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Public finances, efficiency and equity: what are the trade-offs?

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Comments on:

1. Vito Tanzi and Ludger Schuknecht: ‘*Reforming Public Expenditure in Industrialised Countries: Are There Trade-Offs?*
2. Harold L. Wilensky:‘*Trade-offs in Public Finances: Comparing the Wellbeing of Big Spenders and Lean Spenders’*
3. Ruud de Mooij and Paul Tang: ‘*Reforming the Public Sector in Europe: Reconciling Equity and Efficiency’*

The background for the three papers:

European policymakers are presently faced with two major challenges that force them to consider the size and composition of government expenditures and thus the activities of the public sector. Both challenges are “self-inflicted” – they have been created within the EU by political decisions.

The first challenge stems from the Stability and Growth Pact which stipulates restrictions on budget deficits and debt. The second originates from the Lisbon strategy which aims at improving the growth potential of the EU economy.

Both the SGP and the Lisbon strategy assume that governments are able to maintain a high degree of social cohesion.

The term cohesion is not found in the standard textbooks in economics. In short, cohesion implies that the voter and interest groups of the EU Member States will accept the policy measures – the instruments - that would make it possible to reach the objectives of the SGP and the Lisbon agenda.

Judging from many US economists Europe is a ripe case of overregulated labour and product markets and oversized public sectors. The old continent is suffering from **eurosclerosis**. In short, the welfare state, so popular in Europe, is the farewell state. As long as Europe does not take actions, its economic performance will lag that of the rest of the world, in particular the US.

However, steps aimed at reducing public expenditures are met by the objection that they will increase inequality and thus reduce social cohesion.

Economists are prone to find trade-offs and here they have a popular one, that one between equality or equity and efficiency or growth. This trade-off is an old one. It is familiar from the public finance literature.

Do such trade-offs exist?

If so, how significant are they – in the short run and in the long run?

Should policy-makers bother about them?

What can they do to mitigate the trade-offs?

These are the questions dealt with in the three papers in this session.

One way to approach them is to ask the question: is there an optimal size of the public sector say as measured as public expenditures as a ratio of national income?

The three papers presented in this session discuss possible trade-offs in public finances from the perspective of reform.

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The three papers give different answers. In this way it is a nice set of papers. This is a good starting point for a lively discussion. Why do they reach different conclusions?

What is the message of these three papers?

To answer let us consider the following three main questions:

1. Is there a trade-off between equality and growth?

2. Which are the proper policy conclusions?

3. Methodology used (Why different conclusions?)

The first question: Is there a trade-off?

1. Tanzi –Schuknecht: **YES** – in the short run, but not in the long-run **NO**. Rather, in the long run with more growth we can achieve a better result – a richer society.

2. Wilensky: **NO** – there is no ”sharp” trade-off.

3. de Mooij-Tang: **YES** – and it has gotten worse recently due to a number of factors (aging, skill-biased technological change, globalization and increasing social heterogeneity).

The second question: Which are the proper policy conclusions?

1. Tanzi –Schuknecht: **DO IT**!

Expenditures can be cut and should be cut and according to their forecast they will be cut.

They argue that it has been political feasible to reduce the size of the welfare state. The benefits of these reductions have emerged with a long lag. The distribution of income has been affected negatively in the short run – but the effect is not large. Over time, with rising income, all members of society will be better off. Over time, the reduction of public expenditures is associated with higher growth as well as social improvements. Smaller public expenditures may thus give rise to a richer society.

The authors actually make a strong normative conclusion. The **optimal size of the public sector** in a modern Western economy is around 30-35 percent of GDP.

The second question: Which are the proper policy conclusions?

Wilensky: **NO – DO NOT DO IT!**

His paper amounts to a love song to the welfare state and a passionate critique of the "tax cutting mania from Reagan to Bush II". There are no "sharp" trade-offs between social security, equality and economic growth. Still "it makes no sense to talk about a general welfare crisis" either. The welfare state is live and kicking. It does not reduce growth. And most important, the voters want the welfare state. And they are not going to allow it to shrink.

They punish politicians that try to do so like Prodi in Italy in 1998, Chirac in France in 1995 and Kohl in Germany in the mid 1990s.

There may not be a trade-off – but who cares when the voters do not want to reduce the size of the state. "Reform is a slow process that encounters strong public resistance" (p 31) That is the basic conclusion.

The second question: Which are the proper policy conclusions?

3. de Mooij-Tang: **DO IT – BUT DO IT IN AN INTELLIGENT WAY!**

To reform successfully we have to analyse the trade-offs carefully. Otherwise there is a risk of hurting both efficiency and equality.

We may move society to a worse position.

The third question: Methodologies used?

1. **Tanzi –Schuknecht**: Economic approach based on numbers. Macroeconometric estimates for the period 1982-2002. Annual data. Overall view. Clear conclusions.

2. **Wilensky**: Political science approach – many case studies adding up to the universe. Period covered 1950-2000. Clear conclusions.

3. **de Mooij-Tang**: Microeconomic approach – pedestrian. Period covered by estimates 1960-1995. Problems with taxes, unemployment insurance, active labor market policies, employment protection and education are discussed one by one. Clear conclusion: “design intelligent reforms” that increase efficiency.

Comments on T-S:

I fear that there is a bias in their conclusion that cuts in government expenditures increase growth. They start the story in 1982 and end it in 2002. This was a period of **major financial crisis** in several countries in their sample, most notably Finland and Sweden. The financial crisis reduced growth and government expenditures automatically and the recovery worked in the opposite way, reducing the expenditure ratio.

That is why there is a peak during the main phase of the crisis in the two countries in 1993.

As a result of the crisis a number of **supply side measures** were taken to deregulate the Nordic economies. These deregulations are not dealt with explicitly in the paper. The problem with the paper is that it is focused on macroeconomics but we had microeconomic reforms that most likely impacted on growth and thus on the expenditure ratio. These reforms should be included in the account as well.

Comment on Wilensky:

“Reform is a slow process that encounters strong public resistance” That is a basic conclusion .

I would like to suggest that there is a **learning process** going on.

As the voters are learning the economic problems of the welfare state, they are getting more ready to accept reform.

We can look at the case of Germany for example today. And compare it with the Germany of the 1990s.

Even the French may learn ….

Comment on de Mooij-Tang:

I share their common-sense approach when they identify the need for reform of the welfare state. Here I recognize all the sound advice.

But, that is not the problem. The problem is how do we move from the advice to action. How do we implement policies?

They mention this major challenge on the very last page.

That is perhaps where the paper should start. We know all the problems but we do not know how to tackle them in an ”intelligent” way.

THE THREE PAPERS COVER A LOT OF GROUND. STILL A LIST OF ISSUES THAT I FEEL SHOULD BE DEALT IN MORE DETAIL.

1. **THE DYNAMICS OF THE WELFARE STATE**

THE WELFARE STATE DO CHANGE NORMS AND BEHAVIOR IN SOCIETY.

BENEFIT CULTURES

Sick pay makes people sick

Early retirement

Benefit cheating.

(10% on paid parental leave were at their jobs)

Among males 16 % more than normal reported sick during two international skiing competitions reported on TV and Radio. (The Stenmark effect)

INCENTIVES DO MATTER.

THE POLICY CONCLUSION IS THAT REDUCING THE WELFARE STATE BENEFITS WILL HAVE EFFICIENCY EFFECTS – BUT THEY WILL TAKE TIME TO DEVELOP.

These effects are not covered in the estimates of the three papers.

ANOTHER ISSUE:

2. **THE POLITICAL ECONOMY OF THE WELFARE STATE**

THE WELFARE STATE CREATES A DIFFERENT POLITICAL LANDSCAPE WITH MANY GOVERNMENT EMPLOYEES AND MANY RECIEVING THEIR INCOME FROM THE PUBLIC SECTOR.

WHAT HAPPENS WHEN THEY FORM THE MAJOR PART OF THE ELECTORATE – LIKE THE CASE OF SWEDEN? AND THEY ARE SELF-INTERESTED.

THEY VOTE FOR A LARGE PUBLIC SECTOR AND AGAINST REFORM.

PATH-DEPENDENCE. THE POLICY CONCLUSION: YOU CANNOT ROLE BACK THE PUBLIC SECTOR.

THE CASE OF SWEDEN IN THE ELECTION OF 2002:

GÖRAN PERSSON TO THE VOTERS:

”I PROMISE YOU THAT I WILL NOT CUT TAXES”

AND HE WON THE ELECTION

COMPARE THIS WITH THE RECENT US ELECTION

THE DEBATE BETWEEN BUSH AND KERRY.

I PROMISE YOU THAT I WILL NOT RAISE TAXES

ANOTHER ISSUE:

3.WHEN DO COUNTRIES REFORM? WHICH IS THE OPTIMAL TIME?

ACCORDING TO ECONOMIC THEORY: DO IT DURING A BOOM.

THE HISTORICAL EVIDENCE SUGGESTS A SIMPLE ANSWER
COUNTRIES ONLY REFORM DURING BUSTS – THAT IS DURING CRISES.

FINLAND, SWEDEN, UK AND GERMANY

SLOW VERSUS RAPID CRISES

THE QUESTION THEN IS: HOW CAN WE GET A CRISIS GOING? SO WE CAN HAVE REFORM.

ANOTHER ISSUE:

4. THE THREE PAPERS ARE PRIMARILY BACKWARD-LOOKING.

THEY DEAL WITH THE HISTORY OF THE WELFARE STATE BEFORE EMU.

THE WELFARE STATE IS A VERY NATIONALISTIC CLOSED ECONOMY PHENOMENA.

WHAT HAPPENS TO THE WELFARE STATE WHEN IT BECOMES A MEMBER OF A MONETARY UNION WITH A FREE FLOW OF LABOR, CAPITAL AND SERVICES?

HOW DOES EMU AND THE EURO CHANGE OUR POLICY VIEWS?

ANOTHER ISSUE:
5. The role of the monetary regime

The modern welfare state can be regarded as a close companion to the Keynesian view of the world. Kenynesian policies are aimed at stabilizing national income on the macro-level. Welfare expenditures are aimed at income-stabilization at the micro-level.

The change from Keynesian stabilization philosophies to rule-bound macro-economic policies in the 1990s may have changed our views on the welfare state.

This is an issue worth pursuing. It is not dealt with in the three contributions.

WHICH ARE **THE NEW POLICY CONCLUSIONS**?

THERE ARE SOME INTERESTING ONES IF WE START FROM THE FINANCIAL REVOLUTION - THAT IS THE LIBERALIZATION OF FINANCIAL MARKETS.

1. RIGHTS SHOULD BE TRANSPORTABLE – THAT IS INDIVIDUALIZED SO WE CAN MOVE ACROSS BORDERS AND JOBS.

2. THE WELFARE STATE WAS SET UP AS AN INSURANCE DEVICE – SOCIAL INSURANCE.

THE LIFE CYCLE PERSPECTIVE. IN THE CASE OF SWEDEN 80 % OF WHAT YOU PAY IN, YOU GET BACK OVER YOUR LIFE. IT IS A REDISTRIBUTION OVER THE LIFE CYCLE OF THE INDIVIDUAL. 20 % PER CENT IS PURE REDISTRIBUTION ACROSS INDIVIDUALS.

GIVEN THIS PERSPECTIVE AND GIVEN THAT FINANCIAL MARKETS ARE GETTING DEEPER AND DEEPER AND THE PUBLIC KNOW MORE AND MORE ABOUT PRIVATE FINANCE AND EUROPE IS GETTING MORE AND MORE HETEROGENOUS …

PUBLIC (SOCIAL) INSURANCE CAN AND SHOULD BE TURNED INTO PRIVATE INSURANCE

THE WELFARE STATE CAN BE TRANSFORMED INTO A WELFARE STOCIETY WITH THE USE OF THE FINANCIAL MARKET.

THIS IS MY HOPE FOR THE FUTURE …

AND WE SEE IT ALREADY.

OTTO BISMARCK CAN REST IN PEACE.

FATHER OF THE WELFARE STATE