The economic aftermath of the Welfare State in the last century

Vicini, Andrea

April 2011

The economic aftermath of the Welfare State in the last century

by Andrea Vicini

April 2011

In the recent years the **welfare state** was at the center of the debate in many industrialized country. In particular in EU the debate is particular deep, because this aspect is strictly related with a historical tradition.
Historical speaking the diffusion of **welfare state** start after the II world war, with a combinations of two historical factors:

- The progressive diffusion and affirmation of the Keynesian Thought;
- The necessity of accelerate and "lead" the process of reconstruction in particular after the issue of the *Marshall Plan*, from the US in favor of the EU countries.

The period after World War II witnessed much trust in the ability of governments to improve people's economic and social well-being through higher spending. The result was an unprecedented growth especially in the 1960s and 1970s in public expenditure in most industrialized countries[1].
This policy lead to a combination of action which is summarizable in enlargement of the public sphere.
Although the advantages of the welfare states are discussed for many decades, and sometimes was presented as the solution to many social problems for the "poor" country joint with the Keynesian idea of a large public sector, only in the recent years the debate enlarged the attention on the aftermath.
During the last twenty years a number of countries such as New Zealand or Chile have introduced fundamental fiscal and economic reforms to cut back the role and size of government in the economy. Some other industrialized countries such as Australia, Belgium, Ireland, the Netherlands, the United Kingdom, and, more recently, Italy and Spain have started reforming their institutions, cutting public spending, and reducing their large fiscal deficits.
Recently, (2007-2012) the crisis of the **sovereign debts** which assumed particular intensity in the Eurozone, imposed to the governments a rethinking of the old paradigms. For this reasons, now, I think so that we have a excellent historical occasion for reflects about the consequences of the welfare state on the economic performance.
A exhaustive analysis of the economic and social aspects of the welfare State is a monumental works, however in the present paper we focus the attention on what we consider the main consequences.
The first and the more obvious consequence is the formation of public debt. This aspect until five years ago was not seen as a significant problem, but after the **debt sovereign crisis and the Greek default,** the question assumed a different awareness. Very often a determined level of public spending is not compatible with the economy, so it is evident that a similar situation can generate a accumulation of deficit not counterbalanced by an increase of fiscal pressure, this scenario produce in the middle term a increasing percentage of public debt.
The increasing of the tax, which is a remedy respect to a accumulated deficit, is always a taboo for the politicians, because reduce the consent of the government at all levels thus is evident that the dynamic described above is very likely in the major democracies.

1 Cfr.: V. Tanzi, L. Schuknecht – *Can small governments secure economic and social well-being?* – Fraser Institute 1998. p.71-90.

Who is the beneficial of the welfare state?
Why the political class is intentioned to provides a similar “advantage” to a great portion of population?
The reply to the question is in the border among economy and political science. The political class is aware that can generate or destroy consent with alternative public choices. It is evident that the promises before of the elections are a instrument commonly adopted by the governments. This behavior when is repeated in the time generate the *“clientèle”*, in others terms: **groups of pressure** organized which can influence directly the public choices in their favor.
Another argument must be examined with attention, the distortion provoked to the competition. While economic theory suggests that government expenditures on core functions may enhance growth, it also indicates that expansion of government much beyond those core activities will exert a negative impact on the economy[2]. An example may be provoked by the contemporary presence of public and private firms, which generate a distortion in the competition reflected in the market. This situation of rigidity of prices in turn provoke a disequilibrium, or a lack of equilibrium.
Second, as **government grows**, its productivity will **decline**. Government expenditures that protect individuals and their property and provide for the smooth operation of a market economy may yield a high rate of return. As government expands into areas such as the provision of infrastructure and education, the returns may still be attractive. However, as government **continues** to grow relative to the market sector, diminishing returns will set in. Eventually, as more and more expenditures are channeled into activities for which government is ill suited, negative returns will set in and economic growth will be retarded.
In the mentioned Article, Randall and the Others, put in comparison the same historical period for many countries, in this way they find a strong and persistent negative relationship between government expenditures and growth of GDP, both for the developed economies of the OECD and for a larger set of 60 nations around the world. In the few isolated cases where nations reduced their government expenditures by an appreciable amount, this reduction in the size of government was correlated with an increase in the growth rate of real GDP.
This Hypothesis is confirmed in US. Government outlays in the United States have grown from 28.4 percent of GDP in 1960 to 34.6 percent in 1996, and the GDP growth rate has fallen from an average of 4.4 percent in the 1960s to an average of 1.9 percent during the 1990–96 period[3]. Larger government means slower economic growth.
The evidence presented in the Randall's paper provides a explanation: Increases in the size of government have slowed economic growth. Naturally there are alternative explanation respect to the slowdown of economic growth, such as: the globalization, the mobility of capital which direct a great part of the manufacturing firms in Asia, Latin America, an the others low cost labor countries, the oil price, which is another global factor with relevant effect.
However, the regression results presented above suggest that a decrease of 10 percent in government expenditures as a share of GDP will produce an **increase in the GDP** growth rate of about 1 percent. This effect must be examined in the long term, and must be compared with the fiscal illusion generated in the short term, which consider the possibility to increase the income with a increase of public spending. For this reason, is evident that the orientation of the policy in the short term is incompatible with the economic growth which is a action with a long temporal horizon. Similarly to the fiscal pressure there is a range of the government spending as share of GDP (which is estimated by Randall near to 15-20% for the USA) which is “optimal” after there is the predominance of negative effects on the economic activity as in the Laffer's curve.

In the recent years, the debate regarding the welfare and the relative literature, was polarized by a key question, the **sustainability**, of the policy. Although this is a central element, the theme is more

2 Cfr.: J. Gwartney, H. Randall, R. Lawson – *The Scope of Government and the Wealth of Nations* - Cato Journal, Vol. 18, No. 2 (Fall 1998). p. 163-191.
3 Cfr.: J. Gwartney, H. Randall, R. Lawson – *The Scope of Government and the Wealth of Nations* - Cato Journal, Vol. 18, No. 2 (Fall 1998). p. 163-191.

complex. For many economists and politicians the implicit assumption is that the current configuration of the welfare is adequate even in presence of many distortions.
For this motivation various studies discuss the private versus public provision of goods and services and social security and the role of budgetary institutions in maintaining small and efficient governments with low fiscal deficits. The conclusion of this debate seems to be that governments could introduce considerable changes to the way they are currently doing things.
The Tanzi 's paper after a detailed historical introduction to the welfare states and the relative economic literature, point out different but interesting aspects, such as the adequate dimension of the government. The key question debated by Tanzi is:

Can Small Governments Secure Well-Being?

For answering to this question he builds a comparison which considers social and economic indicators between countries and groups of countries.

It is evident that public policies affect these indicators, so for easier comparison between country groups, the Authors Tanzi and Schuknecht divide the countries in three groups:

- **Big government**, public spending exceeded 50 percent of GDP in 1990.
- **Medium governments** reported public spending between 40 and 50 percent of GDP.
- **Small governments** showed government expenditure of less than 40 percent of GDP.

A fourth group mentioned in the paper includes the “newly industrialized economies” such as: Chile, Korea, Singapore, and Hong Kong, which by these standards all report “very small” governments.

A first consideration which emerge and which explain the data examined is the aging of population which affect directly into the public spending via the health policy, whereas regard the educational services which is another factor comparable across countries it is evident that the relation between the percentage of public spending respect to the quality of service, needs others consideration which take in account the different structure such as the voucher system, versus the public system. However a sign is noteworthy, between the New Industrialized Country emerge the South Korea, which is a NIC with a excellent level of educational services, more high respect to others countries.
Another element which emerge from the Research cited, is that the great part of the public expenditure was composed by transfers and subsidies, in the developed countries this percentage is near to 30 percent of GDP. This evidence how the public policy is generally a operation of transfer from a social category to another social category.
Regarding the Size of Government and Economic Performance in different country groups, we can say that there is a inverse correlation, because it is evident that in presence of a limited availability of resources, improve the quality of spending.
In conclusion is evident that although 30 percent of GDP of public spending may be a useful benchmark for some countries, this does not mean that it is the optimal size of government. In the present paper our purpose is show how this question can not be debated only with quantitative indicators. There is a wide number of variables, such as the demographic dynamic, the efficiency of countries’ public sectors, the efficiency of public machine, which can not be captured by the econometrics evidences, however is evident that all represent a important factor for determine the oprtimal level of the public spending in percentage of GDP. Regarding the dimension is evident that small government means less occasion of corruption and interference in the citizen's life.

References

- **V. Tanzi, L. Schuknecht –** *Can small governments secure economic and social well-being?* – Fraser Institute 1998. p. 71-90.
- **J. Gwartney, H. Randall, R. Lawson –** *The Scope of Government and the Wealth of Nations* - Cato Journal, Vol. 18, No. 2 (Fall 1998). p. 163-191.