Ludger Schuknecht

# Preparing for Economic Recovery

# More Market, Better Government

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**Ludger Schuknecht**

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## The Author

**Ludger Schuknecht,** a German economist, was Deputy Secretary-General at the OECD and Chief Economist of the German Federal Ministry of Finance advising on matters of fiscal and economic policy, the international economy and with responsibility for the finance track of the G20 process. He has held posts at the European Central Bank, the World Trade Organization and the International Monetary Fund.

His books include *Public Spending and the Role of the State: History, Performance, Risk and Remedies* (November 2020) and *Public Spending in the 20th Century: A Global Perspective*, co-authored with Vito Tanzi (2000), both published by Cambridge University Press and *Trade Protection in the European Union* (Harwood Academic Publishers, 1992)

His Politeia publications include *Paying for the Future: Working Systems for Pensions and Healthcare*, with Matthias Dauns and Werner Ebert (2015); *More Gain Than Pain: Consolidating the Public Finances*, with Philipp Rother and Jürgen Stark (2011); *Going for Growth* and *Boom, Busts and Fiscal Policy: Public Finances in the Future* (2009).

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## **Foreword -** Sheila Lawlor

The response to the Covid pandemic by many governments in the spring was dramatic. Countries were put into lockdown to prevent the virus spreading; generous public finance packages were instigated to keep economies afloat and ready for businesses to re-open. Then, after a summer return to work, lockdowns were ordered again in the autumn to counter a 'second wave' - just as a vaccine came on to the horizon.

Here in Britain, the cost has been high. Not only have thousands of lives been claimed by the virus, bringing bereavement, sadness, and for some families the death of the breadwinner. Livelihoods have also suffered much more widely: jobs have been lost, businesses have gone under and the future of whole sectors is threatened, even though the exchequer continues to alleviate these consequences. November ONS figures indicate the UK economy shrank by 9.6 per cent since the end of 2019, and the official estimate is now for an 11 per cent fall over the year. Meanwhile public borrowing, already at unprecedented peace time levels and rising, will this year be around £394 billion.

But these extreme developments do not, as most think, depend simply on the pandemic. As Ludger Schuknecht explains, today's problems are not solely, or mainly, the consequence of Covid. The dramatic deterioration of the public finances, the increase in the size and cost of the state and the consequences for growth and investment were already taking place even before this year's Covid measures: they are part of an economic trend in countries such as our own, a trend which has been going on for over a decade.

Dr Schuknecht, a distinguished German economist, who was Deputy Secretary General at the OECD and Chief Economist at the German Finance Ministry and has held posts at the ECB, WTO and IMF, explains that economies such as ours must now reverse a raft of longer-term structural problems which were undermining economic success even before Covid: unsustainable public finances and high levels of debt, damaging government policies that promote protectionism, often with damaging, costly regulation. These are linked to sluggish growth, poor productivity and low investment, problems made worse by too much of the wrong government, often with unfocussed and wasteful public spending. The route to economic recovery is clear. Governments should bring the public finances under control, limit the size and take of the state, open their countries and businesses to free competitive markets and trade, and reject the lure of ‘industrial strategy’, expensive infrastructure projects and other forms of protection. Covid economics may have had its extenuating circumstances – but now governments need to leave it behind and take the lead for a sustained recovery.

The UK is now in a transition from a serious, but no longer very serious, health crisis, to an extremely serious economic crisis and Schuknecht’s proposals explain how it can move to recovery. In *Preparing for Economic Recovery: More Market, Better Government* he builds on decades of research and scholarship as a global economist, often working with other continental economists, including Vito Tanzi, Jürgen Stark, Antonio Afonso and Alberto Alesina, which show how such policies can benefit everyone and particularly poorer people. Schuknecht’s work shows that leaner governments with lower levels of public spending prompt investment and lead to growth; they lead to more jobs and more opportunities for the unemployed. It makes clear that countries which embark on dramatic and rapid fiscal and structural reform tend to do better more rapidly, opening jobs and opportunities to those left behind; and that good healthcare and education systems do not necessarily result from high spending – indeed outcomes are often best where lower levels of spending go hand in hand with better, more accountable systems.

Such thinking should be seen as both a more hopeful and more realistic option for Britain than the model of the bureaucratic and regulatory state, ordering lives and businesses to its laws so as to organise matters in an efficient, rational and consistent manner without fear or favour, as the political theorist Max Weber put it 100 years ago. But Weber, writing in 1922 when public spending averaged less than 20 per cent, could not have foreseen the nature of the contemporary state, often absorbing 40-50 or more per cent of GDP.

For people in Britain Schuknecht’s thinking should strike a chord. It is no accident that the popular movements against the economic policies of a restrictive, protectionist state have often been centre stage in Britain’s political debate: in the battles to repeal the corn laws in the 19th century and end protectionist import duties on corn; the battles fought in the 1980s over the size and role of the state; and in the longer movement to resist the imposition of the restrictive EU regulatory system and protectionism on Britain’s older tradition of free markets, entrepreneurship and opportunity. Economic freedom has invariably been, and should be, treated as another aspect of political and constitutional freedom.

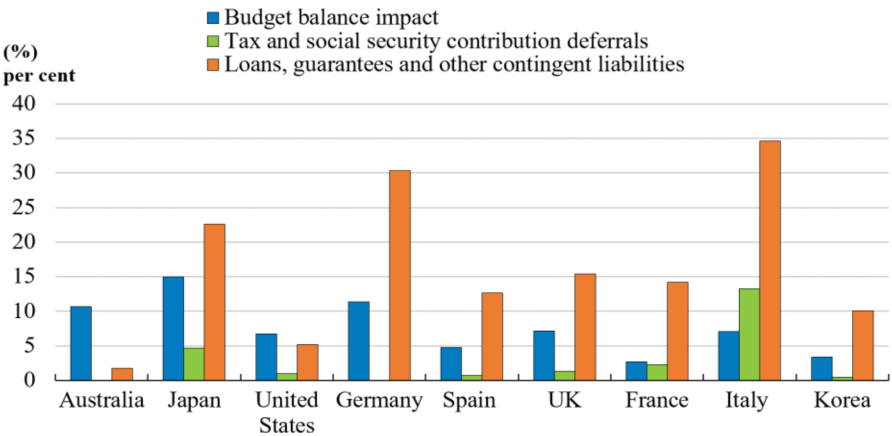
Sheila Lawlor
Founder and Director of Research
Politeia, November 2020

# I
# Introduction:
# Covid, the Economic Response and What to Do Next?

The Covid-19 (or coronavirus) crisis has caused an unprecedented contraction of the global economy. About one quarter of advanced economies, from restaurants to the retail sector and real estate, was strongly affected by the first round of confinement, while a second wave of infections followed that put recovery at risk. While global growth estimates were near 3 per cent for 2020 in January 2020, the IMF's latest World Economic Outlook (from October) projects a stark recession, with global growth declining by 4.4 per cent in 2020 before recovering by 5.2 per cent in 2021 and 4.2 per cent in 2022 (IMF, 2020a). Unemployment or underemployment has increased and is projected to decline only gradually again.

It is remarkable how quickly and strongly governments and central banks reacted to the pandemic to bolster their economies and prevent the collapse of financial markets. Budget support via expenditure and tax measures and loans, guarantees and liquidity measures preserved jobs and enterprises and stabilised the financial system. Budget support differed significantly across countries but was, in most cases, much higher than during the global financial crisis reaching 3 per cent 15 per cent of GDP. Other, indirect support measures such as loans and guarantees amount to up to 35 per cent of GDP in the most important advanced economies (Chart 1).

**Chart 1 Government Financial Support in Selected OECD Countries**




Note: OECD. The Chart shows official estimates, when available, of financial help included in emergency packages announced by governments in response to the Covid crisis, as of 15 August 2020.

This, in turn, has supported confidence and household incomes and helped prevent the scarring of our economies through loss of human and entrepreneurial capital.

But now the key challenge is what to do next? How can we ‘win the recovery’? Will it be primarily via interventionist policies with further government spending, industrial policy, and protectionism? Some observers call for exactly that, claiming that too much market economy is the main obstacle~~.~~ – and that more government intervention and more public spending are needed to fix our economic and social problems.

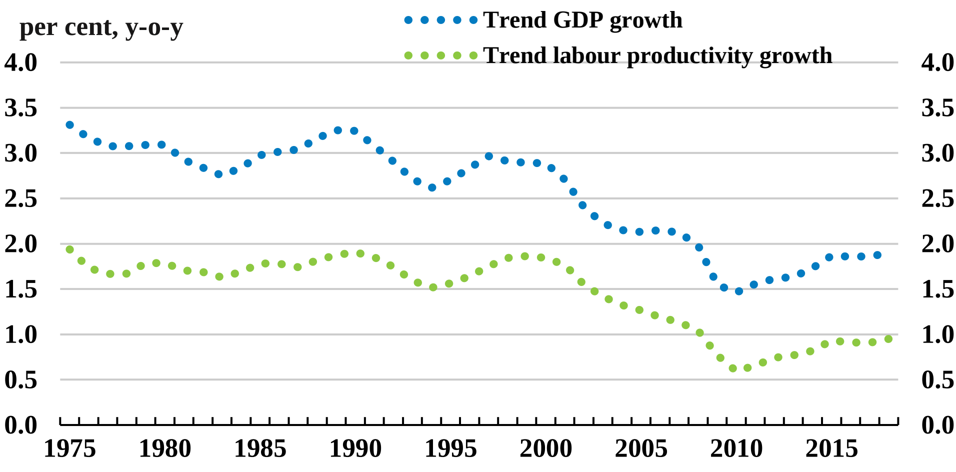
The evidence indicates that there is a better way. We must turn to a market-friendly reform agenda to allow markets to do their job and governments to become better at their own core tasks. It is asking too much of governments to insure us against all contingencies and fix all our problems via more regulation and more spending. If there is anything that our chequered history of crisis and poor growth has shown, it is the need for returning to rules-based economic policy making. The recovery will best be built on a triangle of stability: well-functioning markets (Chapter II), open economies (Chapter III), and high-quality public services and sound public finances (Chapter IV).

# II
# Well-Functioning Markets
# Promoting Growth and High Employment

As the economic recovery unfolds, the focus of debate and policy must be on sustainable growth of our economies in the medium term. The challenge is not cyclical and Covid related but structural, as growth has been declining for decades and prospects are poor.

Potential growth has fallen from over 3 per cent to less than 2 per cent over the past 40 years and annual productivity growth has fallen to less than 1 per cent over the past decade (Chart 2). Structural reforms to enhance productivity were already very tepid in the early 2000s. During the global financial crisis, the reform momentum briefly picked up when European crisis countries reformed their economies. After 2014, however, the reform momentum slowed down again (OECD, 2019c).

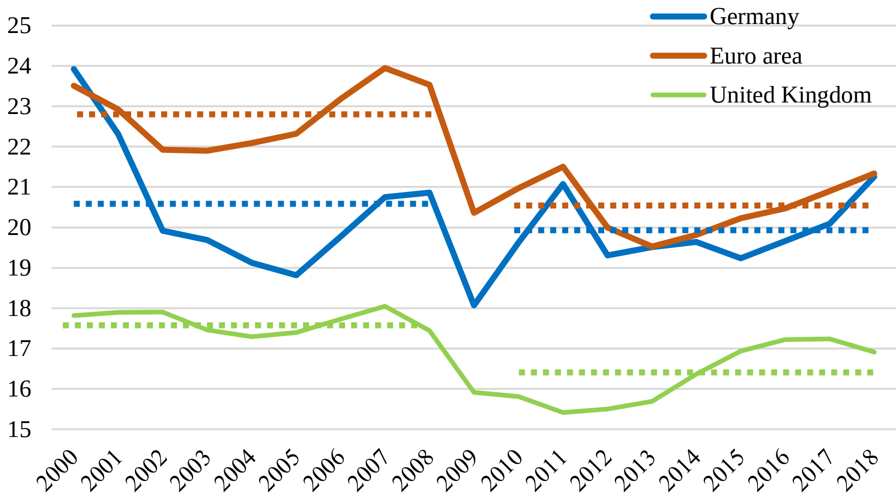
**Chart 2. Potential GDP and Labour Productivity Growth**




Source: OECD Economic Outlook database.

There is further evidence why the weakness of long-term growth is not mainly a demand-related but a structural problem. Low productivity growth went hand in hand with weak private investment in machinery, equipment and plants in the post-financial crisis period in advanced economies (Chart 3). In fact, average euro area investment in the 2010s at 20.5 per cent of GDP was more than 2 percentage points of GDP lower than in the early 2000s. The fall in the US and Japan was similar. Germany and the United Kingdom posted smaller declines in the average investment ratio but they did decline as well.

**Chart 3. Gross Fixed Capital Formation in the 2000s and 2010s**




Source: OECD Economic Outlook database.

Some observers see a need for more public investment to make up for the demand shortfall and to stimulate growth. This is clearly not the whole story. While there has been a decline in public investment, this has been very small. In the euro area, for example, it only amounted to 0.3 per cent of GDP in the 2010s compared to the early 2000s. The bulk of investment (85-90 per cent) in an economy is private investment and more growth and more investment demand should come mainly from the private sector.

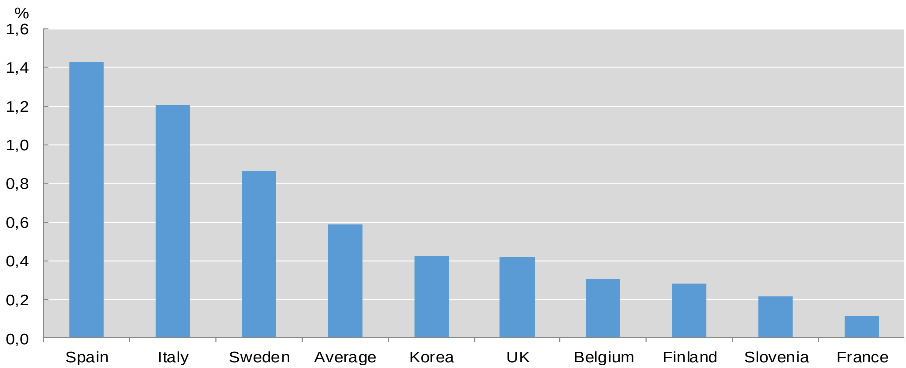
**Towards Growth and Investment. Less sluggishness, better laws**

A helpful compass to understand how robust and sustainable growth in an environment of strong investment would come about is the triangle of stability. The first element is well-functioning domestic economies and markets. In such markets, capital and labour are allocated in an efficient manner so as to produce goods and services that people want to buy, negative external effects are limited, innovation boosts productivity and employment and purchasing power grows for everybody.

One of the major challenges to be tackled if market forces are to reinvigorate investment and productivity, is the trend to economic 'zombification'. This phenomenon was first ascribed to Japan in the 1990s but it seems to have spread to other advanced economies in recent years. Weak banks and companies may survive longer than economically justified if very low interest rates and forbearance policies do not induce their exit from the market. As such enterprises live on, the opportunity for more productive firms to enter and expand shrinks.

Economists refer to this as the process of Schumpeterian 'creative destruction' which 'zombification' impedes. Adalet McGowan et. al (2017) estimate that already in 2013, business investment could have been up to almost 5 per cent higher and productivity over 1 per cent higher in some countries if the share of zombie firms had been minimised (Chart 4). This figure is likely to be much higher in 2020 and post-Covid. Allowing markets to determine which players survive and scaling back government interventions and guarantees will be a major challenge for governments once the Covid dust has settled.

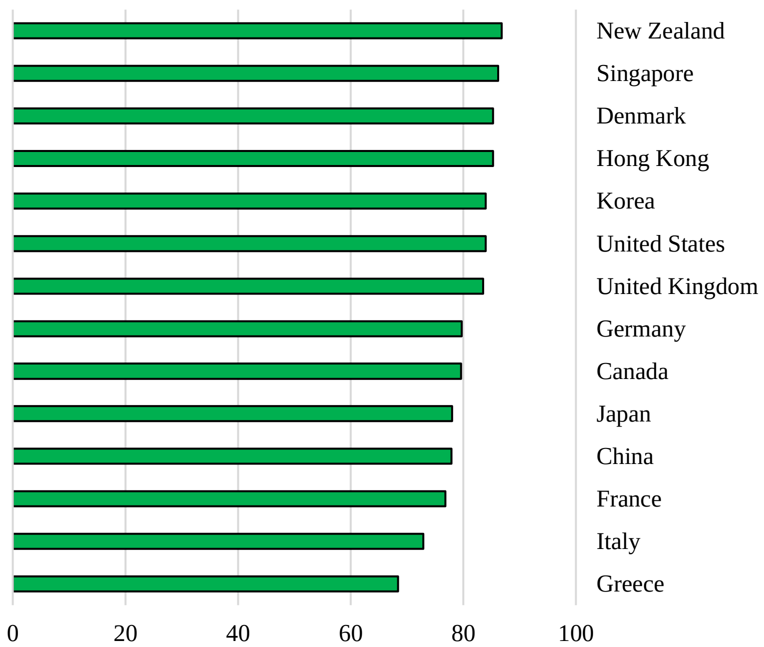
**Chart 4: Productivity Gains from Reducing Zombification**




Source: Adalet McGowan, Andrews and Millot (2017). Productivity means multi-factor productivity. Gains relative to country/industry with lowest rate of zombification.

Well-functioning markets also require sound rules of the game featuring the rule of law, low corruption, an independent judiciary and little economic informality. The 'Ease of doing business' ranking of the World Bank is probably the most prominent proxy (Chart 5). Advanced countries comprise most of the top-ranking countries in this and other indicators and the United Kingdom is doing reasonably well. But here, as in some other areas, top scores mostly go to Asian economies. The situation, however, is quite challenging for some other Western countries. France and, even more clearly, Italy and Greece now rank relatively low and below China. This indicates much room for improvement, notably in Europe and a greater orientation outside seems warranted.

**Chart 5. Ease of doing business score**




Source: World Bank, *Doing Business database* (2020)

Shortcomings across countries are numerous. Some countries have very complex tax systems; some show deficiencies in infrastructure and other public services. Long, complex bureaucratic procedures and uncertainty hold back private and public investment in many countries. For example, all EU countries seem to be suffering from lengthy and complicated processes as regards investment decisions which can cause many years if not decades of delays. The German Normenkontrollrat (National Regulatory Standards Control Council) (2020) deplores the increasingly costly influence of national and EU laws hampering investment. The European Investment Bank (2020) in its most recent survey shows that the availability and conditions of financing are not the main obstacle to investment but regulation, political uncertainty, and skill shortages.

Improvements in these framework conditions can be difficult and require major reforms of entire systems that have grown into their present state over decades. That the role of such reform is central for success with more and better investment is often overlooked. Instead, some economists request more money for quick infrastructure in the belief that it may produce swift positive effects. Most often, however, it is the underlying structures and not a lack of money that causes poor public services.

Other measures which assess the impediments to functioning markets highlight the regulatory arrangements that bind product markets and those that potentially undermine employment.

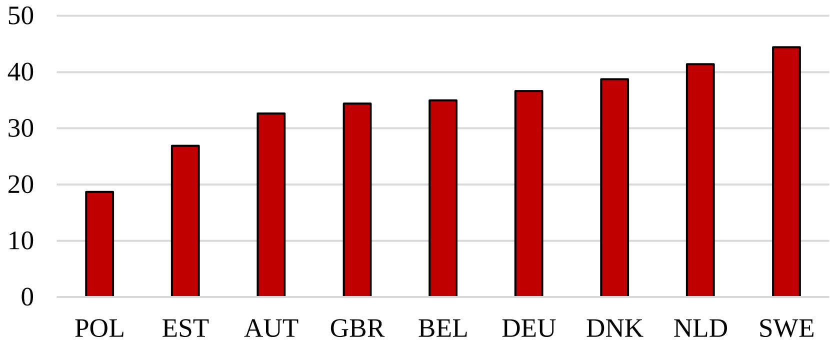
Product market regulations differ significantly across advanced countries and some continental European and Asian economies seem to face the strongest restrictions. Employment protection regulation has declined over recent decades. It is quite low in the US, the UK, Canada and Japan where unemployment is also very low. In Italy, France and Spain high employment protection correlates with high unemployment. But in the Netherlands and Germany as well as in the Nordic countries, protection and low unemployment coincide seemingly without too much damage. This warrants a very close look at country specific circumstances. Still, a number of countries should take advantage of the surge in unemployment and the need to re-boost productivity to improve further their labour and product market regulation.

There is also much to be done to raise educational standards and improve skills in many advanced countries. PISA educational attainment scores in most non-Asian advanced countries lag significantly behind many of their

Asian counterparts; only Finland and Estonia can keep up with the advanced Asian economies of Hong Kong, Korea, Japan, Singapore and Taiwan.

Participation in lifelong learning is limited; so too is the share of adults with adequate digital problem-solving skills (Chart 6). In Europe, for example, only between 20 and 40 per cent of the workforce have adequate digital problem-solving skills. Although this paper cannot concentrate on the questions faced globally and in each country, the evidence is that most Western countries, including the UK, have much work to do to help their education and skill systems to reach globally competitive levels.

**Chart 6. Share of individuals with adequate digital problem-solving skills**




Source: OECD (2020d) Share of individuals scoring at Level 2 or Level 3 in the PIAAC proficiency in problem-solving in technology-rich environments task, by age, 2012, 2015

# Open Economies – Higher Productivity, Higher Employment
## Tackling the Protectionist Barriers to Employment

The second, essential element for strengthening sustainable growth is open international economies and markets. Openness for trade matters for successful, competitive economies: it keeps income high with high-quality jobs; it keeps prices for consumers and business down, and quality high. Some claim that more protectionism increases resilience and the self-reliance of our economies. But this only happens for certain products while the overall effects - through higher prices and lower output - reduce the overall resilience of our economies when taken as a whole.

In fact, the pressure on government is often not to increase resilience and income to the benefit of all, but rather to protect certain producers – through tariffs or partial nationalisation and by adopting policies which favour certain sectors or industries under the general heading, 'industrial strategies'. All evidence, however, shows that trade protection whatever its form brings high costs.

All advanced economies are highly dependent on well-functioning global value chains (Chart 7a and 7b). Protectionism threatens national economies through demand and supply side channels. When exports are disrupted, this affects up to 80 per cent of production in some smaller economies. In the

**Chart 7a. Vulnerability to a demand shock: domestic inputs in foreign demand**

*Percentage of total domestic value added in the manufacturing sector*

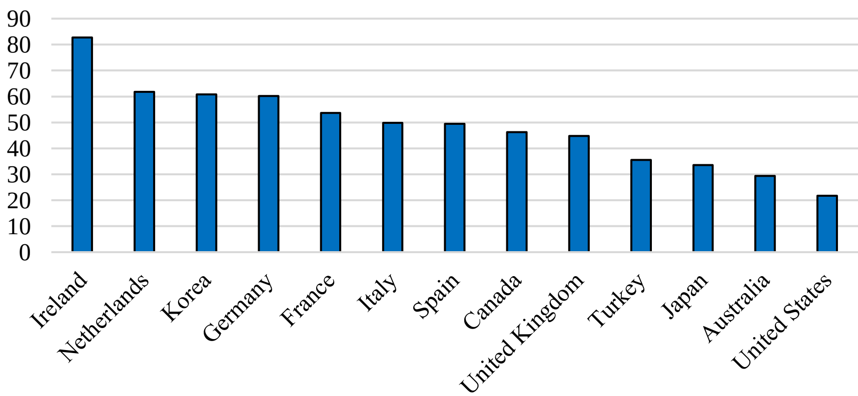
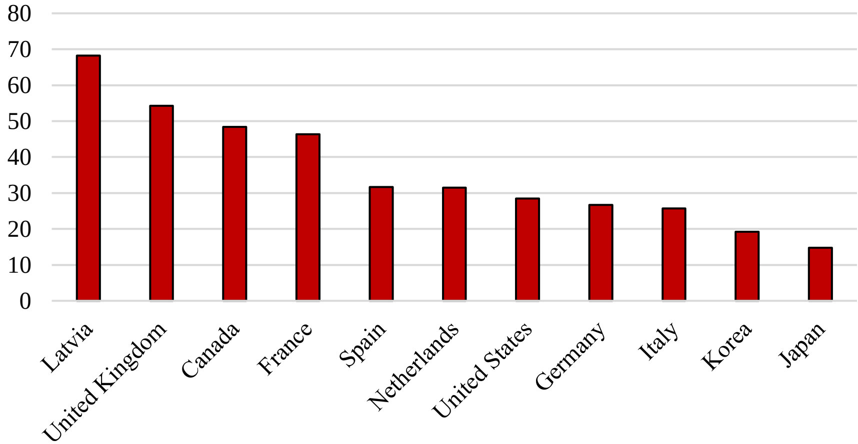


**Chart 7b: Vulnerability to a supply shock: foreign inputs in domestic production**

*Percentage of total foreign value added in the manufacturing sector*




Note: The degree of exposure to a supply shock is computed as a share of foreign value added in gross output of the manufacturing sector, while the degree of exposure to a demand shock is computed as a share of domestic value added in foreign final demand.
Source: OECD TiVA dataset 2018; and OECD calculations.

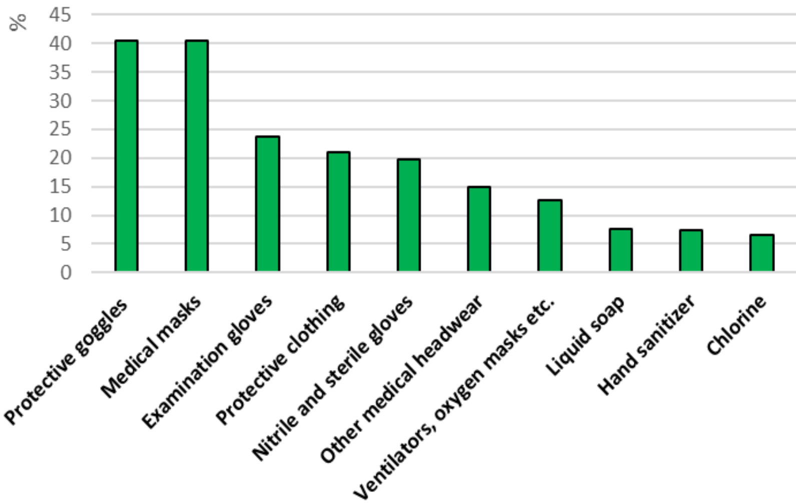
larger European countries like the UK, this share ranges from 40 to 60 per cent. Even in the less-exposed countries, like the US or Japan, repercussions would be significant.

On the supply side, the picture is similar. Domestic producers are dependent on foreign suppliers everywhere and the smaller the economy, the larger this dependence tends to be. Foreign inputs can exceed 60 per cent in domestic production in some small countries and it is still close to 20 per cent in the larger ones. The United Kingdom's manufacturing sector is the most dependent on well-functioning input supply chains amongst the large global economies.

## Protectionist Trends

**Trade protection**, irrespective of motives, can have major adverse effects on prices and incomes. Take the example of medical supplies during the initial phase of the Covid crisis. Price increases due to export restrictions on medical supplies ranged from 6 per cent to over 40 per cent (Chart 8). This means that medical expenses rose significantly. Higher prices imply less purchasing power for other things (or higher taxes when financed through government). Import restrictions have similar effects. It is, therefore, important to keep markets open as much as possible and to limit nationalisation and autarky policies to the minimum.

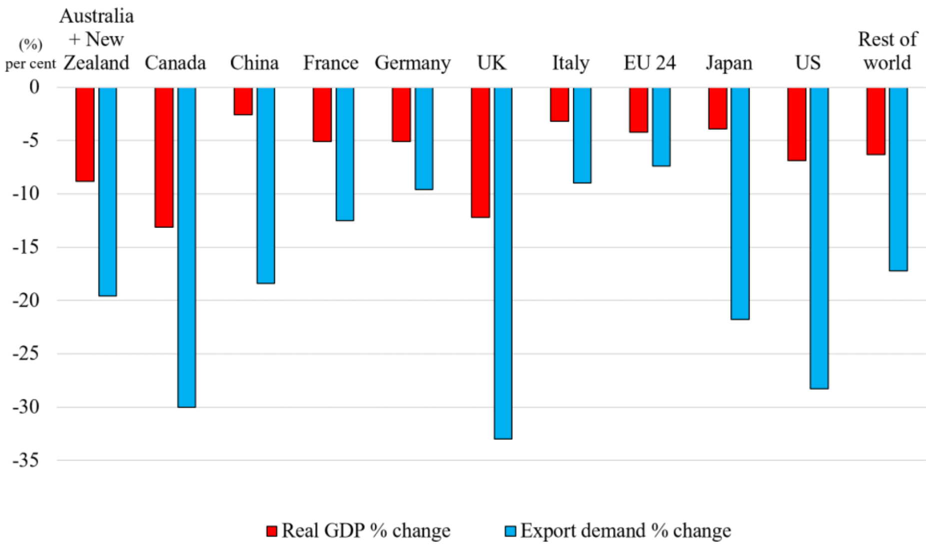
**Chart 8 Possible impact of export restrictions on prices of medical equipment**




Source: Espitia, A. N. Rocha and M. Ruta (2020) Database on Covid-19 trade flows and policies, World Bank.

**Renationalisation** and the trend to partial re-nationalisation would, by contrast, bring very severe consequences. OECD estimates indicate that a move to more nation-centred economic policy would much reduce incomes and destroy many jobs. Under the assumption of 'moderate' renationalisation, customs duties rise to 25 per cent, countries spend 1 per cent of GDP on promoting domestic production and producers are to some extent discouraged from changing suppliers. The overall economic implications are drastic, with a significant fall in GDP and exports (Chart 9). In Germany, GDP would decline by 5 per cent and exports by 10 per cent. In the UK, the GDP loss would be more than 10 per cent and exports would shrink by over 30 per cent. All economies would be hard hit. Naturally, real incomes would then fall significantly. Moreover, inflation may resurge in an environment of very high debt, which would be difficult to manage.

**Chart 9 OECD METRO model simulations of GDP and export demand in a <u>localised</u> economy**




Source: OECD (2020).

Ongoing debates with regard to re-nationalisation of production ('on-shoring') are therefore a matter of great concern. A better option would be to focus on a few essential goods and ensure international provision in a least distortive manner. Nonetheless the risk remains of capture by special interest groups and more broad-based productivity-reducing protectionism as many things 'suddenly' become essential.

**The industrial policies** pursued by some governments pose a further threat to international openness. Governments are increasingly under pressure to channel investment and public funds into certain sectors on the dubious assumption that government may know which are the industries of the future, which products the country has a comparative advantage for, or which products it should have more national autonomy over. While there may be a limited number of instances where for political and systemic reasons, such policies and projects make sense (such as in space or perhaps also regarding hydrogen), this should not be the compass of economic policies. The government is generally not better at knowing the future and it is a poor manager of private companies and projects as history has shown.

**Environmental protection** has prompted a number of initiatives to counterbalance the increase in costs arising from such protection and higher carbon prices. These include import restrictions/tariffs under the label 'Border Carbon Adjustment Tax' to prevent 'carbon leakage' through carbon intensive production shifting to less strict countries. However, such protectionist trade policies could lead to further international conflict and trade wars and are not the right answer. Rather, international co-operation to coordinate policy on climate matters is a better option.

# IV
# Sound Public Finances, Manageable Public Debt Social and Economic Loss – or Gain?

The third element of the triangle of stability is high quality and sustainable public finances. Sound public finances and high quality public services are not only good for economic prosperity but also allow good levels of social protection and opportunities for the poor. However, the last decade saw little progress in this regard and the Covid crisis further aggravated the prospects for fiscal soundness.

The post-financial crisis period before Covid saw very little progress with fiscal vulnerabilities in advanced countries (Table 1, see also Schuknecht, 2019 and 2020). Only Germany and Canada featured reasonably safe public finances with a surplus or a small deficit before both the global financial crisis and the Covid crisis. As a result, public debt in 2019 for G7 countries was about 34 per cent of GDP higher than ten years earlier and averaged 116 per cent of GDP. Public debt in the US, Japan and Italy was well above 100 per cent of GDP while France (and Spain) featured debt around that number in 2019. The only country where debt had returned to pre-financial crisis levels was Germany, and for that policy it received huge criticism. It seems to be very difficult ever to bring down public debt, not to mention to get praise for it.

**Table 1. General Government Overall Fiscal Balance and Debt**

| % of GDP | Overall fiscal balance 2007 | Public debt 2007 | Overall fiscal balance 2019 | Public debt 2019 | Overall fiscal balance 2020 | Public debt 2020 | Overall fiscal balance 2021 | Public debt 2021 |
|---|---|---|---|---|---|---|---|---|
| USA | -2,9 | 64,6 | -6,3 | 108,7 | -18,7 | 131,2 | -8,7 | 133,6 |
| Japan | -3,2 | 175,4 | -3,3 | 238 | -14,2 | 266,2 | -6,4 | 264 |
| Canada | 1,8 | 66,8 | -0,3 | 88,6 | -19,9 | 114,6 | -8,7 | 115 |
| UK | -2,6 | 41,9 | -2,2 | 85,4 | -16,5 | 108 | -9,2 | 111,5 |
| Germany | 0,2 | 63,7 | 1,5 | 59,5 | -8,2 | 73,3 | -3,2 | 72,2 |
| France | -2,5 | 64,4 | -3 | 98,1 | -10,8 | 118,7 | -6,5 | 118,6 |
| Italy | -1,5 | 99,8 | -2,8 | 134,8 | -14,1 | 161,8 | -7,5 | 158,3 |
| Average | -1,5 | 82,4 | -2,3 | 116,2 | -14,6 | 139,1 | -7,2 | 139,0 |

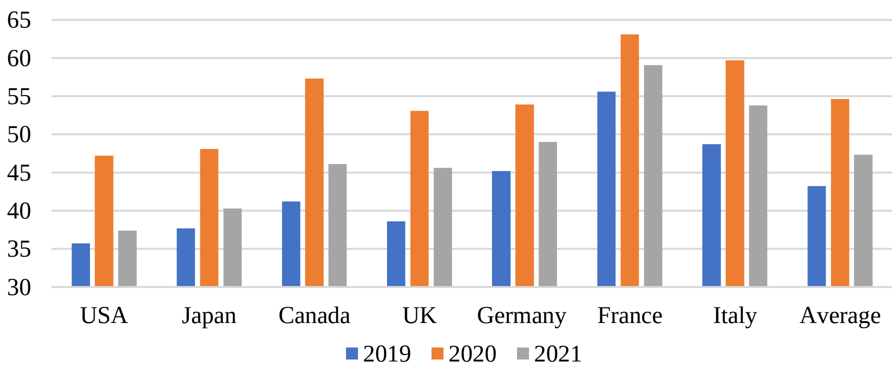
Source: IMF (2020b) Fiscal Monitor, October 2020.

The fiscal situation of many countries' public finances became much worse with the Covid crisis, as Table 1 shows. The autumn 2020 round of fiscal projections by the IMF shows that public debt is expected to jump by over 20 per cent of GDP for the average of the G7 and advanced countries in 2020 compared to 2019. The United States will see public debt in 2020 at a similar level as Italy in 2019. France, Canada and the United Kingdom will also feature debt well above 100 per cent of GDP. Japan's public debt will reach a staggering 266 per cent of GDP. G7 debt would be roughly at the same level as after World War II but without the prospect of high growth in the post-crisis period.

Fiscal dynamics are also scary from another angle. Public deficits have reached double digit ratios as a share of GDP in many large countries, and the deterioration for the G7 countries is over 12 per cent of GDP on average. 2021 will see an improvement to 7 per cent of GDP as growth recovers and public debt will broadly stabilise. But average deficits remain high and risk leading to further debt increases thereafter.

These figures reflect another, deeper challenge: rising deficits reflect major increases in public expenditure ratios from already elevated ratios in many advanced countries (Chart 10). Average public expenditure in G7 countries is expected to rise by almost 12 per cent of GDP in 2020. In France and Italy, the ratio will reach or exceed 60 per cent of GDP. Such expenditure ratios - even if declining in 2021 as predicted by the IMF - are hardly financeable in the long run and need to be brought down again.

**Chart 10 Public Expenditure Ratios, General Government (per cent of GDP)**




Source: IMF (2020b) Fiscal Monitor October 2020.

An ageing population and the potential fiscal costs from high private debt causing difficulties in the corporate and financial sector will potentially further add to countries' fiscal burdens. Many observers, therefore, believe that there are limits to the levels of deficit and debt that can be accumulated as this puts the sustainability of the public finances at risk. Such observers would argue that the return to sound public finances will depend very much on fiscal discipline and growth-friendly reforms.

Other observers, however, doubt that a limit to indebtedness will arise in the foreseeable future and point to ultra-low interest rates as a good argument for even more debt. While it is true that debt service costs are likely to be low for some time, so are real economic growth prospects. Moreover, interest rates may not stay at today's low level. Already great divergences exist across countries and these may further increase when people become more aware of the riskiness of high debt (Fuest and Gros, 2019). The European recovery package of €750 billion may alleviate some short-term concerns but, by itself, it does not address the underlying problems in a number of European countries. Hence, it is not prudent to raise debt 'up to the hilt' and then be surprised when conditions get worse. And while small countries can be 'bailed out' by the international community, it is more difficult with big ones.

Some observers argue that active fiscal consolidation should wait until the recovery is firmly on track and output and employment gaps have become much smaller again (e.g. OECD, 2020; IMF 2020b). The uncertainties - about Covid and the restrictions, the infection rates or the availability of a vaccine - may deter governments from planning for the medium term. But financial markets do not necessarily wait for governments deciding when the moment is right. It is therefore paramount that realistic strategies for a return to sustainable public finances are proposed and preparations start, irrespective of the uncertainties prompted by Covid. The pre-Covid period indicates there was virtually no consolidation in the economic recovery after 2014 – there never seems to be a right time!

The return to sound public finances does not have to be costly for jobs and growth as some people claim. There are structural and fiscal reforms that enhance growth and help consolidate public finances. Confidence effects would then boost demand even if fiscal policies are contractionary so that the net effect is less negative or even positive. Alesina et. al. (2019), Schuknecht and Tanzi (2005) and Schuknecht (2020) provide ample evidence of how expenditure-based consolidation can have positive effects on the real economy, and is more likely to attain higher growth and lower debt at little if no cost to social indicators and with much better prospects for jobs.

Tax increases have rarely proved successful in bringing down debt in a sustainable manner. The evidence is that their debt weight costs typically reduce growth, thus countervailing the positive effects on the public finances. Moreover, in a number of advanced countries tax rates are already near the revenue maximising level (Akgun et. al, 2017) so that further increases might not yield much additional revenue.

Some observers argue that consolidation is not needed – and more public investment spending would pay for itself via higher growth. While it is true that investment could raise GDP and thereby revenue, it is questionable whether in practice, there are enough such high-yielding projects and whether higher spending would actually be used for such projects. As mentioned above, the reality is that good public investments are rarely delayed due to a lack of financing. It seems to be also quite forgotten, that the private sector, via public private partnerships, could take this role without raising public spending and deficits - and has been doing so in many countries.

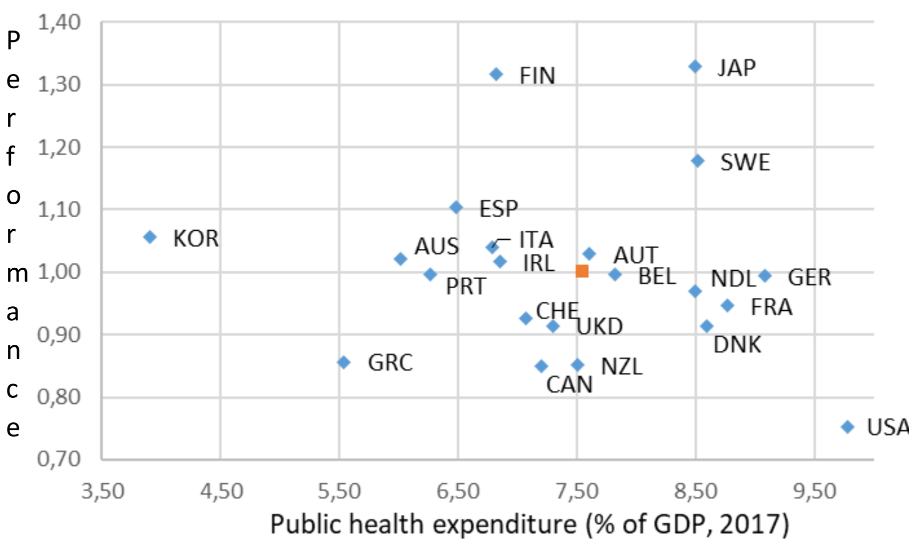
In fact, there are huge differences in the ‘value for money’ citizens get from their governments across countries (Afonso and Schuknecht, 2019; Schuknecht 2020). Countries differ as regards basic framework conditions regarding the business environment and the rule of law. This is also true in all other key areas of economic and government performance such as education or infrastructure (see below). The Covid crisis has starkly revealed some such differences in the health sector.

## Expenditure v Performance – Spotting the Difference

The message on realising the potential for expenditure savings in the post-Covid world is corroborated by the facts about ‘value for money’. When looking at health expenditure and the performance of health systems, there is little relation between spending and health outcomes (Chart 11, see also Afonso et. al (2005) and Schuknecht (2020)). As the Chart reveals, countries have very different expenditure ratios for health (on the X-axis) and perform very differently around an average of 1 (on the Y axis). France had serious difficulties with managing Covid patients but it has one of the highest health expenditure ratios in the world. Greece, that coped relatively well, has one of the lowest. Hence the key is to spend money wisely and in an efficient manner. Or in other words, 'better government' not 'more government' should be the motto looking forward.

The diverse picture for health is very similar in other spending areas such as education or infrastructure (Afonso, Schuknecht and Tanzi, 2005; Schuknecht, 2020). Countries that spend less money do not necessarily perform less well and often do better than big spenders. Social spending is also often poorly targeted so that benefits to the poor are limited while fiscal costs and disincentives loom large. Many countries could achieve much better public goods and services it they spent their money more wisely.

**Chart 11. Health Performance and Health Expenditure (per cent of GDP, 2017)**




Source: Own calculations. Average performance score=1

At the macro level, we see that countries like Switzerland, Australia and Ireland feature public expenditure ratios of 'only' up to around 35 per cent of GDP before the Covid crisis and they are doing well in almost every respect of public sector performance (Afonso and Schuknecht, 2019 and Schuknecht, 2020). By contrast, there are a number of countries with high public spending and mediocre public services. Germany, Canada and the United Kingdom are somewhere in the middle. Most countries have much scope for expenditure reform to boost growth and consolidate their public finances in the future.

**Sound, High Quality Public Finances – How to improve incentives**

First and foremost, it is essential to return to rules-based policy making so that policy makers have an incentive to meet sound macroeconomic objectives and improve the quality of government. Fiscal rules on deficit, expenditure and debt are needed. They allow the adjustment path for public finances to be tailored to the needs of sustainability and the economic environment.

Rules and procedures governing the budget process serve to underpin a country's success in achieving its macroeconomic goals and objects. They also strengthen the quality of public goods and services. Medium-term budgetary frameworks, spending reviews, financial risk analysis and independent fiscal councils are some of the instruments to attain these objectives (OECD, 2019b). The OECD and IMF have issued principles for sound public investment and public private partnership management (Ruiz and Schuknecht, 2019).

There is, however, one prerequisite for fiscal rules to be effective: they must be implemented and enforced. Lack of implementation has been at the root of calamities in many countries, rather than bad rules.

# V
# Conclusion and Next Steps

From a longer-term perspective, there are three major challenges for our economies and our prosperity. First, the evidence suggests that better framework conditions would boost private investment, employment and growth, which would also benefit low-income and vulnerable groups. Second, open markets and international cooperation would enhance productivity, jobs and resilience. And third, governments that pursue sound public finances and focus on key services at a high quality underpin economic and social stability.

Though a strong case could be made at the outset of the pandemic for governments to introduce significant stimulus, the important task now is to plan for recovery with –

**Market Friendly Policies**

- Strengthen the environment in which people invest through unfussy procedures and market-friendly regulations
- Avoid interventions which distort the market
- Improve education and training
- After the crisis is over let firms prosper or perish according to the market

**Trade Friendly Policies:**

- Keep markets open
- Avoid the disruption to supply chains caused by protectionist measures
- Avoid nationalisation of production except for very special cases.
- Seek further international agreements on liberalisation

**Sustainable, High-quality Public Finances**:

- Bring down expenditure, deficit and debt ratios via rules-based policies
- Reform public expenditure to focus on the provision of key public services and strengthening their quality

Market-friendly domestic economies, open borders for trade, and healthy and sustainable finances are the triangle of stability that we need to secure for the future. This is all the more important given all the challenges, from population ageing to financial uncertainty, social stability and climate change, for which we need well-performing and solvent governments.

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In *Preparing for Economic Recovery: More Market, Better Government*, the German economist, Ludger Schuknecht, addresses the fundamental question facing governments across the globe. Should they pursue interventionist policies with further public spending, industrial policy and protectionism? Or should they resist the temptation to increase the size and role of the state, call halt to higher public spending and debt and the cocktail of protectionist and regulatory policies to focus on a market-friendly reform agenda?

Dr Schuknecht, a former Deputy Secretary-General at the OECD and Chief Economist at the German Federal Ministry of Finance, explains that the surest way to recovery is through market-friendly policies, smaller and better government, and open trade. The first step must be to return to rules-based economic policy-making, to build recovery on a triangle of stability, with well-functioning markets, open economies, high-quality public services and sound public finances. It is in this way, the author concludes, through solvent and well performing governments, that the challenges of the future, from financial uncertainty to climate change, can best be met.

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