Going for Growth

The best course for sustained economic recovery

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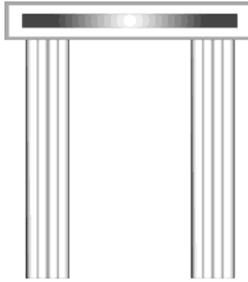

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Going for Growth

The best course for sustained economic recovery

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Preface

As the implications of the fiscal and economic crisis continue to affect western economies, much of the policy debate focuses on how best to promote recovery. Most agree that a strong economic growth potential will be central for a sustained recovery. Nevertheless, it is frequently asked whether further measures of fiscal stimulus should be tried. Or should political leaders abstain and rather pursue a sustained course of reform, curbing the size of the state and ensuring a framework of law which supports market economies?

This study considers the experience of six countries which undertook major economic policy reforms. It focuses on the structural role of the state and particularly on the size and quality of government and official institutions. It also reviews other elements which are central to reform. It suggests that a three-pronged strategy is needed to address today's crisis as well as to revert to sustainable growth and public finances. Such reforms must include the 'classic' array of fiscal and structural reforms, but also the strengthening of the rules and incentives which govern a market economy. Many industrialised countries will need to tackle the issue of big government.

I
Growth: What Benefits, What Strategies?

As many western economies face the wider economic consequences of the financial crisis and high levels of debt and deficits, increasing economic growth is increasingly seen as pivotal if countries are to emerge from the crisis, experience a sustained economic recovery and deal with the future policy challenges. In particular, higher growth potential:

- Helps the reduction of public deficits and debts through higher revenue and lower social expenditure commitments. Debt and deficit ratios are also becoming smaller when the size of the economy against which they are measured becomes larger.

- Helps demand and competitiveness to adjust in countries that have lived beyond their means. It is easier to cut back consumption and lower wages and to reduce excessive private debt without inducing a recession when the underlying growth trend is 3 per cent per annum than with only 1 per cent.

- Helps counter growth-reducing factors that increasingly affect industrialised countries. For example, population aging implies a shrinking labour pool and factors such as environmental policy may absorb a larger share of resources.

What strategies are known to lead to growth and what lessons can be drawn for today's economic circumstances? This study analyses the evidence from a range of countries which have benefitted from successful strategies for growth, including both industrial economies and emerging market economies. The experience of six countries which undertook major economic policy reforms is considered – four industrialised countries, including Sweden, New Zealand, Ireland and East Germany, and two emerging market countries, Chile and Brazil. The analysis focuses on the structural role of the state, and in particular the size of government and the quality of government institutions while also reviewing other important elements for reform. A number of policy lessons for growth orientated policy will be drawn from the experiences of these individual countries' reform for today's crisis countries and advanced economies more generally.

In fact, many of the countries analysed here have characteristics in common with today's crisis countries. For example, the sample countries, before they reformed, were characterised by such features as public finances in disarray, high public expenditure (at least relative to the stage of development), while economic growth and dynamism was stifled by poor public institutions and services and an adverse business

environment. Indeed while other features are also found, high public deficits and public spending are often particularly pronounced amongst advanced countries. A three-pronged strategy is therefore necessary, one which focuses on i) public finances and public expenditure reduction, ii) structural reforms notably in labour, product and financial markets and iii) strengthening the institutional environment of the economy (property rights, judiciary, etc.) so as to increase incentives to work, invest and innovate.

Such reforms build confidence and stability via the rule of law rather than undermine these via ad hoc policy. But they require patience and consistency in the policy approach.

II
Crisis and Reform
Learning from the Past

For the many industrialised and emerging market countries which have undertaken important, growth enhancing reforms, this has often followed their experience of economic crises over recent decades. When seeking solutions for today's crisis countries and for tackling the low growth prospects in advanced economies more generally, a number of 'case studies' are particularly relevant. For advanced economies these include Ireland, New Zealand and Sweden which will be considered, and for emerging market economies the cases of Brazil and Chile will be considered.[1] We also include East Germany, which was a planned economy before the unification with West Germany in 1990 and is therefore a special case.[2]

Before these economies turned to their successful major reform programmes, they shared a number of common features: low or even negative economic growth with high unemployment, high fiscal deficits and rising public debt and a poor regulatory and business environment that stifled human and physical investment and innovation. Table 1 illustrates this pattern: pre-reform average growth was typically negative or very low between -3 and about 1 per cent. Unemployment rates were near or well into double digits. In industrialised countries, deficits were up to around 10 per cent and public expenditure ratios up to 65 per cent. Debt levels were well above 60 per cent up to about 140 per cent. Economic freedom indices such as that of the Fraser institute (which includes economic and institutional elements) suggest that in general these were unfree or very unfree economies.

During the crisis, these countries undertook major macroeconomic and structural reforms (see also Tanzi and Schuknecht, 2000; Hauptmeier et al, 2007). As regards the macroeconomic, all of the countries undertook major fiscal consolidation. Most countries introduced mainly expenditure based changes/adjustment via cuts in public wages, employment and social benefits. As regards structural reforms, all countries liberalised labour and product markets, reduced trade barriers, privatised government enterprises, streamlined public administrations, reduced regulation or significantly strengthened government institutions (see Annex to Table 1).

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[1] Chile implemented substantial economic reforms starting in the 1970s. The political circumstances that led to these reforms were however much criticised.

[2] In East Germany important initial reforms came immediately after unification. Major further reforms for all of Germany were only undertaken in the early 2000s (see end of section below).

Table 1: International success stories

	Economic growth in %$^{+}$		Unemployment in %$^{+}$		Public budget balance in % of GDP^{+}		Public debt level in % of GDP^{+}		Public expenditure ratio in % of GDP^{+}		Institutions (Economic Freedom Index)*	
(period of reforms in parentheses)	ante-reforms	post-reforms	ante-reforms	post-reforms	ante-reforms	post-reforms	ante-reforms	post-reforms	ante-reforms	post-reforms	ante-reforms	post-reforms
Ireland (from 1986)	**1.2** (1984)	**9.8** (1998)	**16.6** (1986)	**4.3** (2002)	**-10.6** (1984)	**2.3** (1999)	**103.5** (1987)	**27.5** (2005)	**50.9** (1984)	**31.9** (2002)	**6.2** (1985)	**8.1** (1995)
New Zealand (from 1973 and 1988)	**-0.1** (1990)	**4.0** (1996)	**10.0** (1993)	**3.9** (2006)	**-7.3** (1983)	**1.6** (1990)	**62.0** (1992)	**40.2** (1999)	**40.7** (1984)	**29.4** (2003)	**6.4** (1960)	**8.35** (2000)
Sweden (from 1991)	**0.0** (1991)	**3.5** (1998)	**9.3** (1995)	**5.4** (2002)	**-7.9** (1994)	**1.0** (2000)	**72** (1994)	**41** (2008)	**64.8** (1993)	**50.2** (2008)	**6.6** (1990)	**7.3** (2004)
Brazil (from about 1990)	**-0.04** (1990) **1.7** (2000)	**>4.1** (1995 and 2006)	**11.3** (2003)	**6.6** (2012)			**80** (1990)	**45** (1996)			**4.2** (1990)	**6.2** (2005)
Chile (from 1974 and in 1980s)	**-2.7** (1974)	**8.8** (1993)	**17** (1993)	**6.7** (1996)	**-30** (1973)° **2.3** (1982)°	**3.9** (1995)	**84** (1974) **141** (1986)	**33** (1980) **5** (2007)	**34.1** (1982)	**19.9** (1995)	**3.6** (1975)	**7.4** (1995)
East Germany (since 2000)	**1.2** (2002)	**1.7** (2005)	**18** (2005)	**11.3°** (2011)			**35**** (2005)	**29**** (2008)			**7.4^{++}** (1995)	**7.4^{++}** (2009)

Sources: Eurostat, IMF, European Commission, Statistisches Bundesamt, World Bank, Fraser Institute, Statistics New Zealand, IMF Historical Public Debt Database, Bundesagentur für Arbeit, Tanzi and Schuknecht, 1997.

Note: $^{+}$ five-year averages, in parentheses middle year of average; Ante-reforms = lowest average, post-reforms = highest average. ° specific value (no average) * A larger index value indicates a better quality of an institution (year of survey in parentheses). ** Only public debt of federal states and municipalities. ++ Values are for Germany in general

Annex to Table 1: Summary on implemented reforms (selection)

	Institutions	Liberalisation	Macro stabilisation
Ireland (reforms since 1986)	▪ Strengthening of public administration and property rights	▪ Deregulation of goods and financial markets, market opening ▪ Increasing competition ▪ Social pact between trade unions, employers and the government ▪ Labour market reforms	▪ Reduction of corporate tax rates ▪ Reform of the education system ▪ Reduction of public expenditures ▪ Consolidation of public finances
East Germany (reforms since 2000)	▪ Adoption of West German institutions and public services	▪ Labour market reforms (Hartz Reforms)	▪ Investment in infrastructure ▪ Promotion of research and development
Sweden (reforms since 1991)		▪ Deregulation of goods and service markets ▪ Rising competition ▪ Privatization of public enterprises ▪ Outsourcing of public duties ▪ Active labour market policy	▪ Fiscal budget rule ▪ Independent monitoring of public finances ▪ Reduction of public expenditures ▪ Tax reforms ▪ Consolidation of public finances ▪ Stabilization of the banking sector
New Zealand (structural change since 1973, further reforms since 1988)	▪ Strengthening of public administration and property rights ▪ Independent central bank	▪ Abolishing of almost all farming subsidies and tariffs ▪ Deregulation of product and financial markets ▪ Privatization of public enterprises ▪ Free floating of exchange rates	▪ Consolidation of public finances ▪ Reduction of public expenditures ▪ Reduction of tax rates
Chile (reforms since 1974)	▪ Independence of central bank ▪ Strengthening of public administration and property rights	▪ Unilateral reduction of tariffs ▪ Liberalization of international trade ▪ Liberalization of goods and financial markets ▪ Labour market reforms ▪ Privatization of public enterprises	▪ Capital-based retirement schemes ▪ Fiscal budget rules ▪ Reduction of tax rates ▪ Consolidation of public finances
Brazil (since 1990)	▪ Strengthening of public administration and property rights ▪ More independence of the central bank	▪ Labour market reforms ▪ Reduction of tariffs and other barriers to trade ▪ Liberalization of goods and financial markets ▪ Rising competition by breaking public monopolies	▪ Consolidation of public finances

A picture of the remarkable success which followed these reforms is visible in Table 1: [3]

- Economic growth accelerated significantly within very few years. Ireland and Chile posted growth near 10 per cent in the late and early 1990s respectively. Brazil, Sweden and New Zealand experienced a strong growth rebound as well during and after their reform periods. Unemployment ratios declined within some years to half their crisis levels or even less. Ireland, for example, posted over 16 per cent unemployment in the pre-reform years (mid to late 1980s) and only about 4 per cent a good decade later.[4]

- Public deficits declined strongly and Ireland, New Zealand and Sweden even posted surpluses on average in the post reform period. The turn-around in the public debt path was strongest in the cases of Chile, Ireland, Brazil and Sweden. Public debt went on a rapidly declining path with Sweden's debt going down by more than 30 percentage points of GDP, Ireland's by over 70 percentage points of GDP (see Figure 1) and Chile's by over 130 percentage points. The main reason for the fiscal turnaround was a much lower public expenditure ratio: Sweden, New Zealand and Ireland's ratio went down by more than 10 per cent of GDP. [5]

- The fiscal, structural and institutional reform process had also significantly changed the perceptions of the role of the state. Institutional indicators of the business environment and economic freedom have improved remarkably, especially in the emerging market economies but also in the industrialised countries. In fact, the economic freedom indicators of about 6-7 in the emerging market economies of Brazil and Chile are not far below the 7-8 in the four advanced economies of Ireland, Sweden, New Zealand and Germany.

The example of East Germany teaches two additional lessons, both very relevant for the crisis countries of this decade. First, East Germany took over the institutional infrastructure of West Germany and, thereby, some of the strengths of its economy. But at the same time it also took over the unreformed welfare state and product and labour markets**.** Reforms were hence not comprehensive enough as only one of the three pillars identified above was addressed.

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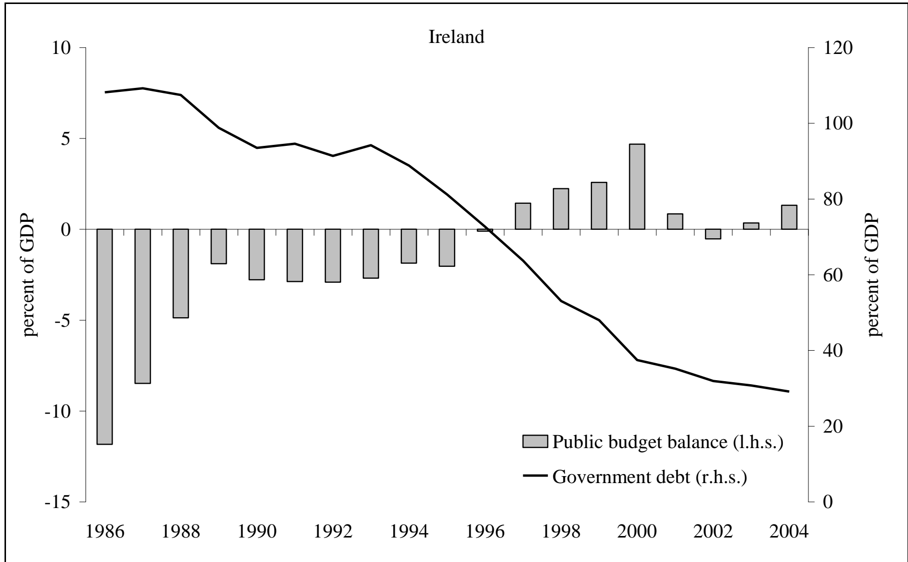
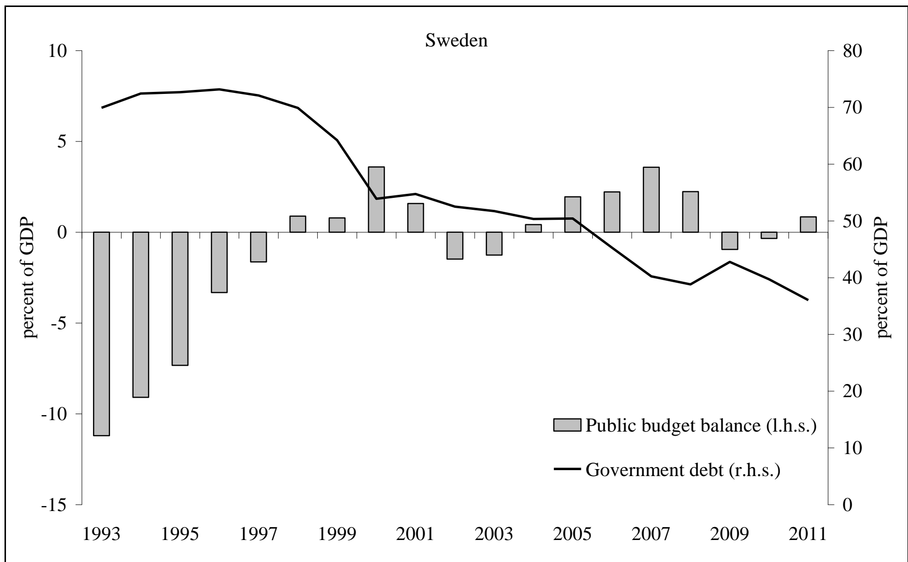
[3] This does not exclude that others factor may have contributed to the economic success of the reforms. For further information on Ireland, New Zealand and Chile, see Tanzi and Schuknecht, 1997.

[4] Despite the recent problems, the reforms in Ireland of the 1980s and early 1990s speak for themselves and do not undermine the case for reform.

[5] Note that Sweden also restructured its banking system.

Figure 1: Turnaround of fiscal policy stances in Ireland and Sweden





Source: IMF

Moreover, the competitiveness of the East German economy was undermined by an unfavourable exchange rate when the German Mark was adopted. All this contributed to a major crisis in Germany by the early 2000s. Fiscal consolidation and structural reform then broadly completed the reform process that started with German unification. Subsequently, growth picked up, fiscal balances improved and the business environment in Germany was also seen much more favourably.

III
What Can Today's Crisis Countries Learn?

Much of the recent economic focus has been on the European 'crisis countries' – (Greece, Ireland, Italy, Portugal, Spain). These feature a number of challenges for policy when it comes to boosting growth. While the reduction of fiscal deficits and debts to which they are subject boosts confidence, it also curtails demand and thereby output. Structural policy weaknesses, in some cases high private debt and shortcomings in competitiveness, hinder growth. Moreover, where weak indicators exist for public institutions, confidence is undermined, as are the incentives of private individuals to work, invest and innovate.

The reform experiences discussed in the previous section should hold important lessons in this regard. They confirm the need for comprehensive strategies including growth-friendly fiscal, structural and institutional reform. And they confirm the broad appropriateness of the crisis countries' strategies for reforms. Table 2 illustrates the difficult situation in the crisis countries: GDP-growth in 2011 has, on average, been very low or even negative and unemployment ratios increased to double digit rates except in Italy. The picture of unemployment is of especial note.

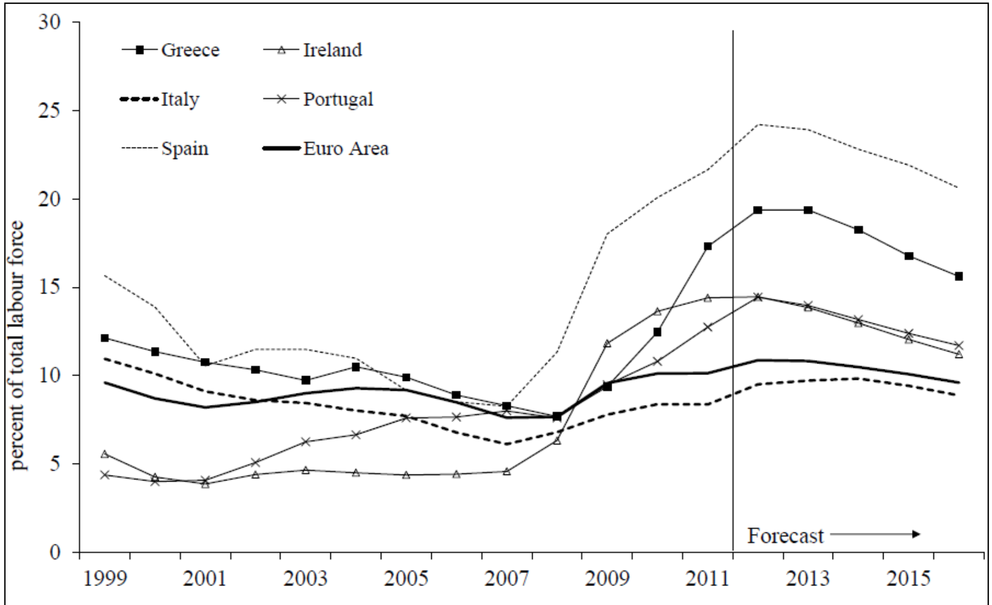
Table 2: The need for restructuring in the euro area

	Real growth rates in % (2011)	**Unemployment** in % (12/ 2011)	**Public debt** in % of GDP (2011)	**Public deficit (-) /surplus** (+) in % of GDP (2011)	**Government expenditure ratio** in % of GDP (2011)	**Legal system and property rights** (2009)*	**Corruption** (2009)*	**World Bank Doing Business** Rank out of 183 countries (2012)
Greece	-6.9	21.0	165.3	-9.1	49.3	5.6	4.2	100
Ireland	0.7	14.7	108.2	-13.1	45.2	7.8	8.3	10
Italy	0.4	9.3	120.1	-3.9	50.0	5.8	4.7	87
Portugal	-1.6	14.6	107.8	-4.2	46.8	6.7	6.8	30
Spain	0.7	23.2	68.5	-8.5	43.4	6.5	6.6	44
Euro area	**1.5**	**10.4**	**79.8**	**-4.1**	**49.4**	**7.2**$^{+}$	**7.3**$^{+}$	**39**$^{+}$

Sources: IMF, Eurostat, Fraser Institute, World Bank. Note: * The index ranges from 0-10 with a larger index value indicating a better quality of institutions. $^{+}$ Average of euro area countries.

The unemployment ratio has increased particularly strongly in Spain and Greece (Figure 2).

Figure 2: Development of unemployment rates in crisis countries

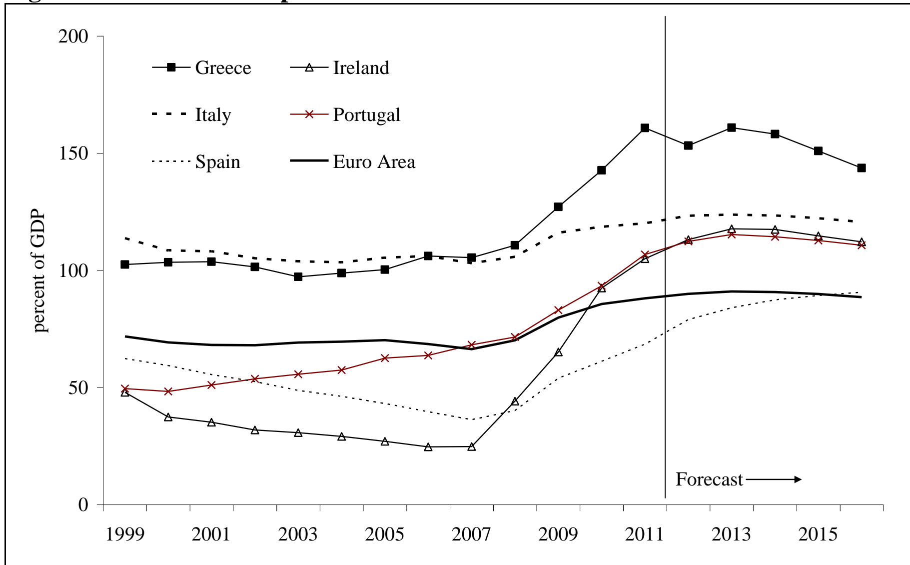


Source: IMF

Deficits have been near 10 per cent of GDP until 2011 though they are expected to go down significantly on the back of strong fiscal consolidation. Public debt has been increasing rapidly over the crisis and is above 100 per cent everywhere except in Spain (Figure 3).[6] The dire fiscal situation was largely due to bloated public sectors with public spending ratios near or above 50 per cent of GDP after years of large spending increases (Hauptmeier et al, 2011). This was particularly the case in Greece, Portugal, Ireland and Spain. Public spending ratios in competitor countries around the globe tend to be significantly lower (e.g. Switzerland, the US, Australia, or New Zealand) and in some of the more advanced economies of Asia (e.g. Singapore, Hong Kong or Korea) about half as high as in the Eurozone (Figure 4).

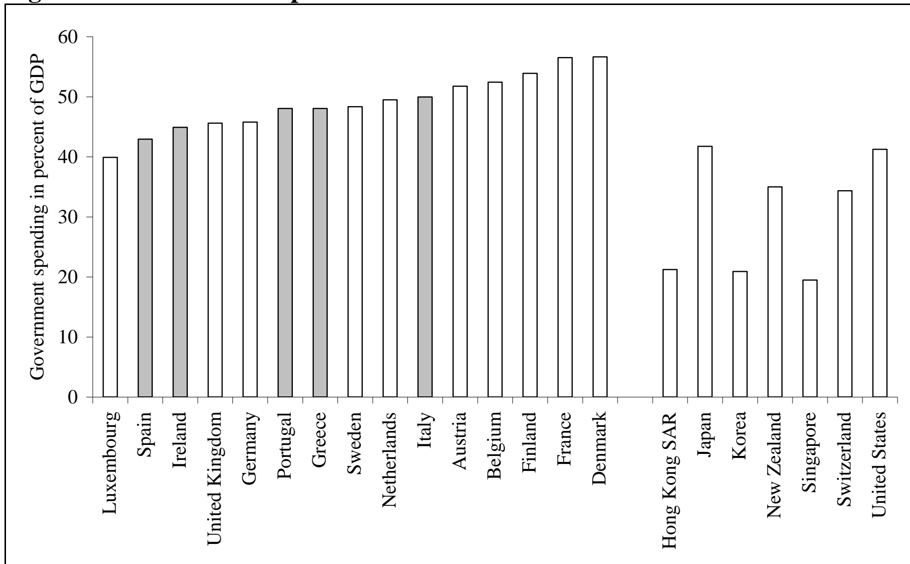
[6] The fiscal crisis in Ireland is, however, mainly due to the bailout of its insufficiently regulated and relatively large financial market.

Figure 3: Public debt in percent of GDP



Source: IMF

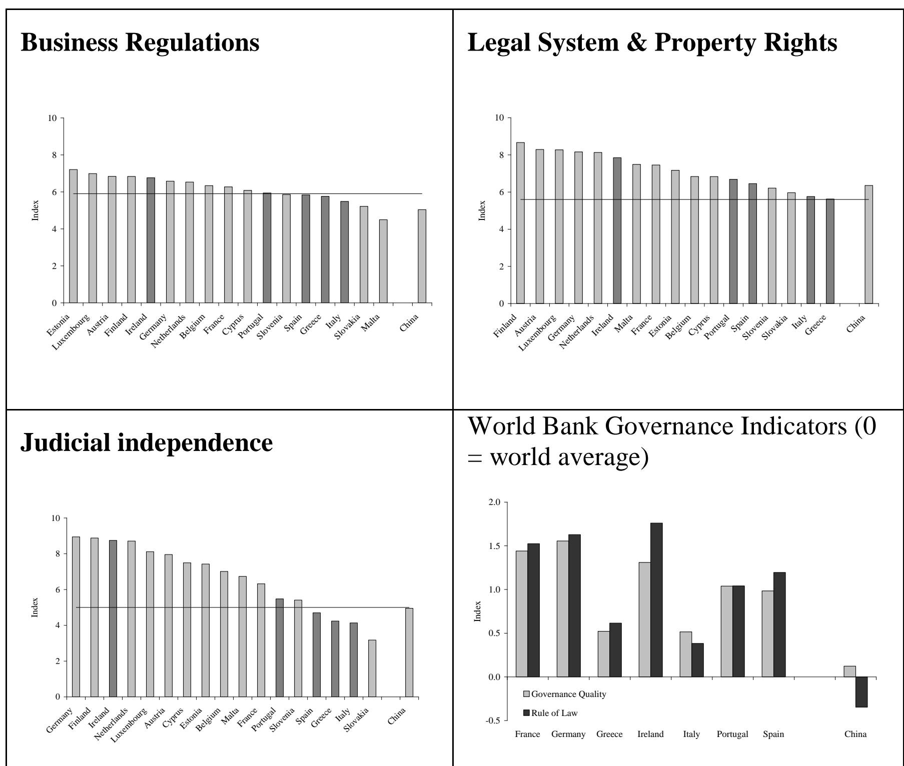
Figure 4: Government expenditure ratios



Source: IMF

Moreover, except in Ireland, indicators of the government institutions in crisis countries are rather weak. Business regulations, property rights, the legal and court system, judicial independence, or the indicator of 'economic freedom' generally display low values near or sometimes even below global averages. Indeed they are broadly in the range of China and some other emerging market countries (Figure 5). Meanwhile private debt remains very large and puts an additional burden on public budgets via banking sector problems and potential future public liabilities in Ireland, Portugal and Spain.

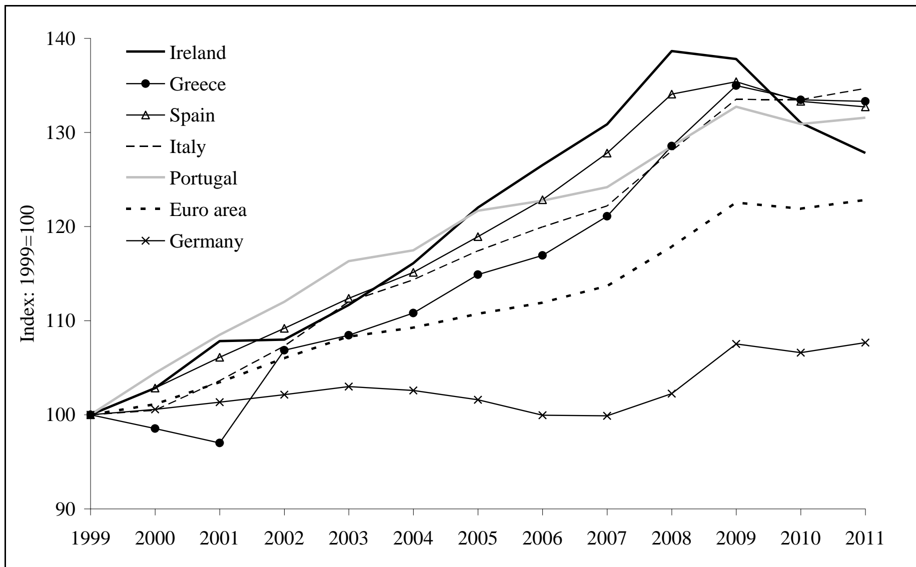
Figure 5: Institutional Quality (horizontal line is the global average)



Source: Fraser Institute, World Bank. Note: The index values from 0 to 10 with higher values indicating a higher quality of institutions. The horizontal line is the worldwide average. Shown data are from 2009 published by Gwartney et al. (2011). The World Bank Governance Indices range from -2.5 to 2.5 with higher values indicating a higher quality of institutions.

These challenges have to be mastered in the context of a fixed exchange rate regime in EMU where excessive wage increases in the past have undermined the competitiveness of companies in crisis countries (Zemanek et al, 2010). As a result, unit labour costs in some countries had increased significantly faster than the euro area average and 20 or more per cent faster than in Germany over the first decade of EMU (Figure 6).

Figure 6: Development of unit labour costs



Source: European Commission

These indicators confirm the importance of the three-pronged reform strategy outlined in the introduction and in the section of past reform experiences: fiscal consolidation, structural reform and a strengthening of government institutions. In fact, significant progress is already in the pipeline notably for reducing public debt and public spending and for introducing structural reform.

Public deficits are scheduled to go down significantly in the crisis countries: to a small deficit only in Italy in 2013, to 3 per cent in Portugal and to about 7-8 per cent in Greece and Ireland in the same year. Spain aims to cut its deficit to below 3 per cent in 2014. Table 3 illustrates past and future planned progress with further deficit reducing measures in e.g. Spain not yet reflected in the figures. Fiscal consolidation plans should also turn public debt dynamics around (Figure 3) from a peak in 2012-13 in all these countries.

Table 3 also shows that the main source of consolidation is public expenditure. The ratio of public spending to GDP is expected to decline by 5 and 3 percentage points between the peak around 2009 and 2013. The decline is especially strong in Ireland and Spain. It is clear that determined fiscal consolidation should continue. In addition, crisis countries need to provide incentives to restructure their banking systems, as their weakness provides ongoing uncertainty for public finances and undermines future growth.

Table 3: Trends in fiscal policy stances and current accounts

Public deficit (-) / surplus (+) in percent of GDP					
	2000	2007	2009	2011	2013*
Greece	-3.7	-6.5	-15.6	-9.1	-8.4
Ireland	4.7	0.1	-14.0	-13.1	-7.5
Italy	-0.8	-1.6	-5.4	-3.9	-1.1
Portugal	-2.9	-3.1	-10.2	-4.2	-3.1
Spain	-0.9	1.9	-11.2	8.5	-6.3
Total expenditures of general government in percent of GDP					
	2000	2007	2009	2011	2013*
Greece	46.7	47.3	53.8	50.0	50.6
Ireland	31.2	36.6	48.8	48.8	43.1
Italy	45.9	47.7	52.0	50.0	49.5
Portugal	41.9	44.3	49.7	48.9	46.1
Spain	39.2	39.2	46.3	43.6	42.0
Current account balance in percent of GDP					
	2000	2007	2009	2011	2013*
Greece	-7.8	-14.6	-11.1	-9.8	-6.3
Ireland	-0.4	-5.3	-2.9	0.1	3.1
Italy	-0.2	-1.3	-2.0	-3.2	-1.3
Portugal	-10.3	-10.1	-10.9	-6.4	-2.9
Spain	-4.0	-10.0	-4.8	-3.5	-1.0

Source: Eurostat, * European Commission Spring Forecast 2012

The adjustment and stability programmes of these countries also display significant progress with structural reforms. These feature the liberalisation of labour and goods markets especially. As a result, an adjustment to competitiveness is also foreseen: unit labour costs in Ireland have already come down significantly relative to the euro area or Germany and unit labour cost convergence is also making progress in the other crisis countries. Current account imbalances have declined or even disappeared. All in all, however, an improvement to competitiveness has a long way to go and structural reforms have yet to be fully implemented. Therefore, determined further progress is also called for on this front.

Progress in the third domain, that of government rules and institutions, is the most difficult to measure and most probably also takes longer to turn into tangible effects on confidence and growth. Moreover, current reform programmes feature relevant reforms mostly only at the margin. Some positive examples should be stressed: reform of the court system in Portugal, strengthening of the business environment in Italy, the reform of government institutions and administration in Greece. Further determined efforts are needed to reap the full benefits of reform programmes for growth.

All in all, the European crisis countries are on the right track by stressing fiscal consolidation and structural reforms, especially labour markets, as part of comprehensive reform agendas. The importance of the rule of law, the business environment and other ‘soft factors’ determined by government rules and institutions should probably be stressed even more in countries’ reform programmes.

IV
Lessons for the Advanced Economies

From the reforms seen through by our sample of countries, there should also be lessons for the other industrial countries especially in Europe and more broadly for their prospects of growth. Not only is the first fiscal pillar especially relevant, but there is also a need for reform efforts as regards the other two pillars. Countries should aim to tackle the size of the state and the levels of public spending, the reform of social entitlements and more focused structural reform.

Industrialised countries have to tackle the issue of big government. The strong increase in the spending ratio is perhaps the worst legacy of the financial crisis and the preceding economic boom period: Even some of the countries that used to have small states of below 40 per cent of GDP such as the US are now in the range well above this figure and some European countries feature public spending ratios above 50 per cent of GDP (Table 4). France's public spending ratio is well above 50 per cent of GDP, the UK reported near 50 per cent in 2011. Outside Asia, only Switzerland and Australia feature relatively small public sectors well below 40 per cent of GDP. Ever larger shares of public spending have been used for social welfare at a time when population aging and the resulting fiscal costs are only just starting to hit public budgets. Countries that experienced the strongest fiscal expansion in good times (notably the UK and the US) also featured strong increases in public deficits and debt ratios with public debt ratios in the G7 countries averaging well above 100 per cent of GDP. Japan, the US, Canada, the United Kingdom, France but also Germany have comparably high public debt levels. If left untackled, this situation seriously puts at risk the prospects for confidence and growth in advanced economies more broadly.

Reducing high deficits, reversing unsustainable debt dynamics and maintaining high quality public services at affordable and growth friendly tax rates will require major reforms of public expenditure and especially social entitlement programmes. This is especially important for countries with public spending approaching or exceeding 50 per cent of GDP. They face a particularly strong challenge because such spending ratios are difficult to finance in a sustainable and growth friendly manner.

The evidence to date has unequivocally shown the diminishing returns of public expenditure in terms of efficiency in reaching government objectives (Afonso et al, 2005). There is also evidence that public spending beyond approx. 35 or 40 per cent of GDP is detrimental to growth (Tanzi and Schuknecht 2000) (Figure 7). The most dynamic economies have not only been the emerging market economies but also some

of the more advanced countries such as Hong Kong and Singapore where public spending is in the order of only 20-30 per cent of GDP.

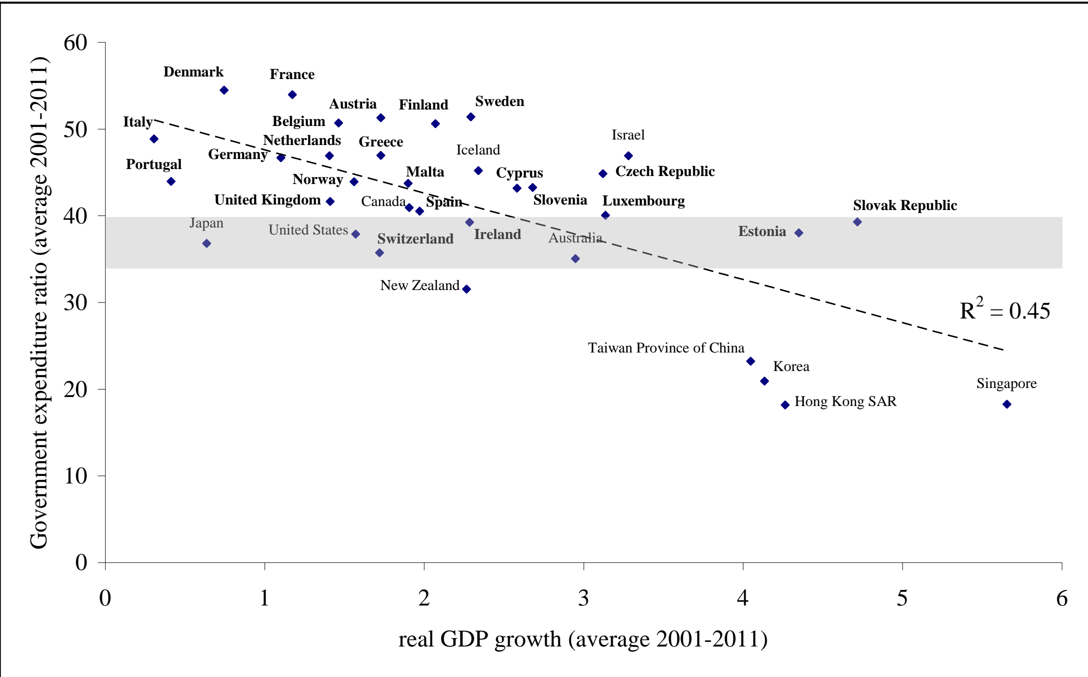
Finally, it is worth recalling that a number of non-crisis industrialised countries could do better in terms of structural policies and government institutions (Table 4). France, Japan and the US feature the relatively 'weakest' indicators for the legal system and property rights. The US shows the poorest figure for corruption and France for the World Bank 'Doing Business' Ranking in this country group. Hong Kong and Singapore hold the top ranks for these institutional indicators. Finally, and without going into more detail, it should not be left unmentioned that dealing with large private sector debt and improving the resilience of the financial sector and the incentives of financial actors should feature prominently in the structural and institutional reform agenda of advanced economies more generally.

Table 4: Reform need in advanced countries

	Real growth rates in % (2011)	**Unemployment** in % (12/ 2011)	**Public debt** in % of GDP (2011)	**Public deficit (-) /surplus** (+) in % of GDP (2011)	**Government expenditure ratio** in % of GDP (2011)	**Legal system and property rights** (2009)*	**Corruption** (2009)*	**World Bank Doing Business** Rank out of 183 countries (2012)
Germany	3.0	5.6	81.2	-1.0	45.6	8.2	8.3	19
France	1.7	9.9	86.0	-5.2	56.1	7.5	7.5	29
United Kingdom	0.7	8.5	85.7	-8.3	49.0	8.2	8.1	7
USA	1.7	8.9	102.9	-9.5	41.4	7.3	6.5	4
Japan	-0.7	4.5	229.7	-10.1	40.7	7.5	8.3	20
Canada	2.4	7.5	84.9	-4.5	42.6	8.1	8.6	13
Australia	2.0	5.1	22.8	-4.3	36.6	8.2	8.4	15
Hong Kong	4.9	3.4	33.8	3.7	20.4	8.2	8.9	2
Singapore	4.8	2	100.7	7.2	17.6	8.3	9.4	1

Sources: IMF, Eurostat, Fraser Institute, World Bank. Note: * The index ranges from 0-10 with a larger index value indicating a better quality of institutions.

Figure 7: Government expenditure ratio and GDP growth, 34 advanced economies



Source: Based on IMF, World Economic Outlook. Note: The grey shaded area shows the optimum range for government expenditure ratio based on Tanzi and Schuknecht (2000). European countries are bold.

V
Conclusions

This paper suggests that central to sustained economic recovery for both crisis countries and many other advanced economies is a strong and comprehensive policy reform agenda. Already several successful examples exist in recent economic history which provide lessons for today's crisis countries and advanced economies:

- The soundness of public finances must be restored. This must be through public expenditure reform notably on the welfare state but also as regards excessive public wages and employment. This should help reduce the size of government, especially in those countries with large public sectors.

- Other, complementary structural reforms are necessary, that improve the functioning of labour, product markets and financial markets.

- The institutional environment of the economy (rule of law, judiciary, etc.) must be strengthened.

For growth we need functioning markets governed by rules and efficient states. This will build confidence and provide incentives to work, invest, and innovate. Economic fine tuning with its disregard for incentives, institutions and legal commitments risks being detrimental to prospects of long term growth. In fact, it can be argued that many of our current calamities of over-indebted industrial economies, desperately propped up with cheap money have been caused by the sirens of economic engineering and short termism (see also Tanzi, 2012).

From such a perspective, significant challenges remain in the crisis countries of Europe. The three-pillar strategy of expenditure-based fiscal consolidation, structural reforms and strengthening of public rules and institutions that countries have embarked on needs to be continued. If this strategy is pursued with much patience and endurance, we can safely expect that confidence and growth will return.

Moreover, there is a lesson for advanced economies in general. The size of government is an important variable for long term growth prospects. Governments with public spending exceeding 40 per cent of GDP and especially those at 50 per cent of GDP should carefully review and curtail their spending obligations and spending efficiency. This should take place as part of broader structural and institutional reform agendas.

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In *Going for Growth: The best course for sustained economic recovery*, three senior economists at Germany's Finance Ministry consider the evidence from six countries which emerged in recent decades from similar problems of high public expenditure and stifled growth. Dr Norbert Hoekstra, Dr Luger Schuknecht and Dr Holger Zemanek indicate that the evidence from a sample of advanced as well as emerging economies is for a three-pronged strategy to tackle the crisis and bring sustainable growth. Not only are fiscal and structural reforms needed, but the rules and incentives governing market economies must be strengthened. And in many industrialised countries government should be downsized.

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