

“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? (2605 words)

Introduction

As of today, all countries ranging from the highly populated China with its booming economic growth, the war ravaged Middle East countries with their rich oil deposits to the economically paralysed Zimbabwe have one thing certainly common among them. They all have a government of some sort whether functional or dysfunctional. If all countries in the world have governments, it must be clear that the existence of a government in today’s societies is necessary though it does not imply that government is all good.

If all countries in the world have a government and on the other hand government is not all good, then we are faced with a problem of how much government is good for the economic wellbeing of the country and the prosperity of its citizens. According to Black, Calitz, Steenekamp and associates (2007:9), “if one is interested in the tax burden imposed on the taxpayer by the government, total tax income/revenue as a percentage of the gross domestic product will be used as the relevant indicator, however government expenditure is not only financed by tax revenue, but by non-tax means such as administrative fees, sale of goods and services and government borrowing which can be domestically or internationally sourced. The expenditure side therefore gives a more accurate picture of the government size”.

In this essay, I am going to show that it is not the absolute size of government which matters in determining economic growth, but the components of total government expenditure, the financing of that expenditure and governance.

To start with, I will deal with the literature and recent research on the relationship between government size and economic growth, thereafter; I will assess the South African government size and its impact on economic growth relative to global norms.

Literature Review

Since the emergence of civilization, no country, business organization or even a social gathering has ever managed to prosper and progress without some form of leading authority or figure overseeing its functions. At country level, this form of authority or figure is the government; without which countries cannot attain higher economic growth, and individuals will continue to live like animals for there will be no law and order enforcement. Thomas Hobbes (1651; 110) described life without a government as “solitary, poor, nasty, brutish, and short” and supported the view that the law and order provided by the government was a necessary component of civilized life. In addition to Hobbes’ view, Smith though an advocate of *laissez-faire*, “... did see a significant albeit limited role of the state. Specifically he saw three major functions of government: (1) protecting society

from foreign attack, (2) establishing the administration of justice, and (3) erecting and maintaining the public works and institutions that the private sector cannot undertake profitably”(Grant/Brue, 2007, 70). Market failure and exploitation of consumers warrant government intervention though too much of it, in many cases leads to shrinking of the private sector and therefore economic growth.

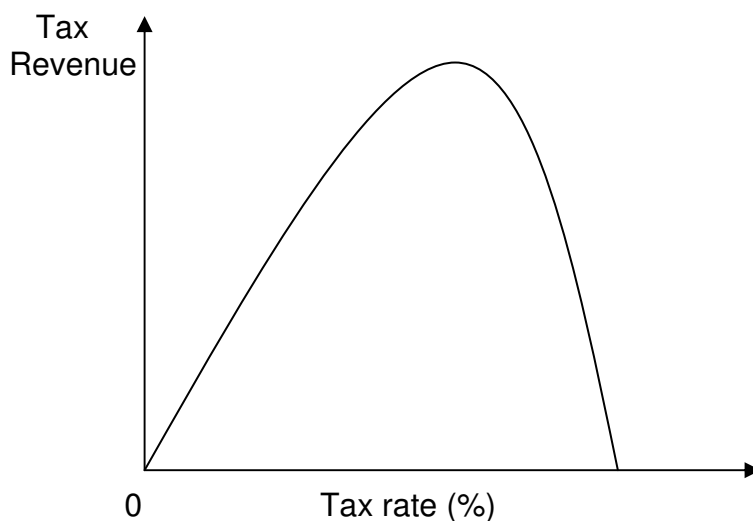
Keynesian macroeconomic theorists see government intervention in the economy through public expenditure as a necessary and functional policy instrument. There is therefore no doubt about the necessity of government in modern economies if they are to attain higher economic progress, but as noted by Kustepeli (2005, 3), “it is a fact that, government absorbs a relatively important share of society’s economic resources and therefore affects growth in many developing countries”.

The size of the government affects economic growth of a country through the impact of taxation, expenditure and the budget balance on economic issues such as the efficiency of resource allocation and the rate of factor accumulation. If government expenditure on goods and services (roads, health care, education, etc) is raised, full multiplied rise in national income will result. A rise in government expenditure is financed by among other sources, tax revenue, but Easterly (1989, 34) found that increasing tax from zero has a positive effect on growth, but with further tax increase the relationship will eventually turn negative. This fact conforms to the Laffer curve (refer to fig 1), which argued “that higher tax rates will not necessarily produce more tax revenue since the tax base will shrink as taxpayers reduce their work effort in respond to higher tax rates (Black, Calitz, Steenekamp and associates, 2007;170).

Fig

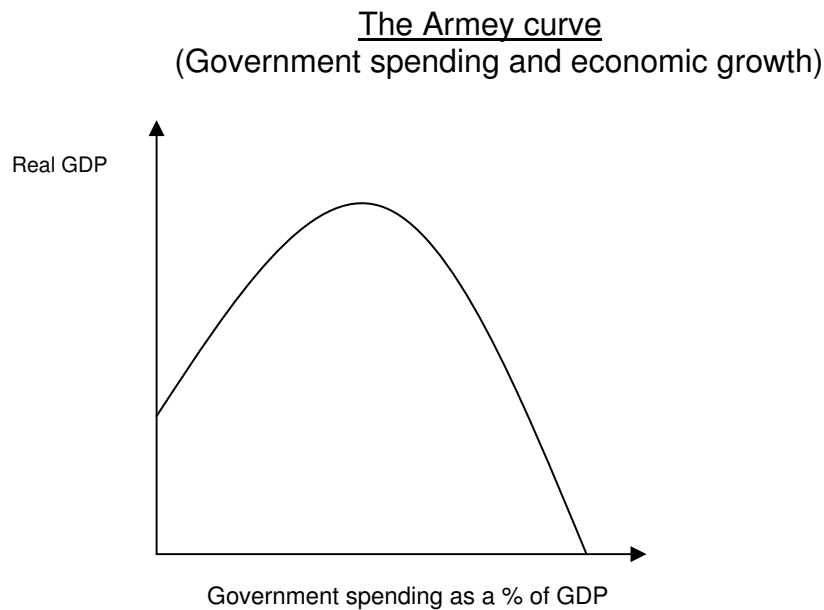
The Laffer curve

(Tax rates and tax revenue)



Increasing tax to finance government expenditure reduces private consumption, investment and savings. The decrease in consumption and investment may completely reverse the increase in government expenditure, resulting in aggregate demand not rising at all.

Fig 2



Using a graphical tool, the Armey curve (refer to fig 2), developed by Richard Armey, it is evident that when there is no government spending, economic growth is low. With increase in government spending, growth increases and then stagnates when spending reaches a certain percentage of GDP. This tendency is caused by the lack of rule of law and the enforcement of property rights when there is no government. When there is only government providing goods and services, growth will slightly increase but if there is a mixture of government and the private sector, maximum growth can be attained only if there is efficient resource use. As government grows too big, inefficiencies will slow down growth.

A handful of studies on the effect of government size on economic growth have yielded varying conclusions. A study by Yuk (2005) concluded that there is bilateral Granger-causality between government spending and economic growth whereas Vedder and Gallaway (1998) concluded that government size in newly emerging economies tends to increase growth while it slows growth in developed economies. Other studies worth noting are those by Loizides and Vamvoukas(2005) which found that public expenditure Granger-cause economic growth but they rejected the notion that increasing government expenditure hampers economic growth, and that by Kustepeli (2005) which concluded that relatively small governments are detrimental for economic growth while medium-sized ones affects growth positively. These points to the inconclusive evidence

that cannot be used as a reference point when dealing with the question of whether big governments are bad for growth.

The aforementioned studies on this subject do not provide straight forward conclusions. This suggests that the effect of government size on economic growth is country-specific, since cross-country studies have failed to give concurrent conclusions. This implies that what prevails in one country does not necessarily have to be the case in all other countries of similar government size. The proper way to addressing this question of government size and growth should be assessing countries individually, based on such factors as the components of government expenditure, sources of revenue and good governance. These factors are unique to each country thus they will affect the economic growth of countries with the same size of government differently.

Milton Friedman (1997) comparing the United States and Hong Kong noted that “Government has an essential role to play in a free and open society. Its average contribution is positive; but ...the marginal contribution of going from 15% of the national income to 50% has been negative.....” From this I can deduce that as long as the size of government is between 15% and 50% of national output, potential economic growth of a country can be achieved only if government expenditure is tailored towards growth enhancing activities such as education and productive capital goods.

Where between that range (15%-50%) is the size of the South African government situated, is the South African government too large, too small or optimum for possible economic growth relative to global norms? The following section addresses these questions

The size of South African Government.

Total Tax Burden

Personal income tax (refer to fig 3) decreased greatly when comparing its contribution to total government revenue in the 1990s when it was above 40 percent of total revenue and the period 2007/2008’s level of around 30 percent of total revenue. Lower individual taxation stimulates economic activity since it increase aggregate demand which is currently greater than supply (Refer to fig 4), but it promotes demand-pull inflation. Although moderating, individual tax remains a key source of government revenue.

Fig 3

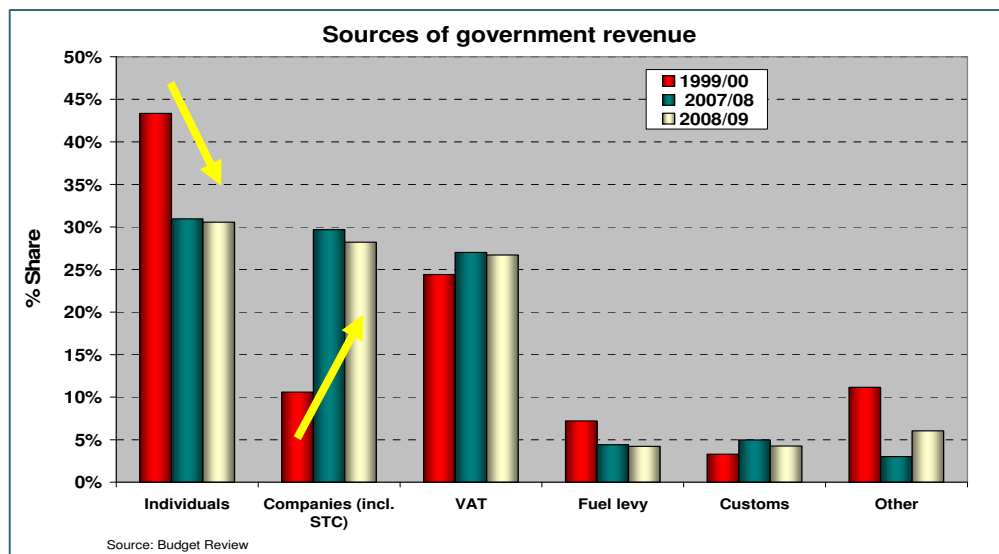
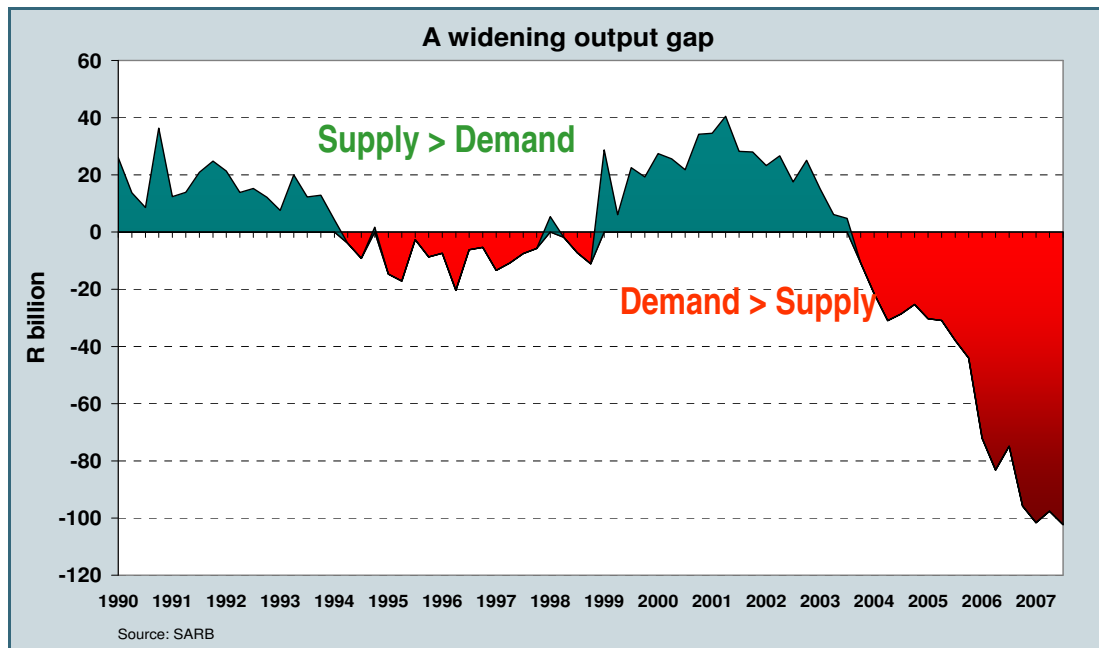


Fig 4



Companies' tax (refer to fig 3) however increased its contribution to total revenue, and even though there was a decrease by one percent this year, 28 percent is still too high and may lead to aggregate supply effects of cost-push inflation. A combination of a cut in companies' tax and individual tax incentives is inflationary, which cause problems to other macroeconomic objectives such as price stability and employment. VAT contributes more than 25 percent to total revenue and there were no vast changes in its rates. Fuel levy and customs together contribute about 10 percent.

Continued revenue streams coupled with an additional tax relief of R7.7 billion for households will support economic growth and job creation through supply-side measures. Tax revenue of 28.4% of GDP for the period 2007/2008, and remaining constant in 2008/2009 (refer to table 1), with the government supporting Eskom for its investment program totalling R60 billion over a five year period will ensure economic growth in the long term. Low debt service cost in light of high revenue estimates and lower government debt, and growth of non-interest expenditure over the next three years will aid to growth prospects. Though revenue is a key element to growth, IDC's Chief economist Lumkile Mondi (as per interview) however point to a lower tax rate burden of around 25% for higher economic growth.

Table 1

National budget framework					
R billion	2006/07	2007/08	2008/09	2009/10	2010/11
		Estimate	Projections		
Total revenue	501.6	580.4	650.0	720.1	789.0
<i>Percentage of GDP</i>	27.8%	28.4%	28.4%	28.7%	28.6%
Total expenditure	484.2	560.1	631.5	704.1	768.5
<i>Percentage of GDP</i>	26.8%	27.4%	27.6%	28.1%	27.9%
Debt service cost	52.2	52.8	51.2	51.1	51.2
<i>Percentage of GDP</i>	2.9%	2.6%	2.2%	2.0%	1.9%
Non-interest expenditure	418.0	489.3	559.9	630.5	693.5
<i>Percentage of GDP</i>	23.1%	23.9%	24.5%	25.2%	25.1%
Budget balance	17.4	20.3	18.5	16.0	20.5
<i>Percentage of GDP</i>	1.0%	1.0%	0.8%	0.6%	0.7%
Gross domestic product	1,807.3	2,045.5	2,286.9	2,506.9	2,758.6

Source: Budget 2008

Total expenditure

“Public expenditure is focused on areas that will increase growth over the medium to long term” (Budget review, 2008)

Government expenditure comprises of social services (education, health, welfare and social security and, housing and community development), protection services (defence and justice, police and prisons), economic services and infrastructure (water and related services) and administration (refer to table 2). In the study of causes and consequences of growth of government, Saunders and Klau (1985:16) concluded that the structure of government spending has shifted away from the provision of more traditional collective goods towards those which increase growth of the welfare state, which provide individual benefits rather than on a collective basis. South Africa resembles this tendency, according to the 2008 Budget review, expenditure has strong focus on road infrastructure development with an increase of R13.4 billion and industrial development with tax incentive (R5 billion) and policy initiatives (R2.3 billion). Social services spend as a percent of total services however decrease from 51.7% to 49.5%

Table 2

Consolidated government expenditure		MTBPS 2008/2009	Budget 2008/2009	Difference (% of total)
Social Services		347.7	354.4	6.7
Education	Education	120.8	121.1	0.3
Health	Health	71.0	75.5	4.5
Welfare and social security	Welfare and social security	100.5	105.3	5.3
Housing and community development	Housing and community development	55.4	52.6	-2.8
Protection Services		96.8	95.3	-1.5
Defense and intelligence	Defense and intelligence	32.5	30.4	-2.1
Justice, police, and prisons	Justice, police, and prisons	64.3	64.9	0.6
Economic Services and Infrastructure		127.6	165.2	37.6
Water and related services	Water and related services	18.3	16.8	-1.5
Agriculture, forestry and fishing	Agriculture, forestry and fishing	14.1	14.6	0.5
Transport and communication	Transport and communication	57.4	71.3	13.9
Other economic services	Other economic services	37.8	63.4	25.6
Administration		41.2	40.3	-0.9
Total		613.3	655.3	42.0
Interest		55.4	55.0	-0.4
Contingency reserve		4.0	6.0	2.0
Total Expenditure		672.7	716.2	43.5

Source: MTBPS Oct '07 and Budget Review Feb '08

Fiscal policy reduced the budget deficit to running a budget surplus in 2007 and in the forecasted three year period to come (refer to fig 5 and 6). Globally South Africa's budget balance compares favourably by running a surplus among countries like Australia in spite of global norms of running budget deficits like the US, Turkey and France (Fig 7).

Fig 5

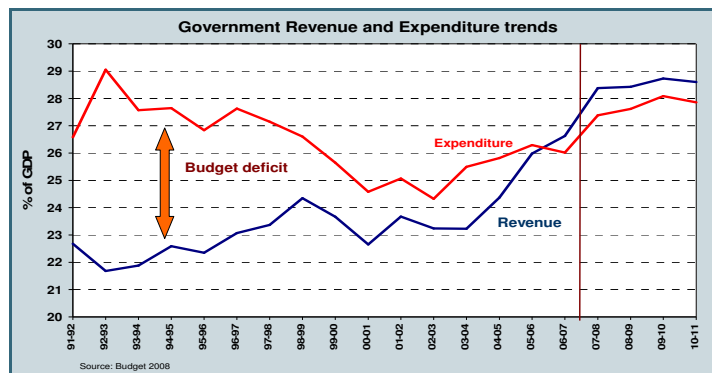


Fig 6

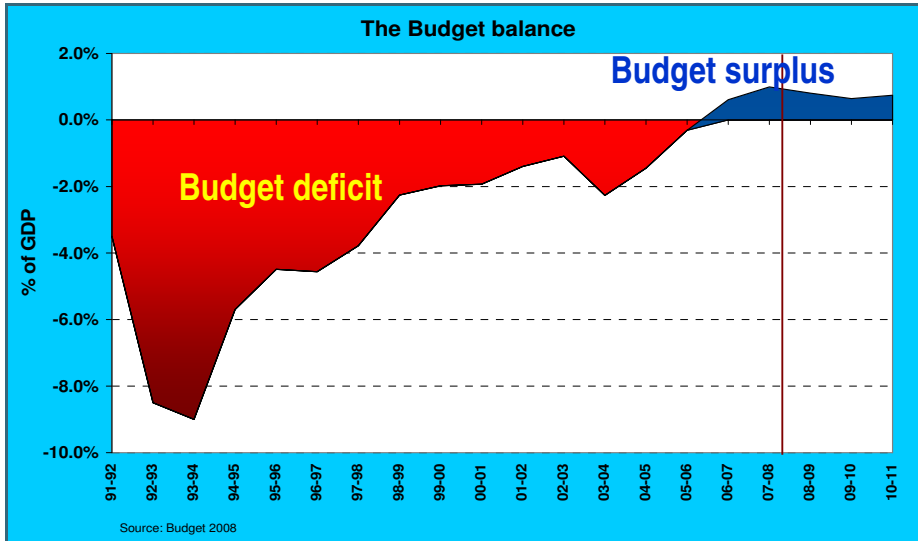
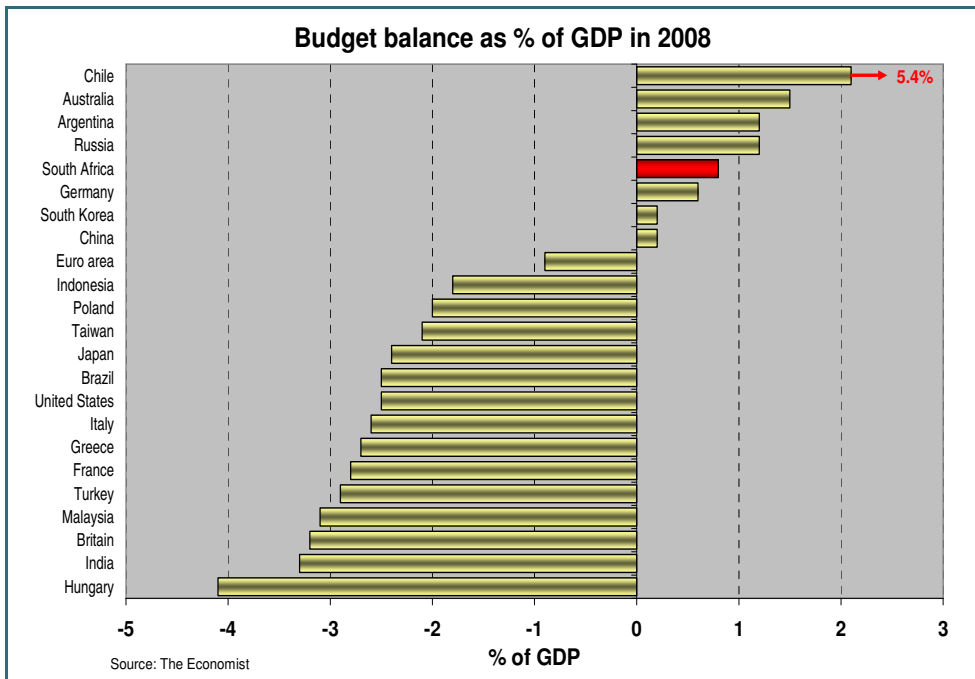


Fig 7

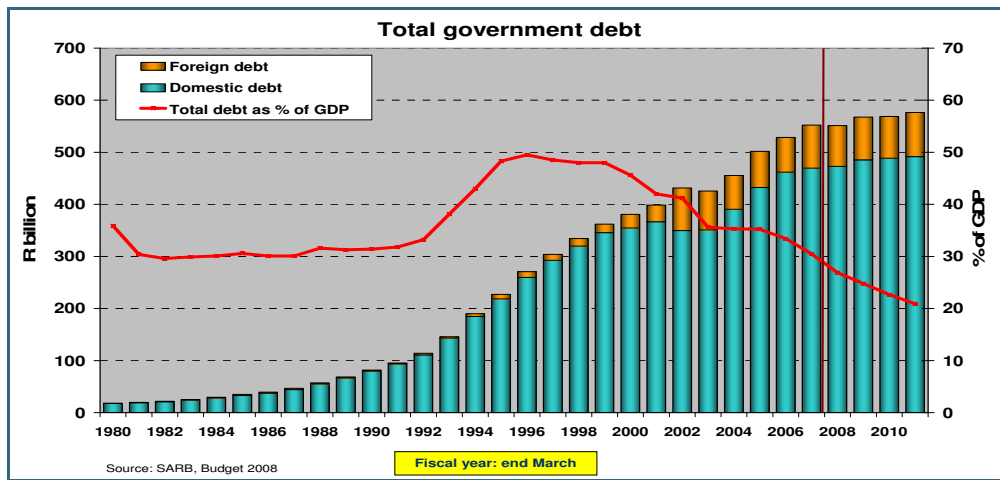


Government Debt

Total debt as a percentage of GDP has been massively reduced since the change in government took place in 1994, but the contribution of foreign debt has increased (refer to fig 8), with possible implications for the balance of payments objective.

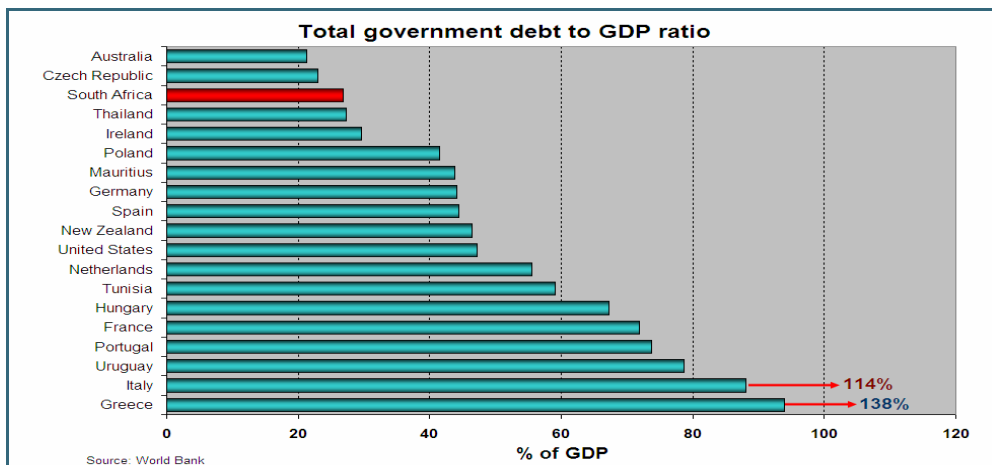
The current account of the balance of payments continue to run a deficit in the light of strong imports associated with fixed investments and strong domestic demand created by capacity constraints in the domestic manufacturing industries. Increased fixed investment will create pressure on the balance of payments over the next medium term.

Fig 8



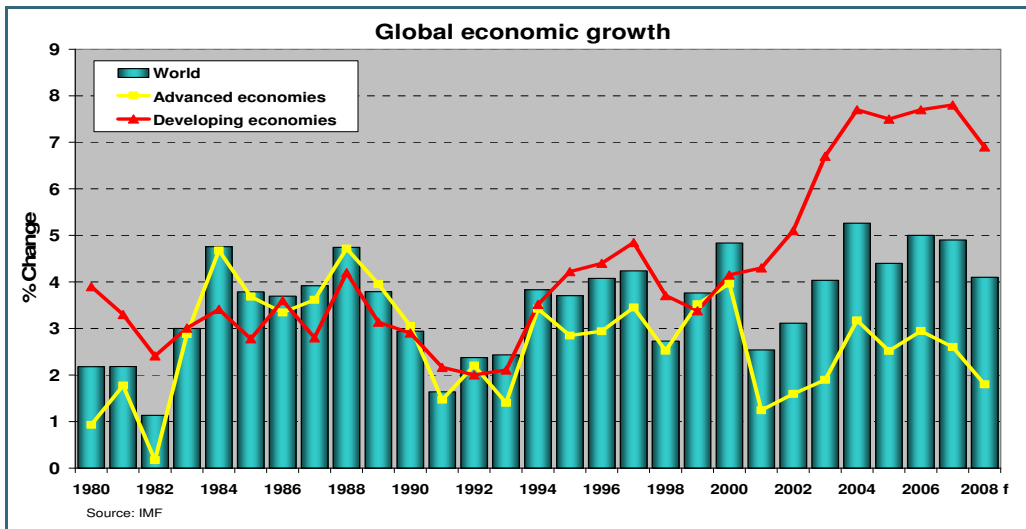
South Africa's low government debt is below the global norm of around 60% of GDP (refer to fig 9)

Fig 9



According to IMF, "the overall balance of risk to global growth outlook is still tilted to the downside." (refer to fig 10) South Africa's economic growth continued to expand despite the global down-side tilted growth, at least since 2003 growth averaged 5 percent (Budget speech 2008, 2).

Fig 10



Conclusion

Cross-country empirical evidence on the effect of government size on economic growth yielded varying conclusions. It therefore suggests that the size of government itself should be given little importance in determining economic growth. Factor accumulation, resource use and mobilisation, type of expenditure, and governance should be factors that play a greater role in determining economic growth.

If large governments cause inefficiencies in the use of resources then a large government can be said to be bad for economic growth. As it stands now, I do not subscribe to the hypothesis of large governments being bad for growth since empirical evidence failed to yield tallying conclusions.

With reference to South Africa, total revenue remained high and stable despite the fact that tax burden on both individuals and companies, and total government debt has been decreased, which mean less interest payments to providers of debt. Even though capital investment increased which is largely from foreign countries, the budget is still in surplus as opposed with global norms of deficit spending. Given these pointers, I do not find evidence to suggest that the South African government is too big, and that economic growth has slowed down except that which is in line with global economic growth trends as a result of high oil prices and global climatic changes inherent in high food prices.

The fiscal stance has been utilised to underpin robust economic growth, increase job creation and investment in infrastructure and production capacity.

Furthermore, it is dedicated to industrial development and achieving higher rates of export growth. To further stimulate economic growth, an environment for small business development has been provided. Moreover, public expenditure has been increased in areas that will support higher economic growth, such as infrastructure, education and health. The budget as a tool for growth contributes to national savings by running a fiscal surplus.

The South African government size is therefore optimum for possible economic growth.

Given the afore mentioned growth-enhancing factors encompassed by the budget, higher economic growth can be achieved with the current size of the government, therefore the government size need not be reduced. On the other hand, increasing its size will take the job of the private sector, leading to low economic growth since the private sector is the major investor and producer of marketable goods and services which has a greater contribution to economic growth. This explicitly means that South Africa's government size is neither too large nor too small for optimal economic growth; therefore nothing should be done to alter its size.

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