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Do not overwhelm the state!

AGNIESZKA GEHRINGER

Abstract

Governments are increasingly assigned new tasks in achieving various economic policy objectives. Looking at the main euro area members, this note shows that the high expectations for the role of the state in solving the pressing problems may be frustrated by declining productivity of public spending and decreasing effectiveness of government.

Zusammenfassung

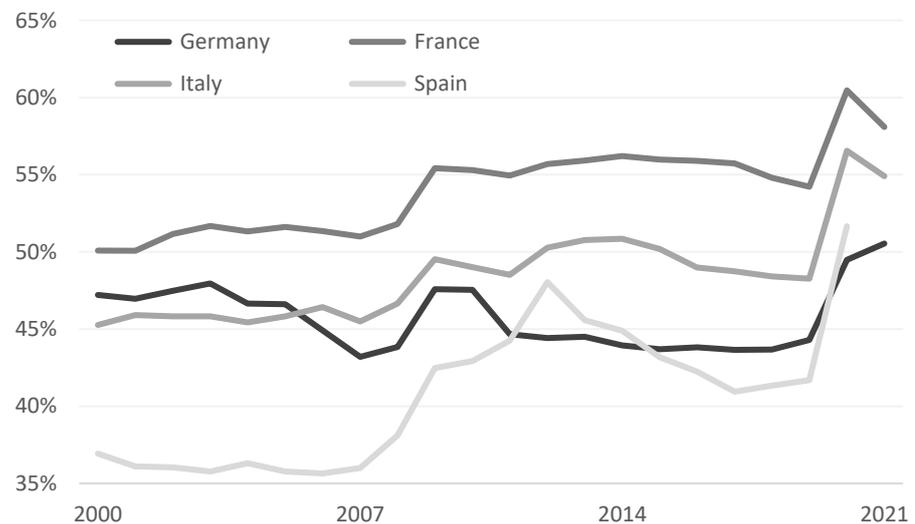
Den Regierungen werden zunehmend neue Aufgaben bei der Erreichung verschiedener wirtschaftspolitischer Ziele zugewiesen. Mit Blick auf die wichtigsten Mitglieder des Euroraums zeigt diese Studie, dass die hohen Erwartungen an die Rolle des Staates bei der Lösung der drängenden Probleme durch die sinkende Produktivität der öffentlichen Ausgaben und die abnehmende Effektivität des Staates enttäuscht werden können.



The growing size of the state

Public expenditures in the four large euro area member states, Germany, France, Italy and Spain, increased significantly over the past decades (**Fig. 1**). The largest surge in total government expenditure as a percentage share of nominal GDP was in Spain, from 37% in 2000 to over 51% in 2020, due to a sharp rise in pandemic-related spending. A similar trend was observed in Italy, with the corresponding share rising from 45% at the beginning of the millennium to 55% in 2021. In France, the increase was less pronounced (from 50% in 2000 to 58% in 2021), but the relative size of government in France tends to be among the highest in the developed world. The most modest increase in the government share occurred in Germany, from 47% in 2000 to 51% in 2021.

Figure 1. Government expenditures as a percentage share of nominal GDP



Source: Flossbach von Storch Research Institute, Macrobond

Multiple factors are likely responsible for the growing size of the public sector. One of the most important explanations can be found in the intense frequency and severity of crises in recent decades. The first significant increase in the share of expenditure took place immediately after the great financial crisis of 2008. The second significant increase was triggered by the coincidence of recent crisis events since late 2019, namely the covid-pandemic and the Russian invasion of Ukraine.

Another important explanation stems from the structural developments of an ageing population and the associated sharp increase in spending on social security systems. However, this upward trend in social spending is also due to increasing pressure from certain interest groups, which has led governments to take on stronger redistributive tasks and reduce public spending,



especially on investment (Fig. 2).¹ The largest reallocation of public funds in recent decades has taken place in France, where the share of public spending on social benefits increased from 28% in 1959 to 34% in 2020. A similar trend can also be observed in Italy: The share of social benefits increased from 34% in 2000 to 40% in 2022, while the share of investment decreased from 6% to 4.8% over the same period. In Spain and Germany, the increase in social spending was less pronounced, but the upward trend is visible in the more recent years.²

Figure 2. Government expenditures for social benefits and for investment as a percentage share of total



Source: Own elaboration Flossbach von Storch Research Institute, Macrobond

Note: Data for more specific expenditure categories is not always easily comparable between countries. For Spain, we use current and capital transfers to approximate for social benefits. This category is broader and correspondingly the share represented in the figure likely overestimates the true one, but its main part should consist of social transfer payments.

¹ In Germany, the public debate is claimed to often be determined by one-sided distributional debate, with political claims that the state should create distributive justice to an ever-greater extent. For a comprehensive background of the underlying debate, see Raddatz, G. (2022). Armut und Ungleichheit in Deutschland: Empörungsdebatten führen in die Irre. Argumente zu Marktwirtschaft und Politik, Nr. 162.

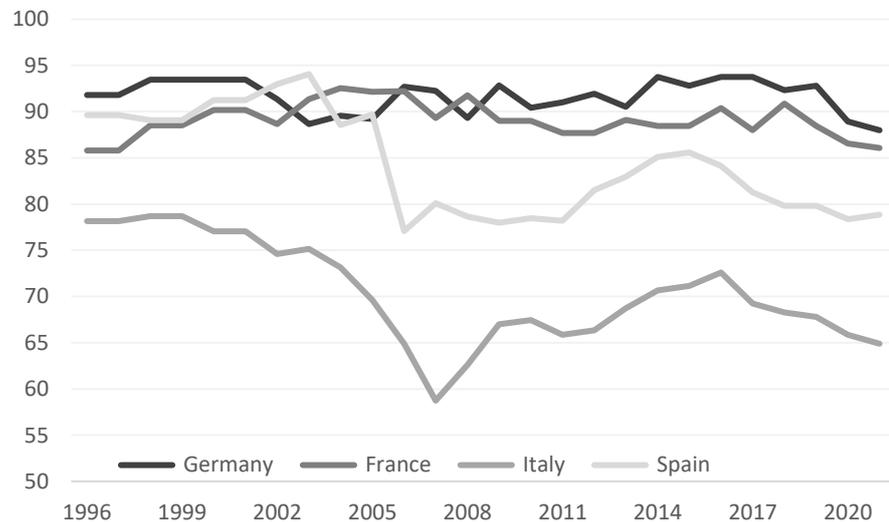
² In Germany in 2021, less than a quarter of all budget funds were earmarked for productive purposes – like infrastructure, education and institutional setting. For a thorough analysis of the underlying trends in Germany, see Laser, C.-F. & Rosenschon, A. (2022). Die Bundesausgaben in Zeiten von Corona im Fokus des Kieler Bundesausgabenmonitors – Eine Strukturanalyse. Available at: <https://www.ifw-kiel.de/de/publikationen/kieler-beitraege-zur-wirtschaftspolitik/die-bundesausgaben-in-zeiten-von-corona-im-fokus-des-kieler-bundesausgabenmonitors-eine-strukturanalyse-0/>



The falling efficiency of the state

Concurrent with the growing presence and responsibilities of the public sector was, however, a fall in efficiency of its activities. There are at least two sources that confirm this. First, the World Bank's Government Effectiveness Index shows a downward trend for all four countries analysed (**Fig. 3**). This index measures, among other things, the quality of public and civil services, the quality of policy formulation and implementation, and the credibility of the government in relation to these policies. Despite the obvious drawbacks of such composite indicators, and in particular the fact that it is an aggregate and imprecise measure of the quality of governance, it clearly points to a deterioration in government effectiveness, at least on average across the above dimensions.

Figure 3. Government Effectiveness Index, percentile ranks

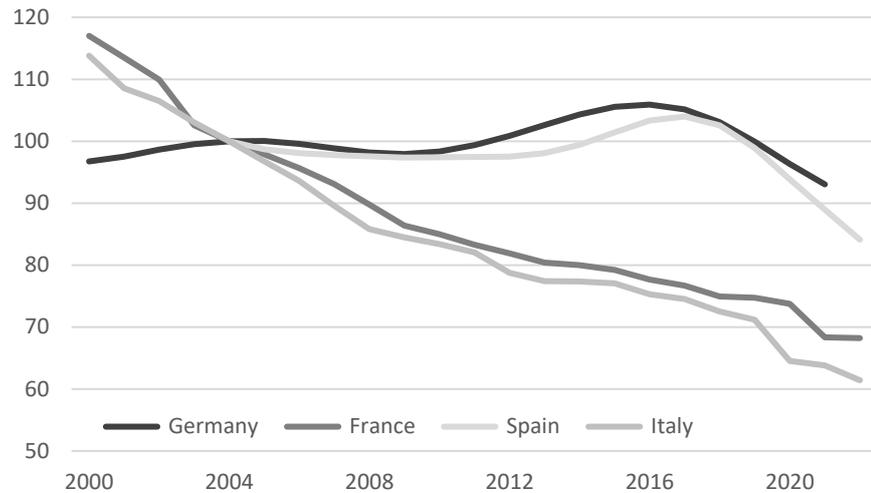


Source: Flossbach von Storch Research Institute, Macrobond

Secondly, the productivity of public spending – expressed in terms of value added created by the public administration per euro of public spending – has also deteriorated significantly, at least since 2000 (**Fig. 4**). The sharpest productivity decline was in Italy and France. In Spain and Germany, productivity development was stable until around 2015, but started to decline thereafter.



Figure 4. Productivity of government expenditures, index (2004=100)



Source: Flossbach von Storch Research Institute, Macrobond

Looking for ways out of overload

The declining efficiency of the public administration is a reflection of technological backwardness coupled with the overburdening of the administration with many duties and responsibilities. Because of its oversize, the state apparatus is self-absorbed instead of pursuing the tasks entrusted to it: providing public infrastructure in an efficient way and setting a regulatory framework for the operation of market forces.³ At this stage, imposing new tasks on the state would likely be counterproductive and wasteful. Instead of allocation ever more resources to the state, governments should focus on reforming public governance and enhancing the efficiency of administration through digitization. A smaller but more efficient public sector would help to raise economic productivity in general.

³ See Mayer, T. (2022). Verantwortlichkeit. Flossbach von Storch Research Institute, Kommentare 02.12.2022, available at: <https://www.flossbachvonstorch-researchinstitute.com/de/kommentare/verantwortlichkeit/>.



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SITE INFORMATION

Publisher: Flossbach von Storch AG, Research Institute, Ottoplatz 1, 50679 Cologne, Germany; Phone +49 221 33 88-291, research@fvsag.com *Directors:* Dr. Bert Flossbach, Kurt von Storch, Dirk von Velsen; *Registration:* No. 30 768 in the Commercial and Companies Register held at Cologne District Court; *VAT-No.* DE200075205; **Supervisory authority:** German Federal Financial Services Supervisory Authority, Marie-Curie-Straße 24 – 28, 60439 Frankfurt / Graurheindorfer Straße 108, 53117 Bonn, www.bafin.de; *Author:* Prof. Dr. Agnieszka Gehringer; *Editorial deadline:* 09. February 2023