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204. This is a comment by Lars Jonung on Part IV (pp. 298-303): Ludger Schuknecht and Vito Tanzi, "Reforming public expenditure in industrialized countries: Are there trade-offs?" and Ruud de Mooij and Paul Tang, "Reforming the public sector in Europe: Reconciling equity and efficiency", chapter 13 and 14 in *Fiscal Policy Surveillance in Europe,* edited by Peter Wierts, Servaas Deroose, Elena Flores and Alessandro Turrini, Palgrave, 2006.

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Comment on Part IV

Lars Jonung

European policy-makers are presently faced with two major self-inflicted challenges that are forcing them to consider the size and composition of government expenditure and thus the activities and scope of the public sector. They are self-inflicted in the sense of being created within the EU by political decisions.

The first challenge is the Stability and Growth Pact's (SGP) restrictions on budget deficits and debt. The second is the Lisbon strategy's aim of improving the growth potential of the EU economy. Both challenges are based on the assumption that national governments are able to maintain a high degree of social cohesion as a complementary goal. Social cohesion is a concept not found in the standard textbooks on economics. In short, it implies that voters and special interest groups of the EU Member States should accept the policy measures – the instruments – that would make it possible to reach the goals of the SGP and the Lisbon agenda.

According to one interpretation, often proposed by US commentators, Europe today is a ripe case of overregulated labour, product and service markets with oversized public sectors and high taxation, preventing rapid growth and efficiency. In short, the old continent is suffering from eurosclerosis. As long as Europe does not take action to prune the size and scope of its public sector, its economic performance will lag behind that of the rest of the world, in particular that of the US.

Policy measures aimed at reducing public expenditure are met by the objection that they will increase inequality and thus reduce social cohesion. Some will be richer but some will be worse off if an Anglo-American policy approach is adopted. Economists like to identify trade-offs and here they have a classic example, one which sets equity, or equality of income and wealth, against efficiency or growth. This trade-off is an old one, familiar from the public finance and political economy literature.

But is this trade-off really present? If so, how significant is it – in the short run and in the long run? Should policy-makers be concerned about it? What can they do to mitigate the trade-off? Can the winners

compensate the losers? One way to approach this set of issues is to ask the question: is there an optimal size for the public sector, say measured in terms of public expenditure as a ratio of national income, that gives rise to the 'best' growth performance? In that case, leaving the issue of equity aside for the moment, high growth will make everyone better off – at least in the long run.

Ludger Schuknecht and Vito Tanzi, in Chapter 13, and Ruud de Mooij and Paul Tang, in Chapter 14, focus on possible trade-offs in public finances arising from reform of the public sector. These two contributions come to slightly different conclusions. Why? Let us look at how they approach the following two main questions:

- Is there a trade-off between equality and growth?
- What are the proper policy conclusions?

In short, Schuknecht and Tanzi answer both yes and no to the first question. There is a trade-off in the short run, but not in the long run. And it is the long run that matters to them. In the long run there is a win–win result: with more growth we can achieve a richer society with a higher standard of living.

According to de Mooij and Tang, the answer is yes – in both the short and the long run. The trade-off will get worse in the long run judging from their discussion of the efficiency–equity trade-off frontier now and tomorrow. Policies that increase efficiency will reduce income equality as long as we are on the trade-off frontier curve. The trade-off will worsen in the future due to a number of expected developments such as ageing, skill-biased technological changes, globalization and increasing social heterogeneity.

The second question concerns the proper policy conclusions to be drawn, which of course depends on the reply to the first question. As Schuknecht and Tanzi are of the opinion that there are no permanent trade-offs at the recent levels of government expenditure in many welfare states, they have a straightforward recommendation: do it – that is, reform public finances by reducing the size of the public sector. Experience shows that public expenditure can and should be cut, leading to large social gains. Not only that, according to their forecast it will be cut in the future, as has been demonstrated by developments in recent decades. In their opinion, the experience of a number of OECD countries has proved that it is politically feasible to successfully reduce the size of the welfare state.

Schuknecht and Tanzi distinguish between early and late reformers and timid and ambitious reformers, demonstrating that those countries with the most ambitious reforms also display the best performance, measured by a set of socio-economic indicators such as economic growth, employment, human development, distribution of relative and absolute income and

quality of government institutions. They also recommend that if a country wants to reduce public spending it should focus on welfare expenditure and transfers, not on 'productive' public expenditure.

True, the benefits of these reductions emerge with a long lag. Thus, the distribution of income is affected negatively in the short run – but the effect is small and sometimes non-existent. Over time, with rising income, all members of society will be better off. In the long run, the reduction of public expenditures is associated with higher growth as well as social improvements and a socially accepted outcome. Smaller public expenditure will thus give rise to a richer society. However, the authors stress that the design of reforms is important and that country-specific circumstances should be considered.

The authors actually suggest a strong normative conclusion. The optimal size of public spending in a modern Western economy appears to be around 30–35 per cent of GDP. This level is sufficient to supply a proper level of government services.

De Mooij and Tang reply to the second question in the following way: do it – but do it intelligently, case by case. They suggest that, to reform successfully, the trade-offs have to be analysed carefully. Otherwise there is a risk of damaging both efficiency and equality. We may move society to a worse position, inside the trade-off frontier.

These different policy recommendations are most likely due to the authors' different methodologies. Adopting a cross-country approach, Schuknecht and Tanzi examine the evolution of a number of socio-economic indicators during the period 1982–2002. They infer their conclusions and recommendations from the behaviour of these broad indicators – yet the indicators are influenced by many factors, not only by changes in government expenditure. De Mooij and Tang take a more disaggregated approach, examining the record of 18 OECD countries for seven five-year intervals in the period 1960–95. Their conclusions are based on regression results covering several types of government policy variables: taxation, unemployment insurance, active labour market policies, employment protection and education. Their regression analysis demonstrates that there are clear trade-offs between equity and efficiency within all policy areas except for active labour market policy and secondary education. In my opinion, looking at reforms from this disaggregated perspective tends to reveal more obvious trade-offs than the broader cross-country approach adopted by Schuknecht and Tanzi.

Besides, I suspect there is a bias in the conclusion by Schuknecht and Tanzi that cuts in government expenditures increase growth – at least for countries experiencing major boom–bust episodes. They start their story in 1982 and end it in 2002. This was a period of major financial crisis in several countries in their sample, most notably in Finland and Sweden. In the two Nordic countries, the financial crisis reduced growth and increased

government expenditure automatically, while the recovery worked in the opposite direction, reducing the expenditure ratio. This is the reason why there is a peak in 1993, the year of the deepest recession in the two Nordic countries, in the share of public spending.

As a result of the crisis, a number of policy measures were implemented to deregulate the Finnish and Swedish economies. These deregulations, not dealt with explicitly by Schuknecht and Tanzi, were a major driving force behind the rapid growth registered in the Nordic countries after the crisis.[1] One problem with their approach is that it is focused on macroeconomic indicators, but microeconomic reforms were also implemented that probably impacted on growth and thus on expenditure ratios as well. In my opinion, the role of financial crises in determining the growth and size of public sectors deserves a more explicit analysis.

Concerning the study of de Mooij and Tang, I share their approach when they identify the need for reform of the welfare state. I recognize and acknowledge all the sound advice. But I fear that this is not the main problem. Rather, it is how we move from intelligent advice to successful policy action. How and when do we implement reform policies? They mention this major challenge in passing but do not address it in depth. This is perhaps where their contribution should start to be really useful for policy-makers.

To sum up, the two contributions add significantly to our knowledge about trade-offs related to public expenditure. The two studies are ambitious and thought-provoking, and provide a valuable illustration of old issues using up-to-date statistics. Inspired by the two studies, I feel four additional issues deserve our attention when we consider reforming public expenditures in Europe. All four issues suggest that the trade-off between efficiency and equity is not stable. Rather, it is likely to change over time due to the influence of a number of developments.

The first issue deals with the dynamics of the welfare state. There is a great deal of scientific and anecdotal evidence to suggest that the growth of the welfare state changes norms and behaviour in society. It creates benefit cultures. In short, sick pay makes people sick, early retirement benefits induce early retirement; high compensation levels induce the overuse of benefits, etc.[2]

The policy conclusion originating from this path dependence is that reductions in public expenditure on welfare benefits may have positive efficiency effects without causing negative, or at least major, distributional effects in the long run when behaviour has adapted accordingly. They may even have positive effects on inequality. Such effects are not covered in the estimates of the two chapters.

The second issue concerns the political economy of the welfare state. The rise of the welfare state has created a political landscape in continental Europe quite different from that of the United States, with a strong political

voice for voters receiving all or part of their income via the public sector in transfers such as pensions, unemployment insurance, early retirement, labour market programmes, subsidies, etc. This group of voters also includes public sector employees.

What happens when they form a major part of the electorate or, in the extreme case, a majority of the voters? We can assume that this special interest group consists of self-interested and well-informed voters. Of course they will have strong incentives to vote for parties supporting a large public sector and against reforms reducing public expenditure. Such a political landscape is a challenge for policy-makers who want to reform public expenditure, as any reduction of expenditure will be seen as a threat to large segments of the voters.

A third issue deals with the optimal point in time to reform. According to economic theory, reform should be carried out during booms when it is most easy to compensate losers and when public finances are strong, as pointed out by Schuknecht and Tanzi. However, historical evidence suggests a different pattern. Countries tend to reform during busts – that is during crises, when it is most difficult to compensate losers. An economic crisis forces policy-makers to rethink their policies. A crisis creates a window of opportunity, which starts to close once the recovery sets in.

The case of the crisis of the 1990s in Finland and Sweden is an excellent example of this reform behaviour. This pattern suggests that the trade-off between efficiency and equality is not stable, but changes over time. The preferences of policy-makers and the public depend on the state of the economy. The cycle of reforms tends to move in the opposite direction to the traditional business cycle.

A fourth issue that comes to my mind is the relationship between reform of the welfare state and globalization and financial sector growth. The two contributions discussed here are primarily backward-looking. They deal with the trade-offs of the welfare state before the inception of Economic and Monetary Union and before the globalization of today. As the welfare state is based on the nation state, it is a closed-economy phenomenon, now being challenged by global integration.

What happens to a welfare state's trade-offs when it becomes a member of a monetary union with a free flow of labour, capital and services at the same time as being exposed to a rising degree of globalization and financial market integration? The trade-offs are likely to change – but to what extent? Can the growth of financial markets allow policy-makers to replace social insurance with private insurance? These questions deserve further analysis. Both the contributions touch briefly on these questions but do not deal explicitly with the answers. I would suggest they are worthy of a conference by themselves.

Let me end on an optimistic note. Public sector reform is a slow process that is encountering strong political resistance in most EU Member States.

Still, significant reforms have been achieved in several countries in recent decades. I believe that there is a learning process going on. As voters across Europe learn about the problems facing the welfare state and see that some countries have reformed with success, they may become more prepared to accept reform at home. Such policy learning may make the perceived trade-off between efficiency and equity more favourable to reform.

Notes

1. See Jonung et al. (2006) for a discussion of the impact of the financial crisis in Finland and Sweden of the early 1990s on government expenditures and growth.
2. The work of Lindbeck (1997, 2004) surveys the dynamics of the welfare states in Europe.