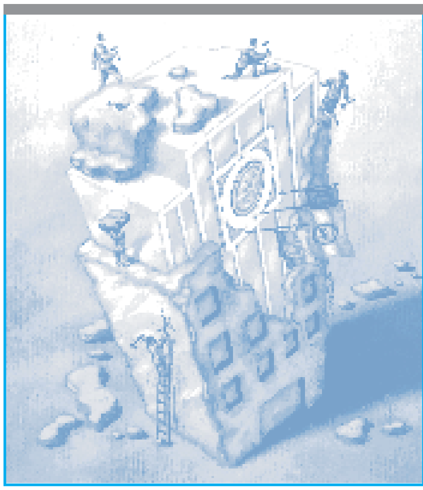

Reforming Government in Industrial Countries

VITO TANZI AND LUDGER SCHUKNECHT

Public spending in industrial countries started growing during World War I but really took off after 1960, mainly to fund social expenditures. But it does not seem to have led to major measurable gains in economic or social welfare. Governments could scale back their activities without necessarily compromising their objectives.

WHAT SHOULD governments do and how big should they be? These questions have been debated for years. Not much is known about the long-term trends in the overall economic involvement of government or about the composition of government expenditure. More important, there is little evidence on (or even discussion of) the economic and social gains from the increasing involvement of the state in the economy. These issues are important in determining whether and how the state should be reformed and what can be learned from the experiences of countries that have attempted to do so.

Over the past century, the size of government in industrial countries has expanded rapidly. In recent decades, this expansion was caused largely by expenditures normally associated with the "welfare state." Over the years, attitudes about the role of the state have been changing, and political institutions have been changing as well, to accommodate demands for more state involvement in the economy. This trend, in conjunction with special-interest politics, facilitated the expansion of expenditure that was less productive in terms of social or economic objectives.

What does this teach us about the reform of the state? There is considerable scope for scaling back government activities without sacrificing much in terms of social and economic objectives. In fact, governments need not be bigger than they were 30–40 years ago. However, to make governments smaller, it is important to rethink the role of the state and to have strong legal and institutional controls on public expenditure. Countries with overly large governments should introduce bold and radical institutional reforms to reduce less productive government activities. If this were done, the future could bring smaller public sectors without significant losses of social welfare.

How government grew

The period up to World War II. Views of the role of the state have changed considerably over the past two centuries. In the nineteenth century, classical economists and political philosophers generally advocated the minimal state—they saw the government's role as limited to national defense, police, and administration. Government involvement in the economy of a number of industrial countries was indeed minimal (see chart), with average public expenditure amounting to only 8.3 percent of GDP in 1870.

In the latter part of the nineteenth century, however, classical economists were challenged by Marxian and socialist thinking. Redistribution was added to the legitimate functions of government, demanding some state-induced transfer of wealth from the rich to the less fortunate. By that time, public primary education was already predominant, and the first social security system, albeit with minimal eligibility and benefits, was introduced in Germany in the 1880s. Nevertheless, the role of government remained limited.

Public spending received a first boost during World War I when war expenditure led to an increase in tax rates. After the war, higher taxes were used mostly to finance higher civilian expenditure. By the late 1920s, many European countries had introduced rudimentary social security systems and, in the 1930s, the Great Depression resulted in a further wave of expansionary government expenditure policies. By 1937, the minimal state had largely disappeared.

The period after World War II. The post–World War II period, and particularly the period between 1960 and 1980, saw an unprecedented enthusiasm for activist expenditure policies. Various factors—such as Keynesian economics, the challenge of socialism, and the theory of public goods and externalities—contributed to this development.

Skepticism about the role of government emerged in the late 1960s and became

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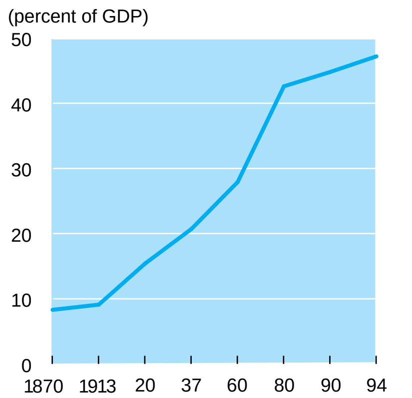
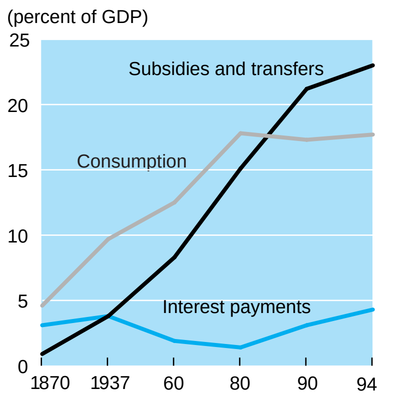
Government spending takes off [1]



Composition of government spending [1]



Source: Vito Tanzi and Ludger Schuknecht, "The Growth of Government and the Reform of the State in Industrial Countries," IMF Working Paper 95/130 (December 1995).

[1] Average government expenditure as percent of GDP in Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

stronger in the 1970s, when shortcomings in the underlying theoretical models favoring activist government policies and problems with their implementation became apparent. But few countries actually shifted their policy regimes. Because of entitlements and the power of interest groups, public expenditure levels continued to increase, on average, albeit at a slower pace. Public expenditure in the industrial countries reached 44.8 percent of GDP, on average in 1990, and by 1994, it had risen to 47.2 percent of GDP.

What were the gains?

Do improvements in social and economic objectives justify that governments now allocate and redistribute between one-third and two-thirds of resources in the economy? Today, many people might answer no. Many now argue that the public production of goods and services is inefficient and that social objectives are not being achieved, or at least not in a cost-effective manner. Government production of goods and services has frequently been identified as inferior to or more costly than private sector production. As regards the welfare state and income transfers, social safety nets have, in many countries, been transformed into universal benefits, and social insurance has frequently become an income support system, with special interests making any effective reform very difficult.

To shed some light on these claims, it is useful to look at historical developments in some social and economic indicators to see how these may have changed in response to the growth of public spending.

For the period up to 1960, a reasonable claim can be made that the increased public spending on education, health, training, and other social programs led to measurable improvements in social indicators. Though the evidence is limited, various government performance indicators suggest that the growth in spending after 1960 may not have significantly improved economic performance or led to greater social progress (see table). In a sense, spending growth was less socially productive after 1960 than before, and this result did not seem to be affected by how much governments spent. The group of countries with "big governments"—those that spend more than 50 percent of GDP—did not perform better than the ones with "small governments," for example, those that spend less than 40 percent of GDP.

Looking at the expenditure composition, public expenditure on subsidies and transfers (or from a functional perspective, social security) increased the most. By 1990, subsidies and transfers accounted for 55 percent of the total expenditure of big governments, 50 percent for medium-sized governments, and about 40 percent for small governments. Interest obligations also developed very differently between country groups: by 1990, interest payments by big governments, at over 6 percent of GDP, were more than twice as high as those for small governments. Other expenditure components, including investment, education, and health, did not differ much between country groups.

Improvements in economic and social indicators after 1960 have been quite limited, and countries with small governments generally have not fared worse than those with big governments. Real economic growth declined somewhat between 1960 and 1990. Average growth for the preceding 5-year period, however, was higher in countries with small governments in both periods. The unemployment rate, the share of the shadow economy, and the number of registered patents suggest that small governments exhibit more regulatory efficiency and have less of an inhibiting effect on the functioning of labor markets, participation in the formal economy, and the innovativeness of the private sector.

Social indicators such as income distribution, literacy, secondary school enrollment, life expectancy, and infant mortality improved modestly between 1960 and 1990 in all three country groups. By 1990, differences between country groups were small. Only certain social cohesion indicators, such as the number of prisoners or divorce rates, were less favorable for countries with small governments, mostly on account of unfavorable data for the United States, and income distribution was somewhat more equal in countries with big government than in countries with small government. The evidence available, while limited, suggests that small governments did not produce less desirable social indicators than big governments. Furthermore, they have had better economic and regulatory efficiency indicators.

Reforming government

Scope for reform. If one accepts the conclusion that (a) by 1960 most industrial countries had reached adequate levels of social welfare, (b) the growth of government over the last 35 years has not contributed much to the achievement of social and economic objectives, and (c) countries with small governments show favorable social indicators in spite of low public spending, there may indeed be considerable scope for reducing the size of the state.

A convenient benchmark to assess the scope for reducing the current size of government is the level of public spending in 1960. Taking 1960 as the benchmark, over the long run, total public expenditure could be reduced to, perhaps, less than 30 percent of GDP without sacrificing much in terms of social or economic objectives.

But how should the composition of government expenditure change to accommodate the decline in total expenditure? Because most of the historical increase in expenditure originated with subsidies and transfers, most expenditure reductions would have to take place in this category. Cutting back the welfare state in a careful

Size of government and government performance

	Industrial countries						Newly industrialized countries [4]
	ÒBigÓ governments [1]		ÒMedium-sizedÓ governments [2]		ÒSmallÓ governments [3]		
	1960	1990	1960	1990	1960	1990	1990
Economic and regulatory efficiency indicators:							
Real GDP growth (in percent) [5]	3.2	2.6	4.0	3.3	4.6	3.3	6.2
Gross fixed capital formation (in percent of GDP)	23.4	20.5	21.1	21.3	19.6	20.7	31.2
Inflation (in percent)	1.7	5.4	1.6	4.3	2.3	6.1	15.3
Unemployment rate (in percent)	2.9	6.1	4.6	9.2	2.7	4.2	2.9
Size of shadow economy (in percent of GDP) [6]	4.9	11.1	3.8	8.2	3.5	6.2	...
Patents/10,000 population (inventiveness coefficient)	...	2.0	...	2.3	...	8.6	...
Social indicators:							
Rank in UN human development [7]	...	11.0	...	13.0	...	6.0	...
Income share of lowest 40 percent	15.6	24.1	16.4	21.6	17.4	20.8	17.0
Illiterate population as percent of population over 15 years old	9.3	2.9	13.3	4.6	2.2	0.5 [8]	9.2
Secondary school enrollment (in percent)	55.0	93.0	51.0	99.0	61.0	89.0	81.0
Life expectancy	72.0	77.0	70.0	77.0	71.0	77.0	74.0
Infant mortality/1,000 births	23.0	6.7	29.0	7.1	22.4	6.4	9.8
Prisoners/100,000 people	...	38.0	...	68.0	...	154.0 [9]	...
Divorces (in percent of marriages contracted, 1987–91)	...	33.0	...	33.0	...	36.0	...
Emigration (in percent of total population) [10]	0.6	0.2	0.3	0.8	0.2	0.1	0.1

Sources: Organization for Economic Cooperation and Development,1995, *Main Science and Technology Indicators*; OECD, 1994, *Trends in International Migration*, *Annual Report*; World Bank, 1993, 1994,*Social Indicators of Development*; United Nations, 1994, *Human Development Report*; Brian Mitchell, *International Historical Statistics,* various issues; Hannelore Weck-Hannemann, Werner Pommerehne, and Bruno Frey, 1984, *Schattenwirtschaft,* Table 7, p. 67; IMF, *Government Finance Statistics Yearbook,* various issues; IMF, *International Financial Statistics*, various issues.

[1] Belgium, Italy, the Netherlands, Norway, Sweden (public expenditure more than 50 percent of GDP in 1990).

[2] Austria, Canada, France, Germany, Ireland, New Zealand, Spain (public expenditure between 40 and 50 percent of GDP in 1990).

[3] Australia, Japan, Switzerland, the United Kingdom, the United States (public expenditure less than 40 percent of GDP in 1990).

[4] Chile, Hong Kong, Korea, Singapore.

[5] Average of preceding five years, 1956–60 or 1986–90.

[6] Most recent data available are for 1978, shown in 1990 column.

[7] 1992.

[8] United States only. Others below 5 percent, United Nations Educational, Scientific and Cultural Organization statistics.

[9] Excluding United States, average is 64.

[10] Data available for 1970 (shown in 1960 column); data for 1990 may include 1993 data for some countries. For the newly industrialized countries, data are available only for Korea (1993).

...: Indicates data not available.

and well-planned way that preserves basic social and economic objectives could yield significant budgetary savings while still providing essential social safety nets and basic social insurance. A major rethinking of public expenditure policies is, therefore, necessary.

There is no precise road map for reform, but scaling down the welfare state is of prime importance. In the long run, reform of pensions and health systems would yield considerable budgetary savings in most countries. With proper reforms, many pension, health, and social insurance needs could be satisfied by a properly supervised private sector. However, this drastic change would require a major departure from the present way of doing things, and it would also call for an expanded regulatory role for the public sector.

The question of where to draw the line between government and private sector activities, however, cannot be answered universally—it changes with time and across countries. The better the market works, the less extended the role of the public sector needs to be. Of course, the more efficient public administration is and the less important rent-seeking activities are, the greater the role that could be assigned to the public sector. Technical analysis should complement the political process in deciding who should perform which function in an economy. It is important to create institutions that are capable of doing such analyses.

Implementing reforms. Arguing for a reduced role for the state raises important questions: how can reforms be implemented politically, and what time frame should be expected? Again, there is no precise road map. Reforms aimed at changing the basic economic policy regime of countries cannot ignore the fact that, in the short run, some groups will be hurt. The political opposition that this will generate guarantees that the full implementation of reforms may take decades rather than a few years.

Reforming government and reducing public expenditure can generate considerable long-term benefits if they bring higher economic growth. However, reforms will stimulate growth mainly when they alter the expectations of the private sector. Such a change may require not just the application of operational policy instruments but a shift in the policy regime or in the rules of the game that constrain policymakers. If existing rules have resulted in expansionary expenditure policies, a reversal will not happen automatically. The rules have to change so that policymakers' incentives also change.

One approach to controlling expenditure is through constitutional rules, which have the advantage of tying a government's hand more firmly than simple legislation, because they are more difficult to reverse. However, they are no panacea because they require strong implementation and enforcement mechanisms. In some countries, constitutional rules are disregarded or circumvented.

The long-term benefits that may derive from less state involvement are not enough to guarantee the required political support for the change. Reforms will inevitably be painful, especially in the short run, for groups that gain from public spending. These groups will oppose reforms and make their introduction and implementation more difficult. The detrimental short-run effects of the reforms on some groups need to be addressed by policymakers. As a basic principle, compensation for large losses and insurance against catastrophic events should be considered, to gain political support for the reforms. If reforms contain sunset clauses or are implemented only with a lag, this can facilitate adjustment to the new economic environment.

As the international economy becomes more competitive, and as capital and labor become more mobile, countries with big and especially inefficient governments risk falling behind in terms of growth and welfare. When voters and industries realize the long-term benefits of reform in such an environment, they and their representatives may push their governments toward reform. In these circumstances, policymakers find it easier to overcome the resistance of special-interest groups. The constraint of international competition may be particularly important for countries where international agreements eliminate undesirable alternatives to adjustment, such as protectionism or competitive devaluation.

Conclusion

Modern societies have accepted the view that governments must play a larger role in the economy and must pursue objectives such as income redistribution and income maintenance. The clock cannot be set back and, in fact, it should not be. For the majority of citizens, the world is certainly a more welcoming place now than it was a century ago. However, we have argued that most of the important social and economic gains can be achieved with a drastically lower level of public spending than that which prevails today. Perhaps the level of public spending does not need to be much higher than, say, 30 percent of GDP to achieve most of the important social and economic objectives that justify government intervention. Achieving this expenditure level would require radical reforms, a well-functioning private market, and an efficient regulatory role for the government.

Radical reforms must aim at maintaining public sector objectives while reducing spending. They will require considerable privatization of higher education and health care, the privatization of some pensions, and many other changes. In this process, the role of government will change from provider to overseer or regulator of activities. Its role will be mainly to set the rules of the game in the economy.

Some movement in the direction indicated above is noticeable already. In many countries there is general disillusionment with the high level of taxation and public spending. However, there is still strong opposition from groups that benefit from this spending to having their benefits reduced. The argument that the reforms would make most citizens better off over the long run will not allay concerns in the short run. Besides, there is always the suspicion that, in shrinking spending, some would lose more than others. Furthermore, some still question whether government will be able to play its new and, perhaps, more demanding role with the necessary degree of efficiency to guarantee that fundamental objectives are achieved with drastically reduced spending. Still, it is likely that over the next few decades, we shall see some important reductions in the share of public spending in GDP in industrial countries.

F&D

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