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The past, present and future of public spending

by

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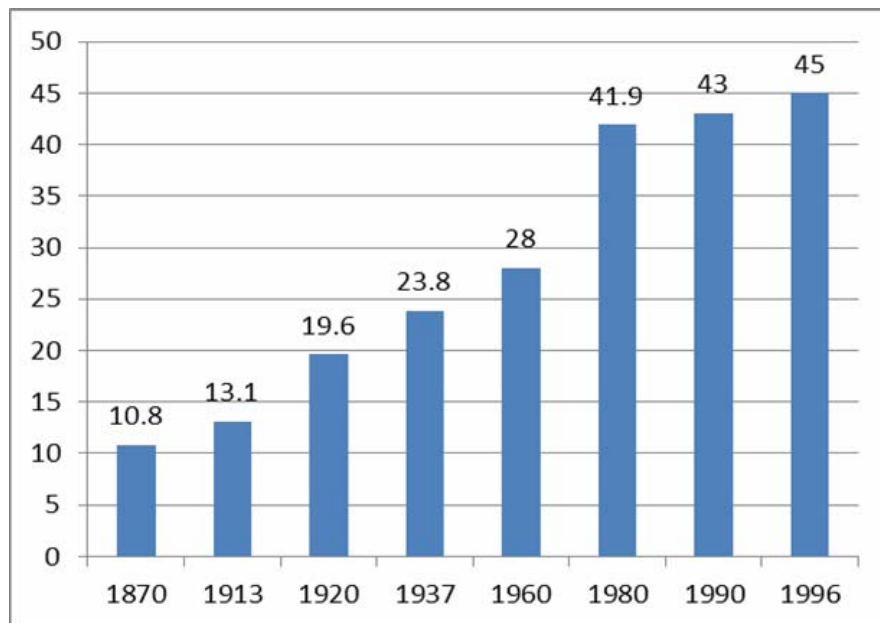
Researchers: Prof. Stephen Thomas, David Hall (Director), Jane Lethbridge, Emanuele Lobina, Vladimir Popov, Violeta Corral

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1. The long-term link between growth in public spending and economic growth

There has been a long-term trend for increasing levels of taxation and public spending in OECD countries. Public spending as a proportion of GDP has risen steadily, in line with economic growth, for 150 years. Tax and spending peaked during the two world wars of the 20th century, but the level of state spending and taxation then remained high and rose again in the years after world war II, until around 1990. This long-run link is known as 'Wagner's Law' after the economist who first identified it in the 1880s. The data itself shows, very simply, that rising levels of public spending are compatible with economic growth.¹

Chart A. Government spending as % of GDP 1870-1996



Average of 14 high income countries

Source: Tanzi and Schuknecht 2000 Public Spending in the 20th Century CUP [Chapter 1](#)

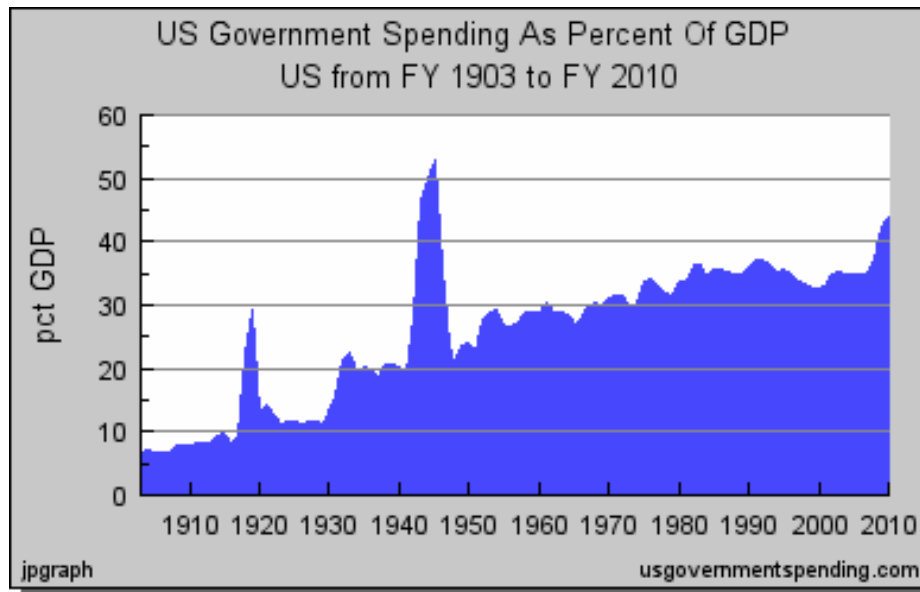
Table 1. Government spending as % of GDP, 1870-1995: countries

Table 1: Total Government Spending Relative to the Size of the Economy (Percent GDP)

	1870	1880	1890	1900	1910	1920	1930	1938	1950	1960	1970	1980	1990	1995
Australia	--	--	--	--	--	--	--	--	23.9	22.8	26.1	33.2	37.1	37.3
Austria	11.4	11.7	12.9	15.0	17.6	14.7	19.8	15.2	25.1	30.4	35.3	47.2	48.2	51.5
Belgium	--	--	--	--	--	--	--	21.8	23.7	30.7	37.5	51.7	54.7	54.6
Canada	6.2	7.0	7.8	8.7	11.3	19.0	18.9	21.6	21.9	29.1	35.8	40.6	46.5	48.1
Denmark	9.2	8.9	10.6	10.8	12.3	15.4	13.5	16.7	19.6	25.2	39.4	55.6	58.1	61.6
Finland	--	--	--	--	--	--	--	--	25.8	26.9	30.5	37.0	42.5	59.1
France	11.0	14.6	14.3	14.5	15.1	22.4	29.4	29.4	29.3	34.0	37.7	43.3	49.6	54.1
Germany	9.5	9.9	12.9	14.2	16.0	25.0	29.4	36.9	29.2	32.2	36.9	46.5	44.9	47.7
Ireland	--	--	--	--	--	--	20.8	32.9	30.3	27.3	37.9	52.3	42.4	40.3
Italy	14.4	13.7	18.4	16.3	17.3	30.2	22.0	29.2	23.0	29.7	31.7	44.9	51.6	51.8
Japan	8.8	9.5	12.0	17.5	24.3	19.2	26.8	29.9	15.9	17.8	18.6	32.3	31.3	36.1
Netherlands	9.1	--	--	--	9.0	13.5	14.0	23.2	27.1	34.6	42.3	56.5	54.0	54.2
Norway	5.9	6.8	7.4	9.9	9.3	12.8	19.1	20.3	24.2	31.3	41.3	48.8	54.8	49.0
Portugal	--	--	--	--	--	--	--	--	16.4	17.8	22.0	38.0	42.8	45.3
Spain	--	--	--	--	8.3	9.3	--	18.4	--	17.7	21.5	31.1	42.0	46.6
Sweden	5.7	--	--	--	10.4	12.8	19.1	20.3	26.3	31.3	42.8	60.9	61.5	67.0
Switzerland	--	15.8	14.3	10.6	14.0	17.0	17.4	23.9	20.8	21.0	26.7	35.0	33.4	38.4
United Kingdom	8.7	9.1	9.2	14.9	12.7	27.4	24.7	28.6	32.0	32.1	37.8	44.3	40.4	44.2
United States	8.3	5.9	6.5	7.9	8.2	9.4	12.2	19.7	22.4	28.4	33.7	35.3	36.8	36.1

Source: Ideology, Institutions, and Public Spending Thomas R. Cusack and Susanne Fuchs June 2002 Wissenschaftszentrum Berlin für Sozialforschung Discussion paper P 02 – 903 <http://bibliothek.wz-berlin.de/pdf/2002/p02-903.pdf>

Chart B. Government spending as % of GDP, USA, 1900-2010



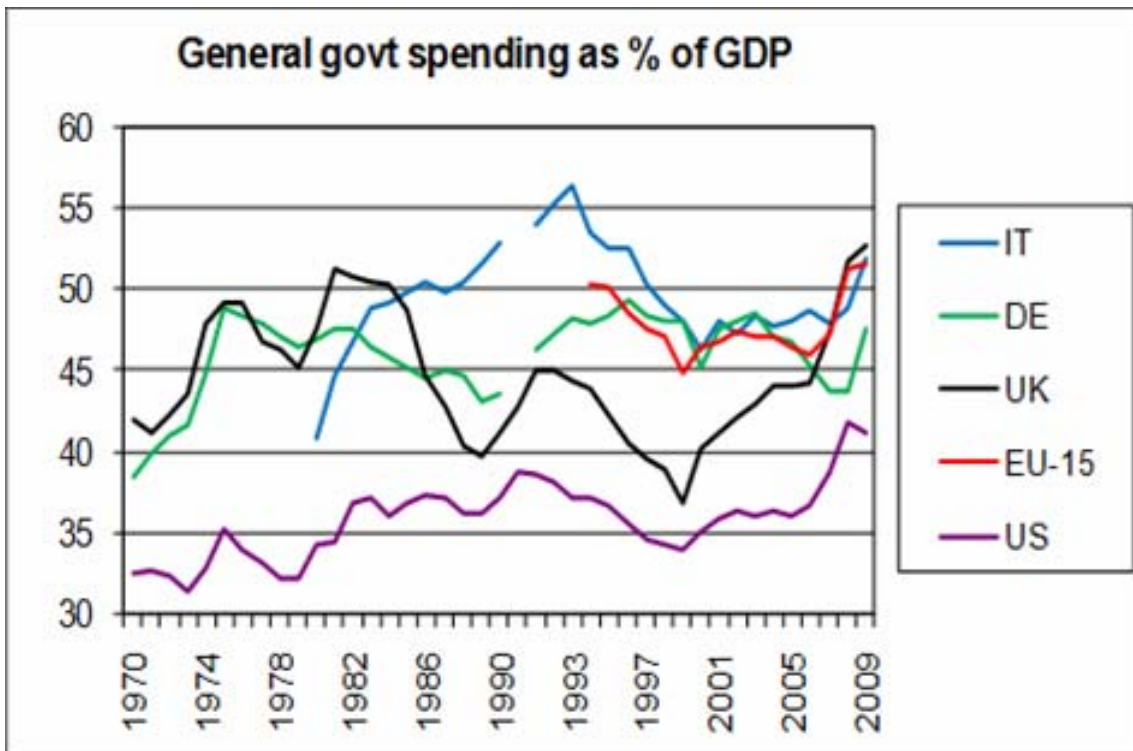
Source: http://www.usgovernmentsspending.com/us_20th_century_chart.html

A series of studies of multiple countries has confirmed the statistical significance of the link. A study of 23 high-income countries from 1970-2006 by two central bank economists confirmed “a positive correlation between public spending and per-capita GDP... [and] a common development among the 23 countries and the widespread validity of the Wagner’s law”.² An earlier study comparing 19 high income countries concluded that: “a large and expanding welfare state may be compatible with and beneficial to, a capitalist economy”.³ A study of 51 developing economies by IMF staff found that there was a consistent link across all countries, confirming “a long-term relationship between government spending and output consistent with Wagner’s law”.^{4,5} An analysis of India from 1950 to 2008 has also confirmed “the validity of Wagner’s law in Indiathere exists a long-run relationship between economic growth and growth in public expenditure”.⁶

Around 1990 the growth of public spending as a % of GDP fell back in OECD countries. Some analysts argue that this meant that the long-run growth was now coming to an end in rich countries, that as public spending grows larger as a proportion of GDP, the burden of tax acts as a brake, so that the growth of public spending stops, and: “the relative weight of government in the set of OECD economies is close to a steady state value”.⁷

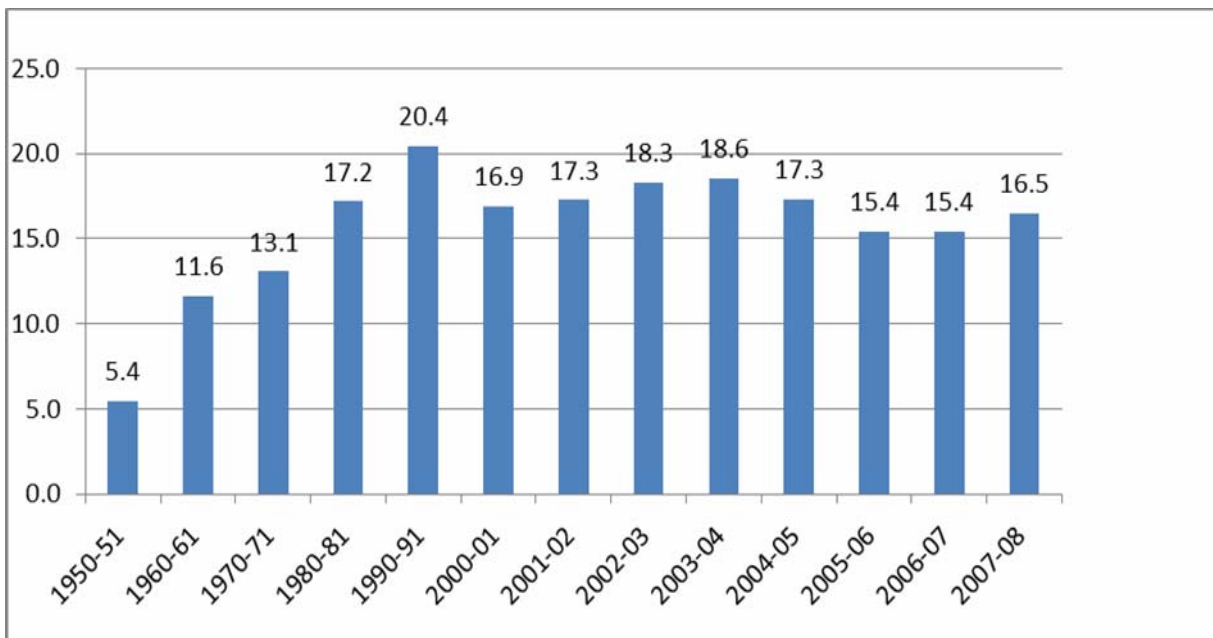
However, after 2000 the overall trend is once again upwards, both in the USA and the EU. This revived upward movement has accelerated even further since the crisis of 2008, so that the growth is back to its long-term trend. And the same pattern can be seen in India, where the application of liberalisation policies from 1990 had the same effect, and the election of a social democrat government in 2004 began a reversal of that trend (see below). So the levelling off may be temporary, and due to political initiatives, not to any economic feature of advanced economies.

Chart C. Government spending as a % of GDP in selected OECD countries since 1970



Source: Eurostat; and PSIRU calculations

Chart D. India: central government expenditure as % of GDP 1950-2008



Source: Satish VERMA, Rahul ARORA 2010. Does the Indian Economy Support Wagner’s Law? An Econometric Analysis. Eurasian Journal of Business and Economics 2010, 3 (5), 77-91; and PSIRU calculations

One rationale for the link is that the growth of public spending is itself a key factor in generating economic growth in general, and the recent slowdown is the result of a trade-off between the growth-enhancing effect

of higher public spending and the disincentives created by higher taxation.⁸ Other analyses point to the role of public spending as an efficient collective long-term insurance mechanism; the productive role of public spending in infrastructure investment; the function of the spending itself in supplying a healthy and educated and therefore productive workforce; and.⁹

Another rationale is that redistribution of income increases consumer demand by giving poorer people more money to spend, and that a healthy, well-educated workforce is more productive: “In the Keynesian model, economic growth is con-strained by effective aggregate demand. State-sponsored redistribution policies thus may accelerate the pace of economic activity to the extent that they place additional income in the hands of families with relatively high marginal propensities to consume. In addition, human capital theory suggests that when oriented towards health and education, such redistributive programs contribute as well to the quality of the labor force, and hence the growth potential of the economy.”¹⁰

It also helps create stable and peaceful relations between capital and labour, thus protecting the system as a whole from alternatives: “The possible patterns of economic evolution consistent with the no-welfare-state option . . . include chaos, stagnation, and the development of new and perhaps unprecedented economic systems”.¹¹

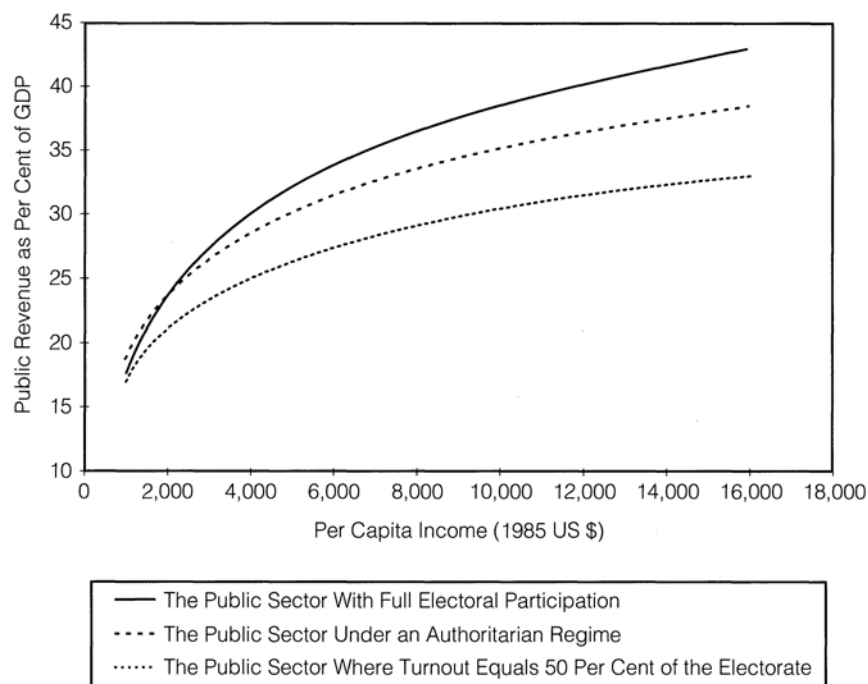
The structure of economies is significant. Economies with a large agricultural sector have lower levels of public spending than similar economies with small agricultural sectors. Industrialised economies need more public services, and a public system of collective support in unemployment, old age etc, to replace the role of the extended family in agricultural societies.¹²

The effect does not just come from the services themselves. A recent study on health and education spending in OECD countries found that “public expenditures affect GDP growth more than private expenditures.”¹³ This is consistent with the strong evidence that public spending on healthcare is much more effective, in terms of health objectives, than private spending on healthcare (see below). The obvious advantage is that providing these services through public spending allows a much greater proportion of the population to get the healthcare and education that they need.

It is also linked to political factors: “Economic development does not mechanically lead to larger public sectors”. Democracies have higher levels of public spending as a proportion of GDP than authoritarian regimes. Spain illustrates this point: while it was still under the dictatorship of Franco in 1974, government revenues amounted to 22.9% of GDP; ten years later, in 1984, the economy had not grown in real terms, but government revenues had risen to 32.7% of GDP. Participation also makes a difference: democracies with high electoral turnouts reach higher levels of public spending than democracies where turnout is 50% or less. Higher life expectancy also increases public spending: the elderly need more public services and a greater incentive to vote for them.¹⁴

The set of curves in the following chart lay down a general framework for the relations between economic growth, public spending and democratic activity.

Chart E. Economic growth and democracy

FIGURE 2 The Evolution of Public Revenue as an Interaction of Economic Development and Democratic Participation

Source: C Boix Democracy, development, and the public sector American Journal of Political Science, 2001
http://pics3441.upmf-grenoble.fr/articles/demo/democracy_development_and_the_public_sector.pdf

2. Responding to the economic crisis

Box A. Saving capitalism

Financial Times 13th October 2008 FT leader 'Nationalise to save the free market'

<http://www.ft.com/cms/s/0/2ec1ce0e-9951-11dd-9d48-000077b07658.html>

“Does this rescue mean the end of private financial capitalism? Of course not. Nationally owned banks seem likely to be a reality in many countries for a decade. But stakes in banks will, eventually, be sold back to private investors. Governments – rightly – will regulate to avoid further crises. They will fail, and then be forced to act to pick up the pieces. There is no alternative...
 ... These leaders are not putting capitalism to the sword in favour of the gentler rule of the state. They are using the state to defeat the marketplace’s most dangerous historic enemy: widespread depression. And they are right to do so.”

The economic crisis and the policy responses have had a large effect on public spending, especially in OECD countries. In all countries, public spending leapt by 3% to 4% of GDP in one year. The average level across all 27 EU countries in 2009 was over 50%, for the first time, and in the USA and Japan it was above 40%, also for the first time.

Table 2. General government total expenditure as % of GDP, EU and other countries

	CZ	DE	FR	IT	DK	UK	EU-27	USA	Japan
1970	n/a	38.5	n/a	n/a	42.2*	42	n/a	32.5	n/a
1980	n/a	46.9	45.7	40.8	52.7	47.6	n/a	34.2	n/a
1990	n/a	43.6	49.5	52.9	55.4	41.1	n/a	37.2	n/a
2000	41.8	45.1	51.6	46.2	53.6	36.8	44.8	33.9	39.0
2005	45.0	46.8	53.3	48.1	52.6	44.1	46.8	36.3	38.4
2006	43.8	45.3	52.7	48.7	51.5	44.0	46.3	36.0	36.2
2007	42.5	43.7	52.3	47.9	50.9	44.2	45.7	36.7	36.0
2008	42.9	43.7	52.8	48.9	51.9	47.4	46.9	38.8	37.3
2009	46.2	47.6	55.6	51.9	58.5	51.7	50.7	41.8	40.4

*1971

Source: **European Commission: Statistical Annex of European Economy** Spring 2010

http://ec.europa.eu/economy_finance/publications/european_economy/2010/pdf/statistical_annex_spring2010_en.pdf

The biggest effect has not come from special additional government spending, but from the normal operation of taxation and public spending systems as 'automatic stabilisers'. Government deficits automatically increase in recessions, because taxes fall and spending on benefits rises. This deficit partially protects people from the fall in their incomes, and acts as an economic stimulus which partly offsets the effects of recession.

The IMF and others assume that unemployment benefits are the key part of government spending which increase automatically in a recession. But other public spending, especially on healthcare and the elderly, also rises in response to recession, and so "automatic stabilization through all elements of social expenditure is about 3.5 times larger than the part coming from unemployment compensation alone."¹⁵

This has two important implications. Firstly, the current attempts to cut public spending on the elderly risk undermining an important element in economic stability. Secondly, governments (and the EU and the IMF), which only take account of unemployment benefit, are not taking proper account of the automatic effect of recessions on this spending, and so the limits on government deficits are being applied too strictly. European Commission reports: "...downplay the automatic forces influencing the budget....the neglect of the cyclical implications of pensions, health expenditure and disability pay, especially in evaluating alternative reform packages, could be storing up problems for the control of budgets in the future."¹⁶

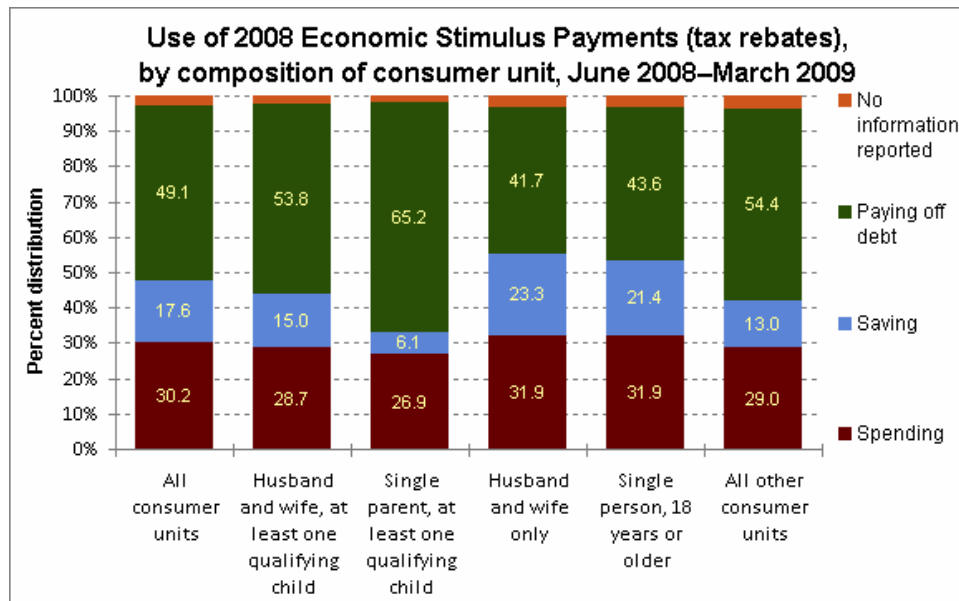
Table 3. Economic stimulus as % of GDP:

	2009		
	Automatic stabilisers	Discretionary policies	Total stimulus
	in 2009		
All G-20 countries	1.9	2.0	3.9
<i>Of which:</i>			
Advanced countries	2.4	1.9	4.3
Emerging market countries	1.1	2.2	3.3

Source: IMF 2009B^{17 18}

The stimulus packages contained a mixture of tax cuts and spending increases. The tax cuts reflect political preferences – as data from the USA later demonstrated, tax cuts are a very poor way of stimulating demand in a recession – because people save a large proportion of them, instead of spending it. Only about 30% of the tax rebates given by the Bush government in May 2008 was actually spent: all types of households used two-thirds or more of the money to save or to repay debts.

Table 4. Tax rebates: saved, not spent



Source: USA Bureau of Labour Statistics. October 2009 pay off debt, spend, or save? The 2008 Economic Stimulus Payments http://www.bls.gov/opub/ted/2009/ted_20091023.htm

Box B. General Motors and public finance

The case of General Motors (GM) shows that the benefits of public ownership, and the problems of weak public services, affect large manufacturing companies as well as the general public. GM was the largest manufacturing company in the world, and still employs nearly 240,000 workers, but had to be rescued from bankruptcy in 2009 and is now owned by the USA and Canadian governments, and a fund owned and run by a trade union. In late 2010 GM is planning a partial re-privatisation by selling about a fifth of its shares on the stock exchange.

GM was rescued by large amounts of public finance. The USA and Canadian governments gave \$61 billion in public finance to GM to help it avoid bankruptcy. Most of this was converted into shares, so that in July 2009 GM became 61% owned by the USA government, and 11% owned by the Canadian government.

GM also asked European governments to give the company up to €3 billion in loan guarantees to help finance the restructuring of its Opel division. In June 2010 the company withdrew the requests and acknowledged it did not need this state aid.

Nearly 20% of shares in GM are controlled by the main union, the UAW. The ultimate reason for this is because the USA does not have a good comprehensive public health service, so that healthcare benefits are an important part of employment contracts, and a significant extra cost to employers. The union shares are owned by a healthcare trust fund, VEBA, which was created by the union to take over responsibility for financing the healthcare for retired employees of GM (and other car makers including Chrysler and Ford). GM gave VEBA 17.5% of its shares and over \$18 billion to take over these liabilities; Chrysler and Ford have paid another \$17.6 billion.

General Motors: S1 statement 18 August 2010: link at

http://www.gm.com/corporate/investor_information/sec/

Financial Times June 16 2010 GM loses patience on Opel loan guarantees

<http://www.ft.com/cms/s/0/d225621e-7941-11df-92c1-00144feabdc0.s01=1.html>

UAW VEBA gets investment staff in order. LexisNexis October 19 2009

<http://www.allbusiness.com/company-activities-management/financial-performance/13285950-1.html>

Financial Times August 18 2010 GM filing begins road back to market

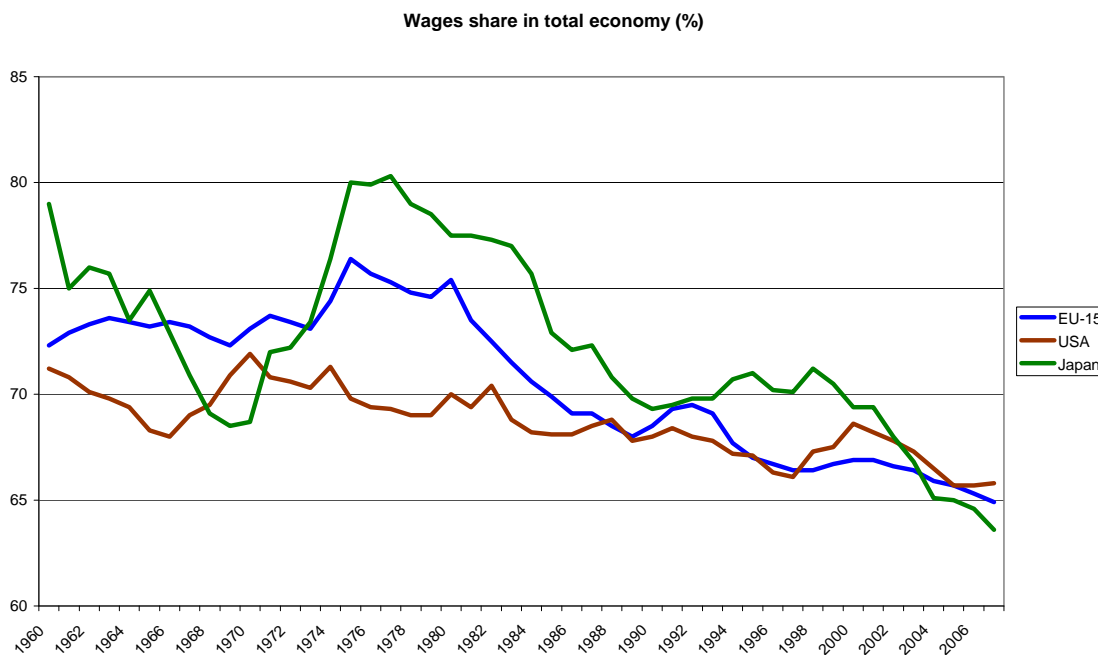
<http://www.ft.com/cms/s/0/67d61304-ab05-11df-9e6b-00144feabdc0.html>

3. Public services and equality

3.1. Growing inequality of profits and wages

Since the 1970s, there has been a world-wide decline in the share of wages in national income. In the high income countries of the north, the workers' share of the economy has declined to around 65% - compared with 70%-80% in the late 1970s.

Chart F. The shares of wages and profits



This decline means that workers have gained little even though productivity has risen massively. In the USA, for example, in the quarter century between 1980 and 2005, productivity increased by 71% while earnings rose only 14%. At the same time inequalities between the top and bottom incomes increased. The share of all income taken by the top 1% of people in the USA doubled from 8.4% in 1980 to 17.4% in 2005.¹⁹ Part of this shift is attributable to privatisations. The share of wages in the public sector is close to 100%²⁰ - there is no extraction of profit – as well as other general factors:

‘This growth in inequality between wages and profits is generated principally in private sector activity in production sectors, and is strongly linked to the effects of globalisation. Union bargaining positions weaken as companies become more internationally mobile. This is reflected in a decline in union organisation in all countries, which includes the effect of the relative growth in informal employment and casualisation: “In the developing countries, employment creation in the organised sector continues to lag behind the growth in the labour force, so that an increasing proportion of workers are dependent upon low productivity and casual employment in the informal sector.” It is also linked to privatisation, which moves economic activity from the public sector, where the share of wages is high, to the private sector, and so: “As a consequence of privatisation and deregulation, capital has gained at the expense of labour, almost everywhere, for profit shares have risen while wage shares have fallen.” It is linked to the growth of international finance: “concentration in the ownership of financial assets has probably contributed to a worsening of income distribution.”’²¹

3.2. Redistribution through benefits and public services

Public spending plays an obvious role in the re-distribution of income. Taxes are paid by people according to their income or spending, and benefits are paid to people who are unemployed or retired or caring for children. But public spending on services also has a very powerful redistributive effect.

The table below shows figures showing how this works in the UK. The distribution of 'original' income – before any state intervention – is highly unequal, with the average income of the top 20% about 15 times greater than that of the poorest 20% of households. This is what the market delivers. The table then adds incomes from benefits, which go mainly to poorer households – this improves equality significantly, more than doubling the income of the poorest 20%, so that the top-bottom ratio falls to 7%. This is what is expected.

The next stages are more surprising. Taxes are taken away, reducing the income people have left to spend. Direct taxes on income take most from the top groups – but indirect taxes, like VAT, take a much bigger proportion of the income of the poorest. The net result is that after all taxes have been paid, the distribution of income is almost unchanged – the top group still have about 7 times as much as the poorest group. So overall, the tax system in the UK (and in most countries) is not progressive.

The final step quantifies the benefit of public services, most importantly education and health. The value is calculated according to how much each group uses the service, and poorer households get greater benefit because they include more children and more people vulnerable to ill-health, like pensioners (although the top groups gain most from transport subsidies). The value of these services to the poorest group is almost as great as all their after-tax cash income from pay and benefits put together. The effect on inequality is as dramatic as the effect of benefits – the top-to-bottom ratio falls from 7 to 4.

So public services themselves are a substantial mechanism for creating greater equality. If other public services like roads, environment, etc, are allocated across households equally, the equalisation effect would be even greater.

Table 5. Redistribution of income through taxes, benefits and public services: UK, 2008/09

(£ per year)	Bottom	2nd	3rd	4th	Top	All households	Ratio Top/Bottom quintile
Original income	4 970	12 020	23 305	38 321	73 810	30 485	15
<i>plus</i> cash benefits	6 431	7 602	5 787	3 609	1 805	5 047	
Gross income	11 401	19 622	29 092	41 930	75 615	35 532	7
<i>less</i> direct taxes	1 270	2 523	5 046	8 798	18 255	7 178	
<i>less</i> indirect taxes	2 862	3 592	4 316	5 579	7 354	4 741	
Post-tax income	7 269	13 507	19 731	27 553	50 006	23 613	7
<i>plus</i> benefits in kind (health, education etc)	6 315	6 411	5 969	5 000	3 870	5 513	
Final income	13 584	19 918	25 699	32 553	53 876	29 126	4

Source: Andrew Barnard 2010 The effects of taxes and benefits on household income, 2008/09UK National Statistics. <http://www.statistics.gov.uk/CCI/article.asp?ID=2440> Other links on distribution of income and wealth are at <http://www.statistics.gov.uk/StatBase/Product.asp?vlnk=10336>

4. Infrastructure and ideology

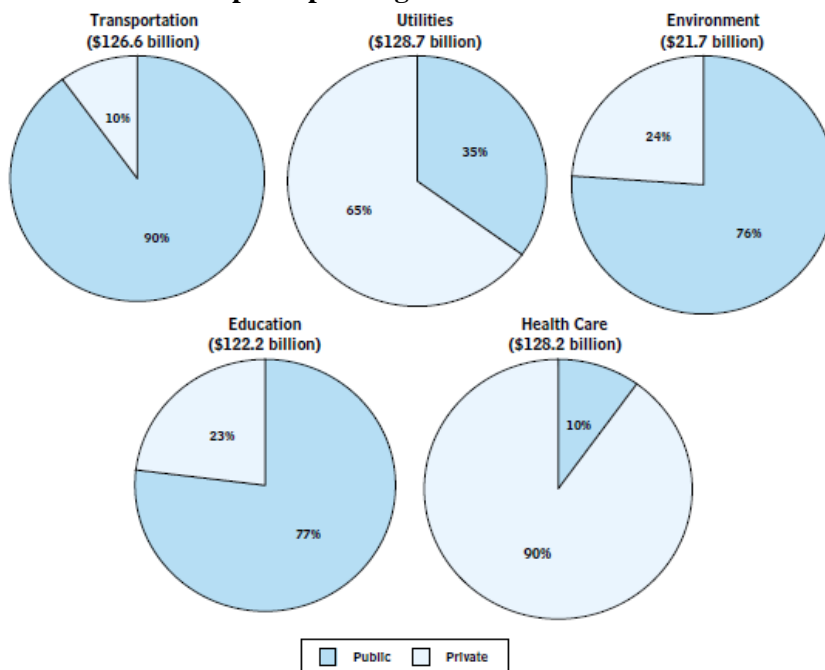
4.1. Infrastructure and other investment

The principal mechanism for financing infrastructure development, worldwide, is still through government and public sector: “A country, e.g. the United States, may feel the need for railways in connection with production; nevertheless the direct advantage arising from them for production may be too small for the investment to appear as anything but *sunk capital*. Then capital shifts the burden on to the shoulders of the state”²²

Box C. Public finance not PPPs

Even in the USA the great majority of investments in transport, education, and environment are made using public finance – and even 35% of utility investment is public sector, reflecting the dominant municipal role in the water sector despite the high levels of private operation in electricity and gas; only in healthcare is the public proportion low. The various forms of public-private partnerships (PPPs) contribute very little. According to a global survey by Siemens in 2007, PPPs only account for about 4% of all public sector investment: and “public sector loan financing is widely expected to remain the key financing instrument across Europe.”²³

Chart A. Capital spending on USA infrastructure 2007



Source: CBO 2009 Subsidizing Infrastructure Investment with Tax-Preferred Bonds
<http://www.cbo.gov/ftpdocs/106xx/doc10667/10-26-TaxPreferredBonds.pdf>

Box D. Stifling public infrastructure development

The efforts of the IMF and the World Bank to limit taxation and borrowing have contributed to a long-term fall in public investment in many developing countries since 1980. (Mckinley 2005) By comparison, China has been investing over 10% of GDP in infrastructure for many years, and India is now (2009) aiming to invest 9% of GDP per year in infrastructure.

Table 6. Public Capital Expenditures as a % of GDP

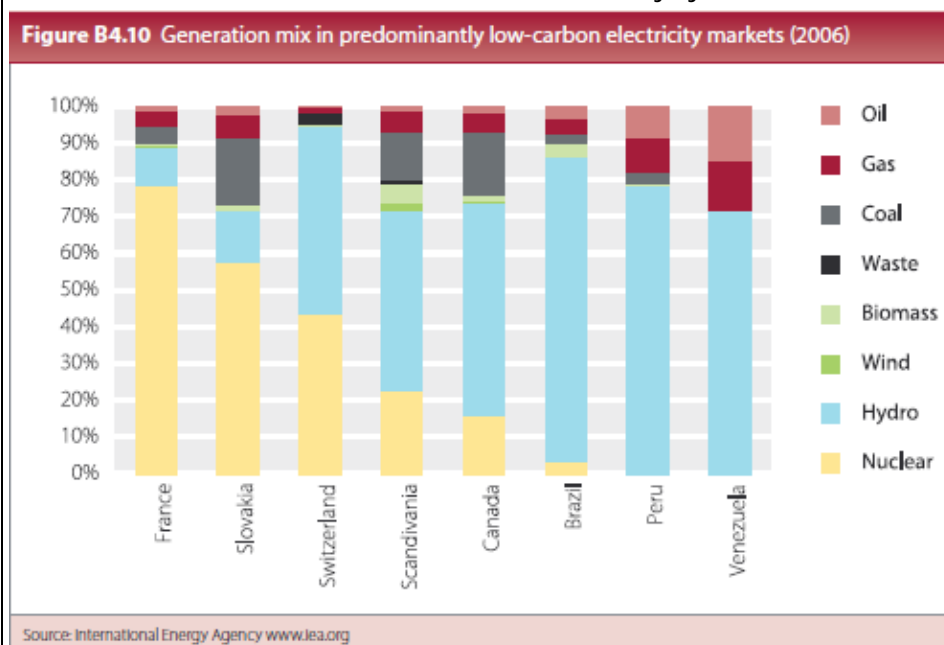
Countries	1980	1990	1998
Burundi	10.9	11.8	3.7
Cameroon	5.2	5.5	1.1*
Guatemala	5.1	--	2.3*
Indonesia	10.4	8.0	5.7
India	1.4	1.8	1.6
Jordan	12.1	5.8	5.7
Kenya	5.9	5.5	3.4
Pakistan	3.1	2.6	2.5
Peru	4.4	1.3	2.6
Philippines	3.4	3.1	2.2
Sri Lanka	16.6	6.1	5.3
Zimbabwe	1.4	2.8	2.1

Sources: *World Development Reports* 1999/2000 and 2000/2001, Table 14. Note: ‘*’ signifies 1997.

Box E. Green energy and fibre-optic telecoms

Policies for developing green energy also have the effect of supporting an increased role for public finance and/or public ownership. Official bodies in the EU are beginning to question whether the necessary investment can be delivered under a liberalised electricity system, because historically low-carbon energy has been delivered by state investment: “Several countries already source over 70% of their power generation from low-carbon sources. For these, investment has typically only occurred with substantial government intervention, even where markets have subsequently been liberalised. We should not accept the significant risks and costs associated with the current market arrangements [in the UK and EU]: changes to the current arrangements are both required and inevitable.”²⁴

Chart G. Countries with low-carbon electricity systems



The same is true in telecoms, where private network operators are also reluctant to make sufficient investment in the fibre-optic networks which are crucial to greater use of the internet. Governments are having to provide public finance: in Portugal, for example, the state provided 85% of the financing for a €1 billion investment programme. The EU’s 2020 strategy paper demands more public finance, calling on governments: “To draw up operational high speed internet strategies, and target public funding, including structural funds, on areas not fully served by private investments”.²⁵

4.2. Progressive shifts in debate

One victim of the crisis has been the credibility of the orthodox economic wisdom, especially in the global south. This reinforces the political developments in Latin America and India, as well as the relatively greater economic strength of Asia. There are also some factors even in the north requiring a re-consideration of the role of the state, notably climate change. So there is a shift in the terms of debate. Neoliberal assumptions are no longer regarded as sacrosanct.

The two boxes below give some examples of this. The first is a speech in 2009 by the chief economist at the African Development Bank, a body not previously noted for a critique of the neoliberal view of the role of the state. The second is a recent article from China, directed at trade unionists in Europe, concerning the role of the public sector.

Box F. Stronger role for state in African countries

“I believe that inasmuch as the current economic crisis exposes a deeper, long-term development problem, it creates in turn, both the necessity and the opportunity for a change of direction. My beliefs are based on the view that the crisis should be grasped as a turning point in the development path of developing countries, particularly here in Africa. In order to overcome the continent’s structural constraints and reduce its external dependence, it is necessary to reconsider the role of the state.

The market only works through incremental changes and small steps. However, developing countries need to stimulate investments by socializing risk, in order to achieve long-term structural transformation. The market has not been and will not be able to carry out these changes alone. The critical question now is not simply how developing countries can cope with the short-term immediate impact of the crisis. More important, the question is how can they emerge from the crisis in a stronger position? What policies should they be crafting now for the post-crisis era?

As pointed out earlier, macroeconomic policies across the developing world during the last several decades have been strongly influenced by the recommendations of the international finance institutions and bilateral aid donors who, in turn, were heavily influenced by the neoclassical school..... As argued by several scholars, the reforms based on this approach have largely failed to develop the private sector as the driving force for development.

I thus want to table for your consideration the need for a marked change in the approach to macroeconomic policies across the developing world and for one that recognizes that government has a vital role to play in restructuring the economy and in creating the conditions for a ‘take-off’ into sustained growth.....

Since economic development is about societal transformation, and not simply a technical economic problem to be left to economists, then governments must also act to ensure that the costs and benefits of adjustment are distributed in an equitable and socially acceptable manner. Failure to do this is very often correlated with social unrest and a general backlash against necessary reforms. For that reason, good public policies should necessarily be seen and used as tools for improving people’s wellbeing. In particular, effective public policies should seek to promote growth that is not only sustainable and equitable, but also, growth that is primarily driven by two key elements: employment creation and the promotion of private enterprise.....

Public investment—especially but not exclusively in traditional infrastructure such as transport, irrigation and energy networks—has a key role to play in driving the development process. This has tended to deteriorate in recent years as foreign assistance has been more directed toward social issues. Social concerns are important, but if progress on these is made at the expense of needed public investment in production sectors and economic infrastructure, the basis for sustained growth will be undermined. Given the severity of the current economic crisis, African governments are already being confronted with rising fiscal deficits as they try to maintain domestic demand and also attempt to boost infrastructure investments. These deficits will need to be accommodated over the short-to-medium term in order to mitigate increased hardship for the population and to keep development programs on track. Given the limited alternative sources of finance, foreign assistance will be critical in enabling these objectives to be met. African governments will still have to explore innovative ways of raising revenue, but they need to do so in ways that avoid regressiveness, and which take account of the still limited administrative capabilities of the state.....

Perhaps I should end by returning to my own beliefs which I shared earlier in my introduction: better and more effective states are needed to formulate and implement public policies if development is to succeed in the world's poorest countries. And I will repeat myself here: I believe that here in Africa, when the state just stands aside waiting for individual action and non-state forces such as entrepreneurship, comparative advantage, and cross-border capital inflows to bring development or transition, the result can be very negative, and in turn produce the sort of stagnation that can lock countries into their unfavorable positions in the world economy.

Extracts from "Public Policy and Economic Development in Africa" Speech by Mr Louis Kasekende Chief Economist, African Development Bank Group, 65th Congress of the International Institute of Public Finance August 13, 2009, Cape Town, South Africa www.iipf.org/speeches/Kasekende_2009.pdf

Box G. Europe's social and political crisis – a Chinese view

"In the recent Great Recession, a 1930s-type collapse was avoided by international governmental action to nationalise bank debts. But the burden of this gigantic bailout is now being heaped onto the shoulders of the working classes, undermining the entire post war model of class consensus. To restore capitalist profit rates, a draconian programme of cuts in the living standards of Europe's workers is underway.

This year has already seen angry public sector general strikes in Greece, Portugal, Italy, Spain and France. All over Europe, social unrest and class conflict is the order of the day. The discontent is galvanized by the fact that the people being made to suffer were in no way responsible for the economic crisis. It is small wonder that people take to the streets when the age of retirement is suddenly increased, their terms of employment are worsened and their jobs are threatened. Most people had become used to the idea that you retire from work before you die!

If European governments get their way, average living standards will fall by 10, 15, or even 25 percent. For the newly unemployed, the fall will be far greater. We are witnessing the breakdown of the entire post war way of life and the end of the expectation that things steadily improve from year to year, decade to decade, and from generation to generation.

Governments have so far been able to get the public sector cutbacks passed through parliament, assisted by the mainstream media and "experts" who almost universally argue that "there is no alternative". At present, the grass-roots revolts lack the leadership, power and determination required to stop and reverse the process. It is possible the disputes will escalate to the point where governments are forced to concede to demands from the street, or fall from office. In these circumstances concessions granted will embolden protestors all over Europe. But at the moment there is clearly a far more coordinated Europe-wide attack against the workers than a unified campaign of defence by the workers.

In excluding any alternatives to cutbacks in social spending, European governments feign ignorance of the significance of what is happening in China. Even those who are supposed to be socialists or social democrats often ignore facts that are staring them in the face. Rather than cutting living standards during the Great Recession, China's government and its public sector banks and corporations invested and expanded spending on health, education, infrastructure and pensions. As a result, general living standards rose. China's policies overcame the worst impact of the world economic crisis and attained precisely planned growth targets, in spite of the almost universal derision and scepticism of western "experts".

The working people of Europe, facing a reversal of all that has appeared normal and natural for decades, may ponder more deeply the root of the Chinese economic miracle than the "experts". The Chinese economy has been considerably strengthened during the biggest global economic downturn since the 1930s. This "miracle" is rooted in the fact that the public sector in China dominates the commanding heights of the economy. In fact, the past two years have seen a significant growth in the influence of the public sector in China. If European trade unionists, social democrats, and communists study the role of the public sector in China, they will be able to develop the alternative economic policies they need in order to counter the myth that there is no alternative."²⁶

China.org.cn, September 13, 2010 Europe's social and political crisis – a Chinese view by Heiko Khoo http://www.china.org.cn/opinion/2010-09/13/content_20917865.htm

5. IMF and EC campaigns against public spending

Two international institutions – the IMF and the EU - have been arguing strongly for 'exit strategies' to unwind the stimulus packages. These strategies have been powerfully focussed not so much on the desirability of reducing public deficits as on the need to avoid increases in public spending. This reflects the policy concern of both institutions, which pre-dates the crisis, that public spending was already rising too fast, and most of all that demographic changes were going to increase public spending throughout northern countries.

In June 2009, for example, the IMF assessment of the impact of the crisis on government spending and borrowing included a long section on the ageing populations of the north, and warned that: “in spite of the large fiscal costs of the crisis, the major threat to long-term fiscal solvency is still represented, at least in advanced countries, by unfavourable demographic trends..... These increases have come on top of an already rising spending trend, in real per capita terms and also relative to GDP, during this decade”²⁷ When the EU council of ministers issued an economic policy statement in May 2009, it focussed almost entirely on the demographic impact on public spending, but barely mentioned the economic crisis.²⁸

Thus the IMF says of the rescue and stimulus packages that, coupled with the fall in tax revenues, they have increased deficits in high income countries by on average 7.5% of GDP. The demographic changes are expected to lead to increases in spending of a further 4-5% of GDP in high income countries.

Table 7. Effects of crisis on primary public spending (IMF estimates)

	Primary public expenditure as % of GDP, 2007	Annual real growth 2008-2010: Primary public expenditure	Annual real growth 2008-2010: GDP	Average adjustment called for by 2030 by IMF
High-income countries	35.8	4.30%	-0.20%	-8.70%
Developing countries	24.5	9.30%	5.10%	-2.75%

Source: IMF 2010²⁹

The IMF also notes that the reforms it says are necessary to reduce healthcare spending have not been implemented. It says:

“...bold reforms are needed to offset the projected rise in age-related outlays, particularly health care. In pensions, a further increase in statutory retirement ages of two years could offset the projected rise of spending of 1 percentage point of GDP over the next 20 years in advanced economies. In health, the challenge is greater, and has so far been underestimated, particularly in Europe. New staff projections show that health spending could rise by 3½ percentage points of GDP over the next 20 years in advanced countries. Reforms are needed to address supply-side incentives, limit public benefits, or reduce the demand for public health services. But while many countries have managed to reform significantly their pension systems, the difficulty of health reform is underscored by the dearth of prominent reforms in advanced countries aimed primarily at reducing spending.”³⁰

In all other public spending, the IMF calls for, as a target, a reversal of the growth in public spending as a proportion of GDP, through a 10 year freeze, and specifically encourages a freeze on the wages bill:

“In other spending areas, in addition to allowing stimulus spending increases to expire, a possible policy goal could be to freeze spending in real per capita terms for 10 years. This would save 3–3½ percentage points of GDP. It would require deep spending reforms. Containing the wage bill has in the past proved to be key to successful fiscal consolidation.”³¹

The European Commission more simply continues insisting on the existing limits on public deficits (3% of GDP) and public debt (60% of GDP). The consequences of this are already apparent across Europe, with cuts in spending, services and jobs, and wage freezes and cuts for public employees.

The outcome of these policy choices in all countries will make a very large difference to the outcomes in terms of the future path of public spending as a % of GDP. If these policies are implemented, the clock will literally be turned back, and the path of public spending in the north may be forced flat again. But these policies clearly imply major conflict, not only with political pressures for higher spending, but also with the socially and economically most efficient options. If not, it seems likely to increase steadily.

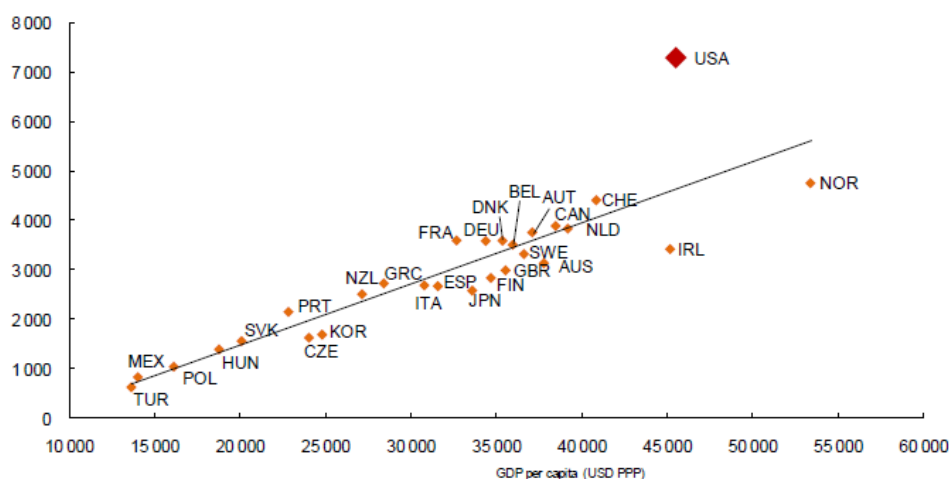
The specific targets identified by the IMF and EU are healthcare and spending. In healthcare there is already evidence of widespread political contests, with some success in defending or extending public healthcare.

6. Healthcare

6.1. State healthcare vs private healthcare

The higher the GDP per capita, the higher is spending on healthcare. This is a very strong relationship, as shown in the chart.

Chart H. Health expenditure per capita and GDP per capita, OECD countries, 2007



Source: OECD Health Data 2009

The USA healthcare system, based on private insurance and private provision, supplemented by a range of government subsidies, stands out for its abnormally high total expenditure. In 2007 the USA spent 16.0% of GDP on healthcare, far ahead of any other OECD country and nearly twice the OECD average of 8.9%. This is not due to greater needs: for example, only 12.5% of the population is over 65, compared with 16.7% in Europe and 21.5% in Japan; and people are no more likely to be sick than in other OECD countries. The excess expenditure is a result of much higher prices charged for branded drugs and hospital procedures; much greater use of diagnostic tests such as scans and some surgical operations; and higher spending on administration.

This higher spending does not produce better results: there is no evidence of any medical gains from the additional operations and tests, USA pharmaceutical companies are less innovative than European companies, and there is much lower use of computer technology such as electronic patient records. The system is less effective: in 2006 the overall life expectancy in the USA was 78.1 years, lower than all OECD countries of similar wealth, and below some developing countries

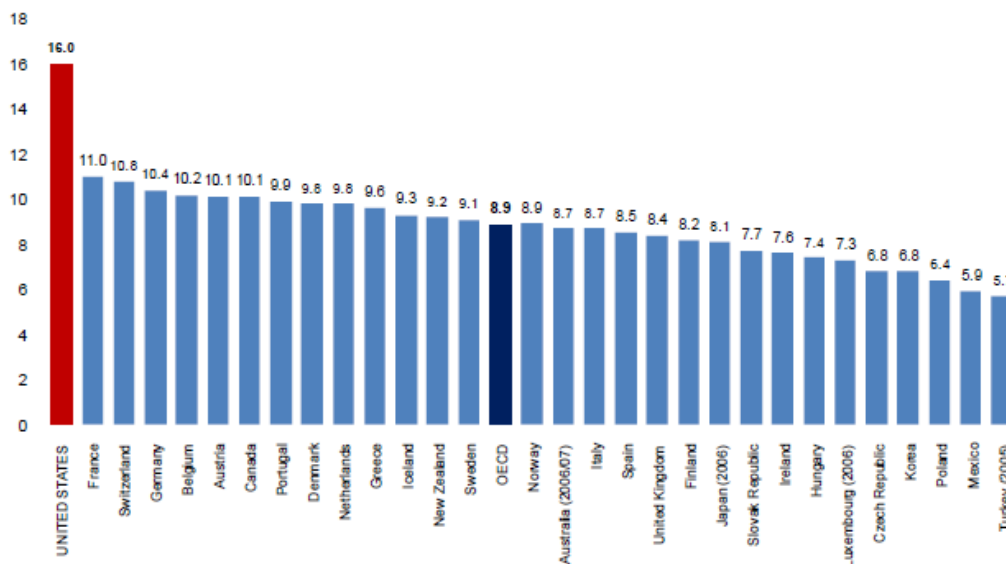
including Cuba and Costa Rica; the USA infant mortality rate was 6.7, higher than all other OECD countries except Mexico and Turkey, and more than double the rate in the Czech republic, Finland, Iceland, Japan, Norway, Portugal and Sweden. Of all OECD countries, only the USA, Mexico and Turkey have not achieved universal coverage.

6.2. Public spending is more effective than private spending

The data includes both public and private spending. Public spending represents the great majority in all OECD countries, except Mexico and the USA. An examination of comparative data on the USA and other OECD countries strongly suggests that a healthcare system based on private spending is less efficient and less effective than systems based on public finance. A recent analysis found that public spending on healthcare has a positive effect on economic growth whereas private spending on healthcare does not (Beraldo et al 2009).³²

In the absence of a publicly financed health service, collective financing for healthcare may fall on employers either through legislation or through collective action by workers. In the USA, healthcare benefits are important elements in collective bargaining, and a key benefit of union organisation, as unions negotiate employer-funded schemes to provide security against ill-health. The cost of this insurance then appears as a higher level of indirect labour costs, on average 12% of total wages. This is a similar effect to employer contributions to social insurance schemes, except that it is not uniform across employers and not compulsory. Companies providing benefits thus carry higher costs than companies in other countries where healthcare is publicly financed (they also carry higher costs than those which do not provide healthcare benefits). General Motors says that its healthcare costs are equivalent to between \$1,500 and \$2,000 of the price of every car sold.

Chart I. Health expenditure as a share of GDP, OECD countries, 2007



Source: OECD Health Data 2009.

Chart J. Health expenditure per capita US PPP \$, 2007, OECD

Source: OECD Health Data 2009

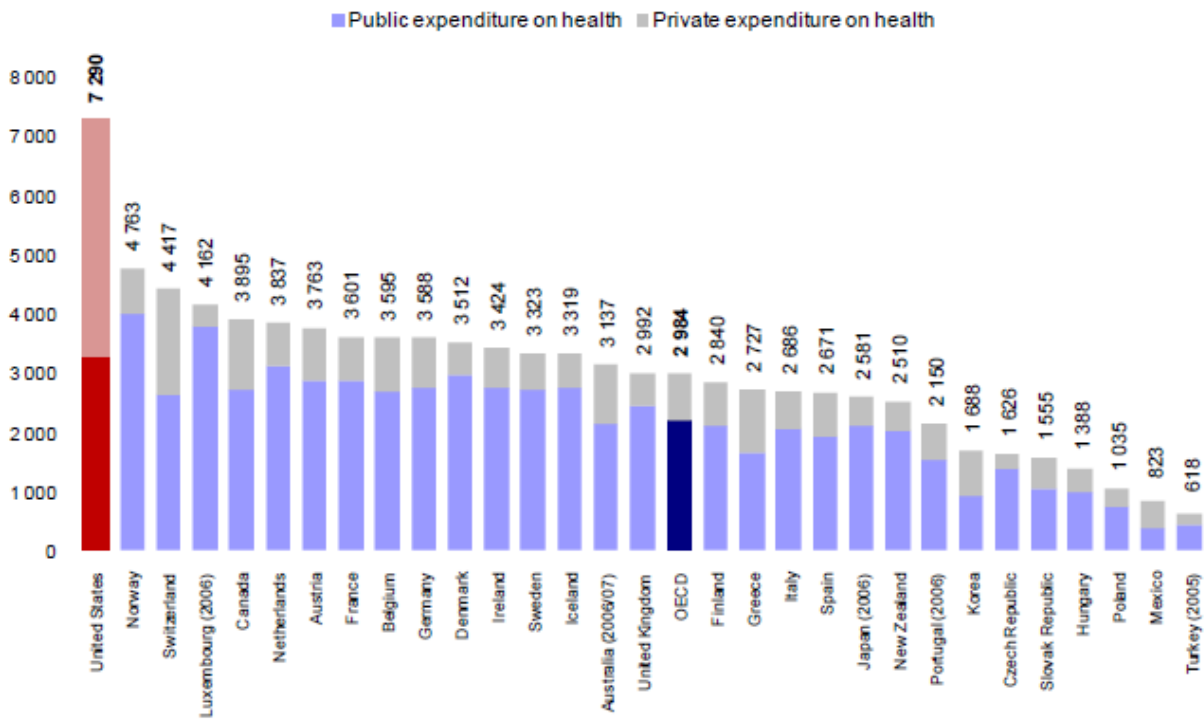


Table 8. [Infant mortality, Deaths per 1000 live births, 2006, OECD](#)

Source: OECD Health Data 2009

Australia	4.7
Austria	3.6
Belgium	4.0
Canada	5.0
Czech Republic	3.3
Denmark	3.8
Finland	2.8
France	3.8
Germany	3.8
Greece	3.7
Hungary	5.7
Iceland	1.4
Ireland	3.7
Italy	3.7
Japan	2.6
Korea	4.1
Luxembourg	2.5
Mexico	16.2
Netherlands	4.4
New Zealand	5.2
Norway	3.2
Poland	6.0
Portugal	3.3
Slovak Republic	6.6
Spain	3.8
Sweden	2.8
Switzerland	4.4
Turkey	22.3
United Kingdom	5.0

6.3. The Political battles over healthcare

The strength of these positive relationships between publicly financed healthcare and economic growth and health outcomes is clear. But the actual path of public spending, and the role of the state and market in healthcare, are subject to intense institutional and political processes and lobbying. Three recent examples of this are the intensive corporate lobbying against attempts to introduce healthcare reform in the USA; the mass political mobilisations against proposals in central European countries for greater elements of private insurance and private provision; and the influence of the pharmaceutical companies on WHO and national government policies on the swine flu.

The attempt by the Obama government to introduce healthcare reform in the USA to extend coverage and increase the role of public finance was bitterly contested by private healthcare companies. The conflict was much greater than over the rescue packages for the financial sector or the stimulus package. The version of healthcare reform that was finally adopted remains based on employers' healthcare plans, a marginal role for the state, and relatively little new taxation. The new law obliges all employers with more than 60 employees to provide healthcare insurance, or else pay a levy to subsidise individual purchase of insurance. It is expected to increase the proportion of the working population covered by some form of health insurance to over 95%. These subsidies will increase annual public spending by \$216bn. by 2019, and taxes by \$41 billion, but projected savings in costs means that the budget deficit is forecast to be reduced.³³

In the last few years, since about 2006, there have been successful campaigns against commercialisation of public health services in the four central European countries – Czech republic, Hungary, Poland and Slovakia. In each country there were proposals to introduce some combination of patient fees, commercialisation or privatisation of hospitals and clinics, and a switch from state insurance to private insurance funds. In each country there has been vigorous public resistance which has succeeded in halting or reversing these proposals.

Slovakia was the first country to introduce the reforms, but has now abandoned them. In 2003, user fees were introduced; two years later, health insurance funds and hospitals were converted into commercial entities, helped by the state paying off their debts of €1.1 billion Euros.³⁴ But following widespread public opposition, a new government was elected in 2006, which abolished user fees. Since then, Slovak health policy has continued to move against the neo-liberal style of reforms, by insisting that health insurers must be non-profit and by explicitly rejecting any privatisation.³⁵

The Czech health-care system is “remarkably efficient” Only 6.8% of the country's total gross domestic product was spent on health care in 2006, one of the lowest levels for OECD countries. The health of the population has improved rapidly in the past 20 years: life expectancies increased by 5.4 years for men and 4.6 years for women, compared with average increases of 4.4 and 3.2 years, respectively, in richer countries. The infant mortality rate is 3.14 deaths per 1000 livebirths -well below the EU average and among the lowest in the world.³⁶ Despite this, the then government introduced patient fees in January 2008, and proposed policies which would privatise the health insurance system, and convert teaching hospitals into commercial companies. There was strong public opposition, led by a civil society movement, the Coalition for Health, which included a general strike in June 2008 involving nearly 1 million workers, and demands from patients' associations and others for abolition of fees and renationalisation of insurance into a single state fund. A court case trying to get the fees ruled unconstitutional failed, but the government lost all the regional elections in October 2008, with a record turnout of 40% of voters. The new regional governments then decided not to charge fees to patients in regional healthcare facilities and pharmacies; the government sought a court ruling that this was unconstitutional. Inconclusive elections in May 2010 resulted in a continued centre-right coalition.

In 2006 the Hungarian government proposed health service reforms which included hospital closures, the introduction of fees, and the privatisation of health finance by the creation of regional, part private, insurance funds. The parliament passed a first law to introduce for patient fees, and fees for other public services, including university education. Campaigns gained enough signatures to force two referenda in 2008. The first resulted in a large majority against the fees; the government abandoned the plans for private insurance companies without waiting for a certain referendum defeat. In 2009, Hospinvest, a private company in which the EBRD took an equity stake of 30%, had already got contracts to run nine state hospitals and clinics, filed for bankruptcy. Hospinvest was set up in 2007 to take advantage of the expected privatisation, which it sold to private Hungarian investors before the bankruptcy.³⁷

In Poland, proposals to commercialise and privatise hospitals were introduced by the government at the start of 2008. The plans also included a list of medical procedures that the state will pay for, and those which patients would have to pay for. They met with strong resistance from the public, with doctors, unions and others combining to reject the plans as tantamount to privatisation. The president of Poland also objected to the proposals, and at the end of 2008 he vetoed the legislation and called for a referendum, saying that he "would not allow for the privatization of the health care system....Human health and life is not a commodity."³⁸The private healthcare sector in Poland is seen as an oligopoly with a bad reputation: "clients of private health centres or hospital complain more and more often about the quality of services".

These policy changes in response to public pressure are themselves being resisted by private health companies. Investment treaties, and possibly the EU Treaty itself, are being used by multinational companies Penta and Eureka to try and force the Slovak government to pay compensation for reversing health privatisation and liberalisation policies. Similar action has been used against the Polish government by Eureka to win compensation worth nearly €2 billion Euros and a policy commitment to further privatisation.³⁹

The same processes and conflicts are visible at international level. The WHO is subjected to constant attention from pharmaceutical and healthcare companies whose business is affected by international policies and advice. In the case of the swine flu scare in 2009, this lobbying had the effect of persuading the WHO, through a committee whose members and proceedings are secret, to declare a global 'pandemic' – in the process, WHO was persuaded to change its definition of a pandemic so that it no longer required "enormous numbers of deaths and illness". The WHO declaration in turn influenced many governments to buy massive stockpiles of the drug Tamiflu, which was claimed to be the only effective treatment available. As a result, the drug companies got profits of \$7bn to \$10bn., according to investment bank JP Morgan. An investigation by the British Medical Journal (BMJ) found that "WHO's guidance on the use of antivirals in a pandemic was authored by an influenza expert who at the same time was receiving payments from Roche, the manufacturer of oseltamivir (Tamiflu), for consultancy work and lecturing."⁴⁰ The BMJ commented on 'the scale of public cost and private profit', and noted that : "countries like France and the United Kingdom who have stockpiled drugs and vaccines are now busy unpicking vaccine contracts, selling unused vaccine to other countries, and sitting on huge piles of unused oseltamivir (Tamiflu)."⁴¹

7. Pensions

7.1. The risks to workers

Many high income countries have been trying to 'reform' their various pension schemes. The ageing of populations due to the low birth-rates and longer life expectancy, is described as a 'demographic timebomb' which threatens economic growth unless reforms are made. These arguments have been used especially strongly against public sector pension schemes and social security pension schemes financed through taxation or social insurance.

One part of the argument is that economies cannot afford to pay for pensions out of taxation, (or out of current contributions in a pay-as-you-go scheme), so pensions should be paid for out of profits from investments. But the pensions are paid out of national income either way – out of financial profits if they are

funded, through general taxation on all income if they are ‘pay-as-you-go’. The pensions would only become more ‘affordable’ to the national economy if they are reduced in value.

There are two key elements to these ‘reforms’, both of which make pensioners carry greater risks:

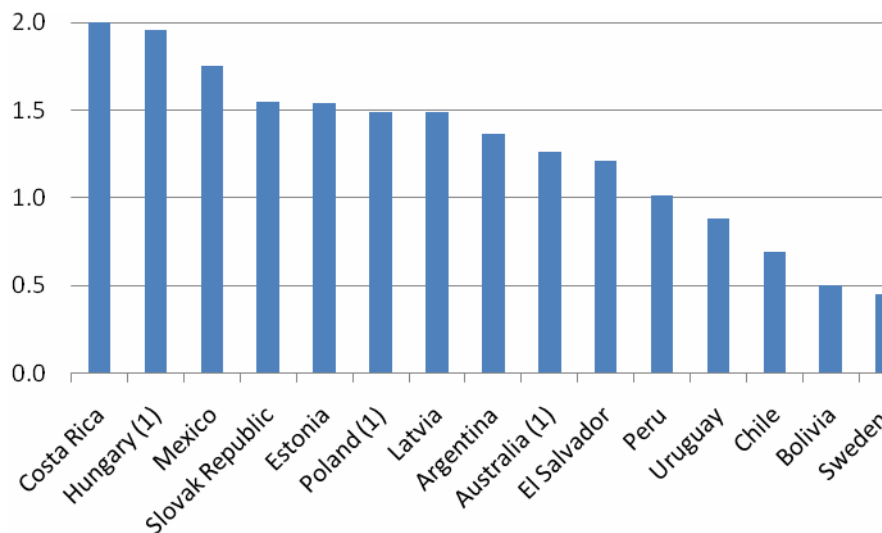
- (1) instead of being paid for out of current contributions (pay-as-you-go), they are instead invested in a fund, and the accumulated profits from that fund are used to pay pensions (funded scheme)
- (2) they do not guarantee that a pension will be a certain proportion of a worker’s salary (defined benefit scheme), but instead say the contributions are fixed, and the level of the pension will be determined by the profits made from investing the fund (defined contribution scheme)

The effect of the reforms is thus to link the value of pensions to the level of profitability. If schemes are invested through a fund and the value of investments falls, then employers and/or workers have to pay higher contributions to keep the fund solvent – or cut benefits. In ‘defined contribution’ schemes, where benefits are not fixed, then the level of pensions falls in response to the falling returns of the fund.

Workers are especially vulnerable where workers have to invest through personal pension funds, as in Chile.⁴² The effect of this investment risk on workers’ pensions is very large. A recent report covering pension funds in OECD countries estimates that the returns from investing a fund can vary between 32% and 74%, a huge variation which could mean the difference between a comfortable pension or “borderline poverty”.⁴³

Another risk is that private pension funds can charge very high fees for administering the funds. The figure below shows how this can vary: the OECD comments that “if pension funds’ members in Hungary paid fees as low as in Sweden, their pension benefits would be 30% higher”.⁴⁴

Chart K. Administrative charges in selected OECD and non-OECD countries, 2007 (as a % of total assets)



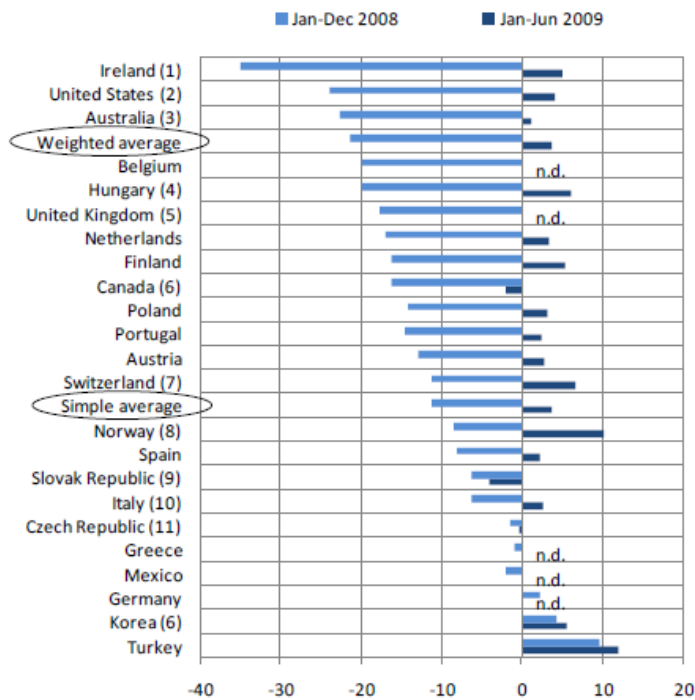
7.2. Pension fund deregulation

One form of financial deregulation has been the relaxation of traditional restrictions on pension funds investments. These were typically restricted largely to investing in government debt, with extra incentives in the form of tax relief for the funds, which had multiple advantages for the funds of security and long-term assets to match their long-term liabilities, and for the state a reliable source of demand for bonds and other government debt. Deregulation meant that funds were able to diversify into national and international equity investments, providing extra funds for private capital at the same time as governments were reducing their borrowing.

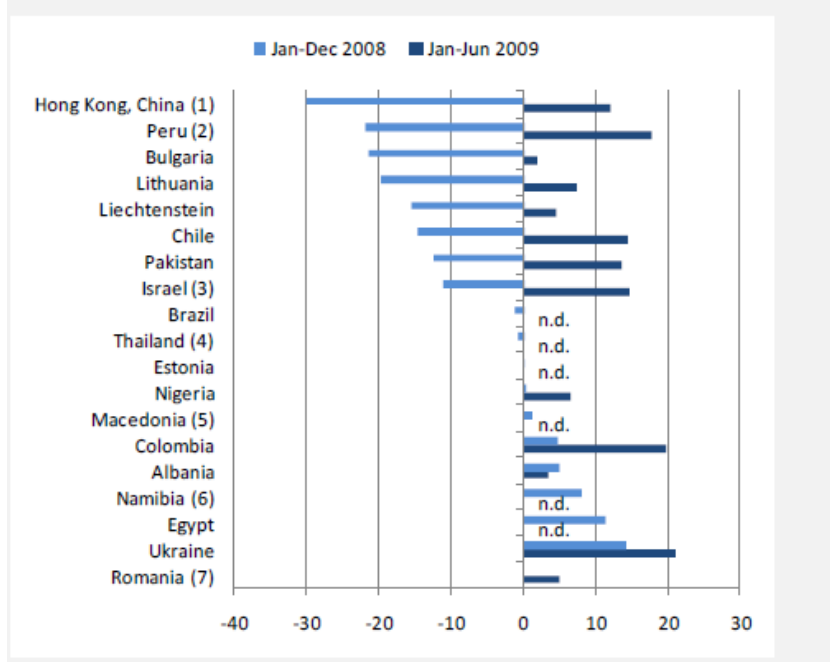
One result has been that some of the largest pension funds have themselves become leading financiers of privatisation in its various forms: in Chile, for example, one-third of the water companies and a major electricity distribution company, are now majority-owned by the Ontario teachers pension scheme⁴⁵, and in the UK, local government pension funds alone own as much as 3.5% of companies whose main business consists of contracted-out public service work, such as Serco and Capita.⁴⁶

The recession has already had an impact on pension funds, because of the fall in the value of company shares. In 2008 pension funds in OECD countries lost 23% of their value on average, the equivalent of USD \$5.4 trillion, (although there has been some recovery in 2009 as stock market prices rose again). Pension funds in developing countries were also hit, although to a lesser extent where their stock markets were less affected by the economic crisis.⁴⁷

Figure 1. Pension funds' nominal investment rate of return in selected OECD countries



Pension funds' nominal investment rate of return in selected non-OECD countries



Source: OECD Pension markets in Focus Issue 6 October 2009

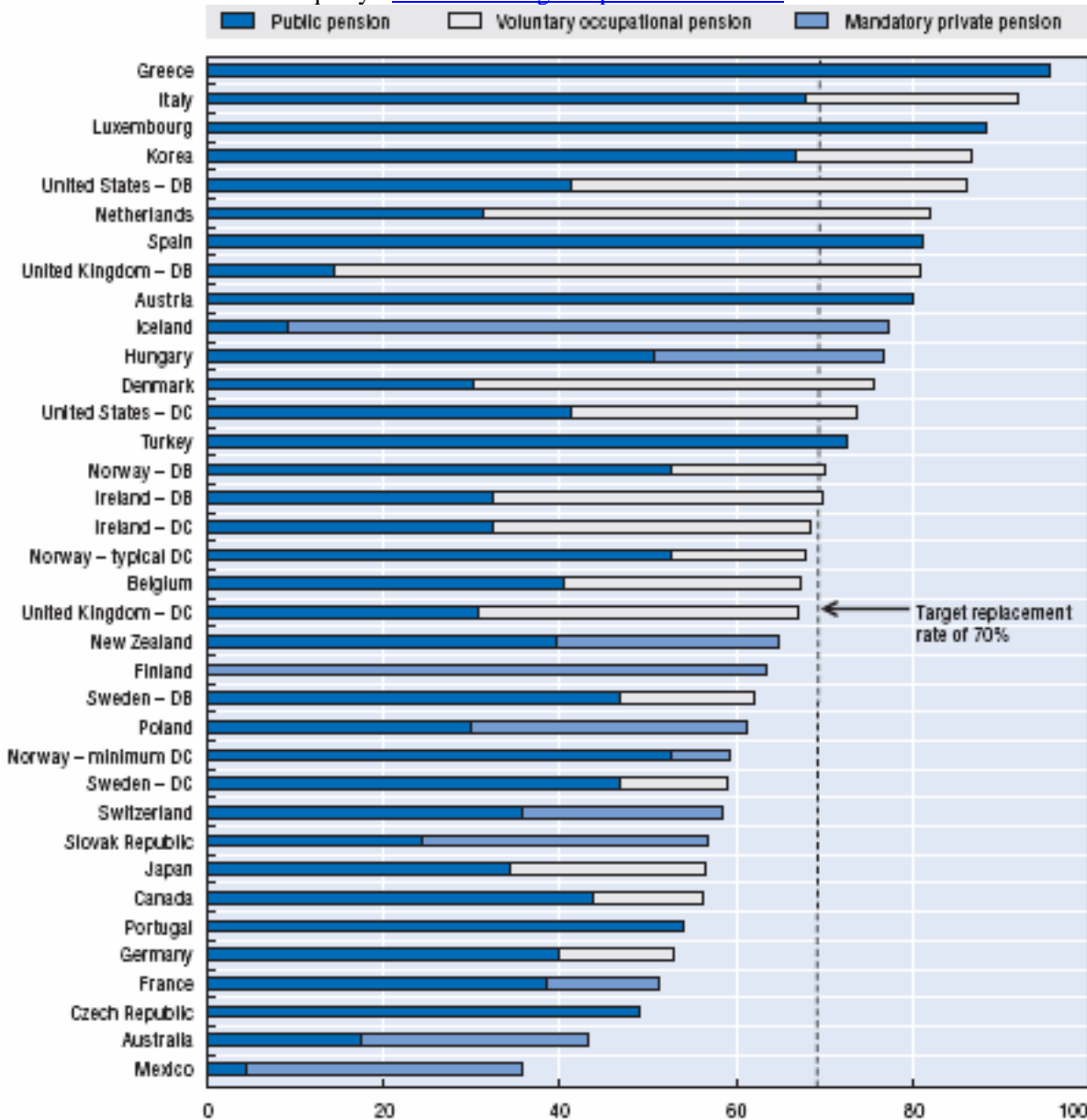
<http://www.oecd.org/dataoecd/30/40/43943964.pdf>

7.3. The relative importance of state pension provision

Even in OECD countries, the state pension is far more important as a way of providing a decent level of pensions, as shown in the chart below. Ultimately, governments carry some of the risk if private pensions are cut in value, because (a) pensioners will pay less tax, and (b) workers may become entitled to means tested benefits, so government spending increases.⁴⁸

Chart L. Pensions as a proportion of workers income, from state and private schemes

Source: OECD Benefit adequacy www.oecd.org/daf/pensions/outlook



Box H. Netherlands – impact of reforms on workers’ health

These reforms not only impact on workers income but also on their health. The Netherlands decided to change the pension rules for public employees so that those born in 1950 or later get worse pensions when they retire. A study found that after this change, depression rates among those born in 1950 or later were about 40% higher than among those born earlier and retiring under the old rules. Most of those affected reacted by working longer or saving more to try and restore the lost benefits. The study concluded that

governments should realise that "a sudden irreversible deterioration of future prospects can have serious consequences for the mental health of workers nearing retirement"⁴⁹ Continuing to work longer is one way of coping with the loss of income, but also has a similar effect in increasing the risk of depression.⁵⁰

Box I. Argentina: renationalisation of privatised pension funds

Argentina has renationalised its pension schemes since 2006. The country had developed a national pension scheme from the early 1900s, which expanded from covering 24,000 civil servants in 1904 to provide for 428,000 workers by 1944. In 1994, under pressure from the international financial institutions to reduce government debt, the system was reformed by creating private pension funds to which people had to pay contributions. These funds charged large administration fees, and were very unpopular.⁵¹ In 2006 the government restored a parallel state system, and then in 2008 renationalised the private funds. This also increased the government's assets - the funds owned 13% of all shares on the stock market, including 22% of the privatised Telecom Argentina. Control of the funds has helped Argentina initiate a \$21 billion public works programme as an economic stimulus, and increased government revenues: social security contributions increased by 62% in the year to March 2009, half of it due to pension contributions, as well as increases in receipts of VAT.⁵²

Box J. China: increasing state pensions to boost spending

China is increasing pension rights for millions of rural workers. These pensions are partly paid for from taxation, through government subsidies, partly through collective insurance schemes, and partly through individual savings. The government has also introduced state support for urban pensions through creating a new National Social Security Fund, and subsidising and guaranteeing the private pension schemes which already exist.⁵³

One reason for introducing new pension rights supported by public finance is to encourage people to spend more. Chinese workers save large proportion of their income to provide for retirement, and also to protect themselves against the risk of ill-health. As a result, Chinese workers spend less, which reduces the level of economic demand within China. The Chinese government is introducing new plans for publicly financed healthcare for the same reason.⁵⁴

8. Some comments

- As a matter of empirical observation and sober forecast, public spending as a % of GDP is currently at historically high levels of 40% in OECD countries.
- Globally, public spending is virtually certain to continue rising sharply, as the role of the state continues to grow in developing countries.
- Whether it continues to grow, or if the IMF can reverse it, will depend on political outcomes.
- There are economic as well as social arguments for maintaining and protecting public spending. These arguments apply to spending on services, benefits, and infrastructure. The benefits of 'temporary' spending in an economic crisis are not the only economic case.
- There are quite specific infrastructure issues, including climate change and access to water and sanitation which will require higher public investment, as well as demographic factors increasing need for healthcare.
- The crisis has weakened the ideological dominance of neo-liberals.
- Both benefits and services (and utility connections) are important instruments for reducing inequalities in societies.

Notes

- ¹ The link is not the same as the Keynesian effect of higher government deficits boosting demand and so stimulating investment. It is a link between public spending and growth, not between deficits and growth.
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