to balance their books.

In the past two years, however, a new strand of thinking has emerged, claiming that globalization, fiscal reform, and liberalization will reduce the governments’ ability to provide basic services and social safety nets. It is argued that economic and social well-being will suffer as governments are forced to down-size, with potentially serious consequences for the poor and for social stability. As a consequence, these authors recommend a large array of often poorly justified interventions that include more public spending and protectionism.²

We shall argue that countries with “small” governments generally do not show worse indicators of social and economic well-being than countries with “big” governments—and often they achieve an even better standard. Countries with “small” governments can provide essential services and minimum social safety nets while avoiding the disincentive effects caused by high taxes and large-scale redistribution on growth, employment, and welfare. If there is a normative conclusion arising from our analysis, it is that fiscal reform and lower public spending should be possible in many countries without sacrificing much social and economic well-being. The resistance to these reforms, however, is more the result of vested interests than of their effect upon welfare.

The chapter is structured as follows: section 1 briefly outlines the historical development of public spending in industrial countries; section 2 compares social and economic indicators as affected by public spending in industrial and newly industrialized countries; section 3

looks at distributional indicators across countries and section 4 analyzes the economic performance of different groups of countries; section 5 compares a selection of countries with small governments in more detail; and section 6 concludes with a brief examination of reforms in a number of industrialized and newly industrialized countries.

History of the growth of government

The public sectors of today's industrialized countries once absorbed a much smaller share of resources than they do at present. Table 1 illustrates that government spending during the late nineteenth and early twentieth century averaged less than 12 percent of GDP, or only about a quarter of today's level. A century ago, Japan, The Netherlands, Norway, and the United States reported levels of public expenditure less than 10 percent of GDP. France was even considered as having a "very big" government at 12.6 percent of GDP (Leroy-Beaulieu 1888). A large share of the budget was spent on the military, essential public works, and on government administration. In this period, universal public primary education, major investment projects, and embryonic social safety security systems were introduced in many countries; economies were thriving and poverty was declining (Connell 1980; Altentetter 1986).

World War I and the Great Depression started the departure from this pattern of low public spending and *laissez-faire* policies. To finance their participation in the first World War, several countries extended their revenue base considerably. After the war, the larger tax base allowed governments to maintain higher expenditure levels, in part to pay for war-related debt and reparations (Peacock and Wiseman 1960). As a consequence, public expenditure increased in 1920 to an average of nearly 20 percent of GDP, with governments in France, Germany, New Zealand, or the United Kingdom spending about one-quarter of GDP. The Great Depression of the early 1930s resulted in a new, significant wave of programs of public expenditure, including the New Deal in the United States. The Great Depression was considered as a major failure of *laissez-faire*. Furthermore, a number of countries were soon engaged in wars or preparations for war, so that by 1937 public spending had edged up to an average of 23 percent, reaching 30 percent in France, Germany, and the United Kingdom. However, Norway, Spain, and Sweden still reported levels of public expenditure well below 20 percent of GDP.

The period since World War II and, in particular, between 1960 and 1980 saw a rapid increase in public spending. This increase is particularly remarkable because it took place during a period when most countries were not engaged in war efforts. John Maynard Keynes's



Table 1: Growth of general government expenditure in industrialized

Country	1870	1913	1920
General government for all years			
Australia	18.3	16.5	19.3
Austria	...	...	14.7 ^b
Canada	...	...	16.7
France	12.6	17.0	27.6
Germany	10.0	14.8	25.0
Ireland	...	...	18.8
Japan	8.8	8.3	14.8
New Zealand	...	...	24.6
Norway	5.9	9.3	16.0
Sweden	5.7	10.4	10.9
Switzerland	16.5	14.0	17.0
United Kingdom	9.4	12.7	26.2
United States	7.3	7.5	12.1
Average	10.5	12.3	18.7
Central government for 1870 – 1937, general government thereafter			
Belgium	...	13.8	22.1
Italy	11.9	11.1	22.5
Netherlands	9.1	9.0	13.5
Spain	...	11.0	8.3
Average	10.5	11.2	16.6
Total Average	10.5	11.9	18.2

Sources: Vito Tanzi and Ludger Schuknecht (1997a), *Reconsidering the Fiscal Role of Government: The International Perspective*, *American Economic Review*, 87:164-168; and OECD (1997) *Economic Outlook*, Paris.

a In some cases, pre-World War II data have been calculated on the basis of GNP or NNP instead of GDP.

^b Central-government data for this year.

^c Data refer to 1970.

countries, 1870–1996 (percentage of GDP)^a

1937	1960	1980	1990	1996
14.8	21.2	34.1	34.7	36.6
20.6	35.7	48.1	48.6	51.7
25.0	28.6	38.8	46.0	44.7
29.0	34.6	46.1	49.8	54.5
34.1	32.4	47.9	45.1	49.0
25.5	28.0	48.9	41.2	42.0
25.4	17.5	32.0	31.7	36.2
25.3	26.9 ^{b,c}	38.1	41.3	34.7
11.8	29.9	43.8	54.9	49.2
16.5	31.0	60.1	59.1	64.7
24.1	17.2	32.8	33.5	39.4
30.0	32.2	43.0	39.9	41.9
19.7	27.0	31.4	32.8	33.3
23.2	27.9	41.9	43.0	44.5
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21.8	30.3	57.8	54.8	54.3
24.5	30.1	42.1	53.2	52.9
19.0	33.7	55.8	54.0	49.9
13.2	18.8	32.2	42.0	43.3
19.6	28.2	47.0	51.0	50.1
22.4	27.9	43.1	44.9	45.8

The General Theory of Employment, Interest, and Money (1936), Richard A. Musgrave's *The Theory of Public Finance: A Study in Public Economy* (1959), and John Kenneth Galbraith's influential book *The Affluent Society* (1958) suggested expansions in the allocative, redistributive, and stabilizing roles of government. These approaches were built on the assumption that expansionary expenditure programs could identify and target potential beneficiaries at low administrative cost and high efficiency (Tanzi 1986). Most studies at that time did not find any negative impact upon the economy by the very high marginal tax rates prevailing at the time.

In addition, institutional provisions for accommodating interventionist policies were introduced in national constitutions or through the legislature and national court systems (Moser 1994). The growth of government was also facilitated by the dynamics of the political process in democratic societies (Forte and Peacock 1985; Mueller 1986; Buchanan, Rowley, and Tollison 1987; Alesina and Perotti 1995a).

This historical and institutional perspective is essential in explaining the growth in public spending after World War II. Initially, public expenditure increased relatively slowly to an average of only 28 percent of GDP by 1960. The Scandinavian countries expanded public spending more rapidly during this period whereas Germany, Japan, or Switzerland had smaller governments than they had before World War II. The public spending of less than 20 percent of GDP recorded in Japan and Switzerland in 1960 was, in fact, comparable to the levels of public expenditure prevailing in the newly industrialized countries today.

Between 1960 and 1980, public spending increased very rapidly, growing from 28 percent of GDP in 1960 to 43 percent of GDP by 1980. In Belgium, the Netherlands, and Sweden, the government spent over 50 percent of GDP by 1980. In the following period, growth in expenditure slowed down but there was no decrease in most countries. Public spending averaged 45 percent of GDP in 1990 and 46 percent in 1996. In very recent years, a number of countries started fiscal reforms aimed at reducing public spending—notably New Zealand and, among the newly industrialized countries, Chile (Tanzi and Schuknecht 1997b). However, several other countries—including Canada, Ireland, the Netherlands—have also started reducing public spending.

Examining the changing composition of expenditure will also help us to understand better what has driven the growth of public sectors in industrialized countries. Between the late nineteenth century and 1960, about one-half of public expenditure was on public consumption. Since 1960, however, this share has declined to 40 percent. The other main spending category that witnessed a decline is public investment: it absorbed 20 percent of total spending a century ago, but accounted for hardly more than 5 percent of total spending in the 1990s.

The most important increase in spending has been recorded for transfers and subsidies (which are the main ingredients of the so-called welfare-state spending). Income transfers and subsidies amounted to about 10 percent of the much lower total spending in the late nineteenth century. This share increased to half of all spending today, as limited social-safety nets have often been transformed into universal entitlement programs. Spending on transfers and subsidies increased most rapidly in the past 35 years, from an average of less than 10 percent of GDP in 1960 to 23 percent of GDP in 1995. This is equivalent to about three-quarters of the total expenditure increase since 1960. In addition, frequent fiscal deficits and growing public debt have boosted governments' interest obligations in almost all industrialized countries. Interest spending reached 10 percent of GDP or 20 percent of total spending in Belgium and Italy in the early 1990s, or almost as much as their total spending in 1913.

Government revenue increased in tandem with public expenditure until the 1960s—until then, balanced budgets prevailed. In the 1970s and 1980s, however, many countries developed persistent fiscal deficits, as revenue increased less quickly than spending. Public sector revenue in the 1990s averages over 40 percent of GDP. This is a remarkable level of revenue collection that most economists would not have thought possible only 50 years ago.³ However, it requires high marginal and average rates of taxation, and still does not cover spending in most industrial countries.

The size of government and the public production of goods and services

One way of answering the question whether small governments can secure economic and social well-being is by comparing social and economic indicators between countries and groups of countries. As public policies affect these indicators, the latter can illustrate different standards of government performance. For easier comparison between country groups, we divide the countries in table 1 into three groups.⁴ In “big” government countries, public spending exceeded 50 percent of GDP in 1990. “Medium” governments reported public spending between 40 and 50 percent of GDP. “Small” governments showed government expenditure of less than 40 percent of GDP. A fourth group includes the “newly industrialized economies” of Chile, Korea, Singapore, and Hong Kong, which by these standards all report “very small” governments.

The upper part of table 2 illustrates the difference in levels of total spending and in the composition of expenditure between the country groups in about 1990. The lower part reports on socio-economic indicators that are presumably affected by public expenditure. Public spending

Table 2: The size of government and the production of goods and services (about 1990).

	Size of government			
	Big ¹	Medium ²	Small ³	Very Small ⁴
Total Public Expenditure (% of GDP)	55.1	44.9	34.6	18.6
Consumption	18.9	17.4	15.5	9.1
Investment	2.4	2.0	2.2	2.7
Expenditure by Function				
Health	6.6	5.9	5.2	1.8
Education	6.4	5.6	5.0	3.3
Administrative Efficiency (10 = best, 0 = worst score)				
Judiciary system	9.3	8.6	10.0	8.3
Red tape	8.1	7.8	9.0	8.9
Corruption	8.2	8.2	8.1	7.2
Education				
Illiteracy rate	1.2	1.2	1.0	5.9
Secondary school enrolment (in%)	96	100	92	85
Average mathematical achievement⁵	515	523	533	607
Tertiary enrolment ratio for women 18–23 years (value = 100)	101	79	100	76
Health				
Life expectancy	77	77	77	75
Infant mortality 1,000 births	6.7	7.1	6.4	8.6

Sources: Mauro (1995); OECD (1996); Tanzi and Schuknecht (1998); Transparency International (1996); UN, Human Development Report (various issues); World Bank, World Development Indicators (1997).

1 Belgium; Italy; The Netherlands; Norway; Sweden (public expenditure more than 50 per cent of GDP in 1990).

2 Austria; Canada; France; Germany; Ireland; New Zealand; Spain (public expenditure between 40 and 50 per cent of GDP in 1990).

3 Australia; Japan; Switzerland; United Kingdom; United States (public expenditure less than 40 per cent of GDP in 1990).

4 Newly industrialized economies: Chile, Hong Kong, China, Korea, Singapore.

5 International median = 500; 8th grade students, 1994; Korea only from newly industrialized countries.

in countries with “big” government averaged 55 percent of GDP compared to about 35 percent of GDP for countries with “small” governments. The corresponding figure is less than 20 percent of GDP for the newly industrialized economies. But, the Asian crisis revealed that budgetary spending in these countries did not always cover all public sector obligations such as implicit financial liabilities. The difference in public expenditure on goods and services (government consumption), however, was much less significant. Government consumption of 18.9 percent in countries with large public sectors was 3.4 percentage points higher than in countries with small public sectors. Nevertheless, “thrifty” governments spend only about 10 to 15 percent of GDP on government consumption, compared to 20 or more percent of GDP by some of the big spenders. Health and education are two of the important components of government consumption in most countries.⁵ Spending by newly industrialized countries on government consumption is similar to that of some industrialized countries with low public spending. However, they report the highest outlays on public investment, higher than that of all groups of industrialized countries.

Adam Smith identified public administration as one of the key roles of government and all groups receive relatively high scores. However, the country group with small governments features the most efficient judiciaries and the least red tape, with near perfect scores for all countries. Corruption is limited in most industrialized countries, and indices of corruption are similar across country groups. The newly industrialized countries show better scores than most industrialized countries for red tape but slightly poorer scores for judicial efficiency and corruption. The relatively high scores in these areas reflect a functioning public administration that provides adequate public services and secures property rights.

The public provision of many health and education services is also seen as one of the key roles of government. The governments of the industrialized countries typically spend between 5 and 7 percent of their GDP on public education and on public health. Spending of education and health care is 1.5 percent of GDP (or 20 percent) higher in countries with big governments than in those with small public sectors. However, public spending on education in industrialized countries is almost twice as high as it is in newly industrialized countries, and spending on health is almost three times as high. Furthermore, in industrialized countries public spending in these areas has doubled since 1960 when public spending for education was only 3.5 percent of GDP and spending for health was 2.4 percent of GDP. (These amounts are similar to those for today’s newly industrialized countries.) Part of the increase in public spending in industrialized countries is probably due to the ageing of the population, which raises the costs of health care.

However, more generous public support for health care systems, more public provision of education, and free secondary and tertiary education in many countries have probably also contributed to the increase.

Performance indicators are quite similar across groups of countries for health and education. Literacy, secondary school enrollment, infant mortality, and life expectancy are relatively uniform across industrialized countries. Medium-sized governments trail behind somewhat in tertiary school enrollment for women. Educational attainment (as measured by the mathematical scores of eighth graders attending secondary school) is highest in countries with small governments.

Newly industrialized countries show lower indicators for literacy, and for secondary school enrollment. It is remarkable, however, that the educational standards in Korea are significantly higher than in all industrialized countries. In fact, the international comparison of education levels awards top ranks to Japan and Korea whereas other industrial countries trail behind (OECD 1996).

The size of government and the redistribution of income

We mentioned above that most of the growth in public expenditure in industrialized countries since 1960 was on account of transfers and subsidies. This spending category also shows the most pronounced difference between groups of countries. Countries with big governments apply over 30 percent of GDP to transfers and subsidies (table 3). This is more than twice the 14 percent recorded for countries with small public sectors. Almost every third dollar earned in the first group is redistributed through the public sector in the form of cash transfers to consumers. Transfers and subsidies in all industrial countries, without exception, are considerably higher than in the newly industrialized countries. In the latter group, only 6 percent of GDP is spent on this category. This spending pattern illustrates that voters in many industrialized countries have given a very strong redistributive role to their governments.

Historical data on income distribution can help us understand the effects of redistribution. The earliest data we could find are from the 1910s or 1920s and include only a handful of countries. Table 4 illustrates the ratio of income of the top 10 percent of the labour force compared to the median income of the labour force. The table indicates that in all countries incomes have become more compressed during this century. While in the 1920s and 1930s the top 10 percent earned two to three and one-half times more than the median, this ratio had declined to about two times the median by the 1960s and did not change much until the mid-1970s. Wage compression continued after 1960 only in Switzerland. Austria, Norway, and Sweden reported the most

Table 3: The size of government and distributional indicators in different country groups (about 1990)

	Size of government			
	Big ¹	Medium	Small	Newly Industrialized
Public expenditure (% GDP)				
Subsidies and transfers	30.6	21.5	14.0	5.7
Income distribution				
Income share of lowest 40% of households	20.1	18.7	17.3	15.3
Share of transfers to poorest 20% of households ²	22.2	25.2	33.6	...
Income equalization via taxation and transfers poorest 40% of households ³	2.7	2.2	2.1	...
Employment				
Unemployment rate ⁴	8.5	11.9	6.6	2.9

Sources: IMF, GFS (1996); OECD (1995); World Bank, World Development Indicators (1997); Zandarakili (1994).

¹ Belgium; Italy; The Netherlands; Norway; Sweden (public expenditure more than 50 per cent of GDP in 1990).

² 1980s for most countries.

³ About 1980, as percent of total income.

egalitarian wage structure in the 1970s but differences among the 7 countries were very small by that time. The figures show that much equalization in the income distribution took place before 1960. Wage equalization and the introduction of basic social legislation and social insurance led Galbraith to observe already in 1958 that “the basic uncertainties of life had been eliminated” (Galbraith 1958: ch. 8). This was when government spending on transfers and subsidies averaged less than 10 percent of GDP.

Looking at income distribution and public expenditure in the 1990s, we can find a number of interesting patterns. First, the income distribution has become somewhat more equal than it was in 1960 (World Bank 1997). It is also more equal in countries with big governments than in those with small public sectors. We use the income share of the poorest 40 percent of households as a measure of income

Table 4: Ratio of income of the top 10 percent of labour force to the median income

	1920s	1930s	1960	Mid-1970s
Austria	2.0	...	1.9	1.9
Denmark	2.8	2.7	2.0	2.0
Germany	2.4 ¹	...	2.2	2.1
The Netherlands	...	2.5 ²	2.1	2.0
Norway	3.4	...	2.0	1.8
Sweden	2.5	3.0	1.9	1.9
Switzerland	...	...	2.8	2.0
Average	2.6	...	2.1	2.0

Source: Flora, Kraus and Pfering (1987).

¹ 1913

² 1946

distribution.⁶ Table 3 shows that this group of households in countries with big governments have 20 percent of national income at their disposal. This share is, on average, 2.8 percentage points higher than in countries with small governments but in some cases there is no difference at all. Therefore, the question should be asked whether this marginal difference in the distribution of income justifies public spending levels which are on average 20 percent of GDP higher (55 percent as compared to 35 percent). Newly industrialized countries report a more unequal income distribution on average. However, Chile's indicator depresses considerably the average for this group whereas Korea shows more equal income distribution than most industrialized countries.

The results reported above suggest that public expenditure may often be a relatively inefficient instrument for equalizing incomes. The reasons for this can be seen in rows 2 and 3 of Table 3. Transfers are much better targeted in countries with small public sectors. In countries with big public sectors, only 22 percent of transfers benefit the poorest quintile. In France or Sweden, more than 20 percent of transfers go to the richest 20 percent of households (OECD, 1995).⁷ In countries with small governments, one-third of transfers reaches the poorest quintile, and Australia and Switzerland report as much as 40 percent. Zandavakili (1994) has estimated that income equalization for the poorest 40 percent of households as a result of transfers and taxation has been less than 3 percent in countries with large public sectors, hardly one percent more than in countries with small public sectors.

The poor targeting of transfers in countries with big governments seems to have created a “machinery” for reshuffling money between social groups with winners and losers not being clearly identifiable. This and the efficiency losses associated with redistribution has led Palda (1997) to conclude that equal cuts in public spending and in taxes would be beneficial to a large share of the population in industrialized countries. He calls the current situation “fiscal churning” and estimates that this unnecessary spending amounts to several percent of GDP in Canada.

Income distribution, however, is not only determined by government tax and transfer policies. The even distribution of human capital across societies is seen as another, perhaps even more important, equalizer of income that can be achieved without much government intervention beyond public support for education. Furthermore, human capital helps people climb up the income ladder. Table 5 reports some simple ordinary-least-squares (OLS) regression results for the effect of government redistribution and human capital on income distribution. The coefficient of the “transfers and subsidies” variable (as a proxy for

Table 5: Regression Analysis of Income Distribution

Dependent Variable: Income Distribution ¹			
Independent Variables coefficient (t-statistic)	Estimate 1	Estimate 2	Estimate 3
Constant	1.84 (0.43)	1.63 (0.38)	-5.33 (0.77)
Public transfers and subsidies	0.11 (1.98)		0.16 (3.12)**
Total public spending		0.07 (1.75)	
Secondary school enrolment	0.15 (3.12)**	0.15 (2.98)*	
Educational attainment ²			0.04 (3.16)**
Number of observations	18	18	15
R ² adjustment	0.52	0.49	0.48

¹ Income share of poorest 40 percent of households.

² Variable comprises average national scores in mathematical achievement test, 8th grade students.

* = significant at the 95 percent level; ** = significant at the 99 percent level.

redistribution) is significant (in estimation 1 only marginally so) but the coefficient of the “total public spending” variable is insignificant in explaining differences in income distribution across industrialized countries. Both variables for human capital, *i.e.* secondary school enrollment and educational attainment are significant for explaining income distribution. The coefficient of the secondary school enrollment variable suggests that a 10 percent higher enrollment rate increases the income share of the poorest 40 percent of households by 1.5 percent. An average educational standard that is 10 points (or 2 percent) better improves income distribution by 0.4 percent. These results are intuitive because a higher secondary school enrollment rate or average educational attainment is likely to benefit the poorer segments of society most.⁸

Another issue is the distribution of employment within societies. It has been claimed that in many countries, wages of low-skilled labour are kept artificially high, thereby raising unemployment rates. Generous social-security benefits reduce the incentives for the unemployed to look for work (for a survey, see Lindbeck 1996).⁹ Unemployment, especially unemployment among youths and long-term unemployment, also undermines equality of opportunity, as the unemployed have little opportunity to better their situation. There is some evidence that unemployment is more prevalent in countries with big and medium-sized governments. Unemployment in countries with small public sectors averaged 6.6 percent in 1996, compared to 8.5 and 11.9 percent in the other two groups of countries. It is also not surprising that unemployment in the newly industrialized countries is very low—less than 3 percent.

The adverse personal and social consequences of unemployment—especially unemployment among youths and long-term unemployment—should probably be added to the social costs of high government spending when the trade-off between higher public spending with more equal income distribution on the one hand is compared with smaller public spending with less equal income distribution on the other hand. More importantly, the same benefits for the poor can be reached with fewer public transfers or subsidies, if public spending is better targeted. We will see below that Japan, Korea, and Switzerland report a relatively more equal income distribution while their total public spending and transfers are much lower than in other industrialized countries with less even income distribution.

The size of government and economic performance

The last group of indicators compares the economic performance of the groups of countries. Table 6 shows that over the period from 1986 to 1994, economic growth has not been very different from one group to another. Over 10 years, however, 0.5 percent of difference between

Table 6: The Size of Government and Economic Performance in Different Country Groups, about 1990.

	Big Government	Medium Government	Small Government	Newly Industrialized Countries
Real GDP growth (1986-1994)	2.0	2.6	2.5	6.2
Standard deviation of GDP growth (1986-1994)	1.6	2.1	1.9	...
PPP-based per capita GNP (US\$)	18,280	17,297	20,448	16,673
Gross fixed capital formation (in percent of GDP)	20.5	21.3	20.7	31.2
Inflation (1986-1994)	3.9	3.7	3.7	15.3
Public debt (in percent of GDP)	79.0	59.9	53.3	13.5
Economic freedom indicator (10 = best)	6.6	7.2	7.6	7.5
Size of shadow econo- my (in percent of GDP)	17.7	12.0	9.4	...

Sources: Gwartney, Lawson and Block (1996); OECD Economic Outlook (various); UN, Human Development Report (various); Schneider (1997).

small and big governments accumulates to more than 5 percent, which is not an insignificant amount. In addition, a growth rate of 2.5 percent versus 2 percent can make the crucial difference between declining or growing unemployment, as the growth of productivity and the labour force was in this order of magnitude in many industrialized countries in the past decade. Furthermore, GDP per capita is much higher in countries with small governments. In the 1960s and 1970s, in general the GDP per capita of poorer countries moved significantly closer to that of the richer countries. The fact that the GDP per capita of poorer countries with large public sectors has not been catching up to that of richer countries over the past 10 years could indicate an increasing adverse effect of large public sectors on growth.

It is also worth noting that GDP per capita (based on purchasing power parity) has been growing rapidly in the newly industrialized countries. In fact, all of these countries were catching up to the richer countries quickly. Hong Kong and Singapore show GDP per capita equal to some of the richest industrialized countries.

One of the main justifications for growing public spending since the Great Depression and the publication of Keynes's ideas has been the assumed need for a stabilization policy directed at reducing fluctuations in growth over the business cycle. However, countries with small governments rank in between countries with large and medium governments regarding the standard deviation of GDP growth. The ratio of the standard deviation and the average growth rate (the coefficient of variation) for countries with small governments is the lowest amongst the industrialized country groups. There is hence no evidence that higher public spending leads to more stable growth paths.

The next two indicators, formation of gross fixed capital and inflation, do not show much difference across groups of countries. This illustrates that large public spending has so far not undermined investors' confidence or monetary stability. However, public debt has been growing rapidly in the past two decades, particularly in countries with large public sectors. Public debt averages almost 80 percent of GDP in countries with big governments, and some of the most highly indebted industrial countries like Italy or Greece have been paying considerable risk premiums on their public debt obligations.¹⁰ Note also that public debt in newly industrialized countries is very small, reflecting the low deficits that they have had.

In recent years, a number of other indicators measuring countries' economic health have been developed. One of them is the economic freedom indicator by James Gwartney, Robert Lawson and Walter Block (Gwartney, Lawson and Block 1996; Gwartney and Lawson 1997). Their composite index of economic freedom shows that countries with small governments and the newly industrialized countries perform very well on this score. The size of the shadow (or underground) economy is another indicator that reflects people's willingness to opt out of the formal economy. Schneider (1997) has provided estimates of the shadow economy for a number of industrialized countries. We can observe a strong correlation between high spending by government (and corresponding taxes) and the size of the shadow economy. One-sixth of the economies with big governments are estimated to be informal. This compares with an underground economy of less than one-tenth in countries with relatively small public sectors.

More details on small governments

So far we have compared various administrative, social, and economic indicators among groups of countries. We found that, on balance, small governments do not perform worse and often perform better than big governments in promoting social and economic well-being. This section will focus on a number of countries with relatively small

governments. The basic positive message from above remains: good social and economic indicators are compatible with small public sectors. However, small governments do not perform equally well in all countries and in all areas.

Tables 7a and 7b compare various administrative, social, and economic indicators for 6 countries: the United States, Japan, Switzerland, Chile, Korea, and Singapore. Indicators of administrative efficiency show some variance among these countries. The indicators for Chile and Korea show relatively low scores for the efficiency of the judiciary while those for Japan and Korea are below average for red tape and corruption. Singapore and Switzerland, on the other hand, show perfect or near perfect scores in all three categories.

Japan, Switzerland, Korea, and Singapore, on balance, show the best scores for social and distributional indicators. There is not much difference among these countries in life expectancy, infant mortality, and secondary school enrollment. However, Korea has lower life expectancy, and Korea and Chile have slightly higher infant mortality, than the other countries. However, the United States also reports relatively high infant mortality. There seems to be a considerable difference in the availability and quality of education. Japan, Korea, and to a somewhat lesser extent Switzerland report educational achievements for secondary school students much above the average for industrial countries, whereas secondary education in the United States ranks below average. We do not have data on educational attainment for Chile but its secondary school enrollment rate is relatively low. Furthermore, Chile reports a relatively unequal income distribution. The poorest 40 percent of households receive about 10 percent of national income—half as much as they do in Korea. If we added indicators of social stability such as the divorce rate or the share of the population in prison, the United States would look relatively unfavorable. While it is questionable whether this is the result of too little social welfare spending, the social indicators show nevertheless that American social policies do not always secure high quality secondary education, and seem to be less effective in preventing violence than in many other industrialized countries.

Table 7a illustrates the low unemployment rates in industrialized countries with small public sectors and table 7b shows the rates in newly industrialized countries. The figures contrast with those for western Europe, where many countries report double-digit unemployment. All 6 countries report full or near full-employment. However, it is worth remembering that Korea's and Singapore's jobless rate below three percent was typical for many industrialized countries during the 1960s as well.



Table 7a: Indicators of government performance for selected industrialized countries with “small” governments (early 1990s)

	United States	Japan	Switzerland
Administrative efficiency indicators:²			
Efficiency of Judiciary system	10.0	10.0	10.0
Red tape	9.3	8.5	10.0
Corruption	7.8	6.7	8.8
Social and distributional indicators:			
Life expectancy (1995)	77	80	78
Infant mortality (per 1,000 live births, 1995)	8	4	6
Secondary school enrolment ratio	97	96	91
Average achievement in mathematics (8th grade, 1994)	500	605	545
Income share of lowest 40% of households (about 1990)	15.4	17.7	18.7
Labour market indicators:			
Unemployment (mid 1990s)	5.4	3.3	4.7
Economic Indicators:			
Economic growth (% , 1991-1995)	2.3	1.3	1.6
PPP-based per capita GNP (US\$, 1995)	26,980	22,110	25,860
Inflation (1991-1995)	3.2	1.4	3.2
Gross public debt (1994/1995)	64.3	81.3	48.2
Economic and political freedom indicators:²			
Economic freedom	8.0	7.3	7.9
Political rights	10.0	10.0	10.0
Civil liberties	10.0	10.0	10.0

Sources: See previous Tables 2, 3 and 6.

¹ External debt only.

² Ranking between 0 = worst and 10 = best.

Table 7b: Indicators of government performance for selected newly industrialized countries (early 1990s)

	Chile	Korea	Singapore
Administrative efficiency indicators: ²			
Efficiency of Judiciary system	7.3	6.0	10.0
Red tape	9.3	6.5	10.0
Corruption	7.9	4.3	9.3
Social and distributional indicators:			
Life expectancy (1995)	76	72	77
Infant mortality (per 1,000 live births, 1995)	12	10	4
Secondary school enrolment ratio	70	93	84
Average achievement in mathematics (8th grade, 1994)	...	607	...
Income share of lowest 40% of households (about 1990)	10.5	19.7	17.3
Labour market indicators:			
Unemployment (mid 1990s)	4.6	2.4	2.7
Economic Indicators:			
Economic growth (% , 1991-1995)	7.4	9.5	8.8
PPP-based per capita GNP (US\$, 1995)	9,520	11,450	22,770
Inflation (1991-1995)	13.9	6.2	2.5
Gross public debt (1994/1995)	17.4 ¹	8.0	15.2
Economic and political freedom indicators: ²			
Economic freedom	6.2	6.7	8.2
Political rights	7.0	9.0	7.0
Civil liberties	8.0	8.0	7.0

Economic growth across these 6 countries with small public sectors also provides an interesting picture. The United States and the three newly industrialized countries show relatively high growth in the early 1990s. The Asian crisis, however, has somewhat tarnished this picture. Japan and Switzerland report only very sluggish economic growth during the first half of the 1990s. This could be due to the fact that these countries have many regulations (like price regulations or cartels) that do not burden the budget but do constrain economic growth.¹¹

GDP per capita (based on purchasing power parity) in the three industrialized countries and Singapore is among the highest in the world. Chile and Korea have been catching up rapidly but still lag considerably behind. Another period of rapid growth, however, may see them catch up with some of the poorer industrial countries like Ireland, New Zealand and Spain. Inflation has also been very low in these countries and public debt is relatively low. The United States and Switzerland show public debt near the average for small governments; only Japan reports a considerable burden of public debt. However, on a “net” basis, Japan’s public debt is also relatively small.

Towards smaller government and government reform

A considerable body of literature has emerged in recent years discussing government performance and reform (see Tanzi and Schuknecht 1998 and 1997b). Various studies discuss the private versus public provision of goods and services and social security and the role of budgetary institutions in maintaining small and efficient governments with low fiscal deficits.¹² The conclusion of this debate seems to be that governments could introduce considerable changes to the way they are currently doing things.

A number of countries such as New Zealand or Chile have introduced fundamental fiscal and economic reforms to cut back the role and size of government in the economy. Some other industrialized countries such as Australia, Belgium, Ireland, the Netherlands, the United Kingdom, and, more recently, Italy and Canada have started reforming their institutions, cutting public spending, and reducing their large fiscal deficits. Newly industrialized and developing countries like Argentina, Malaysia, and Mauritius have introduced far-reaching public sector reforms as well. Privatization of public enterprises and services, and social-security reform with fully funded pension systems are reported for a number of these countries. There is also renewed interest in rules limiting fiscal deficits. The Maastricht Treaty of 1991 established strict fiscal eligibility criteria for the members of European Monetary Union (EMU) and many countries in the European Union (EU) have been

reducing their fiscal deficits in the run-up to EMU. The EU members have also agreed on the so-called “stability and growth pact” limiting budget deficits after the introduction of the Euro. Meanwhile, the United States had committed itself to achieving a balanced budget by the year 2002 but it expects to report a surplus in the fiscal year 1998.

Some of these countries have experienced higher growth and falling unemployment as a result of reform. However, in some cases reforms can take a number of years to become credible and show the desired results.¹³ Furthermore, many industrialized countries have yet to tackle their high spending levels and the upward trend in spending that results from generous welfare programs especially.

The purpose of this chapter was to show that countries can achieve reasonable social and economic performance indicators without their governments absorbing over 40 or 50 percent of GDP. The newly industrialized countries with public spending of about 20 percent of GDP or the industrialized countries with government expenditure of 30 percent or not more than 40 percent of GDP might provide some useful lessons for the other countries with higher levels of public spending. Although 30 percent of GDP of public spending may be a useful benchmark for some countries trying to curtail their public sectors, this does not mean that it is the optimal size of government. This depends very much on the circumstances of each country, the efficiency of countries’ public sectors, and the preferences of their populations. Nevertheless, given the growing interest in reducing public spending and implementing government reforms, we can repeat our previous optimistic forecast (Tanzi and Schuknecht 1998) that we are likely to see somewhat smaller and more efficient governments in the future.

Notes

- 1 For a survey of the change in economic ideas and how it affected institutions and policies see, for example, Tanzi and Schuknecht 1998 and 1997a.
- 2 For one of the less populist studies promoting this view, see Rodrick 1997.
- 3 In fact, Keynes in correspondence with Colin Clark confirmed the latter’s suggestion that “25 percent [of GDP] is probably near the maximum tolerable proportion of taxation” (Clark 1964).
- 4 This is the same methodology followed in Tanzi and Schuknecht 1997a.
- 5 In some countries, part or all health expenditure is financed through the social security system and education is financed, in part, through grants to private schools. These expenditures are then accounted under transfers and subsidies and not under public consumption.

- 6 The data on the income share of the poorest quintile is often not very reliable.
- 7 The relatively poor targeting of public expenditure in many Latin American countries is discussed in Tanzi 1996.
- 8 These findings are consistent with the findings for developing and industrialized countries by Bourguignon and Morrisson 1983 and 1990.
- 9 High social-security benefits may reduce the efforts to look for work but labour market rigidities are also very important (if not more important) in explaining high unemployment in many countries (Lindbeck 1996).
- 10 Italy, in particular, has undertaken major efforts at fiscal consolidation in preparation for European Monetary Union. The risk premium on its public debt therefore declined considerably in the mid-1990s.
- 11 Tanzi 1995 discusses the dangers of replacing budgetary policies with less efficient quasi-fiscal regulations.
- 12 For a more detailed study of budgetary institutions see Milesi-Feretti 1996; for a study of private versus public provision of goods and services, see Mueller 1989. On pension reform, see, *e.g.*, World Bank 1994.
- 13 More rapid positive responses are possible under certain circumstances (see Giavazzi and Pagano 1990; Alesina and Perotti 1995b; McDermott and Wescott 1996) and the examples of Ireland and Denmark are often mentioned in this context. Interestingly enough, the Italian economy has been growing considerably while the fiscal deficit was cut by an extraordinary 4 percent in 1997.

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