

Debating the Size of Government is a Distraction¹

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For a market economy to flourish, government needs to be effective and constrained but it need not be small. Casual empiricism should make this claim self-evident. Among the richest economies in the world are the Nordics (Denmark, Norway, and Sweden) which seem to thrive (on a wide range of metrics) in spite of their apparent preference for high taxes and public spending. The twentieth century saw governments in advanced countries increase their tax take in GDP from around 10% to 40% while living standards continued to expand.

There is no paradox to explain. Countries which have large governments, measured by share of taxes or spending, also by-and-large have effective governments. So the real focus should be on why this happens in some places and not others – focusing on government size is not only a distraction, it diverts focus from what matters.

The Nordic countries are an example of what, in my work with Torsten Persson,² we have called a development cluster where peace, high income and effective government go together. To see this, consider four widely-used measures of government effectiveness. First, these countries have among the highest scores for upholding the rule of law according to the World Justice Project. Second, they have among the highest rankings for respect for personal freedoms as documented by Freedom House. Third, Transparency International regards them as having among the lowest levels of corruption. Fourth, they are market friendly; for example, they are highly ranked by the World Bank Doing Business project on a range of business regulations.

At the other extreme are countries which perform badly on a range of indicators and are poor to boot. But there is an Anna Karenina principle. While all functioning countries are alike, poorly functioning countries are often unhappy in their own idiosyncratic way. Having bad government is often a compounding factor, but almost never is the problem one of taxing or spending too much. Poor countries around the world tend to have a tax take in GDP in the 10-20% range – similar to today's affluent countries of a century ago.³

That effective government and large government tend to go together is not difficult to explain since they have common roots. If the citizens of country see their government delivering in ways that matter, they are willing to entrust the state with more of their money and to widen the range of spending functions. Such countries have large government precisely because government works.

But less obvious is discerning which factors underpin effective government. The best explanation is that government works best when its actions are limited by appropriately-designed constraints. These come in two main forms. The first is constraints on executive power. There is a range of institutions that play this role: an independent judiciary, active media and functioning legislative oversight are the three cornerstones which ensure that government actions are scrutinized and operate within a framework of rules. The second is to ensure that poorly-performing policy-makers

¹ This is a slightly expanded version of a piece which will appear in *Economic Ideas You Should Forget* edited by Bruno Frey and David Iselin.

² See Besley T and Persson T. *Pillars of Prosperity: The Political Economics of Development Clusters*, Princeton: Princeton University Press, 2011.

³ For details, see Besley T, and Persson T "Taxation and Development," in *Handbook of Public Economics*, Volume 5 edited by Alan J. Auerbach, Raj Chetty, Martin Feldstein and Emmanuel Saez, Oxford: Elsevier, 2014.

are removed from power. Open elections, a well-informed and educated citizenry, backed by a strong civil society have evolved as the main means for achieving this.

Creating effective institutions to constrain government is not straightforward. Strong democratic values are needed to support them. Governments always prefer weaker constraints on their actions so they need to understand that their citizens will object and, if necessary, protest if they try to undermine the institutions that constrain them.

A key action of government, for better or worse, is redistribution. One of the major benefits of constrained government is that such redistribution takes place in a relatively transparent and rule-driven way. Constraints on government behaviour make it more likely that spending promotes common interests. Much redistribution in modern states (via mass health funding and social security) redistributes resources over the life-cycle to the benefit of a wide range of citizens. Redistribution within constraints can also enhance the legitimacy of market economy by making its rewards more inclusive. There is a strong case for funding redistributive spending via broad-based taxes such as a VAT or the personal income tax. Progressive taxation based on clearly-defined tax codes has become an accepted principle of limited government rather than using selective and arbitrary forms of revenue generation.

Countries with unconstrained governments still use the organs of government to redistribute resources but mostly in ways that promote narrow interests and are more economically damaging than the programs of constrained governments. Examples include giving monopoly power to government cronies, expropriation and violation of property rights, and using protection and regulations to create rents to favour a ruling elite. All of these come at significant economic cost, with knock-on consequences for innovation and growth.

Constrained states are often more effective at regulation and undertaking strategic investments which promote prosperity. Regulation permeates every sphere of economic life from certifying product quality, to licensing professions to ensuring workplace safety. Good regulation requires a framework of roles and arms-length implementation can often enhance its effectiveness.

Governments can support innovation not only through protecting intellectual property rights and supporting infrastructure, there is also potential role for pro-active support in strategically significant areas such as defence and decarbonisation. But government must be held to account for the choices that it makes which will only happen if there is transparency and scrutiny. We have seen time and time again how industrial policy is dangerous when the state is ineffective, allowing large and selective transfers in unaccountable ways. One of the crowning achievements of the EU has been to create a binding framework for state aids as part of its commitment to a single market which puts such policies in the daylight. Promoting an effective market economy also needs competition policy to ensure that new entrants face a level playing field and inefficient firms are forced out.

Constrained governments are most able to intervene based on the economic case for intervention to supplement or support markets whether on redistributive or market-failure grounds. Once government spends a large slice of the pie (around 40% in many advanced countries) it has a stake in maintaining an effective private sector to fund the state. This explains why protecting property rights and reducing corruption are hallmarks of large states. These benefits from broad tax bases and a focus on common interest spending have productivity advantages which dwarf the deadweight losses from high taxes. And they can be delivered when the institutional framework is in place to ensure that the state serves common rather than private interests.

Those who are concerned about a large government share have frequently failed to appreciate the difference between constrained, and therefore limited, government and small government. They may be right in taking the fight to economists who are excessively glib in advocating government interventions without proper consideration being given to the institutional framework to support them. However, advocating a small government share for its own sake is equally dystopian and certainly no path to greater human freedom as is often claimed. When it comes to the promotion of prosperity along with economic, social and political freedoms, it is the large and effective states around the world built on appropriate constraints on what government can do that are leading the way.