Public Spending in the 20th Century

A Global Perspective

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Contents

	List of Tables	*page* xi
	Preface	xv
	PART ONE The Growth of Government: A Historical Perspective	1
I	The Growth of Government since 1870	3
	1 The Period up to Word War I	3
	2 The Interwar Period	9
	3 The Period until 1980	10
	4 The 1980s and the 1990s	18
	5 The Symmetry of Expenditure Growth	20
	6 Concluding Remarks	22
II	The Composition of Public Expenditure	23
	1 Government Real Expenditure	24
	2 Subsidies and Transfers	30
	3 Social Expenditure	32
	4 Interest on Public Debt	45
	5 Concluding Remarks	47
III	Revenue, Deficits, and Public Debt	50
	1 Revenue	51

	2 Deficits	61
	3 Public Debt and Implicit Liabilities	64
	4 Concluding Remarks	67
	PART TWO Gains from the Growth of Public Expenditure	71
IV	Historical Evidence on Government Performance	73
	1 A Note on the Methodology Followed	73
	2 Economic Indicators	77
	3 Social Indicators	89
	4 Concluding Remarks	98
V	The Size of Government and Its Performance	99
	1 Introduction	99
	2 Public Expenditure Patterns	100
	3 Economic Performance, Public Debt, and Labor Market Indicators	102
	4 Social Indicators	108
	5 Environmental Indicators	110
	6 Distributional and Social Stability Indicators	112
	7 Governance-Related Indicators	115
	8 Concluding Remarks	119
VI	The Experience of the Newly Industrialized Economies	120
	1 Public Expenditure Patterns in the Newly Industrialized Economies	121
	2 Economic and Labor Market Indicators	124
	3 Social and Distributional Indicators	127
	4 Governance-Related Indicators	129
	5 Concluding Remarks	130
	PART THREE The Role of the State and Government Reform	131
VII	Rethinking the Role of the State	133
	1 The Scope for Reform	133

2 Changing the Policy Regime 136
3 Reducing the Role of the State 139
4 The Implementation of Reforms 143
5 Reform and the Globalization of Economies 148
6 The Time Frame for Reform 149
7 Concluding Remarks 151

VIII Fiscal Rules and Institutions 152
1 The Importance of Fiscal Rules and Institutions 152
2 The Budgetary Process 154
3 Fiscal Rules 157
4 New Trends in Public Expenditure Management 161
5 Implementation Agencies 165
6 Corruption and the Rule of Law 167
7 Concluding Remarks 170

IX Blueprint for Public Expenditure Reduction 171
1 The Importance for Reforming Expenditure Policies 171
2 Privatizing Public Enterprises, Services, and Investment 174
3 Education 184
4 Pension Reform 190
5 Reform of the Health Sector 198
6 Scaling Down Other Income Transfer Programs 202
7 Quasi-Fiscal Policies 203
8 Accounting for Resource Use 204
9 Concluding Remarks 206

PART FOUR Recent Experiences of Countries in Reforming the Government 207

X Recent Reform Experience 209
1 Changing the Policy Regime in New Zealand 210
2 Changing the Policy Regime in Chile 213
3 Fiscal Reform in OECD Countries 215

4 Fiscal Reform in Newly Industrialized Countries 225
5 Concluding Remarks 229

XI Fiscal Reform in the Public Debate 230
1 The Prominence of Fiscal Reform in the Public Debate 230
2 The Debate on Deficit and Spending Limits 234
3 Expenditure Polices in the Public Debate 237
4 Implementation of Reforms: Between Globalization and Vested Interests 241
5 Concluding Remarks 245

XII The Future of Public Spending 247

Bibliography 254
Author Index 273
Subject Index 278

List of Tables

I.1	Growth of General Government Expenditure, 1870–1996	*page* 6
II.1	Government Real Expenditure, 1870–1995	25
II.2	Government Employment, 1870–1994	26
II.3	Public Expenditure on Defense, 1900–95	28
II.4	Government Expenditure on Subsidies and Transfers, 1870–1995	31
II.5	Public Expenditure on Education, 1870–1993	34
II.6	Social Insurance Coverage in Western Europe: Pension, Unemployment, and Health Insurance, 1910–75	36
II.7	Public Expenditure on Health, 1913–94	37
II.8	Development in Systems Generosity of Pension Benefits	40
II.9	Public Expenditure on Pensions, 1913–93	41
II.10	Public Expenditure on Unemployment, 1937–96	43
II.11	Public Expenditure on Other Income Transfer Programs, 1992	44
II.12	Central Government Expenditure on Interest, 1870–1995	46
II.13	General Government Expenditure on Public Investment, 1870–1995	48
AII.1	Aging Population, Percentage of Population over 60 Years Old	49
III.1	General Government Revenue, 1870–1996	52

III.2 Government Revenue Composition, 1870–1994 56
III.3 Tax Rates: VAT/Sales Tax, Income Tax, and Payroll Taxes, 1996 60
III.4 General Government Fiscal Balance, 1960–96 62
III.5 Gross Public Debt from a Historical Perspective, 1870–1996 65
III.6 Estimated Net Pension Liabilities of Selected Industrialized Countries 68
IV.1 Economic Indicators from a Historical Perspective: Real Economic Growth 78
IV.2 Economic Indicators from a Historical Perspective: Per Capita GDP 79
IV.3 Economic Indicators from a Historical Perspective: Unemployment Rate 81
IV.4 Economic Indicators from a Historical Perspective: Inflation 83
IV.5 Real Interest Rates on Public Debt, 1960–90 85
IV.6 Risk Premiums on Public Debt, Selected OECD Countries, 1991–5 87
IV.7 Fiscal Deficits, Public Debt, and Savings of G-7 Countries, 1970–94 89
IV.8 Social Indicators from a Historical Perspective: Infant Mortality and Life Expectancy 90
IV.9 Social Indicators from a Historical Perspective: Education 93
IV.10 Social Indicators from a Historical Perspective: Income Distribution 95
IV.11 Targeting of Transfers versus Universal Benefits, Mid-1980s 96
IV.12 Equalization of Income Distribution through Taxation and Transfers, Mid-1980s 97
V.1 Size of Government and Public Expenditure Composition, about 1960 and 1990 101
V.2 Size of Government, Economic Performance, Financial Indicators, and Labor Market: Indicators in Different Country Groups, about 1960 and 1990 104
V.3 Size of Government, Health, Education, and Environment Indicators in Different Country Groups, about 1960 and 1990 109

V.4 Size of Government and Distributional and Social Stability Indicators in Different Country Groups, about 1960 and 1990 113
V.5 Size of Government and Governance-Related Indicators, about 1990 117
VI.1 Government Performance Indicators, Selected "Small" Governments, and Newly Industrialized Countries, Early 1990s 125
VII.1 Level of Fiscal Churning in Selected Industrial Countries 141
IX.1 Blueprint for Government Reform of Various Expenditure Programs 173
IX.2 Assessing Benefits of Private versus Public Provision of Goods and Services in Infrastructure 178
IX.3 Private versus Public Provision of Goods and Services 182
IX.4 Sources of Income of Higher Education Institutions, Mid-1980s 189
IX.5 Contribution Gaps of Pension Systems and the Effects of Reform in Selected Industrial Countries 193
IX.6 Cost Control and Public versus Private Health Expenditure, 1992 200
X.1 Public Expenditure Development and Government Reform: Chile and New Zealand 212
X.2 Public Expenditure Development and Government Reform: Selected Industrial Countries 217
X.3 Public Expenditure Development and Government Reform: Selected Newly Industrialized Countries 226

I The Growth of Government since 1870

Economists' and society's views of the role of the state in the economy have changed remarkably over the past two centuries. Because of this, public institutions and the government's involvement in the economy have changed as well. Since 1870, government spending has increased considerably in all of today's industrialized countries. Although this increase has not been equal in all countries, it is nevertheless remarkable that the growth in public spending has been a general phenomenon despite the considerable institutional differences and geographic and language barriers that have existed among industrialized economies. Government spending increased most rapidly until about 1980. Since the early 1980s, it has been growing more slowly and in some instances has even declined. We shall argue in this book that, in spite of pressures for more public spending due to the less fiscally friendly environment that will prevail in future years because of demographic developments, public spending is likely to fall in the future.

1. THE PERIOD UP TO WORLD WAR I

The Dominance of Laissez-Faire

In the nineteenth century classical economists and political philosophers generally advocated a state with minimal economic functions. This attitude was in part a reaction to the major distortions

that governmental intervention had caused in the eighteenth century.[1] As Keynes put it: "Almost everything which the State did in the eighteenth century in excess of its minimum functions was, or seemed, injurious or unsuccessful" (Keynes, 1926, p. 12). Classical economists thought that the government's role should be limited to national defense, police, and administration because government "cannot have any other rational function but the legitimate defense of individual rights" (Bastiat, 1944–5). In 1776, Adam Smith had described his views on the role of the state in providing public goods or, in his words, "erecting and maintaining those public institutions and those public works, which, though they may be in the highest degree advantageous to a great society, are, however, of such a nature, that the profit could never repay the expense to any individual or small number of individuals. . . . [These public works are mainly] those for facilitating the commerce of the society, and those for promoting the instructions of the people."[2] Thus, in some ways Smith introduces an early version of the concept of a public good.

Furthermore, classical economists "were [. . .] among the most forceful advocates and pioneers of state education" (West, 1970). Referring to the lower "classes," Smith already recognizes the importance of education for modern states: "The state [. . .] derives no inconsiderable advantage from their instruction. The more they are instructed, the less liable they are to the delusions of enthusiasm and supposition, which among ignorant nations, frequently occasion the most dreadful disorders." Many people of the time also stress the importance of education for keeping young people from doing-mischief.[3]

For classical economists, the government role should be small and essentially limited to the allocation of resources (see Robbins, 1962). The countries' institutional frameworks, such as the U.S. Constitution,

1. On this see a little known book by Keynes (1926).
2. Adam Smith, *The Wealth of Nations* (1937, p. 681). By the beginning of the nineteenth century, private charity was already considered inadequate, and public relief and punishment programs for the poor were introduced, mainly to maintain law and order (Rimlinger, 1971). Distributional policy interventions during crisis periods also occurred. See Rothbard (1962) on debt relief in the panic of 1819 or Hammond (1957) on banking and politics before the Civil War.
3. See West (1970, pp. 112–13). However, West also writes that the degree of state intervention as developed over the past hundred years would have not been approved by classical economists.

did not specify any other economic role for the state. Consequently, in the last century, public spending was minimal in a number of industrialized countries for which data for 1870 could be found (Table I.1).[4] Around 1870, unweighted average public expenditure amounted to only about 10 percent of gross domestic product. In the United States, government expenditure was about 7 percent of GDP, and, in most newly industrialized European countries of the period, such as Germany, the United Kingdom, or the Netherlands, expenditure did not exceed 10 percent of GDP. By the standards of classical economists, Australia's, Italy's, Switzerland's, and France's public expenditure share, in the range of 12–18 percent of GDP, was considered as heavy state involvement in the economy. A leading French economist of the time, Paul Leroy-Beaulieu (1888), addressing the question of the proper share of taxes in the economy, suggested that a share of 5–6 percent was moderate while a share beyond 12 percent had to be considered "exorbitant" and would damage the growth prospects of an economy.

In the latter part of the nineteenth century, however, classical economists started to be challenged by Marxian thinking, which strongly influenced the socialist movement in Europe. By the end of the century, the German economists Schmoller and Wagner had added redistribution of wealth to the legitimate and normal government functions. They justified government policies aimed at redistributing wealth from the rich to the less fortunate. Up to that time, policies with redistributive effects had been mostly ad hoc and aimed at protecting some groups in particular situations such as famines, banking crises, and so on. By that time, the government role in providing *primary* education was already predominant (Connell, 1980) even though a large share of the population still did not have access to and thus did not attend the schools. The first social security system, albeit with minimal eligibility and benefits, was introduced in Germany in the 1880s (Altenstetter, 1986). It has been argued that "by the end of the nineteenth century, the setting was prepared for the modern concepts of social protection" (Rimlinger, 1971).

4. In a recent paper, one of the authors has warned that the role of government is not limited to spending but can be pursued through quasi-fiscal activities and regulations (see Tanzi, 1998c). In this book, we focus on spending and taxing and thus largely ignore that warning.

Table I.1. *Growth of General Government Expenditure, 1870–1996* (Percent of GDP)

	Late 19th Century	Pre World War I	Post World War I	Pre World War II	Post World War II			
	about 1870[a]	1913	1920	1937	1960	1980	1990	1996
General government for all years								
Australia	18.3	16.5	19.3	14.8	21.2	34.1	34.9	35.9
Austria	10.5	17.0	14.7[b]	20.6	35.7	48.1	38.6	51.6
Canada	...	...	16.7	25.0	28.6	38.8	46.0	44.7
France[c]	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[d]	...	...	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[b]	...	...	24.6	25.3	26.9	38.1	41.3	34.7
Norway[d]	5.9	9.3	16.0	11.8	29.9	43.8	54.9	49.2
Sweden[c]	5.7[b]	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
Average	**10.8**	**13.1**	**19.6**	**23.8**	**28.0**	**41.9**	**43.0**	**45.0**

Central government for 1870–1937, general government thereafter								
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
Average	**9.1**	**11.3**	**14.6**	**18.0**	**27.6**	**48.6**	**50.1**	**48.6**
Total average	**10.7**	**12.7**	**18.7**	**22.8**	**27.9**	**43.1**	**44.8**	**45.6**

Sources: Compiled by Tanzi and Schuknecht based on Fernández Acha (1976); Andic and Veverka (1964); Australia, Bureau of Census and Statistics (1938); Institut National de la Statistique [Belgium] (1952); Brosio and Marchese (1986); United States Bureau of Census (1975); Butlin (1984); Norway, Statistisk Sentralbyrå (1969, 1978); Delorme and André (1983); Flora, Kraus, and Pfenning (1983); IMF, *Statistical Appendix*, New Zealand; IMF, *Switzerland: Recent Economic Developments* (1996); *Historical Statistics of Japan* (1987); Mitchell, *International Historical Statistics* (various years); Neck and Schneider (1988); The Netherlands, Centraal Bureau voor de Statistiek (1956); New Zealand Official (1938); OECD, Economic Outlook (1996, 1997); Italy, Istituto Nazionale de Statistica (1951); *Österreichisches Statistiches Zentralamt* (1935).

[a] Or closest year available for all columns. Pre-World War II data sometimes on the basis of GNP or NNP instead of GDP.

[b] Central government data for this year, New Zealand: 1960 = 1970, and 1994–95 = 1996.

[c] 1996 data; calculations are based on the Maastricht definition, and are smaller than that published by the INSEE, the national statistical agency.

[d] 1995 instead of 1996, because of break in data calculation.

Nevertheless, laissez-faire attitudes continued to predominate and the role of the government remained limited. The average share of public expenditure in GDP increased slowly between 1870 and World War I growing from 10.7 percent in 1870 to 11.9 percent in 1913. This share included central, state, and local government spending for most countries (see details in Table I.1). The arming of Austria, Germany, France, and the United Kingdom in anticipation of World War I is reflected in higher public expenditure levels in these countries, while expenditure in Japan, Norway, the Netherlands, and the United States was still below 10 percent of GDP. In a few countries, the share of government expenditure in GDP even declined over this period. The remarkable feature is that these low shares of government spending were achieved in a period when much of Europe was becoming modern and when many large public works (railroads, metros) were completed.[5]

The Effects of World War I

The first World War brought about a considerable increase in average levels of government expenditure. This increase was largely a result of military and other war-related spending. As governments had expanded their revenue base to finance at least part of their war efforts, they could maintain higher expenditure levels after the war (Peacock and Wiseman, 1961). They also had to pay back their war-related debt or reparations. By 1920 or shortly thereafter, public expenditure had increased to an average of 18.7 percent with only Sweden, Spain, and the United States staying near 10 percent of GDP. In France, Germany, Italy, and the United Kingdom, the countries most affected by the war, expenditure exceeded 25 percent of GDP. Australia, Austria, Canada, Ireland, Japan, the Netherlands, Norway, and Switzerland belonged to the group of "medium-sized" governments with expenditure levels below 20 percent of GDP.

5. A note of warning on the data is perhaps necessary. Obviously, there are problems of comparability of data. However, these problems are not likely to change the basic trends reported.

2. THE INTERWAR PERIOD

The End of Laissez-Faire

After World War I, general attitudes toward the role of the government started changing as reflected by the title of Keynes's 1926 book, *The End of Laissez-Faire*. In that book, Keynes wrote that: "The important thing for government is not to do things that individuals are doing already, and to do them a little better or a little worse; but to do those things which at present are not done at all" (pp. 46–7). He implied that there were many things that were not being done at that time.

By the late 1920s many European countries had introduced rudimentary social security systems, and the Depression resulted in a wave of expansionary government expenditure policies including social programs (Ashford and Kelley, 1986). The Depression was seen by many as a monumental failure of the market economy and of laissez-faire, a failure that justified governmental intervention and made many intellectuals look with varying degrees of admiration at the economic experiments going on in Russia and in Germany and Italy. The United States introduced major public expenditure programs with the New Deal (such as Aid for Families with Dependent Children), and other governments authorized higher spending on the unemployed and on public works partly to create employment in the context of the Great Depression. Starting from the mid-1930s, growing military spending in response to the threat of Hitler's Germany also contributed to the rise in public expenditure in European countries.

By 1937, public expenditure had increased to an average of 22.8 percent or about double the 1913 level. Expenditure had increased in all countries and the increase was most pronounced in Canada, Germany, Japan, the Netherlands, Spain, Sweden, Switzerland, and the United States. However, part of this increase was due to the fall in GDP caused by the Depression rather than to a real increase in public spending.[6] With the exception of Australia, Norway, and Spain, public expenditure exceeded 15 percent of GDP in all countries. By

6. The increase looks even less dramatic when account is taken of the fact that in 1937 some countries were already preparing for war.

1937, the minimal state committed to laissez-faire policies was on the way out. The ground had become fertile for the future growth of the welfare state, and in this growth income redistribution would play a large role.

3. THE PERIOD UNTIL 1980

The Growing Influence of Keynesianism

The post–World War II period, and particularly the period between 1960 and 1980, saw an unprecedented enthusiasm for activist expenditure policies coupled with rapid growth in the involvement of the government in the economy. In his influential book, Richard Musgrave (1959) described the allocative, stabilizing, and redistributive functions that a modern government should undertake. The development of the theory of public goods and of the concept of externality suggested a growing allocative role for the state. The popularity of socialism among Western intellectuals and some political leaders made the redistributive role a progressively more appealing and more important one.

In *The Ethics of Redistribution*, Bertrand de Jouvenel (1952, p. 73), a French political philosopher, would write:

> Public finance generally is a dull subject, but public finance in the first half of the twentieth century is entrancing: it has been revolutionized and in turn has been the means of a revolution in society. Out of many new aspects of public finance, the two most notable are, first, that it has been used to alter the distribution of the national income between social classes, and, second, that the fraction of national income passing through public hands has increased enormously.

It should be noted that he was writing in the 1950s, well before the real expansion in public spending had taken place.

Keynes's *General Theory,* popularized through influential works by Alvin Hansen, Abba Lerner, Lawrence Klein, and others, provided the tools for stabilization and, yet, another powerful reason for governmental intervention. The great fear of unemployment after the Great Depression came to be tempered by the belief that the application of Keynesian demand policy could eliminate or at least reduce business cycles and unemployment. The enormous impact of Keynes's writings on policymaking in the 1960s and 1970s (if only as

a pretext for expansionary special interest policies) made this period the Keynesian era. To some extent, the influence of Keynes may have confirmed his own prediction that "the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else."[7]

Galbraith's politically influential book, *The Affluent Society* (1958), written during the fiscally conservative Eisenhower administration, expressed in a pointed and well-articulated fashion the attitude of the economic avant-garde at that time. Influenced by the experience of the Great Depression and the seeming success of expansionary fiscal policies before the war, Galbraith backed the view that "in the event of insufficient demand, taxes should be cut and public outlays [should] be increased, as is now widely accepted." In his view, the previous "conventional wisdom of balanced budgets at all times" had become obsolete (p. 18). Galbraith was particularly unhappy about the insufficient government activity in the production of public goods and services. Thus, in a way he was building on the views of Keynes expressed in 1926 in the *End of Laissez-Faire*. As Galbraith put it, "the myopic preoccupation with (private) production and material investment has diverted our attention from the more urgent questions of how we are employing our resources and, in particular, from the greater need and opportunity for investing in persons" (p. 332). To Galbraith, "public poverty" prevailed not only in education but also in basic research, education, pollution control, and foreign assistance for relieving starvation. In other words, public poverty could be alleviated by more public spending. He concluded that "government expenditure is likely at any given time to be near the minimum which the community regards as tolerable" (p. 241). This conclusion seems far from more recent views about the level of public expenditure.

To Galbraith, opposition to social insurance and legislation was another liberal fallacy that reflected Ricardian and Malthusian gloom and social Darwinism (1958, chapter V). By the late 1950s, only a few decades after the introduction of social legislation and social

7. Keynes continues, "Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back." In 1966, Walter Heller wrote about "Lord Keynes's spectacular rescue of economics from the wilderness of classical equilibrium" (p. 4).

insurance in most countries, he observed approvingly that "the basic uncertainties of life had been eliminated" (1958, chapter VIII). In this statement he anticipated one of the important justifications for government spending, namely the reduction of risk for most citizens.

This strong faith in the role of government was shared by Francis Bator, another influential economist at that time. In *A Question of Government Spending*, he stated his view of a good society as follows: "My conception of the good society . . . lead me to believe that we are dangerously shortchanging ourselves on defense, foreign aid, education, urban renewal, and medical services; that we badly need to increase allocations to these and a variety of other tasks" (Bator, 1960, p. xiv). In other words, there was a strong need for more public spending. Similar views were expressed in 1958 by James Tobin, who wrote that "Orthodox fiscal doctrines have again dominated our policies during the five years since 1953, and again have brought the nation to the brink of catastrophe . . ." (in Tobin, 1966, p. 57). Writing in 1960, he added that: "Increased taxation is the price of growth" (ibid. p. 87).

The forceful stance for bigger government involvement in the provision of goods and services by the aforementioned economists and others was accompanied by new developments and techniques in the evaluation of government programs and in budgeting. See Merewitz and Sosnick (1971). Earlier decades mainly dealt with institutions and accountability in the budgeting process, sometimes using rules of thumb to assess the benefits of government programs. In the 1950s and early 1960s, some came to believe that planning, programming, and budgeting systems and other techniques would increase the efficiency of public expenditure (Premchand, 1983).

Cost/benefit analysis of public projects, for example, was considered a major breakthrough in economic planning techniques. New techniques were assumed to remove political discretion from budgetary decisions so that public money could be properly and efficiently allocated by the government. It is difficult now to convey the excitement of that period in this area. "An air of mystery began surrounding it through expressions like input-output, linear programming, discounted cash flow, critical path analysis," leading some economists to predict that these will be "as revolutionary in [their] policy implications as was the Keynesian revolution in economics" (Peters, 1973, p. 10). Smithies (1964) emphasized the role of program

budgeting in determining national program goals and suggested that budgets can be a "precise instrument for planning, appropriation, administration, and control" which could help "to clarify and refine government objectives and the allocation of resources." An engineering approach to public policies and social welfare emerged as the evaluation and implementation of policies were assumed to become more and more efficient.[8]

It was also believed at the time that progressive taxation, presumably with a stable tax base and no serious disincentive effects, could provide the financing for these more ambitious expenditure policies. Furthermore, these expenditure policies could identify and target potential beneficiaries at low administrative and efficiency costs. It is remarkable that, at the time, most studies did not find any negative impact on the economy deriving from high marginal tax rates. The so-called second generation analyses of the impact of high marginal tax rates were still some years in the future.

The Decline of Fiscal Institutions

This intellectual belief in a positive role of the state and its power to carry out such a role came to be embedded in the legal-institutional framework for countries' policymaking. Some erosion of constraints on government expenditure policies had already begun in the late nineteenth century (Moser, 1994). Before World War II, the Great Depression was the main cause for an erosion in constraints on fiscal deficits, when, for example, in the United States, the Supreme Court ruled that "the power of congress to authorize appropriations of public money for public purposes is not limited by the direct grants of legislative power found in the Constitution." Thereby it provided the judicial opening for extensive public works and the developing of welfare programs (Niskanen, 1992).

The erosion in the legal-institutional constraints on fiscal deficits accelerated after World War II when many European countries came to accept welfare rights as constitutional rights. Several countries

8. On Schumpeter's view of the beneficial effect of economic uncertainty and recessions, Galbraith comments that "government inactivity was equal to not calling the fire department when a house is on fire because the fire had work to do" (Galbraith, 1958, p. 46). This image of the economy in recession as a burning house with government demand policies as the fire rescue squad is a typical example of a social and economic "engineering" approach to government.

made strong legal provisions for interventionist policies in their constitutions (e.g., Germany and Switzerland) or through their legislature (e.g., Germany and the United States), and supreme courts supported such policies when interpreting the consistency of activist legislation with the existing legal framework (Moser, 1994).

In Germany, the new postwar constitution stressed the role of the state in shaping the "social market economy." In the late 1960s, the stabilization law extended the role of government to the promotion of macroeconomic stability. After the first oil crisis, the German supreme court exempted the government budget from the constitutional deficit limit. Article 81 of Italy's constitution also provided some formal constraints on fiscal policies, including the requirement to match new or higher expenditure in the budget with means to finance them. The vagueness of this rule on what constitutes appropriate "means" probably facilitated its relaxation in the 1960s (Eusepi and Cerioni, 1989). In Switzerland, the most far-reaching revision of federal powers was introduced in 1947 that included the subsidization of industry and agriculture. In 1971, the Swiss court permitted state intervention for social policy motives.

The U.S. Constitution has no strong provisions against economic and social legislation and is very difficult to change. The Supreme Court of the United States de facto helped in changing constitutional rules by permitting, first, the New Deal legislation and later, postwar activist legislation such as the 1946 Employment Act (Moser, 1994). The Employment Act of 1946 declared that the federal government was responsible to promote "maximum employment, production, and purchasing power" (Okun, 1970, p. 37). This was indeed a major departure from laissez-faire.[9] In the words of James Tobin: "with this Act as a solemn expression of national policy, no Administration, Democratic or Republican, can avoid a modest amount of economic planning" (1966, p. 10).

The growth of government was also facilitated by the dynamics of the political process in democratic societies. Expenditure growth was furthered by interest groups lobbying for spending programs and by bureaucrats demanding larger budgets. Monetary financing of government deficits weakened expenditure control. Additional institu-

9. These few examples show that there is surprisingly little discussion on how the legal-institutional framework underlying fiscal policymaking in industrialized countries changed to accommodate expansionary fiscal policies and deficits.

tional factors led to asymmetries in the political costs of taxing and spending. In democracies, legislators typically have an incentive to enhance their political support by voting for spending projects in their districts, because wealth is transferred to their voters while the costs are borne by all voters in the country. By the same token, they are reluctant to increase taxes that affect their constituencies. In some countries, certain changes in the federalist decision-making processes have increased expansionary pressures on the budget.[10]

A number of other reasons for the growth in public spending have been advanced (for a survey see Holsey and Borcherding, 1997). Rapid urbanization in industrial countries is likely to have facilitated increasing taxation and to have created more demands for public spending. More recently, the aging of the populations in industrialized countries has started to contribute to the growth of spending although the full pressure from aging will only be felt in the coming decades. Wagner's Law (named after a publication by Adolf Wagner in 1876) has been probably the most prominent but not very convincing explanation for government growth. Wagner argued that a rise in public spending was a kind of natural development that would accompany the growth of per capita income. Wagner's Law fails to explain why public spending did not grow between 1870 and 1913. In this book, we argue that the growth in public spending resulted from changing views on the role of government in the economy.

It is important to maintain a historical and institutional perspective when assessing the expansion of public expenditure since World War II. Between 1937 and 1960 public expenditure, as a share of GDP, increased at a relatively slow pace and much of the increase was probably related to the growth of defense spending especially during and after World War II. Average, unweighted public spending grew from about 22 percent of GDP on average in 1937 to 28 percent of GDP by 1960. In Japan, Switzerland, and Spain, public expenditure was still below 20 percent of GDP in 1960. Public spending even declined in Germany, Japan, and Switzerland. The growing role of government,

10. For a number of theoretical and empirical articles on this subject see Forte and Peacock (1985); Mueller (1986); Buchanan, Rowley, and Tollison (1987); Frey (1988); Winer and Hettich (1991b); and the essays in Breton, Galeotti, Salmon, and Wintrobe (1991). Wildavsky (1985) provides a "cultural" explanation for the growth of public spending. Lindert (1994) shows that political economy factors were already relevant for explaining the growth in social spending between 1880 and 1930 in various countries. For a survey of the literature on deficits see Mueller (1997) and Alesina and Perotti (1995a).

however, manifests itself at the same time in considerable spending growth in Australia, Austria, the Netherlands, Norway, Sweden, and the United States.

The rapid expansion of public expenditure between 1960 and 1980 is remarkable because it occurred when most countries were not engaged in war effort; there was no depression, and the demographic developments were generally fiscally friendly. That expansion reflects mainly the previously mentioned change in attitude toward the role of the state. The 1960s and 1970s was the heyday of Keynesianism and the time when governments were perceived by many to be efficient in allocating and redistributing resources and in stabilizing the economy. This was also the period when basic social security systems acquired some of the characteristics of the welfare state.[11] Consequently, public expenditure as a share of GDP increased from around 28 percent in 1960 to around 43 percent in 1980. The share almost doubled in Belgium, Ireland, Japan, Spain, Sweden, and Switzerland, and increased rapidly in most of the other industrialized countries. By 1980, public expenditure exceeded 50 percent of GDP in Belgium, the Netherlands, and Sweden. No industrial country kept public expenditure below 30 percent of GDP and only Japan, Spain, Switzerland, and the United States stayed close to this level.

The 1960–80 period could be described as the golden age of public sector intervention. It was a period much influenced by perhaps naive perceptions of how governments operate (Tanzi, 1997). Normative views of how the government should act prevailed over positive views of how governments actually act in the real world. The public choice literature had still not had much influence. More recent experience has shown that the romantic or idealized view of how policy is made and is carried out is, at times, far removed from reality. In some ways extreme versions of this romantic view were implicit in the work of Tinbergen (1952) and Johansen (1965). What were these naive perceptions of how government operate? Implicitly or explicitly it was assumed that:

(a) The actions of the policymakers were generally driven by the

11. In many countries the social security systems expanded their activities outside the field of insurance for old age. Also, the link between contributions and pensions became more tenuous for individual contributors. Thus, social security contributions came to be seen as taxes by many of those who paid them.

objective of promoting social welfare. Thus, rent seeking on the part of those who formulated the policies was assumed to be insignificant or nonexistent. The literature on rent seeking would appear only in the 1970s and would not become influential until later.[12]

(b) The public sector was monolithic and with an obvious nerve center where all the important economic decisions for the whole sector were made in a rational and transparent way. Therefore, policies could not be inconsistent among them. For example, the policies pursued by the public enterprises or by other decentralized entities (such as local governments, stabilization boards, and social security institutions) could not be at odds with those pursued by the central government; and, of course, within the central government, there was consistency in the policies promoted by the various ministries.[13] It is puzzling how little interest there was until the 1990s in issues of fiscal federalism and policy coordination *within* countries.[14]

Policies were assumed to be consistent not only in space but also in time. The political horizon of governments would be long enough so that current policies would not conflict with future policies. Such conflicts can result either from mistakes or from political considerations (such as winning the next elections) that may lead policymakers to choose, in the short run, policies that are clearly inconsistent with long-run objectives. Once again, the literature on the time inconsistency of economic policy is a product of more recent years.[15]

(c) Policy decisions were reversible. Thus, government employees could be dismissed when no longer needed; public wages could be cut as well as increased; incentives could be removed when their objec-

12. See Tullock (1967) and Krueger (1974).
13. For examples of inconsistent or uncoordinated policies within the U.S. government, see Krueger (1993). An extreme example for the United States was provided by the subsidies given to the producers of tobacco at the same time as the government was trying to discourage smoking.
14. For examples of inconsistent policies between the central government and the local governments, see Tanzi (1996c) For recent surveys on practices in fiscal federalism, see Ter-Minassian, editor (1997). For a historical study on fiscal federalism, see the collection of essays in Musgrave (1965), and, in particular, Rafuse's study on the destabilizing expenditure and revenue dynamics at the state and local level in the postwar United States.
15. See Calvo (1978). There is now a large literature that confirms the existence of political cycles in public expenditure behavior.

tives had been achieved or their implementation time had expired; entitlements could be ended; and so on. During the 1980s, governments had to face the unpleasant reality that it is far easier to increase benefits (such as pensions and wages) than reduce them; or to hire civil servants than to fire them.

(d) The policymakers had full control over the policy instruments. They could rely on honest and efficient public sector employees who would implement efficiently and objectively the policies decided at the top. The literature on corruption, principal-agents problems, and rent-seeking is relevant here and is, once again, a product of recent years;

(e) Finally, it was assumed that the policymakers had a good and correct understanding of how economies operated. The certainty of Keynesian economics, with the addition of the Phillips curve, had not yet been challenged in a convincing way, either empirically or theoretically, as it started to be in the 1970s.

4. THE 1980s AND THE 1990s

Growing Skepticism of Government Intervention

Skepticism about the proper role of the state, in many of its activities, started emerging in the late 1960s and the 1970s. It was then that shortcomings in the underlying theoretical models which favored activist government policies in allocation of resources, in stabilization, and in income distribution became evident, at first, to a small group of critics (Buchanan, Friedman, and a few others) and then to a growing number of observers. Some critics also started to question the practical implementation of these policies.

The failure of government policies to allocate resources efficiently, to redistribute them in a well-targeted manner, and to stabilize the economy in the stagflation of the 1970s was coupled with results of new studies that highlighted the disincentive effects of high taxes and the growing underground economies.[16] The usefulness of the new programming and budgeting techniques was also called into question. Policy formulation had not sufficiently recognized the institutional

16. Once again, it is strange that the phenomenon of the underground economy was not discovered until the late 1970s.

and systemic constraints. Moreover, difficulties arose in defining government objectives or assigning monetary values to many costs and benefits (Premchand, 1983). As deficits and public debt were rising, many economists argued that government had grown much beyond its justified role, undermining economic incentives, property rights, and economic freedom, and "mortgaging" the income of future generations (Buchanan, 1975).

The new skepticism about "benevolent" government making the "right" policy choices, and about its technical ability to conduct efficient policies, reawakened the academic interest in the role of political institutions and in the incentives for policymakers. Especially the public choice and new institutional economics literature has discussed the importance of constraints on fiscal policymaking. This debate initially focused largely on the United States. In recent years, however, renewed interest in institutional constraints on fiscal deficits, public debt, and public spending has emerged in other industrialized countries.[17]

At the political level, in the 1980s the tide turned in favor of a smaller government role. With Margaret Thatcher as prime minister of the United Kingdom and Ronald Reagan as president of the United States, two forceful and articulate opponents of big government came into power in two very influential countries. From their powerful positions, they carried out a determined political attack on large government.[18] Over the course of the 1980s and early 1990s, more and more social and political groups began attacking what they considered excessive government spending and expensive welfare states, and many reforms promised and initiated by the government.[19] Also many OECD countries started a strong attack against regulations.

17. Suggestions for the United States have included more inclusive majority rules for spending and tax increases, a line-item veto for the president, limiting the Senate's power to cutting (but not raising) expenditure, and, most prominently, a balanced-budget amendment to the constitution (Wagner and Tollison, 1987; Buchanan, 1985). The new literature on the role of institutions is discussed in more detail in Part Three of this study. In Europe, some attention has also been paid to constitutional limits on tax rates. Switzerland, for example, has imposed such limits on the rates of the recently introduced value-added tax. See also Forte (1989, 1998).
18. Reagan popularized the view that, far from being a solution to problems, the government could be a cause of them. For a critical account of Reagan's contempt for government see, for example, *New York Times Magazine*, August 11, 1996.
19. See Assar Lindbeck (1997) and Chapter X of this book.

New Trends in Public Spending

With some noteworthy exceptions, relatively few countries, have so far accompanied their antigovernment rhetoric with successful shifts in their policy regimes toward less state involvement and cuts in public expenditure.[20] In part because of the tyranny of past commitments, and because of the power and resistance of groups with strong entitlements on public spending, on average, public expenditure levels have continued to increase, but the pace has definitely slowed down (see Table I.1). In 1990, unweighted average public expenditure reached 44.8 percent of GDP. In 1996, it reached 45.6 percent of GDP. Over the 1980–96 period, the share of public expenditure in GDP declined in Belgium, Ireland, New Zealand, the Netherlands, and the United Kingdom. It increased by another 5 percent of GDP or more in Canada, France, Italy, Norway, Spain, Sweden, and Switzerland. Italy and Norway have increased spending by another 10 percent of GDP or more in the 1980s, but in the past six years, spending has come down in both countries as well as in Canada. The long recession in Switzerland and the German unification also caused public expenditure to increase significantly as a share of GDP in these two countries in the first half of the 1990s. Despite the considerable rhetoric and public perception, the United Kingdom and especially the United States have not been very successful in reducing public spending since 1980.

When the overall developments between the late nineteenth century and the late twentieth century are compared, it is noticed that half of the growth in government expenditure – from 10 percent of GDP around 1870 to 28 percent in 1960 – occurred during the two world wars. Expenditure growth to 46 percent of GDP in the thirty-six years after 1960 equaled the expenditure growth in the previous ninety years even though the post-1960 period was free of major wars or depressions.

5. THE SYMMETRY OF EXPENDITURE GROWTH

Governments grew rapidly in all industrial countries over the past 126 years. However, growth in public spending was not fully sym-

20. However, some progress has been made in reducing regulations on economic activities.

metrical across countries. In 1870, Switzerland, France, and Australia had the highest levels of public spending. Today, Australia and Switzerland have among the smallest governments in this group. The United Kingdom had one of the largest governments in the interwar and post–World War II period but by the mid-1990s, it showed a relatively low level of public spending. The most striking change in the size of government took place in Sweden and Norway, which had among the smallest governments until World War II and which, by the 1990s, had among the largest governments. New Zealand, Norway, and Ireland are the first industrialized countries that, since the late 1980s, have reduced public expenditure considerably.

When looking at the reasons for these asymmetric developments, it comes as no surprise that public spending in countries with stronger institutional constraints on taxation and spending grew more slowly than in those without such binds. In Switzerland, for example, the power to tax is restricted by the constitution and these constraints were not relaxed much over recent decades. Laws setting income and indirect tax rates, for example, are only valid for ten years. After that period they need to be extended (or changed) via a popular referendum. The limited power to tax has probably contributed to government expenditure growing much more slowly than elsewhere in Western Europe.

Japan is also an interesting example of how institutional constraints can slow the growth of government. Recall, that in Japan, government expenditure grew only from less than 20 to about 36 percent of GDP between 1960 and 1996. The political system in Japan after World War II resulted in the dominance of one party with extensive checks and balances. This party seemed to encompass all the important social groups that balanced the interests of various factions (Olson, 1982). The system also included a relatively autonomous and a generally considered effective and powerful bureaucracy.[21] The number of institutional changes, especially those facilitating the expansion of government, was limited. Thereby, policymakers seemed to reflect a desire to promote the countries' overall welfare (rather than the welfare of selected special interests) and to keep government lean and efficient. However, this view may need revision in light of recent

21. More recently, the ability of this bureaucracy has been put into question by a series of scandals and by the problems that the Japanese economy has been experiencing. Also, the Japanese have been pressured to increase public spending to stimulate the economy.

developments that have indicated that the bureaucracy may have been less efficient than previously thought.

There is very little discussion in the literature on institutional changes in countries which saw the most rapid increases in public spending, especially the Scandinavian countries.[22] In Italy, the constitutional constraints probably prevented major increases in public spending (and in deficits) until 1960. Afterwards, and especially in the Keynesian heyday of the 1970s, public expenditure started to increase rapidly, perhaps because these constraints were relaxed or were no longer effective (Eusepi and Cerioni, 1989).

6. CONCLUDING REMARKS

In this first chapter we have documented the increase in public expenditure across industrialized countries in the past 126 years. While initially, the two world wars permitted some significant increases in revenue and expenditure levels, it was the period between 1960 and 1980 that saw the most rapid expansion. Changes in public expenditure levels largely followed changes in attitudes toward the role of the state and changes in the institutions which constrain government intervention in the economies. These changes in attitude characterized both policymakers and economists. The 1980s and early 1990s have witnessed once again another change in attitudes toward the role of the state. This period has witnessed, perhaps, the first attempts at reversing the trend of expenditure growth. In the rest of this book, we shall argue that this change in attitudes is likely to lead to a reduction, over future years, in the share of public spending in GDP in most of the industrial countries. This would happen in spite of a relatively less fiscally friendly environment due to demographic changes and other factors.

22. But see Lindbeck (1997).