PUBLIC SPENDING AND THE ROLE OF THE STATE

Given high government spending, debt and the new challenges on the horizon, the themes of this work are more relevant than ever: the essential tool of spending by the state, its ‘value for money’, likely risks in the future, and the remedies to create lean, efficient and sustainable government. This book takes a holistic and international approach, covering most advanced countries, and discusses a historical overview of public expenditure, from the nineteenth century to the modern day, as well as future challenges. It sees the government’s role as providing sound rules of the game and essential public goods and services. In presenting the relevant arguments, information and policy recommendations through comprehensive tables, charts and historical facts, the book addresses a broad readership, including students, professionals and interested members of the public.

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Public Spending and the Role of the State

History, Performance, Risk and Remedies

LUDGER SCHUKNECHT
To my wife Jyoti
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Preface

Nothing in life is to be feared, it is only to be understood. Now is the time to understand more so that we fear less.

Marie Curie

The curious task of economics is to demonstrate to ‘men’ how little they really know about what they imagine they can design.

Friedrich August von Hayek

Much of what makes today’s advanced economies work well requires government and government spending: the rule of law and effective regulation, security, modern infrastructure, good education and basic social safety nets. Vito Tanzi and I called these the ‘core tasks of government’ in our book *Public Spending in the 20th Century* twenty years ago. Governments that do well on these core tasks build trust in them and amongst their citizens. Markets then function well and people are likely to prosper in freedom with little regard to their economic and social background.

We also argued in our book that governments do not need to be very big to perform these tasks: government spending of 30–35% of gross domestic product (GDP) is enough, perhaps 40% in some cases. Government expenditure reforms are a good way for governments to stay lean, efficient and sustainable, and there was much optimism about ‘limited government’ at the time.

In the current situation, with a global financial crisis behind and ‘new’ challenges from the COVID19 pandemic, the environment to cybersecurity, we are experiencing an unprecedented sense of unease about the role of government and public expenditure and a decline in trust that governments still can and will deliver on their core tasks. We are witnessing very vocal calls for more public spending by some and for less government spending by others. Some have voiced concerns about too much austerity...
and too little redistribution, while others have deplored falling productive spending and too much debt.

It seems, therefore, timely to revisit the role of the state and public expenditure, to look at the strengths and weaknesses of the 'spending state' and the challenges for the future across a broad range of advanced countries. There are four main themes and findings:

• First, government is essential for a well-functioning market economy. Governments delivering on their core tasks – not just spending more money – are trusted more to deliver. Government has grown enormously over the past 150 years, building up the administration, infrastructure and education systems and, in recent decades, the welfare state. Social spending has grown to over half of total spending, while the share of other spending has declined. However, revenue has often not been keeping up, and public debt has reached record levels in a number of countries.

• Second, there are huge differences in the performance and efficiency of governments, with smaller governments tending to do better in many cases. Three reform waves in the 1980s, 1990s and 2010s show that lower spending can reinvigorate both governments and economies. Experience shows that public spending of 30–35% of GDP, perhaps 40%, suffices to do well for core tasks. One could call this a pragmatic ‘optimum’ – without being dogmatic about it for every country case.

• Third, there are dark clouds caused by the ever-increasing insurance role of government, notably in the social and financial sphere. If social expenditure trends continue or if a financial crisis leads to major spending obligations and debt increases again, public finances may not be sustainable in many countries and may put domestic economies, central banks and international stability at risk.

• Fourth, many governments need to strengthen their rules and institutions to deliver better on their core tasks, adjust the size of the state, shrink their debt and limit future fiscal and financial risks. Economists can contribute to this by advising on stronger governance and better policies, and they can help in building realistic expectations of what governments can, and should, do.
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All remaining errors are naturally my responsibility.
Acronyms and Abbreviations

BIS Bank for International Settlements
CBA cost-benefit analysis
CCP centralised trading platform
CEE Central and Eastern Europe
CGFS Committee on the Global Financial System
DEA data envelope analysis
ECB European Central Bank
EEAG European Economic Advisory Group
EFB European Fiscal Board
EFSM European Financial Stability Mechanism
EMU European Monetary Union
ERM European Exchange Rate Mechanism
ESM European Stability Mechanism
ESRB European Systemic Risk Board
ETF exchange-traded fund
FSB Financial Stability Board
G7 Group of Seven: Canada, France, Germany, Italy, Japan, United Kingdom, United States
G20 group of 19 largest economies + the EU
GDP gross domestic product
GFSR Global Financial Stability Report (IMF)
GNP gross national product
IFS Institute for Fiscal Studies
IMF International Monetary Fund
IOSCO International Organization of Securities Commissions
NATO North Atlantic Treaty Organization
Acronyms and Abbreviations

NPL  non-performing loan
OBR  Office for Budget Responsibility (UK)
OECD Organisation for Economic Co-operation and Development
PIMA Public Investment Management Assessment (IMF)
PISA Programme for International Student Assessment
PPF  production possibility frontier
PPP  public–private partnership
SDR  Special Drawing Right (IMF)
SFT  security financing transaction
SGP  Stability and Growth Pact
SOE  state-owned enterprise
VAT  value added tax
WEO  World Economic Outlook
WTO  World Trade Organization