

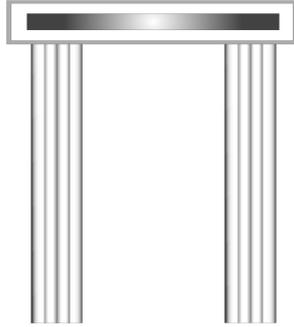
**Ludger Schuknecht**

**The Economy, The Public Finances  
and The Challenges Post Covid:  
The Longer View**

Working Paper July 2020\*

**POLITEIA**

**A FORUM FOR SOCIAL AND ECONOMIC THINKING**



## POLITEIA

A Forum for Social and Economic Thinking

Politeia commissions and publishes discussions by specialists about social and economic ideas and policies. It aims to encourage public discussion on the relationship between the state and the people. Its aim is not to influence people to support any given political party, candidates for election, or position in a referendum, but to inform public discussion of policy.

The forum is independently funded, and the publications do not express a corporate opinion, but the views of their individual authors.

**[www.politeia.co.uk](http://www.politeia.co.uk)**

The Economy, The Public Finances and The Challenges Post Covid  
The Longer View

Ludger Schuknecht

Working Paper July 2020\*

\* This is a working draft of a longer analysis which will be published by Politeia in a revised extended, and updated version in the autumn.

**POLITEIA**

2020

First published in 2020  
by  
Politeia  
14a Eccleston Street  
London  
SW1W 9LT  
Tel: 0207 799 5034

E-mail: [secretary@politeia.co.uk](mailto:secretary@politeia.co.uk)  
Website: [www.politeia.co.uk](http://www.politeia.co.uk)

© Politeia 2020

Cover design by John Marenbon

## The Author

**Ludger Schuknecht** is Deputy Secretary-General at the OECD. He was Chief Economist at the German Federal Ministry of Finance (2011-2018) advising on the fiscal and economic policy issues, the international economy and responsible for the finance track of the G20 process. He has been Senior Advisor at the European Central Bank (1999-2011), and an economist at both the World Trade Organisation (1997-1999) and IMF (1992-1996). His books include *Public Spending in the 20<sup>th</sup> Century: A Global Perspective* co-authored with Vito Tanzi (2000). His new book, *Public Spending and the Role of the State: History, Performance, Risk and Remedies*, will be published later this year.

His Politeia publication include *Boom, Busts and Fiscal Policy: Public Finances in the Future* (2009), *More Gain Than Pain: Consolidating the Public Finances* with Philipp Rother and Jürgen Stark (2011); *Going for Growth: The Best Course for Sustained Economic Recovery* with Norbert Hoekstra and Holger Zemanek (2012) and *Paying for the Future: Working Systems for Pensions and Healthcare* with Matthias Dauns and Werner Ebert (2015).

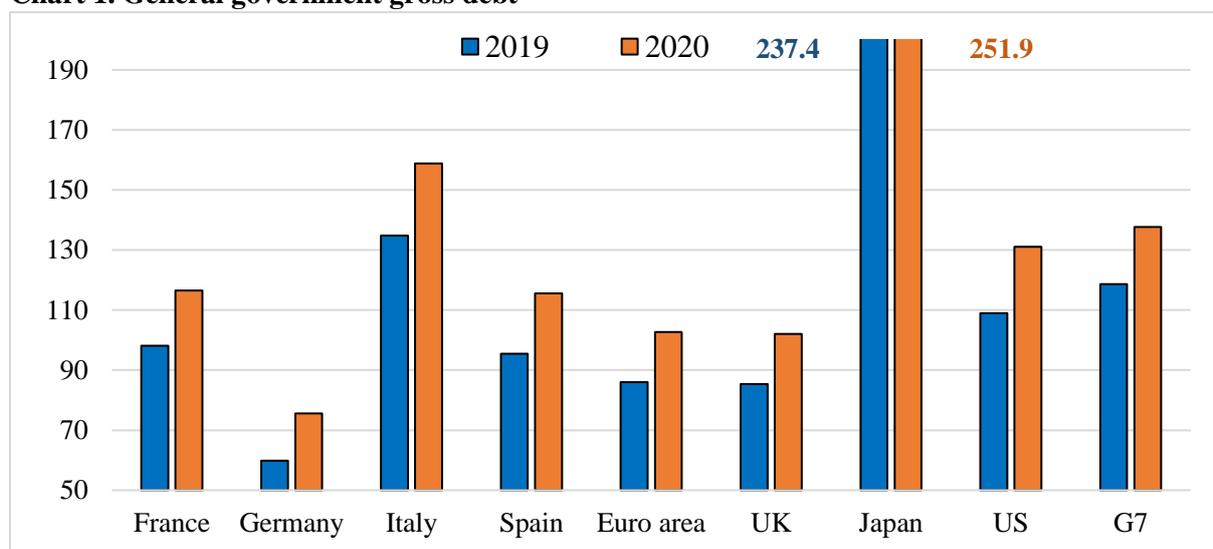
## The Economy, The Public Finances and the Challenges post Covid - The longer view\*

### I The Triangle of Stability: Sound Public Finances and Sustainable Public Debt

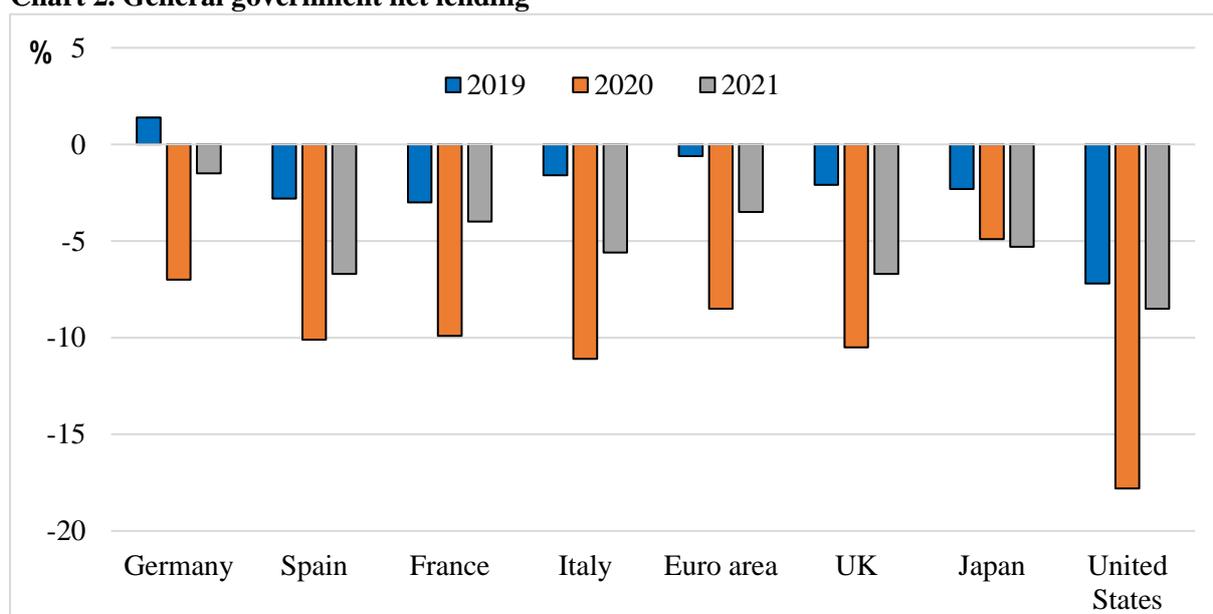
Now that western economies are emerging from the lockdown, the challenge is to put in place the policies for economic recovery. A clear plan which focuses on the triangle of stability, with market and growth-friendly structural policies, a healthy financial system and sound and sustainable public finances, will help promote sustained recovery. The Covid-19 crisis has underpinned the importance of all three and especially that of sustainable public finances on which this paper will focus.

The dismal situation of many countries' public finances becomes obvious from the latest round of fiscal projections by the European Commission. Public debt is expected to jump by about 15 per cent of GDP for the average of advanced countries in 2020 compared to 2019. Public deficits reach double digit ratios as a share of GDP in many large countries, a deterioration by over 7 per cent of GDP on average (Chart 1 and 2, see also European Commission, 2020).

**Chart 1. General government gross debt**



**Chart 2. General government net lending**

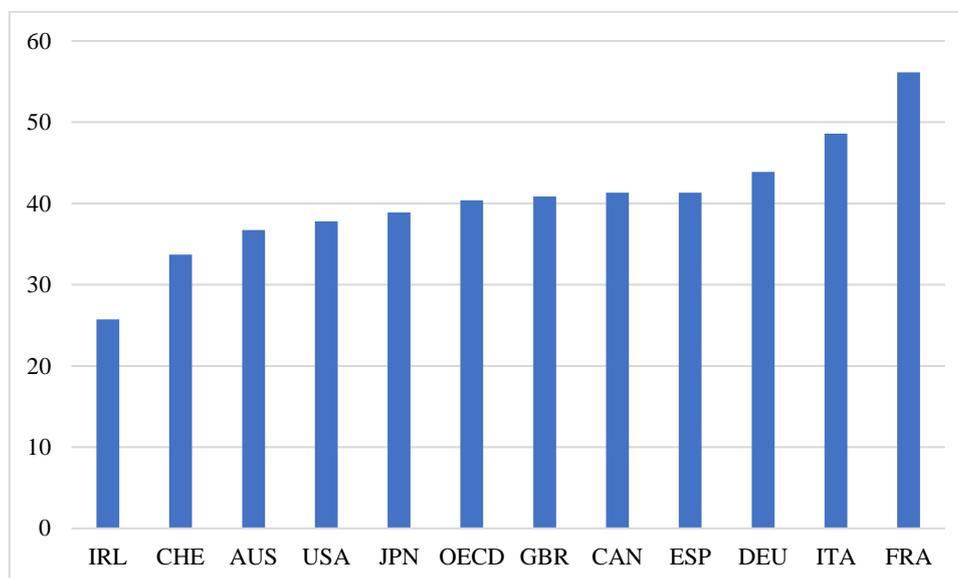


Source: European Commission, 2020, Spring Forecast.

\* This is a working draft of a longer analysis which will be published by Politeia in a revised, extended and updated version in the autumn

Euro area debt will average above 100 per cent of GDP with Italy above 150 per cent of GDP and Greece around 200 per cent. Japan's public debt will exceed 250 per cent, the United States 130 per cent. The G7 public debt will reach about the same level as it was at the end of World War II – without the prospect of strong growth eroding it quickly as it did 50-70 years ago.

**Chart 3. with expenditure bars for total expenditure, advanced OECD countries**



*Note: Data for 2018, data for Australia and OECD average are for 2017*

*Source: OECD, Government at a Glance, 2019a*

These figures reflect major increases in public expenditure ratios from already elevated ratios of up to 56 per cent of GDP (Chart 3). Average public expenditure in advanced countries are expected to rise by another 7 per cent or so of GDP and in some countries the ratio will reach around 60 per cent in 2020. Such expenditure ratios are not financeable in the long run and need to be brought down again.

Most observers see limits to deficit and debt accumulation and risks to the sustainability of public finances. Even though there is some disagreement as to how far and how long the current phase of debt expansion should and can continue, ultimately higher spending, higher taxes and higher debt will undermine growth and confidence in fiscal sustainability. Debt service costs are likely to be very low looking forward but so are real economic growth prospects. However, interest rates may not stay as low as today and there are great divergences across countries that may increase further when the risk sentiment shifts (Fuest and Gros, 2019). The European recovery package of Euro 750 billion may alleviate some short term concerns but, by itself, it does not address the underlying problems in a number of European countries.

Finally, 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. The Covid-19 crisis has revealed some such differences in the health sector.

This yields three main lessons as regards the what, the when and the how of fiscal consolidation and reform in the future. The first (on the 'what') is relatively straightforward. It is essential that governments bring debt down again and for that, governments need to re-approach near balanced budgets in the years to come. The past decade has shown that only countries with low deficits also succeeded in bringing down public debt. Higher growth rates and surpluses would of course allow a faster debt reduction. But even with a surplus for several years, it took Germany a whole decade to reverse the financial-crisis related debt increase. A chronic deficit of several per cent of GDP will do little in that regard when economic growth is limited.

## II When to Consolidate?

The second question on the ‘when’ is very difficult. 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). Let’s hope that financial markets provide us with sufficient time. But if the pre-Covid period provides any guidance, countries will need to ‘bite the bullet’ at some point. There was virtually no consolidation in the economic recovery after 2014—there never seems to be the right time!

There is a link between the ‘when’ and the third question, the ‘how’ that is important to consider. 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 how expenditure based consolidation can have positive effects on the real economy, and is more likely to attain higher growth and lower debt than corresponding tax increases. The trade-off between consolidation and recovery is not as black and white as some economists insinuate.

Tax increases have rarely proven successful in bringing down debt in a sustainable manner. Their debt weight costs typically reduced growth, thus countervailing the positive effects on 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.

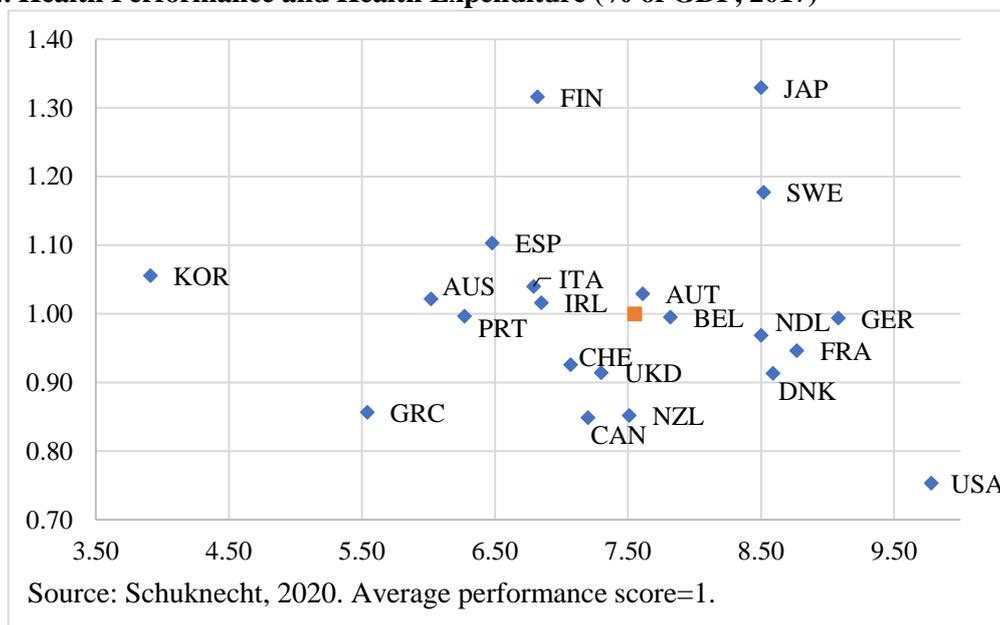
The challenge of consolidation seems to be rendered more complicated this time around, as there are many calls for additional public spending. For example, some observers argue that deficiencies in the management of the Covid-19 crisis requires higher social spending. This, however, is highly debatable.

## III Expenditure – A Good or Bad Indicator of Performance

When looking at health expenditure and the performance of health systems, there is little relation between spending and health outcomes (Chart 4, see also Afonso et. al (2005) and Schuknecht, (2020). 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 picture is very similar in other spending areas such as education or infrastructure. Countries could achieve much better public goods and services if they spent their money more wisely.

**Chart 4. Health Performance and Health Expenditure (% of GDP, 2017)**



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 (2018 data) and they are doing well in almost every respect of public sector performance (see earlier Chart 4 and 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 public finances in the future.

#### **IV Fiscal Policies in the Coming Years**

What then, should guide fiscal policies in the coming years?

First and foremost it is essential to return to rules-based policy making to meet 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).

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, not bad rules.

## **Bibliography**

- Afonso, A. and L. Schuknecht (2019) How ‘Big’ Should Government Be? *Economics and Business Letters* 8(2) 85-96.
- Afonso, A., L. Schuknecht and V. Tanzi (2005) Public Sector Efficiency: An International Comparison. *Public Choice*, 123(3–4): 312–347.
- Akgun, O., D. Bartolini and B. Cournède (2017) The Capacity of Governments to Raise Taxes. OECD Economics Department Working Papers 1407.
- Alesina, A., C. Favero and F. Giavazzi (2019) *Austerity: When It Works and When It Doesn’t*. Princeton University Press.
- Fuest, C. and D. Gros (2019) Government Debt in Times of Low Interest Rates: The Case of Europe. *EconPol Europe Policy Brief* 16/2019.
- Organisation for Economic Cooperation and Development (OECD) (2019a) *Government at a Glance*, Paris.
- Organisation for Economic Cooperation and Development (OECD) (2019b) *Budgeting Outlook*. Paris
- Organisation for Economic Cooperation and Development (June 2020) *Economic Outlook* 107, Paris.
- Schuknecht, L. (2020 forthcoming) *Public Spending and the Role of the State*. Cambridge: Cambridge University Press.
- Schuknecht, L. and V. Tanzi (2005) *Reforming Public Spending: Great Gain, Little Pain*. London: Politeia.