

"Large governments are bad for growth." To what extent does empirical evidence support this assertion? Is the South African government abnormally large or should its role be increased?"

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DOES GOVERNMENT NEED TO GO ON A DIET?

The impact of government size on economic growth in South Africa.

Introduction

Economists in search of the Holy Grail.

The factors that determine economic growth have long been a source of interest (and contention) in economic theory. Economists through the ages have pondered ways in which to ensure that an economy grows and thrives, beginning with Adam Smith's seminal work, *The Wealth of Nations*, in the 1700's and continuing with, amongst other theories, the development of Solow's model in the 1950's and Maddison's (2003) research on economic growth patterns around the world . Why the fascination?

Economic growth is an essential component to improving the quality of people's lives. If a country does not grow, development may be achieved through redistribution of wealth (i.e. one individual is enriched at the expense of another), but economic growth enables *all* citizens in a country to prosper. It is clear that government realizes the importance of growth. The Growth, Employment and Redistribution Act (GEAR) and the Accelerated and Shared Growth Initiative for South Africa (AsgiSA) are two macroeconomic strategies that have been implemented in South Africa with the purpose of aiding economic growth. However, could the very size of government, measured by government expenditure as percentage of Gross Domestic Product (GDP), be hindering growth? The World Bank's 2007 World Development Indicators show that government spending in South Africa amounted to 29.6% of GDP in 2005, which is much higher than the average 18-20% for other upper middle - income countries (Laubscher, 2008).

This paper examines the relationship between government size and economic growth, and aims to provide possible solutions to furthering growth in South Africa.

The theory behind the thinking

The role of government size on economic growth.

Various theories pertaining to government's role in the economy exist. Smith (1776) proposed a laissez-faire approach in *The Wealth of Nations*, arguing that the economy would function at an optimum level only if government did not interfere with the workings of the free market mechanism. Keynes (1936), on the other hand, argued that it was necessary for government to interfere with the free market system in order to

stimulate demand in times of economic recession, and in so doing reduce unemployment. .

If we assume that Keynes' theory is applicable, and we expect government to ensure a stable economic environment in which growth can occur, what then, is the role of government size? Wagner's Law states that growing governments is a ubiquitous feature of developing nations (Black, Siebrits & van der Merwe, 2006). The Meltzer-Richards hypothesis contends that the size of government changes because of changes of the median voter, who is seen as the decisive force in the voting process and the one who determines the tax level, as well as the pressure that is put on a government to redistribute wealth (Black, Siebrits & van der Merwe, 2006). Thus, governments seem to expand as the economy and voters' base itself grows.

The theory behind why government size expands as a nation develops explains that developing nations need larger governments in order to better protect the economy against external shocks (Rodrik, 1998). The problem sets in when a government reaches the size where its spending crowds out private investment, which is traditionally viewed as an essential determinant of growth. This phenomenon usually occurs when governments have to borrow funds in order to finance budget deficits (Abel *et al.*, 2008). Another explanation for why large governments are bad for growth is the theory of diminishing returns (Vedder & Gallaway, 1998). As government expenditure, on infrastructure and social security, increases the returns are large initially. There comes a point, however, when the law of diminishing returns sets in and the returns become less.

It is important to remember that government can, and does, play an essential role in economic growth. Governments ensure social stability and rule of law in a country, without which no progress can be made. The key seems to lie in whether government is devoting resources to unproductive or productive projects. The building of the Gautrain is a prime example of productive government spending, since 753 000 individuals will be employed during the construction thereof, and an additional 40 000 people will be employed in surrounding areas. The Gautrain will furthermore serve to ease congestion on South African roads and improve public transport (Jacobs & Mashatile, 2006).

Weighing in the results

What does empirical evidence suggest?

Studies carried out in America, and various other Organisation for Economic Co-operation and Development (OECD) nations, tend to support the hypothesis that large governments are bad for growth. When comparing growth rates between America and Europe, Mitchell (2005) found that real economic growth was higher in America, which has a smaller government relative to the large welfare states of most European countries. He concludes that large governments hinder growth. Dar and AmiKhalkhali (1989) found that large governments in 19 OECD nations had a detrimental effect on economic growth because factor productivity usually declines as government size increases. They concluded that smaller governments are more conducive to economic growth because they promote efficiency by lessening market distortions and minimizing the crowding-out phenomenon. Peden and Bradley (1989) argue that much of the slowdown in the economic growth rate that occurred in America in previous decades can be attributed to the larger size of government.

Studies carried out in South Africa interestingly show that the size of government may influence economic growth to a lesser extent. Brunt (2007) suggests that attention should rather be paid to the establishment of clear property rights, because government efforts at promoting growth are mostly ineffective in the long run. De Wet (2005) draws the conclusion that government has limited power to influence growth (through indirect taxes on goods and services, specifically).

Salmond (2006) offers a neat explanation as to why this might be the case. He argues that large governments, in smaller, open economies such as South Africa, have less influence on economic growth, because the factors that drive growth in such economies are largely outside of government's sphere of control. Tsangarides (2005) proposes that, although generally speaking, determinants of growth that are important for the rest of the world – including smaller governments - are also vital for Africa, the transfer mechanisms of these factors are different in Africa. The level of democracy, as well as debt, in a country, is also important. A study of government size in New Zealand has also shown that the size of government is secondary to the actual composition of government revenue and spending (Grimes, 2003).

The question then, seems to have less to do with the size of government than with the efficiency with which government is addressing its core functions. This includes certain very important macroeconomic aims such as combating poverty and unemployment and promoting the equal distribution of wealth.

Statistics regarding the South African situation seem less than desirable. Schwabe (2004) indicates that the poverty rate in South Africa stood at 57% in 2001, while the poverty gap had increased from R56 billion in 1996 to R81 billion in 2001. South Africa is notorious for its high level of income inequality. The 2007/2008 United Nations Development Program's human development report ranks South Africa 121st out of 177 countries in terms of income inequality, with a Gini index of 57.8, where 0 represents absolute equality and 100 represents absolute inequality. Norway, a highly developed nation, has an index of 25.8 (UNDP, 2007). In September 2007, the official unemployment rate in South Africa stood at 23% (Anon., 2007). The following section examines other factors that could possibly be playing a role in South Africa's economic growth.

The carrot that gets the donkey moving

It's all about incentives.

Easterly (2001) repeatedly mentions in *The Elusive Quest for Growth* that people respond to incentives. It is government's role to ensure that the necessary incentives for investment and entrepreneurship exist within an economy. Easterly (2001) points out certain policy decisions that can aid the creation of incentives:

- Trade

It is imperative that any country that wishes to flourish will restrict barriers to trade to the absolute minimum. South Africa has largely succeeded in doing this ever since being readmitted to the international arena in 1994. Under GEAR, various improvements such as the replacement of quantitative restrictions with tariffs, the eradication of import surcharges, and the phasing down of tariffs have helped in moving South Africa toward a more outward-looking approach (Department of Finance, 2008).

- Monetary policy

The main goal of monetary policy in South Africa is to ensure financial stability. An inflation targeting approach has been adopted by the Reserve Bank, with the aim being to keep inflation within the range of 3-6%. Since inflation is a major disincentive for saving, it is worrying that recent CPIX estimates place the inflation rate at 10.1% (SARB, 2008).

- Regulatory policy

Excessive red tape is a disincentive and considerable cost for entrepreneurs wishing to start their own businesses. Whilst the World Development Report (World Bank, 2008) ranks South Africa 35th out of 178 nations for ease of doing business, our labour laws are viewed as very rigid. The ease of employing workers stands at a considerably lower rank at 91. The implication of such strict labour laws is that, although the interests of productive workers are protected, a company will find it very difficult to lay off workers who are unproductive (Lindert, 2004).

Public service...or disservice?

Issues regarding public service in South Africa.

The ability of a government to provide well-organized and efficient public services is another crucial requirement for the stable functioning of an economy. Here it is essential that government must adopt the stance that it is necessary to treat the cause of a problem rather than the symptom.

The current energy crisis in South Africa is worrying in that very few modern businesses can operate without electricity, and it is affecting the whole economy, from large mining companies, right through to small business enterprises. AngloGold Ashanti alone reported losses of 200 000 ounces resulting from power cuts in January 2008 (Anon., 2008a). Reading in *The Elusive Quest for Growth* that firms in countries such as Chad, Congo, Malawi and Uganda report power outages once every two weeks, is very discomfoting, and starting to sound all too familiar given the current situation in South Africa (Easterly, 2001).

The Department of Social Services seems to be on the right track with its proposal for reviewing the eligibility criteria for child support grants. The goal is to structure eligibility criteria in such a way that caregivers are held accountable for the benefits that children must receive from these grants (Manuel, 2008). Included herein is the absolute necessity of providing education for children. Mexico instituted the PROGRESA in 1995, which transferred grants to families on several conditions such as, the enrolment of children in schools, and an 85% attendance record, as well as regular visits to clinics for the whole family. The program saw a rise in female student enrolment rates from 67% to 75% and a rise in male student enrolment from 73% to 78% (Perkins *et al.*, 2006).

It is of course true that school attendance does not always imply a learning process or the acquisition of skills. Results from a PISA (Programme for International Student Assessment) study in 2003 indicate that South African learners are far behind the rest of the world when it comes to basic mathematic ability (Perkins *et al.*, 2006).

Education policy must be constructed in such a way that learners are certain of acquiring skills that will be demanded from them in the workplace. JIPSA (Joint Initiative for Priority Skills Acquisition) is an example of a government initiative that is aimed specifically at addressing this need in the education system. Government spending on education should be geared towards educating teachers and reducing absenteeism, as well as providing nutrition to children in poorer communities, since learning cannot take place on an empty stomach.

Notes on a scandal

Bribe the Beloved Country.

It is no secret that corruption is a problem in South Africa. Certainly, this problem has recently been at the forefront of news reports seemingly more than ever, with the investigations into the embarrassment of the arms deal scandal receiving worldwide attention.

Freedom from corruption comprises one of ten indicators used to compile the Economic Freedom Index, in which South Africa has recently fallen from 55th to 57th position, with declines in fiscal and monetary freedom, and problems with government size, being the main culprits for the weaker position. Transparency International's Corruption Perceptions Index ranks South Africa 51st out of 163 nations. This ranking is regarded as representing "significant corruption" (Anon., 2008b).

Corruption is detrimental to economic growth for the simple reason that it is bad for business. Investors do not wish to lend their money to officials who cannot be trusted. Zhang (2008) also states that corruption has a negative impact on growth because it leads to rent-seeking, misallocation of resources, and reduces the efficacy of any aid that a country might receive.

The poor, helpless communities of a country are further burdened when government officials have the audacity of enriching themselves at the expense of the very people whom they are charged with serving and protecting. The government must fight corruption, and our legal system must not place anyone above the law.

Conclusion

Time to contact Weigh – Less.

The South African government does seem abnormally large when compared to other upper middle-income countries. Though there seems to be scope for expanding the size of government as the country develops, empirical evidence suggests that the effect of government size on growth in South Africa may not be as noticeable as that of government size in more industrialized nations, because of factors such as country size and trade openness (Salmond, 2006).

The overall trend of economic growth does however seem to imply that “what is good for growth around the world is, in principle, also good for growth in Africa” (Tsangarides, 2005). One of these factors is smaller governments, and South Africa’s ranking in terms of economic freedom has recently declined, partly as a result of government size.

It is my opinion that the South African government should therefore not increase its role in the economy. Efforts should rather be made to ensure that government uses its current capacity for maximum efficiency, by ensuring that the necessary incentives for economic growth exist within the country’s macroeconomic framework. This could be done by addressing certain issues that are problematic currently.

By continuing to ensure price stability in the economy through fighting inflation, lessening some of the red tape regarding labour laws in the country, ensuring that the underlying causes that lessen the efficiency of public service delivery are addressed, and adopting a zero tolerance attitude toward corruption, I feel that government can go a long way in using its current capacity in a manner that is conducive to economic growth.

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