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The Size of Government in Non-Slave States

by

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by Allan H. Meltzer*

The question asked by the organizers of this session is: Is there an inherent limit to the size of government in a democracy? The answer to this question is clearly yes if we measure the size of government by the average tax rate or by the average share of expenditure of government. Neither is an ideal measure of the size of government, but both are likely to be correlated with more satisfactory measures such as the net distortion removed or imposed by government. With this caveat, I use the share of spending by government to measure the size of government.

The reason an affirmative answer to the central question can be given is that we have never observed average tax rates near 100% in any country that can be described as democratic. In most "democracies" government spends less than 50% of measured income. Even in countries with strong commitments to income and wealth redistribution, marginal tax rates rarely reach 100%, and for good reason. Confiscatory taxes do not produce revenue. Long before tax rates reach 100%, most taxpayers find leisure (or non-labor) preferable to activities that produce taxable income. Governments cannot continually spend a larger fraction of income than they collect in current and future taxes.

The proposition that the maximum average tax rate is less than 100% does not depend on democracy, however that term is defined. The limit is set by the absence of slavery, or if one prefers by the very high cost of maintaining an economy based on slavery. The ultimate limit on taxation is the individual's freedom to allocate time between activities that produce taxable income and activities that do not. High marginal tax rates encourage

* This paper draws heavily on work with Scott Richard, particularly Meltzer and Richard (1979).
the development of substitutes for taxable employment including substitution of one's own services for the services of others, barter and untaxed enterprises including, but not limited to, activities usually described as crimes. When these methods of limiting taxes become too costly, the disaffected emigrate.

The presence or absence of democracy is not critical for establishing the existence of a limit to the size of government. I find the same general process at work in the authoritarian societies in which I have lived for a time, ranging from Brazil to Yugoslavia, and I would be surprised to learn that effort and after-tax reward are unrelated wherever people are able to choose the quantity and quality of effort supplied.

The rest of my comment tries to answer Professor Cameron's main questions. While I have dismissed the political process as a determinant of the inherent limit to the size of government, I regard it as one of the decisive factors determining the relative size of government observed in each country. The following section develops the role of the political process. Then, I attempt to explain the heightened interest in proposals to limit the size of government.

The Role of the Political Process

Two independent decisions must be made in each country. Both depend on the political system. One is the decision about the amount to be spent by government. The other is the decision about how the spending is to be financed. Each of these decisions gives rise to a number of subsidiary choices. For spending, these include the distribution by category -- for example, decisions about public goods, income redistribution, the amount spent on regulation -- and decisions about who gains and loses from the
transfers. On the revenue side, government allocates the tax burden among the taxpayers by setting the tax schedule and by choosing to tax now or to defer taxes to the future or to inflate.

There is little dispute about these statements as long as we remain at the level of generality of the two previous paragraphs. Disputes arise when we begin to give meaning to terms like "political system" and "government." By the political system, I mean the voting rules -- the rules that specify (1) who has the right to vote and (2) who is the decisive voter. By government, I mean the decisions implied by utility maximizing subject to the voting rule. In a country with universal franchise and majority rule, the median voter is the decisive voter. The government carries out the decisions that maximize the utility of the median voter. An authoritarian government carries out the decisions that maximize the utility of the individual who is decisive within the group that holds power.¹

Once the voting rule is established, the decisive voter sets the amount of spending, determines how the spending is allocated and decides how revenues are raised. At least four types of decisions are required. The amounts spent for public goods and for redistribution must be set. Once these choices are made, the size of the budget is determined but the choice of the method of financing remains. Resources can be acquired by taxing, by selling bonds and by printing money.

¹ This does not deny that a military government can be responsive to some popular demands. To remain in power while avoiding both disruption and reliance on terror, authoritarian governments sample and respond to public opinion. "Authoritarian" is best thought of as a relative term.
In principle, there should be few problems about the amount spent on public goods. The very nature of these goods implies that the decisions about the amount to spend do not depend on the voting rule. Unanimity, or near unanimity should prevail. Many of the problems that are treated in the literature on public goods arise because there is no clear, operational definition of a public good. Some political scientists and economists appear to define government as a supplier of public goods and to accept any collectivized decision as a decision about public goods. On this view, the political process is a process for providing and financing the supply of public goods.

I believe that answers to questions about the relative size of government cannot be obtained from an analysis that treats all collective activity as the provision of public goods. It is not helpful to explain the differences in the relative size of government between countries by ascribing the differences to differences in the taste for public goods. Nor does it help to analyze a sustained fall in the relative size of government as belated recognition that there were fewer public goods than was previously believed. Government is an agency for redistributing income and wealth. We mistake the role of modern governments if we neglect this aspect.

The decisive voter determines the amount to be spent on redistribution by the society in which he lives by maximizing his utility. Since the voting rule determines who is the decisive voter, the voting rule determines the share of income redistributed.

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2 The qualification recognizes that, as Aranson and Ordeshook (1) emphasize, there is private production of public goods. There is also the much discussed problem of free loading.
The sum of spending for public goods and for redistribution determines the share of income taxed and the average tax rate. Increased tax rates lower aggregate income by reducing the effort of those who pay taxes. Increased redistribution reduces aggregate income, also, by increasing the number of welfare recipients who do not work. The reduction in aggregate output and income sets a limit to the amount available for redistribution and to the amount redistributed. Even if the decisive voter is a welfare recipient, total income is not redistributed. Someone must have an incentive to work.

[Insert Figure 1 about here]

Figure 1, from Meltzer and Richard (1979), summarizes the argument. Let \( \rho \) be the share of income redistributed and let \( x \) be the voter's income. These are two polar positions. At \( x_0^* \), the decisive voter is on welfare. His entire income comes from redistribution, so redistribution is at a maximum. At \( x_0^{**} \), the decisive voter votes against any redistribution, so taxes are levied only to pay for public goods. We find most democratic governments between the two extremes. There is some redistribution, but the decisive voter is in the labor force.

The taxes levied to pay for current spending can be borne by the current or by future generations. In the absence of constitutional prohibitions the decisive voter will choose to tax both current and future income. This can be done by issuing debt. Increases in debt raise interest rates and reduce the size of the future capital stock and the level of income. Debt issues, like current taxes, are limited by their effect on incentives to work and to accumulate capital.

The political process redistributes income in societies subject to majority rule because votes are concentrated near the median and the income
of the median voter is below the mean income of the society. The median voter gains by transferring enough income to increase his consumption. In choosing the amount of redistribution, he balances the loss to him from lower effort and lower real income for everyone against the gain from redistribution.

Let the decisive voter be at a two-thirds majority and the amount redistributed declines. Let an authoritarian regime, favoring redistribution, take power, and the amount of redistribution shifts to the position that would be chosen by a decisive voter in the lower tail of the income distribution. The position of the decisive voter, not the details of the political process are critical for deciding the amount of redistribution and the share of income taxed.³

The Growth of Government

The process I have described is an equilibrium process. At each point of observation, there is a limit to the size of government and government has that size. We can weaken this last, strong implication by introducing uncertainty about the characteristics of the decisive voter. This would, most likely, make the tax rate approximately the same over a range of voters. Minor changes in the composition of the electorate, or the outcome of a particular election, would leave the tax rate unchanged. Qualifications of this kind make the propositions looser but do not change their meaning.

A more important problem is to explain why the size of government changes. There are three main reasons.

³ This does not imply that methods of enforcement, freedom and other aspects of life will not differ in authoritarian and democratic societies. At any level of income and income redistribution, utility will differ.
First, the shape of the income distribution changes. The gains and losses from taxation and redistribution depend on the shape of the income distribution, particularly the relation between the income of the decisive voter and the mean income. As the income of the decisive voter approaches the mean income of the community (from below), the decisive voter bears more of the taxes and benefits less from redistribution.

Second, during the last one hundred years, the franchise has been extended in western Europe and in North America. Property qualifications have been removed and in many places literacy has increased and literacy requirements for voting have been reduced. Growing urbanization reduced the cost of voting and, in the United States, urbanization of blacks was followed by legislation removing barriers to their voting. Earlier, the poll tax had been removed as a qualification for voting. Each of these actions spread the franchise down the income distribution.

Third, there has been a marked increase in the number of households headed by a single person. In part, this reflects the increase in the divorce rate and in part the changing role of women in the labor force. Whatever its origins the effect is to reduce income per household and most likely to push the effective median household income away from the mean.

My answer is yes to Professor Cameron's question: "Are there political and/or economic forces that have generated a secular increase in the public economy, both in absolute size and in size relative to that of the private economy?" The spread of the (before-tax, before transfer) distribution of income and the decline in the number of income earners per household appear to have changed the desired and actual size of government. Preliminary empirical studies suggest that these factors have worked in
the United States to increase the relative size of government. The spread of the franchise appears to have been less significant for the United States.

Why Government Growth Slowed

During the past few years, evidence has accumulated that voters have resisted further growth of government. There is some evidence that this time, complaints about tax rates have been followed by action. Prime Minister Thatcher was elected in Britain despite, or perhaps because of, her advocacy of less government involvement in economic activity. The Jarvis-Gann amendment in California reduced property taxes and was followed by reduction in income taxes. Programs to reduce taxes or limit government have been approved in several states and more than half the legislatures have endorsed the proposal for a constitutional convention called for the purpose of adopting a balanced budget amendment. These and other well-known examples suggest a change in attitude.

I am not convinced that there has been a permanent change in the trend growth of government. I believe the changes we have observed in recent years are the result of the permanent reduction in the level of income resulting from the oil price increases. The loss of real income must be distributed between major components of spending. The level of government spending desired by the decisive voter in each country, and the amount of taxes he chooses to levy, is lower as a result of the oil shock.

The oil price increase can be regarded as a tax levied by the oil cartel on all users of oil. The tax must be paid by giving more current or future exports in exchange for imports of oil. If we all work as
much and produce the same real value of goods and services, we have less available for spending on domestic production.\(^4\) The greater difference between income and spending is the amount of additional exports that we use to pay for oil.\(^5\)

If we treat the oil price increase as a tax, consumers have higher taxes and lower income after the price increase. They consume less, invest less and desire less spending by government.

The U.S. government responded to the oil shock by reducing tax rates and increasing spending. The increased spending was financed by higher current and future taxes and by higher inflation. A principal effect of inflation is to increase the taxes we pay by moving people into higher tax brackets. The result has been higher taxes and more redistribution than would have been chosen if the voters had known the level of income that followed the oil shock.

Viewed from this perspective, there is a lower level of income and a smaller demand for government spending and redistribution. There is, in this analysis, no reason to expect a reduction in the average tax rate or size of government. The demand by the public is a demand to remove the unforseen and undesired increase in the relative size of government resulting from the reduction in the level of income with the government budget unchanged (or increased).

\(\text{\textsuperscript{4}}\) There may be other effects of the tax. If the tax is not neutral, the capital-labor ratio and the growth rate may fall. For analysis of the effect of the oil shock on the growth rate see papers by Rasche and Tatom (\(\text{\textsuperscript{5}}\)) and by Wachter and Perloff (\(\text{\textsuperscript{5}}\)).

\(\text{\textsuperscript{5}}\) The fact that the cartel takes a part of their revenue in bonds or other income yielding assets is a minor complication. The purchase of income yielding assets instead of current exports indicates that they plan to spread their higher consumption across time.
To have a permanent effect on the size of government, the oil shock must change the distribution of income. It may be true that aggregate income, and therefore mean income, is more affected by the oil shock than the median income. For example, average income may have a larger component of income from capital than median income. If the oil shock lowered income from capital relative to labor income, mean income has declined relative to median income. A decline of this kind lowers the relative size of government. There is some evidence that the ratio of mean to median fell in the U.S. in the mid-seventies, but it is too early to be certain.
\[ p_{max} \]

\[ x^* \]

\[ x^{**} \]

FIGURE 1