Atlantic Council

GLOBAL BUSINESS
& ECONOMICS PROGRAM

EuroGrowth **Initiative**

EUROPE NEEDS TO TRIM ITS EXCESSIVE FISCAL BURDEN

Foreword by
José Manuel Barroso
Stuart E. Eizenstat

Author
Anders Åslund

A EuroGrowth Initiative Publication

EUROPE NEEDS TO TRIM ITS EXCESSIVE FISCAL BURDEN

Foreword by
José Manuel Barroso
Stuart E. Eizenstat

Author
Anders Åslund

ISBN: 978-1-61977-469-8

Cover photo credit: Berlinimpressions/123RF.

September 2016

EUROGROWTH INITIATIVE TASK FORCE

CHAIRS

José Manuel Barroso
Former European Commission President

Stuart E. Eizenstat
Former US Ambassador to the European Union
Former Deputy Secretary of the US Treasury

MEMBERS

Anders Åslund
Resident Senior Fellow, Atlantic Council

Gordon Bajnai
Group Chief Operating Officer, Meridiam;
Former Prime Minister of Hungary

Thomas C. Barrett
Director & Chief Representative,
European Investment Bank;
Minister of the EU Delegation to the United States

Neil R. Brown
Director, KKR Global Institute

Courtney Geduldig
Executive Vice President,
Public Affairs McGraw Hill Financial

C. Boyden Gray
Former US Ambassador to the European Union

Stefano Itri
Vice President, BDT Sales, Beretta

Andrius Kubilius
Former Prime Minister of Lithuania

Laura J. Lane
President, Global Public Affairs, UPS

Enrico Letta
Dean of the Paris School of International Affairs
(PSIA) at Sciences Po in Paris;
Former Prime Minister of Italy

Sir David G. Manning
Former UK Ambassador to the United States

Andrea Montanino
Director, Global Business and Economics
Atlantic Council

Richard L. Morningstar
Former US Ambassador to the European Union;
Founding Director & Chairman,
Global Energy Center, Atlantic Council

Peter Scher
Chairman of the Washington, DC, region,
and Head of Corporate Responsibility
JP Morgan Chase & Co.

Wayne T. Smith
Chairman and Chief Executive Officer, BASF USA

Earl Anthony Wayne
Fellow, Atlantic Council; Career Ambassador;
former Assistant Secretary of State for Economic
and Business Affairs

ABOUT THE EUROGROWTH INITIATIVE

The Atlantic Council 'EuroGrowth Initiative' is an EU-US platform to stimulate thinking on how the current challenges for the European economy can be transformed into opportunities to achieve a more sustainable growth path. Through briefs, reports, and events, the EuroGrowth Initiative identifies practical solutions and best practices, and provides a forum for new and innovative ideas. The initiative aims to energize—not teach—key stakeholders on both sides of the Atlantic and bring them to design the right approaches for growth, taking into consideration the unique European institutional setting.

Leveraging the expertise and network of the Atlantic Council's Global Business and Economics Program, the EuroGrowth Initiative presents Europe in a new light and promotes a deepened transatlantic partnership as Europe and the United States build a path for long-term growth together.

ACKNOWLEDGMENTS

The EuroGrowth Initiative is made possible by generous support by BASF, Beretta, the European Investment Bank, JPMorgan Chase & Co., United Parcel Service, Inc. (UPS), Ambassador C. Boyden Gray, and Ambassador Stuart Eizenstat.

The Atlantic Council and its donors do not determine, nor do they necessarily endorse or advocate for, any of this publication's conclusions.

FOREWORD

One of Europe's great concerns is low economic growth, especially after the global financial crisis that erupted in 2008. There may be many factors to low growth, but one peculiarity that appears to have contributed to this problem is that Europe has much larger public expenditures (and therefore taxation) than many other developed countries.

In the recent past, most non-European Union (EU) members of the G20 agreed to follow the example of the United States by increasing their fiscal spending to boost economic growth. However, the already high level of public expenditures and the burden of public debt did not allow European countries to do the same, limiting the scope for countercyclical fiscal policies.

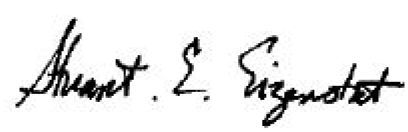
The ongoing debate among economists and G20 finance ministers about what level and kind of fiscal spending is needed to spur sustainable economic growth shows that there are no easy answers on the question of public expenditures. Quality matters as much as quantity, and the optimal size of public expenditure is far from clear. Anders Aslund's paper provides a fresh analysis of how European governments should spend their money to foster economic growth in a low growth and low inflation environment. We believe that raising EU growth potential is a multifaceted task and depends on a large number of components, of which public expenditure is only one.

The EuroGrowth Initiative of the Atlantic Council, co-chaired by the two of us, has commissioned a series of issue briefs investigating how to reinvigorate economic growth across Europe. These briefs hold a diverse range of views on how best to promote growth and do not necessarily reflect our own, but we recognize their sound intellectual framework and the joint desire to see Europe prosper.

With the EuroGrowth Initiative, we want to support a stronger Europe for the benefit of European citizens, the United States, and the entire world. Through the papers we publish and the events we organize, we want to galvanize a truly transatlantic community of stakeholders forging transatlantic solutions to current challenges. The substantial arguments put forth in this paper are a manifestation of this relationship at work.

José Manuel Barroso
Former European Commission President

Stuart E. Eizenstat
Former US Ambassador to the European Union
Former Deputy Secretary of the US Treasury



INTRODUCTION

Europe suffers from two major handicaps: poor economic growth and high unemployment. In 2015, the European Union (EU) finally returned to its pre-crisis gross domestic product (GDP) level, but average EU unemployment is 10 percent, compared to about 5 percent in the United States, the United Kingdom, Ireland, Denmark, and Germany. Europe needs more structural reforms to solve these problems. The crucial structural concern is that overall, public expenditures in Europe are 10 percent of GDP higher than in other developed countries. To enhance economic growth, Europe needs to reduce its excessive fiscal burden.[1]

KEY FINDINGS

- On average, EU countries have a 10 percent of GDP larger share of public expenditures than other developed nations.
- Not all EU countries have high public expenditures. They vary greatly, from 35-58 percent of GDP in 2014.
- Until the 1980s, the optimal size of public expenditures for economic growth was barely discussed. The discussion focused instead on how to finance public expenditures and keep the budget deficit and public debt at tolerable levels.
- Government expenditures on core public goods benefit economic growth, but their marginal utility declines when it exceeds 40 percent of GDP.
- The best way of cutting public expenditures is to eliminate or minimize what is not desired, such as subsidies that reduce economic welfare and efficiency.
- The worst kind of cuts are even cuts of all expenditures, because this does not structurally improve the public sector and all services are likely to deteriorate.
- Four groups of public expenditures should be slimmed down, namely public pensions, social benefits and transfers, public debt service, and especially public procurement.
- Considering that Europe's greatest economic problems are minimal growth and high unemployment, the EU should endeavor to reduce member countries' public expenditures to give them better opportunities to grow.
- Public expenditures of 35-42 percent of GDP appear desirable for an EU country.

With only 7 percent of the world's population, Europe still accounts for one fifth of global GDP, but half of the world's public expenditures.[2] A World Bank report of 2012 concluded:

> Governments in Europe spend about 10 percent of GDP more than their peers. Differences in government size within Europe and between Europe and its peers are largely explained by social spending. In 2010, countries in Western Europe spent 9 percent of GDP more on social transfers and 13 percent of GDP more on overall public spending than four 'Anglo-Saxon' countries (Australia, Canada, New Zealand, and the United States) and Japan.[3]

In 2009, at the peak of the global financial crisis, the EU countries' average public expenditures reached 50.3 percent of GDP. During the crisis, this share naturally rose as GDP contracted, while the cost of unemployment benefits and bank bailouts surged, but in 2015 this portion remained high at 47.4 percent of GDP.

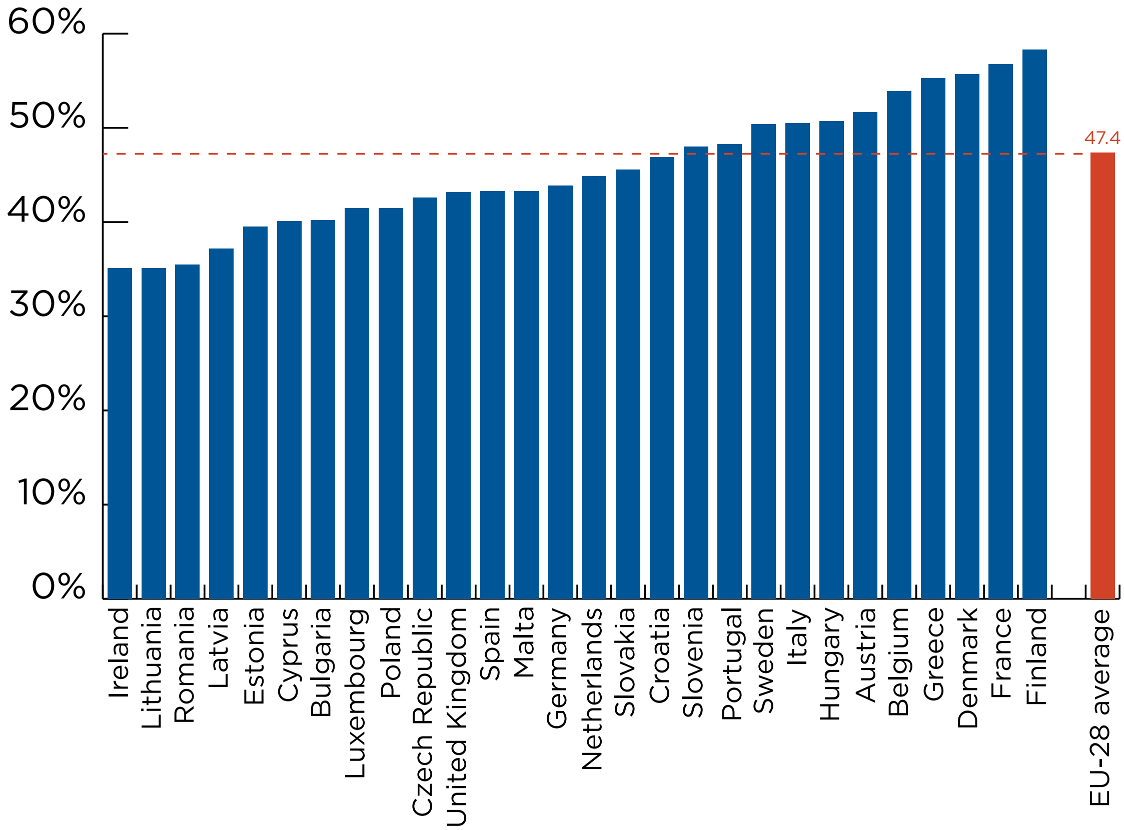
Not all EU countries have high public expenditures. They vary greatly, from 35-58 percent of GDP in 2014. Countries with public expenditures exceeding 50 percent of GDP are quite diverse: One group is the well-functioning Scandinavian countries (Finland, Denmark, and Sweden), while another consists of longtime EU members that are not particularly reform-minded (France, Belgium, Austria, Italy, and Greece), as well as two East European countries (Hungary and Slovenia). By contrast, nine EU countries, namely Ireland,

1 This issue brief has benefited from my research for our forthcoming book with Simeon Djankov, *Europe's Growth Challenge* (Oxford University Press). I am grateful to Simeon Djankov, Vito Tanzi, Andrea Montanino, Lilac Peterson, and Marie Kasperek for valuable discussions.

2 Indermit S. Gill and Martin Raiser, eds., *Golden Growth: Restoring the Lustre of the European Economic Model,* World Bank, 2012.

3 Op. cit., p. 354.

Figure 1. Public expenditure levels per EU member state, as percent of GDP



Source: Eurostat.

Lithuania, Romania, Latvia, Estonia, Cyprus, Bulgaria, Luxembourg, and Poland have public expenditures of 35-42 percent of GDP, while the rest are in the range of 40-50 percent of GDP (see graph 1).

Several questions arise that this issue brief intends to address. Why have public expenditures become higher in the EU than in other countries at a similar level of economic development? How have varying levels of public expenditures impacted economic growth? What level of public expenditures is desirable and how can the desired level be achieved? The paper concludes with six major policy recommendations.

WHY DID EUROPEAN PUBLIC EXPENDITURES RISE SO HIGH AND BECOME EXCESSIVE?

During the twentieth century, public expenditures surged for many reasons. Vito Tanzi, who headed the Fiscal Affairs Department of the International Monetary Fund (IMF) for two decades, has produced two seminal books on the development of public expenditures, *Public Spending in the 20th Century,* written with Ludger Schuknecht[4] and *Government Versus Market: The Changing Economic Role of the State*.[5] These are the best guides on the topic.

Traditionally, public expenditures were tiny because the *laissez-faire* policy of minimal government intervention in economic affairs dominated until World War I. The role of the state was limited to external and internal security, basic state administration, key infrastructure, elementary education, and some health care. This did not cost more than about 10 percent of GDP. From 1870 to 1913, their ratio as a share of GDP barely grew, rising from an average in developed countries of 11 percent to 13 percent.[6]

The quarter of the century before World War I was the golden age of social democratic theories, when many advocated a greater role for the state. The German economist Adolf Wagner was an early proponent for redistribution of wealth through taxes and social benefits, and he left a lasting legacy. In 1876, Wagner argued that the share of public expenditure in national income would increase with rising national income, which became known as Wagner's law and gained wide acceptance.[7] Its logic is easy to understand. The richer a country grows, the more education, health care, pensions, and other forms of social welfare it can afford; most Europeans presumed these additional benefits would be both financed and provided by the state.

The big expansion of the state occurred during World Wars I and II, which annihilated *laissez-faire.* States mobilized all possible resources to the defense of the nation. During World War II, marginal income taxes skyrocketed to over 90 percent in many Western countries.[8] Prohibitive customs tariffs and far-reaching currency regulations restricted foreign trade. Rationing was imposed, and many countries nationalized major industries. Although these were emergency measures, extensive state controls persisted until they were intentionally dismantled.

In the 1930s, the Great Depression dealt a nearly mortal blow to the old-style classical economics that insisted the market would naturally find its balance. In 1932, Franklin D. Roosevelt was elected US president and launched far-reaching state intervention in his New Deal. In 1936, John Maynard Keynes published his famous *General Theory of Employment, Interest, and Money.* Keynes' fundamental insight was that the market did not necessarily lead to macroeconomic balance. He argued that the government should increase expenditures and reduce taxes in order to stimulate demand to pull the economy out of depression.[9]

The previous strict limits to state action were eased up, but it was unclear when "Keynesian economics" was applicable and how it could be used. As Tanzi noted, it "was always politically easier to increase spending or reduce taxes than to do the opposite." Therefore, the Keynesian paradigm caused a policy asymmetry that would lead to steadily higher public spending in the long run.[10] The central issue shifted from which public expenditures were justified to how much the state could finance.

In the early postwar period, Europe retained extremely high marginal personal income taxes, strict currency regulation, and tightly controlled national financial markets. At least in Northern Europe, which for historical reasons had small and effective state administrations, income and wealth could hardly avoid taxation. Overall, the total tax burden remained moderate until the end of the 1960s, when extreme leftwing ideas spread throughout Europe and drove up effective taxation, as nominal tax rates were not adjusted to rising inflation. The transition from sales taxes to comprehensive and ever higher value-added

4 Vito Tanzi and Ludger Schuknecht, *Public Spending in the 20th Century* (New York: Cambridge University Press, 2000).

5 Vito Tanzi, *Government Versus Market: The Changing Economic Role of the State* (New York: Cambridge University Press, 2011).

6 Tanzi, 2011, op. cit., p. 9.

7 Tanzi and Schuknecht, 2000, op. cit., p. 15.

8 Including the United States from 1951-63.

9 John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (London: Macmillan, [1936] 1973).

10 Tanzi, 2011, op. cit., p. 85.

taxes added a large source of non-distortionary tax revenue.[11] Since tax revenues rose seemingly without effort in Northern Europe, public expenditures surged accordingly.

The 1960-80 period could be described as the golden age of public sector intervention,[12] and the 1970s were the heyday of Keynesianism. The dominant Keynesian view was that the government should reduce unemployment through demand management by increasing inflation. Strikingly, the economic efficiency of high public expenditures was hardly discussed, nor were the high marginal income taxes seriously questioned. The view prevailed that the state could do no wrong, but it had to intervene ever more to correct market failures.

In the 1950s, Northcote Parkinson had discussed the problems of steadily growing and dysfunctional bureaucracies, and he formulated "Parkinson's Law," which stated that the number of employees in a bureaucracy increased by 5-7 percent per year irrespective of the work to be done because an official wanted to multiply his number of subordinates, who then made work for one another. His prime example was how the British Colonial Office had expanded when Britain's empire declined. Unfortunately, Parkinson's Law was treated more like humor than a serious social critique.

> The main blow against the ideology of high public expenditures . . . was the emergence of "stagflation" in the 1970s.

The main blow against the ideology of high public expenditures, however, was the emergence of "stagflation" in the 1970s. In 1973, an oil crisis hit the West and oil prices rose sharply. Rather than tighten their belts, European governments pursued policies derived from Keynesian concepts, which held that increased public expenditures would reduce unemployment. Instead, the outcome was economic stagnation with high inflation and ever higher unemployment. Inflation rose to 10-20 percent, as did unemployment in most Western countries. The 1970s also saw serious structural crises in Europe, as much of the steel industry, mining, and shipbuilding, especially state corporations, went under, exposing them to critical scrutiny. Lawrence Summers has summarized the received wisdom that fiscal policy "was not considered to have a primary role in managing demand because it was slow acting and might push interest rates up and because monetary policy could do what was needed."[13]

In 1978-9, the United Kingdom experienced a winter of discontent with devastating wildcat strikes, bringing society close to anarchy. Britain became known as the sick man of Europe because of its low postwar growth and its dysfunctional labor market. In May 1979, Margaret Thatcher was elected conservative prime minister on a radical free-market platform. She broke the old social welfare paradigm in Europe as a whole.

The crisis also spread to the north. The rich North European countries had developed the most extensive and costly social welfare systems, and in the 1980s they were hit by one financial crisis after the other. The root of these crises was always a large budget deficit that the states could no longer finance. Other problems were high inflation and unemployment, an exchange rate crisis, and a banking crisis. Such crises hit Denmark in 1982, the Netherlands in 1987, Norway, Sweden, and Finland in 1989-92. Swedes were shocked to find that their country had slipped from the fourth wealthiest country in the world in 1970 to the eighteenth wealthiest in 1990. For these two decades, its growth rate had lagged one percentage point a year behind the Organization for Economic Co-operation and Development (OECD) average.[14] These crises triggered a rethink of liberal economic thinking. Fundamentally critical questions were finally posed about what the state should do and how.[15]

The many state failures caused a revival of free market thinking. Suddenly, the leading old free market economists Friedrich Hayek and Milton Friedman attracted new attention and received Nobel Prizes. They and their Chicago School saw not market failures, but state failures. The new public choice school of thought criticized the all-embracing social welfare state, claiming that the state was not intrinsically

11 Because the value-added tax (VAT) is a consumption tax that is applied to a product in each stage of its production, and any producer can deduct incoming VAT from the VAT he or she is liable to pay.

12 Tanzi and Schuknecht, 2000, op. cit., p. 16.

13 Lawrence H. Summers, "The Age of Secular Stagnation. What It Is and What to Do About It," *Foreign Affairs*, March/April 2016.

14 Andreas Bergh and Magnus Henrekson, *Government Size and Implications for Economic Growth* Washington: American Enterprise Institute Press, 2010.

15 The most successful example was probably the so-called Lindbeck Commission in Sweden: Assar Lindbeck et al., *Turning Sweden Around* (Cambridge, MA: MIT Press, 1994).

good.[16] It pointed out the limitations of the rationality and efficiency of the state.

In 1989, communism collapsed in Eastern Europe, delivering another blow to a large role for the state. The foremost East European economic policymakers, Leszek Balcerowicz in Poland and Vaclav Klaus in Czechoslovakia were more radical free marketers than any West European leader, apart from Prime Minister Thatcher. They opted for fast privatization, small public expenditures, low taxes, and markets as free as possible.

16 Its origin is traced to James Buchanan and Gordon Tullock, *The Calculus of Consent* (Ann Arbor, MI: University of Michigan, 1962).

In the 1980s, financial markets were increasingly deregulated and globalization caught on. Money was no longer limited to individual countries but could ever more easily be transferred between countries. As very wealthy people emigrated to countries with lower taxes, their capital could no longer be taxed at high levels, and the same was soon true of corporate profit taxes, as tax competition caught on. Left to bear the tax burden were ordinary people, who had to pay value-added taxes, high payroll taxes, and income taxes. This appeared neither fair nor just.

By the early 1990s, much of Europe had arrived at the fundamental questions: What is the state really supposed to do? What is the right level of public expenditures? What should the state stop doing, and how should it abandon such tasks?

IMPACT OF PUBLIC EXPENDITURES ON ECONOMIC GROWTH

Strangely, until the 1980s there was little discussion about how large public expenditures were good for economic growth. The issue was rather how to finance public expenditures and keep the budget deficit and public debt at tolerable levels.

In the 1980s and early 1990s, Sweden had the largest public expenditures in the world as a share of GDP, which attracted the attention of Swedish economists. In 2010, Andreas Bergh and Magnus Henrekson published a useful book, *Government Size and Implications for Economic Growth*.[17] They examined studies of growth of real GDP per capita over long periods and found that "the research is actually close to a consensus: In rich countries, there is a negative correlation between total size of government and growth."[18] They added: "No OECD country has collected taxes of more than 40 percent of GDP *and* during the same decade achieved an average annual growth rate exceeding 3 percent."[19] Their overall conclusion was: "The most recent studies find a significant negative correlation: an increase in government size by 10 percentage points is associated with a 0.5 percent to 1 percent lower annual growth rate."[20]

The World Bank came to a very similar conclusion in 2012: "Over the last 15 years, higher initial government size has led to slower economic growth. In Europe, a 10 percentage point increase in initial government size leads to a reduction in annual growth by 0.6-0.9 percentage points. Government reduces growth, particularly when it exceeds 40 percent of GDP."[21]

17 Andreas Bergh and Magnus Henrekson, *Government Size and Implications for Economic Growth* (Washington: American Enterprise Institute Press, 2010).

18 Op. cit., p. 1.

19 Op. cit., p. 9.

20 Andreas Bergh and Magnus Henrekson, 2011, "Government Size and Growth: A Survey and Interpretation of the Evidence," *Journal of Economic Surveys*, *25*(5), 872-897.

21 Indermit S. Gill and Martin Raiser, eds., *Golden Growth*, op. cit., p. 354.

> [E]xcessive government consumption, subsidies, and social transfers harm economic growth, while basic public activities are beneficial.

The main breakthrough in the study of the impact of public expenditures on economic growth occurred in 1989, when Robert Barro published a regression analysis of seventy-six relatively developed countries. He concluded that "government consumption is inversely related to growth, whereas public investment has little relation with growth."[22] He reckoned that all government consumption, apart from defense and education, had a negative effect.[23] His insights have been reflected in many other academic articles. The prosaic conclusion was that "productive government expenditure enhances growth, whilst non-productive expenditure does not."[24] Hansson and Henrekson assessed that government transfers, consumption, and the volume of total outlays had a negative impact, while education expenditures benefited economic growth.[25] An overall conclusion is that government consumption, subsidies, and government investment have a "sizeable, negative and statistically significant effect on growth."[26]

It makes sense that excessive government consumption, subsidies, and social transfers harm economic growth, while basic public activities are beneficial. A modern society needs a substantial and well-functioning state, and government expenditures on core public goods benefit economic growth, but their marginal utility declines at a certain level.

22 Robert Barro "Economic Growth in a Cross Section of Countries," National Bureau of Economic Research Working Paper, No. 3120, September 1989.

23 Robert Barro, *Determinants of Economic* Growth (Cambridge, MA: MIT Press, 1997).

24 Richard Kneller, Michael F. Bleaney, and Norman Gemmell, "Fiscal Policy and Growth: Evidence from OECD Countries," *Journal of Public Economics*, 1999, 74(2), pp. 171-190.

25 Pär Hansson and Magnus Henrekson, "A New Framework for Testing the Effect of Government Spending on Growth and Productivity," *Public Choice*, 1994, 81(3-4), pp. 381-401.

26 Antonio Afonso and Davide Furceri, "Government Size, Composition, Volatility and Economic Growth," *European Journal of Political Economy*, 2010, 26(4), pp. 517-532.

Several controls are needed to evaluate what public spending makes sense. In particular, controls are needed for initial GDP levels to avoid any confusion with the catch-up growth of less-developed nations. The relevant measure is not GDP but GDP per capita, since what is of interest is the relative wealth of people rather than changes in the size of the population. It is claimed that the Scandinavian countries have managed to combine high public expenditures with respectable economic growth, but this is not quite accurate. The initial quality of governance is important. Since the nineteenth century, these countries had well-functioning small state apparatuses and very free economies, which made them rich. When their states expanded in the 1970s and 1980s, their growth declined, and they all ended up in serious financial crises, which forced them to carry out vigorous structural reforms promoting new growth. They grew the most when they cut public expenditures and regulations.

The conclusion is that rich countries have "a robust negative correlation between total government size and growth."[27] Or as the World Bank put it: "What government does and how it finances its activities are [also] important."[28]

27 Andreas Bergh and Magnus Henrekson, *Government Size and Implications for Economic Growth*, (Washington: American Enterprise Institute Press, 2010), p. 30.

28 Indermit S. Gill and Martin Raiser, eds., *Golden Growth*, op. cit., p. 355.

WHICH PUBLIC EXPENDITURES ARE DESIRABLE AND WHICH ARE NOT?

The tables were turned on the public sector. Increasingly, the question became pragmatic rather than ideological: It was no longer whether an individual should be allowed to profit from one activity or another, but how government services could be delivered to the public in the most efficient way. Also, is the public or private sector more efficient in each specific case?

Hardly anybody disputes that genuine public goods exist, but their sphere is limited. The most fundamental need of a state is external defense, which NATO demands should rise from the current EU-wide level of 1.4 percent of GDP to 2 percent of GDP in each member state. The second key state function is internal security, comprising law and order, courts, prosecutors, police force, and prisons. EU law enforcement is effective and not very expensive, costing 1.8 percent of GDP in 2013 with minimal variations.[29] A third basic state function is public administration, which costs 1.5 percent of GDP in the United Kingdom, which probably has the best state administration in the world.[30] Public investment is needed primarily in infrastructure, and it is remarkably stable over time and throughout Europe at around 3 percent of GDP.[31] These truly public goods should cost only 8.3 percent of GDP in Europe.

> A transition is desirable to the three-pillar model the World Bank has promoted since 1994: a public minimum pension, a mandatory private saving pension, and an optional private pension saving.

But the modern state has wider responsibilities. Education needs to be delivered to all citizens and immigrants. Private or public institutions can provide education, but the state needs to carry the financial responsibility. Surprisingly, the public cost of education is rather limited at an average of 5 percent of GDP, and the variations between countries are small. The second major social service is health care. In 2013, the average public cost of health care in Europe was only 7 percent of GDP.[32]

The third big social expenditure item is public pensions, which have stabilized at 9 percent of GDP. As the World Bank notes: "Large spending on pensions is the main reason why governments are bigger in Europe than elsewhere."[33] The variations are great from 4 percent of GDP (Ireland) to 14.4 percent of GDP (Greece). The differences depend on public responsibility, retirement age, and level of benefits. Pension expenditures need to be trimmed. This is not only a matter of cost but also of inter-generational justice: As the World Bank put it: "High public spending on pensions, combined with moderate spending on education and health, suggests that governments favor the elderly over the young and working-age generation desiring long-term growth prospects."[34] A transition is desirable to the three-pillar model the World Bank has promoted since 1994: a public minimum pension, a mandatory private saving pension, and an optional private pension saving.[35] The Netherlands has been the most successful EU member state, having cut its public pension costs by almost half to merely 6.9 percent of GDP in 2013, while providing eminent and secure pensions. In general, public pension costs higher than 8 percent of GDP appear excessive.

Unemployment benefits attract a lot of attention, but they are quite limited, costing only 1.6 percent of GDP in 2014, which seems sensible. Other social benefits are a mixed bag of disability pensions, sickness, maternity and family allowances, early retirement, social welfare, and housing subsidies, reaching 5 percent of GDP in

29 Eurostat, Government Expenditures by Function, May 2015, http://ec.europa.eu/eurostat/statistics-explained/index.php/Government_expenditure_by_function_%E2%80%93_COFOG#General_government_expenditure_by_function.

30 Ibid.

31 Tanzi and Schuknecht, 2000, op. cit., pp. 47-48.

32 OECD, "Health Spending,", https://data.oecd.org/healthres/health-spending.htm.

33 Indermit S. Gill and Martin Raiser, eds., op. cit., p. 393.

34 Ibid.

35 World Bank, *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth.* (Oxford: Oxford University Press, 1994).

the early 1990s.[36] These expenditures require critical scrutiny, and they should be limited to 3 percent of GDP. Altogether, these five items of social expenditures should amount to 24.6 percent of GDP.

In addition to these two blocks of genuine public goods and desirable social expenditures, a few items are generally desired. The most successful governments spend 1 percent of GDP on research and development, and wealthy countries spend up to 1 percent of GDP on development aid.[37] Environmental protection costs on average 0.8 percent of GDP, and recreation and culture 1 percent of GDP. In addition, some undesired public expenditures are difficult to escape. The most obvious is foreign debt service of at least 1 percent of GDP, though countries with persistently big public debts, notably Italy and Belgium, had public interest payments reaching 10 percent of GDP in 1995.[38]

These expenditures total 38 percent of GDP. Similarly, Vito Tanzi's overall verdict was that public spending of "around 35 percent of GDP should be sufficient for the government of a country to satisfy all the genuine objectives," and that public spending above 40 percent of GDP "does not seem to improve welfare."[39] We may stretch this interval slightly and argue that a level of public expenditures of 35-42 percent of GDP appears desirable for an EU country.

36 Tanzi, 2011, op. cit., pp. 43-45.

37 Eurostat, Government Expenditures by Function, May 2015, http://ec.europa.eu/eurostat/statistics-explained/index.php/Government_expenditure_by_function_%E2%80%93_COFOG#General_government_expenditure_by_function.

38 Tanzi and Schuknecht, 2000, op. cit., pp. 45-47.

39 Tanzi, 2011, op. cit., pp. 234-5.

HOW TO ACHIEVE THE DESIRED LEVEL OF PUBLIC EXPENDITURES

Having established both the desired size and composition of beneficial public expenditures for economic growth and social welfare, we move on to the question: What public expenditures are undesirable and how should they be reduced? Nine EU countries[40] already have public expenditures below the suggested ceiling of 42 percent of GDP and do not necessarily need any further cuts.

The best way of cutting public expenditures is to eliminate or minimize what is not desired, such as subsidies that reduce economic welfare and efficiency. Another means of economizing is to carry out systemic reforms of whole sectors, such as the pension system, to improve their efficiency. The worst kind of cuts are even cuts of all expenditures, because this doesn't improve the operation of the public sector and all services are likely to deteriorate.

Europe should eliminate several kinds of undesired public expenditures as much as possible, reduce others, and reform some sectors. The big undesired element is enterprise subsidies. Then, there are four groups of public expenditure that should be slimmed down, namely public pensions, social benefits and transfers, public debt service, and public procurement.

> Europe should eliminate several kinds of undesired public expenditures as much as possible, reduce others, and reform some sectors.

One of the least desired public expenditures is enterprise subsidies, which should be minimized; in 2013, the average EU country spent no less than 4.3 percent of GDP on "economic activities," which are by and large enterprise subsidies.[41] This includes all kinds of assistance, such as regional aid, support of small- and medium-sized enterprises, development of high tech, and state enterprise subsidies. These expenditures should be minimized, and the European Commission is doing much to accomplish this through its independent competition policy, which goes after "state aid."

Pension reforms can generate major savings while stimulating the economy. The Netherlands has set the best example. The state should provide a minimum pension for all and oblige companies or employees to set aside a substantial share of their earnings to a second pillar of mandatory private savings. Citizens should be encouraged to accumulate private pension savings with suitable tax incentives. As in the Netherlands, citizens and the country as a whole would benefit from large and safe private pension savings. A first measure is to rein in unjustified early pensions for specific professional groups. A second measure is to gradually raise the retirement age to 67 and higher as life expectancy increases. Next, public pensions need to be adjusted to the actuarially correct level, and mandatory private pension savings need to be promoted. By necessity, pension reforms take a long time, but they are vital for economic welfare. The European countries today that need pension reforms the most are Greece and Italy.

Social benefits and transfers vary greatly from country to country and need to be trimmed where excessive to offer the right combination of social security and socially beneficial incentives. Sweden has done much of this in the last two decades, but it is the North European countries and France that have most to do in this regard. In 2014, the EU average social expenditures of all kinds were 19.5 percent of GDP, which is too high. It ranged from 12 percent of GDP in Romania, Latvia, Lithuania, and Estonia to nearly 25 percent of GDP in Denmark, Finland, and France. These expenditures can be trimmed in many ways, but they should be reduced. Some social benefits are not justified, while the level of compensation could be moderated in other cases. An average level of 17 percent of GDP as is currently the case in the United Kingdom would appear sufficient.

40 Ireland, Lithuania, Romania, Latvia, Estonia, Cyprus, Bulgaria, Luxembourg, and Poland.

41 Eurostat, Government Expenditures by Function, May 2015, http://ec.europa.eu/eurostat/statistics-explained/index.php/Government_expenditure_by_function_%E2%80%93_COFOG#General_government_expenditure_by_function.

At present, public debt service is limited because of the exceptionally low interest rates, but sooner or later they will rise, and then the cost for public debt service could become substantial. Governments would be well advised to pay off much of the public debt through privatization of ample remaining public assets, such as real estate and energy companies.

One of the best ways to render public expenditures more efficient is to open up public procurement as much as possible to open competition, which can trim the cost and reduce public expenditures in the order of 1-2 percent of GDP.

It is often argued that democratic countries cannot carry out major fiscal adjustments, but that is not true. During the years 1993-2007, seven EU countries slashed their public expenditures as a share of GDP by more than 10 percent, namely Slovakia, Sweden, Finland, the Netherlands, Germany, the Czech Republic, and Bulgaria. Sweden cut them by 20 percent.[42] In 2009, the three Baltic countries carried out fiscal adjustments of 8-10 percent of GDP in one single year. Many EU countries have proven their ability to do so; some of them quickly, some of them over a prolonged period. Usually, this occurs at a time of crisis, but that is not always the case. The key is that a government decides it really wants to do so.

Currently, the desired level of public expenditures is entirely up to the member states' governments, since the EU has no common rules with regards to public expenditure. By contrast, the Maastricht criteria are supposed to restrict members' budget deficit to a maximum of 3 percent of GDP and their public debt to 60 percent of GDP (though not very successfully so). Considering that Europe's greatest economic problems are minimal growth and high unemployment, the EU should endeavor to reduce member countries' public expenditures to give them better opportunities to grow. Given the empirical evidence, the EU would be well advised to adopt another fiscal Maastricht criterion of maximum public expenditures of 42 percent of GDP.

The EU is close to budget balance. In 2015, the average budget deficit was 2.4 percent of GDP, according to Eurostat. If public expenditures are reduced and revenues maintained, fiscal space opens up. How should this space be used? On average, an EU country collects 40 percent of GDP in taxes, while the total state revenues amount to 45 percent of GDP.[43] The difference between total tax revenues and total state revenues are non-tax state revenues, such as dividends from state enterprises, privatization income, and royalties from natural resources. Which taxes should be cut first? Traditionally, the four dominant taxes in Europe have been corporate profit taxes, indirect taxes, personal income taxes, and payroll taxes. These taxes have developed in different and specific ways.

Corporate profit taxes are no longer important for EU state revenues, yielding merely 2.5 percent of GDP in 2013. Profits are fungible and tax competition is intense, compelling all EU countries to cut their corporate profit tax rates sharply in the last two decades to an average of 26 percent in 2016. The tax rates keep falling because profits and capital move so easily from country to country within the EU, while the revenues vary little. The average profit tax rate is likely to fall to 20 percent because of tax competition, but this rate decline will presumably be revenue neutral.

Indirect taxes, primarily value-added taxes (VAT), have been harmonized through EU directives.[44] The VAT rates vary little from 17-25 percent and are comprehensive. The indirect taxes are non-distortionary and well collected, delivering an average of 14 percent of GDP in state revenues. These are arguably the most efficient taxes and should be maintained.

The remaining two taxes, personal income taxes and payroll taxes, are much more problematic. Both tend to be high, but they are highly differentiated. They are levied on labor, resulting in a large tax wedge between the labor cost to an employer and the net income of an employee, while Europe's second biggest problem after low growth is high unemployment.

The marginal income taxes vary astoundingly from 10 percent in Bulgaria to 57 percent in Sweden. Six East European countries have flat income taxes, while most West European countries have sharp progression. On average, personal income taxes yield 8 percent of GDP in revenues, but it varies incredibly from 3 percent of GDP in Bulgaria to 29 percent of GDP in Denmark.[45] The highest income taxes need to come down, especially the high marginal income taxes over 50 percent.

42 Eurostat, "Total General Government Expenditures, % of GDP," European Commission, http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tec00023&plugin=.

43 The differential consists of non-tax revenues, such as dividends from state corporations and privatization revenues.

44 Hillary Appel, *Tax Policies in Eastern Europe: Globalization, Regional Integration and the Democratic Compromise* (Ann Arbor: University of Michigan Press, 2011).

45 Eurostat, "Main National Accounts Tax Aggregates," April 26, 2016, http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=gov_10a_taxag&lang=en.

Payroll taxes are the least transparent taxes, as they are predominantly being paid by employers. Often, they masquerade as insurance payments. In 2014, EU payroll taxes averaged 13.4 percent of GDP, yielding more than five times as much revenue as the corporate profit taxes. The variations are great from 1 percent of GDP in Denmark to 19 percent of GDP in France. Many countries cut their payroll taxes during the Eurocrisis to enhance employment. It makes sense to reduce payroll taxes as they are non-transparent and punish people for working. Governments should clarify what is a tax and what is insurance. The insurance payments should become the property of the payee, while the remaining payroll tax should be minimized, as in Denmark.

POLICY RECOMMENDATIONS

Europe needs to adopt policies that promote economic growth and employment. Public expenditures that are harmful or inefficient need to be trimmed. State subsidies should be a key focus of reduction. Pension reforms aiming at a balance of security and stimulus need to be restored. Excessive tax wedges on labor should be reduced though cuts in payroll taxes and personal income taxes as fiscal space opens up. Social transfers and benefits need to be slimmed down to a reasonable volume. Several EU countries have already accomplished the desired goals in all categories, and other EU countries could look to them for guidance. Public debt should be brought down through sales of public assets before interest rates rise high. Six major policy recommendations follow from this analysis.

Recommendation No. 1: Discussion of fiscal policy should focus not only on fiscal balance but also on the need to reduce public expenditures to promote economic growth and employment.[46] The EU aspires to not only economic stability but also higher economic growth. It should also consider how to persuade member countries with excessive public expenditures to reduce them. It could introduce an additional Maastricht criterion of maximum public expenditures of 42 percent of GDP. Naturally, a long transition period would be required.

Discussion of fiscal policy should focus not only on fiscal balance but also on the need to reduce public expenditures to promote economic growth and employment.

Recommendation No. 2: Thanks to EU rules against state aid, the European Commission Directorate for Competition (DG COMP) and the European Court of Justice can rule against enterprise subsidies as they frequently do. These actions could be reinforced and member states should review their expenditures on "economic activities" and attempt to reduce them.

Recommendation No. 3: As the global financial crisis and Eurocrisis have abated, most EU countries need to return to pension reforms. The three-pillar pension model holds up well. A basic, public minimum pension should preferably be financed with general budget revenues rather than payroll taxes. A second pillar of compulsory saving should be a real pension insurance. Accordingly, the non-transparent payroll taxes could be minimized. Such a pension reform would increase savings and investment, develop capital markets, improve incentives, reduce taxes, enhance security, and ultimately promote economic growth. The Dutch pension system stands out as the best one, with good pensions, sound incentives, security, and stability.

Recommendation No. 4: In order to reduce unemployment and enhance economic efficiency, tax wedges should be slimmed down to reduce the cost of labor to employers. Both payroll taxes and personal income taxes should be substantially reduced as soon as fiscal space is created through expenditure cuts. The highest progressive income taxes should be reduced. No marginal income taxes above 50 percent appear acceptable.

Recommendation No. 5: Social benefits and transfers need to be reviewed and trimmed where they are excessive in order to offer the right combination of social security and socially beneficial incentives.

Recommendation No. 6: Over time, public debt needs to be reduced in most EU countries, as the average public debt currently amounts to 87 percent of GDP and sooner or later interest rates are bound to rise. Debt reduction requires that fiscal discipline be maintained, and much of the public debt can be paid off through privatization of public assets.

46 A tragic example of the opposite scenario is Finland. Its GDP declined during four of the seven years after 2008, while its public expenditures as a share of GDP increased from 47 percent of GDP in 2007 to 58 percent of GDP in 2015—the highest in Europe. However, the Finnish fiscal balance was reassuring.

ABOUT THE AUTHOR

Anders Åslund is a resident senior fellow in the Dinu Patriciu Eurasia Center at the Atlantic Council. Prior to that he was a senior fellow at the Peterson Institute. His research examines the economic policy of Russia, Ukraine, and Eastern Europe, and focuses on the broader implications of economic transition. He worked at the Carnegie Endowment for International Peace from 1994 to 2005, first as a senior associate and then from 2003 as director of the Russian and Eurasian Program. He has worked at the Brookings Institution and the Kennan Institute for Advanced Russian Studies at the Woodrow Wilson Center. Dr. Åslund served as an economic adviser to the governments of Russia (1991 to 1994) and Ukraine (1994 to 1997). He was a professor at the Stockholm School of Economics and the founding director of the Stockholm Institute of East European Economics. Additionally, Dr. Åslund has served as a Swedish diplomat in Kuwait, Poland, Geneva, and Moscow. He is a member of the Russian Academy of Natural Sciences, an honorary professor of the Kyrgyz National University, and chairman of the Advisory Council of the Center for Social and Economic Research, Warsaw, as well as of the Scientific Council of the Bank of Finland Institute for Economies in Transition. He is also an adjunct professor at Georgetown University and earned his PhD from Oxford University.

Atlantic Council Board of Directors

Atlantic Council

The Atlantic Council is a nonpartisan organization that promotes constructive US leadership and engagement in international affairs based on the central role of the Atlantic community in meeting today's global challenges.

Atlantic Council

1030 15th Street, NW, 12th Floor,
Washington, DC 20005

(202) 463-7226, www.AtlanticCouncil.org