Book Review

VITO TANZI, 2010. GOVERNMENT VERSUS MARKETS: THE CHANGING ECONOMIC ROLE OF THE STATE. CAMBRIDGE, ENGLAND: CAMBRIDGE UNIVERSITY PRESS.

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Vito Tanzi's important, well-written and occasionally provocative new book provides an historic account of the development of the state in a worldwide perspective. Part I is an excellent essay on the role of the state, well worth reading in its own right, which draws together the book's main arguments and conclusions. Part II describes the development of the role of government and public spending during the past century, and the factors that contributed to it. Part III outlines theories related to the role of the state in different settings and discusses the policy tools that have become more important in recent years. Part IV focuses on results, in terms of significant socio-economic indicators, that can be attributed to the growth of public spending in recent decades, with the main focus on advanced OECD countries. The concluding chapter reviews the issues that are likely to influence the future economic role of the state.

Public expenditure as a share of national income grew massively in many industrial countries from about 10 percent of GDP in the 1870s to around 40 percent in recent years, and even higher levels in some European countries. A large part of this growth came after World War II, and especially after 1960. Most of the growth comprised additional subsidies and transfers from the budget in areas such as public pensions, health services, education, public housing, assistance to large families, subsidies to public and private enterprises, as well as assistance to the old, the very young, and the handicapped. Public spending for these activities had been almost nonexistent at the beginning of the 20th century. Citizens came to regard the government's new role as normal and essential. In promoting this expanded role, governments needed to find new sources of revenue, and tax rates and tax levels also went up sharply.

Tanzi provides an excellent survey of the rich literature of public finance which has attracted some of the best minds in economics. The book includes a very useful discussion of the Italian school of public finance (Salerno, De Vito de Marco and others) which, as Tanzi notes, has been insufficiently recognized in the literature, and which provides important insights into developments such as the theory of fiscal illusion and public choice theory. Tanzi gives close attention to the work of Adam Smith, Marx and

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Keynes, noting that "each of these economists would probably have been surprised, and occasionally shocked, at how his ideas were interpreted, transformed, used, and often abused by his followers" (169).

The book includes a fascinating analysis of the Nordic model of public finance. This model depends on the assumption that policy-makers are objective promoters of a well-defined social welfare. Tanzi argues that this assumption was not unrealistic given the fairly homogenous societies that prevailed in these countries, their feeling that they were a community, the degree of social cohesion, and the trust in those who represented the government. However, the model clearly represents an extreme case, and the homogeneity of the Northern European countries has declined in recent years and, with it, some of the faith in high levels of public spending.

Fiscal illusion – the belief that an expanded government role is efficient, beneficial and welfare promoting – has played an important part in encouraging the growth of public spending. Citizens often fail to recognize the costs associated with "free services", and that in many areas the private sector is a viable alternative to the government as a service provider. Tanzi comments that "should governments give up their quasi-monopoly power over some of these sectors (pensions, health, education), especially in today's world, private sector alternatives would quickly appear, as they appeared when governments gave up their monopolies over airlines, telephones and other areas" (25). Another obstacle to reducing public spending is the "fundamental law of public program development" (121). When a new program is introduced it looks lean, has a limited scope and a well-defined group of beneficiaries who are easy to identify. Over time, standards are slowly relaxed and the number of beneficiaries goes up, together with expenditure on the program.

The book includes some interesting empirical analysis. Tanzi provides a critique of the thesis put forward by Dani Rodrik that governments have expanded fastest in the most open economies, especially in the area of social protection. The correlations presented in Chapter 6 suggest the reverse hypothesis, namely that the more open the economy, the less their governments have spent. In Chapter 11, Tanzi attempts to test whether there is a continuous, positive relationship between higher public spending and higher social welfare, or whether there may be diminishing returns, in terms of welfare gains, to such spending. The results presented are not favorable to big governments: there is no evidence that higher spending generates better performance indicators of public spending.

Tanzi is critical of the assumption made by many economists that public spending should be equated with the benefits arising from the programs concerned. The two are very different concepts and may diverge significantly. Spending is often not received by the citizens who use public services, but by the public servants – teachers, doctors, nurses, policemen, and so on – who deliver them. Moreover, the benefits of spending programs frequently accrue to the middle and upper classes rather than the poor on

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whom the programs are targeted. Social public spending in Latin America for example has done little to improve the income distribution “which continues to be characterized by Gini coefficients that are the highest in the world” (242).

Overall, the book is highly skeptical of the benefits of big government. Even when a government is pressured into reducing the size of the budget, it has other instruments at its disposal which to some degree substitute for higher spending. These include the regulation of utilities and private enterprise, the ownership of public corporations and other assets, and “nudging and cajolement”. For example “in Sweden and Denmark [the role of government in the economy] is played mostly through public spending, whereas in China, it is mainly played through various forms of regulations” (205). A government that strengthens the quality of its bureaucracy will increase its capacity to play a larger economic role, using a greater range of policy tools. Regulation, however, is a problematic area since regulators in financial markets and other sectors are subject to capture, and as Stiglitz has observed “regulations rarely or never make a market more efficient” (216). In the final section of the book, Tanzi discusses a range of factors that in recent years have made the business of government more complex, more subject to capture and principal-agent problems, and less transparent.

This fine book suffers from a few shortcomings. Tanzi could have discussed recent work by the G-20 group of countries on the quality of budget institutions, and efforts by Transparency International, the Open Budget Initiative and other groups to make fiscal information more transparent. He could also have discussed the development of new techniques, such as public expenditure reviews and results-based budgets that analyze the efficiency of public spending programs. However, at root such techniques, while informing the debate on the size and role of public spending, play second fiddle to the institutional and political factors that drive the policy-making process.

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