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January 24, 1996

WP/95/130

Subject: The Growth of Government and the Reform of the
State in Industrial Countries

CORRIGENDUM

Page 30, columns 1 and 3, heading: for "1993" read "1983"
for "1992" read "1982"

Other Distribution:
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WP/95/130

INTERNATIONAL MONETARY FUND

Fiscal Affairs Department

**The Growth of Government and the Reform of the
State in Industrial Countries***

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December 1995

Abstract

This paper describes the growth of public spending in industrial countries over the past century. It identifies several periods: the periods between 1870 and 1913; the period between the two World Wars; the post World War II period up to 1960; and the period after 1960. Public spending started growing during World War I but its growth accelerated after 1960. The paper outlines the reasons for this growth and speculates that recent government growth has not brought about much economic or social progress. The paper sees the future of government mainly in setting the "rules of the game," and provides a rough blueprint for reform. It also discusses experiences with government reform in selected countries, and predicts that over the next decades, public spending as a share of GDP will fall.

JEL Classification

E62, H5, H11, N10

*Paper presented at the Conference on "Inequality, the Welfare State and Social Values," El Escorial (Madrid, Spain), July 11-13, 1995. The views expressed are strictly those of the authors. We are grateful for the comments by Charles O'Loughlin and Beatrice Weder. The statistical assistance received from Ms. Solita Wakefield and the bibliographical assistance received from Ms. Yvonne Liem were much appreciated. The paper is scheduled to be published in a volume on *Social Inequality, the State and Values* edited by Andres Solimano.

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Summary

This paper discusses the question of what governments should do and, more specifically, how much they should spend on doing it. It documents the expansion of public spending over more than a century in the industrial countries for which data could be found. Over this long period, the public attitude about the role of government has changed dramatically and has required government to play a progressively larger role. Institutional constraints on expenditure were relaxed which led to a remarkable increase in the share of public spending in GDP, especially in industrial countries.

On the basis of various social and economic indicators, the paper speculates that significant gains in social and economic objectives were associated with the increasing government role until the 1960s when the level of public spending for the most industrial countries rose to the range of 20 to 30 percent of GDP. The enormous growth in public spending after the 1960s, however, is less likely to have brought about further significant gains in social and economic objectives. The countries that did not increase their spending much beyond the level reached in the 1960s seem to have performed as well or better in terms of many of those indicators than those that did. Thus, in a way the increase in public spending over the 1960-90 period can be ineffective.

The paper discusses various reforms that can be carried out by countries so as (a) to reduce the share of public spending in GDP while (b) trying to preserve the objectives that the state tries to achieve through its spending. The paper also briefly analyzes the experience of a few countries that, in recent years, have attempted to carry out major government reforms aimed at reducing the level of public spending. It outlines the major elements of these reforms. The paper concludes that in future years, the level of public spending is likely to fall as a share of GDP in industrial countries.

I. Introduction

What should governments do and how big should they be? These questions have been discussed vigorously and frequently for years. However, the discussion has often been confined to developments after World War II. Not much is effectively known about the long term trends in the overall economic involvement of government and about the composition of government expenditure. More importantly, there is little evidence on (or even discussion of) what countries gained, in terms of economic or social objectives, from the increasing involvement of the state in the economy. These issues are, however, important in determining where the state should be reformed and what can be learned from the experiences of countries that have attempted to reform the state in recent years.

The paper documents a rapid expansion in the size of government, for today's industrialized countries, in the past 125 years. This expansion was caused largely by expenditures normally associated with the "welfare state." Thus, it was not technical factors which caused most of the growth of government. 1/ Over the years, prevalent attitudes vis-à-vis the role of the state have been changing and the political institutions have been changing as well to accommodate the demands for more state involvement in the economy. We will argue that this trend, in conjunction with special interest politics, also facilitated the expansion of expenditure which was less productive in terms of social or economic objectives.

What lessons does this teach us for the reform of the state? The conclusion of this paper will be that there is considerable scope for scaling back current government activities without *sacrificing much in terms of social economic objectives*. We will argue that, in fact, governments may not need to be bigger than they were 30-40 years ago. However, to make governments smaller than they are today, it is important to have strong legal and institutional controls on public expenditure. Countries with overly large governments should introduce bold and radical institutional reforms to make possible a reduction of the less productive government activities. If this were done, the future could, indeed, bring back smaller public sectors without significant loss in terms of social welfare. Of course, during the transition to a smaller state, some groups would gain or lose more than others. Furthermore, such a transition would necessarily be politically difficult because of the resistance on the part of those groups which would experience losses of benefits in the short run. 2/

The paper is organized as follows: section II describes the growth in the level of government expenditure for several industrial countries over

1/ These technical factors are often behind the so-called Wagner's Law or Baumol's disease which attempt to explain why government expenditure tends to grow over time in response to economic development.

2/ The promise that most would gain over the long run is not likely to make those who lose in the short run refrain from attempting to prevent the changes.

the past 125 years. It also attempts to show how this correlates with changes in attitudes towards the role of the state and with changes in political institutions. Section III looks at the composition of government expenditure and revenue, while section IV assesses the gains, in terms of identifiable economic and social objectives, which may have accompanied government growth. Section V looks at the scope for and political implications of major fiscal reform, evaluates progress in a few reform-oriented countries, and discusses trends in the future role of the state. Section VI provides some concluding remarks.

II. The Growth of Government from a Historical Perspective

1. The period up to World War II

Economists' and societies' view of the role of the state have changed considerably over the last two centuries. In the 19th century classical economists and political philosophers generally advocated the minimal state in part as a reaction to the distorting role that governments had played in the 18th century. 1/ Perhaps, this reflected the view that: "Almost everything which the State did in the eighteenth century in excess of its minimum functions was, or seemed, injurious or unsuccessful." (Keynes, 1926, p. 12.) They saw the government's role limited to national defense, police and administration because government "cannot have any other national function but the legitimate defense of individual rights" (Bastiat, 1944-45). In 1776, Adam Smith had anticipated the role of the state in providing public goods or, in his words, "erecting and maintaining those public institutions and those public works, which, though they may be in the highest degree advantageous to a great society, are however, of such a nature, that the profit could never repay the expense to any individual or small number of individuals... [These public works are mainly] those for facilitating the commerce of the society, and those for promoting the instructions of the people." 2/

For classical economists, the government role should be small and limited to the allocation of resources. The countries' institutional frameworks, such as the U.S. Constitution, did not specify any other economic role for the state. Consequently, in the last century, government involvement in the economy of a number of industrialized countries, for which we could determine the level of spending for 1870, was minimal

1/ See on this a little known book by Keynes (1926).

2/ Adam Smith, *The Wealth of Nations*, page 681, (1937). By the beginning of the 19th century, private charity was already considered inadequate, and public relief and punishment programs for the poor were introduced, mainly to maintain law and order (Rimlinger, 1971).

(table 1). 1/ Average public expenditure amounted to only 8.3 percent of GDP. In the U.S., government expenditure was less than four percent of GDP, and, in most newly-industrialized European countries of the period, such as Germany or the Netherlands, expenditure did not exceed 10 percent of GDP. By the standard of classical economists, France's government share of 12.6 percent was considered as heavy state involvement in the economy. 2/

In the latter part of the nineteenth century, however, classical economists were challenged by Marxian thinking which strongly influenced the socialist movement in Europe. Toward the end of the century, the German economists Schmoller and Wagner added redistribution to the legitimate government functions demanding some state-induced redistribution of wealth from the rich to the less fortunate. By that time, public primary education was already predominant (Connell, 1980) and the first social security system, albeit with minimal eligibility and benefits, was introduced in Germany in the 1880s (Altenstetter, 1986). "By the end of the nineteenth century, the setting was prepared for the modern concepts of social protection" (Rimlinger, 1971).

Nevertheless, laissez-faire attitudes continued to predominate and the role of the government remained limited. The average share of public expenditure in GDP increased slowly between the 1870s and World War I growing from 8.3 percent in 1870 to 9.1 percent in 1913. The arming of Germany, France and the United Kingdom, in anticipation of World War I, is reflected in these countries' higher public expenditure levels, while expenditure in Japan, Sweden, Spain, Norway, Switzerland and the United States was still below ten percent of GDP. In a few countries, the share of government expenditure in GDP even declined over this period. It should be recalled that this was a period when much of Europe became "modern" and when many large public works (railroads, metros) were completed. 3/

The first World War brought about a considerable increase in average levels of government expenditure. This increase was largely a result of military spending. As governments had expanded their revenue base to finance at least part of their war efforts, they were able to maintain higher expenditure levels after the war (Peacock and Wiseman, 1961). In part they also had to pay back their war-related debt or reparations. By 1920 or little thereafter, public expenditure had increased to an average of 15.4 percent with only Spain, Sweden, Switzerland, and the U.S. staying

1/ In a recent paper, one of the authors has warned that the role of government is not limited to spending but it can be pursued through quasi-fiscal activities and regulations (see Tanzi, 1995). In this paper, we focus on spending and taxing and thus largely ignore that warning.

2/ See Leroy-Beaulieu (1888) for such an attitude and for an anticipation of the Laffer Curve.

3/ Perhaps a note of warning on the data is necessary. Obviously, there are problems of comparability of data. However, these problems are not likely to change the basic trends reported.

Table 1. The Growth of Government Expenditure, 1870-1994

(in percent of GDP)

	Later 19th century (about 1870) 1/	Pre-World War I (about 1913) 1/	Post World War I (about 1920) 1/	Pre-World War II (about 1937) 1/	Post World War II (1960)	(1980)	(1990)	(1994)
Austria	...	...	14.7	15.2	35.7	48.1	48.6	51.5
Belgium	...	...	...	21.8	30.3	58.6	54.8	54.8
Canada	...	...	13.3	18.6	28.6	38.8	46.0	47.4
France	12.6	17.0	27.6	29.0	34.6	46.1	49.8	54.9
Germany	10.0	14.8	25.0	42.4	32.4	47.9	45.1	49.0
Italy	11.9	11.1	22.5	24.5	30.1	41.9	53.2	53.9
Japan	8.8	8.3	14.8	25.4	17.5	32.0	31.7	35.8
Netherlands	9.1	9.0	13.5	19.0	33.7	55.2	54.0	54.4
Norway	3.7	8.3	13.7	...	29.9	37.5	53.8	55.6
Spain	...	8.3	9.3	18.4	18.8	32.2	42.0	45.6
Sweden	5.7	6.3	8.1	10.4	31.0	60.1	59.1	68.8
Switzerland	...	2.7	4.6	6.1	17.2	32.8	33.5	37.6 2/
United Kingdom	9.4	12.7	26.2	30.0	32.2	43.0	39.9	42.9
United States	3.9	1.8	7.0	8.6	27.0	31.8	32.3	33.5
Average	8.3	9.1	15.4	18.3 3/	28.5	43.3	46.1	49.0
Australia	...	...	...	...	21.2	31.6	34.7	37.5
Ireland	...	...	...	...	28.0	48.9	41.2	43.8
New Zealand 4/	...	...	...	...	26.9	38.1	41.3	35.7
Average	...	...	...	...	25.4	39.5	39.1	39.0
Total average	8.3	9.1	15.4	20.7	27.9	42.6	44.8	47.2

Sources: OECD, Economic Outlook, 1994 and 1995; Mitchell, B., International Historical Statistics, various issues; Tanzi and Fanizza, "Fiscal Deficit and Public Debt in Industrial Countries," WP/95/49, IMF; Fernandez, Acha, "Datos basicos para la Historia de Financiera de España," 1976; Bureau of Census Historical Statistics of the USA, 1975; IMF Government Finance Statistics.

1/ Or nearest available year after 1870, before 1913, after 1920 and before 1937.

2/ 1992.

3/ Average; computed without Germany, Japan and Spain (all undergoing war or war preparations at this time).

4/ GFS data, data available for 1960 is 1970, central government data only.

below 10 percent of GDP. In France, Germany, and the U.K., the countries most affected by the war, expenditure exceeded 25 percent of GDP. Austria, Canada, Japan, the Netherlands, and Norway belonged to the group of "medium-sized" governments with expenditure levels between 10 and 15 percent of GDP.

After World War I, attitudes towards the role of the government started changing as reflected by the title of Keynes' 1926 book, *The End of Laissez-Faire*. In that book, Keynes wrote that: "The important thing for government is not to do things which individuals are doing already, and to do them a little better or a little worse; but to do those things which at present are not done at all." (op. cit., p. 46-47). Keynes implied that there were many things that were not being done at that time.

By the late 1920s many European countries had introduced rudimentary social security systems and the Great Depression resulted in a wave of expansionary government expenditure policies including social programs (Ashford and Kelley, 1986). The Great Depression was seen by many as a great failure of laissez-faire, a failure that justified governmental intervention. The U.S. introduced its first major public expenditure program with the "New Deal". By 1937, public expenditure had increased to an average of 20.7 percent, or of 18.3 percent when excluding Germany, Japan, and Spain which were in a state of war or war preparation. 1/ Expenditure had increased in all countries and had increased by over 40 percent in Canada, Germany, Japan, the Netherlands and Spain. With the exception of Sweden, Switzerland and the United States, public expenditure exceeded 15 percent of GDP in all countries. By 1937, the "minimal state" committed to "laissez-faire" policies had largely disappeared. The ground was becoming fertile for the future growth of the welfare state.

2. The post World War II period

The post World War II period, and particularly the period between 1960 and 1980 saw an unprecedented enthusiasm for activist expenditure policies coupled with rapid growth in the involvement of government in the economy. In his influential book, Richard Musgrave (1959) described the allocative, stabilizing and redistributive functions of modern government. The development of the theory of public goods and externalities suggested a growing allocative role for the state. Keynes' *General Theory* provided the tools for stabilization and another powerful reason for governmental intervention. 2/ And the popularity of socialism made the redistributive role progressively more important. It was believed at the time, that progressive taxation, presumably with a stable base and no serious disincentive effects, could provide the financing for expenditure policies. Furthermore, it was believed that these expenditure policies could identify

1/ Part of this increase in the ratio of spending to GDP was the result of the fall in GDP rather than the increase in real spending.

2/ In 1966, Walter Heller wrote about "Lord Keynes' spectacular rescue of economics from the wilderness of classical equilibrium." (See Heller, p. 4.)

and target potential beneficiaries at low administrative and efficiency costs (Tanzi, 1986). It is remarkable that most studies, at the time, did not find any negative impact on the economy associated with very high marginal tax rates.

This intellectual belief in the role and the power of the state was also imbedded in the legal-institutional framework for countries' policy-making. Some erosion of constraints on government expenditure policies had begun already in the late nineteenth century and had continued until World War II (Moser, 1994). However, after World War II this process accelerated. Several countries made strong legal provisions for interventionist policies in their constitutions (e.g., Germany and Switzerland) or through their legislature (e.g., the United States) and supreme courts supported such policies when interpreting the consistency of activist legislation with the existing legal framework (Moser, 1994).

In Germany, the new post-war constitution stressed the role of the state in shaping the "social market economy." In the late 1960s, macroeconomic stabilization was also embedded in the constitution as a government objective. After the first oil crisis, the German supreme court exempted the government budget from the constitutional deficit limit. In Switzerland, the most far-reaching revision of federal powers was introduced in 1947 which included the subsidization of industry and agriculture. In 1971, the Swiss court permitted state intervention for social policy motives. The U.S. constitution has no strong provisions against economic and social legislation and is very difficult to change. The supreme court of the United States de facto helped in changing constitutional rules by permitting, first, the New Deal legislation and later, post-war activist legislation such as the 1946 Employment Act (Moser, 1994). The Employment Act of 1946 declared that the federal government was responsible to promote "maximum employment, production, and purchasing power." (See Okun, 1970, p. 37.) This was indeed a major departure from laissez-faire.

The growth of government was also facilitated by the dynamics of the political process in democratic societies. Expenditure growth was furthered by interest group lobbying for spending programs and by bureaucrats demanding larger budgets. Monetary financing of government deficits weakened expenditure control. Additional institutional factors led to asymmetries in the political costs of taxing and spending. In democracies, legislators typically have an incentive to enhance their political support by voting for spending projects in their districts, because wealth is transferred to their voters while the costs are borne by all voters in the country. By the same token, they are reluctant to increase taxes which affect their constituencies. In some countries, certain changes in the

federalist decision-making processes have increased expansionary pressures on the budget. 1/

It is important to keep this historical and institutional perspective in mind when assessing the expansion of public expenditure since World War II. Between 1937 and 1960 public expenditure, as a share of GDP, only declined in Germany and Japan, but it increased considerably in Austria, Canada, the Netherlands, Sweden, Switzerland, and the United States. The average expenditure level increased from 20.7 percent of GDP to 27.9 percent.

The rapid expansion of public expenditure between 1960 and 1980 is remarkable because it occurred when most countries were not engaged in war efforts. Public expenditure as a share of GDP increased from an average of 27.9 percent of GDP in 1960 to 42.6 percent in 1980. It about doubled in Belgium, Ireland, Japan, Spain, Sweden, and Switzerland, and increased also very rapidly in the other industrialized countries. By 1980, public expenditure exceeded 50 percent of GDP in Belgium and Sweden. No industrial country kept public expenditure below 30 percent of GDP and only Australia, Japan, Spain, Switzerland and the United States stayed close to this level.

Skepticism about the role of government emerged in the late 1960s and 1970s when shortcomings in the underlying theoretical models favoring activist government policies and problems with their implementation became apparent. The failure of expenditure policies to allocate resources efficiently, to redistribute in a well-targeted manner, and to stabilize the economy in the stagflation of the 1970s was coupled with newly discovered disincentive effects of high taxes and growing underground economies. With Margaret Thatcher as Prime Minister in the U.K. and Ronald Reagan as President of the U.S., two forceful and articulate opponents of big government came to power. From their powerful positions, they carried a determined political attack on large government. 2/

Few countries, however, accompanied their anti-government rhetoric with actual shifts in their policy regimes. 3/ In part because of the tyranny of past commitments, and because of the power of interest groups, on average, public expenditure levels continued to increase, albeit at a slower pace. In 1990, public expenditure reached 44.8 percent of GDP. In 1994, it reached 47.2 percent of GDP. Over the 1980-1994 period, the share of public expenditure in GDP only declined in Belgium, Ireland, New Zealand and,

1/ For a number of theoretical and empirical articles on this subject see Forte and Peacock (1985), Mueller (1986), and Buchanan, Rowley, and Tollison (1987). For a survey of the literature on budget deficits, see also Alesina and Perotti (1995).

2/ Reagan popularized the view that, far from being a solution to problems, the government could be a cause of them.

3/ Section IV will look in more detail at experiences with government reform.

marginally, in the Netherlands. It increased significantly in Canada, France, Italy, Norway, Spain, and Sweden.

When comparing the overall developments between the late 19th century and the late 20th century, it is noticed that half of the government expenditure growth--from 8 percent of GDP around 1870 to 28 percent in 1960--occurred over the two World Wars. Expenditure growth to 47 percent of GDP in the 34 years after 1960 equalled the expenditure growth in the century before.

The most striking change in the size of government took place in Sweden and Norway which had amongst the smallest governments in the 19th century and in the early part of the 20th century and which now have amongst the "biggest" governments. The next section will look at changes in the composition of government expenditure to shed more light on the changing role of the state over the past 125 years.

III. The Composition of Government Expenditure from a Historical Perspective

1. Government consumption

Government consumption ^{1/} has grown considerably over the past 125 years. At the end of the 19th century, government consumption ranged between 2.5 and 6.7 percent of GDP for the six countries for which data are available (table 2). Comparing these numbers to overall expenditure in table 1, it is evident that, at that time, between half and two thirds of total expenditure fell into this category. The very low level of expenditure also suggests that governments provided just a minimum in services beyond "the administration of justice" and defense. Public education and spending for infrastructures were probably the other main expenditure categories in the late 19th century.

Government consumption increased from an average of 4.6 percent in 1870 to 9.7 percent of GDP in 1937. In France, it almost tripled from 5.4 to 15 percent of GDP. In the other countries, the increases were more modest. Over this period, government consumption as a share of overall public expenditure hardly changed and ranged between 50 percent for France and two thirds for the Netherlands or the United States.

By 1960, government consumption had increased to 12.5 percent of GDP. The average increase was moderated by the decline in government consumption in France and Spain which, in 1937, had been at war or in preparation for

^{1/} Defined as the sum of wages, salaries, materials and supplies. This is the part of government spending that absorbs or uses *directly* economic resources. It is an economic definition that does not identify the function of the expenditure. It may thus include social spending provided in kind (i.e., public housing) rather than in cash.

Table 2. Government Consumption, 1870-1994

(in percent of GDP)

	About 1870	About 1937	1960	1980	1990	1994
France	5.4	15.0	14.2	18.1	18.0	19.5
Japan 1/	...	...	8.0	9.8	9.1	9.8
Netherlands	6.7	12.3	12.6	17.9	14.5	14.4
Norway	2.6	3.2	12.9	18.8	21.0	20.8
Spain	4.9	10.7	8.3	12.5	15.5	17.0
Sweden	5.5	10.4	16.0	29.3	27.4	27.3
United States	2.5	6.5	16.6	17.6	18.1	16.4
Average	4.6	9.7	12.7	17.7	17.7	17.9
Australia	...	...	11.2	17.6	17.1	17.2
Austria	...	...	13.0	18.0	17.8	19.0
Belgium	...	...	12.4	17.8	14.5	15.3
Canada	...	...	13.4	19.2	19.8	20.2
Germany	...	...	13.4	20.2	18.4	19.3
Ireland	...	...	12.5	19.2	15.1	15.8
Italy	...	...	12.0	14.7	17.4	17.1
New Zealand	...	...	10.5	17.9	16.7	15.4
Switzerland	...	...	8.8	12.7	13.3	14.3
United Kingdom	...	...	16.4	21.6	20.6	21.6
Average	...	...	12.4	17.9	17.1	17.5
Total average	4.6	9.7	12.5	17.8	17.3	17.7

Sources: European Commission, General Government Receipts, Expenditure and Gross Debt, 1995; OECD, Main Economic Indicators, 1995; Mitchell, B., International Historical Statistics, various issues; Delorme, R. and C. Andre., L'Etat l'Economie, 1983; Foster, R. A. and S. Stewart, Australian Economic Statistics, 1969; Okawa, K., Estimates of Long-Term Economic Statistics of Japan since 1868, 1979, pp. 172-173; IMF, Government Finance Statistics.

1/ Government consumption and interest were 5.2 percent of GDP in 1885 and 19.3 percent in 1937.

war. Norway, Sweden, and the United States expanded government consumption considerably during this period. Surprisingly, the highest share of government consumption in 1960 can be observed in the United States (16.6) and the lowest one for Japan (8.0 percent). 1/ By 1960, on average, government consumption had fallen below 50 percent of total expenditure.

The next two decades saw further increases in government consumption, with the average increasing to 17.8 percent of GDP. By 1980, only Japan, Spain, and Switzerland stayed around the 10 percent threshold; on the other hand, Sweden's, Germany's, and the U.K.'s government consumption exceeded 20 percent of GDP.

This increase in public consumption can explain only part of the growth of total government expenditure in this period. The share of public consumption fell from almost 50 percent in 1960 to about 40 percent of total public expenditure in 1980. In addition, productivity growth in the public sector seems to have been much slower than in the private sector. For example, Levitt and Joyce (1987) have argued that although government consumption in the U.K. increased from 16.5 percent of GDP in 1964 to 21.8 percent of GDP in 1984, the real increase was negligible. At 1980 prices, government consumption only increased from 20.7 to 20.8 percent. 2/

Since 1980, government consumption has remained broadly constant within the 17-18 percent of GDP range and has even declined in Belgium, Ireland, New Zealand, the Netherlands and Sweden. The main reason for this decline may lie in the declining involvement of government in the production of goods and services through privatization or subcontracting of services to the private sector.

2. Transfers and subsidies

The most dramatic change in the composition of government expenditure can be observed for transfers and subsidies (table 3) indicating that policy decisions rather than technological factors have played the greatest role in the growth of public spending. In the late 19th century, the average level of subsidies and transfers was less than 1 percent of GDP. At that time, the United Kingdom was the leader in this category with 2.2 percent of GDP while France and Japan hardly reached the one percent mark. Transfers in Spain or Norway were negligible.

By 1937, the Great Depression coupled with the emerging social security systems had resulted in an increase in average expenditure on subsidies and

1/ In the United States, this increase was largely due to defense spending which, in 1960, was much higher than in 1937. In fact, the difference between these two countries in 1960, is explained almost entirely by the difference in defense spending.

2/ This divergence in productivity growth between the public and the private sector is sometimes referred to as Baumol's disease (see Baumol 1967).

Table 3. Government Expenditure on Subsidies and Transfers, 1870-1992

(in percent of GDP)

	About 1870	About 1937	1960 1/	1970 1/ 2/	1980 1/ 2/	1992 1/ 2/
Canada	0.5	1.6	9.7	12.4	13.2	14.9
France	1.1	4.2	11.4	21.0	24.6	28.9
Japan	1.1	1.4	3.9	6.1	9.8	8.5
Norway	0.2	4.4	12.1	24.4	27.0	35.3
Spain	0.1	2.5	1.0	6.7	12.9	21.0
United Kingdom	2.2	10.3	14.0	15.3	20.2	24.2
United States	...	2.1	5.7	9.8	12.2	13.4
Average	0.9	3.8	8.3	13.7	17.1	20.9
Australia	...	...	...	10.5	16.7	18.5
Austria	...	...	...	16.6	22.4	22.6
Belgium	...	...	...	20.7	30.0	29.0
Germany	...	...	...	12.7	16.8	19.2
Ireland	...	...	...	18.8	26.9	23.4
Italy	...	...	...	17.9	26.0	29.1
Netherlands	...	...	...	29.0	38.5	38.5
New Zealand	...	...	...	11.5	20.8	16.5
Sweden	...	...	...	16.2	30.4	34.4
Switzerland	...	...	...	7.5	12.8	13.3
Average	...	...	...	16.1	24.1	24.5
Total average	0.9	3.8	8.3	15.1	21.2	23.0

Sources: OECD, Economic Outlook, 1995; Mitchell, B., International Historical Statistics, 1992; Delorme, R. and C. Andre, L'Etat et l'Economie, 1983; Foster, R. and S. Stewart, Australian Economic Statistics, 1969; Peacock and Wiseman, The Growth of Public Expenditure in the U.K., 1961; Okawa, K., Estimates of Long-Term Economic Statistics of Japan since 1868, 1979; IMF, Government Finance Statistics.

1/ Or closest year available.

2/ Central government.

transfers to 3.8 percent of GDP. France, Norway, and especially the U.K. had experienced the largest transfers. While in the late 19th century transfers and subsidies amounted to only about 10 percent of public expenditure, by 1937 this share had risen to almost 20 percent.

Transfers and subsidies continued to increase until 1960 when they reached 8.3 percent of GDP or about 30 percent of total public expenditure. The U.K. continued to be at the top of the list. Canada, France and Norway exhibited the strongest increase to around 10 percent of GDP but Japan and the United States also expanded their transfer and subsidy provisions considerably. Only Spain reduced expenditure in this category.

Between 1960 and 1980, the earlier social policies became today's welfare state. Consequently, subsidies and transfers as a share of GDP more than doubled to over 20 percent of GDP or about 50 percent of government expenditure. 1/ In Belgium, France, Ireland, Italy, the Netherlands, Norway, and Sweden, expenditure in this category exceeded or approached one quarter of GDP with a share of 38.5 percent of GDP as a maximum in the Netherlands. Japan was the only country where transfers and subsidies stayed below 10 percent of GDP. Over the post 1980 period, the expansionary trend continued but at a slower pace. Expenditure on transfers and subsidies increased to almost one quarter of GDP, still roughly half of total government expenditure. However, there were marked differences among countries as a few countries, such as Ireland and new Zealand started to curtail the role of the state while some others, and especially Spain, continued expanding their welfare expenditures.

The development of social expenditure between 1960 and 1990 tells a similar story (table 4). Social expenditure as a share of GDP more than doubled between 1960 and 1980, from 10 percent to over 20 percent of GDP, and was largely unchanged over the next decade. The share of expenditure for education (not indicated) and health were roughly constant at one quarter of social expenditure each over the period. Forecasts made on the basis of the aging of the population suggest that the share of social expenditure and especially of pension and publicly financed health will continue to increase over the next several decades in the absence of changes in the underlying policies.

3. Interest payments

In recent years, interest payments have emerged as an important component of public expenditure. Historically, interest payments were only high during post-war periods, to service war-related debt. Interest payments in the U.S., for example, exceeded one third of government expenditure during the post-civil war period, and increased from less than 1 percent of GDP before World War II, to over 2 percent in the years after

1/ Before World War II, social security was largely fragmented and decentralized, while post war expansion of the welfare state coincided with a widespread nationalization of social security.

Table 4. Social Expenditure Components
OECD Countries, 1960-1990

(in percent of GDP)

	1960	1970	1980		1990	
			Non-EC	EC	Non-EC	EC
Health	2.6	4.0	5.6	5.5	6.0	5.2
Pensions	...	...	6.6	8.0	7.5	9.0
Other	7.5	10.0	6.0	7.2	7.6	7.5
Total Social Expenditure	10.1	14.0	21.6	21.6	21.2	21.7

Source: OECD, New Orientations for Social Policy, 1994a, Table 1.

the second World War. 1/ After the 1960s, however, the rapid rise in public expenditure and subsequent public debt accumulation in most industrialized countries was not war-related. The government expenditure on interest increased rapidly from an average of 1.4 percent of GDP in 1970 to more than 4 percent in 1992 (table 5). In Belgium and Italy, interest payments now exceed 10 percent of GDP or about 20 percent of total government expenditure--a serious burden on the countries' government finances. 2/ Only few countries have escaped this trend. For the majority, the ratio of public debt to GDP continues its upward trend.

Another disturbing development in fiscal expenditure patterns is the decline in government gross-fixed capital formation in recent decades. In the EU, for example, expenditure in this category declined from an average of 4.3 percent in 1970 to 3.2 percent in 1985 (Tanzi, 1986). In fact, there seems to be a negative correlation between expenditure for interest payment and expenditure for public sector capital formation (Tanzi and Lutz, 1993).

4. Revenue

The growth of public expenditure needs to be financed. Until two decades ago, this had been achieved mainly through increased revenue collection. (See table 6.) In 1960, total government revenue averaged 28.2 percent of GDP, almost equal to the total expenditure of 27.9 percent. Balanced budgets predominated and the "big spenders" of that time--Austria, France, Germany, the Netherlands, Sweden, or the U.K.--also had the highest revenue-to-GDP ratios. By 1970, revenue had increased to 32.4 percent of GDP, still roughly in balance with expenditure. The oil shock of the mid-1970s caused the first major divergence between public expenditure and public revenue as governments attempted to maintain real incomes through increased spending.

By 1994, the picture had changed considerably. Revenue had increased to more than 43 percent of GDP but expenditure had grown even faster. Countries with high expenditure levels still had the highest revenue to GDP ratios. In Belgium, the Netherlands, Norway and Sweden the revenue to GDP ratio exceeded 50 percent. On the other hand, Australia, Japan, Switzerland, and the United States had revenue levels of "only" around 30 percent of GDP, reflecting their lower expenditure levels. However, unlike in 1960, revenue had fallen considerably behind expenditure and most countries had a fiscal deficit.

Between 1970 and 1994, revenue increases were largely on account of higher direct taxes and social security contributions while revenue as a share of GDP did not change much for indirect taxes and other revenue. In

1/ After World War II, in the United States, the share of public debt to GDP was about twice what it is today. However, the level of real interest rate was very low or even negative thus reducing the burden of the debt.

2/ Large interest payments can potentially lead to an explosive situation when they result in larger deficits and in growing debt-to-GDP ratios.

Table 5. Government Expenditure on Interest, 1870-1992

(in percent of GDP)

	About 1870	About 1937	1960 1/	1970 1/ 2/	1980 2/	1992 1/ 2/
France	5.2	5.4	1.7	0.5	1.5	2.5
Netherlands	2.4	4.8	3.2	1.3	3.7	4.7
Spain	3.3	3.9	0.9	0.5	0.7	3.4
United States	1.4	1.0	1.7	1.3	2.3	3.7
Average	3.1	3.8	1.9	0.9	2.1	3.6
Australia	...	...	...	1.7	1.8	1.5
Austria	...	...	...	0.8	2.5	3.9
Belgium	...	...	...	2.8	6.2	10.1
Canada	...	...	...	1.2	2.5	4.6
Germany	...	...	...	0.4	1.0	1.7
Ireland	...	...	...	3.5	6.3	7.5
Italy	...	...	...	1.8	5.4	11.4
Japan	...	...	...	0.4	2.4	3.0
New Zealand	...	...	...	2.6	3.9	5.7
Norway	...	...	...	1.0	2.7	2.6
Sweden	...	...	...	1.0	4.1	4.2
Switzerland	...	...	...	0.3	0.5	0.5
United Kingdom	...	...	...	2.7	4.7	2.7
Average	...	...	...	1.6	3.4	4.6
Total average	3.1	3.8	1.9	1.4	3.1	4.3

Sources: Mitchell, B., International Historical Statistics, 1992; Delorme, R. and C. Andre, L'Etat et l'Economie, 1983; Peacock and Wiseman, The Growth of Public Expenditure in the U.K., 1961; IMF Government Finance Statistics.

1/ Or closest available year.

2/ Central government only.

Table 6. Government Revenue, 1960-1994

(in percent of GDP)

	Total Revenue				Indirect Taxes		Direct Taxes		Social Security Contributions		Other	
	1960	1970	1990	1994	1970	1990	1970	1990	1970	1990	1970	1990
Australia	24.4	24.2	30.6	32.9	7.7	8.5	13.2	17.5	0.0	0.0	3.3	4.6
Austria	34.4	35.7	47.2	48.2	13.3	16.0	9.0	13.3	9.1	14.8	4.3	3.1
Belgium	27.5	37.0	48.8	50.3	13.1	12.2	11.2	17.1	10.4	17.2	2.3	2.2
Canada	25.7	31.3	41.9	42.2	9.9	9.4	14.0	17.7	3.0	5.2	4.4	9.6
France	34.9	39.3	49.0	49.4	15.0	15.1	7.1	8.9	14.4	21.0	2.8	4.0
Germany	35.0	38.9	43.8	46.8	13.2	12.4	10.8	11.5	12.6	16.8	2.4	3.1
Italy	28.8	28.8	42.2	45.1	10.5	10.6	5.1	14.4	11.2	14.4	2.0	2.8
Ireland	24.8	33.2	37.9	38.8	18.8	16.4	8.5	13.8	2.5	5.2	3.4	2.4
Japan	18.8	19.7	31.4	32.7	4.4	4.1	9.4	15.2	4.4	9.2	1.5	2.9
Netherlands	33.9	41.1	49.9	52.1	10.8	12.3	13.0	15.5	13.8	17.0	3.5	5.0
New Zealand ^{1/}	...	27.4	39.7	35.9	7.5	12.5	16.7	21.6	0.0	0.0	3.2	5.6
Norway	33.1	39.3	56.3	55.3	16.8	16.4	15.1	16.1	6.3	12.1	1.1	11.7
Spain	18.1	22.8	39.5	41.2	7.9	10.7	3.4	12.0	6.4	13.0	5.4	3.8
Sweden	32.1	39.8	64.9	60.1	11.2	17.2	21.6	23.4	5.9	15.6	1.1	8.7
Switzerland	23.3	23.8	33.4	34.2 ^{2/}	6.4	5.8	9.7	12.9	5.6	10.4	2.1	4.3
United Kingdom	29.9	39.8	38.8	36.31	16.2	15.8	14.4	14.0	5.1	6.3	4.1	2.7
United States	26.3	29.2	29.4	31.2	5.6	4.8	14.0	12.7	5.6	8.7	4.0	3.2
Total average	28.2	32.4	42.6	43.1	11.1	11.8	11.5	15.2	6.8	11.0	3.0	4.7

Sources: Tanzi and Fanizza, "Fiscal Deficit and Public Debt in Industrial Countries, 1970-1994," May 1995, WP/95/49, IMF; OECD, Historical Statistics, 1992; Commission of the European Communities, General Government Receipts, Expenditure and Gross Debt, 1987 and 1995; IMF, Government Finance Statistics.

^{1/} Central government data only for 1990 and 1994.

^{2/} 1992.

1970, direct and indirect taxes each yielded about one third of total revenue. 1/ Social security contributions of 6.8 percent of GDP and other revenue of 3.0 percent of GDP contributed the remainder. In 1990, revenue from direct taxes had increased to 15 percent of GDP and exceeded 20 percent of GDP in New Zealand and Sweden. Social security contributions averaged about 11 percent and exceeded 15 percent in Belgium, France, Germany, the Netherlands, and Sweden. These figures suggest high marginal tax and contribution rates and high cumulative tax rates in many countries.

In summary, the growth of government in today's industrialized countries reflects largely the growth in the provision of goods and services over two World Wars, and, more importantly, the rapid growth of the welfare state since 1960. Recently interest payments have also been rising because the revenue increases did not keep pace with the expenditure growth leading to the rapid accumulation of government debt. The next section will look at the question of what countries have gained in terms of social and economic objectives from the growth in government spending.

IV. What Have Countries Gained from the Growth in Public Spending?

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 observers might answer this question in the negative. Many now argue that the public production of goods and services is inefficient and that social objectives are not achieved, or at least are not achieved in a cost-effective manner. Government production of goods and services has frequently been identified as inferior or more costly than private sector production. 2/ As regards the welfare state and income transfers, social safety nets have, in many countries, been transformed into universal benefits with widespread free-riding behavior, and social insurance has frequently become an income support system with special interests making any effective reform very difficult (Roberti, 1989). The social policies of the OECD countries often appear inefficient if not ineffective in achieving their stated objectives, and they have been found to undermine self-reliance (OECD, 1994). 3/ 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. We also compare

1/ Earlier data was not readily available.

2/ This is mainly due to noneconomic objectives being added on to economic objectives of government production. For a survey of this issue, see Borchenberg, Pommerehne, and Schneider, 1982, and World Bank, 1995. The recent enthusiasm towards privatization indicates that many policymakers share this view.

3/ There are also growing concerns that countries are approaching the limit of revenue collection as political resistance increases and disincentives depress activity and drive people into the underground economy (Peacock, and Tanzi respectively in Bristow and McDonagh, 1986).

the social "performance" of country groups with different levels of public spending.

1. Historical developments in social indicators

In the period between the 1870s and World War I, social indicators reflected reliance on the market mechanism, and the limited government involvement in the economy. In the late 19th century, unemployment was mostly below 5 percent. At that time, public primary education was generally fairly widespread, and by 1900, universal primary education with five or more years of presumably compulsory schooling was well established in Western Europe, North America, Australia, and New Zealand (Connell, 1980). 1/ In 1870, average years of schooling exceeded 5 years but countries such as Austria, Italy, Ireland, Japan, the Netherlands and the U.K. lagged behind (table 7). In Canada, France, Switzerland or the United States average attendance of school exceeded 7 years. However, death rates and infant mortality were very high, reflecting limited progress in medical techniques and services or little use of the medical progress made. In this period, one has to agree with Keynes that there was need for the government to play a larger role "to do things which...[were] not done at all."

By 1937, social indicators had improved markedly except for unemployment as most countries were still suffering from the Great Depression. Infant mortality had declined considerably from an average of 176 per 1,000 births in 1870 to 68 in 1937. Some countries exhibited almost modern levels of infant mortality of well below 50. The death rate had come down from an average of 21.3 per 1,000 in 1870 to 12.5 in 1937. Some countries showed death rates below 10. In addition to the impact of governmental action, these changes reflect technical progress in the health sector as well as increases in per capita income. Average primary school attendance had increased to over 7 years, with no country showing less than 5 years.

By 1960, health indicators had improved further. Infant mortality had fallen to 27 with much less variance among countries. The death rate had also fallen further to about 10, and it did not deviate much among the countries listed. In addition, unemployment had virtually disappeared, suggesting relatively well-functioning labor markets and little disincentives to work. It seems that by 1960, several basic social problems had been successfully tackled. For the period up to 1960, a reasonable claim can be made that the increased public sector spending (on education, health, training, etc.) had led to measurable improvements in social indicators.

1/ By 1900, the extension of public secondary education was under consideration in many of these countries (Connell, 1980). In practice, however, those who completed primary education were still a minority in several of the countries.

Table 7. Social Indicators before World War I until 1960

(in percent of GDP)

	<u>Unemployment Rate</u>			<u>Infant mortality</u>			<u>Death rate</u>			<u>Years of primary schooling</u>	
	About 1870 1/ (in %)	About 1937 (in %)	1960	About 1870 (per 1000/births)	About 1937 (per 1000/births)	1960	About 1870 per 1000/population)	About 1937 per 1000/population)	1960	About 1870 (average years)	About 1937 (average years)
Australia	3.9	8.8	2.4	111	38	20	14.2	9.4	8.6	6.2	9.2
Austria	...	...	3.5	253	92	38	29.4	13.3	12.7	3.6	7.3
Belgium	...	13.8	5.4	145	83	31	23.6	12.5	12.4	5.0	8.0
Canada	...	9.1	7.0	187	77	27	16.2	10.4	7.8	7.5	10.0
France	7.0	...	...	101	70	27	28.4	15.0	11.3	7.2	7.9
Germany	0.2	4.6	1.3 2/	298	64	34 2/	27.4	11.7	11.6 2/	...	7.4
Ireland	...	...	6.7	95	73	29	17.2	15.3	11.5	2.9	7.3
Italy	...	4.6	4.2	230	109	44	...	14.3	9.5	2.9	5.7
Japan	...	3.7	1.1	...	106	31	18.9	17.1	7.6	4.3	7.1
Netherlands	2.5	26.9	1.2	211	38	18	...	8.8	7.7	4.7	7.1
New Zealand	...	...	...	93	39	23	11.1	9.6	8.8	6.4	9.3
Norway	3.9	20.0	2.5	101	42	19	16.2	10.4	9.1	5.9	6.3
Spain	...	...	...	203	130	36	31.6	18.9	8.7	5.5	5.0
Sweden	...	10.8	1.4	132	45	17	19.8	12.0	10.0	6.3	5.7
Switzerland	...	10.0	...	222	47	21	25.8	11.3	9.7	8.0	7.0
United Kingdom	3.7	7.8	1.7	160	58	22	22.9	12.4	11.5	2.6	6.8
United States	4.0	14.3	5.5	...	50 3/	23 3/	17.0	10.8 3/	9.5 3/	7.9	8.4
Total average	3.6	11.2	3.4	176	68	27	21.8	12.5	9.9	5.7	7.4

Source: Mitchell, B., International Historical Statistics.

1/ Or earliest before 1913.

2/ West Germany only for 1960.

3/ Data is for white population only.

2. Government performance, social indicators,
and government spending after 1960

Though the evidence available is limited, various government performance indicators suggest that the growth in spending after 1960 may not have brought about significantly improved economic performance or greater social progress. In a sense, this growth in spending was less socially productive than that before this period. 1/ The group of countries with "big governments"--those that increased spending the most--did not "perform" better than the ones with "small governments", i.e., the countries that increased spending the least. As mentioned before, between 1960 and 1990, public expenditure increased in all countries. But today's "big governments" grew faster than the others. By 1990, their share of public expenditure in GDP had increased from an average of 31 percent in 1960 to 55 percent in 1990 (table 8). By comparison, the size of "small governments" had increased from 23 to 35 percent. 2/

Looking at the expenditure composition, public expenditure on subsidies and transfers (or from a functional perspective, social security) had increased the most. By 1990, subsidies and transfers comprised 55 percent of the total expenditure of big governments, 50 percent of medium-sized governments, and about 40 percent of small governments. 3/ Interest obligations had 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 (table 9). 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. Gross fixed capital formation and inflation did not change significantly between 1960 and 1990, and by 1990, they did not differ much between country groups. The unemployment rate, the share of the shadow economy, and the number of registered patents suggest that small governments exhibit more regulatory efficiency and inhibit less the functioning of labor markets, the participation in the formal economy and the innovativeness of the private sector. The worsening of the unemployment rate and the growing shadow economy since 1960 may also reflect interventionist policies and rising taxes during this period, particularly in countries with large state sectors.

1/ At that time, there was much optimism that governments could solve many social or economic problems through higher spending. With the benefit of hindsight, many now agree that that optimism was unjustified.

2/ For the classification of countries into these groups, see footnotes to table 8.

3/ Of course, as shares of GDP, the differences were much greater.

Table 8. The Size of Government and Public Expenditure
Composition in Different Country Groups

(in percent of GDP)

	Industrialized Countries						Newly Industrialized Countries 4/
	"Big" Governments 1/		"Medium-sized" Governments 2/		"Small" Governments 3/		1990
	1960	1990	1960	1990	1960	1990	
Total expenditure	31.0	55.1	29.3	44.9	23.0	34.6	18.2
Consumption	13.2	18.9	12.2	17.4	12.2	15.5	5.0
Transfers and subsidies 5/	22.3	30.6	15.2	21.5	10.2	14.0	5.7
Interest 5/	1.5	6.4	1.3	4.2	1.3	2.9	1.5
Investment 5/	3.1	2.4	3.2	2.0	2.2	2.2	3.4
Expenditure by Function							
Health 6/	2.6	6.6	3.0	5.9	2.3	5.2	3.3
Education	4.5	6.4	2.9	5.6	3.4	5.0	3.4
Social security 5/	13.5	19.5	9.6	13.9	6.2	7.9	1.0
Research & development 7/	...	2.0	...	1.6	...	2.0	...

Sources: OECD, Economic Outlook, 1994; Poullier, J-P., OECD Health Systems, 1993, Vol. 2, Tab. 4; UNESCO, World Education Report, 1993, Vols. 1 & 2; UN, Human Development Report, 1993, Tab. 12; IMF, Government Finance Statistics.

1/ Belgium, Italy, 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 40-50 percent of GDP in 1990).

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

4/ Chile, Hongkong, Korea, Singapore; 1990 or nearest available year.

5/ Central government, 1972.

6/ 1991 data for 1990.

7/ Annual average for 1989-1991.

Table 9. The Size of Government and Government Performance Indicators in Different Country Groups

	Industrialized Countries						Newly Industrialized Countries 4/
	"Big" Governments 1/		"Medium-sized" Governments 2/		"Small" Governments 3/		1990
	1960	1990	1960	1990	1960	1990	
<u>Economic and regulatory efficiency indicators:</u>							
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	...
<u>Social indicators:</u>							
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 15+	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/'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: OECD, Main Science and Technology Indicators, 1995; OECD, Trends in International Migration, Annual Report, 1994b; World Bank, Social Indicators of Development, 1993 and 1994; UN, Human Development Report, 1994; Mitchell, B., International Historical Statistics; Weck, Pommerehne and Frey, Schattenwirtschaft, 1984, Table 7, p. 67; IMF, Government Finance Statistics; IMF, International Finance Statistics.

1/ Belgium, Italy, 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 40-50 percent of GDP in 1990).

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

4/ Chile, Hongkong, Korea, Singapore.

5/ Average of preceding five years, 1956-1960 or 1986-1990.

6/ Most recent data available is 1978, used in 1990 column.

7/ 1992.

8/ US only. Others below 5 percent, UNESCO statistics.

9/ 1991.

10/ Excluding United States, average is 64.

10/ Data available for 1960 is 1970, data for 1990 may include 1993 in some countries. Newly industrialized countries data, only Korea is available (1993).

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. At the same time, emigration, an indicator for the hope for a better life in another country, declined, except for countries with medium-sized governments. However, in 1990, differences between country groups were small. Only certain social cohesion indicators such as the number of prisoners or the divorce rate were less favorable for countries with small governments, mostly an 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. 1/ In conclusion, 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.

3. Newly industrialized economies 2/

Public spending in today's newly industrialized economies is much lower than in the industrialized countries. Average total expenditure amounts to only 18.2 percent of GDP (table 8), with the main difference from the industrialized countries being lower expenditure on subsidies and transfers. However, expenditure on health, education, and public investment in newly industrialized economies is relatively high. Public investment expenditure of 3.4 percent of GDP exceeds the average share for industrialized countries.

Here again, we find that small government does not seem to produce unfavorable economic performance or less desirable social indicators (table 9): school enrollment, life expectancy, and infant mortality in these economies do not differ significantly from those of the more advanced industrialized countries. The unemployment rate is considerably lower, and the income distribution is not much more unfavorable either.

Comparing public expenditure and social indicators in some newly industrialized countries of Asia and Chile in 1992 or 1993 with those of selected industrialized countries during a roughly comparable period of per-capita-GDP (1960-1970) confirms the favorable picture for today's newly-industrialized countries (table 10). In 1960, total public expenditure and the expenditure composition in Japan were similar to those of Chile, Korea, or Singapore today. At the same time, in 1960, public expenditure on government consumption and on social security was already higher in Italy than it is today in the newly industrialized countries.

1/ Whether a 2- to 3-percentage-point difference in the income share of the lowest 40 percent of households is worth 20 percent of GDP more in public expenditure and taxes is debatable.

2/ Our sample of newly industrialized economies includes Chile, Hong Kong, Korea, and Singapore. We refer to these as economies rather than countries because of the inclusion of Hong Kong.

Table 10. The Size of Government and Economic and Social Indicators at Comparable Levels of Development, Selected Countries

(in percent of GDP, unless otherwise indicated)

	Industrialized Countries			Newly Industrialized Countries		
	Italy 1960	Japan 1960	United States 1960	Chile 1993 2/	Korea 1992 2/	Singapore 1992 2/
Public Expenditure						
Total Expenditure	30.1	17.5	27.0	21.8	17.0	19.0
Consumption	12.0	8.0	16.6	6.2	5.7	9.9
Transfers and subsidies	...	3.9	5.7	11.1	8.4	2.7
Interest 1/	1.8	0.5	1.3	1.3	0.6	2.4
Investment 1/	2.5	3.2	1.2	3.2	2.3	4.5
Health	3.4	1.9	1.3	2.9	4.4	3.4
Education	3.6	4.1	4.0	3.7	3.6	3.4
Social Security	9.8	3.8	5.0	7.3	1.7	0.4
Economic and social indicators						
Real GDP growth (in percent)	8.0	13.1	2.2	6.6	9.5	8.8
Inflation (in percent)	1.4	3.6	1.5	12.7	6.2	2.3
Unemployment rate	4.2	1.1	5.5	4.6	2.4	2.7
Income share of the lowest 40 percent	15.6	15.3	15.9	17.0	19.7	15.0
Illiterate population as percent of population +15	9.3	2.2	2.2	6.6	3.7	13.9
Secondary school enrollment (in percent)	34.0	74.0	86.0	72.0	90.0	70.0
Life expectancy	70.0	69.0	70.0	72.0	71.0	75.0
Infant mortality/'000 births	40.0	25.0	25.0	17.0	11.0	6.0

Sources: World Bank, Social Indicators of Development, 1993 and 1994; UN, Human Development Report, 1993; UNESCO World Education Report, Vol. 1 & 2, 1993; Poulhier, J-P., OECD Health Systems, 1993, Vol. 2, Tab. 4; OECD, Historical Statistics, 1992; IMF, Government Finance Statistics; IMF, International Financial Statistics; IMF, World Economic Outlook.

1/ 1972 for Italy, Japan and United States, central government data.

2/ Or nearest available year.

The similarities in social indicators between industrialized countries of 1960 and newly industrialized countries of 1992 are striking. Unemployment, income distribution, literacy, schooling, life expectancy and infant mortality, are all quite similar with a few exceptions such as Italy's low secondary school enrollment in 1960 or Singapore's relatively high illiteracy rate in 1992.

In summary, we conclude that social indicators improved the most between 1870 and 1960 when the welfare state was still in its infancy. The expansion of public expenditure and of the welfare state during the last three decades has yielded limited gains in terms of social objectives while possibly damaging the countries' economic performance. Today, countries with small governments and the newly industrialized countries show similar levels of social indicators but these are achieved with lower expenditure, lower taxes and higher growth than countries with big governments.

The next section will look at the potential scope for government reform, experiences in reform countries, and possible developments in the future role of the state.

V. Reforming Government

1. The scope for reform

If one accepts the conclusion that: (a) by 1960 most industrialized 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) today's newly industrialized countries show favorable social indicators in spite of low public spending, there may indeed be considerable scope for reducing the size of the state especially for the "big government" countries.

A convenient benchmark to assess the scope for reducing the current size of government is the level of public spending in 1960 and, perhaps, in today's newly industrialized countries. In Japan or Switzerland, in 1960, the level of public expenditure was less than 20 percent of GDP, almost identical to the level in newly industrialized countries today. Public expenditure in other governments did not exceed 30 percent of GDP. Over the long run, total public expenditure could be reduced to, perhaps, under 30 percent of GDP without sacrificing much in terms of social or economic objectives.

It is important to consider how the composition of government expenditure should change to accommodate the decline in total expenditure. In Japan or Switzerland in 1960, public consumption absorbed less than 10 percent of GDP. This is about half of today's average expenditure on public consumption for industrialized countries (table 2). Hence, there should be considerable scope for cuts in public consumption in many countries.

Because most of the historical increase in expenditure originated with subsidies and transfers, much expenditure reductions would have to take place in this category. Subsidies and transfers amounted to less than 4 percent of GDP in Japan in 1960, and had increased to around 10 percent in Japan or Switzerland by 1992 (table 3). This level is similar to that prevailing in some of today's newly industrialized countries (table 10). It is only half of the average of over 20 percent of GDP for all industrialized countries in 1992. Cutting back the welfare state in a careful 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. Some fundamental and radical reforms will be unavoidable if the objective of much lower public expenditure is to be achieved. The experience of countries that have attempted to reduce public spending confirms this view.

There is no precise roadmap for reform but scaling down the welfare state is of prime importance. In the long run, pensions and health systems' reform would yield considerable budgetary savings in most countries. One could argue that there is no compelling economic reason for far-reaching state involvement in these areas beyond basic social assistance, e.g., in the form of a basic allowance for the poor or the unemployed, and of insurance against catastrophic events such as major illnesses or accidents for everyone. With proper reforms, most pension, health and social insurance needs could be satisfied by the private sector thus reducing the need for public spending. However, this drastic change would require a major departure from the present way of doing things. 1/ It would also require an expanded regulatory role for the public sector.

There is little controversy over the need for free public primary education. There is some controversy as to the role of the public sector for secondary education. At the level of tertiary or university education, however, fully or partly privately financed universities could replace costly public university systems. 2/ In the United States, for example, university education is largely private. Some countries have also experimented with privatizing the government production or even the provision of many goods and services. The private building and operation of roads, prisons, airports, railroads, and municipal services could be

1/ For proposals of fundamental reforms in this area, see World Bank, *Averting the Old Age Crisis* (Washington, D.C.: Oxford University Press, 1994b). For an analysis of such a possibility for the United States, see Laurence J. Kotlikoff, "Privatization of Social Security: How it Works and Why it Matters," in *Tax Policy and the Economy*, James M. Poterba, editor NBER Conference Report, 1995.

2/ Scholarships or access to credit could help students from poor families to acquire university education.

extended considerably in many countries. ^{1/} Once again this would require a relatively well working private market and an efficient regulatory role for the government.

The question of where to draw the line between government and private sector activities, however, cannot be answered universally. Where to draw the line changes with time and across countries. The better working is the market economy, the less extended can be the role of the public sector. Of course, the more efficient is public administration and the less important are rent-seeking activities, the greater could be the role assigned to the public sector. Technical considerations such as cost-benefit analysis should complement the political process in deciding on who should perform which function in an economy. Thus, it is important to create institutions (such as the Congressional Budget Office in the United States) that are capable of doing such analyses.

Reducing public expenditure will free up resources for private use and reduce the demands on the tax system. The overly strong reliance on direct taxes and social security contributions in many industrial countries could be reduced. Marginal tax and contribution rates could, thus, become more modest. This would reduce the disincentive effects of taxation and stimulate growth. The tax base could be broadened as the incentive to leave the formal economy or to seek tax exemptions declines. Budget surpluses could be generated to retire part of the accumulated public debt and, thereby, reduce the interest burden for the budget. In summary, *public expenditure as a share of GDP could be lowered considerably without necessarily compromising social welfare.*

2. The implementation of reforms

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

Reforming government and reducing public expenditure can generate considerable long-term benefits if they result in higher economic growth. However, reforms will stimulate growth mainly when they alter expectations of the private sector about the future investment climate for both real and human capital. Such a change in expectations may require not just the

^{1/} There is by now a considerable body of literature discussing the private provision of infrastructure, especially utilities and transportation (World Bank, 1994a), roads (Gomes-Ibañes and Meyer, 1993), health (Young, 1990), and education (Walford, 1989; or James, 1984, on the experiences of the Netherlands). See also Van der Gaag (1995) on private and public sector activities in developing countries.

application of operational policy instruments but a shift in the policy regime or in the rules of the game which constrain policy makers (Brennan and Buchanan, 1985; Solimano, 1994). 1/ If existing rules have resulted in expansionary expenditure policies, a reversal in such policies will not happen automatically (Forte and Peacock, 1986). The rules have to change so that policy makers' incentives for fiscal policy making also change.

This rather abstract argumentation has been translated by some economists into various practical policy recommendations and policy platforms aimed at controlling the forces that result in public expenditure growth. A prominent approach for controlling expenditure is through constitutional rules. For example, in the U.S. the idea of a balanced-budget amendment has been proposed by some and rejected by others for some years. In some countries, constitutional rules now guarantee the independence of their central banks, rendering the monetization of fiscal deficits more difficult. It has been argued that direct democracy as a constitutional principle has slowed down the expansion of public expenditure in Switzerland (Pommerehne and Schneider, 1982).

Constitutional rules have the advantage that they tie a government's hand more firmly than simple legislation, because they are more difficult to reverse. However, they are no panacea for fiscal problems because they require strong implementation and enforcement mechanisms. 2/ In some countries where they exist, they are disregarded or circumvented. Consensus building and strengthening of interest groups and agencies with an interest in the new rules may increase their chances of implementation and may assure their longevity.

The expected long-term benefits which may derive from less state involvement are not enough to guarantee the required political support for the change. Reforms will be inevitably painful especially in the short run, for those groups which had gained from the public spending. These groups will oppose the reforms and will make the introduction and the implementation of the reforms 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 only implemented with a

1/ On the operational level, expenditure control can be strengthened with the help of improved accounting procedures. The introduction of market-simulating incentive schemes in the "production process" of the public sector can also improve expenditure control and efficiency (Peacock in Bristow and McDonagh, 1986).

2/ The importance of credibility for policy commitments is discussed in Borner, Brunetti and Weder (1995).

lag, this can facilitate adjustment to the new economic environment. (Buchanan, 1994). 1/

3. Experiences with government reform

Recent experiences with government reform in a number of countries have one common feature: countries which successfully reversed expansionary trends in public expenditure and revitalized their economies did so through fundamental changes in the underlying policy regime. The country experiences also confirm what we argued before: major government reforms take a long time to implement. We will briefly look at four countries that have attempted to reform the state in the past 15 years, i.e., Chile, New Zealand, Ireland, and Belgium, and discuss major changes in expenditure policies and in the underlying policy regime.

Chile: The most impressive reduction in public expenditure has been achieved in Chile. Total expenditure declined from a maximum of 34.1 percent of GDP in 1982 to 21.8 percent in 1993 (table 11). 2/ Transfers and subsidies were halved to 11 percent of GDP while government consumption also declined considerably from 10.8 to 6.2 percent of GDP. By 1993, total investment had increased from 14.6 to 25.6 percent of GDP, growth was high, and unemployment low. A pioneering reform of the pension system sharply reduced the role of the government in this area. 3/ Chile undertook also "dramatic reforms of its health sector by decentralizing the government-run health system and by creating private health insurance institutions." (See World Bank: World Development Report 1993a, p. 162.)

The impressive results have been achieved with a mixture of constitutional and quasi-constitutional reforms which fundamentally altered the character of the Chilean government and economy. The new 1980 constitution guarantees property rights and limits the role of government as a discretionary regulator. Social security and most public enterprises were privatized, and the central bank became independent. Budgetary procedures were reformed and many government procedures were submitted to stricter rules and accountability. All this reduced the scope of lobbying for preferential tax treatment, social benefits, or favorable regulation by special interests. It replaced a "clientelistic state" with "a more

1/ This strategy benefitted the implementation of the Common Market in the EU. The adjustment of all parties involved, including opponents to free trade, was facilitated considerably by the fact that announcing and advertising the reforms planned for end 1992 started already in 1986 after agreement on the Single European Act (Schuknecht, 1992).

2/ The table compares expenditure policies during the year when total expenditure was at a historic maximum with the most recent year available.

3/ The Chilean pension reform is having, and is likely to continue having, a profound effect on the pension systems of other countries.

Table 11. Public Expenditure Development and Government Reform ^{1/}

(in percent of GDP)

	<u>Belgium</u>		<u>Chile</u>		<u>Ireland</u>		<u>New Zealand</u>		<u>United Kingdom</u>		
	1993	1994	1992	1993	1983	1994	1988	1994	1983	1989	1994
<u>Public Expenditure</u>											
Total expenditure	63.9	54.8	34.1	21.8	53.2	43.8	45.6	35.7	44.7	37.5	42.9
Government consumption	17.5	15.3	10.8	6.2	19.3	15.8	11.5	15.4	21.7	19.4	21.6
Interest ^{2/ 3/}	8.2	10.1	0.5	1.3	9.1	7.5	7.2	5.7	3.9	3.3	2.7
Transfers & subsidies ^{2/ 3/ 4/}	33.0	29.0	20.6	11.1	30.9	23.4	24.8	13.2	21.9	17.3	24.2
Capital expenditure ^{2/ 3/}	4.4	2.5	2.2	3.2	3.8	2.6	2.1	1.3	2.0	2.1	3.7
Health ^{3/}	6.2	7.0	2.3 ^{2/}	2.5 ^{2/}	6.8	5.0	3.0	5.6	5.4	4.9	5.5
Education ^{3/}	7.5	6.2	5.0	2.9	6.2	5.1	5.7	5.7	5.6	4.7	...
Social security ^{2/ 3/}	23.5	21.3	14.3	7.3	13.1	11.4	14.8	14.0	11.6	10.2	12.8

Source: Poullier, J-P., OECD Health Systems, 1993, Vol. 2, Tab. 4; UNESCO, World Education Report, 1993; OECD, Economic Outlook, 1992 and 1995; IMF, Government Finance Statistics.

^{1/} The table compares the year of maximum public expenditure with the most recent available data.

^{2/} Central government data.

^{3/} Or nearest available year.

^{4/} Includes transfers to other levels of government. Therefore, some double counting may occur in the government consumption and transfers and subsidies categories.

autonomous state" where "the costs of government transfers and interventions are (at least partially) internalized, and therefore sound fiscal policy becomes achievable" (Velasco in Bosworth, Dornbush, and Laban, 1994). 1/

New Zealand: New Zealand is another country which has reduced the role of state through far-reaching changes in its economic policy rules. In 1988, public expenditure amounted to 45.6 percent of GDP but by 1994 it had declined to 35.7 percent. This reduction was achieved almost exclusively in the area of transfers and subsidies which were reduced from 24.8 percent in 1988 to 13.2 percent in 1994. Interest expenditure had also come down from 7.2 percent in 1988 to 5.7 percent in 1994. As the transmission of reforms in the economy takes some time, these consolidation efforts have only recently resulted in a revitalization of the economy and in an increase in the growth rate.

In New Zealand, the reform process started in 1984. Most state enterprises were privatized, and subsidies and price support for agriculture were abolished. The tax system was simplified, marginal rates were sharply reduced, and the tax bases were broadened (Ministry of Finance, 1986). The central bank was made independent with an inflation ceiling as its only objective. In 1990-91, social policy reform replaced universal entitlements by a modest safety net with means-testing. Significant structural changes in the public administration gave rise to output-oriented administrative performance evaluation, and changes in the budgetary process facilitated the implementation of fiscal policy objectives (Scott 1995). Although New Zealand does not have a formal constitutional tradition, these changes altered the economic policy regime in a fundamental way. As with Chile, rent-seeking opportunities were reduced through privatization, transfer and subsidy reductions, tax reform, and the reorientation of administrative incentive structures. In addition the government invested into social consensus building and strengthened vested interests in the new policy regime (e.g., they introduced a privatization ministry) (Treasury, 1990).

Reform in New Zealand was achieved mainly through a strong executive controlling parliament which is typical for a Westminster-style governance structure. Fortunately for New Zealand, so far both main political parties have supported the reform effort. 2/ However, the U.K. itself illustrates a possible weakness of the Westminster system: reforms are relatively easy to reverse. Although public expenditure in Britain had declined from almost 45 percent in 1983 to 37.5 percent in 1989, by 1994, this reduction had been largely reversed (table 11). Transfers and subsidies were higher in 1994 than at the beginning of the Thatcher-reforms in 1983. But as of now, there is no evidence that the reforms in New Zealand are in danger of being reversed.

1/ Although this new policy regime was achieved under an autocratic regime, so far it has remained unaltered under the new democratic regime.

2/ The same has occurred in Chile proving that over the medium term, fundamental reform may not be political suicide.

Ireland: Ireland also achieved an impressive reduction in public expenditure between 1983 and 1994. Total expenditure declined from 53.2 percent to 43.8 percent of GDP. Reducing subsidy and transfer payment has been the driving force as such expenditure declined from over 30 percent of GDP to 23.4 percent. Fiscal consolidation has also already translated into declining outlays for interest on public debt of more than 3 percent of GDP.

In Ireland, a public debt level of 130 percent of GDP is considered one of the main reasons why public consensus on fiscal consolidation emerged in the mid 1980s. ^{1/} In addition, Ireland is economically and politically oriented towards the European Union. The common market project and, more recently, the Maastricht Treaty and its convergence criteria have provided a strong outside incentive for Ireland to get its fiscal house in order.

Belgium: Although Belgium achieved a considerable adjustment in public expenditure between 1983 and 1992, the changes were less fundamental than in the above countries and the picture is not quite as positive. Total public expenditure declined from 63.9 to 54.8 percent. However, since 1990 there has been no further progress in reducing public expenditure. In Belgium, the outside constraints of the Common Market and Maastricht as well as a heavy public debt burden also appear to have driven the adjustment of public expenditure. However, the reform package has consisted in a number of marginal policy adjustments rather than in bold changes in the country's policy regime. Recent changes in the federalist structure could make expenditure control even more difficult.

4. Trends in the role of the state

Economic thinking has come a long way from classical political economy and the minimal state, via Marxist or Keynesian interventionism, to today's emphasis on rules and accountability in making state activity more productive. However, at the political level, this emphasis has so far changed policy regimes in only a few countries. An important reason is that interest groups oppose the curtailment of their rent-seeking opportunities or the reduction in their benefits.

There are, however, a number of reasons why the reform of the state might progress in an increasing number of countries. These reasons include the lagged impact of economic thinking on policy-making, easier access to information about successful reforms, and stronger international competition between countries. Changes in economic thinking and better understanding of what governments should do take time to affect decisionmakers. The impact of ideas is certainly very powerful, as Keynes pointed out, but that impact is felt only after a period which can be very long. For example, Keynesian writings of the 1930s did not have a strong influence on policy making until the 1960s. Similarly, modern thinking about the role of the state is likely

^{1/} For "An Irish Overview" of the situation in Ireland in the mid-1980s, see the intervention by Alan Dukes, TD, then Minister of Finance of Ireland, in Bristow and McDonagh, op. cit., pp. 127-138.

to have its full influence on policy making only at some future time. For the time being, it has affected mostly a few countries and there is evidence that it begins to influence many countries including the EU countries and the United States (even though the latter already ranks as a "small government" country in our definition).

More easily available information about international "success stories" cannot fail to affect other countries and to influence the actions of their policymakers. 1/ The success of the newly industrialized Asian countries and of some Latin American countries has been well documented and interest in their policy strategies is widespread. These are countries with small governments.

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 towards reform. In these circumstances, the 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 such as the Maastricht Treaty eliminate undesirable alternatives to adjustment, such as protectionism or competitive devaluation. 2/ The successful reforms of Ireland, New Zealand or Chile may spread to more countries.

VI. Concluding Remarks

This has been a broad and wide-ranging paper that has shown how public expenditure, as a share of GDP, grew, over more than a century, in all the industrial countries, to reach the recent high levels. Over the past century, the ratio of public expenditure to GDP grew as much as five times. It is difficult for us today to visualize a world with countries in which governments spent only 10 percent of GDP. However, the countries that did so a century ago were not backward countries but vibrant and modernizing economies. For example, much of the Paris that we admire today was built at a time when France was spending only about 12-13 percent of its GDP for public sector activities. However, these countries did not yet have public health, public pensions for almost everyone, free education at all levels, unemployment compensation, subsidies to families and households and so on.

Modern societies have accepted the view that governments must play a larger role in the economy and must pursue modern objectives such as income

1/ A virtuous contagion effect may be at work in this area. The IMF and the World Bank are likely to help promote this effect.

2/ The conclusion of the Uruguay Round and the strengthening of GATT through the forming of the WTO also increase international competition and, indirectly, pressure for fiscal reform.

redistribution and income maintenance. The clock cannot be set back and, in fact, it should not be set back. For the majority of citizens, the current world is certainly a more welcoming world than the one that existed 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 what 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 governmental interventions. However, this would require radical reforms, a well-working, private market, and an efficient regulatory role for the government.

The radical reforms must *aim at maintaining the public sector objectives while reducing the level of public spending*. They will require much privatization of higher education and of health care. They will require the privatization of some pensions and many other changes. In this process, the role of the 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.

The paper has shown that some movement in the direction indicated above is noticeable. In many countries, there is general disillusionment with high level of taxation and with high level of public spending. However, there is still strong opposition, from the specific groups that benefit from the spending, to have their own 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 the shrinking of the spending cake some would lose more than others. Furthermore, some still question whether the government will be able to play its new and, perhaps, more demanding role with the necessary degree of efficiency to guarantee that the fundamental objectives are achieved with drastically reduced spending. ^{1/} Still, from the discussion in this paper, we predict that over the next decades, we shall see some important reductions in the share of public spending in GDP in industrial countries.

^{1/} If the reduction in public spending were accompanied by a proliferation of inefficient regulations then the advantages of the change will be limited. See on this possibility Tanzi (1995).

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