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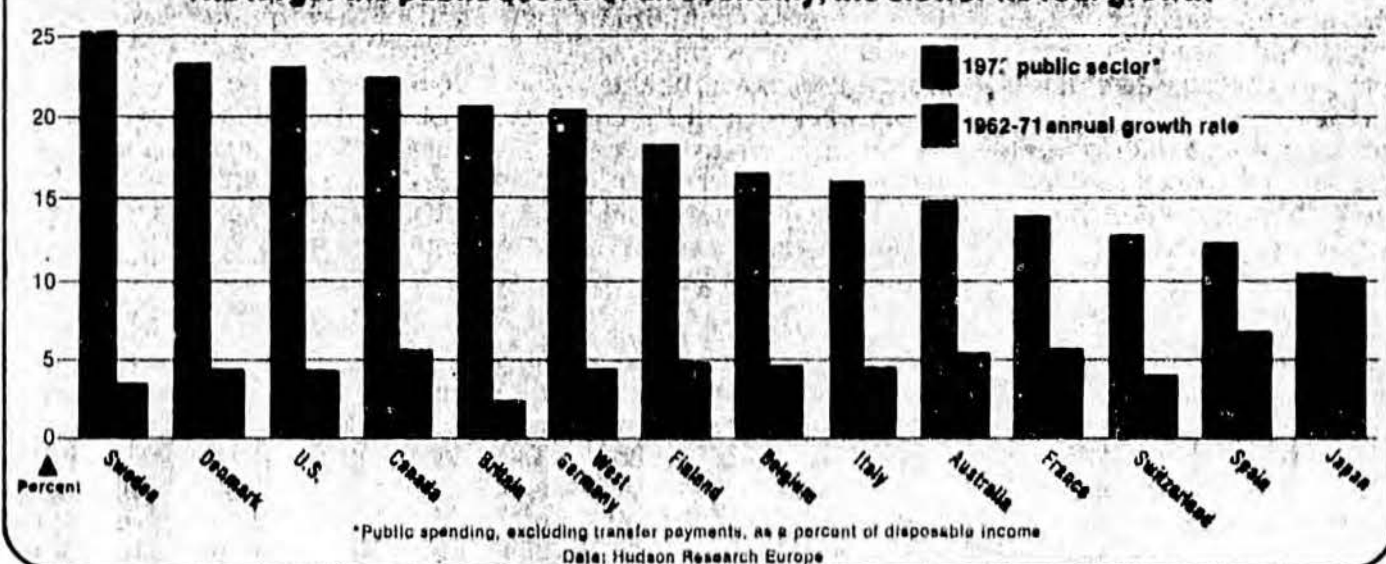
Government growth crowds out investment

European studies show the adverse impact of large public outlays

"I tend to feel that an over-large public sector is a sign of incipient decline," says Edmund Stillman, director of Hudson Institute Europe, an independent Paris-based affiliate of Herman Kahn's U. S. think tank. This view arises from ongoing research led by Hudson economist Richard Ensor. Hudson's findings tend to show that overall growth is the lowest in countries where the government sector is largest. That raises the strong suspicion that large and growing by the expanding government sector in Western industrialized countries has been massive—cutting attainable growth rates by as much as one-third in the past 15 years.

A major reason government grows rapidly is that higher public spending always proves effective as a short-term cure for recession. But since the level of public spending seldom falls after recovery gets under way, a ratchet effect comes into being. The long-term result, according to Alexandre Lamfalussy, chief economist for the Bank for International Settlements, is that "in many advanced countries, taxation seems to have approached or exceeded the limits of economic efficiency."

Wage-push inflation may provide an important warning signal that government is growing too fast. When expanded



public spending actually causes slower economic growth.

The Hudson findings are one example of an impressive body of European research pointing to this same conclusion. In Britain, which has had slow growth for the last 60 years, two Oxford economists, Robert Bacon and Walter Eltis, have documented the case against a growing government with impressive attention to the detailed impact of specific public policies on the industrial structure. Similar implications have also emerged from a study by David Smith, principal research officer in economics at England's National Westminster Bank. And the Organization for Economic Cooperation & Development is preparing a study on the same subject for publication early next year.

The new studies differ in detail, but in general they conclude that the toll taken

Three other major themes of the new studies:

Differences in the size of the government are not the only factor explaining differences in growth rates among countries.

Any economy's "natural" growth rate depends basically on the growth of its labor force and the productivity of its workers. Both vary over time and between countries because of a variety of cultural, technological, and other factors, of which the size of government is only one. Still, David Smith's study estimates that differences in public-sector size accounted for fully 35% of the overall variation in growth rate in his 19-nation sample during the 1960s.

Not all public programs are equally harmful to growth. Though the traditional view is that transfer payments—such as social insurance, unemployment compensation, and welfare—are the most wasteful form of government expenditures, both Smith and the Hudson group found that such payments had far less impact on differences in growth rates than did government spending for goods and employees. Bacon and Eltis lay far less emphasis on transfers than on the huge growth of government payrolls, and Smith stresses the fact that transfers do not actually tie up productive resources in the production of socially designated services. This distinction has important implications for public service employment proposals in the U. S.

public services are provided freely, the principal test of their desirability is whether people will pay the resulting taxes without demanding higher wages. "Those who control public expenditure create the public sector that they believe to be correct," Eltis says dryly. "But the workers have shown an unwillingness to pay for the level of services that public officials deem appropriate." He cites the increased militance of British labor that began in the mid-1960s as a vivid example of the hazards of an overblown public sector.

The mechanism by which a larger public share leads to slower growth is to be found in shrinking profits and falling investment—a gigantic non-monetary "crowding-out effect." Since there is a long-run relationship between an economy's stock of capital equipment and the level of output it can produce, any given

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growth rate requires that a certain proportion of total production must be invested in new capital goods. If, for instance, it took $3 worth of capital investment to produce $1 worth of annual output, then a 4% rate of growth in productive capacity would require that 12% of each year's net national product be set aside for new investment. If the higher taxes resulting from higher government costs eat into profits and private savings to the degree that investment of this 12% proportion becomes impossible, growth will fall below the 4% rate, even if labor force and productivity growth remain favorable.

The link. The Hudson group feels that it has statistical evidence of a significant causal relationship between a rising income share for public spending and a lower share for private investment. This linkage is stronger in some countries than others, Hudson's Stillman concedes, and in some cases the slow growth of an aging economy could cause higher public spending, rather than vice versa. Nonetheless, he believes that "nonmarket spending, (as opposed to investment in self-supporting public enterprises) is the preemptive factor in overall economic growth."

Public spending grows because it is a short-term cure for recession

The institute's *Hudson Letter* recently estimated the degree to which specific economies have been hurt by the rapid growth in government over the past 15 years. For Denmark and Sweden, the attainable growth rate has been cut by 1.3 to 1.5 percentage points; for Canada, Finland, Germany, and Britain, about 0.8 points; the other European members of OECD are assigned reductions of 0.4 to 0.5 points. France, which does not appear to have enlarged its public sector share, is the exception. Smith has arrived at similar estimates. He suggests the rule of thumb that "each 5% increase in the share of disposable income absorbed by state consumption implies a 1% drop in the growth rate."

Bacon and Eltis have focused on the British experience, and believe that 1966 marked a costly turning point for that nation. Government responded to balance-of-payment difficulties with a plan to slow the growth of government purchases in order to free resources for use by industries that export or compete with imports. But it did not provide the proposed additional stimulus of a devaluation, and it also shelved a long-range economic plan to stimulate industrial expansion. It was in this offhand fashion, the Oxford economists say, that Britain's economic structure was nudged fatefully in the direction of rising public-sector costs. Without the encouragement of either strong export markets or the industrial expansion targets of the discarded national plan, business cut back on private investment. Meanwhile, government departments steamed ahead toward employment goals that had been based on the assumption of a stronger economic recovery.

Employment. Despite recurring attempts to shore up the private economy, a spiral of rising public sector payrolls and falling private investment took hold. "Over the period from 1966 through 1974," Eltis notes, "the market sector was losing 175,000 jobs per year, and the public service sector was adding perhaps 120,000 per year. That means a smaller number of producers of marketable outputs in the private sector has got to support a larger number of tax-supported public employees."

Inevitably, taxes rose sharply. Amounting to nearly 30% of earnings, the average British worker's tax burden is now proportionately higher than that of a bank manager or university professor in 1963. And deficits have also mounted.

The point is not that public services should be eliminated, but that either their growth must be kept in balance with private output or people should be prepared for a growth slowdown. "As per capita incomes rise," Bacon says, "you would expect people to be prepared to give more of their own consumption to make room for public consumption. I think Sweden, prior to the latest election, was an example of this."

In fact, the Scandinavian countries, with their smaller, relatively homogeneous populations, have generally done a good job of basing public-sector expansion upon the agreement of union leadership to accept a fair share of realistically estimated costs. In England, on the other hand, discipline in the labor movement and accuracy in public-sector cost projections have both been lacking, according to the account in Eltis and Bacon's new book (*Britain's Economic Problem: Too Few Producers*). From 1966 to 1970, the public sector's pretax income rose by more than 15% as a ratio to that of the market sector. The consequence of the higher taxes that resulted was "nearly universal pressure for wage settlements in excess of 10%, at a time when the inflation rate was much less than this." Soon enough, of course, price movements had to catch up; by 1970 inflation was nearing 10%. And with government continuing to expand employment almost any time workers became available, the process accelerated. Consumer prices rose 16% in 1974 and more than 24% in 1975. Ironically, all of this occurred at the same time that British industry had succeeded in shaking off decades of apparent decline, raising annual productivity growth from 2.2% in the 1950s to 4.2% since 1961. Unfortunately, the balance had been

tilted too far—instead of faster total growth, a shift in resources to the public sector was the only result.

Resource allocation. Without having studied the British case in detail, American growth theorists are agnostic about the contribution that wage-push inflation has made to declining rates of investment. While conceding that such inflationary pressures can be one source of profit reductions, particularly in an economy as open to low-cost import competition as Britain's, Robert M. Solow of the Massachusetts Institute of Technology feels that the inflation and growth problems may proceed independently of each other. "Workers always want more take-home pay *and* more public services," he says, "whenever they can get them."

Growth depends on keeping public services in balance with private output

As for the slow growth problem, Solow notes that even without inflation, the public sector would take an expanding share of total resources in any case where policymakers continuously used fiscal stimulus to maintain relatively full employment, while relying on tight monetary policy to restrain occasional inflationary pressures. Even without wage-push, "you would automatically get a shift in the composition of output in favor of government purchases and away from interest-sensitive activities, such as private investment," says Solow, who is considered to be the ranking growth theorist in the U. S.

For the U. S., the immediate question raised by the new studies is over the wisdom of the public employment programs as a cure for high unemployment. Solow concedes that "the Bacon-Eltis argument could hold against a large public service employment program on an ongoing basis." Most American economists tend to feel comfortable only with relatively small public service employment proposals that either disappear or shrink in size whenever unemployment reaches low levels.

Thus far, it would appear that U. S. politicians will not repeat the excesses of their British counterparts in both the Labor and Conservative parties. Of the two Presidential candidates, Jimmy Carter has spoken strongly in favor of job creation efforts. But he has said that if tax-receipt gains lagged behind his projections, he would slow down the growth of social service programs.

Meanwhile, Eltis, who is spending the year as visiting professor at the University of Toronto, is watching from his post across the border. He says: "Presumably, your American experts have looked carefully at the tax consequences of the proposals they put forth. If not, it's entirely irresponsible." ■

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