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Economic Growth needs Reform, not Stimulus. Former IMF Fiscal Affairs Director explains that Keynesian policies would do more harm than good

News of a 0.7% fall of UK GDP for the three months ending June have triggered fresh demands for a further ‘Keynesian stimulus’ and the injection of fresh public funds to stimulate the economy. But Politeia’s *Realistic Recovery: Why Keynesian Solutions Will Not Work*, explains that this would be the wrong course. The author, Professor Vito Tanzi, a former Fiscal Affairs Director at the IMF in Washington, shows why this is.

Today’s recession is no ordinary cyclical downturn. It comes after a decade of governments building up unsustainable deficits and public debt; and it follows the bursting of a number of bubbles. A further rise in public spending would worsen the already dangerous fiscal problems from which countries suffer – prolonging distortions, undermining investor confidence and raising the cost of borrowing.

If countries’ fiscal balances had been sustainable before the crisis, and if the recession were a traditional ‘Keynesian’ one, then stimulus might have a place. But this is not an ordinary recession. The fiscal situations of western economies before the crash were neither prudent nor sustainable.

Instead, says Tanzi, clear action can be taken for recovery and growth. What’s needed is the downsizing of the state and the ending of state monopolies when it comes to providing public services. Tanzi explains public spending tends to follow a set pattern – it normally goes up: when it comes to benefits or public services the number or categories of beneficiaries tend to expand – so too do the number of public officials ‘providing’ the service. Costs therefore rise. Take the example of Greece’s pensions system where those classed as having ‘arduous’ professions – including hairdressing and musicians – receive more generous pension provision and categories have risen to 600. Or, the US food stamps programme which has escalated to one in seven Americans having food stamps by 2011. Even where the benefit was intended as universal, the services provided have grown as is clear from the UK’s experience.

If economies are to recover there must, says Tanzi, be a ‘careful re-engineering [of] the role that the state plays in the economy’, so that government pursues its important social objectives more efficiently:

First it should move to lower public spending. ‘The reduction in public spending... *over the medium term*, should be large enough to wipe out the fiscal deficits and initiate a trend toward the reduction of public debts to bring them to more sustainable levels.’

Second, it must move to ‘major structural reforms’. These should aim, as Tanzi says, ‘**to make economies more flexible and more efficient**’. Governments may need to return to the original purpose of social support. They may also need to move ‘**some programmes [or services] completely out of the public sector**’. The inefficiencies which characterize public services or programmes normally develop when monopolies exist and providers ‘do not face the pressures of a competitive market’, says Tanzi.

Third, there are lessons to be learned from lower spending economies with good public services. Differences in public spending of up to 20 per cent of GDP exist among industrialised countries, including Australia, Switzerland, Japan, and Korea. Though public spending is lower than in Britain, the welfare provide to their citizens is not of a lower standard. If order is to be restored to the public accounts, then these lessons must be taken to heart.

Professor Vito Tanzi was Director of Fiscal Affairs at the IMF (1981-2000) and Undersecretary for the Economy and Finance in the Italian Government (2001-2003).

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