

Introduction

What Should Governments Do?

Government is a contrivance of human wisdom to provide for human wants. 'Men' have a right that these wants should be provided for by this wisdom.

Edmund Burke

What we have ignored is what citizens can do and the importance of real involvement of the people involved.

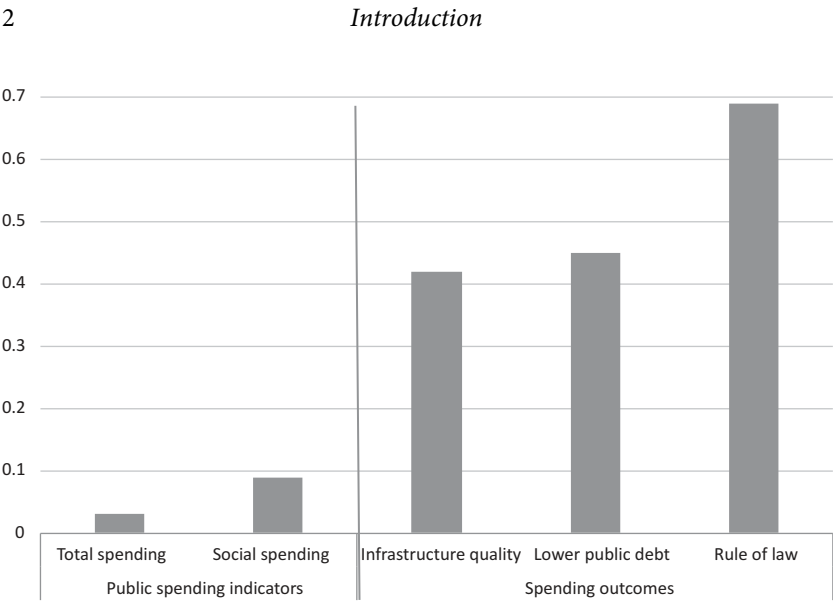
Elinor Ostrom

Highlights

Well-functioning governments are at the basis of a modern, democratic society, the rule of law and a market process that generates trust, opportunities, prosperity and freedom.

To maintain the economic success of advanced economies and the trust of our citizens, governments need to do well on their core tasks: setting sound rules of the game in the market economy and providing high-quality, essential public goods and services. These include security, education, infrastructure, basic social safety nets, the environment and sound public finances. Public expenditure is an important tool in this regard, but more spending is not correlated with more trust – ‘better’ spending and better performance on core tasks is (Figure I.1).

This introduction also sets out the map of the book: How public spending has evolved over time and how it has been financed in Part I; government performance and efficiency, the role of expenditure reforms and the ‘optimal’ size of government in Part II; the main fiscal risks in the social and financial sphere in Part III; and the case for strong rules and institutions to govern public spending and limit fiscal risks in the concluding Part IV.



Source: Koenig and Schuknecht (2019). Correlation coefficient on Y-axis

Figure I.1 Correlation between trust in government, public spending and performance on core tasks.

I.1 Public Expenditure as a Key Tool of Government

Without government, life would be ‘miserable, brutish and short’. We would be stuck in anarchy, without freedom and security, with hunger, disease and ignorance, as stressed by Thomas Hobbes over 350 years ago (Hobbes, 1651).

From that vantage point, governments have been stunningly successful. The world has never been more peaceful, secure and prosperous than today. Never has poverty been so limited and never have people had so many opportunities to better their lives. We have never been so free to pursue happiness. Collaboration between people and trust in our governments help the smooth functioning of our societies and economies. This success story holds in particular for advanced economies, but also increasingly for emerging markets and government expenditure has played a key role in it.

But many advanced country governments seem to be in crisis today. Many people are unhappy about what governments do despite the obvious successes. This is confusing at first sight and it is definitely a wake-up call to ask what is going wrong and what needs to change.

When analysing the crisis of Western government, we can learn much from looking at the private sector. When companies are in trouble, we

often hear that they have neglected their core business, that they allowed spending to get out of control, that they have too much debt and that they missed the boat on important, emerging challenges. We expect them to become more focussed, lean, resilient and forward looking. In our own private lives, it is not that much different, and we often have to adjust and reform our ways of doing things.

This should also hold for government, and we should ask similar questions. Government should provide core goods and services via spending and regulation and financed by taxes. It should react to new challenges while 'living within its means'. But with governments, we often hear a different tune. Many people see them as a 'Wunschkonzert', a kind of 'Father Christmas' responsible for fulfilling all our wishes: prosperity, employment and stability at all times for everybody. We frown upon cost-consciousness and financing constraints while complaining about high taxes, waste and a lack of long-term strategy. Of course, this does not work.

This book looks at one of the key tools of government, public expenditure. It asks how public spending has evolved over time and how it can serve both citizens and society to master the present and the future. The basic argument is this: in order to continue the success story and maintain the trust of our citizens in a fast-changing world, we need to spend public money wisely. Governments should focus on their core tasks, be lean, efficient and financially sustainable, reform where needed and prevent undue risk. This requires sound rules and institutions for both government and the economy!

I.2 The Role of Government in the Market Economy: The Classical View

What is the role and what are the core tasks of governments in the market economy? Classical economists and economic philosophers ever since Adam Smith (1937) have seen the main role of governments as setting the rules of the game for market economies (Hayek 1960; Buchanan and Tullock, 1962; Buchanan, 1975; Brennan and Buchanan, 1985). The rules of the game need to define safe property rights and a framework for their exchange in markets. Hence, there is a need for a well-functioning public administration with a secure code of law and regulation. We will refer to this as the 'rule of law'.

In the eighteenth century, Adam Smith realised that governments should prevent an obstruction of markets and competition. A strong

antitrust system and open international trade rules can achieve this goal. Externalities are another reason to intervene in markets (Pigou, 1920, 1928; Coase, 1960). This includes, for example, environmental protection, safe medicine and consumer protection.

In recent years, the potential for externalities in financial markets has received increasing attention. Information problems and the sheer size of losses have fostered the recognition that both rules and regulation need to improve incentives in the financial system. In fact, many rules and regulations now have the objective of preventing damage that would be costly to citizens and government.

Beyond this rule-setting role of government, there are also good reasons for the provision of other public goods and services. Security is an obvious case in point: (almost) every country needs a defence force. There is also a strong reason for a domestic security force – the police – to protect internal security, complemented by a system of justice. The public administration and the justice system enforce property rights and contracts, and rules and regulations so that markets can work.

Beyond security and law enforcement, there are further core public goods. The most prominent one today is probably education. Since the nineteenth century, public education has become a widespread achievement in the world, starting at the primary level but now also including secondary and tertiary education. Without public education, people and societies would not invest enough in knowledge formation, and this would reduce the potential for society-wide progress, opportunity and prosperity.

Governments today also have an important role in enhancing social inclusion. Government provision of social safety nets, including health, poverty alleviation and elderly care, is not only socially desirable but has a strong public goods component. Health services should (inter alia) prevent diseases from becoming epidemics. Poverty reduction measures prevent people from becoming criminals out of desperation. Basic safety nets for the elderly reduce the need for costly self-insurance, in the face of ever more people becoming eighty, ninety or even a hundred years old. Many economists now refer to the ‘social market economy’ model when emphasising the need for well-targeted safety nets that complement markets.

Another ‘popular’ public good is infrastructure, such as roads, water and sewage systems or energy networks. Private provision of such infrastructure is often impossible, or at least difficult, because construction requires collective action and it is hard to charge for consumption. Private provision has become much easier with the spread of tolls or network charges, but there is still a considerable need for public engagement.

One should also add sound and sustainable public finances as a public good and a core task of government. Avoiding undue fiscal risk is part of this task. Sound public finances raise people's confidence that public services will still be available and of high quality in the future. Sound public finances also allow governments to run deficits in downturns without undermining confidence via the so-called automatic stabilisers. Over-indebted governments may need to undertake one-off cuts, especially in bad times. Over-indebtedness often results in instability and inflation via default or 'printing money' to finance the debt. All this is detrimental to both people's and countries' well-being.

An analogy to the game of football can illustrate the importance of 'good' rules of the game and their interplay with high-quality public goods and services. Football is a great game because it has rules that make it exciting, reward good skill and leave enough uncertainty for the occasional surprise result. But it would be far less successful and exciting if there were no clubs providing training opportunities and cities building infrastructure, especially in less privileged areas.

The benefits to society from 'good performance' on the core tasks of government are many and various and provide everybody with an opportunity to participate in economic and social life. In former times, being born to a poor family meant that you had no such opportunity, if you survived childhood at all. Today, everybody in a well-functioning industrialised market economy has the opportunity to access clean water and go to school. In the past, living in a poor quarter meant little access to the justice system and primitive, if any, roads. The much greater inclusiveness of modern market economies is often forgotten in today's debate.

A market process based on the rule of law with a lean, efficient and sustainable government is also the basis of individual freedom. Money in private hands gives freedom of choice to individuals, but rules prevent my choice impinging on the freedom of others (Hank, 2012). Governments that ensure the rule of law secure individual freedom.

Governments also promote freedom through doing well on core public goods and services. The case of security is obvious: no security, no freedom. However, good education and good roads also enhance individual freedom through the opportunities they create. If we know more, if we can access a broader market, we have more choice and we can live up to our potential more fully. One can therefore call this an important part of freedom.

Collier (2018) also emphasises the 'sense of belonging' – a culture of fairness and loyalty that a community of mutual obligations and rules creates. Rules based on values and morality then help communities and

societies to live through long periods of adverse circumstances. One could see this as another social dimension of the rules- and market-based society whose value was already stressed by Adam Smith.

Trust in governments doing ‘the right thing’ is a prerequisite and a consequence of a well-functioning market economy. People will not want to follow the rules set by an untrustworthy government. With trust, society and the market economy function in an orderly fashion with limited friction. An order of high and growing complexity emerges without anybody specific in control of all the elements (Simpson, 2013). This is quite miraculous, but also a bit scary. In this order, freedom, opportunities and trust condition and reinforce each other. The outcomes – prosperity with growth, jobs and investment – are the ‘symptom’ of this order’s success.

I.3 The Role of Government in the Market Economy: The Keynesian View

We can also see and define the tasks of government from the perspective of the intended outcome rather than process. Building on Keynes (1936), Richard Musgrave (1959) and many since have detected a threefold role for government. Public goods and regulation should improve the resource allocation of the economy, and economic growth would be a good way to measure this.

Public spending should also aim at actively stabilising the economy against undue fluctuations. Debt in downturns and surpluses in upswings would smooth demand and leave room to deal with unforeseen circumstances. Finally, the role of the state is to alleviate poverty and equalise incomes (and wealth) via redistribution. This would also be economically beneficial as, to simplify a little, the rich tend to save too much and the poor invest too little.

The process-oriented view of Adam Smith and other classical economists and the outcome-oriented view of Musgrave are rather different. But they overlap in many ways: a good, incorrupt public administration means a more efficient use of resources and more income potential for the poor. This, in turn, boosts growth and income equality. Good public education works in the same direction. It is equally important to measure and control outputs and outcomes so as to make governments both accountable and performance-oriented.

Balance is important, however. Too much focus on outputs may lead to a neglect of process. Outcomes are seemingly easier to measure than

process and, hence, have a ‘comparative advantage’ for monitoring. But it is process more than outcomes that governments can influence. An exclusive focus on outcomes supports a view that economic results can be ‘fine-tuned’ like a machine and that government is responsible for them. This, however, is more than government can deliver (James, 2009).

I.4 Trust in Government

One can argue endlessly from different conceptual perspectives about the role of government. However, in a democracy, our citizens decide whether they support our market-based economic system, its direction and its governance. To do so, they need to have trust in government and what it is doing. The last decade has shown that this trust cannot be taken for granted.

What builds trust in government? There are good arguments and evidence that governments attaining core tasks and the rule of law are trusted more because that is what people want. For that, public spending is needed – but it is doing well on these tasks, not more spending, that builds trust (König and Schuknecht, 2019).

The link from the role of government to trust in government and the market economy is indirect (Figure I.2). If governments perform well on their core tasks, we are likely to witness better functioning markets, greater freedom and opportunities and more growth and prosperity. This boosts people’s satisfaction and trust in the ability of government to deliver on their expectations. A virtuous circle arises when more trust means more compliance with rules, people paying taxes and investment boosting growth.

If governments do not deliver, we are likely to see poor performance of the economy, parts of society without opportunities and a general sense of frustration with the economic and political system. A sense of loss of control, of lawlessness and insecurity and of ‘the rich having it all’ starts to spread when corruption rises, public education deteriorates, the environment degrades or people’s personal security depends on the income level of their neighbourhood.

Worse still, the poor performance of the market economy may induce governments to blame the market instead of themselves. This risks discrediting the economic system and may create a spiral of new intervention, worsening performance and further undermining of trust.

A simple analysis can illustrate these claims. Eurobarometer regularly conducts a survey of trust in government for most EU member countries.

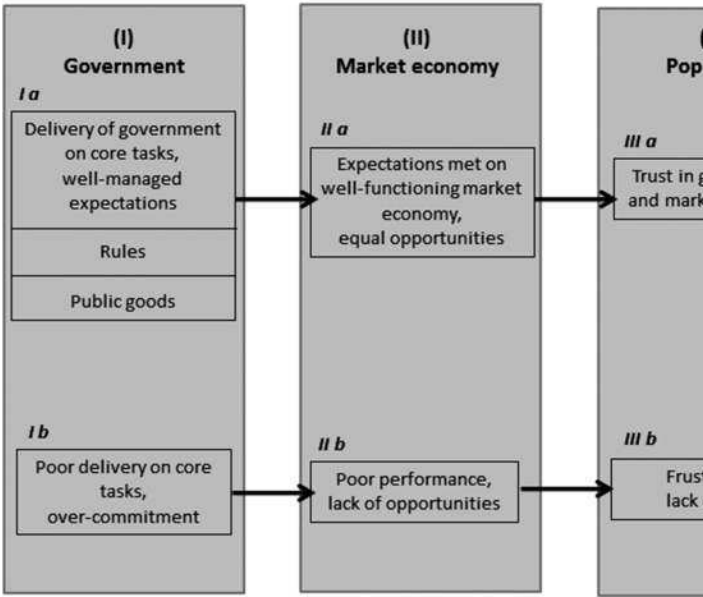


Figure I.2 Link from government performance to trust.

The survey results are compared, with measures of government spending as inputs and measures of outcomes on government core tasks.

There are many indicators from various sources, and we focus on a few which seem most suitable. The ‘rule of law’ indicator by the Fraser Institute is a proxy for good rules of the game in society. It compiles data on judicial independence, impartial courts, protection of property rights and contract enforcement, amongst others.

Total government spending or spending on public administration serves as a proxy for how much governments spend on providing the ‘rule of law’. Similarly, public education spending measures inputs and the OECD PISA score measures outcomes in education. We can also see how trust relates to infrastructure spending and a World Bank infrastructure quality indicator. Social spending and the income share of the poorest 40% of households measure inputs and outcomes as regards safety nets and income distribution. Public debt serves as an indicator of the soundness of public finances.

Table I.1 provides the results for twenty-one European countries for the period 2005–2015. The numbers reflect the degree of correlation between spending and performance indicators on the one hand and trust on the other. An indicator near zero implies no correlation; the higher an indicator, the more one can speak of a relevant positive correlation, and a value of 0.3 is a good borderline. Correlations are important and illustrative but we should not overinterpret them; they do not necessarily imply causality.

The results are telling: there is very little correlation between trust in government and public expenditure. Even social expenditure does not correlate with more trust in government. The only expenditure component where the correlation is reasonably strong is education. We will see in Part II that there is very little correlation between spending and performance and some countries do very well with little public money.

By contrast, government performance matters a lot. The correlation coefficient is highest for ‘rule of law’ – the proxy for ‘good’ rules of the game. High-quality infrastructure also shows a relatively strong correlation with trust. The picture is modestly positive regarding education/PISA and income distribution.

Sound and sustainable public finances are also very relevant for trust. In fact, the correlation between trust and debt in the pre-enlargement EU is quite remarkable and the highest of all coefficients. Citizens are probably quite aware of the problems that over-indebtedness creates.

10

Table I.1 *Correlation between trust in government, public spending and performance on core tasks*

All EU			
Role of government	Public spending	Correlation with trust	Performance on core tasks
Rules of the game	Total spending	0.03	Rule of law Regulation Globalisation
Infrastructure	Public investment	0.06	Infrastructure quality
Education	Spending on education	0.42	PISA
Social safety nets	Social spending	0.09	Income share 40% poorest households
Sound public finances			Public debt

Sources: OECD for all input variables and PISA; IMF WEO for debt; World Bank for the index for infrastructure, regulation; WDI for income share of bottom 40%; KOF globalisation index. Trust from Eurobarometer, 2005–2010.