

Government Size and Implications for Economic Growth

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Builds on own research and survey of others' work

- Pär Hansson & Henrekson, *Public Choice*, 1994
- Stefan Fölster & Henrekson, *European J of Political Economy*, 1999
- Fölster & Henrekson, *European Econ Rev*, 2001
- Bergh and Karlsson, *Public Choice*, 2010
- Karlsson and Bergh, Conference Paper, 2008

Motivation and purpose

- Even small long-term differences in growth rates add up to very large differences in income levels
- Close correlation between GDP per capita and direct measures of well-being
- Large differences in G/GDP and $Taxes/GDP$ in today's wealthy democracies
 - Tax/GDP some 50% in Sweden, but 30% in the U.S.
 - Roughly 27% in both countries in 1960
- Growth effects?
- Systematic studies across many countries are called for

Four methodological problems

- How should government size be measured?
- How to select countries and time periods?
- What other variables should be included in the analysis (catching up, demography etc.)?
- Can a relationship be interpreted as causal?
 - Economic downturns may cause both G and slow growth
 - Countries that do not experience growth problems from raised taxes do not take action, while those that stagnate do → no effect will be detected

What effect should be expected?

- Positive effects
 - G used productively, e.g. institutions, education, research.
 - Correction of market failures
 - Reduce the cost of social inequality (tricky in practice)
- Negative effects
 - Distortionary taxation creates a wedge between social and private value (less market work, productive entrepreneurship and human capital investment)
 - Crowding out of private investment and private production
 - Institutional sclerosis and rent seeking
- To know the total effect, we need empirics.

Studies included and older evidence

- Use total government size (Taxes or Exp. /GDP)
- Focus on rich countries
- Published in scientific journals
- Should preferably include variation over time
- Early studies mostly find negative effect, but primitive
- Some studies find no effect, but there are no studies that find a positive effect
- Several succeed in showing that negative effects can be "shot down" by including new controls, change the sample of countries and time periods

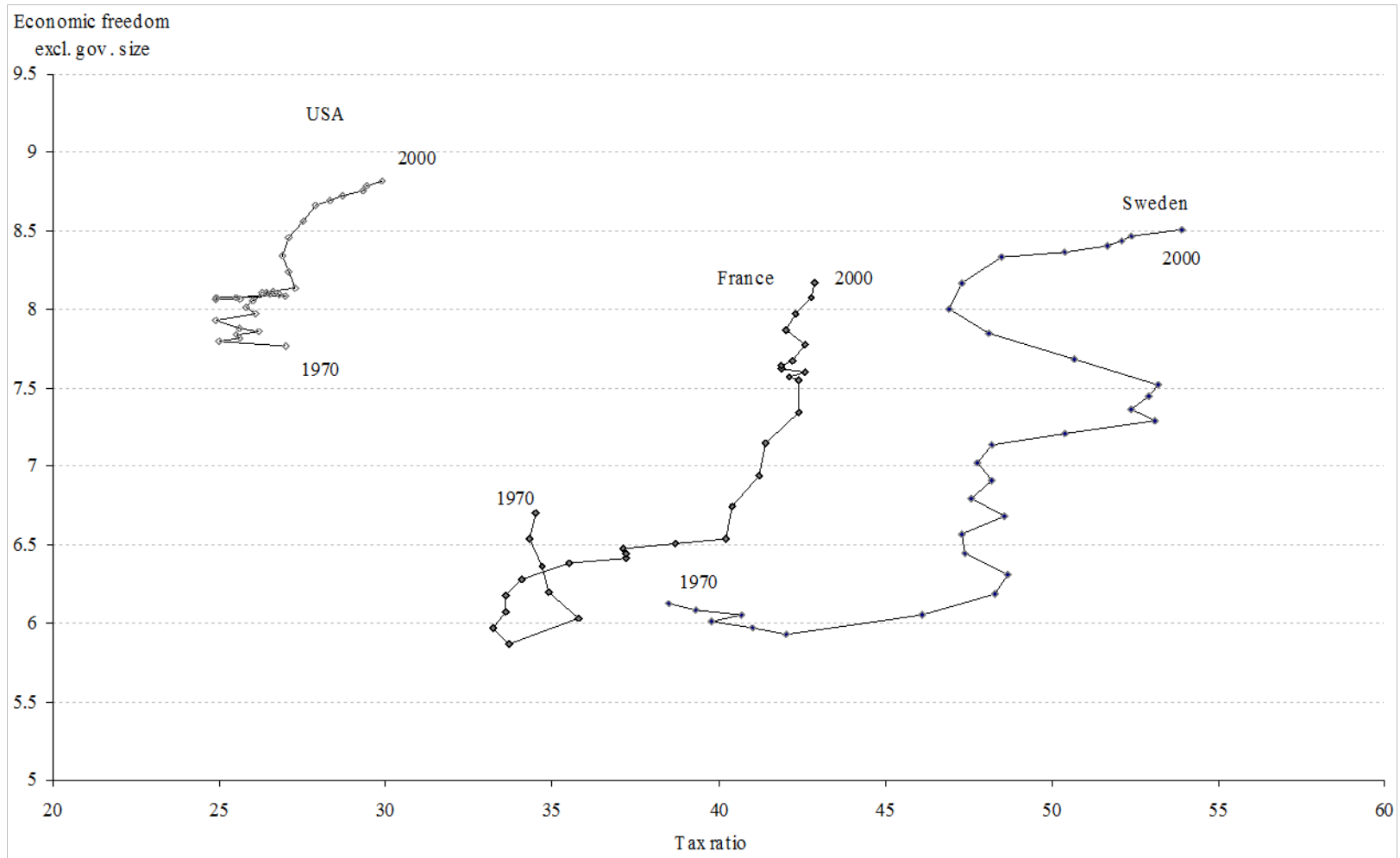
Newer evidence based on more sophisticated studies

- Fölster-Henrekson (2001), Bergh-Karlsson (2010), Romero-Avila & Strauch (2008)
- A robust negative effect of gov't size on growth
 - A 10 percentage point larger government size associated with 0.5 to 1 %-age points lower annual growth rate
- Unlikely to be caused by reverse causality
- Scandinavian countries are puzzling?

Institutional quality

- Economic freedom
- Scandinavian countries with large governments have increased economic freedom the most in recent decades, which has offset negative effects from large government

Economic freedom in the U.S., France and Sweden 1970–2000



High labor taxes and specialization

- U.S. more market work, but less household work and similar level of leisure as Sweden
- High taxes on labor and consumption → encourage black market production and household production
- Large parts of the professional service sector face harsh competition from "do-it-yourself" and the black market
- Cross-country comparison shows that high labor taxation → lower relative employment in personal services

Conclusions

- Larger government relative to GDP in today's wealthy democracies has a clear negative effect on economic growth
- Countries with large governments can offset negative effect by other institutions and policies.
- The U.S. unlikely to be able to avoid negative growth effect of larger G/Y
 - Already high level of freedom
 - Great diversity in ethnicity, level of education and social fractionalization