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Working Paper

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IUI Working Paper, No. 50

Provided in Cooperation with:
Research Institute of Industrial Economics (IFN), Stockholm

Suggested Citation: Robinson, A.; Ysander, Bengt-Christer (1981) : Flexibility in Budget Policy: The Changing Problems and Requirements of Public Budgeting, IUI Working Paper, No. 50, The Research Institute of Industrial Economics (IUI), Stockholm

This Version is available at:
https://hdl.handle.net/10419/94888

FLEXIBILITY IN BUDGET POLICY

The Changing Problems and Requirements of Public Budgeting

by

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Working Paper No 50, 1981
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Förvaltningsbolaget SINDEX Stockholm 1981

Introduction - The Concern for Flexibility

Public budget-makers in the western industrial countries are facing new tasks. Instead of a redistributing and reserving for public use part of an anticipated rapid growth of affluence, they are now often left with the much more difficult and unpleasant task of breaking the expansion of public expenditure and of reallocating resources within a stagnating and inflation-ridden economy. Moreover they can no longer rely on the accuracy of economic forecasting. In trying to tackle these new tasks they often come to realize that the welfare strategies and planning methods hitherto used have entrapped them into a rather rigid system of commitments and responsibilities with little leeway for intramarginal adjustments and reorientations. This has intensified the search for new ways to create flexibility, new strategies and planning methods that are better designed for the needed adjustment to a changing environment.

In the following we will first try to spell out more clearly the various reasons behind this need for flexibility in public budgeting. We do this in two steps. We start by taking a longer view of the trends in public expenditure and finance, pointing at some major adjustment problems of budget policy that grew out of the construction and expansion of the "welfare state". This potential need of budgetary flexibility was, however, first made accute and generally acknowledged by the experience of economic stagnation in recent years. We therefore also look more closely at the present situation, where so much of budget policy is involved in fighting, and/or adjusting to, economic stagflation.

While economic development calls for flexibility, the development of bureaucracies, political institutions and voter attitudes seem bound in the opposite direction - towards an increasing rigidity in decision-making and spending patterns. In the second section of the paper we review these political trends and discuss to what ex-

tent the tendency towards institutional rigidity can also be viewed as arising out of the new budgeting tasks - is connected with the concern of the welfare state for individual security.

Most of the problems we discuss are common to all western industrial economies, although the extent to which they are critical - and generally perceived - may vary. We have throughout used the following eight countries as a common frame of reference: Canada, France, Italy, The Netherlands, Sweden, UK, USA, and West Germany.

Some indicators of Government sector development and economic performance in these countries during the preceding quarter-century, have been assembled in a statistical appendix. We have however found it convenient to exemplify the economic developments mostly with Swedish material while using predominantly British data in demonstrating political trends.

Why Do We Need Flexibility? - The Economics of Public Budgeting

THE LONG-TERM PERSPECTIVE - SOCIAL SECURITY AND ECONOMIC ADJUSTMENT

From Collective to Individual Security

How much flexibility you need in public budgets is a question of what external and internal changes you must be ready to adjust to and how well foreseen these changes will be. From the point of view of this public "risk-taking", public budgets have radically changed over the last half century.

In the old "guardian state" a main task of the state was concerned with collective security, minimizing and insuring against the risk of external or internal assaults on society, by defense and foreign policy, and by the judiciary and other control systems of central administration. Besides these expenditures on collective security - what the economists usually call pure collective goods - another major category of expenditure was investments in roads and in other kinds of infra-structure. In economic jargon the investments were concerned with "semi-collective goods", characterized by a high proportion of fixed cost, long economic life span and large returns to scale, which made them natural candidates for tax financing.

With public budgets dominated by these ambitions and kinds of expenditures, flexibility was needed only to adjust to changes in the national security situation and to long term trends in internal migration and urbanization, etc.

Other kinds of risks, whether arising from changes in the economic conditions or from the vicissitudes of families and enterprises, were born by the individual unit directly affected. It was still

the individual firm or the individual household that had to do most of the adjusting, not the public budgets.

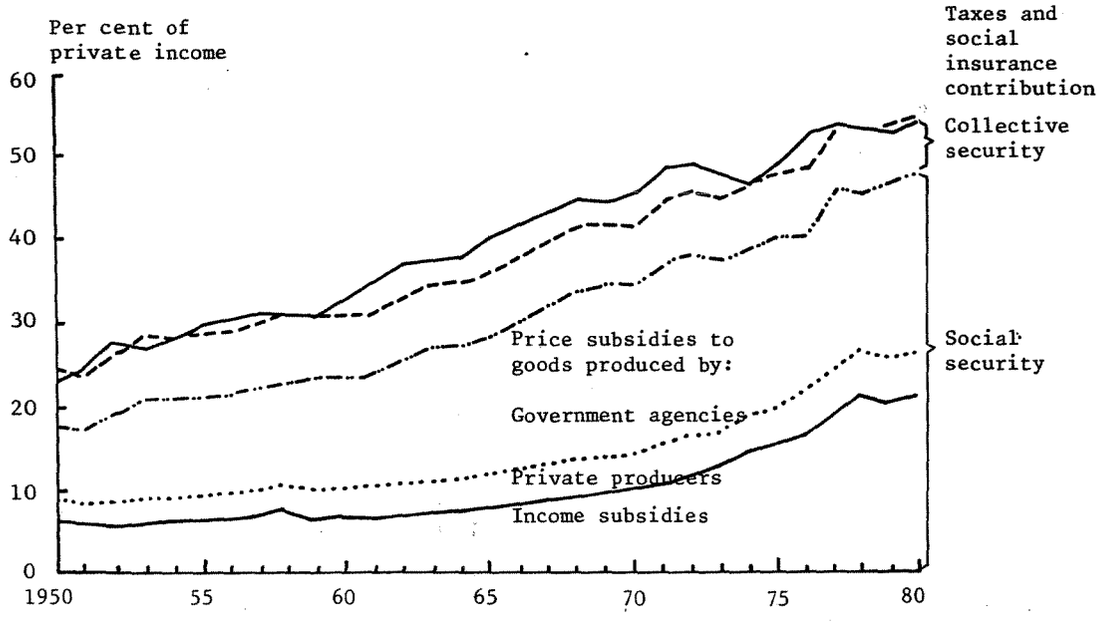
The development over the last half century from the "guardian state" to the "welfare state" has meant a shift of emphasis from collective security to social and individual security. The major and growing part of the public budgets in the western industrial countries is now aimed at ensuring reasonable standards for the individual household. To a growing extent the public budgets are thus acting as buffers or insurance against the individual lifecycle or family situation, against unemployment and ill-health, against the cost of bringing up children and the cost of growing old. This fact that much risk-taking has been moved upwards from the individual household - and sometimes also from the individual firm - to government, obviously creates new needs for flexibility in public budgets. Social risk-sharing is not a zero-sum game where one individual's fortune may be expected to even out another's misfortune. Demographic mutations and changes in the economic environment may require drastic changes not only in total public resource use but also in the allocation of resources between different purposes.

How difficult it may be to attain the needed flexibility will i.a. depend on what form has been given the individual standard guarantees. The government can guarantee income by way of transfers to individual households or firms, or it may instead guarantee the availability of certain social services directly by publicly producing the services and distributing them free of charge or heavily subsidized, i.e. as public consumption. Public consumption may for other reasons be a preferred way, but from the point of view of flexibility it certainly has the disadvantage of creating further commitments and adjustment problems for the public-budget makers.

When it comes to demonstrating trends and tendencies involved in public expansion Sweden is usually a good example to choose since the relative expansion of public expenditure and tax financing has here been carried further than in any other industrialized

country. (Klingman and Peters, 1980; Ysander, 1981a.) Figure 1 shows how the Swedish "welfare strategy" developed during the period 1950-1980 in terms of a simple break- down of public budgets. All public expenditure of a non-business, non-contractual nature has here been grouped in two main categories: collective security and social security. Under the general heading of collective security all current and investment expenditure for defense and foreign policy, general administration, judiciary system and fire service have been counted. All other expenditures are subsumed under the heading of social security, i.e. are assumed to be mainly concerned with guaranteeing or preserving individual standards. Social security expenditures have been further broken down into two categories: one is "income subsidies" or direct transfers to households and the remainder is described as "price subsidies". There are, finally, two different kinds of price subsidies. The

Figure 1. The Swedish Welfare Strategy - The Use of Taxes 1950-80



Source: Ysander (1979, 1981 a)

major part - called public consumption and related investment in the national accounts - goes to government agencies, producing various types of social services in education, health, social welfare, roads, etc. The rest are subsidies for current or investment expenditures within the private sector, e.g. for housing and food, to public utilities or to ailing industries.

A thick line at the top shows the development of income from taxes and social insurance contributions.[1] All budget items have in the figure been measured as shares of private income.[2]

The figure shows a very striking development pattern. The share of income used for collective security has remained more or less constant over the whole period, around 10 per cent. The dramatic expansion of the public budget share has entirely been due to the increase in social security expenditure. This has more than trebled its share during the 30 years. The proportion in social security expenditures of public consumption and related investments as well as of income subsidies has remained fairly unchanged during the period. The share of price subsidies to private producers has expanded at a slower rate than other social security expenditure, in spite of the considerable increase of industrial support measures in late years.

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[1] The difference between this income and the total expenditure for collective and social security should not be misconstrued as a measure of total budget surplus or deficit. To arrive at a measure of net government financial saving, the surplus or deficit of tax financing, shown in the figure, must be added to the net of government business or contractual transactions, i.e. income from interest on government lending, from operating surpluses, etc., minus the cost of contractual expenditures like interest on government borrowing, etc. Only by then adding to this net financial saving the net of government credit and financial investment transactions do we return to the total budget surplus or deficit, as commonly defined.

[2] Private income is here defined as total private factor income less capital depreciation plus income subsidies. It can be viewed as the maximal possible tax-base for an income tax. The use of private income instead of GNP as a common denominator can be justified both by the need to have the measure as invariant as possible for changes in the tax and expenditure structure and by the wish to make possible an interpretation of the shares as "tax burden", "subsidy dependence", etc.

The role played by capital formation in general and infra-structure investment in particular in the Swedish public budget is also diminishing. The GNP share of public capital formation is now less than it used to be 30 years ago.

Welfare strategies do of course vary between different countries. Compared to Sweden most other OECD countries have experienced a less rapid total expansion of public budgets and are also relatively less dependent on price subsidies in general and public consumption in particular. This is particularly true for countries like Italy and France, where social security expenditures have traditionally been dominated by income transfers to households. The different development patterns for government expenditures are shown in the statistical appendix 5:1-4. In 5:4 we also see how the relative importance of public consumption, i.e. of the free distribution of social services, is reflected in the development of public employment. The relative dependence on public consumption is of course very relevant to the question of budget flexibility. It seems reasonable to argue that welfare strategies which depend more on public consumption - involving relatively more of public production and employment - tend to make it harder both economically and politically to adjust downwards, at least in the short run.

Whatever the differences in welfare strategy, certain main traits are however common to public budget development in the different countries. The share of total incomes channeled through public budgets has everywhere been continuously growing. The relative role played by expenditures for collective security has been continuously dwindling, particularly rapidly during the 70's. Finally, a diminishing share of public expenditures is used for capital formation.

Social Insurance through Public Budgets

Social security expenditures can to a large extent be construed as a way of "insuring individual standards". One way of studying what public budgets do for the individual household is to look at their impact on the anticipated real life-income of a young individual. The expectations of future standards for the individual will i.a. be determined by life cycle changes, by the need for educational services for himself and any future children, old age care for himself, etc., and by various kinds of risks of ill-health or unemployment, etc. The existence of public budgets may affect this anticipated life income in two different ways. In part the public budget may be construed as an obligatory group insurance policy with premiums computed from average probabilities for the various social events. The other kind of impact will be direct changes in the individual's real income prospects.

The part of the impact that can be construed as an insurance of life income or standards affect the individuals expectations in at least two ways. Firstly, it redistributes the resources available over time in proportion to the expected needs in different phases of life. Government can here be said to act as a substitute for a perfect credit market, making it possible for the individual to lend and borrow in proportion to his or her needs. Secondly, it changes the variance of the anticipated real income or standard in different years for the individual. Social security here assumes the role of a pure risk insurance, compensating the individual for various kinds of economic and family vicissitudes.

Changes in the individual's real income prospects through public budgets may again be characterized in two different ways. Collective and social security may shift the levels of expected life income by affecting available resources or by changing incentives. It may also redistribute expected life incomes between individuals and households. Besides these redistributions that are openly accounted for in the tax and transfer system there are of course also

"disguised" redistributions due to the difference between the collective and obligatory "insurance contracts" involved in social security and the insurance the individual would voluntarily have contracted. A healthy, talented and well educated individual may e.g. run less risk than another fellow and may moreover value security differently.

Open redistribution between expected life incomes seems in fact to play a very marginal role in the public budget systems. The dominant part of the social security budget can be interpreted as an insurance of individual life time standards or income. Thus the actual redistribution is not from rich to poor so much as between age cohorts of the general population - a "lifetime" redistribution. This has obvious implications for the study of government risk-taking and the need for flexibility or adjustment in public budgets. Public budget makers must be ready to adjust to various kinds of demographic and economic changes and most such adjustments will affect a major part of the voters.

Demographic Changes

Since so much of government expenditure is concerned with insuring individual standards one major reason for requiring flexibility and adjustment in public budget is the prospect of demographic changes. The goods and services needed by a household vary a great deal with the composition of the household, the number and age of adults and of children, etc. If social security is interpreted to mean the insurance of certain standards for each type of household, population changes that entail drastic changes in the age structure, or in the pattern of migration and localization, may obviously require a corresponding adjustment and reallocation of budgetary resources. The adjustment problem will often be further magnified by the fact that the population changes also affect the proportion of people in active ages constituting the productive basis - and the tax base - for society. Demographic

development patterns from 1950 onwards and projected tendencies towards the turn of the century for our eight countries are described and exemplified in statistical appendix 1.

The development of birth and death rates for the various countries are shown in appendix 1.1. In all countries a low and stabilized death rate contrasts against a still volatile but in the long-term declining birth rate. The birth rate which has declined sharply since the mid-60's, is in most countries expected to remain low also during the remaining decades of the century. Historical experience tends however to show that no great reliance can be put on predictions of the birth rate. There seems to be no assurance of stability in birth rates in the mature industrial society where fertility is controlled according to the changing desires and economic circumstances of successive parental generations. Within the overall pattern of aging populations, we may also in the future have to deal with the various problems raised by fluctuating child populations.

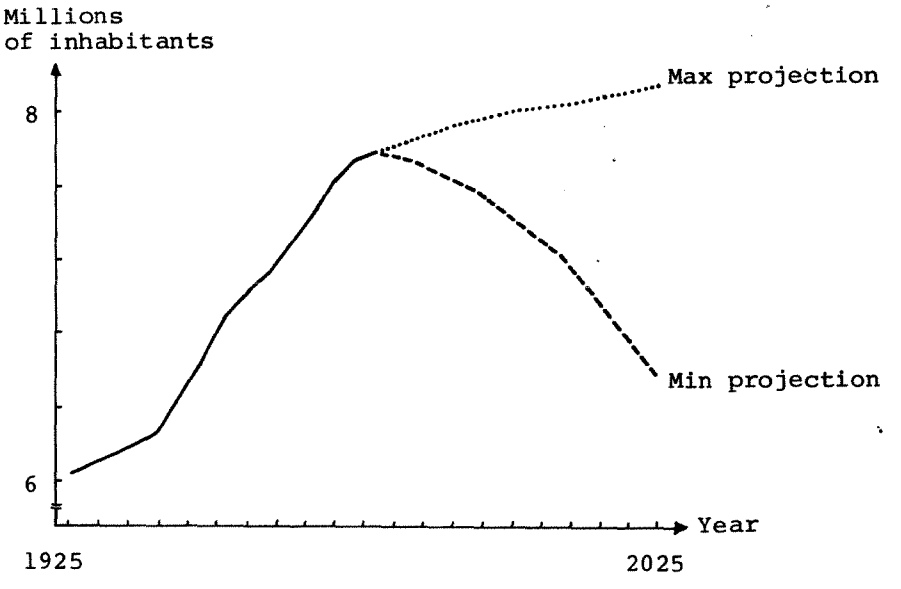
The implications of these trends in birth rates for the age structure of the population are spelled out in appendix 1.2. We there see that, although the aging process may be more or less advanced in the different countries, all are characterized by a declining rate of population increase, and by reproduction rates that imply long-term population decrease and an ongoing shift upwards in the age structure, giving relatively more old people and less children. This 'aging' of the population is in most cases expected to continue at least over the next decades. According to United Nations' population statistics and projections, there were in 1950 in the more developed regions of the world almost 9 individuals in active age (15-64 years) for each person over 65. The projected ratio for the year 2000 is instead 5 to 1. In Western Europe this ratio is now only 4 to 1 and still declining.

Since Sweden also in this respect constitutes an extreme example of the common trends, the adjustment problem implied by popula-

tion changes may be exemplified from Swedish data. Figure 2 shows the Swedish population development 1955-2025 according to an official projection made some years ago. The figure demonstrates the two common traits of population change that we emphasized above: the high degree of uncertainty and the long-run tendency towards a declining and aging population.

Both the uncertainty and the aging have obvious consequences for the economy. The constant ebb and flow in the number of children passing through school and of young adults coming of age to join the labor force, to marry and establish new households, has unsettling effects on the functioning and development

Figure 2. The Swedish Population 1925-2025



Source: National Central Bureau of Statistics (1976)

of the educational system, of the labor market, and of the demand for housing and consumer durable goods. The increasing number of old people creates economic, social and political problems of meeting the needs of the aged for income maintenance in retirement, for medical care and housing, etc.

As an example of these possible consequences for public budgets we recount in Table 1 some estimates of consumption patterns for different age groups in Sweden in 1975. It should be emphasized that no attempt has here been made to estimate independently the private consumption costs of children. The figure for this in the table is simply the sum of those public transfers to the households that are specially ear-marked for the private consumption of children. The actual distribution of private consumption within the family has thus been left open. What is of some interest to us here is the fact that, although the total consumption of older people was estimated to be some 20 per cent below that of people in active ages, their consumption of publicly produced service - roughly equivalent to that of children - was twice as large as that of people in the active ages. The transfer of an individual from active to retirement age, does not only mean that his or her total consumption cost, only slightly reduced by retirement, now has to be "born" by the remaining income earners. It

Table 1. Private and Public Consumption per Capita for Different Age Groups in Sweden, 1975 (Sw.Cr)

	0-14 years	15-64 years	65-w years	Total
Private consumption	2 200	26 700	14 900	18 200
Public consumption	11 500	6 600	11 900	8 700
Total consumption	13 700	33 200	26 900	27 000

Source: Åberg and Nordin, 1977, p. 79.

also means a radical reshuffling of the "consumption basket" with a heavy emphasis on various kinds of social services.

Changes in the Economic Environment

Another major reason for the need for flexibility in public budgets has to do with the changes in the economic environment and the uncertainty surrounding these changes. Technological changes and shifts in competitive or bargaining positions change the relative prices and with that the real income of individual households and firms as well as that of countries. The experience of the industrial countries in the 70's affords dramatic examples of this. Two big oil price hikes entailed a considerable worsening of terms-of-trade for many oil importing countries and affected the competitive position and profitability of many branches of industry. The discovery of new natural resources in some cases led to a devaluation of the old and to changes in the relative wealth of nations. The increasing competition from NIC-countries helped to initiate a long term decline and stagnation in many of the traditional industrial branches of the western countries. An unusually severe and well syncronized recession coupled with rising trends in inflation rates created stabilization problems which in many countries are still far from solved. How this story unfolded itself in the eight countries is indicated by the figures and numbers in the statistical appendix 2-4, where an overview of the developments in production, trade and employment is presented.

Altogether, the uncertainty surrounding industrial and macroeconomic planning has undoubtedly increased compared to the first postwar decades, which now in retrospect seem to exhibit an unusually stabile and orderly economic development - at least for the western industrial countries. The Bretton Wood system of fixed exchange rates, the highly regulated capital markets and the international cooperation and planning for reconstruction and trade liberalization, all then contributed to make the world relatively safe for economic planners. This experience may well prove

to have been historically unique and is now definitively a thing of the past.

During earlier public budget regimes, without the safety net of social security, most of the adjustment responsibility would be borne by the individual household or the firm directly affected. The changing fortunes of competition would be registered in the varying factor incomes, and from the income earners the effects would spread to dependents by way of intrafamily transfers. To the extent that social security budget means insuring individual standards, much of this economic risk-taking has now been taken over by the government.

The adjustment needed by way of public budgets not only means redistributing the gains and losses at a certain time, using profits from expanding parts of the economy to compensate the welfare losses of ailing industries and regions and of adversely affected households. Another and perhaps even more difficult task is the adjustment of overall levels of domestic consumption.

Long term changes in terms-of-trade and in the competitive position of a country sometimes require considerable downward adjustment of consumption levels and trends.[1] The major responsibility for enforcing these overall adjustments and ensuring that the consequences are fairly distributed among the various segments of the population, will today fall on the public budget-makers. This is a task for which they are often ill prepared, which may be one major explanation why so many countries have failed in carrying through effective stabilization policies in recent years.

There is another important but more controversial side to this story of government risk-taking. Economic adjustment does not

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[1] It has, e.g., been calculated that a rapid - three year - adjustment to an oil price shock of the same magnitude as the one in 1973, would in Sweden require a downward shift of 3 per cent of per capita consumption over the three years and an 8 per cent cut in real wages during the first years. See Ysander(1981b).

only mean tightening the belt and persevering through the hard times. It also means successively restructuring the economy, getting resources out of declining industries and production areas into expanding production sectors and new innovative efforts. When the individual standards are to a certain extent guaranteed by the government and expected gains and losses are evened out, the personal inducements to move, to take new initiatives and new risks may very well be adversely affected. This could be true of subsidized industrial firms as well as of subsidized households and could reduce the mobility of both capital and labor and, ceteris paribus, introduce new rigidities in the whole economy. To the extent that this is true, it means that more and more of the responsibility also for initiating change and effecting mobility will be placed with the government. Increasingly active labor market and industrial policies could then be viewed as an unavoidable sequence to a matured social security system.

Increased government intervention in this sense however also increases the flexibility requirements for public budgets since e.g., with a limited labor supply, workshops somehow must be closed before new ones can be opened. Another example of this need for flexibility, by now experienced by most countries, is concerned with wage policy. On the one hand economic adjustment in market economies presupposes a certain degree of flexibility in nominal wages. On the other hand the claims to guaranteed standards, rooted in the social security system, coupled with union solidarity, tend to make relative and absolute adjustment of nominal wages hard to achieve. To accommodate simultaneously both these contrary claims may require a fine-tuned continuous adjustment of the tax and transfer system. How far it is possible to go in this direction is however still a controversal question.

That public budgets in the future need a lot more of built-in flexibility is incontestable. What we still do not know, and where different views and ideologies still sharply differ, is to what extent

public budget adjustments can be substituted for individual adjustments without losing the efficiency gains of a decentralized economy.

Retarded Growth

It is usually much easier to adjust when resources are expanding than to do so in a stagnating climate where expansion for one category of expenditure can only be bought at the price of contracting another kind of expenditure. This partly explains why so much attention is focused on the question of budget flexibility right now in a time of industrial stagnation. However, quite apart from the present tendencies towards declining industrial productivity, there are good reasons to suppose that future budget makers will have to operate within much narrower growth limits than during the first postwar decades. This is simply due to the existence in the economy of several sectors with different rates of productivity increase.

It seems reasonable to assume that the more labor intensive service sectors will always on the average register a lower productivity increase than those prevailing in industry. Given this assumption, even a balanced growth of industrial production and service production will require that successively more people are moved from the industrial sector into the service sectors while the overall rate of productivity increase in the economy will decrease, tending in the long run towards that of the service sector with the least increase in productivity. If we also want to have the consumption of goods and services for each type of household show a balanced growth - not an unnatural norm in a welfare state - then obviously, with an aging population, the shift of labor into service sectors and the decline of the overall productivity increase will be even more rapid, everything else being equal. If, on top of that, we add the fact that only dramatic increases in inter-continental migrations now seem to be able to prevent a long term decline of the labor supply in the western industrial countries, it seems fairly certain that future public budget-

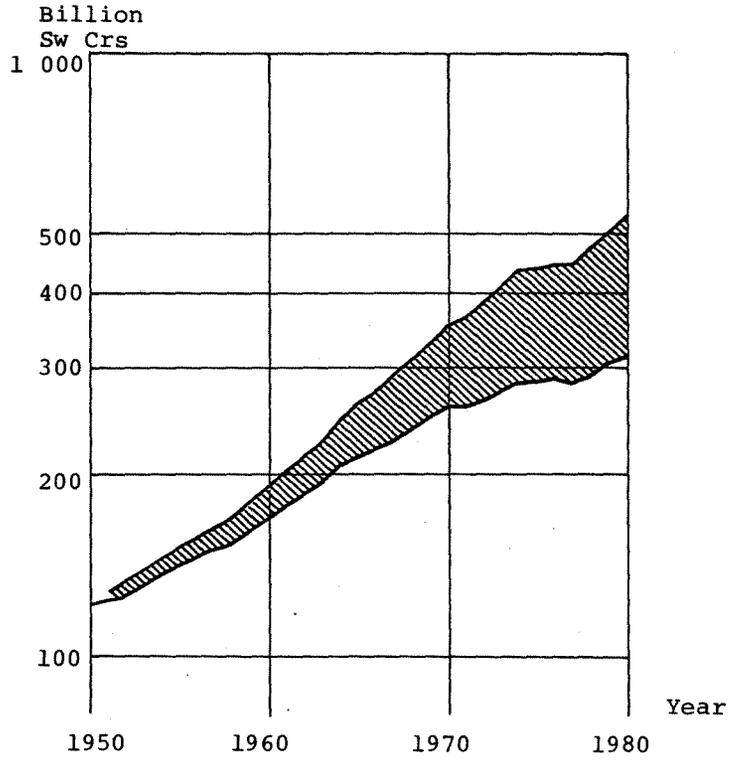
makers will have successively less new resources to play with and will have to fall back more on internal savings.

The growth of recorded GDP will in fact tend to show an even more marked retardation than that which is actually happening in total domestic production. One reason for this could be a relatively expanding "black and grey" sector of the economy i.e. an increasing share of productive activities that goes unrecorded due to illegal tax evasion or because they are performed within the household and never marketed. Another, and less speculative, reason is the accounting conventions used in national accounting and in our definition of GDP. As long as we treat public consumption by definition as a sector with a zero increase in productivity, any growth of public consumption implies that official figures of GDP will show an exaggerated retardation.

Figure 3 exemplifies this accounting illusion from Sweden, the country with the largest and fastest increasing share of public consumption. The lower curve shows the actually recorded growth of GDP in Sweden for the period 1950-1980. The upper curve shows how this growth would have been recorded if instead we had used the alternative convention of assuming that the productivity increase in the public sector was the same as that of the private sector.[1] As the figure shows, this alternative assumption would have meant that total production increased five times during the 30 years instead of three times as actually recorded. If we neglect the possibility of an actual decrease in productivity in the public employment it means that we would expect the actual increase of productive capacity to lie somewhere within the shadowed area in the figure. Wherever exactly it lies, it is a reasonable assumption that the retardation of recorded growth of GDP, already noticeable during the first three postwar decades, will continue in the future. It is therefore futile to hope that the pres-

[1] And also that the cost of capital use is the same for the public as for the private sector.

Figure 3. The Statistical Uncertainty - Swedish GNP 1950-80 under Alternative Assumption



Source: Ysander (1981 a)

ent concern with budget flexibility can soon again be forgotten in a new sustained wave of economic affluence and expansion.

Macroeconomic Constraints on Budgetary Adjustment

There are other factors, besides the tendency towards retarded growth, that makes it more difficult than before to effectuate the needed budgetary adjustment. As shown by appendix 5:6 the share of total incomes that is channeled through the public budgets has in all countries grown during the last two decades, in the case of Sweden e.g. doubling since 1961. The same is true of public employment as demonstrated by the figures in appendix 5:4. In the extreme case of Sweden public employment now tends to surpass employment in the manufacturing industries. The table in appendix 5:5 shows that the elasticity of government receipts relative to GDP, as estimated over the last two decades, range from 1.08 in Germany to 1.32 in Sweden. This rapid expansion of the relative importance in the economy of the public sector also means, that considerations of macroeconomic effects and consequences for the private sector must play an enlarged and constraining role in calibrating and timing the adjustments in public budgets. Let us just here note some of the best known instances of these macroeconomic constraints on budgetary adjustment.

Taxes play an increasingly important role in determining the cost of producing goods and services. Tax increases, unfortunately timed, may contribute to an upward "cost push" effect on domestic inflation, directly by way of commodity prices or indirectly by way of their influence on wage settlements. To the extent that the tax increases also squeeze profits and disposable incomes they may also restrict effective supply both in the factor and the commodity markets. High taxes - and the concomitant high degree of tax consciousness - therefore tend to make tax adjustments a very delicate operation even without stagflation.

On the expenditure side the macroeconomic constraints mostly discussed are concerned with the influence of government budgets

on the factor markets. With government as both a dominant employer and a dominant borrower on the capital market, the rate of public expenditure increase must necessarily affect the cost situation for producers within the private sector. Saying this does not mean that one has to subscribe to the simplified picture of government and private firms competing directly on a homogeneous labor market or a market for loanable funds. Even if public employment is to a certain extent "segregated" from the industrial labor market, the rate of increase in public employment will undoubtedly affect the overall development of wage cost in the economy. Even if the capital market is partly rationed by the government itself and the availability of capital funds mainly determined by monetary policies, an increasing deficit in the public budgets will in the end tend to push up the price of capital - the interest rate. If the deficits grow big enough not even the best intended monetary policy will moreover be able to avoid some of the deficits spilling over into inflationary additions to the liquidity in the economy. It should perhaps be emphasized that these constraints refer to the timing and rate of budgetary adjustments, not to the level or relative size of the public sector.

As a further and final example of the stability constraints on budget adjustment we can use the problem of capitalization. If, for instance, like in Sweden, two-thirds of all incomes are channeled through public budgets and one-third of disposable incomes derive from public transfers, it would indeed be remarkable if income expectations and capital values would not be largely determined by the tax and transfer system. This means that drastic changes in taxes and transfers may lead to speculative instability on the markets concerned entailing large windfall profits and losses for the capital owners. Housing policies in Western Europe during the postwar period afford many good illustrations of this problem (cf. Ysander, 1981c).

What these examples show is simply the fact that with the growing importance of the public economy, budget policy becomes an integral and indeed often a major part of general economic policy. This places constraints on the possible rate and timing of budgetary adjustments.

THE SHORT-TERM PERSPECTIVE - ADJUSTING FOR STAGFLATION

Industrial Stagnation and Deficit Spending

The question of budget flexibility has in recent year acquired a new urgency and new dimensions by the stagflation developments in the western industrial countries. The average rate of annual inflation in these countries has more than doubled over the last ten years. At the same time industrial production and investment are stagnating and resource utilization and employment are still far below normal levels in most countries. As can be expected, industrial stagnation and high unemployment in most countries go together with a public budget deficit. The demand for social security expenditures rises while at the same time there is a shrinking of the base for direct taxes and for social security contributions.

In trying to find a policy against stagflation, the governments in the western countries seem to have been faced with two policy options, both with undesirable side-effects and neither of which has so far proved efficient. One option is to keep up employment by a cautious expansion of domestic demand while at the same time trying to contain the budget deficit by finding new and less inflationary sources of tax finance. You pay the risk of increased inflation and a mounting deficit in the hope that if you manage to hibernate a couple of more years the world inflation will be dampened by outside efforts.

The contrary option is to focus on the fight against inflation, accepting the risk of a fastly arising unemployment. Restrictive monetary policies are combined with a relative shrinkage of both taxes and public expenditures in the hope of dampening inflation by simultaneously restricting public demand and expanding private supply. The risk involved is that, if the second effect does not materialize, all you are left with is unemployment.

Alternative measures have also been tried including selective incentives for industrial expansion and income and price policies directed towards the goal of breaking inflationary expectations.

Whichever option is tried one experience seems to be common to all present day public budget-makers. The limits on real resource growth and on tax financing are now effective and generally acknowledged to a much greater extent than ever before. As shown in statistical appendix 5:7 most of the countries show a mounting public deficit. Whatever the long term view and the political priorities, most parties involved in public budget-making now seem to concede the fact that growth both of public consumption and of total public expenditures during the remaining years of the 80's will have to be slow. This means that part of the necessary new public expenditures for the rapidly rising number of older people, etc., will have to be provided by a more strictly economizing with already existing public resources and a more cautious "marketing" of existing social services.

Price Expectations and Inflation Adjustment

The high rate of inflation has also brought attention to a number of questions concerning the management of public budgets in an inflationary economy. The problems involved are both political and technical. They have to do both with the rapid rate of price change and with the increased uncertainty surrounding these changes.

There are really two main questions involved. The first concerns if and to what extent you should adjust for inflation. A second group of questions concerns how such adjustment should be made and estimated. To adjust completely to inflation by "indexing" the whole budget - taxing real instead of nominal incomes and fully compensating on the expenditure side for all additional costs due to price movements - could at best be interpreted as an attempt

to keep the public budget neutral in the fight against inflation. Instead of trying to break or change the price expectations in the private markets the public budget-makers accept and accomodate them. In the worst case it could mean that you superimpose a new inflationary spiral, by partly compensating for the effects of your earlier compensations, by lessening the resistence against price and wage increases and by running up a bigger deficit because of the rising relative cost of public services. There is thus a reasonable argument for limiting the extent of inflation adjustment in the hope of breaking price expectations and price movements.

There are also many different questions concerning the most efficient way of indexing various budget items. The current tax rules in most countries exhibit a perplexing mixture of nominal and real terms. The indexing of tax scales is a fairly simple first step that has by now been taken in most countries. To further approach a consistent real tax system is, however, a very complicated business which cannot moreover be discussed in isolation from the problem of indexing the credit market and of inflation accounting in the rest of the economy.

On the expenditure side inflationary adjustment involves a series of questions concerning the criteria to be used in deciding the suitable degree of compensation and the choice of price index to be used in adjusting the various expenditure items. Once these decisions have been made, one is still left with the quite difficult problem of making estimates for the adjusted budget. You need to find some way of building price expectations into the budgetary process in a consistent way. The basic tool you need to do such estimates - a model of price determination in the economy - is still lacking in most treasuries.

Inflation also affects budgetary planning in other ways. One of the main reasons for the increasing unreliability of macroeconomic models is probably connected with the fact that most of these

models do not take price expectations explicitly into account. If price expectations may radically change behavior and by that also the economic outcome, and, if these expectations cannot in any simple way be explained in terms of the recent development of economic aggregates, then the models will fail to produce accurate forecasts. This forecasting failure has obvious and important implications for budgetary flexibility. It forces the government to shorten its prospective in budgetary planning and it makes it necessary to find ways of reviewing and changing budgetary decisions with short notice, to make the whole process of budgetary decision-making more flexible and less drawn out in time.

How Did We Get So Inflexible? - The Politics of Public Budgeting

Changing Political Roles and Inflexible Budgets

We showed above how the build-up of the welfare state has increased the need for flexibility and adjustment in public budgeting. The postwar experience of public decision-making has, however, exposed tendencies in the opposite direction - towards more inflexible budgets and less political control of public spending. This is not just an unfortunate coincidence. The political changes may be viewed as reflecting the new tasks assigned to the public sector in a welfare state. When the new tasks are tackled with planning methods more appropriate to the execution of public duties in a guardian state the result will be increased rigidity.

In describing these tasks above we particularly stressed the shift from the production of collective security services to the insurance and redistribution of individual benefits. Let us briefly spell out some of the possible implications of this for the roles and rules of public decision-making.

To the extent the impact of public programs is no longer national and collective, but limited to certain groups of individual beneficiaries, you would expect the organization of voters into interest groups. Instead of just having individual voters expressing their preferences on national interests in political elections, the voters will be represented by their various interest groups, competing and lobbying for the public resources. The mandatory power of the political establishment will have to make trade with the mandatory power of interest organizations.

When the government commitments directly touch on the individuals' private welfare, it is only natural that these commitments are perceived as social contracts, the obligations of which must be honored. No one is likely to sue the government for damage

because it is postponing, say, a weapons acquisition, a new courthouse or a national road project. Any short-term tampering with the conditions for pensions or other social insurance benefits is, on the other hand, likely to cause a public outcry about infringement of rights and contractual obligations. The rigidity in spending plans this may lead to, will tend to be further reinforced by the fact that any reduction is apt to be viewed as discrimination against a particular group of beneficiaries.

The new emphasis on distribution will also change the politician's role. Instead of trying to interpret the electorate's wishes in terms of a socially optimal amount of e.g. armaments or judiciary resources, he or she must now act as umpire in the midst of an unlimited amount of competing claims for the distribution of welfare. The demand for, say, more policemen does after all have a limit, while there is no assured limit to the demand for a bigger slice of the common bounty. Ideology, in the sense of an arrangement of individual preferences along an undimensional scale of possible collective actions, will tend to become superceded by the politics of group interest, with each group appraising the budget impact by its own private standard. The fact that so much of social insurance concerns so many - a kind of life-time redistribution - will serve, however, to secure a certain political stability and coherence.

When public budgets mainly dealt with collective security the political establishment could in principle still retain the full responsibility both for interpreting the wishes of the voters and for translating them into detailed spending decisions. The budgeting dialogue between political decision-makers and executive bureaucrats could then be viewed as simply a way of informing the politicians about technical possibilities and constraints. With the political role more and more turned into that of an insurance broker with the taxpayers as more or less willing underwriters, the politicians will often come to depend more on their bureaucratic agents, who must do the actual insurance adjusting. There will,

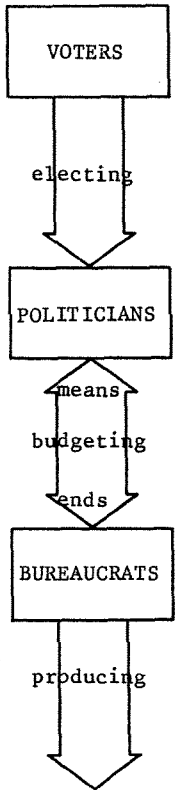
almost unavoidably, be a decentralization of public spending and marketing. It will be the agents who will hear the claims and do the actual settling. It is through the agents that much of the needs, and the wishes for more generous criteria and coverage in insurance, will be channeled. The agents will present the final bill of earlier commitments and try - possibly with the support of entrenched interest groups - to compete for new spending authority.

The position of the bureaucrats or public agents will be further strengthened by increased government involvement in the production of welfare services. The demand for welfare service will not only be registered but to a certain extent also regulated by the suppliers. This will make the bureaucratic interests closely allied with the interest groups concerned and make political revisions of programs correspondingly more difficult. It may also have the unfortunate and unintended effect of further widening the gap between the individual clients and the political decision-makers.

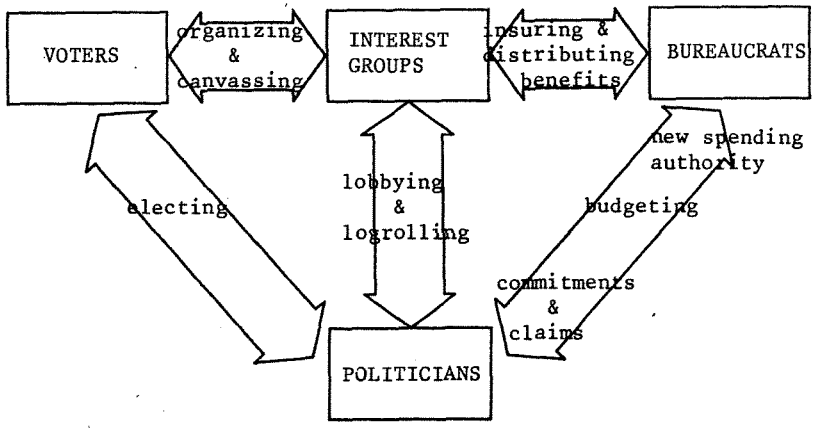
If we bring together the abovementioned points we see that the change in economic tasks and obligations is likely to cause a corresponding change in the conditions for public decision-making. A very simplified picture of the "old" and the "new" model of decision-making is drawn in Figure 4. The "guardian hierarchy model" - in political science particularly associated with the work of Max Weber - is still used as a common frame of reference for much normative work on planning and budgeting methods, as instanced by the argumentation for PPBS-systems. That the more complex "welfare distribution model" is closer to current practice would probably be acknowledged by most people with actual experience of public administration. Equally well established is the fact that as we continue to fit our planning methods and practices to the guardian hierarchy model, public budgeting in the welfare state tends to become increasingly inflexible, reducing the room for necessary political adjustments.

Fig. 4. Two Models of Public Decision-Making

The Guardian Hierchy Model



The Welfare Distribution Model



Economic and political developments of public budgeting in the welfare state thus appear to be intertwined but seemingly irreconcilable. Centralization of individual risk-taking is not viable if no political room is left for the necessary central adjustments.

We will come back later, in our concluding remarks, to the possible ways of meeting this challenge, of disolving the conflict by creating more flexibility for political control and budgeting. First, however, we shall try to trace the changing political roles and the increased rigidities in public decision-making through the history of postwar Britain, dealing in turn with planning methods, bureaucrats, politicians and voters.

The Methods of Budgeting

The history of the development and use of budgetary techniques reveals how politicians gradually come to realize that they need instruments of budget-making expressly designed to fit current economic, environmental and political needs. While they search for new tools they continue to use old ones. When the old tools are not adapted to new conditions rigidities appear in the processes of planning and control. In this section we shall show how the techniques employed in Britain in the expansionist phase of public spending from 1950 to 1975 have acquired characteristics that inhibit flexibility in a period of limited resources and rapid inflation.

In the old 'guardian state', when governments were primarily concerned with collective security, simple methods of public expenditure planning and control could be effectively employed. The British system of 'Treasury control' perfected in the 19th century under Gladstone was highly regarded as a shining example of executive budgeting. A system that provided, on a yearly basis, prior sanction by the finance ministry, parliamentary authorisation of expenditures and taxes, and careful 'post-hoc' audit, sufficed for the era of limited government. But the expansion of pub-

lic capital formation and the advent of the welfare state in the 1950's revealed deficiencies in this traditional 'circle of control'.

The deficiencies of annual appropriations and controls first came to light as governments embarked on large-scale capital projects. Highway construction and the building of hospitals and schools did not take place in the course of a single financial year. Plans made in one year entailed expenditures for many years ahead. Later, governments also realized that their open ended commitments in the sphere of social welfare and insurance had a continuous impact on the shape of the public budget. Although continued expansion of the public sector was politically popular with the electorate it carried economic dangers with it. Politicians could not proceed too fast with new schemes if they wished to avoid undue strains on the economy. Thus budget makers came to recognize that they required some estimation of the long-term effects of their decisions on the total of future public expenditure and on the shape of the whole economy. Instead of annual budgets they needed to make multi-year budgets.

In 1958 the Estimates Committee of the British House of Commons issued a report which demonstrated the inadequacies of annual budgeting in a period of expanding government expenditures. The Plowden Committee (1960) recommended the establishment of the Public Expenditure Survey Committee (PESC) which has operated since 1961. PESC's task is to survey all public services in Britain - including local government and nationalised industries - and to project forward for five years the expected costs of current programmes and agreed decisions. Five year forward looks had already been used for some individual departments including defence prior to 1961 but the novelty of PESC was that it covered the entire public sector in one exercise.

PESC itself is not a planning system because it merely records the future financial effects of decisions already taken. But it is used as the basis on which plans for new spending initiatives are

agreed. Armed with projections of economic growth over the same five year period as the PESC costings, ministers can put the two sides of the equation together. They can see how much of future economic resources will be absorbed by current commitments and how much room is likely to be left for further expansion of public services. They can then agree on how and when to introduce their new programs. So long as the forecasts of future expenditures on current commitments are stable, that is, so long as inflation is correctly forecast and its effects are calculable, and so long as the forecasts of future economic expansion are accurate, PESC appears to provide an ideal basis for rational public expenditure planning. It appears to offer the prospect of making rational decisions about the desired changes to the total size of the public sector, and to encourage rational allocation of future resources among competing functions of government. However, the way in which PESC has been used by politicians, especially as economic circumstances have altered, has encouraged rigidities in expenditure programs instead of increasing the rationality of the planning process.

It was perhaps just bad luck that PESC was first used at the very time that Britain was moving from a period of postwar economic expansion and relatively low rates of inflation into a period of slow and uncertain growth coupled with increasing rates of inflation. But experience with the use of multi-year budgets in other countries reveals similar tendencies. A device that might work well under conditions of stable economic growth has limited governmental freedom of action and choice under conditions of scarce resources.

It is easy to blame the PESC instrument itself, the economic forecasters, or the politicians for the rigidities that have arisen from the use of this device. But it should be remembered that the way in which it was used merely reflected widely shared current attitudes and assumptions. In spite of warning signs, no-one really wanted to believe that economic growth could come to

an end. When PESC was first introduced, economic growth was expected to continue indefinitely and to bring only benefits. Politicians and public alike agreed on the advantages of economic growth. It appealed to both Conservatives and Socialists. It offered the attractive prospect of expanding public services and of creating a 'humane' state without the accompanying pain of excessive taxation or overly harsh redistribution of income and wealth.

The relationship between economic growth and the development of a welfare state was eloquently pursued in influential books by Anthony Crosland (1956), and J. K. Galbraith (1958). A developed and expanding economy, in their estimation, offered plenty of scope for collective provision of public services without affecting the individual's prospects of personal affluence. Anyone who suggested, as did E. J. Mishan (1967), that growth might have concomitant disadvantages and that it might not necessarily increase welfare and happiness found himself swimming against a strong intellectual tide. Expectations of continued economic growth remained an underlying assumption of politicians and budget makers. PESC therefore simply acted as a handy tool for the realisation of a dominant ideology - the ideology of growth. Indeed, many politicians still have not accepted that there are costs and limits to growth and hope that the current economic conditions under which they have to work are merely a severe example of a passing slump.

Even so, PESC might have proved a good basis for expenditure planning if the estimates of costs of current programs and the forecasts of future resources had generally been accurate. But the estimates of costs were always too low and the forecasts of future resources always too optimistic. Over-optimistic expectations of the room for new programs led politicians to overspend. They compounded this effect by their attitude to the programs once they had been agreed in Cabinet. Once a new program has been agreed to and written into PESC its status changes from that of proposal to that of commitment. Adjustments then become

very difficult because they have to be presented as 'cuts' even if they are simply 'cuts' in projected increases.

There are other reasons why the way in which PESC was used encouraged rigidity in public spending. PESC became a part of the machinery for management of the economy. It recorded the long term effects of commitments to public services. The economy had to be managed so that the promises could be kept. There were, of course, other important objectives of economic management - balance of payments, exchange rate stability etc. - but the maintenance of the public sector gradually become more and more an effective constraint as the public sector grew in size.

In Britain, since the war, the economy has generally been regulated through demand management. In theory fiscal demand management can be carried out by making adjustments either to future and current public expenditure or to taxation. In practice taxation, not spending, was generally the preferred tool of adjustment. Politically the firm commitments to expenditure programs, enshrined in PESC, discouraged the use of the spending tool. Alterations to social programs, in particular, proved politically risky in Britain where the electorate widely accepted the Beveridge principles of the welfare state. Current spending on goods and services become particularly difficult to adjust, especially in periods of rapid inflation. Where governments were forced to make cuts in spending they tried to concentrate on capital programs. Projected capital programs not yet started could always be postponed. Expenditure, however, has technical disadvantages as a tool of economic management. There are considerable time lags between the announcement of a change and its consequent effects on the economy. 'Stop-go' in public spending creates disturbances and instability in administration and may even generate extra costs. So when adjustments have had to be made to accomodate disturbances in the path of economic growth, taxation has always been preferred. The all-party Expenditure Committee of the House of Commons, in its Ninth Report of 1974, concluded that:

> "changes in the level of public expenditure should be used only as a tool of last resort .... short term management of the economy should primarily be carried out by changes in taxation."

In 1976, however, the British government was forced by an economic crisis to make very considerable budgetary adjustments. Constrained by the requirements of the IMF loan, it had to use both taxation and expenditure as tools. By now, however, governments had come to see that over reliance on multi-year budgeting under PESC had tied their hands too much. The figures in PESC had become firm commitments that they had no reasonable means of altering. New machinery was therefore required for the control of public spending. A device was required that would ensure that the Cabinet plans were adhered to in practice, and would permit year by year adjustments to spending programs as circumstances dictated. Thus 'cash limits' were introduced in 1976 and now cover some 60 per cent of public expenditure in Britain. They do not, significantly, cover social insurance such as unemployment benefits which have expanded considerably during the recession. They are not, therefore, a universal tool for injecting control and flexibility into public spending. Cash limits tell departments and agencies of government how much money they can expect for the coming year in cash terms. They mark something of a return to the pre-PESC annual Treasury control and PESC has accordingly been downgraded politically.

The successful implementation of cash limits as a device for greater flexibility and control in public spending depends largely on the attitudes of the departments and agencies. Some agencies, after five years of cash limits - but only two years of strictly applied limits without inflation adjustment - are beginning to respond by searching for flexibility in the use of their resources. But many others do not yet realize the import of Anthony Crosland's words in 1975 when he told British Local Authorities: 'the party is over'. Cash limits can only inject flexibility of response into government agencies if the agencies themselves are willing

to look hard at their activities and goals. Cash limits are used by central government to tell agencies: 'This is the amount of money that you have to spend - see what you can do with it'. Earlier techniques of budget making were used by governments to say 'This is what we want you to do - see how much money you need to do it'.

In the expansionary period of public spending a whole constellation of associated budget making techniques known generally as PPBS - Planning, Programming, Budgeting System - (Program Budgeting, Output Budgeting, Cost-benefit Analysis, Management by Objectives, Program Analysis and Review i.a.) were introduced into the governmental machinery of many countries including Britain. First used successfully in the defence departments of U.S.A., Britain and Sweden, these new approaches to budget construction appeared to offer advantages that could be employed throughout the public service. Instead of costing services by their inputs - staff, materials, and services - the desired objective or goal of a government agency was first specified and then an analysis made of the best allocation of resources to achieve that end. The techniques of rational economic analysis were to be brought to bear on the needs of government. Properly applied the system had two requirements. Firstly, it needed clear specification of goals, and secondly it needed well researched and analysed breakdown of likely costs (Robinson, 1972).

Initially PPBS was welcomed and encouraged by central governments. In 1966 President Johnson decreed that it should be used throughout the U.S. Federal government. Canada, Sweden and Britain experimented with the system. Local authorities, as well as central governments, turned over to the new approach. In 1970 the incoming Conservative government in Britain under Edward Heath issued a White Paper boldly entitled: 'A new style of government'. The new style was to include a greater use of rational budget making techniques together with a re-organisation and rationalisation of the central Departments of State to pull the whole

machine into one coherent whole. But, in practice the PPBS approach to budget construction proved expensive and difficult to operate. Although it was technically feasible, higher levels of government soon became disenchanted with it. They found the strain of assessing needs and setting clear objectives beyond them. It gradually disappeared from the central government machinery. Even in the U.S.A. where the greatest enthusiasm for the approach was exhibited, the wholesale use of it was abandoned. But it left behind an intellectual residue. Its effect was much greater on the periphery of government than at the centre. It transformed the way in which budget makers within departments, agencies and local authorities, construct their annual requests for money. Bureaucrats, even if their agency does not indulge in a full scale 'program budget' or 'output budget' exercise each year, find it very convenient to continue to think in terms of fixed programs and objectives when planning their requests for funds. In the absence of machinery for the clear political specification of goals the use of PPBS and related techniques at the lower levels of government has merely served to encourage a tendency towards rigidity.

The experience of the use of techniques for budget construction - PESC, PPBS and Cash limits - illustrates the fact that tools are only as good as the people who use them. It is no use devising good tools for budget construction if they are subverted by the attitudes and behaviour of politicians. PPBS failed because central government failed to play its part, and cash limits may fail if agencies cannot respond to limitations. The first requirement of all budgetary techniques is that politicians should have a clear idea of what their goals really are. Politicians often have only a vague idea of what they want. Even when they get as far as writing down proposals in an election manifesto they often have hardly considered what those proposals mean in practice. The relationship between political goals and governmental organisation is not clear-cut either. Each objective, even were it to be clearly specified, cannot necessarily be matched by a single agency to carry it out. Functions of government departments frequently overlap.

And unless politicians regularly review the classification of functions and redraw lines of demarcation no flexibility between organisations can be achieved.

Bureaucratic Structure and Behaviour

Most countries have acquired a large bureaucratic machine to deliver the services and benefits of the welfare state (see statistical appendix 5:4). The structure of the bureaucratic machine varies in some detail from country to country. Some countries are constitutionally more centralised than others. They have developed traditions of strong central control and a uniform provision of services. In other countries decentralisation is a more predominant characteristic. But there are some common features of structure that seem to have become essential in the welfare state. Most countries have a centrally determined standard of public service provision and a degree of decentralisation in the delivery of those services to the public. Decentralisation of delivery appears to be a necessary consequence of the large size of modern government and of the needs of regional variations. (See statistical appendix 5:1.)

The bureaucratic structure is also determined by the manner in which social insurances are delivered. Services can be provided either by a state run monopoly or via schemes of insurance that cover the costs of provision in the private sector. Health services, for example, are provided by a state monopoly in Britain but via schemes of insurance in France and Germany. There is obviously some inherent capacity for rigidity in the first model unless it has something to compare itself with. Comparison may be possible if there is a parallel private sector. In Britain, for example, private medicine exists side by side with the state system.

The degree of propensity towards rigidity of structure and organisation is not, however, simply a function of either centralisation or monopoly power. Decentralised delivery systems can also become rigid if there is no mechanism for the constant re-evaluation of their goals. Decentralisation of structure can encourage rigidity by removing the possibility of central or independent criticism of agency performance. Under the traditional hierarchical structure of the classical government department a constant chain of command was maintained. Once agencies are decentralised or 'hived off', the chain of command is broken and agencies are more likely to develop a life of their own. As a result agencies can be established by central government, go out into the field to perform their tasks, and continue to flourish for years even if their original function has long since disappeared.

If all types of bureaucratic structure appear to have tendencies towards rigidity, is there something inherent in the nature of organisations that creates this effect? Supposing that politicians could be encouraged to take a more active and critical part in the specification of goals and objectives, could a bureaucratic structure be designed that would respond to the directions of politicians?

Max Weber thought that he had found the answer to this question over one hundred years ago when he formulated his theory or model of 'bureaucracy'. Weber believed that there were two forms of rationality - the rationality of ends and the rationality of means. Politicians employed the rationality of ends when they determined the goals and objectives of the political system. Bureaucrats employed the rationality of means as they sought to discover the best possible form of organisation to ensure that objectives are carried out. The bureaucrat must exhibit a 'disinterested' attitude to his work free from the contamination of political values. To this end he must have a secure job, a good salary, and be isolated from the temptations of the commercial and political systems.

There are many difficulties in translating this model of a responsive 'disinterested' bureaucracy into the requirements of the modern welfare state. Among other things the model assumes that the only task of bureaucrats is to determine the best means of achieving given political ends. It fitted well with the old 'guardian state' in which governments were primarily concerned with collective security and regulation. It does not, however, offer an adequate model of organisation for a public sector that performs a wide variety of tasks, among them the manufacture and distribution of goods and the delivery of services and subsidies direct to the public. It fits ill with a form of government that is decentralised and has deliberately given its employees discretionary powers.

The classical Weberian form of bureaucracy does not even seem relevant to the practical experience of those civil servants who still perform the traditional tasks of 'administration' in central government. It has been challenged in recent years by academics who have pointed out the impossibility of separating 'policy' from 'administration', and in articles and books by people with practical experience of government, among them the British politicians Tony Benn, Brian Sedgemoor and Michael Meacher. Ministers sometimes feel that they have a hard time trying to impose their political objectives upon an unresponsive and obstructive bureaucracy. Some countries, recognising the strength of bureaucratic resistance to political direction, have instituted buffers between the politicians and the bureaucrats to ensure that political goals are more deeply penetrated into the bureaucratic machine. The Americans have always made a number of political appointments to the top levels of the federal government. The French have devised a system of Ministerial 'Cabinets' which is also used in some other countries and in the EEC. The British experimented with 'Political advisers' to ministers in the 1970's but these temporary attachments to the civil service have rarely been of sufficient stature or numbers to have an appreciable impact on the general pattern of minister/civil servant relationships.

The problem of clear definition and of firm imposition of political objectives is not solved simply by imposing the politician's will on the top most reaches of the central bureaucracy. In modern government those at the top of the administrative structure often have as little knowledge of day to day operations in the lower reaches of their complex machine as any minister. This effect is enhanced by the creation of 'hived-off' or semi-autonomous agencies only loosely connected to their sponsoring department. It is absurd, for example, to imagine that the permanent secretary at the British department of employment has a complete grasp of the many programs operated by the fast expanding Manpower Services Commission. Most such agencies are monitored by some one in the middle levels of the department and the departmental head and its minister must rely for their information on the communications that reach them from below. The size, complexity, and necessary decentralisation that is inevitable in a large organisation ensures that neither political nor bureaucratic master is in practical charge of operations.

Size, decentralisation and variety of function have had their effect in transforming the nature of modern governmental structure. Studies of the way in which people actually behave in bureaucracies also cast doubt on the capacity of organisations to respond to externally generated goals. Classical Weberian bureaucracy requires that the organisation respond to goals set by politicians. It also requires that in doing this bureaucrats practice rationality in selecting means. This, of course, is also the philosophy behind PPBS. Reports of organisational behaviour by Downs (1966), Simon (1957), Lindblom (1959), Wildavsky (1964, 1975) and others reveal that rather than conducting exhaustive searches for the 'best' solution, bureaucrats 'satisfice'. Organisations do not like to make radical re-evaluations of their tasks. They prefer to make less troublesome 'incremental' changes. As Lindblom described it, they 'muddle through'. Above all, people in organisations like to maintain good relations with colleagues. Studies of the budgetary process in the U.S.A. and Britain by Wildavsky (1964,

1975), Heclo-Wildavsky (1974) and others confirm the tendency towards incrementalism for the sake of peace in the 'financial community'. Thus internal requirements of minimum of effort and disruption, conflict with the external requirement for radical re-evaluation necessary for flexibility.

Many organisations, too, come to believe that they are better placed to interpret changing needs and requirements than are the politicians. They, after all, deliver the services and are in day to day contact with clients. They believe that they, not the politicians, can best interpret society's needs. Thus they are able to generate goals related to public needs from within themselves. This claim by bureaucracies deserves closer investigation than it has hitherto received. Agencies make the claim that they respond to demands for services. But, in fact, they control the supply of services, and the public can only take what is offered to them. Agencies of government therefore often act more like firms supplying goods in the market than like simple service bodies responding to autonomously generated demand (cf. i.a. Tarschys, 1975).

The position of the bureaucrat in the welfare state is strong vis-a-vis his political master, and it is strong vis-a-vis the general public. In particular bureaucrats are often in a better position to press their claims upon government than are their clients by being well organised and represented by powerful unions. The British government has established special devices - the Ombudsman, Consumer Committees for Nationalised Industries i.a. - to channel consumer complaints, but their use is limited. Perhaps, it might be argued, the consumer of public services is already perfectly well able to make his voice heard through the representation of his interests in an elected Parliament. This comment would have some validity if, in fact, elected Parliaments were primarily concerned to represent the individual elector's interests. Analysis of the current role of Parliaments and the behaviour of their members does not bear this out. Parliaments do not only channel demands from individual members of the electorate. They

also channel demands from organised interest groups, among them the bureaucracy itself. Indeed, analysis of communications received by elected members reveals that the channels of communication are used much more by organised groups than by individuals. Thus groups and bureaucracies, not the general public, come to determine the shape and content of public programs.

The Role of Legislatures

Whether a country has chosen to have a representative system based on geographical districts - as in U.S.A., Canada and Britain - or on the proportional representation of votes cast for each political party in the election, there is no doubt that the way in which modern legislatures represent 'the national interest' has been modified by the existence of organised interest or pressure groups. Organised groups have many advantages over the individual elector. They have access to information and can provide material that is useful to elected members when they are making speeches or attending committee hearings. Although legislators make much of their contact with the 'public', studies of communications between them and their constituents reveal that most of their contacts are either with close party supporters or with 'representatives' of interest groups.

The nature of the representative process has been changing considerably as the public sector has expanded. This change has been little understood. Those who studied the work of legislative bodies in the 1950's and 1960's thought that they had discerned the 'decline of the legislature'. A common pattern appeared in all countries. As the government's activities expanded, it seemed to be gaining power at the legislature's expense. A vast literature on the role and decline of legislative assemblies included books with emotive titles like 'What's wrong with Parliament?' and 'Congress in Crisis'. They all added up to the conclusion that legislatures had lost their powers to the executive branch of govern-

ment and that they were now only of minor significance in the determination of policy. They were most particularly apathetic in the field of public finance (Robinson, 1978).

It is perhaps not surprising that legislatures should have appeared particularly passive in determining the patterns of finance. Most legislatures work under constitutional restrictions on the extent to which they can alter their government's proposals for spending and taxing. The most extreme case is afforded by the British example where government spending plans are never, and taxing plans are rarely, altered in any detail by votes in the House of Commons. At the other end of the spectrum is the U.S. Congress which has considerable constitutional powers over the size and shape of the federal budget and has enhanced its powers considerably since the passage of the 1974 Budget Act. The various continental and scandinavian countries fall somewhere in between the British and American models in the freedom of action that they permit their legislatures in altering the government's budget. In most cases their powers are considerably restricted and limited. But in practice even the powerful U.S. Congress in its most assertive mood makes only incremental adjustments to the executive's Budget proposals. Why should such a powerful legislature restrain itself when it comes to the budget?

There are strong psychological forces at work that limit a legislative assembly's capacity to alter the executive budget. Politicians now find that they are the captives of what they, and their predecessors, have already created. They consider that much of the government's budget is 'uncontrollable' and therefore not open to adjustment. Past decisions embodied in legal requirements and entitlements now take up such a large proportion of existing budgetary resources that little room for flexibility exists (cf. i.a. Green, 1980). The main determinant of the size of this year's budget is the size of last year's budget. Changes can only take place at the margin. The precise degree to which any budget is, or is not, open to adjustment year by year depends in the last analysis

on what is defined as a fixed commitment and therefore 'uncontrollable'. In most countries the commitments to social insurance are regarded as fixed. These items now form the bulk of the annual budget and all other items - apart from defence - are regarded as residuals. Commitments to social insurance, however, are only commitments until the law is changed. Any legislature, if it wanted to do so and had a sufficient majority of votes, could stop or change any program. The commitment is not so much a legal one as a psychological one.

If we examine the actual role of legislative assemblies in the budgetary processes during the period of expansion of the welfare state, we find that they have played a passive and limited role in one sense only. Certainly, they have not played a very active part in the critical evaluation of existing programs and in making judgements of an allocative nature. Unlike their counterparts in the 19th century they have not been greatly concerned with efficiency and effectiveness of government. But that is not to say that they have played no part in the expenditure process. They have played a part, and a very important one. As well as articulating demands legislatures support governments. The evidence from studies of legislative behaviour reveals that their role has been that of an encouraging chorus providing background music to the main themes of government. They have called continually for new hospitals, schools, roads and better levels and coverage of social insurance. Many of them have thought that this was their proper role in the expenditure process. By and large, over the years, they have found the results gratifying. The introduction of new programs has enabled them to return triumphant to their constituencies proclaiming that they have played their part by representing constituency and group needs. Few have displayed much interest in the detailed examination of the Government's spending proposals or in the evaluation of the effectiveness and efficiency of services. Most problems, they imagine, can be solved by throwing more money at them. Thus they have allowed what constitutional powers they had over money to atrophy through lack of use.

Many legislative assemblies, like the British House of Commons and the American Congress, have machinery that permits them to make studies of government effectiveness and to evaluate the strengths and weaknesses of government programmes. Originally the audit machinery was designed to ensure that money was spent by government departments as authorised by the legislature. Audit departments, generally enjoying a degree of independence from the executive branch and reporting directly to the legislature, examined departmental expenditures to make sure that no money was illegally or wrongfully spent. In more recent times the audit of government expenditure has taken on a wider meaning. It now also means seeing that government agencies spend their funds efficiently and effectively. 'Effectiveness' audits can also include examples of alternative methods of achieving goals.

The most developed independent audit machine is the American General Accounting Office (GAO), a Congressional Agency (Mosher, 1979). One step behind the GAO and currently doing the sort of work that the GAO did fifteen years ago is the British Office of the Controller and Auditor General. The experience of the GAO, which employs over 5,000 staff, illustrates both the value and the limitations of an independent agency that scrutinises government at work. Such a body, however large, can conduct only a small number of enquiries each year relative to the size of the whole public sector. Although its more startling revelations attract some publicity, it is difficult to trace through the effect of its work on the content of new policy decisions. In spite of these limitations, however, the case for audit bodies remains. They are essential to provide elected representatives with an independent view of the operations of government. Otherwise they get only the view from the bureaus. But audit departments are not the complete and full answer to the problem of adequate political 'feedback' in the large-scale decentralised welfare state.

The British House of Commons in 1979 altered its Select Committee system to provide another means of 'shadowing' the operations of government. There are now 13 select committees of

back-bench MPs with the duty of studying the work of government departments. It is as yet too early to make any firm evaluation of their effectiveness. Certainly they have heard evidence from a large number of civil servants and pressure groups and they have collected valuable information about how the government machine operates. But they do not customarily take evidence from the 'grass roots' or individual consumers of public services. When they want to get the public view they generally call upon representatives of organised groups. Thus they get the departmental and the organised view of services. There is always a danger, too, that legislative committees will become apologists for the departments that they scrutinise. Both the British and the American experience show examples of this phenomenon. When, for example, governments want to re-allocate or modify defence spending, the legislative committees concerned with defence spring to the support of the departmental view. So, unless legislative committees can obtain a truly independent assessment of a department's work, they are unlikely to prove an effective counter-balance to bureaucratic power.

For most parliamentarians the task of careful sifting through detailed reports on the work of government departments is not their first priority. Apart from their constant pleas for higher spending, few elected representatives paid much attention to the budgetary process until the economic crises of the mid-1970's. They thought that this aspect of Parliamentary procedure was on the technical fringe of politics, of little interest to them, their constituents or the media. When they were given new opportunities for debate they did not use them. In Britain where from 1970 regular debates were held on the PESC figures published as the Annual Expenditure White Paper, the response was deeply disappointing. The debates were lack-lustre and poorly attended.

The economic crises of the mid-1970's gave parliamentarians in many countries a shock. They discovered that their constituents and pressure groups continued to want more and better services

but they also wanted lower taxes. Once the tap of economic growth was turned off, expanding services could only be provided by increased taxation or borrowing. There appeared to be some limits to taxation. By the time that the welfare state had reached its full development, taxation had ceased to be a matter of re-distribution between rich and poor and had become a matter of re-distribution between the bulk of the population at the various stages of its life-cycle. If services were to be retained or expanded in a period of non-growth, then everyone would have to pay. Thus politicians found themselves in the grip of a pincer movement. The public continued to press for better services, the bureaucracy supported them and defended itself from attack, yet the tax-payers wondered if they really wanted to pay more (Jay, 1976; King, 1978).

Thus the new spirit of interest in parliamentary control of government expenditure embodied in the Congressional Budget Act of 1974, the Italian Reforms of 1978 and the developments of the British Select Committee system in 1970 and 1979 can be related to the representatives' perception of some apparent changes in political attitudes among the electorate. In some countries, interpreting the new attitudes was made easier for politicians because they took the shape of political movements. The passage of Proposition 13 in California, the budgetary limitations imposed in many other U.S. states, and the formation of specific anti-tax parties for example, seemed firm evidence of a change in public attitudes. Britain in 1979 and U.S.A. in 1980 elected Governments pledged to cut public spending and taxes. Yet, in 1981, the French elected a socialist government, breaking many years of Conservative rule.

Attitudes of the Electorate

Firm evidence about the attitudes of the electorate towards public expenditure and taxation is hard to find. Few of the major

election surveys have included questions that provide directly relevant data. What evidence there is seems to suggest that there is a continued attachment to the public sector as a vehicle for social insurance, but some desire for lower taxation. There is also some evidence that higher taxation would be preferred to cuts in expenditure. But no study has yet been able to discover whether those who are still willing to support higher taxation are themselves taxpayers. This question is especially significant in British local government where taxpayers, i.e. businesses paying property taxes, may not be voters and the voting consumers of local services are often not local taxpayers either because they have no property or because they are in receipt of rebates on property taxes. It is still not possible to say with certainty what someone who is both a taxpayer and a consumer of public services thinks about the correct balance between provision and cost.

There are, however, some elegant theories which remain to be tested. Anthony Downs (1966), in 'Why the government budget is too small in a democracy', suggests that the elector knows more about the costs of taxation than he knows about the benefits that public expenditure can bring him. He therefore votes for the party that offers him the lowest taxes - and therefore the lowest package of public expenditures. This view of the relationship between perceptions of expenditures and taxation is rejected by Sam Britten in 'The Economic Contradictions of Democracy' (1975). Britten believes that the voter has a good idea of what benefits he personally can get from public spending but thinks that someone else will pay for them through taxation. Thus he selects the party that offers the most goods because he doesn't realize that he will have to pay for them himself. Neither of these theories has been subjected to rigorous testing in attitude surveys. We must piece together various bits of research to get some clue as to which is correct.

In fact the results are confusing. The problem is that the electorate knows very little about the size and nature of public spending programs and has a poor understanding of the tax system. Perfect knowledge, of course, is not required in either the Downs or

the Britten theory of voter choice but some knowledge is required in any model of the 'rational' voter. A recent study of British attitudes towards the cost of Britain's membership of the EEC showed that more than half of the respondents thought that expenditure on the EEC was higher than on any of the major social programs (health or education). The respondents were unable to produce even a fairly accurate rank ordering of expenditures among the major categories. Studies in the U.S.A. have revealed a similarly low level of knowledge about the broad facts of public spending. Given such low levels of knowledge among the public it is not surprising that they are unable directly to give clear and unambiguous signals to politicians about the changing distribution of needs and about how much they are prepared to pay for them. The politician's reliance on information and signals from groups, and from the bureaucracy is understandable.

It would be wrong, however, to conclude that, because the electorate cannot produce an accurate rank ordering of expenditures among the broad public expenditure categories or easily assess 'trade-offs' between spending and taxing, it is totally ignorant of the most important questions that confront government budget makers today. The electors are the consumers of the activities of the state. They use the education and the health services; they spend the money that is redistributed to them in the form of social insurances. They do have their own views about the efficiency and effectiveness of these programs. But their individual experiences are not easily captured by attitude surveys. Their voices are not well orchestrated. They cannot easily combine to make their views heard clearly in the political system. The traditional representational system has not adapted itself to cope with the requirements of a modern bureaucratic welfare state. It is therefore difficult for politicians to discern changing trends and needs and to formulate clearly defined new objectives independent of the bureaucracy.

Voter apathy and confusion is already apparent in many democratic countries as trust in governmental capacity is eroded. After all, if politicians cannot govern, why bother to vote them into office?

In Conclusion - The Art of Creating Flexibility

We have argued above that the increased concern for budget flexibility is not just the result of present economic difficulties. The need for flexibility is a fundamental one, arising out of the very nature of the social security system that has been created in "the welfare state". Collective risk-sharing implies the need for collective adjustments as the needs of society and the economic conditions change. Even if the economies of the western world had continued to grow, the size and nature of the public sector would, ultimately, have required politicians to recognize that they would have to make budgetary adjustments.

In the first postwar decades the need for such adjustments was hidden or swamped by the fact that the public sector had not yet been fully developed, and by economic growth levels that permitted an uniquely rapid expansion of public budgets. Politicians were thus shielded from having to make really hard choices of an allocative nature. When from time to time, economic circumstances dictated that they had to make some adjustments they could always raise taxes. When that option became less open to them they resorted to borrowing to pay for current services. That option has now been virtually exhausted.

Until recently politicians never reached a point where they were required seriously to question their goals and to assess the effectiveness of existing programs. That moment is fast approaching in all countries, and in some it has already arrived.

Even if we should take the most optimistic view of the possibilities of future economic progress and expect to regain former rates of growth in industrial productivity, the sheer magnitude of the social security already attained and the unavoidable retardation of overall growth in the economy will mean that in the future more and more concern will have to be directed towards the adjustment of public budgets to demographic and economic struc-

tural changes. At present, our capacity to adapt budgetary thinking and techniques is being severely tested by the need to adjust to stagflation - and to the politics devised to combat stagflation.

The fundamental long-term requirements for public budget-making are of both economic and political origin. From the economic point of view new tools are needed that permit adjustments in a large public sector primarily concerned with risk-sharing for individuals, in an economy with retarded growth, undergoing demographic and structural changes.

From the political point of view new tools of budgetary planning must help politicians to perceive these economic needs for adjustment and the limits of possible further commitments. They must also assist politicians to communicate more clearly to the electorate the conditions and resource constraints under which public spending decisions have to be made. Budgetary tools should also encourage politicians to look more critically at their goals and objectives.

Finally, the tools of budgetary management ought to include the possibility of more effective countervailing forces that can provide independent evaluation and assessment of the performance of government services.

One obvious but rather drastic way of limiting the need for public adjustment would be to hand back part of the risk-taking to the households and firms by privatizing more of the social services. This could mean privatizing the production decisions by creatting e.g. more favorable conditions for private schools, medical units, and insurance companies. It could also, or instead, mean privatizing the purchasing decisions by making more use of market pricing for social services and income insurance, decreasing the subsidies in "public consumption", possibly compensating this by increased income subsidies. The political decision-makers would

then be able to avoid a number of difficult adjustment decisions but there would be a price paid, almost by definition, in terms of less security for some individuals or firms.

A more substantial transfer to the private sector of the current public budget decisions is, however, hardly a realistic alternative in any country. We must then search for ways of creating more flexibility within the framework of existing public budgets.

Flexibility would have to be introduced already in the design of decisions, programs and organizations.

Increased budget flexibility may involve a general shortening of the life-span or length of commitment of expenditure programs and contracts. More use could be made of so called "sunset legislation", where a time limit or a time for an unconditional review of the program in question, is explicitly stated already in the original decisions. The possible scrapping of old programs may have to become as much a political concern as the initiating of new ones. This could involve a much more careful costing of programs in advance and a more serious and continuous attempt of evaluation of current programs by way of political reviews or a broader use of public pricing. Long-term expenditure decisions may also have to include conditional clauses about economic conditions and available finance, etc.

We may have to prepare public resources - everything from agencies and civil service organizations to public buildings and public employees - for multiple use. This may involve making agencies less tailor-made for special tasks, more multifunctional and ready to compete for new programs and duties, designing buildings and rewriting contracts accordingly. An important and necessary part of any such attempt must be a new design of government careers, rewriting employment contracts so as to create more mobility between different government jobs and between private and public employment.

You do not, however, usually get flexibility for nothing. Creating flexibility can imply sacrificing gains in efficiency and security that are only possible to realize with a long-term commitment. Civil servants may not enjoy the idea of a possible retraining and multiple use of buildings tend to be expensive. This simply means that we must try to minimize costs also in the search for flexibility. There is, however, always the possibility that flexibility in public agencies in some cases may indeed be costless, increasing productivity by providing new incentives and by avoiding some stultifying effects of organizational aging.

To achieve greater budgetary flexibility in the long run requires more than the mere change of budgetary and planning techniques. It presupposes a new understanding and acceptance by the voters of the need for flexibility as a condition for making the social security system economically viable. One way of gaining that acceptance could be to bring as many as possible of the hard choices directly before the individual voter, which could imply an increased degree of political decentralization. There is however obviously limits to how far such a decentralization could be taken as long as the collective risk-sharing and solidarity of the social security system extends beyond the borders of individual municipalities.

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Statistical Appendix [x]

Government Sector and Economic Performance in Eight Countries:
Canada, France, West-Germany, Italy, Netherlands, Sweden, U.K.,
and USA

[x] We gratefully acknowledge the assistance of Torsten Ysander in collecting the date for this appendix.

Statistical Appendix

1 Population

1 Birth and death rate, 1950-90

2 Population characteristics and trends

2 Production, Consumption, Investment and Prices

1 Production, Consumption and Investment, 1960-79

2 Prices, 1960-79

3 Foreign Trade

1 Unit Labor Cost, 1968-80

2 Imports and Exports, 1963-81

3 Current Balance of Payment, 1961-79

4 Employment

1 Industrial Employment, 1960-80

2 Unemployment, 1960-80

5 Government Sector

1 Central and Local Government Expenditure as percentage of GDP, 1961-78

2 Government Consumption, Transfer and Capital Formation as percentage of total Government Expenditure, 1961-78

3 Public Relative Private Consumption, 1961-78

4 Public Employment as share of Total Employment, 1965-76

5 Growth of Government receipts relative to GDP, 1955-78

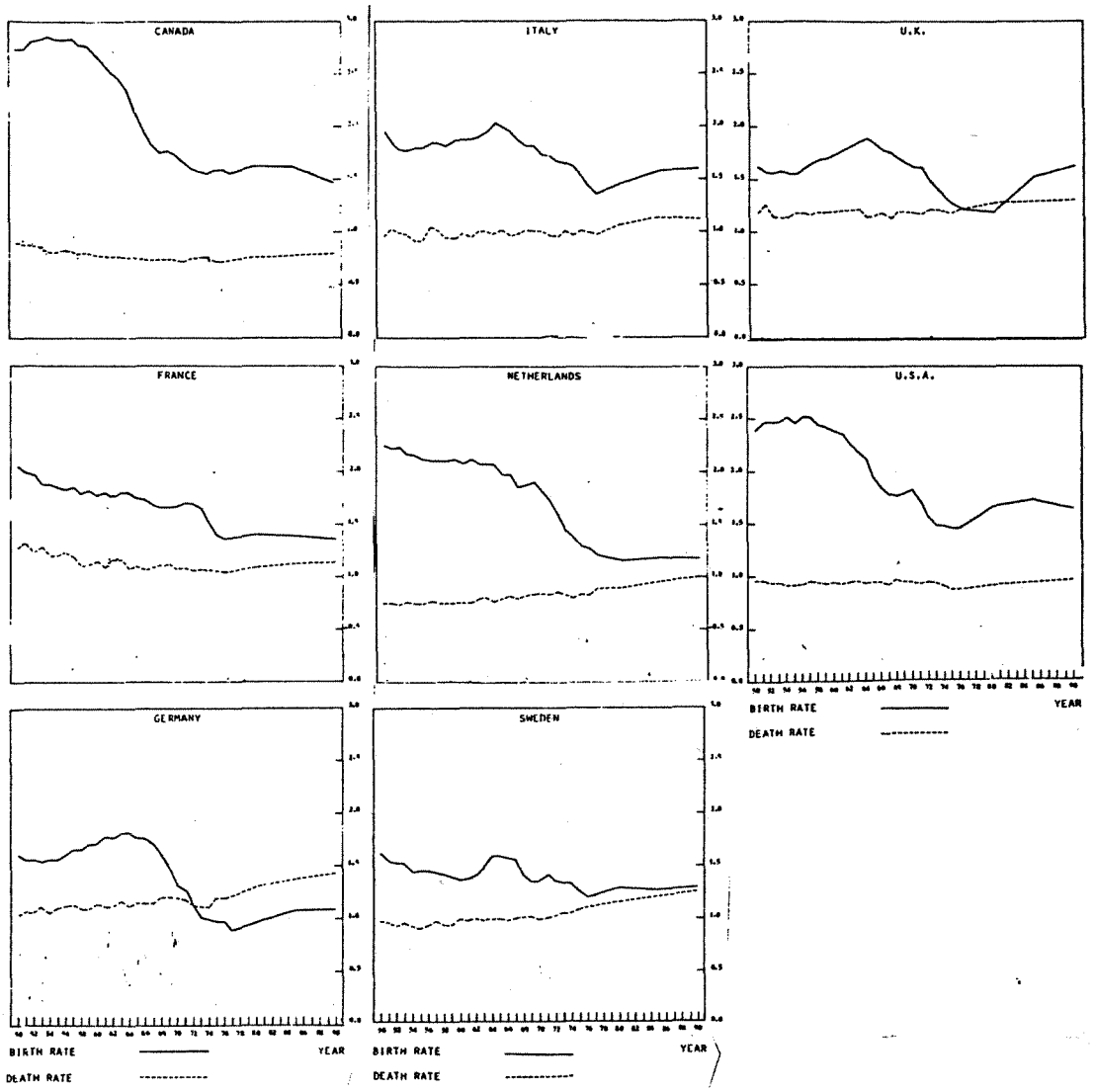
6 Taxes and Social Security Contributions as percentage of GDP, 1961-78

7 Government Surplus and Deficit as percentage of GDP, 1961-78

Statistical sources

1. Population

Figure 1:1 Birth and death rate 1950-1990



Source: (1).

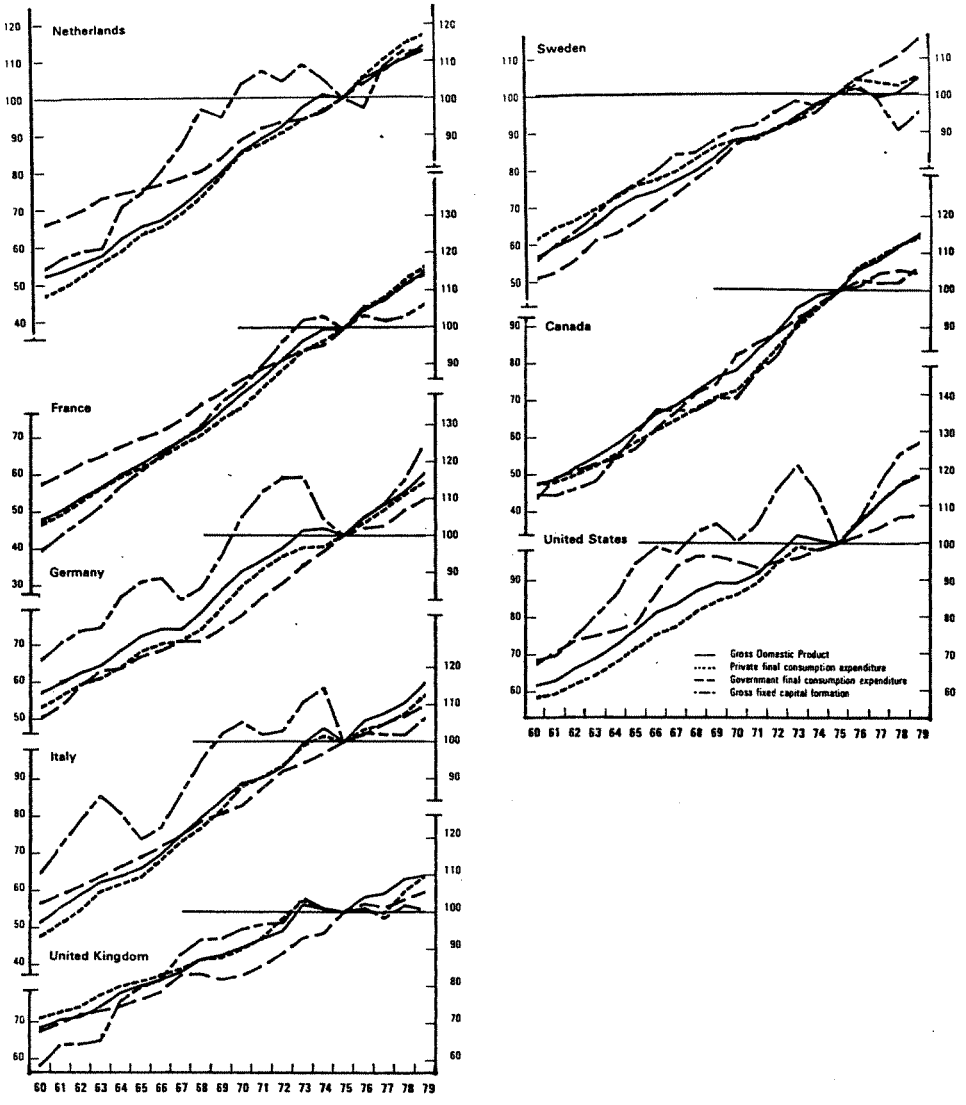
Table 1:2 Population characteristics and trends

	Annual growth rates (percent)		Age distribution percent 1975 - 2000			Gross reproduction rate	Expectation of life
	1950-1975	1975-2000	0-14	15-64	65-	1975-1980	1975-1980 (years)
Canada	2.01	0.98	26.5 -22.1	65.0 - 67.6	8.5 - 10.3	0.91	73.5
France	0.93	0.33	23.9 - 20.1	62.6 - 66.5	13.5 - 13.4	0.91	73.2
Germany	0.85	-0.15	21.8 - 16.0	63.9 - 69.5	14.3 - 14.4	0.70	71.8
Italy	0.71	0.36	24.0 - 21.7	63.9 - 65.2	12.1 - 13.1	0.93	72.5
Netherlands	1.20	0.50	25.3 - 17.3	63.9 - 69.9	10.8 - 12.8	0.77	74.8
Sweden	0.62	0.15	20.7 - 19.1	64.2 - 63.4	15.1 - 17.5	0.82	75.0
U.K.	0.41	0.05	23.3 - 19.8	62.7 - 65.1	13.9 - 15.0	0.84	72.3
USA	1.35	0.79	25.1 - 22.7	64.4 - 65.1	10.5 - 12.2	0.89	73.2

Source: (1) and (8)

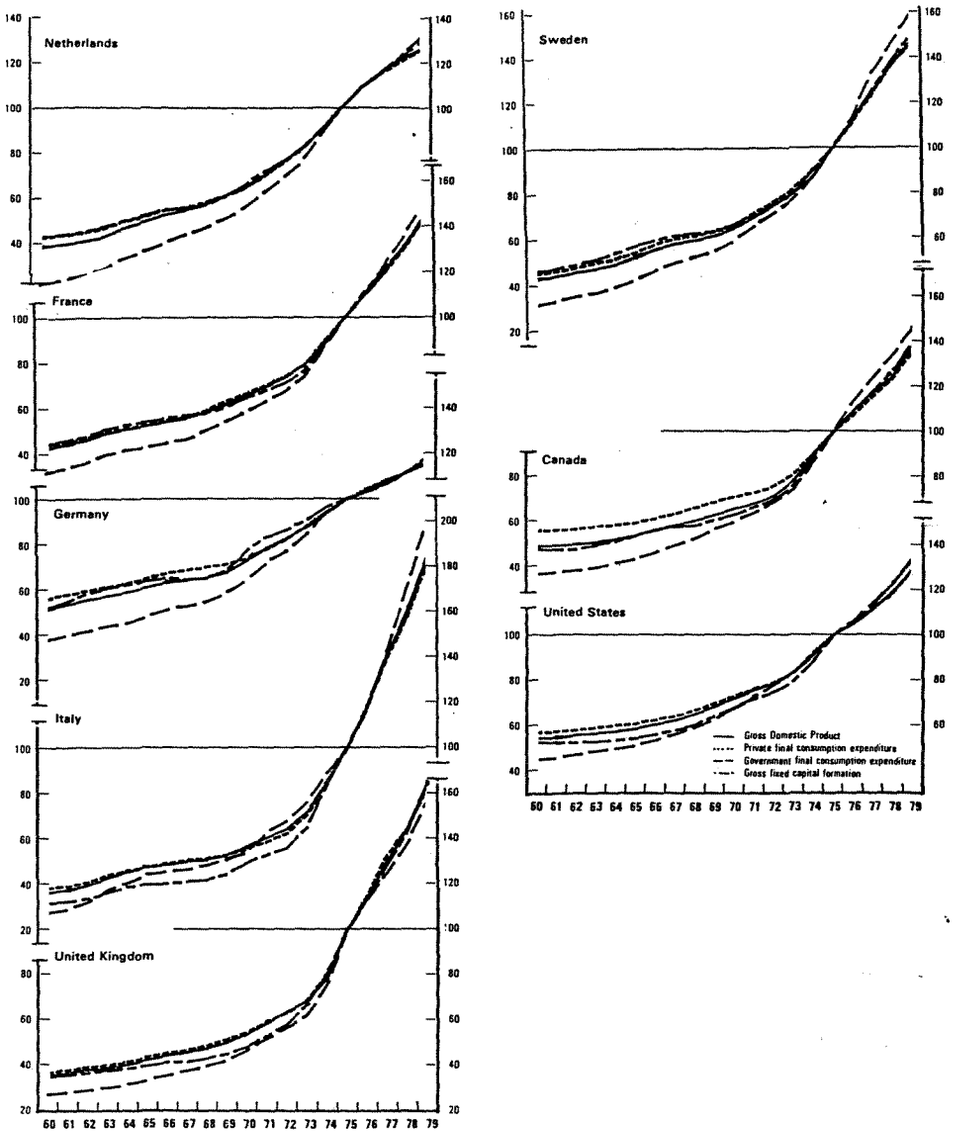
2. Production, Consumption, Investment and Prices

Figure 2:1 The Volume of GDP, Private and Public Consumption and Investment, 1960-79
1975 = 100



Source: (6).

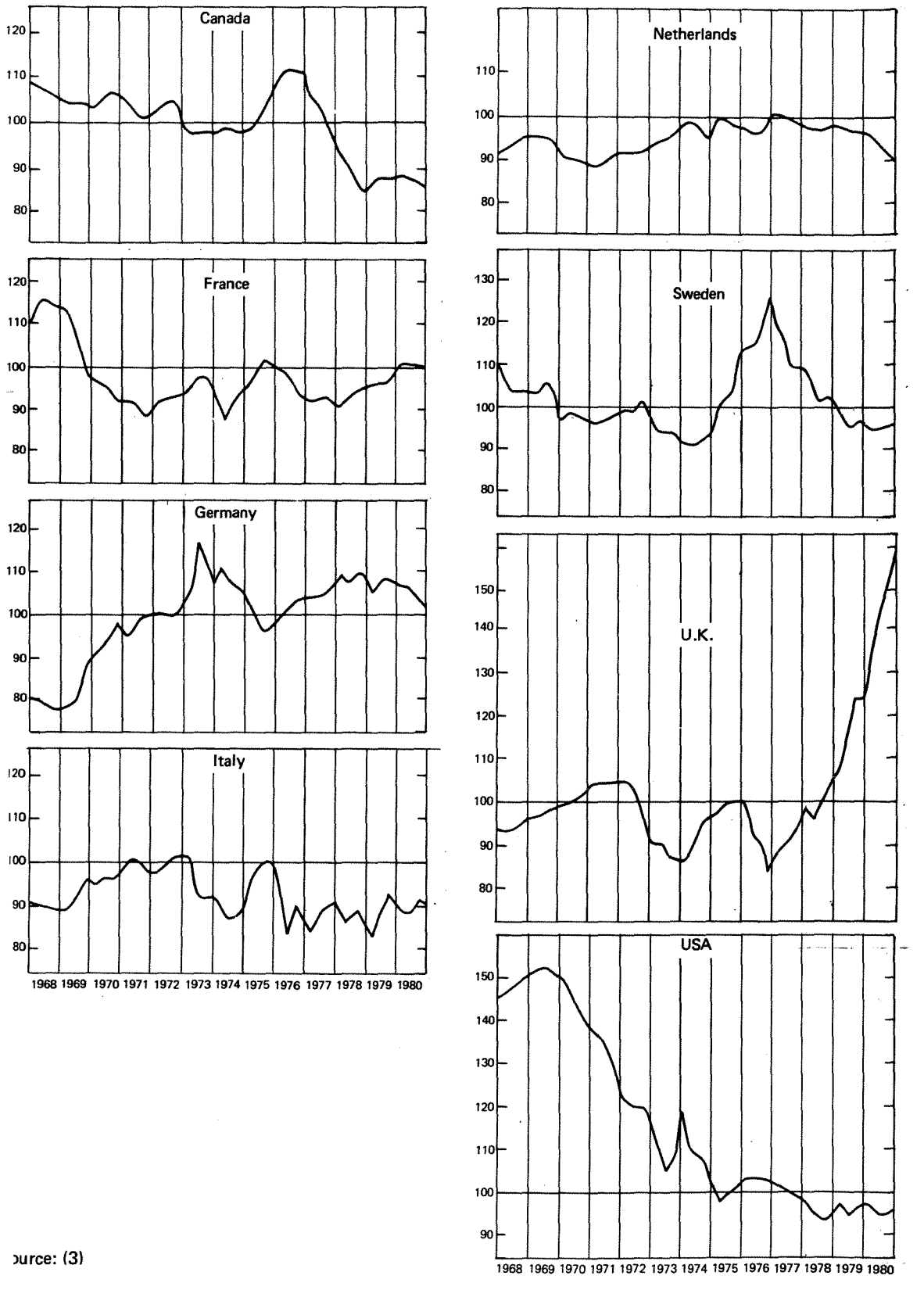
Figure 2:2 The Price of GDP, Private and Public Consumption and Investment, 1960-79
1975 = 100



Source: (6).

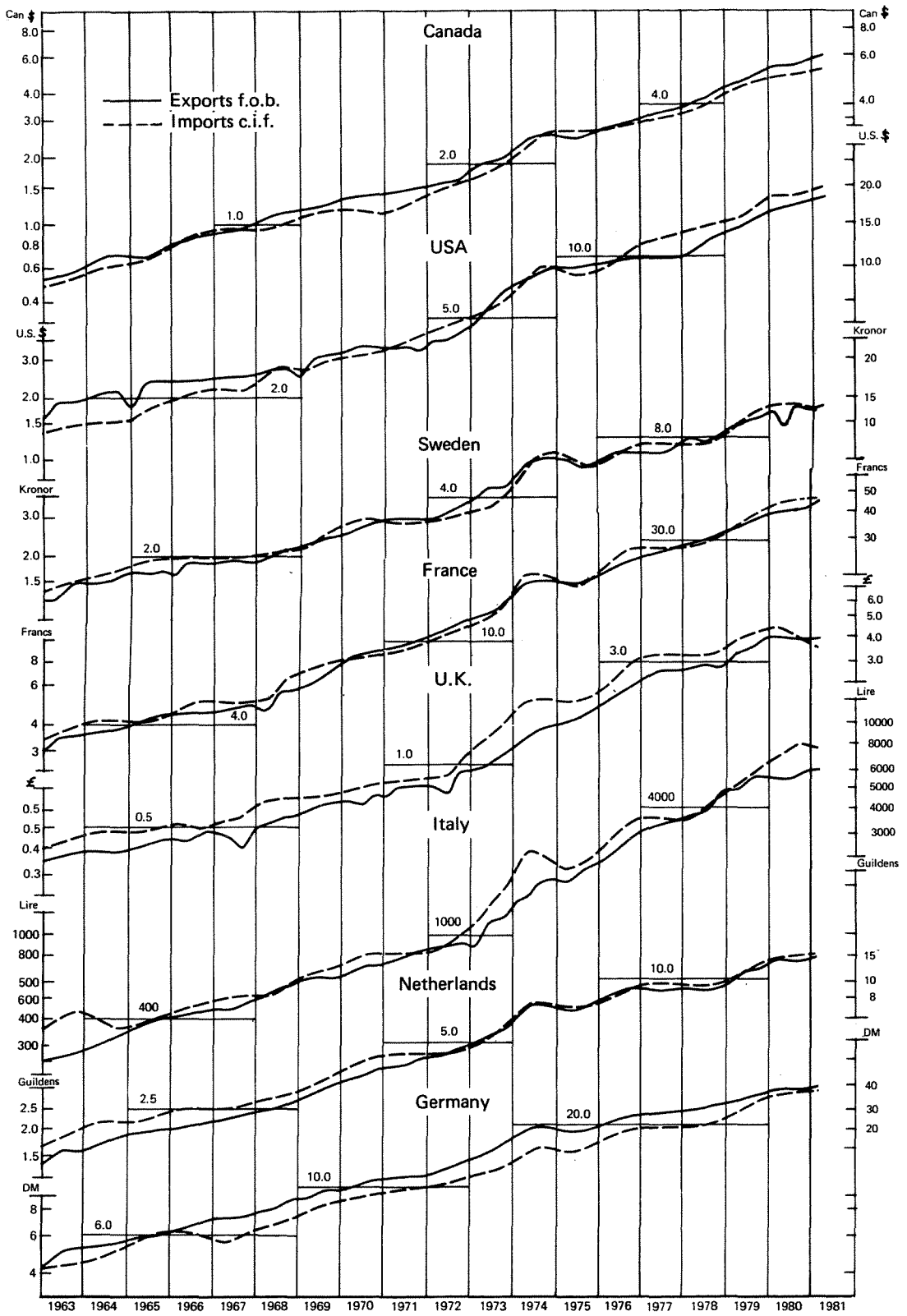
3. Foreign Trade

3:1. Unit Labor Cost in Manufacturing, 1968-80
Indices in Common Currency: 1975=100



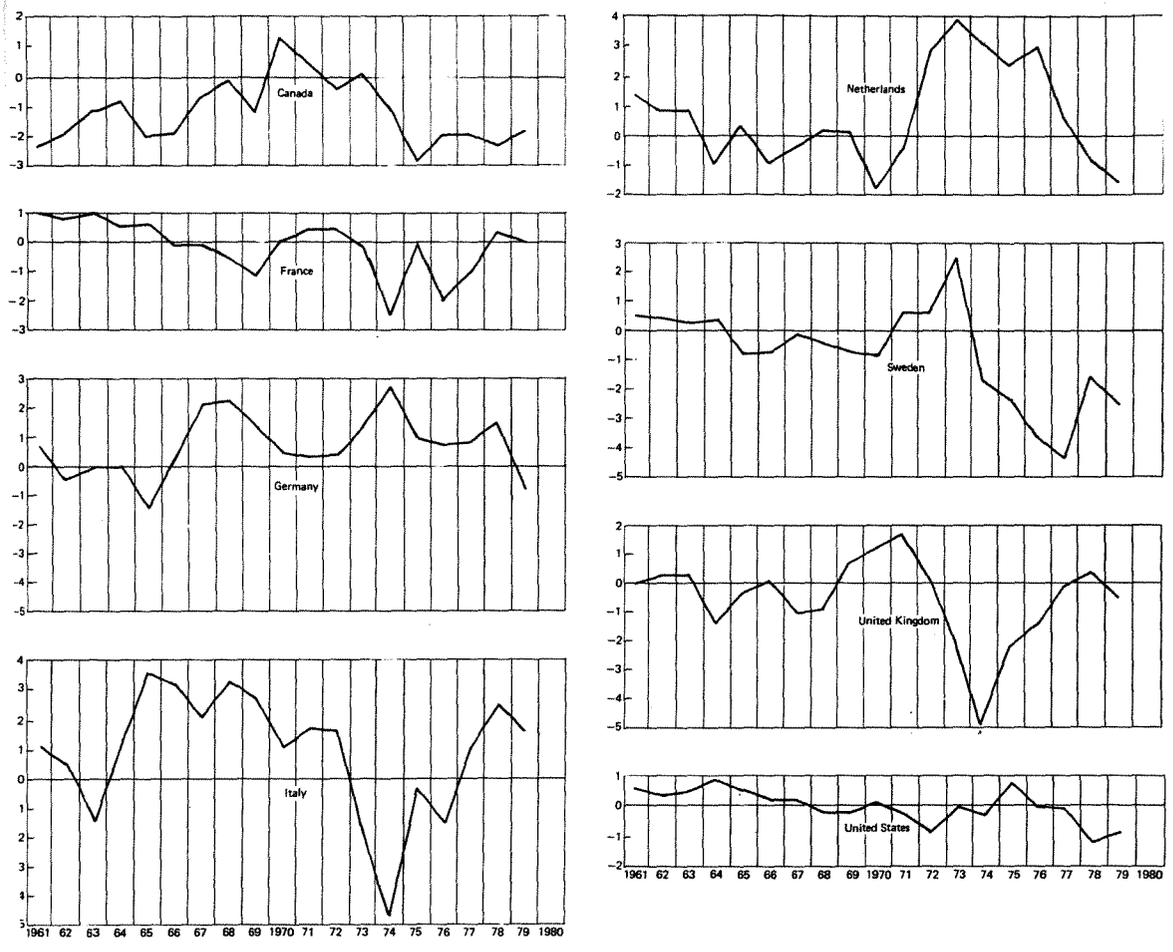
ɔurce: (3)

3:2. Imports and Exports, 1963-81
Seasonally adjusted, 3-month moving averages, Semi-logarithmic scale, billions



Source: (3)

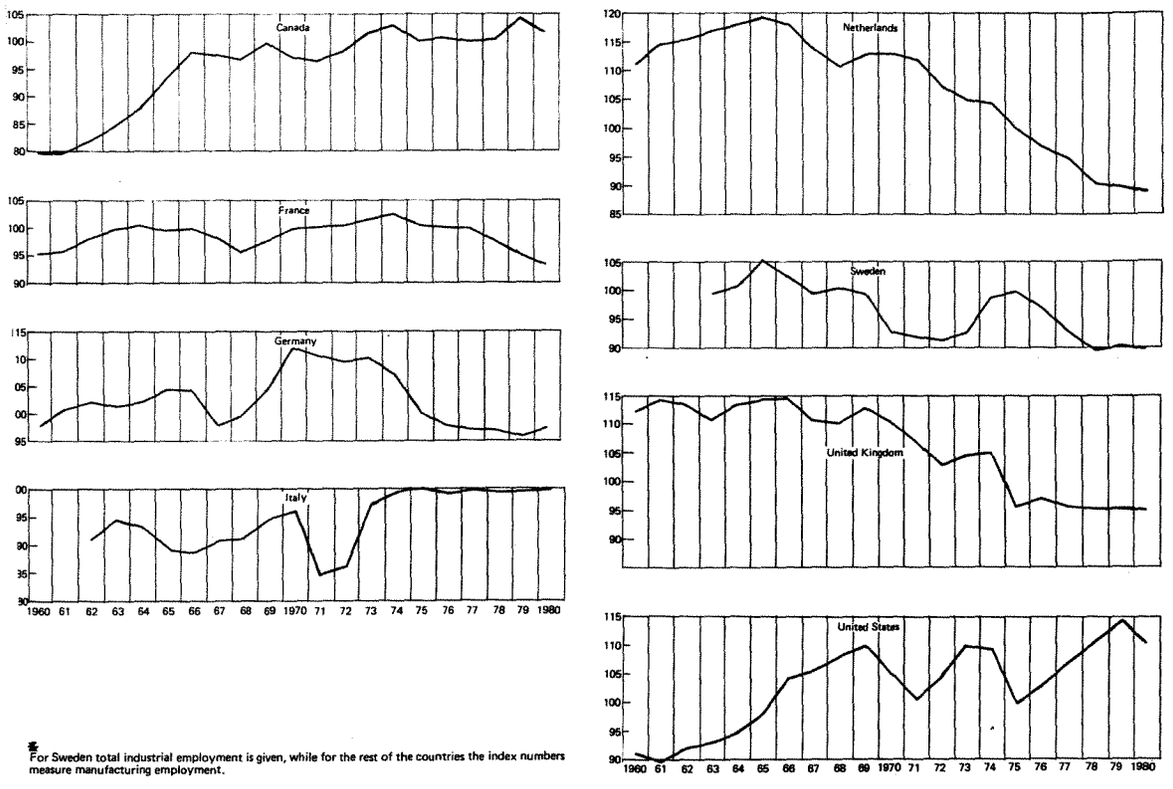
3:3. Current Balance of Payment as Percentage of GDP, 1961-79



ource: (5)

4. Employment

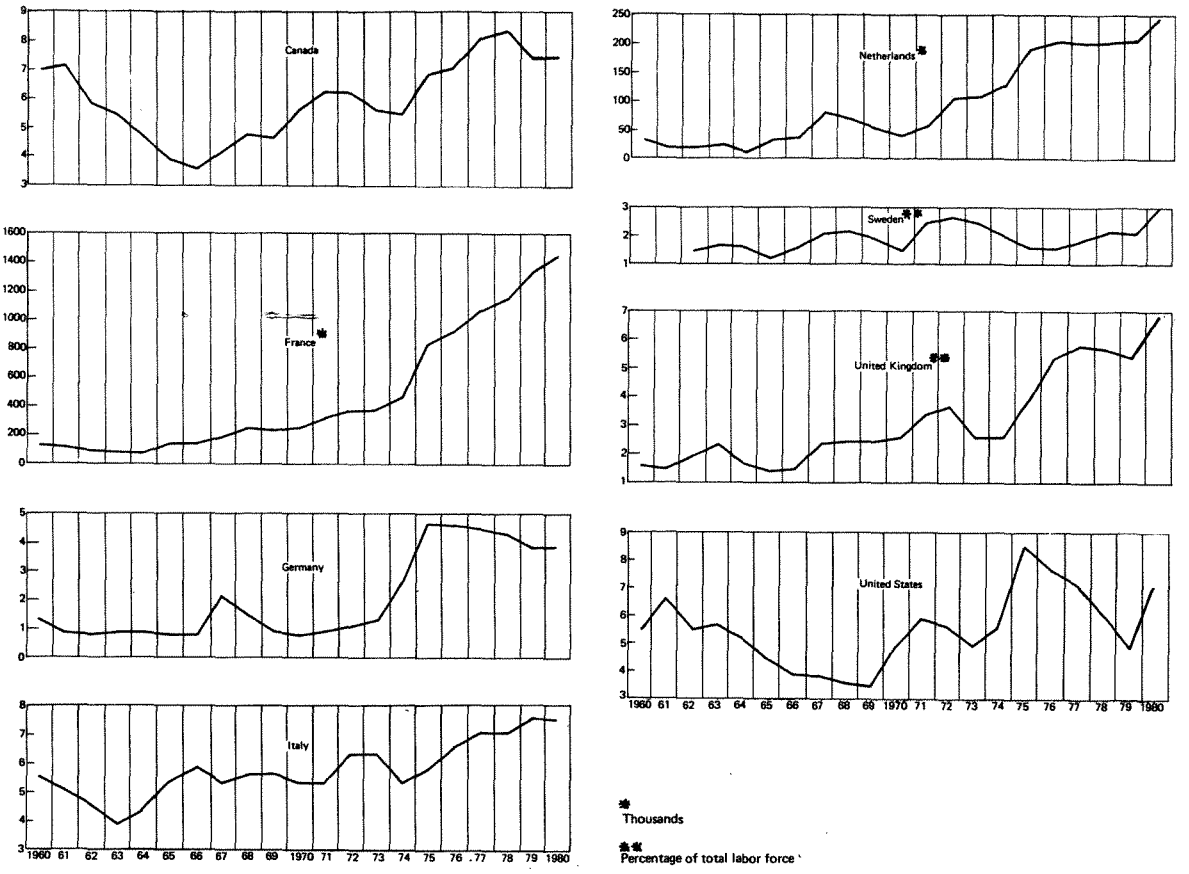
4:1. Industrial Employment*, 1960-80
1975=100



*For Sweden total industrial employment is given, while for the rest of the countries the index numbers measure manufacturing employment.

Source: (2), (3), and (4)

4:2. Unemployment as a percentage of Civilian Labor Force, 1960-80



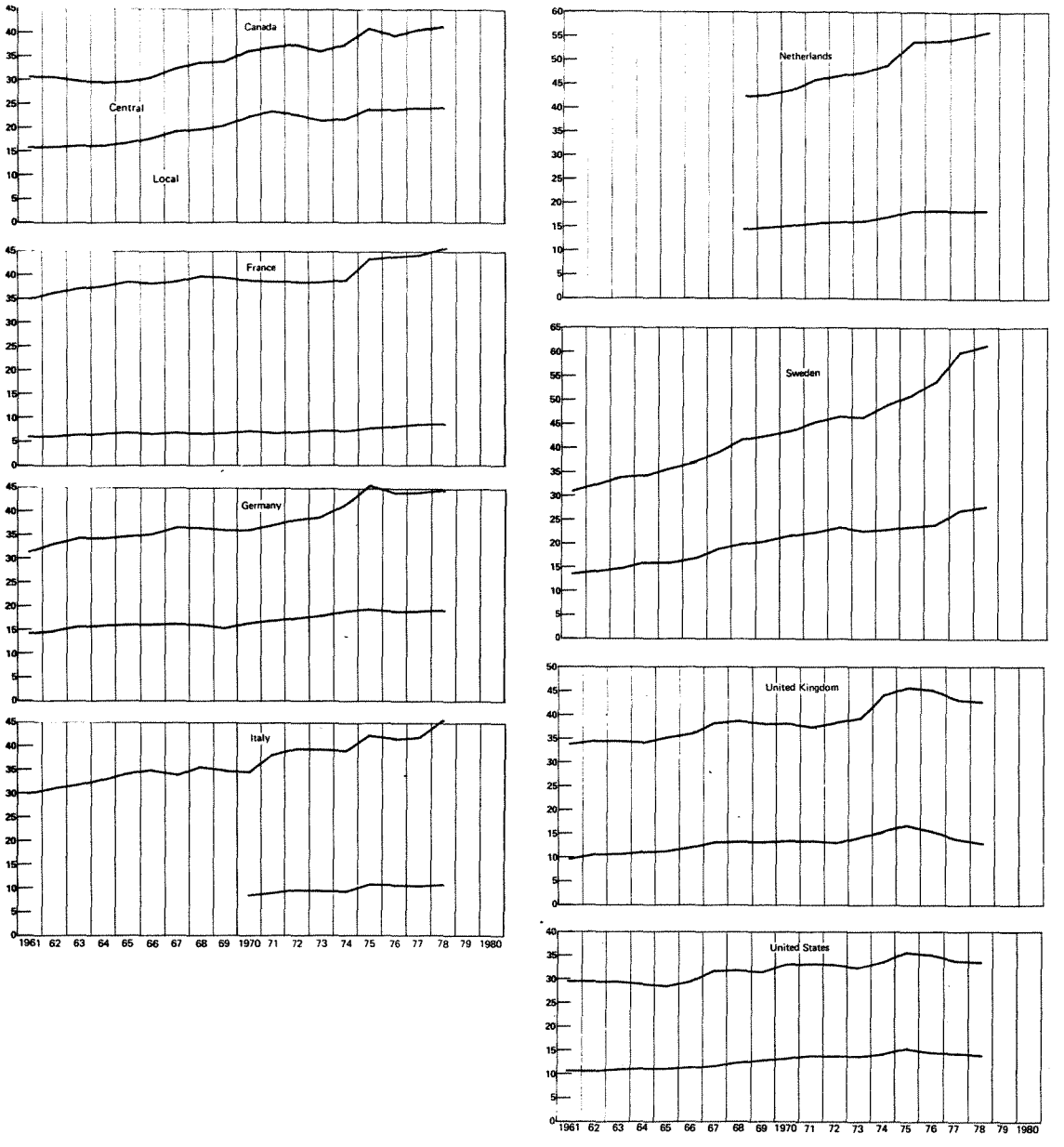
* Thousands

** Percentage of total labor force

Source: (2), (3) and (4)

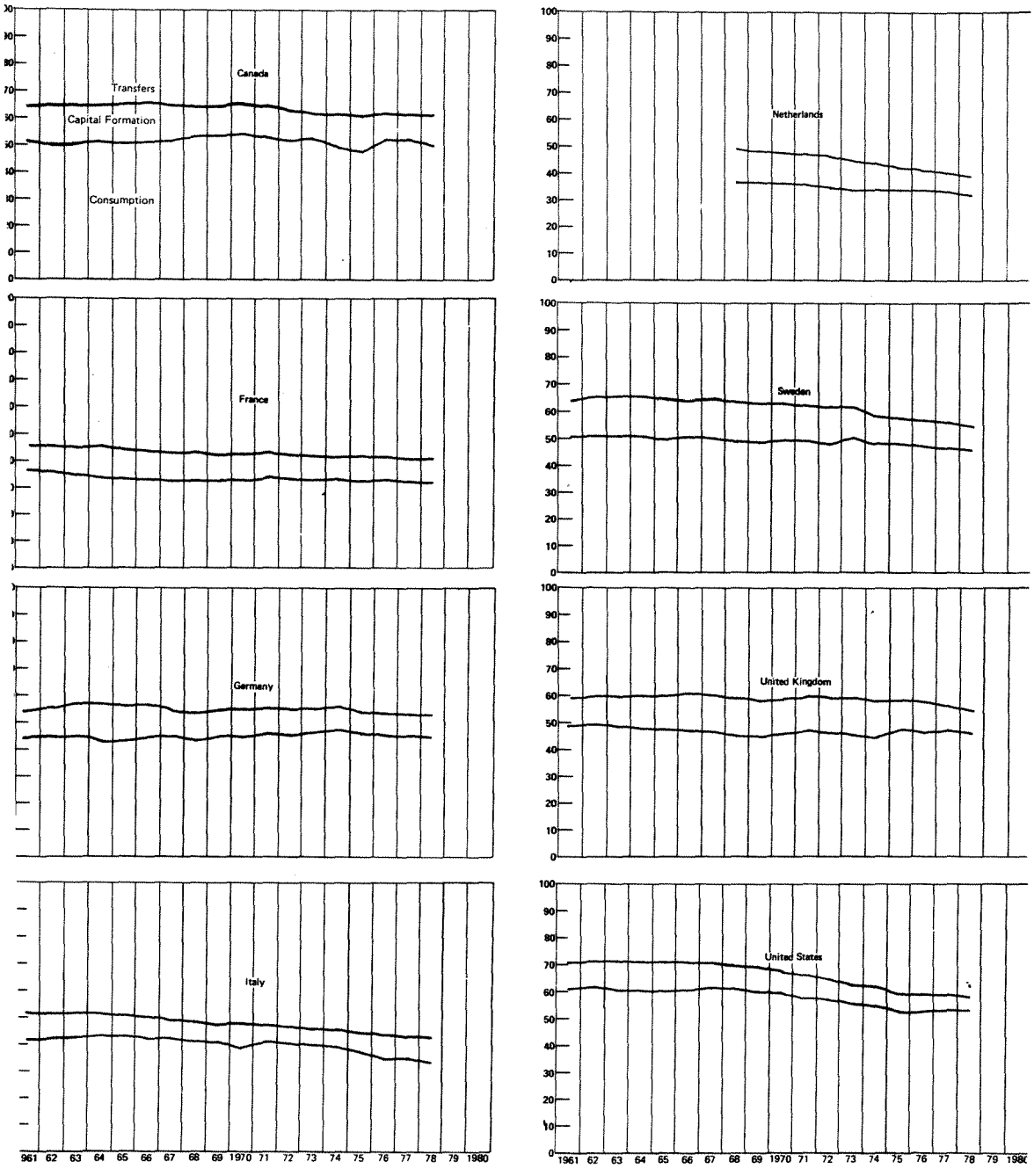
5. Government Sector

5:1. Central and Local Government Expenditure as Percentage of GDP, 1961-78



Source: (5)

5:2. Government Consumption, Capital Formation and Transfers as Percentage of total Government Expenditure, 1961-78



ource: (5)

5:3. Public Consumption as Percentage of Private Consumption, 1961–78
Current Prices,

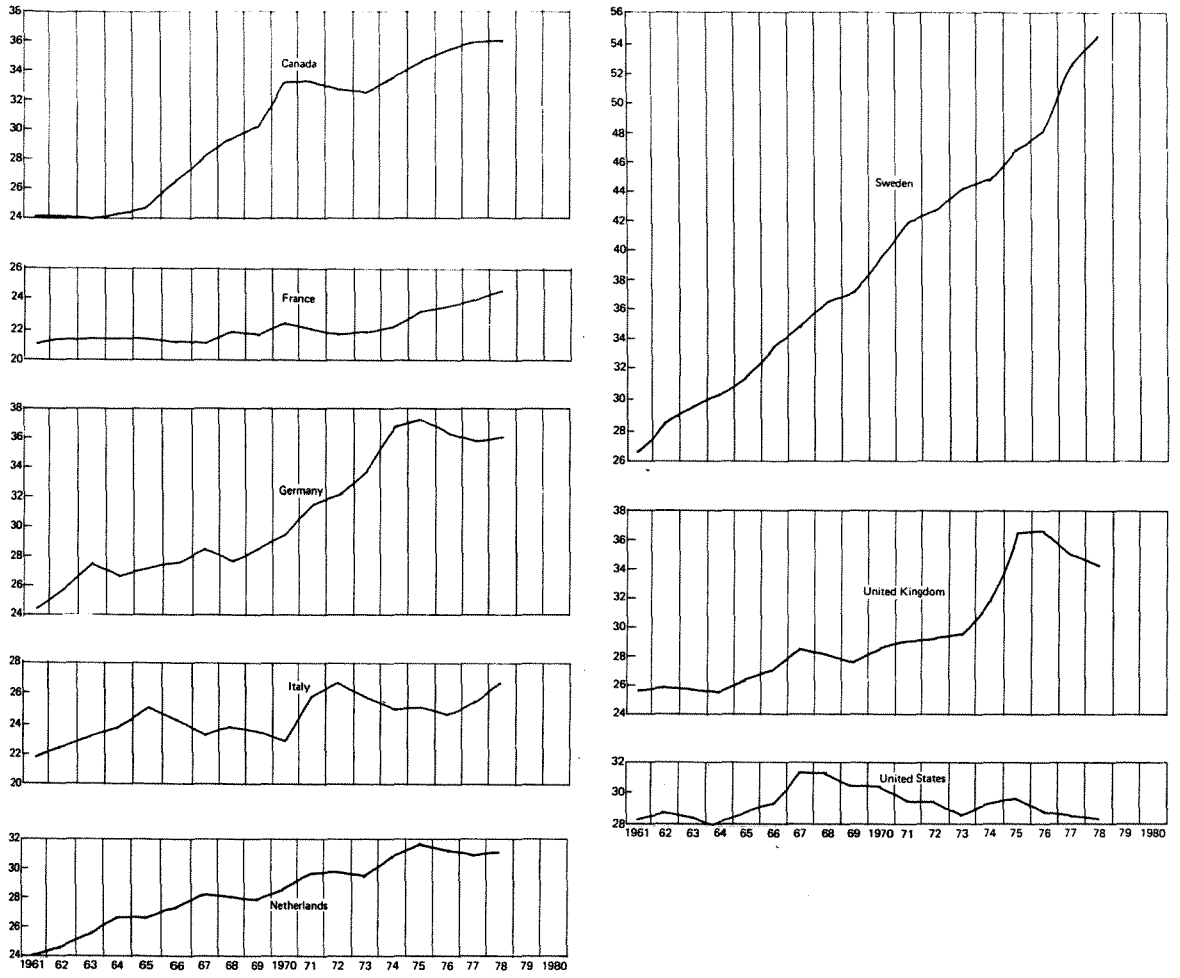


Table 5:4. Public employment as share of Total Employment, 1965-76

	Percent of public employment in total employment[a]		Average annual % change
	1965	1976	
Sweden	15.3	26.4	5.1
Germany	9.8	14.2	3.4
U.K.	15.7	21.7	3.0
Italy	9.6	12.3	2.3
Canada	18.2	22.2	2.0
Netherlands	11.5	13.9	1.7
France	12.4	14.3	1.3
USA	18.0	19.4	0.7

[a] Comparisons over time are more relevant than comparisons across countries because there remain some large conceptual differences among country's definitions of their public sector.

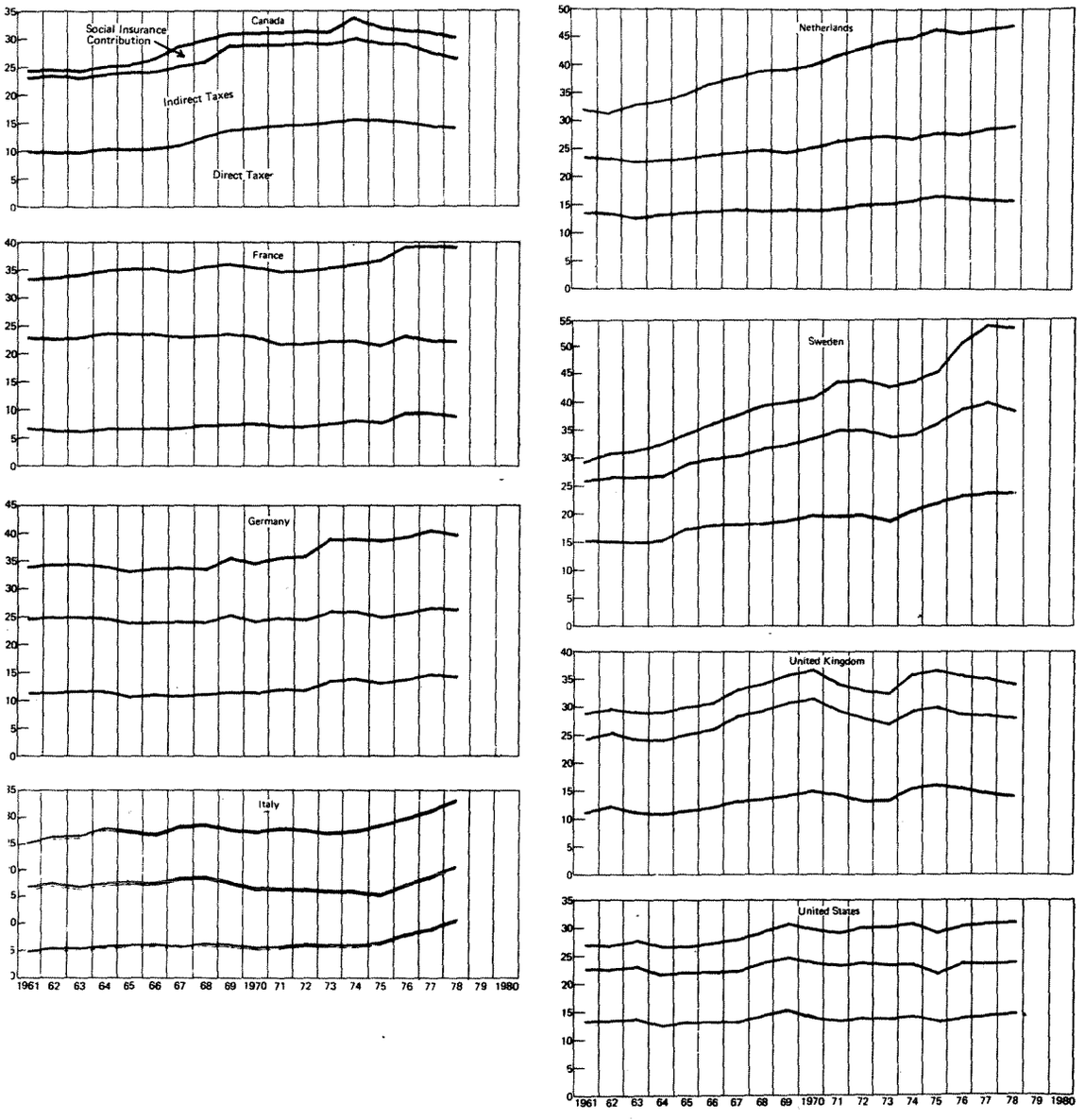
Source: (7)

Table 5:5. Growth of Government receipts relative to GNP

	Average annual % increase, 1955-78		
	GDP (1)	Receipts (2)	Elasticity (3) (2):(1)
Sweden	9.6	12.7	1.32
Netherlands	10.3	13.1	1.27
USA	7.5	8.8	1.18
Canada	9.8	11.3	1.15
Italy	11.9	13.7	1.15
U.K.	9.7	10.6	1.09
France	11.6	12.6	1.09
Germany	8.9	9.7	1.08

Source: (5)

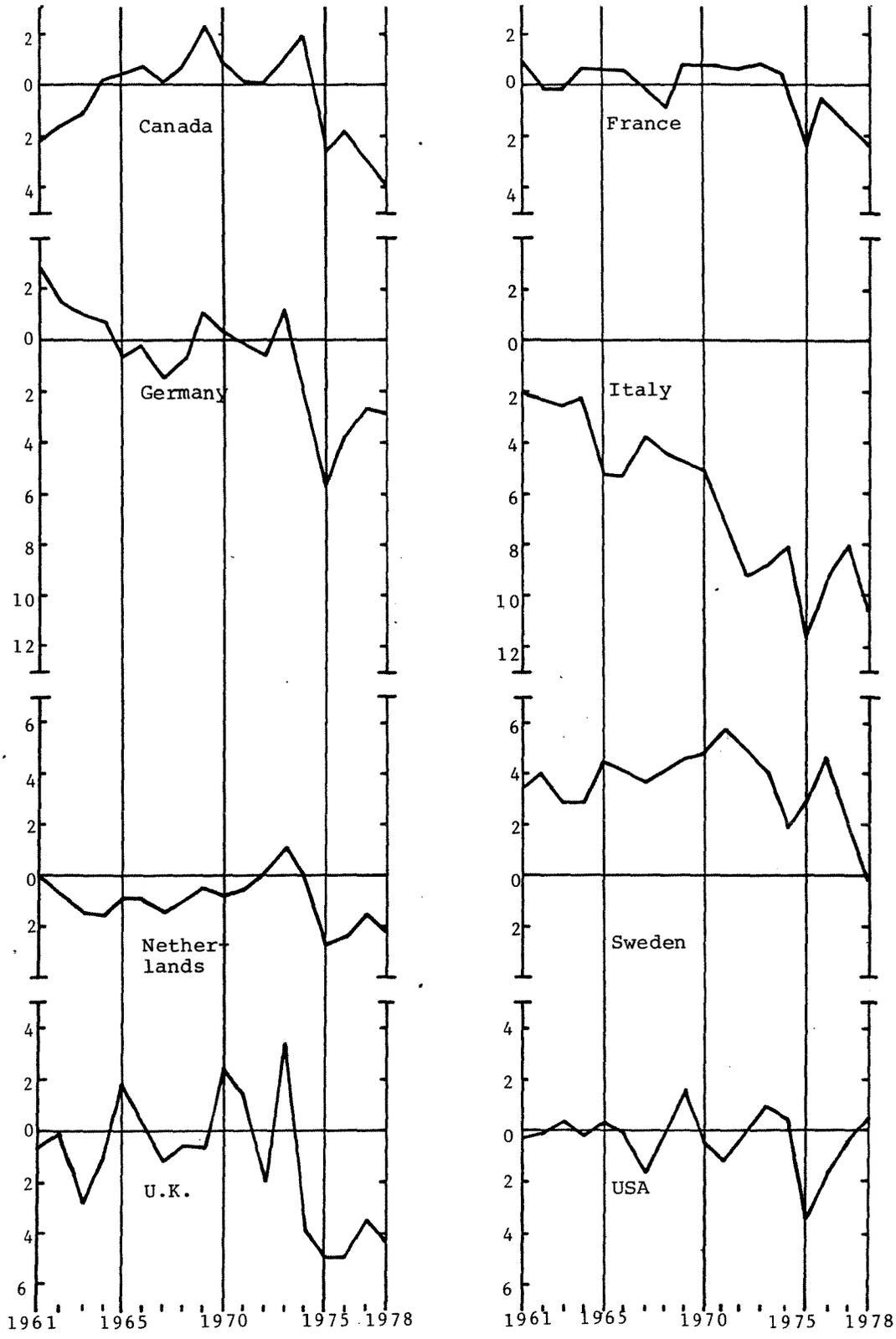
5:6. Taxes and Social Insurance Contributions as Percentage of GDP, 1961-78



Source: (5)

Table 5:7. Government Surplus and Deficits as percentage of GDP, 1961-78

Source: (5).



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