ECB Public Finance Workshop

Challenges for government spending in the EU

6 December 2007, Frankfurt am Main

Welcome and introduction

Philippe Moutot (ECB)

- On behalf of the ECB, and in particular the Fiscal Policies Division, it is a great pleasure for me to welcome you all to this ECB Public Finance Workshop.

- The organisers, António Afonso and Ad van Riet, have invited experts from the European System of Central Banks, the European Commission and the academic world to discuss the "Challenges for government spending in the EU".

- Given the quality of the papers on the programme I am certain it will be an interesting workshop with fruitful discussions.

***

- To kick-start the workshop, allow me to make some brief observations on **why we should care about government spending**, a challenging issue for fiscal policy makers and also of great interest to central bankers.

  - The economic consequences of the size of the government have increasingly been in the focus of policy debates;

  - Moreover, the existing fiscal framework in the EU has increased the awareness of the relevance of sound fiscal policies;

  - In this context, the composition of fiscal consolidations has become a quite extensively studied topic in the EU;

  - Furthermore, the Lisbon Reform Agenda and the Stability and Growth Pact argue for assessing fiscal policy developments also by taking into account the quality of public finances, especially the efficiency and effectiveness of public spending;

- Let me now give you **two quotations on public spending**,

  - one from the ECB:

"Public expenditure ratios have steadily increased in the euro area since the 1960s before peaking and, in some cases, declining in more recent years. ***Public expenditure is nevertheless much higher than in most other industrialised countries.*** *According to many observers****, it exceeds the levels required for the efficient provision of essential public services****."*

(ECB, Monthly Bulletin, April 2006, p. 73).

  - another from the European Commission:

"The need to improve competitiveness, concerns about fiscal sustainability and growing demands by taxpayers to get more value for public money as well as the need to reconsider the scope for state intervention in the economy has prompted ***efforts to increase the focus of budgets on more growth-enhancing activities*** *and gear the tax mix and the allocation of resources within the public sector towards better* **efficiency and effectiveness**. *"*

(European Commission, The EU Economy: 2007 review, p. 9)

[quotations are in Slide 2]

- I would then stress from these quotations the ideas of **size** and **efficiency**

- Indeed, the size of the general government sector, measured by the total expenditure-to-GDP ratio, steadily increased both in the euro area and in the EU15 from 1980 to 1995, being in 2007 also well above the corresponding ratios in the US and in Japan.

[these developments are illustrated in Slide 3]

- **“Big” general government sectors are unwelcome for several reasons**:

  - A high level of government spending requires high taxes and social contributions, which distorts economic incentives as well as the efficient allocation of production factors and ultimately undermines potential growth and employment.

  - Alternatively, given the reluctance to raise taxes to fully finance extra government spending, in many cases big governments have been associated with persistent budget deficits, with consequences for demand, inflation and interest rates.

  - Looking ahead, there is a key issue of unfunded implicit government liabilities. Rising costs of ageing (public pensions, health care and dependency-related costs), suggest that in many EU countries the government expenditure ratio is set to increase even more if nothing is done about it;

  - Finally, there are important issues of public spending efficiency for several EU countries when compared to the OECD average. Indeed, in its October 2007 conclusions, the Ecofin Council stressed again the importance of modernising public administrations for achieving “better value for money”, delivering better services to the public, improving the control of government expenditure and enhancing competitiveness.

- From a cross-country perspective, to provide **some illustrative evidence on public spending efficiency**, I should like to borrow some results from a paper by Afonso, Schuknecht and Tanzi (2005). They bring the two aspects of size of government and efficiency of public spending together, showing that there is evidence of good public sector performance (i.e. effectiveness) with both

    - **higher public spending/lower efficiency** (Finland, Sweden, and Denmark)

    - and **lower public spending/higher efficiency** (Austria, Japan, Ireland, US).

[illustration of public spending inefficiencies in Slide 4]

- The slide shows the composite public sector performance indicator as reported in Afonso et al. (2005), with sub-indicators (reflecting the different objectives, i.e., institutions, education, health, infrastructure, distribution, stability, economic performance) having an equal weight.

- In a nutshell, the efficiency indicator is computed by dividing the performance indicator by the total public spending-to-GDP ratios (relevant for each performance sub-indicator), normalised across countries.

- **Finally, let me end** with **some conclusions and fiscal policy recommendations**:

  - High public expenditure implies high taxes and is likely to inhibit potential growth;

  - Expenditure reforms need to be of a structural nature in order to:

    - Improve public sector efficiency (e.g. in health and education), freeing resources;
    - Increase growth-enhancing expenditure, for instance, R&D (Lisbon strategy);
    - Face the fiscal cost of demographic ageing;
    - Ensure the soundness of public finances and compliance with the EU fiscal framework.

[conclusions on Slide 5]

  - These elements, which are embodied in the SGP and the Lisbon Agenda, constitute an increased reference point for discussion of fiscal issues not only inside but also outside the EU.

- I thank you for your attention and wish you an enjoyable workshop.

References

Afonso, A.; Schuknecht, L. and Tanzi, V. (2005) "Public Sector Efficiency: An International Comparison", *Public Choice* 123 (3-4), 321-347.

EC (2007). The EU economy: 2007 review, Moving Europe's productivity frontier. November.

ECB (2006). "The importance of public expenditure reform for economic growth and stability", ECB Monthly Bulletin, April, pp. 61-73.

Annex

More details on the slide on performance and efficiency

Exercise and caveats
The slide presents the results of an exercise that shows how much efficient countries (with a good performance and relatively low resource use) concretely spend in certain policy domains to attain core objectives following Afonso, Schuknecht and Tanzi (2005) “Public Sector Efficiency, An International Comparison”, *Public Choice* pp 321-347.

None of the performance and expenditure measures is perfect. But they were the best available at the time in terms of measuring the attainment of objectives and related public expenditure with a reasonable degree of international comparability. All in all and despite efforts to be scientific, a considerable degree of judgement underlies these case studies.

Indicators and sources
In **education**, the underlying performance measure is the OECD composite PISA score of the year 2000. Total public education expenditure is used to measure efficiency. Japan, the Netherlands and the UK combine high PISA scores with relatively low spending.

The countries seen as exemplary for “**other goods and services**” follow relatively complex calculations. Economic performance and stability and institutional quality are the outputs while goods and services spending (minus education) measure the inputs. For measuring economic performance, the real economic growth rate, per-capita GDP and the unemployment rate are used. For measuring stability, the coefficient of variation of economic growth and the average level of inflation over the 1990s is applied. Institutional quality was proxied by “red tape”, “quality of the judiciary, corruption and size of the shadow economy. Japan, Ireland and Switzerland came out as good performers with relatively low spending.

Infrastructure quality is measured via the IRIS public communication and transport quality indicator. This is set in relation to public investment spending. Austria, Canada, Denmark and Sweden perform well with limited resource use. Note, however, that some countries have even higher scores as investment spending had been starved in the 1990s (e.g. UK) and for this reason they are not used as good benchmarks.

Income equality was measured via the income share of the poorest 40% of households. These were set in relation to public transfer spending to measure efficiency in attaining more equal income distribution. Japan and Norway spend relatively little for attaining a high equality score.