

Economics of Policy Issues

EC3161

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Notes No. 5

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Lecture Contents

- Topics
 1. Growth of government
 2. Cooperation and trust
 3. Views on the need for government

- Readings
 - Public Finance and Public Policy (2009), Arye Hillman. 2nd Edition. Chapter 10

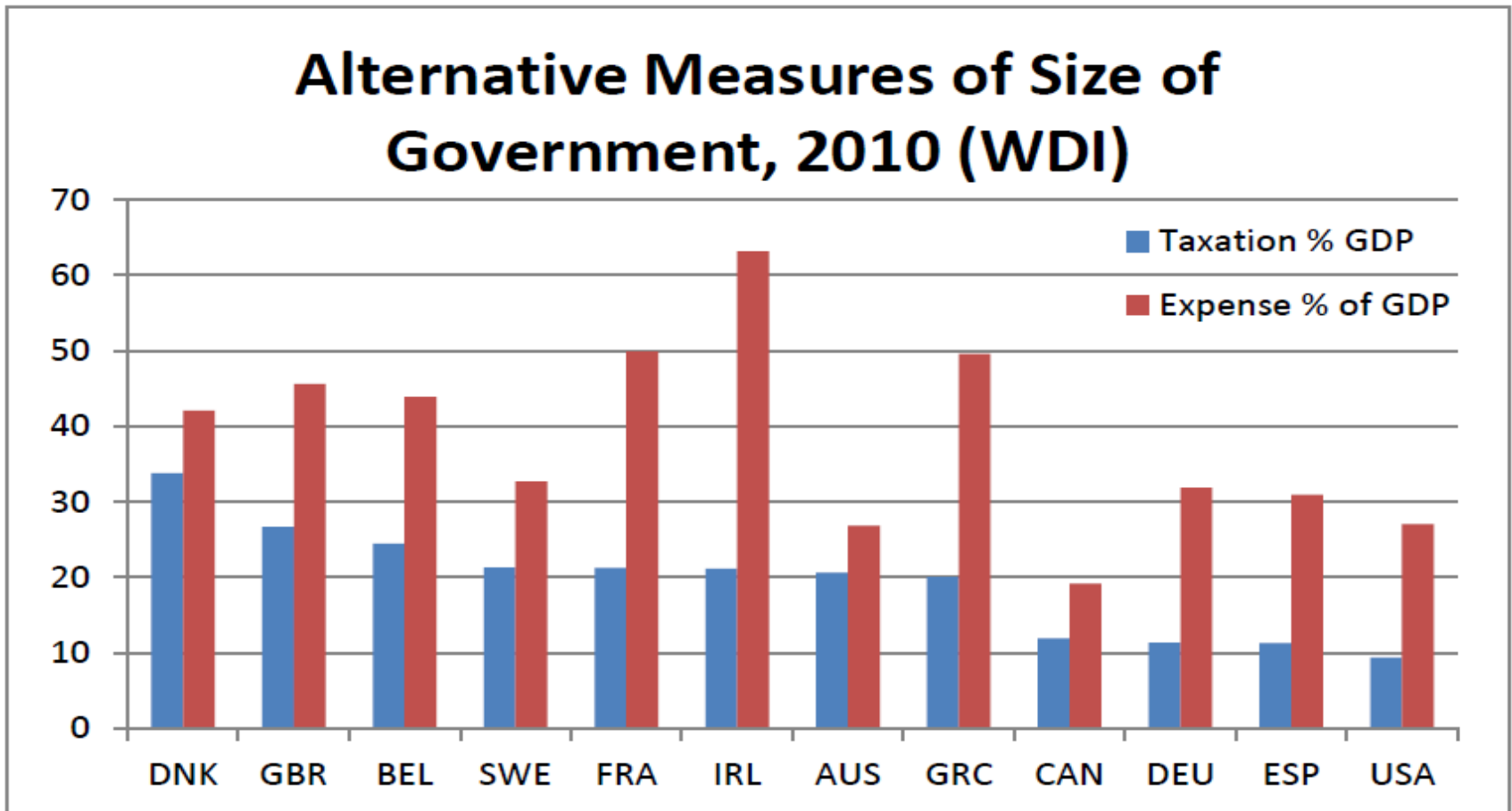


1. Growth of Government

- Measurements of the size of government:
 - Taxation as a % of GDP/GNP
 - Public spending as a % of GDP/GNP
 - Ownership of firms by government
 - Level of government regulation
- How and why did government grow?
 - 1776-1850: Public spending was small or miniscule, or non-existent
 - Adding private charity would not much change the picture



Snapshot of Recent Time



Expense is cash payments for operating activities of the government in providing goods and services. It includes compensation of employees (such as wages and salaries), interest and subsidies, grants, social benefits, and other expenses such as rent and dividends.

Government Social Spending (up to 1850)

Country	Year	Government relief for the poor (proportion of GNP)	Public education (proportion of GNP)
England and Wales	1776	1.59%	Zero
	1820/21	2.66%	Zero
	1850	1.07%	0.07%
U.S.	1850	0.13%	0.33%
Netherlands	1790	1.70%	
	1850	1.38%	
Belgium	1820	1.03%	
	1850	0.28%	0.38%
Sweden	1829	0.02%	
Other countries	1776-1815	Zero or negligible	Zero or negligible

Source: Lindert (2004)



1776: Incomes and the quality of life

Society

1. Pre-industrial agrarian societies: Income primarily from agriculture
2. People worked land as serfs, artisans congregated in urban areas
3. The royal family and noble families owned the land
4. Social mobility negligible, being poor was viewed as fate or divine providence, as was being of the nobility and being wealthy

Democracy

5. The right to vote and to be a political representative was based on ownership of land and other conferred privilege
6. Democracy not “1 person 1 vote”, only privileged men who voted
7. Votes on taxes, landowners voting on how to tax themselves

Public Health

8. Infectious diseases (and hygiene) was not well understood



- No effective administration for domestic taxation
- For revenue governments relied on:
 - Excise taxes or import duties
 - Sale of the right to be a domestic or foreign-trade monopolist
 - Loans from private bankers
- Main objective of government was national defense and internal security (protection from rebellion)



- Along came the industrial revolution and the emergence of a middle class
 - The industrial revolution ended the role of land as the primary source of wealth
 - A nouveau-rich middle-income population
 - The right to vote was extended
 - Intermarriage with the nobility
- This began a process of growth of government



- The first emergence of income tax
 - Introduced in England to pay for war against Napoleon (1798)
 - Cost of U.S. civil war led northern government to introduce an income tax (1862)
- Initially tax rates/revenue were small
- Rates/revenue did not expand until administrative tax collection capabilities were established in the 20th century



- Wagner's law
 - The size of government as measured by public spending increases proportionately more than the growth of national income (Wagner, 1893)
 - Income elasticity greater than 1 (normal good)



Share of social spending in GNP in the 20th Century

Country	1910	1930	1980	1990	1995
Japan	0.18%	0.21%	10%	12%	12%
U.S.	0.56%	0.56%	11%	12%	14%
Australia	1.12%	2.11%	11%	14%	15%
Greece	0	0.07%	9%	14%	14%
Portugal	0	0	10%	13%	15%
Canada	0	0.31%	13%	17%	18%
New Zealand	1.35%	2.43%	16%	22%	18%
Ireland	..*	3.74%	16%	18%	18%
Spain	0.02%	0.07%	13%	17%	19%
Austria	0	1.20%	23%	25%	21%
U.K.	1.38%	2.24%	17%	18%	23%
Italy	0	0.08%	17%	21%	24%
Netherlands	0.39%	1.03%	27%	28%	26%
Germany	0.59%	4.82%	20%	20%	25%
France	0.81%	1.05%	23%	24%	27%
Belgium	0.43%	0.56%	22%	23%	27%
Norway	1.18%	2.39%	19%	26%	28%
Demark	1.75%	3.11%	26%	27%	31%
Finland	0.90%	2.97%	18%	25%	32%
Sweden	1.03%	2.59%	30%	32%	33%



- **Contradictions of Wagner's Law**
 - Spending on relief for the poor declined in the first half of the 19th century
 - Malthus argues that higher incomes for poor leads to population growth that eventually restores incomes to subsistence levels.
 - Economic thinking at the time argued for no intervention in food markets.
 - Making assistance to the poor self-defeating (consequences for the Ireland 1845-1849)
- **However, data confirms Wagner's law for social spending in the 20th century**



- Why has Wagner's Law prevailed in the 20th century?
 - Demand-side influences on the growth of government
 - Supply of revenue for government
 - Political influences on growth of government
- Empirical determination of the significance of different reasons is hindered by simultaneity



Demand-side Influences

1. Demand for public spending increases as governments assigned responsibilities to achieve social objectives
2. Growth of the middle class transforms previous private goods to public goods (Director's law)
3. As incomes increase, people become more bothered by and more attentive to adverse externalities
 - Clean water, clean air and protection from crime



4. More to insure against when people have higher incomes and wealth (greater relative personal loss)
5. Improvements in health care result in people living longer, increased cost of health care
6. Demand for paternalistic policies and for regulation can increase with income
 - To protect against fraud
 - To ensure safety
 - To guarantee safety of medicine



Supply of Revenue for Government

1. The tax base expanded
 - Lower-income people achieve above-subsistence income surpluses, can be taxed
 - People who lived self-sufficient lives have taxable market transactions
 - Women in the labor market
2. Amenability of people to taxation: advances in transportation and communication expanded tax revenue for government



3. Fiscal illusion (taxpayers do not know that they are paying taxes) increases long term need for tax revenue,
- Indirect taxes: Government borrowing



Political Influences

1. Majority voting

- When a minority pays a substantial part of taxes, majority has incentive to vote for more taxation and public spending

2. Extension of the franchise

- Lower-income people had the right to vote
- Beneficiaries of government income transfers are in general the poor, and not the median voter



3. Women tend to vote in favor of expansion of the social insurance role of government
4. Bureaucrats: If a large proportion of population are in the public sector, there will be a strong political constituency for further growth in government



5. Specialization provides incentives for the formation of income related special-interest groups (Vintners, tourism, farmers etc)
- Special-interest rents created through protectionist international-trade policies (losers from free trade are more concentrated)
 - Freer trade can increase social welfare
 - Some empirical evidence: More open economies tend to have larger governments



What happened in the 2nd half of 20th century?

1. Government consumption increased
 - Government spending on itself including the financing of the government bureaucracy
2. Transfers and subsidies increased
 - Increased inefficiencies due to the leaky bucket of redistribution
 - Moral hazard
 - Adverse selection if immigration decisions are made in response to social benefits



3. Interest payments increased

- Increased bond financing of government spending
- Fiscal illusion
- Intergenerational opportunism

4. Public investment

- A relatively small part of public spending that did not expand



Increase in Public Spending 1960-90

	Large governments ^a		Medium governments ^b		Small governments ^c	
	1960	1990	1960	1990	1960	1990
Government spending	31.0	55.1	29.3	44.9	23.0	34.6
Consumption	13.2	18.9	12.2	17.4	12.2	17.4
Transfers and subsidies	11.9	30.6	10.4	21.5	6.9	14.0
Interest	1.5	6.4	1.3	4.2	1.3	2.9
Investment	3.1	2.4	3.2	2.0	2.2	2.2

^a Large governments had public spending more than 50 percent of gross national product in 1990 (Belgium, Italy, the Netherlands, Norway, Sweden).

^b Medium-sized governments had public spending between 40 and 50 percent of gross national product in 1990 (Austria, Canada, France, Germany, Ireland, New Zealand, Spain).

^c Small governments had public spending less than 40 percent of gross national product in 1990 (Australia, Switzerland, United Kingdom, United States).

Source: Tanzi and Schuknecht (2000)



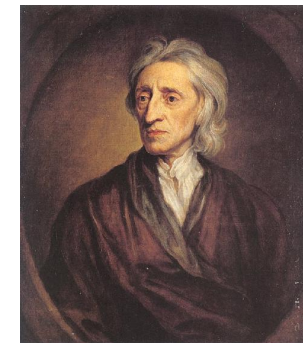
Social Benefit and the Growth of Government

- Has growth of government been socially beneficial?
- The growth of government since the time of Adam Smith in high-income societies has facilitated high incomes
 - The rule of law
 - Supply of public goods
 - Resolution of externality problems
 - Paternalistic public policies
 - Social insurance reduced insecurities of life
- In recent times, we still have political debate over whether more or less government is beneficial



Some Philosophy: Hobbes and Locke on the Desired Nature of Government

- Thomas Hobbes, *Leviathan* published in 1652
- John Locke, *Two Treatises of Government* published in 1690



Contrasting Views on the Nature of People and Required Government

- Hobbes
 - All people seek power over others
 - Peace only arose because people feared retaliation from a superior ruler
 - Rule of a dictator should suppress the evil inclinations of people and peace would break out
 - Hobbes postulates what life would be like without government, a condition which he calls the state of nature

“In such condition, there is no place for industry; because the fruit thereof is uncertain: and consequently no culture of the earth; no navigation, nor use of the commodities that may be imported by sea; no commodious building; no instruments of moving, and removing, such things as require much force; no knowledge of the face of the earth; no account of time; no arts; no letters; no society; and which is worst of all, continual fear, and danger of violent death; and the life of man, solitary, poor, nasty, brutish, and short.

— Chapter XIII, Leviathan



Contrasting Views on the Nature of People and Required Government

- Locke
 - Heavily influenced both the American and French Revolutions.
 - In a natural state all people were equal and independent, and everyone had a natural right to defend his “Life, health, Liberty, or Possessions”. This became the basis for the phrase in the American Declaration of Independence: “Life, liberty and the pursuit of happiness”.
 - The exercise of reason led people to understand that the state of nature was civilized
 - Every individual entitled by natural law to be free of the imposed order of others
 - Inefficient outcome of the prisoners dilemma of anarchy would be avoided by mutual consent based on reason
 - “No government can have the right to obedience from a people that have not freely consented to it”



Restraint on Government

- The encompassing interest of Hobbes' leviathan
 - Society would require protection against Hobbes' leviathan
- Locke's accountable government
 - Because of the political principal-agent problem, society requires protection against Locke's government



- How can society protect itself from growth of government that taxpayers and voters do not want?
 1. A Constitution
 - Constitution overrides the authority of government by subjecting people in government to pre-designated rules of behavior
 - Constitution overrides the will of the majority when majority voting takes place, by protecting the rights of the minority



- How can society ensure that the designers of a constitution will place the public interest before their own interest?
 - A new constitution might come into effect at some point in the future
- A formal constitution is not required if past laws and precedents provide limitations on the decisions of government (UK for example)



2. Zero-based budgeting provides transparency for taxpayers and voters wishing to judge whether increased public spending is desirable
 - A prospective constrain on government



2. Cooperation and Trust

- Cooperation and trust in a society determine the extent of the need for government
- Is the voluntary cooperation based on reason proposed by Locke feasible?
- To escape the prisoners dilemma of anarchy, people have to convince other people that they will behave rationally and choose to cooperate
 - Promising to cooperate can simply be “cheap talk”



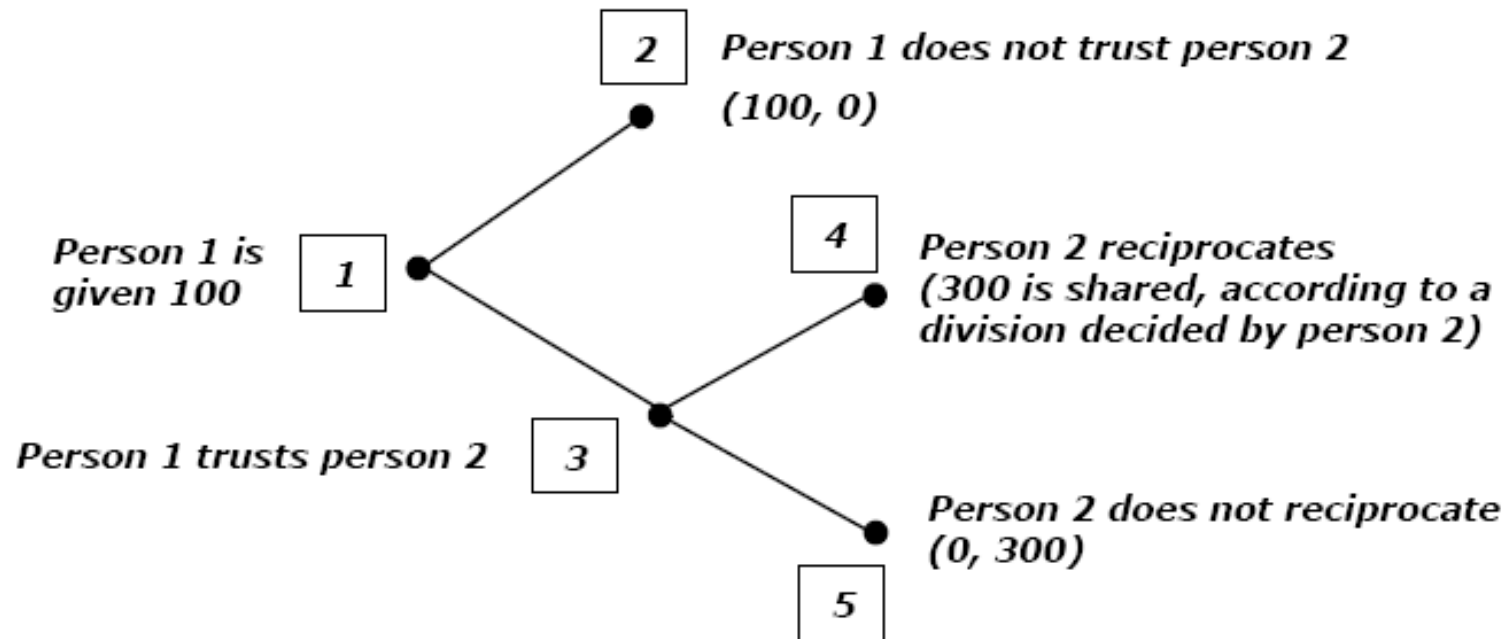
- Voluntary contribution to a public good. People will rationally cooperate and not free ride if
 - Interactions is indefinitely repeated into the future
 - Individuals do not discount the future too much (future is relatively important)
 - Identity of people involved will be the same
- Anonymity in society, diminishes the value of reputation (remember the dictatorship game)
 - Not applicable at the level of anonymous society
- Contrary to predictions of prisoner's dilemma, people do charity, do not litter etc
 - Can be due to ethical restraint, self esteem or norms



Social Norms and Trust

- Social norms of reciprocal trust can replace personal reputation as the basis for cooperation
- We can measure the level of trust through the trust game
 - Person 1 is given \$100, can keep all or transfer all to Person 2
 - If transferred the \$100 becomes \$300 in the hands of Person 2
 - Person 2 can keep the money or give back a certain proportion of the money (reciprocate trust)
 - Both people know the rules of the game
 - The rational equilibrium is for Person 1 to keep the \$100 as it is rational to anticipate that Person 2 will keep the \$300. Giving the \$100 to Person 2 reflects an expectation of reciprocating behaviour





The trust game

- People living in a society in which there is sufficient trust for the wealth increasing transfer to be made will be better off
- Gender Differences
 - Men and Women are equally likely to transfer the \$100 at node 1
 - After the transfer women are on average more generous than men in rewarding or reciprocating trust. 37.4% (women) versus 28.6% (men) returned.



Distrust and Social Segmentation

1. Trust will cease when it becomes clear that anonymous strangers are untrustworthy
2. Transaction costs in economic activity increase when the public good of trust dissipates and distrust displaces trust



Trust and Trustworthiness in Anonymous Populations

	Person 2 trusts person 1	Person 2 does not trust person 1 (or does not reciprocate trust)
Person 1 trusts person 2	10, 10	- 15, 15
Person 1 does not trust person 2 (or does not reciprocate trust)	15, - 15	0, 0

- Nash equilibrium at (0,0)
- With mutual trust, a positive sum game
- Without mutual trust, a zero-sum game



- Trust in small groups
 - Persons 1 and person 2 know each other's group identity
 - If they are from the same group, they mutually trust one another; if they are from different groups, they mutually distrust one another
 - When the two people are from the same group, the outcome is (10, 10)
 - When the two people are from different groups, the outcome is the Nash equilibrium (0,0)



Social Capital

- Because of the benefits of trust, trust has been described as social capital
- Social capital is the consequence of investment (investing in positive interactions with others)
- Robert D. Putnam, 2000, *Bowling Alone*
 - Activities that had traditionally been undertaken in social groups had, by the end of the 20th century, come to be more likely to be undertaken alone
- Social capital affects personal happiness
- Governments cannot easily implement public policies to increase trust



3. Views on the Need for Government: Political Economy

- Separation of economics from political economy
 - Economics was defined as a scientific discipline independent of subjective judgments and independent of politics
 - Economics aimed to present politicians with options of efficient outcomes, politicians would then choose based on level of redistribution
 - The notion of lump sum taxes supported this division
- However, as we have seen separating questions of efficiency and social justice are impossible (approach taken in this course)
 - Lump sum taxes not used in practice



- The definition of social justice matters in considering efficiency and social justice
- If social justice is defined as the natural right of possession and ex-ante equality of opportunity there is no conflict with efficiency



Why Reliance on Government is Controversial

- Reliance on government is controversial because of:
 - Different views of human nature
 - Different views that follow about responsibilities of government



View from the Left

- The view from the left stresses the responsibilities of governments
 1. Principal-agent problems
 - Political and bureaucratic principal-agent problems are minimal
 - Information limitations and rational ignorance of voters and taxpayers are not important
 - Incentive effects of taxation and the Laffer curve do not constraint collection of tax revenue
 - Moral hazard is not a significant problem, people do not take advantage of benevolence (or insurance or at least looking after the unlucky is more important)



2. Voting and locational choice (regional differences in policy)

- A representative individual is a good approximation because people have preferences
- The tyranny of the majority in majority voting is not a big issue
- Competition among governments through location choice is not important
- Centralized government is preferable to decentralized government because of redistribution of income and avoidance of tax competition



3. The choice between efficiency and social justice

- Priority for social justice over efficiency
- Preference for the imposed order of government
- Sympathy for Rawls' complete insurance



View from the Right

- Merit in the social benefits of efficiency
- The limitations of government
 1. The political-principal agent problem
 - Politicians and bureaucrats are people with self-interests and personal objectives
 - Assigning responsibilities to government is limited by rational ignorance and other informational impediments limit political and bureaucratic transparency and accountability to taxpayers and voters
 - There are problems of rent seeking
 - Constitutional restraint on government is beneficial



2. Asymmetric information and public policy

- A well-intentioned government is limited by
 - Asymmetric information
 - Excess burden of taxation
 - The Laffer curve
- There are necessary responsibilities of government that require cost-benefit analysis but the limitations of cost-benefit analysis should be understood



3. Voting

- Personal market decisions are preferred because majority voting ensures neither efficient nor socially just outcomes
- Ostrogorski's paradox (direct and representative democracy produce different outcomes)
- Need for checks and balances when decisions are made by voting

4. Fiscal federalism and competition among governments

- A fiscal-federal structure is beneficial
- Governments can cater to diverse preferences
- Competition among governments
- The common pool problem is avoided



5. Private resolution and personal choices

- Private voluntary finance for public goods through user prices and locational sorting
- Private resolution of externality problems
- Private voluntary charitable giving for people in need

6. Efficiency and social justice

- Emphasis on efficiency
- Bentham is preferred to Rawls
- Competitive markets are preferred to government decisions
- Personal freedom



An Overview

	The Left	The Right
Influenced by:	Rawls	Bentham
Redistribution	++	+
Taxation	++	+
Regulation	++	+
Centralisation	++	+
Immigration	++	+
Light examples	British Labour Party, Irish Labour Party, Obama's Democrats, French Socialist Party	FG, FF, British Conservatives, US Republican Party, German CDU
Extreme examples	Irish Socialist Party, Sinn Fein (?)	US Tea Party



Agreements and Ambiguities

1. Entitlements and Equality

- Both favour entitlements to provide equality of opportunity
- Right more concerned with how entitlements affect incentives
- Challenge for the left is that equality of opportunity leads to ex-post inequality

2. Immigration

- Both acknowledge that migration beneficial for the free movement of people with a work ethic
- Light left generally recognises that a generous social welfare system is inconsistent with open borders policies

3. Paternalistic policies

- Left can be sympathetic to paternalistic policies
- Right less receptive to paternalistic policies



Human Nature

- Self-interested incentives that underpin the market economy are also the basis for government
 1. No need for government to maintain competitive markets if no one took advantage of monopoly power
 2. If people respected the natural right of possession and the right to freedom/life of others, the rule of law through government would not be required
 3. If people revealed their true benefits from public goods and voluntarily to paid efficient Lindahl prices, taxation would not be required and the excess burden and administrative costs of government would not be incurred
 4. There would be no tax evasion if people did not seek to free ride on tax payments



5. Public policy and public finance would not be required to resolve externality problems, if people were considerate in taking into account how their behavior affects others
6. The responsibility of government to provide social insurance would be unnecessary, if people accepted the metaphor of the veil of ignorance and there would be no inhibitions to providing social insurance if behavior were not subject to moral hazard
7. No political principal-agent problems if people political decision makers and bureaucrats only sought the public interest

- Achievement of efficiency and social justice in general requires more than voluntary decisions based on personal self-interest
- Personal behavior required for an efficient and socially just society contradicts self-interested human behavior



- There is therefore a need for government
- The questions is how much government
- Societies are required to decide about how much government

We have been discussing about how societies might make that decision!



Thank you!

