CESifo WORKING PAPERS

6997
2018

April 2018

# The Role of Government and Trust in the Market Economy

*Nadja König, Ludger Schuknecht*

CESifo

**Impressum:**

CESifo Working Papers
ISSN 2364-1428 (electronic version)
Publisher and distributor: Munich Society for the Promotion of Economic Research - CESifo GmbH
The international platform of Ludwigs-Maximilians University's Center for Economic Studies and the ifo Institute
Poschingerstr. 5, 81679 Munich, Germany
Telephone +49 (0)89 2180-2740, Telefax +49 (0)89 2180-17845, email office@cesifo.de
Editors: Clemens Fuest, Oliver Falck, Jasmin Gröschl
www.cesifo-group.org/wp

An electronic version of the paper may be downloaded
· from the SSRN website: www.SSRN.com
· from the RePEc website: www.RePEc.org
· from the CESifo website: www.CESifo-group.org/wp

CESifo *Working Paper No. 6997*
*Category 2: Public Choice*

# The Role of Government and Trust in the Market Economy

## Abstract

This paper studies the role of governments and its link to trust. We argue that the public's trust strongly depends on governments delivering on their core tasks in a market economy. In some economies, a neglect of core tasks can be observed and there seems to be some erosion, notably in terms of securing sound rules of the game in industrialised countries. We find very little correlation between government expenditure and trust but a strong correlation with delivering on core tasks. This leads us to conclude that it is not government spending per se that needs to increase to build trust, but rather better focused government activities.

JEL-Codes: H110, H410, H500.

Keywords: role of government, public goods, trust in government, quality of public finances.

*Nadja König*
*Federal Ministry of Finance*
*Wilhelmstr. 97*
*Germany – 10116 Berlin*
*Nadja.Koenig@bmf.bund.de*

*Ludger Schuknecht*
*Federal Ministry of Finance*
*Wilhelmstr. 97*
*Germany – 10116 Berlin*
*Ludger.Schuknecht@bmf.bund.de*

May 2018
The opinions expressed herein are those of the authors and do not necessarily reflect those of the author's employers. Paper presented at the ERA Conference in Trier, October 20th 2017; the paper will be published in the ERA Kongressband "The Authority of EU Law – Do we still believe in it?", forthcoming autumn 2018", edited by Wolfgang Heusel. The authors wish to thank Otmar Issing, Niklas Potrafke, Helmut Herres, Torsten Arnswald, Florian Meyerhöfer and Holger Zemanek for their valuable comments.

## 1. Introduction

Growing populism, market scepticism and euroscepticism are, above all, a reflection of a lack of trust. Governments create expectations and build or destroy trust depending on whether they deliver. This has an important link to economics.

First, governments are tempted to promise too much to everybody. This is bound to create frustrations instead of building trust because people’s desires are unlimited while financing is not. Moreover, the ability of governments is limited by the "laws" of the market against which adverse policy measures can only temporarily prevail (Böhm-Bawerk 1914, Issing 2009). Moreover, there is the risk of contradictions between extensive promises to different groups (high social welfare versus low taxes; security versus open borders). Governments may find it hard to resist this temptation which would require dealing with the scarcity of their means and prioritising their tasks.

This leads to the second argument: governments spend more and more money but less of it is spend on what people expect from governments as their core tasks. The first and foremost core task is public order and security, both in a non-economic and an economic sense: implementation and enforcement of the basic rules of the game (including absence of physical and economic crime), reasonable economic stability, education, infrastructure and basic social safety nets (Musgrave 1959, Buchanan 1975, Friedman 1977). Doing well on their core tasks allows governments to promote equal opportunity, prosperity and social welfare. It allows people to see a better future even if they are not privileged from birth. People would then see their expectations met, which builds trust.

But governments are subject to political pressure, which potentially leads to over-commitment in the social sphere and to neglecting core tasks. This can contribute to disappointed expectations and poor trust.

A third political economy argument is relevant here. Trust in governments in delivering outcomes is closely linked to the process of decision making. People are more likely to develop trust when their own preferences have entered the decision making process. And they are more willing to cope with disappointment if they themselves participated in the decision. In Europe, many decisions are elevated to the EU level without first gaining the support of the population. If people feel they are not participating in the process leading to certain policy choices and if these policies then fail to deliver the desired outcome, people tend to blame the EU and their own governments rather than taking responsibility themselves.

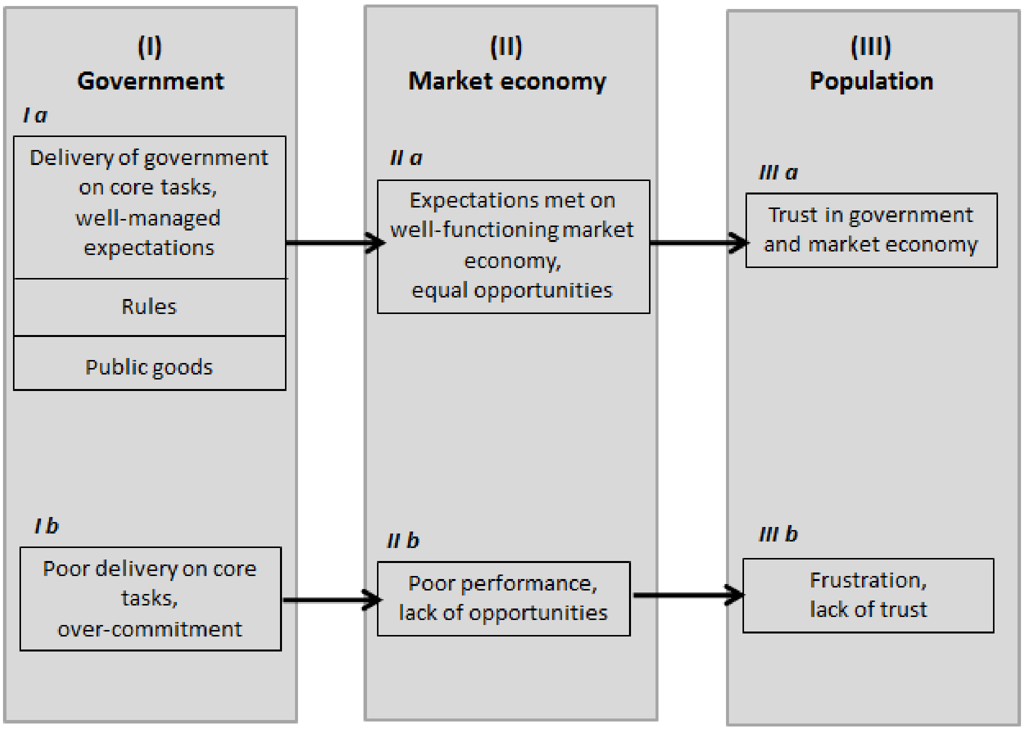
In this paper we focus on the first two issues and argue that governments need to deliver on their core tasks to build trust. We find some indications that governments are at risk of neglecting their core tasks while over-committing in the social sphere in particular. Certainly, a much more thorough analysis of these claims is needed.

The following chapter 2 provides a framework regarding what people expect from governments as their core tasks. Chapter 3 contains some stylised facts on how governments exercise their core tasks and how this has changed over time. Chapter 4 provides some policy recommendations and a conclusion.

## 2. Core tasks of government: some conceptual issues

The link from the role of government to trust in government and the market economy is indirect (Figure 1). If governments perform well on their core tasks, we are likely to witness more growth and prosperity, better opportunities and more satisfaction by people in the ability of governments to deliver on their expectations. This builds trust.

Figure 1: The link from government performance to trust




However, if this is not the case, we are also likely to see poor performance of the economy, parts of society without opportunities and a general sense of frustration with the economic and political system. Worse, the poor performance of the market economy may induce governments to blame the market instead of themselves. This risks discrediting the economic system and may create a spiral of new intervention, worsening performance and further undermining trust.

What are the core tasks of governments to boost prosperity and opportunity?

The economic literature since Adam Smith sees a key role of governments in setting the rules of the game for market economies. These rules need to define safe property rights and a framework for their exchange in functioning markets. Externalities are a reason to intervene in markets (Coase 1960; Pigou 1920, 1928; Musgrave 1959). Hence, there is a need for a well-functioning public administration with a good code of law and environmental regulation. Governments should also prevent an obstruction of markets and competition by providing a well-functioning antitrust system and open international trade rules.

In recent years, the potential for externalities in financial markets has received increasing attention. Information problems and the sheer size of externalities have resulted in a growing recognition that regulation needs to better align the incentives in the financial system to avoid the socialisation of losses.

Beyond this rule-setting, role of government, there is also a good reason for the provision of other public goods. Security is an obvious case in point: (almost) every country needs a defence force. There is also a strong reason for a domestic security force—the police—to protect internal security, complemented by a system of justice.[1]

Beyond security, there are further public goods worth discussing. The best-known is public infrastructure, such as roads, water and sewage systems. Private provision of such infrastructure is often impossible or at least difficult because construction requires collective action and consumption is non-exclusive. Although today much infrastructure can be produced and financed privately because user fees such as tolls or network charges have become possible, there is still a considerable need for public engagement through regulation if not production and financing.

The most prominent public good today is probably education. Since the nineteenth century, free public education has become a common achievement in the world, starting with primary education but now also including secondary education. Without public education, people and societies would not invest enough in knowledge formation, thereby reducing the potential for society-wide progress and prosperity.

A further public good relates to governments' role in enhancing social inclusion and reducing income inequality. Government provision of basic social safety nets, including health, poverty alleviation and elderly care, is not only socially desirable but has a strong public goods component. Health services prevent diseases from becoming epidemics. Poverty reduction measures prevent people from becoming criminals out of desperation. Basic safety nets for the elderly reduce the need for costly self-insurance against longevity risks.

Finally, governments have the means to stabilise the economy in downturns (or finance wars if needed) by incurring debt which is then paid down in better times. On average, so the orthodoxy goes, governments should have balanced budgets which would leave room for dealing with new tasks and unforeseen developments without incurring critical or destabilising debt.

The benefits to society from such measures are two-fold: first, sound rules of the game, security, education and social safety nets as well as public infrastructure provides everybody with opportunities to participate in economic and social life. In former times, being born to a poor family meant that you had no opportunity if you survived childhood at all. Today, everybody in a well-functioning industrialised market economy has the opportunity to access clean water and learn basic life skills at school. In the past, living in a poor quarter meant little access to the justice system and primitive, if any, roads. The provision of basic rules of the game, public goods and social safety nets has, hence, enormously increased people's opportunities. And it has made growth much more inclusive with much smaller wealth and income divergence than, say, 200 years ago. This is often forgotten in today's debate.

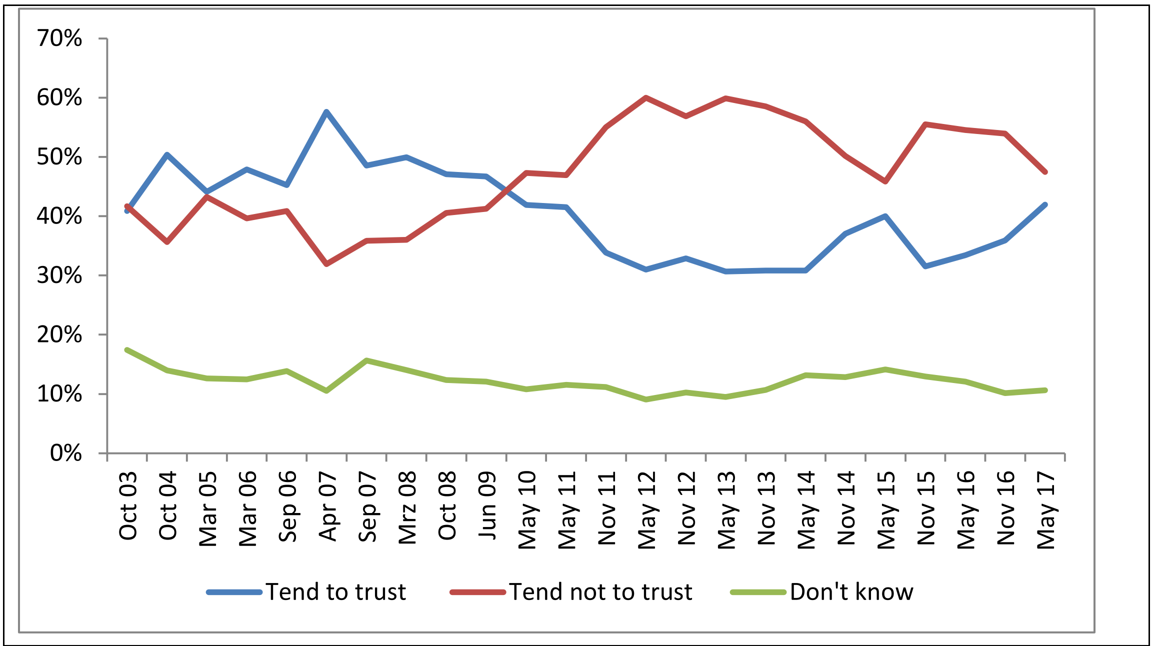
[1] These examples show in fact that the conceptual distinction between rules of the game and public goods that complement the rule-setting role of government is rather fluid. Good laws make no sense without policy and justice. There can be no environmental protection without an agency to enforce it.

## 3. The role of government and trust in the market economy: some stylised facts

In this section, we will look at fulfilment of the core tasks of government, that people expect to be met and at some indicators of trust in governments. This is not an easy task.

Regarding the second issue, do we really have a trust problem in Europe? That is a difficult question to answer, but there is some indication to the affirmative. The European Commission conducts a survey to get insights about citizens' opinions about EU institutions[2]. Since 2003, a question about citizens' "Trust in the European Union" has been added to the survey. Figure 2 tracks responses to this question over the past fifteen years. On balance, trust was higher during the first decade of this millennium than thereafter, although trust has rebounded somewhat recently. But even during the first decade, the trusting group was only slightly larger than the non-trusting one.

Figure 2: Trust in the European Union




*Source: Eurobarometer*

### 3.1 Rules of the game

As outlined above, one of the most important tasks of the government in a market economy is to facilitate market exchanges, manage risk and encourage growth by providing a well-functioning legal framework. Suitable and efficient rules of the game are central to ensuring efficient economic processes and hence economic success. The latter, in turn, is an important element in establishing and maintaining the trust of businesses and citizens in both the government and the economic system.

Measuring rules of the game is not easy. And the link between rules of the game and trust is rather indirect. A popular indicator to evaluate an economy's regulative framework is the "Doing Business Indicator", which has been published annually by the World Bank since

[2] The Eurobarometer was established in 1974, but with only a very limited number of survey questions.

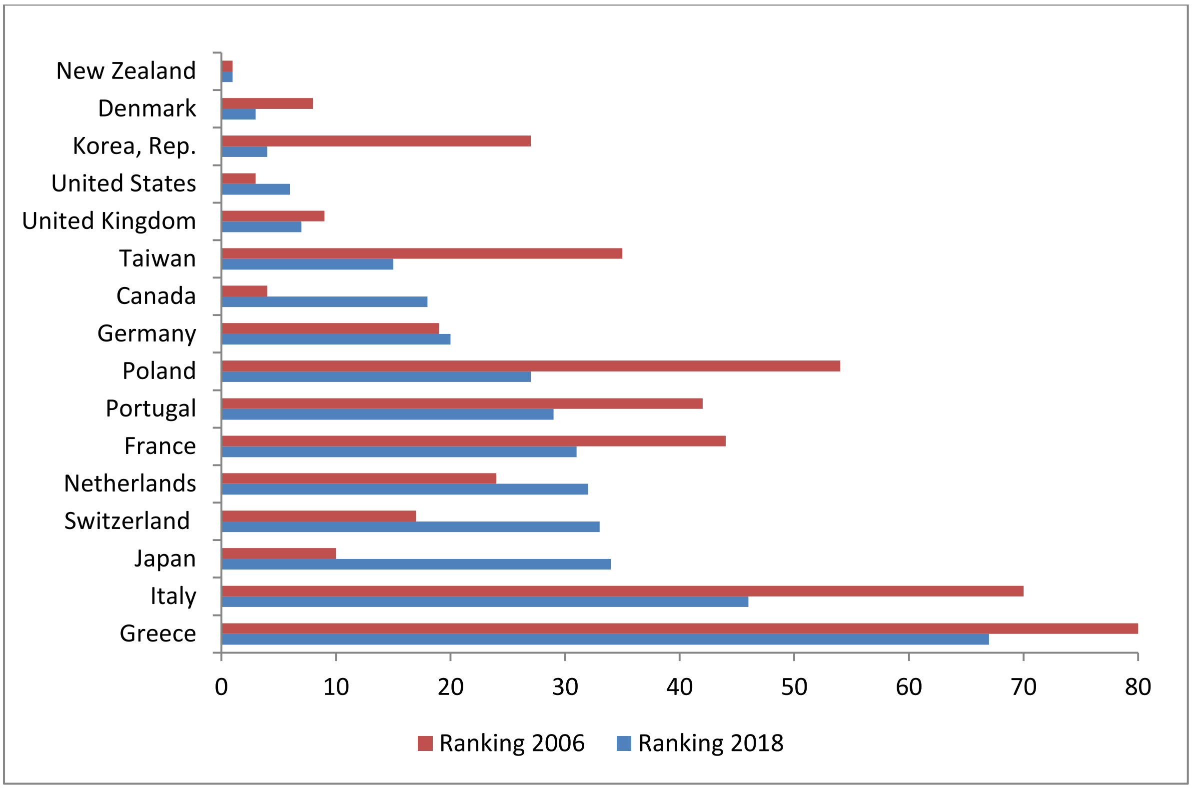
2004. The “Doing Business” report compares locational conditions of 190 economies regarding their regulatory conditions. A high-quality regulatory framework should be a sign of "good" rules of the game for the market economy. It enhances the trust of businesses in governments and, through better economic performance, also affects positively the sentiment of the population more generally.

Figure 3 shows the World Bank’s ranking on ease of doing business in 2006 and 2018.[3] We look at the rankings instead of the index as data for the latter is only available from 2010 onwards. Although, information on the absolute performance would be more interesting from the perspective of this paper’s hypothesis, the rankings still provide a good indication for relative performance. New Zealand ranked first when the indicator was launched in 2004 and first in 2018. Many European economies, however, have important shortcomings. Even Germany, ranked 20th in 2018, performs only moderately well. Italy and Greece both rank low, at 46th and 67th, respectively.

While this figure illustrates the deficiencies of many industrialised countries when it comes to the basic rules of the game for business activity, the fact, that the relative rank of many industrialised countries has declined since 2006 gives greater cause for concern. Figure 3 shows selected countries rankings have changed since 2006. A strengthened legal-institutional framework (or better rules of the game) would be indicated by an increase in the respective countries’ ranking. One can see that the overall picture is mixed for industrialised countries. By contrast, many emerging economies are catching up. Korea, for example, has improved its rank from 27th in 2005 to 4th in 2018. Indeed, relative to many emerging economies, industrialised economies have lost ranks.

[3] The rankings for all economies are benchmarked to June 2017. For more information see: http://www.doingbusiness.org/reports/global-reports/doing-business-2018. The report looks at different categories that impede or support businesses. In total ten sub-categories are evaluated: “starting a business”, “dealing with construction permits”, “getting electricity”, “registering property”, “getting credit”, “protecting minority investors”, “paying taxes”, “trading across borders”, “enforcing contracts”, “resolving insolvency”. The average value of the sub-categories determines a country’s rank. It is important to note, that the methodology of “Doing Business” has changed since it was first published in 2004. Care should therefore be taken when interpreting the data.

Figure 3: Doing Business Indicators, rankings for 2006 and 2018

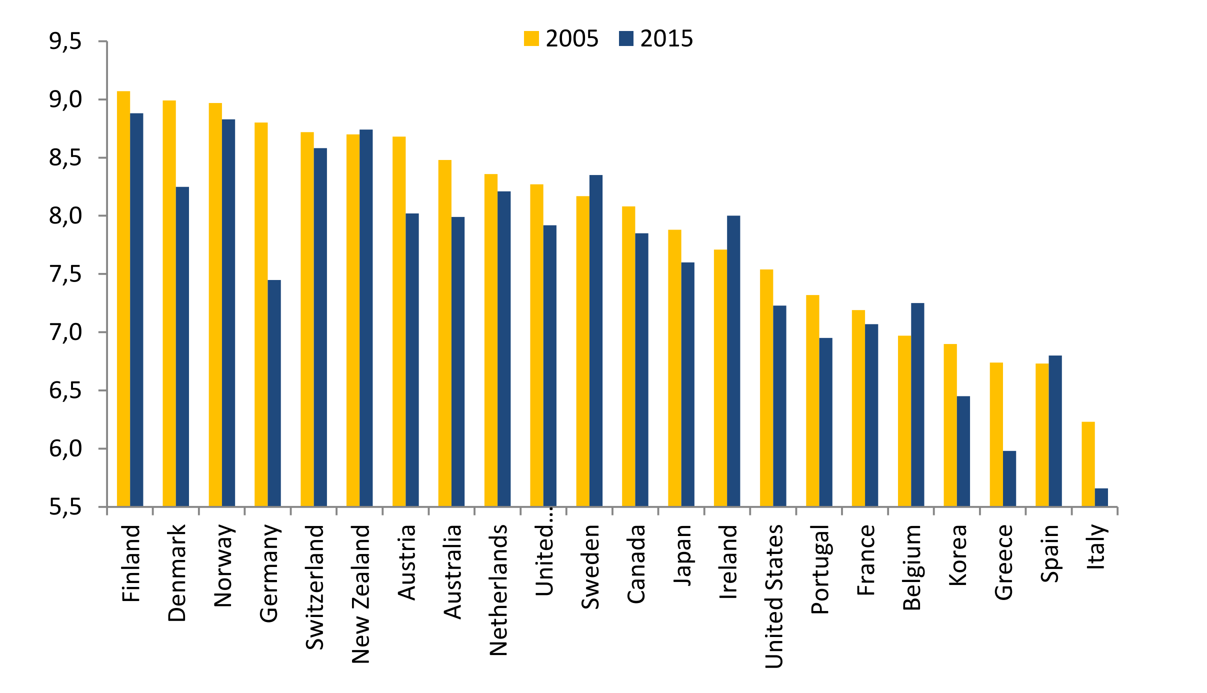



*Source: The World Bank: Doing Business Indicators; http://www.doingbusiness.org/*

The "rule of law" is probably the most important element of a well-functioning and well-governed market economy (Hayek 1960) where people trust the government. A neutral and fair legal system and secure property rights are essential to levelling the playing field for all agents in an economy. The Fraser Institute annually publishes the *Economic Freedom of the World Report* (Gwartney et al. 2017), which provides a suitable measure of the quality of the legal system and property rights.[4] Figure 4 displays the respective index in 2005 and 2015. Generally, the performance of governments on this core task has deteriorated over the past decade for the countries in our sample. The Nordic countries perform best; Southern European countries least well.

[4] https://www.fraserinstitute.org/studies/economic-freedom. This is one of five sub-indicators of the Economic Freedom of the World (EWA) Index. The other indicators are: Size of Government, Sound Money, Freedom to Trade Internationally and Regulation. Afonso et al. (2005) studied public sector performance and distinguished between "opportunity indicators" and "Standard Musgravian indicators".

Figure 4: Legal system and property rights sub-index




Source: *Economic Freedom of the World: 2017 Annual Report*

### 3.2 Public goods

We will now take a closer look at further public goods. As mentioned, the provision of high-quality infrastructure is central to creating an attractive environment for the private sector, thereby ensuring innovation, employment and productive growth - and hence, trust in the market economy. Providing good infrastructure for everyone is also important for economic inclusion, i.e. for ensuring equal standards of transport, communication, health, etc.

In this respect, public investment expenditure constitutes an important input factor in ensuring high-quality infrastructure. Table 1 displays how expenditure in public investment has changed since the 1980s. Across most economies, we observe a decline in public investment. The decline is largest in Japan, which had however, extremely high rates of investment in the 1980s. The only two economies with positive changes in public investment in the past 35 years are Canada and Norway. Public investment in Germany is rather low, but significant parts of infrastructure investment (energy, communication, health) are classified as private investment. It is also interesting to note that the decline in public investment expenditure seems to be much smaller or there is even no decline at all in countries that have a relatively "lean" public sector. This includes for example Australia, Canada, Korea and Switzerland.

Table 1: Public investment expenditure, % of GDP

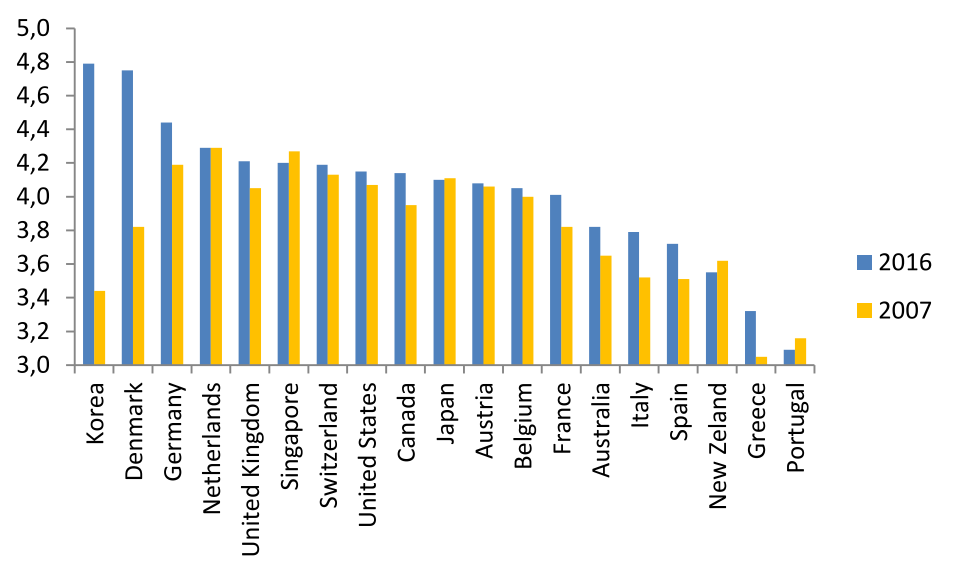
| | 1980 | 2000 | 2016* | Difference between 2016 and 1980 in percentage points |
|---|---|---|---|---|
| Australia | 3.5 | 3.0 | 3.3 | -0.2 |
| Austria | 5.3 | 2.7 | 3.0 | -2.3 |
| Belgium | 5.2 | 2.4 | 2.3 | -2.9 |
| Canada | 3.5 | 2.9 | 3.9 | 0.4 |
| Denmark | 4.2 | 2.8 | 3.7 | -0.5 |
| Finland | 4.8 | 3.5 | 3.9 | -0.9 |
| France | 4.1 | 3.9 | 3.4 | -0.6 |
| Germany | 4.1 | 2.3 | 2.1 | -2.0 |
| Greece | 3.2 | 5.1 | 3.1 | -0.1 |
| Ireland | 5.6 | 3.5 | 1.8 | -3.9 |
| Italy | 3.5 | 2.9 | 2.1 | -1.4 |
| Japan | 9.4 | 6.8 | 3.7 | -5.7 |
| Korea | 4.7 | 5.5 | 4.4 | -0.3 |
| Netherlands | 4.5 | 3.8 | 3.5 | -1.0 |
| New Zealand | | 3.1 | 4.0 | |
| Norway | 4.9 | 3.4 | 5.4 | 0.5 |
| Portugal | 5.1 | 4.6 | 1.5 | -3.6 |
| Spain | 2.4 | 3.7 | 1.9 | -0.4 |
| Sweden | 6.4 | 3.9 | 4.4 | -2.0 |
| Switzerland | | 3.1 | 3.0 | -0.1 |
| United Kingdom | 3.1 | 1.7 | 2.6 | -0.4 |
| United States | 3.9 | 3.6 | 3.2 | -0.7 |
| Average | 4.6 | 3.5 | 3.2 | -1.1 |

*Source: OECD government accounts, European Commission, *or latest available.*

When it comes to the quality of infrastructure, there is a sparse amount of international data available. Some information can be gained from a sub-indicator on infrastructure of the Logistics Performance Index[5] (LPI), which is published by the World Bank. It reveals some surprising facts. Figure 5 illustrates the most recent results for 2016 and 2007. The most striking improvement exhibits Korea. Contrary to some observers' claims, also Germany is performing well having improved the quality of infrastructure in the past ten years. This can largely also be ascribed to the creation of a favourable framework for private sector investment and the preceding privatisation of parts of the infrastructure (telecom, energy). On the whole, the picture is very mixed and there was little change for most advanced economies. Again Southern European infrastructure seems to be judged more negatively on average despite some improvement in the past decade.

[5]The LPI is a weighted average of country scores on six dimensions: Customs, Infrastructure, International Shipments; Logistics Competence, Tracking & Tracing and Timeliness.

Figure 5: Index for infrastructure (Sub-Index of the Logistics Performance Index)




*Source: The World Bank, Logistics Performance Index, https://lpi.worldbank.org/*

Turning to other public goods and services, it is worth looking at core public administration expenditures as an indicator of government input for producing such goods. This category includes general public services (which include various administrative expenditures)[6], public order and safety, and recreation, culture and religion. We refer to them as core public administration expenditure, as they serve to provide key public goods, including the implementation of an economy's rules of the game. People therefore rightly expect these functions to be fulfilled by the government.

The data (Table 2) show how much governments spend on these key areas and how they set priorities in spending.[7] In almost all countries, spending on these categories has been declining over the past 20 years. Only the UK has seen virtually stable core public administration expenditures between 1995 and 2015. Germany’s ratio was particularly high in 1995, at 20.8 % as a share of GDP, mostly due to reunification expenditures, which somewhat overstates the drop thereafter.

[6] Executive and legislative organs, financial, fiscal and external affairs; foreign economic aid; basic research; general public services; public debt transactions; transfers of a general character between different levels of the government.

[7] For more detailed information see OECD (2017), Government at a Glance 2017.

Table 2: Core public administration expenditures, % of GDP

| | 1995 | 2005 | 2015 | Difference between 2015* and 1995 in percentage points |
|---|---|---|---|---|
| Australia | | 10.1 | | |
| Austria | 18.3 | 17.0 | 15.6 | -2.6 |
| Belgium | 20.5 | 19.7 | 17.5 | -3.0 |
| Canada* | 19.5 | 13.3 | | -6.2 |
| Denmark | 17.3 | 12.6 | 13.8 | -3.5 |
| Finland | 19.9 | 14.1 | 16.0 | -3.9 |
| France | 16.3 | 14.8 | 14.9 | -1.4 |
| Germany | 20.8 | 12.4 | 11.7 | -9.1 |
| Greece | 23.2 | 16.7 | 21.6 | -1.6 |
| Ireland | 14.0 | 9.2 | 8.9 | -5.1 |
| Italy | 21.8 | 15.8 | 15.0 | -6.7 |
| Japan | | 9.9 | 9.5 | -0.4 |
| Netherlands | 16.4 | 13.4 | 12.1 | -4.3 |
| Norway | 15.0 | 11.0 | 12.4 | -2.6 |
| Portugal | 16.4 | 14.7 | 16.0 | -0.4 |
| Spain | 17.2 | 13.2 | 14.0 | -3.2 |
| Sweden | 19.7 | 14.2 | 13.7 | -6.0 |
| Switzerland | | 11.0 | 10.5 | -0.5 |
| United Kingdom | 10.3 | 10.3 | 10.2 | -0.1 |
| United States | 13.1 | 11.5 | 10.8 | -2.3 |
| Average | 17.6 | 13.2 | 13.6 | -3.3 |

*Source: OECD, Government expenditure by function database, own calculations (*or latest available data).*

Table 3 gives a more detailed view of the category of public order and safety. Due to different definitions of public order and safety and possible changes in the concepts over time, comparability of data is difficult and interpretation should be handled cautiously. One can see that expenditure trends for public order and safety as a share of GDP are quite different across economies. In Germany, for instance, expenditures on public order and safety have declined marginally over the past 20 years. Others countries also report small declines or increases. On the whole, these data do not point to a general erosion of internal security related spending. However, it is hard to say whether expenditure trends were adequate relative to widespread public perceptions of rising crime. They are also difficult to evaluate in economic terms, in the absence of information about the demand for such services and the appropriate deflator. This, in conjunction with a frequent perception of decreased security, would need to be analysed in more depth.

Table 3: Expenditures on public order and safety, % of GDP

| Year | 1995 | 2005 | 2015 | Difference between 1995 and 2015 in percentage points |
|---|---|---|---|---|
| Australia* | | 1.6 | | |
| Austria | 1.5 | 1.4 | 1.4 | -0.1 |
| Belgium | 1.4 | 1.7 | 1.8 | 0.3 |
| Denmark | 0.9 | 0.9 | 1.0 | 0.0 |
| Canada | | | | |
| Finland | 1.4 | 1.3 | 1.2 | -0.1 |
| France | 1.5 | 1.5 | 1.6 | 0.1 |
| Germany | 1.6 | 1.6 | 1.6 | -0.1 |
| Greece | 0.9 | 1.5 | 2.1 | 1.2 |
| Ireland | 1.8 | 1.4 | 1.1 | -0.8 |
| Italy | 1.9 | 2.0 | 1.9 | -0.1 |
| Japan | | 1.2 | 1.3 | 0.0 |
| Netherlands | 1.4 | 1.7 | 1.8 | 0.4 |
| Norway | 1.0 | 0.9 | 1.1 | 0.1 |
| Portugal | 1.6 | 1.9 | 2.1 | 0.5 |
| Spain | 2.0 | 1.8 | 2.0 | 0.1 |
| Sweden | 1.4 | 1.3 | 1.3 | -0.1 |
| Switzerland | | 1.6 | 1.7 | 0.1 |
| United Kingdom | 1.9 | 2.4 | 2.0 | 0.1 |
| United States | 1.9 | 2.1 | 2.0 | 0.1 |
| Average | 1.5 | 1.6 | 1.6 | 0.1 |

*Source: OECD, Government expenditure by function database (Differences refer to latest available data; *no or only limited data available).*

In the area of education, there is probably less cause for concern as regards the overall level of public spending. Public expenditure has increased modestly in recent decades from about 5 percent of GDP in 1980 to 5 ½ percent in 2015 for the average of industrial countries. Germany's expenditure ratio is slightly below average; the Nordic countries show the highest and Southern European countries the lowest spending ratios.[8] Furthermore, here again, it is hard to say whether spending has kept up with increasing demand, given that a much larger share of young people attend secondary and tertiary education today than was the case 20 or 40 years ago.

When it comes to education outcomes and opportunities, results are mixed. Overall, results from the OECD's PISA study point to higher PISA scores in advanced economies compared with the beginning of the millennium. In particular, most Nordic countries and Asian economies as well as Canada are performing very well and far above the international average. Germany's performance has improved in the past 15 years and was above average in 2015 in all three performance categories.[9]

[8] However, as is also the case for infrastructure, cross-country comparisons on public spending on education are to be treated with caution as the share of public and private schools differs strongly across countries.

[9] PISA assesses three categories: Maths, Reading and Science.

The most concerning issue in education is probably the lack of quality education for the poor and disadvantaged. In this respect, PISA further aims to assess the provision of quality education regardless of students' socioeconomic background. Performance tends to be relatively independent of students' socioeconomic background in the Nordic and Asian economies, while there is a strong link in many Western and Central European economies. Whereas most countries do not exhibit any changes in the impact of students' social background for their performance since 2006, Germany and the U.S are exceptions, with slight improvements. In tertiary education, however, which is outside the scope of PISA, cost dynamics have been very strong in many countries, meaning that access concerns are mounting.

### 3.3 Social safety nets

Rules of the game and public goods are not enough. If the poor and needy do not benefit from public expenditures, they will be left too far behind in terms of welfare and opportunity and it is likely to exert negative influence on trust. Here, the record of social expenditure as a measure of government inputs, seems to be exemplary at first sight: Social expenditure trends in Europe have been well above GDP growth in recent decades (Schuknecht and Zemanek 2018).

Social expenditure in industrial countries has increased from about one sixth of GDP in 1980 to about one quarter of GDP in recent years (Table 4). This is a huge increase in just one generation. Social expenditure almost everywhere in Europe is comparatively high. In Germany, social expenditure was already very high in 1980, at over one fifth of GDP. It has increased further to one quarter of GDP which is slightly above average. Social expenditure has increased very strongly, in the Mediterranean European countries and exceeds 30 % of GDP in France. The Netherlands is the only country to have reduced social expenditure since the 1980s. Anglo-American countries and Switzerland spend less than average, at around 20% of GDP.

Table 4: Social expenditure, aggregated data, % of GDP

| | 1980 | 2000 | 2016 | Difference between 1980 and 2016* in percentage points |
|---|---|---|---|---|
| Australia | 10.3 | 18.2 | 19.1 | 8.8 |
| Belgium | 23.1 | 23.5 | 29.0 | 5.9 |
| Canada | 13.3 | 15.8 | 17.2 | 3.9 |
| Denmark | 20.3 | 23.8 | 28.7 | 8.4 |
| Finland | 17.7 | 22.6 | 30.8 | 13.1 |
| France | 20.2 | 27.5 | 31.5 | 11.3 |
| Germany | 21.8 | 25.4 | 25.3 | 3.5 |
| Greece | 9.9 | 18.4 | 27.0 | 17.1 |
| Ireland | 15.7 | 12.6 | 16.1 | 0.4 |
| Italy | 17.4 | 22.6 | 28.9 | 11.5 |
| Netherlands | 23.3 | 18.4 | 22.0 | -1.3 |
| New Zealand | 16.7 | 18.5 | 19.7 | 3 |
| Norway | 16.1 | 20.4 | 25.1 | 9 |
| Portugal | 9.5 | 18.5 | 24.1 | 14.6 |
| Spain | 15.0 | 19.5 | 24.6 | 9.6 |
| Sweden | 24.8 | 26.8 | 27.1 | 2.3 |
| Switzerland | 12.8 | 16.3 | 19.7 | 6.9 |
| United Kingdom | 15.6 | 17.7 | 21.5 | 5.9 |
| United States | 12.8 | 14.3 | 19.3 | 6.5 |
| Average | 16.6 | 20.0 | 24.0 | 7.4 |

*Source: OECD, Social Expenditure Statistics (*or latest available, 2015)*

Increasing public social expenditure is indicative of another problem that we outlined earlier: governments promise to do too much and thereby risk to reducing rather than to increasing trust. First, rising social expenditure has in many countries, come at the expense of other core government functions (see Schuknecht and Zemanek, 2018 for an empirical analysis).

Second, high social spending does not necessarily mean effective and efficient (i.e. well-targeted and well-prioritised) use of the money. In many economies, social protection has been extended to a broad range of people who do not necessarily require social support. When looking at the definition of social spending¸ the sheer number of sub-categories is striking. In Germany, a survey of family-related benefits shows a large number of different programmes which are hardly coordinated and, in some cases, even contradictory in their objectives (Bonin et al. 2012). Most of the programmes do not have much to do with the underlying objective of providing basic social safety nets.

The result is a spiral of growing benefits via a growing number of programmes while efficiency and consistency suffer. The process is likely to be reinforced in the coming decades by population ageing, which may bring more countries to the limits of solvency and occasion a need for significant further reform. This, in turn, may bring about a new round of frustration and loss of trust.

Third, growing benefits to some leave others disgruntled about not benefitting or not benefitting equally from such spending. Deaton (2015) rightly points out that people are doing better than ever in history: living standards, life expectancy and quality of life have been growing and may continue to do so in the future. Yet, poverty reduction has remained imperfect and poverty elimination elusive, as much in societies is measured against relative and not absolute standards.

The perception of social injustice, in particular towards the elderly, often stands in stark contrast to reality. It is worth taking a look at old-age poverty rates as an example. Table 5 shows the percentage of households with incomes below the 50 % of median household disposable income. It is true that old-age poverty still exists. And it is, relatively speaking, larger in countries with lower social expenditure. That said, old-age poverty has declined significantly in recent decades and is often lower than poverty amongst children or other disadvantaged groups. The old have benefitted much more from income gains than other groups in the past decade (Chen et al. 2018). In some countries, retirees and pensioners tend to be richer on average than the rest of the population.

Table 5: Percentage with incomes below 50% of median household disposable income, 2012*

| | People aged over 65 | Whole population |
|---|---|---|
| Australia | 33,5 | 14,0 |
| Austria | 11,4 | 9,6 |
| Belgium | 10,7 | 10,2 |
| Canada | 6,7 | 11,8 |
| Denmark | 4,6 | 5,4 |
| Finland | 7,8 | 7,1 |
| France | 3,8 | 8,1 |
| Germany | 9,4 | 8,4 |
| Greece | 6,9 | 15,1 |
| Ireland | 6,9 | 8,4 |
| Italy | 9,4 | 12,7 |
| Japan | 19,4 | 16,0 |
| Korea | 49,6 | 14,6 |
| Netherlands | 2,0 | 7,9 |
| New Zealand | 8,2 | 9,9 |
| Norway | 4,1 | 8,1 |
| Poland | 8,2 | 10,2 |
| Portugal | 8,1 | 13,0 |
| Spain | 6,7 | 14,0 |
| Sweden | 9,3 | 9,0 |
| Switzerland | 23,4 | 9,1 |
| United Kingdom | 13,4 | 10,5 |
| United States | 21,5 | 17,6 |

*Source: OECD Income Distribution Database, *or latest available*[10]

According to a study by the Institut für Wirtschaft (IW) Köln[11] on income inequality and the perception thereof, perceived inequality within a society and actual income inequality

[10] 2013 for Finland, the Netherlands and the United States. Korea 2009, 2012 for all others.

deviate substantially. Most people perceive inequality as relatively large, i.e. they assume that more people are at the bottom of income distribution than is actually the case. An exception is the U.S. where people tend to strongly underestimate the share of households at the bottom of income distribution.

The financial crisis is likely to have contributed to the distributional struggle within Western countries. How can it be that well paid bankers are bailed out by tax-payers, violating the fundamental principle that capitalists are responsible for profits and losses while social benefits are frozen or cut as high debt needs to be brought down? This is linked to the earlier discussion of governments not delivering on their core mandate while benefitting the rich. And it is linked to the question about rules of the game: we have failed in setting the rules of the game in the financial sphere appropriately, which would have prevented the need for bail-outs in the first place.

### 3.4 Economic stability

A stable economic environment is essential, not only for businesses to flourish and develop, but also for social stability. A sound fiscal position is conducive to economic stability. It allows governments to undertake their tasks in a well-ordered and reasonably prioritised manner, with reserves and capacity to act during recessions or crisis. In countries with fiscal problems, governments have had to carry out emergency measures and cuts. And typically, such cuts do not affect the least productive spending but the least politically difficult, such as public investment. When unsound government finances coincide with inflation, this often erodes public salaries and with them morale and integrity. It is perhaps no surprise that low-deficit and low-debt countries such as Scandinavian economies or Switzerland seem to have more effective governments.

[11] https://www.iwkoeln.de/__extendedmedia_resources/176927/index.html

Table 6: Public debt, % of GDP

| | 1980 | 2000 | 2016 | Difference between 1980 and 2016 in percentage points |
|---|---|---|---|---|
| Australia | | 19.5 | 41.1 | 21.5 |
| Austria | 37.2 | 65.9 | 83.9 | 46.7 |
| Belgium | 76.4 | 108.8 | 105.5 | 29.2 |
| Canada | 45.3 | 80.7 | 92.3 | 47.1 |
| Denmark | 33.2 | 52.4 | 39.9 | 6.7 |
| Finland | 10.9 | 42.5 | 63.6 | 52.7 |
| France | 20.8 | 58.6 | 96.6 | 75.9 |
| Germany | 33.1 | 58.9 | 67.6 | 34.6 |
| Greece | 22.5 | 104.9 | 181.3 | 158.8 |
| Ireland | 67.5 | 36.1 | 76.4 | 8.9 |
| Italy | 64.8 | 105.1 | 132.6 | 67.8 |
| Japan | 50.0 | 139.0 | 239.2 | 189.1 |
| Korea | | 17.1 | 38.6 | 21.4* |
| Luxembourg | 9.7 | 6.5 | 22.6 | 12.9 |
| Netherlands | 44.6 | 51.4 | 62.6 | 18.0 |
| New Zealand | | 26.0 | 29.5 | 3.5* |
| Norway | 46.7 | 28.1 | 33.2 | -13.5 |
| Portugal | 37.7 | 47.9 | 130.3 | 92.6 |
| Spain | 16.6 | 58.0 | 99.3 | 82.7 |
| Sweden | 42.3 | 51.3 | 41.7 | -0.7 |
| Switzerland | | 54.6 | 45.4 | -9.2* |
| United Kingdom | 42.8 | 37.3 | 89.2 | 46.4 |
| United States | 45.7 | 59.0 | 107.4 | 61.7 |
| Average | 39.3 | 56.9 | 83.5 | 44.1 |

*Source: IMF, World Economic Outlook (*Difference between 2016 and 2000).*

Sound public finances and low public debt can, from that perspective, also be considered public goods because they can help stabilise the economy during crisis.[12] But from this point of view, too, many industrialised countries are failing. Table 6 shows public debt as percentage of GDP. In 1980, only few industrialised countries had public debt in excess of 60 % of GDP. Today, public debt averages about 120 % of GDP in the G7 countries, several industrial countries report near or above 100 %, and one country, Japan, even well above 200 % of GDP. In addition, several European countries have experienced fiscal crises and required financial bail outs that went hand in hand with stringent adjustment programmes.

## 4. The link between trust and government activities

In this section we will look at the link between the core functions of government and trust as hypothesised in section 2. At this stage, we limit ourselves to a simple correlation analysis between government expenditure (inputs) and government performance (outcomes) on the

[12] There is a large amount of literature on the potential damage of public debt. A negative link between high public debt and growth has been found by Pattilo et al. (2004) and Kumar and Woo (2010). Checherita-Westphal and Rother (2012) focus exclusively on the euro area and confirm that particularly high debt levels can have a detrimental impact on growth.

one hand and trust in governments on the other hand. Table 7 provides the correlation coefficients for 21 European[13] countries for the period 2005-2015.

There are a number of interesting findings. First, public expenditure (input variables) seem to matter only little for trust. Higher total and - perhaps more importantly - social expenditure are not correlated at all with more trust in government. The only expenditure component where the correlation coefficient is reasonably positive is education.

Second, outcome indicators as regards core roles of government are mostly well correlated with trust. The correlation coefficient is highest for good rules of the game ("rule of law" variable) and moderate for regulation. Also, high quality infrastructure shows a correlation of almost 0.5, which could be seen as relatively strong. The picture is more mixed a regards education. High PISA scores—as an indicator of high quality education—are not strongly correlated with trust. Only in pre-Eastern enlargement Europe the figure is higher, at almost 0.3.

As regards basic social safety nets, we chose the income share of the bottom 40 % of households as indicator. While this is not a perfect measure of basic safety nets, it is relatively reliable. For this, the correlation coefficient is moderate at 0.32. Sound public finances, as reflected for example in low debt-to-GDP ratios are also correlated with trust: the coefficient is relatively high at almost 0.5. Overall, the correlation between trust and outcome variables tends to be considerably stronger in Pre-Eastern enlargement economies.

Finally, we also include an index for globalisation in the analysis. Globalisation is often blamed for a loss of trust or the rise of populism (Potrakfke 2015). From the perspective of this paper, open markets and trade integration are a core function of government which boosts prosperity and high-quality jobs. Therefore, we would expect a positive correlation between the two. The correlation results confirm the latter claim: trust and globalisation (represented by the KOF globalisation index) are positively correlated where an index value of almost 0.44 can be considered as relatively strong.

[13] Pre-eastern enlargement economies are Austria, Germany, Belgium, Denmark, France, Ireland, Italy, the Netherlands, Portugal, Sweden, Spain, Greece, Luxembourg and the United Kingdom. Eastern European economies include Czech Republic, Hungary, Poland, Slovenia and Slovak Republic, Estonia and Latvia.

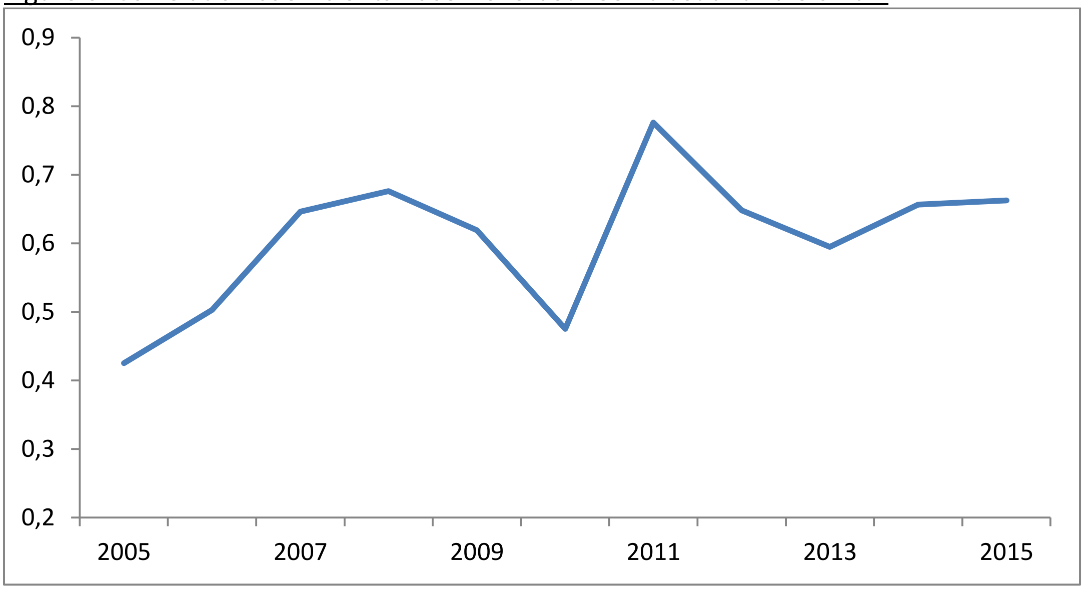
Table 7: Correlation coefficients between trust and input / outcome variables (2005 – 2015)

| Role/government | Spending | | Outcome | | Outcome pre-enlargement Europe |
|---|---|---|---|---|---|
| **Rules of the game** | Total spending | 0.028 | Rule of law | 0.685 | 0.688 |
| | | | Globalisation | 0.439 | 0.387 |
| | | | Regulation | 0.334 | 0.375 |
| **Infrastructure** | Public investment | 0.062 | Infrastructure quality | 0.423 | 0.478 |
| **Education** | Spending on education | 0.419 | PISA | 0.328 | 0.316 |
| **Social safety nets** | Social spending | 0.086 | Income share 40% poorest HH | 0.322 | 0.5394 |
| **Sound public finances** | | | Public debt | -0.452 | -0.733 |

*Source: OECD for all input variables and PISA; IMF WEO for debt; World Bank for the index for infrastructure, Fraser Institute for the indices on rule of law and regulation; WDI for income share of bottom 40 percent; KOF globalisation index.*

Third, the correlation between outcomes and trust has been growing over time. Figure 6, for example, shows that the correlation coefficient for trust and the rule of law started out near 0.4 in 2005 before increasing significantly, ending near 0.65 in 2015 (with some bumpiness around the financial crisis as all countries were affected by a loss of trust in 2009/10 before trust recovered in the more stable high-trust countries in 2011).

Figure 6: Correlation coefficients 2005-2015 between trust and rule of law

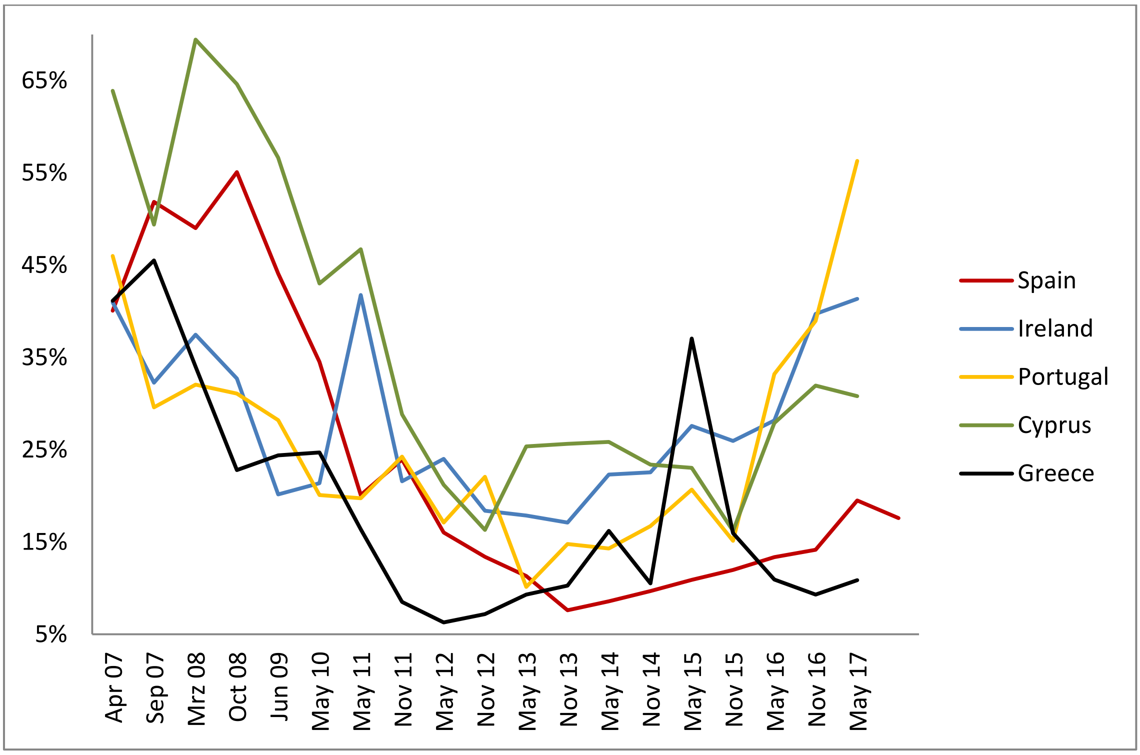



*Source: Fraser Institute, own calculations.*

Another angle from which to look at the relationship between trust and government performance is the experience with European adjustment programmes. Such programmes (which focussed in particular on reforms strengthening the rules of the market economy) have gone hand in hand with a resurgence of trust in governments, as Eurobarometer data shows (Figure 7). Trust has recently increased most in Portugal and Ireland, and modestly in

Cyprus and Spain. This confirms the role of sound policies and the opportunity offered by reforms offer when it comes to re-building trust. This brings us to the conclusion of this study.

Figure 7: Trust in own governments




*Source: Eurobarometer*

## 5. Conclusions

The results of this study provide some indications that the erosion of trust in governments and in the EU, along with the rise of populism may have to do with governments' neglecting some of their core tasks, i.e. setting societies' rules of the game and providing core public goods. There is some indication of declining government performance, most notably as regards the "rules of the game". Moreover, there is little relation between trust and public expenditure (inputs) but more between "good" rules and strong basic public good provision (outcomes) and trust. This leads us to conclude that it is not government spending per se that needs to increase to build trust, but rather better focused government activities. Moreover, there is no relation between trust and growing social expenditure, but growing correlation between outcomes, most notably rule of law and trust over time. Yet, we have only scratched the surface in analysing this important question.

There is a risk that the neglect of core tasks and the decline of trust may continue in the future. Population ageing coupled with the political dominance of social spending may exacerbate over-commitment in the social sphere. This, in turn, could undermine growth, prosperity and trust further in the future. A vicious circle of higher social spending, non-delivery on core tasks and less trust may contribute to a continuing spiral of populism. It will potentially hit hardest those countries where welfare states (and expectations in the state) are already the largest.

What are the policy implications? We suggest that governments should refocus on their core activities. This has been argued by many economists for decades. Governments should give priority to setting people- and market-friendly rules of the game, and to providing core public goods such as security and education. Social safety nets and the spending involved should be much better targeted. The agenda should also include fiscal stability with low deficits and debt as this enhances governments' ability to fulfil their core tasks and react to new challenges. All this contributes to overall economic, financial and social stability, and to less disappointment with governments. The favourable experience and the re-emergence of trust in countries that have reformed governments in recent decades (including most recently in Europe) are a case in point.[14]

One important issue here is when to tackle reforms. In most cases, it is an acute crisis or the threat thereof that causes governments to act: the financial crises in the Nordic countries in the early 1990s, the post-unification bust in Germany after the turn of the millennium, and the crisis in Southern European countries in recent years. Good times with high growth, which economists argue should be the time for reforms, have typically been times of over-commitment and over-spending, laying the roots for later crisis.

Another important point relates to the role of fiscal policy when it comes to achieving government core tasks. As outcomes matter, we need to change fiscal policy to prioritise key outcomes related to core tasks.

We close with a few more observations on the most difficult issue of participation and trust.[15] Two schools of thought seem to prevail. The first school emphasises participation, for example via referenda. This certainly reduces the risk of dissatisfaction and hence potential loss of trust. But it may be slow and cumbersome. This is broadly the Swiss model. Weiler (2012) calls this "process legitimacy" where decisions are taken via democratic process.

The second school emphasises paternalism. Important decisions including many decisions on centralisation in Europe are taken this way. Weiler (2012) calls this "political messianism" because the decision will take people to the "promised land", sometimes decidedly against their will. If centralisation is a success, it will gain "results legitimacy" ex post. Of course, if things then go wrong and the "promised land" remains elusive, people blame their governments, other governments and Brussels. This is particularly relevant when one country's economic weakness results in another country's financial risks leaving all societies frustrated. There are perhaps important lessons from this, not least with regard to trust in the euro and the further integration of the euro zone.

---

[14] In light of this, it is also no surprise that relatively small and efficient governments in Switzerland, New Zealand and Canada fulfil their core functions reasonably well with moderately sized welfare states and public expenditure ratios around or below 40 % of GDP (Tanzi and Schuknecht, 2000). Some more inefficient European governments with big welfare states do less well, with public spending over 50 % of GDP. Scandinavian countries are the exception, with big but effective public sectors, following significant reforms in recent decades.

[15] There is some literature examining the implications of centralisation, with very mixed results at best. The abolition and merging of local communities and the effect on citizen participation has yielded little in terms of administrative efficiency while reducing participation and identification (Lassen and Serritzlew 2011, Blesse and Rösel 2017 and many more).

## References


Afonso, A., Schuknecht, L. & Tanzi, V. (2005), *Public sector efficiency: An international comparison;* Public Choice, Volume 123, Issue 3–4, pp 321–347.

Baum, A., Checherita-Westphal, C., and Philipp Rother (2012), *Debt and Growth: New evidence from the Euro Area*; ECB Wordking Paper Series, NO 1450.

Blesse, S. and Rösel, F. (2017), *Gebietsreformen: Hoffnungen, Risiken und Alternativen*, Ifo Working Paper No. 234.

Böhm-Bawerk; Eugen (1914), *Macht oder ökonomisches Gesetz?* In: Zeitschrift für Volkswirtschaft, Sozialpolitik und Verwaltung. Band 23.

Bonin, H., Fichtl, A., Rainer, H., Spieß, C. K., Stichnoth, H. and Wrohlich, K. (2013), *Lehren für die Familienpolitik: Zentrale Resultate der Gesamtevaluation familienbezogener Leistungen*, DIW Wochenbericht Nr. 40.2013.

Buchanan, J.M. (1975), *The Limits of Liberty – Between Anarchy and Leviathan*, The University of Chicago Press, Chicago / London.

Checherita-Westphal, C. & Rother, P., (2012), *The impact of high government debt on economic growth and its channels: An empirical investigation for the euro area*, European Economic Review, Elsevier, vol. 56(7), pages 1392-1405.

Chen, T., Hallaert, J., Pitt, A., Qu J., Queyranne, M.; Rhee, A., Shabunina, A., Vandenbussche, J., Yackovlev, I. (2018), *Inequality and Poverty across Generations in the European Union*, IMF Staff Discussion Note No. 18/01.

Coase, R. H. (1960); *The Problem of Social Cost*, Journal of Law and Economics, Vol. 3 (1960), pp. 1-44, The University of Chicago Press.

Deaton, A. (2015), *The Great Escape - Health, Wealth, and the Origins of Inequality,* Princeton University Press.

Doing Business Report (2018); *Reforming to Create Jobs*; The World Bank *http://www.doingbusiness.org/reports/global-reports/doing-business-2018.*

Friedman, M. (1977), *Fair versus free*, In: selections from The Collected Works of Milton Friedman, p. 135-137.

Jones, Randall S. (2013), *Education Reform in Korea*, OECD Economics Department Working Papers, No. 1067, OECD Publishing, Paris. http://dx.doi.org/10.1787/5k43nxs1t9vh-en

Gwartney, J., Lawson, R., Hall, J. (2017), *Economic Freedom of the World 2017 Annual Report*, Fraser Institute.

Hayek, F.A. (1960), *The Constitution of Liberty*, University of Chicago Press.

Issing, O. (2009), *Politischer Wille oder ökonomisches Gesetz? Einige Anmerkungen zu einem großen Thema*, CFS working paper series ; No. 2009,24.

Kumar, Manmohan S. and Woo Jaejoon (2010); *Public debt and Growth*, IMF Working Paper 10/174 (Washington, D.C.: International Monetary Fund).

Lassen, D. D. und S. Serritzlew (2011), *Size and Equal Opportunity in the Democratic Process: The Effect of the Danish Local Government Reform on Inequality in Internal Political Efficacy*, World Political Science Review 7: 1–15.

Musgrave, R.A. (1959), *The Theory of Public Finance: A Study of Public Economy*, New York: McGraw-Hill.

OECD (2017), *Government at a Glance 2017*, OECD Publishing, Paris. http://dx.doi.org/10.1787/gov_glance-2017-en

OECD (2015), *Old-age income poverty*, in Pensions at a Glance 2015: OECD and G20 indicators, OECD Publishing, Paris.

Pattillo, C., H. Poirson and L. Ricci (2004), *What are the channels through which external debt affects growth?*, IMF Working Paper 04/15 (Washington, D.C.: International Monetary Fund).

Pigou, A.C. (1920), *The Economics of Welfare*, London (MacMillan), 4. ed. 1932.

Pigou, A.C. (1928), *A Study in Public Finance*, London (MacMillan & Co. Ltd.)

Potrafke, N. (2015), The Evidence on Globalisation, The World Economy, Volume38, Issue3, pp. 509-552.

Schuknecht, L. (2013), *Has Public Insurance Gone Too Far*?, CESifo Working Paper Series 4217, CESifo Group Munich.

Schuknecht, L. und Zemanek, H. (2018), *Social Dominance*, CESIfo Working Paper (forthcoming).

Tanzi, V. and Schuknecht, L. (2000), *Public Spending in the 20th Century – A Global Perspective*, Cambridge University Press.

Weiler, J.H.H. (2012), *Europe in Crisis – On 'Political Messianism', 'Legitimacy' and the 'Rule of Law',* Singapore Journal of Legal Studies, p. 248-268.