CUCKOO IN THE NEST

There's been a huge growth in government spending in the last 150 years. DAVID B. SMITH asks: Are governments now spending beyond the point at which welfare is maximised? Or are we beyond the point at which enough can be raised in taxation to finance spending?

Arguably, the most important political-economy development of the past one-and-a-half centuries has been the hugely increased role of the state in mature, developed economies.

Today's government spending ratios are typically some four-and-a-quarter times the ratios observed in the late 19th century.

Together with demographic developments, state intervention determines the 'deep parameters' of the economy, which are often assumed fixed in theoretical analyses and in macroeconomic forecasting models.

Like an inexorable glacier, however, these long-term factors eventually swamp the shorter-term influences that dominate politics, finance and much theoretical economic analysis.

The international experience

The OECD regularly publishes annual figures for the general government spending burden (and government receipts) in its *Economic Outlook* reports.

This and other information, can be used to obtain data on the share of government spending in national income from the late 19th century onwards. Data for a selection of countries are shown in Table 1.

As can be seen, the typical industrialised state was spending just over one tenth of national output around 1870, between a fifth and a quarter in the inter-war period, something under 30

Difficulties in measuring the government spending and tax burdens

It might be thought that measuring the proportion of national income spent by the government over time is a simple exercise.

Conceptually, all that is required is agreed measures of national output and government spending that are: 1) consistently defined over time, and 2) measured compatibly, if international comparisons are being made.

In practice, however, there are several different measures of national output, while government spending can also be measured in many ways, depending on whether semi-autonomous bodies - such as public corporations, for example - are included. In addition, international statisticians regularly re-work their figures on different conceptual bases.

For example, the specific measure of GDP used to represent 'national output' can make a difference of up to 5.5 percentage points to the calculated UK government spending ratio.

As a result of changes in the way things are measured, perhaps surprisingly, even historical estimates of the share of government spending in the economy frequently change.

Similar qualifications apply to the international data. In OECD estimates, the present estimates of national government spending burdens, say, twenty years ago may differ by up to *plus or minus 5* percentage points from the figures published at the time.

Is there a 'best buy'?

In general, best practice is to use the OECD's statistics for international comparisons and the UK Office for National Statistics (ONS) measure of government expenditure compiled by sub-sector and economic category for Britain.

The major difference between the two data sets is that the OECD divides general government expenditure by market-price GDP when calculating its spending ratios, while the British figures use the factor-cost measure.

The factor-cost measure correctly excludes taxes and subsidies from the definition of national income and so is arguably better.

The ratio of UK general government expenditure to GDP in 2015-16 was 39.8 per cent using market-price GDP and 45.3 per cent using the factor-cost measure. This latter figure is probably the best estimate of the share of government spending in UK GDP.

per cent in 1960, and some 45 per cent to 46 per cent in 2015.

The typical spending burden today is 4.2 times what it was in 1870 and twice the level prevailing when Keynes's *General Theory* appeared in 1936.

The British experience – 1870 to 2015

Britain's experience has been broadly similar. The ratio of UK general government expenditure to factor-cost GDP was generally between 10 per cent and 15 per cent from 1870 and 1913.

The spending ratio peaked at 51.1 per cent in 1917, during World War I, before dropping to 22.9 per cent in 1920 as wartime expenditures were cut back.

Subsequently, the spending ratio spent much of the inter-war period fluctuating between 27.5 per cent and 33.7 per cent, before hitting a record 75.6 per cent in 1944, when World War II was at its highpoint.

Spending reached a post-war trough of 36.5 per cent in 1955, during the 1950s Churchill administration.

After that, the spending ratio started a steady upwards climb: firstly, under the paternalist Conservative Harold Macmillan, and subsequently during the 1964-1970 Labour administration.

The latter saw the spending ratio peak at 45.5 per cent in 1969 when the UK had to be bailed out by the International Monetary Fund (IMF).

The government spending ratio fell to 40.5 per cent in 1973, but then rose rapidly in the mid-1970s. The spending ratio peaked at 44.4 per cent in 1976, at the end of which the UK again had to borrow from the IMF.

In 1979, Lady Thatcher inherited a spending ratio of 41.6 per cent. However, this rose to 47 per cent during the recession of 1981 before falling to 39 per cent by 1990, when she left office.

The ratio stood at approximately that level when New Labour took office in 1997. Interestingly, this figure declined to 38.5 per cent in 2000, during Gordon Brown's flirtation with 'prudence', but then the purse strings were relaxed and it had already risen to 42.9 per cent in 2007, ahead of the global financial crash.

The subsequent recession, and the costs of the bank bail

Table 1: Ratios of general government expenditure to GDP at market prices (%) – selected countries

	1870	1913	1920	1937	1960	1980	2000	2010	2015
Australia	18.3	16.5	19.3	14.8	21.2	34.1	34.6	36.6	35.6
France	12.6	17.0	27.6	29.0	34.6	46.1	51.1	56.4	57.0
Germany	10.0	14.8	25.0	34.1	32.4	47.9	44.7	47.4	44.0
UK	9.4	12.7	26.2	30.0	32.2	44.7	37.8	48.8	43.2
USA	7.3	7.5	12.1	19.4	30.0	35.3	33.9	43.2	37.8

Sources: Tanzi & Schuknecht (2000),OECD Economic Outlook (June 2016, Annex Table 29), and OECD data bank.

outs, meant that the spending ratio had climbed to over 50 per cent in 2010, before falling to just over 45 per cent in 2015.

So, in fact, the current government is spending around the same as a percentage of national income as before the sterling crises that provoked the 1969 and 1976 IMF loans.

Why should we worry about the government spending ratio?

THE CURRENT GOVERNMENT IS SPENDING AROUND THE SAME AS A PERCENTAGE OF NATIONAL INCOME AS BEFORE THE STERLING CRISES THAT PROVOKED THE 1969 AND 1976 IMF LOANS

Many politicians and economists seem unaware of how far the UK and other industrialised economies are highly socialised by historic standards.

This is particularly true of UK regions, such as Northern Ireland and Wales, which, it could be argued, have smaller private sectors than the Soviet Union's former Eastern European satellites under Communism.

The measurement issues are crucial because policy recommendations to increase public spending, that might have been helpful when government spending was roughly half its present level in the 1930s, might prove highly de-stabilising starting from the current higher base.

Given the effects of government spending and taxation on growth and welfare, it is reasonable to ask whether there are "growth maximising" or "welfare maximising" levels of government expenditure. There is a third important statistic, which is the maximum sustainable share of taxation in GDP.

Measurement issues make it difficult to identify the growth, welfare and revenue maximising levels of government spending with precision. Nevertheless, certain rules of thumb have emerged from work in this area:

- The growth maximising share of government spending in GDP appears to be between 18.5 per cent and 23.5 per cent of market-price GDP, using current (October 2016) British definitions. Ratios in this sort of range are typical of the fast growing South-East Asian 'Tiger' economies, countries such as Japan and Korea in their high growth phases, and even Australia, Canada and Spain in the 1950s.

- Using the definitions of the time, Tanzi and Schuknecht (2000) and Tanzi (2008) claimed that the welfare maximising share of government spending in GDP was at most 30 per cent to 35 per cent of market-price GDP. This conclusion reflected

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[i] Tanzi and Schuknecht (2000) and Tanzi (2011) are especially useful sources.
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their detailed examination of the effects of state spending on measures of human wellbeing. This corresponds to a range of 26.5 per cent to 32.5 per cent on present ONS definitions.

- The upper limit on taxable capacity in Britain seems to be around 33 per cent of market-price GDP. After allowing for other government revenues, and a small budget deficit of some 2 per cent of GDP, this suggests that spending only becomes sustainable when it falls into the 37 per cent to 38 per cent range. A similar rule of thumb also seems to apply to the OECD in aggregate.

Conclusion

Making a success of Brexit requires improving the micro-economic flexibility of the UK economy as resources have to be shifted from supplying continental markets to the wider world outside.

Such supply-side flexibility is unlikely to be achievable while the government is absorbing over 45 per cent of factor-cost GDP and the private sector is hamstrung by an excessive regulatory burden, much of which could be removed if we exited the European Union's single market.

A 1950s Churchill-style 'bonfire of controls', together with bold tax simplification and reform, should be overriding aims of the new administration•

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