IDI Presents:

17th Annual CAESAREA FORUM

The Requisite Size of Government: Between Economy and Politics

Team chair: Prof. Joseph Zeira

Summary of Findings

Israel Democracy Institute

Caesarea Economic Policy Planning Forum

17th Caesarea Forum, July 1-2 2009

Preparatory team

Team chair **Prof. Joseph Zeira**, Department of Economics, Hebrew University of Jerusalem

Team members **Alon Etkin**, Economics and Research Department, Ministry of Finance

Prof. Avi Ben-Bassat, Department of Economics, Hebrew University of Jerusalem; Israeli Center for Academic Studies; Senior Fellow, Israel Democracy Institute

Ra'anan Dinur, former Director General of the Prime Minister's Office (2006-2009)

Yehuda Saban, Coordinator of Macroeconomics, Budget Department, Ministry of Finance

Dr. Michel Strawczynski, Director, Macroeconomics and Policy Division, Bank of Israel Research Department

Prof. Avia Spivak, Department of Economics, Ben-Gurion University; Senior Fellow, Van Leer Institute

Prof. Hillel Rapoport, Department of Economics, Bar Ilan University

Research assist. **Ana Zapsochni**, Israel Democracy Institute and Hebrew University of Jerusalem

Abstract

This document sums up the work of the team on the topic “The Requisite Size of Government: Between Economy and Politics.” To the best of our understanding, the role of the team was to try to clarify and elucidate issues related to determining the size of Israel’s government relative to the size of the economy. It was not our intention to lay out explicit recommendations as to the optimal size of the government, because it is clear to us that this matter cannot be subject to the decision of professionals, but should rather be decided upon by public representatives who reflect the diverse range of opinions and views held by the public. Professionals can provide an outline for the issue, the various possibilities, their advantages and disadvantages, but the decision ultimately lies in the hands of the nation’s leaders, who should have a range of options to choose from—as opposed to only one, which they must adopt unquestioningly.

The size of the government—and by this we are referring to the relative size of the government (relative to the size of the population and relative to its revenues, or more correctly its GDP)—is a highly important variable. It measures the share of economic activity that is carried out and financed publicly versus the share that is financed privately. It measures which services the government provides to the public, and at what quality, as opposed to the many other services that the public consumes privately. The public provision of services has a very long history. Back in ancient times, as soon as human societies began to organize with a governmental structure, it became clear that it was necessary to have a ruler in order to produce and supply certain services—mainly security, law and order, infrastructure and support for science. These services are known as “public goods,” and are characterized by the fact that they are not supplied directly to individuals, but rather to the public as a whole. Therefore, these goods are not priceable by any market mechanism, and the private market cannot supply them.

Since the Industrial Revolution of the 19th century, the list of services provided by governments has greatly expanded, to include education, health, social insurance and more. These services are not public goods as defined above, and are supplied to individuals, but they are provided by governments because each of them is associated with a certain “market failure,” due to which the service is not provided in the full and desired manner. This development, which was

[*] The document presented here is an unedited draft.

accelerated in the 20th century, and particularly after World War II, has caused governments to grow substantially in the past hundred years. It is important to note that even states that provide all these services do not necessarily do so with the same scope or at the same level of quality. There are significant differences between different countries, which can be reviewed in the full length report of our committee's findings.

We usually measure the size of the government by a simple parameter, which is the ratio between the government expenditure and the gross domestic product (GDP).[1] This measurement is of course highly problematic, because it does not measure the size of the government services, but only their cost of production. For example, we do not measure the amount of defense that the army provides to the state, but only the size of defense expenses, meaning the cost of manufacturing defense alone. Similarly, we do not measure the quality of public education or the level of insurance for individuals against unemployment, poverty or illness, but rather the cost of manufacturing these services. The reason that we do not have measures for the outputs of public services is that these services are not traded on the market and have no price tag attached to them. This problem, of a lack of measurement of public services, is a problem seen frequently within the social sciences in general, and economic science in particular, and we will not propose a solution for it in this document. However, it has become apparent through our discussions that there are ways of circumventing this problem in several areas, and in some of them the measures of the expenditures provide a good estimate of the quantity and quality of the service given (due to the strong relationship between inputs and outputs).

An important point, which was clear to the team throughout its discussions, was that the size of the government or the scope of public services has a price that cannot be avoided. In order to finance a larger government, it is necessary to collect more taxes from the public, since a deficit is not a way to finance government expenditures in the long term. A deficit enlarges the government debt, and if this should grow, the economy will reach high levels of debt that will threaten government and economic stability, and greatly increase interest payments and taxes in the future. Therefore, any discussion of the size of the government is in effect also a discussion of the amount of taxes that should be collected from the public. This statement is not only an expression of a

---

[1] By the term "government," we are referring to the government in the broader sense, or the public sector, which besides the central government, also includes the local government, public non-profit organizations (health funds, hospitals and universities), and in Israel, the National Institutions as well.

budgetary truth, it is also an educational statement of the first order. Only willingness by the general public to pay for certain public services will afford these services deep and solid public support. Only the willingness to pay for education, or for comprehensive social insurance in the welfare state, will ensure that these services will indeed be given in the long term as well, rather than being cut at the first opportunity.