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# **REPAIRING THE BUDGET CONTRACT BETWEEN CITIZENS AND THE STATE**

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# THE FINANCIAL CRISIS HAS UNDERMINED THE BUDGET CONTRACT BETWEEN CITIZENS AND THE STATE (1)

- A nation's budget is a contract in which citizens pay taxes in exchange for services and benefits from government
- Many features of this contract, such as authorized activities and expenditures, are explicit
- But some of its most important features are implicit and are embedded in citizen expectations
- These expectations were elevated during the long period of economic and governmental expansion
- However, the financial crisis has destabilized national budgets, and may (in some countries) lead to fundamental changes in citizen-state relations
- Adjustments are likely to be contentious because destabilization has occurred during a period of low citizen trust/confidence in political institutions

## THE FINANCIAL CRISIS HAS UNDERMINED THE BUDGET CONTRACT BETWEEN CITIZENS AND THE STATE (2)

- **THE FISCAL CONTRACT** – provides for government to maintain prudent, politically-acceptable budget aggregates that are sustainable over the medium-term and beyond, and that current fiscal policies will not unduly disadvantage future taxpayers and beneficiaries
  - The crisis has revealed that public finance in some countries is on an unsustainable path, and that fiscal consolidation and austerity are required to correct severe imbalances
  
- **THE SOCIAL CONTRACT** – promises citizens that in exchange for participating in the economy and paying taxes, government will finance pensions, health care and other social protections
  - Severely impacted countries have been impelled to reduce promised or expected benefits, and to shrink the protective role of the state. Less impacted countries have also adjusted the state's social footprint

## THE FINANCIAL CRISIS HAS UNDERMINED THE BUDGET CONTRACT BETWEEN CITIZENS AND THE STATE (3)

- **THE PERFORMANCE CONTRACT** – provides for efficient operation of government and delivery of accessible, responsive public services
  - Low levels of trust reflect declines in actual or perceived government performance. The financial crisis may further depress citizen confidence if it causes significant reduction in the volume or quality of services
  
- **THE RELATIONAL CONTRACT** – promotes stable, trusting relationships between citizens and the state, and strengthens the other budget contracts
  - Because citizen regard was low before the onset of the crisis, governments cannot draw on it to mobilize support for corrective budget policies

# REPAIRING THE FISCAL CONTRACT

## THE PROBLEM

- The Great Recession compelled governments to disregard preset fiscal targets
- Pre-Crisis fiscal rules generally combined excessive rigidity and feeble enforcement
- The rules were pro-cyclical: they did not adjust to changes in economic conditions
- Pro-cyclical rules seed problems in good times that become apparent when the economy falters
- Countries that have a fiscal responsibility process generally fared better during the crisis than those with fixed rules
- Contradictions in public opinion – citizens want bigger programs but smaller government – complicate the task of devising workable fiscal rules

# REPAIRING THE FISCAL CONTRACT

## **FISCAL RULES THAT ARE FLEXIBLE AND ENFORCEABLE**

- The fiscal contract should not impel government to harm vulnerable citizens during adverse economic times
- It is feasible to devise rules that protect cyclically-sensitive expenditures (such as unemployment benefits)
- A fiscal contract should cover the Medium Term and be cognizant of Long Term implications
- Governments should consider clawback mechanisms to put public finance back on track when fiscal limits are breached because of adverse economic conditions
- Fiscal limits are not self-enforcing: they require capacity to monitor fiscal prospects and out-turns and to take corrective action
- An independent fiscal entity to protect economic conditions and assess budget policy may strengthen fiscal contracts

# REPAIRING THE SOCIAL CONTRACT:

## THE PROBLEM

- Social contracts are inscribed in laws that mandate payments or other transfers to eligible beneficiaries
- They are not pure contracts because governments can unilaterally alter their terms
- Social contracts inflate citizen expectations and thereby contribute to disappointment and distrust
- Many social contracts are grounded on the premise that sustained economic growth will finance future payouts
- The financial crisis and demographic trends have undermined this premise
- Contemporary social contracts have made national government into the holder of risk to society
- They transfer risks from households and firms to government and future taxpayers
- Social contracts have often been based on disregard or miscalculation of future costs
- Citizens believe that government is only giving back what it took in taxes: they therefore feel cheated when government trims benefits

# **REPAIRING THE SOCIAL CONTRACT: MAKING THE TERMS MORE SUSTAINABLE**

- Governments should account for the social risks they are holding, including prospective costs
- Transforming social contracts from open-ended commitments into reciprocal obligations may reduce benefits but will make them more effective
- Social contracts should distinguish between risks that benefit recipients and risks that adversely affect them
- Beneficiaries should share in the cost of longer life spans and improved health care
- Social contracts should make full use of cost-sharing mechanisms such as copays and deductibles
- Social contracts should have adjustment mechanisms to keep them on a sustainable path



# REPAIRING THE PERFORMANCE CONTRACT: THE PROBLEM

- OECD Governments are more open and accessible than in the past, and citizens can readily obtain performance data
- But evidence of improved services has not countered the decline in trust and confidence
- Lack of accountability for failure may have a greater impact on public opinion than successful performance Citizen expectations appear to rise faster than government performance
- Austere budgets preclude improving services by increasing public expenditures
- Inasmuch as most direct services to citizens are delivered by subnational political or administrative entities, the national government is not credited for service improvements even when it finances them

# REPAIRING THE PERFORMANCE CONTRACT: IMPROVING PUBLIC SERVICES

- Performance Budgeting (PB) can be a useful tool to improve government performance and communicate results to citizens
- However, a budget that merely lists workload, outputs and other data does not fulfill PB's potential
- Governments can improve PB by more closely linking resources and results
- Governments should view performance as a measure of change
- PB should highlight changes in activities and services due to changes in resources
- Linking resources and results requires better information and allocation of costs

# REPAIRING THE RELATIONAL CONTRACT

- When parties to a contract have an ongoing relationship and expect to interact in the future, compliance depends more on trust than on the formal terms of the contract
- Trust is important because no contract is complete – it cannot specify all relevant terms and conditions or anticipate all the issues and contingencies that may arise
- Budgeting benefits from having both formal contracts that prescribe and limit government action, as well as relational contracts that facilitate political agreement and administrative efficiency
- Trust is essential during all stages of budgeting, not only within government but between citizens and the state
- In fiscally stressed countries, budget relationships have been scarred by mistrust and anxiety

# ECONOMIC CONDITIONS DO NOT ADEQUATELY EXPLAIN LOW POLITICAL TRUST

- The decline in trust coincided with the end of the postwar boom and slowdown in growth
- Since the 1970s, OECD economies have continued to grow, but at a lower pace, and less consistently than during the immediate postwar period
- Weaker growth gives governments less incremental resources to distribute in expansionary budgets
- Policy initiatives often have been crowded out by built-in increases in existing programs
- Political leaders have shifted from taking credit to avoiding blame, as deficits have become more common and budgets less supple
- But economic conditions are not the whole story: trust scores have continued to decline even during growth periods
- Trust is not simply a referendum on the government of the day, but a statement concerning the relationship between citizens and the state

## **MULTIPLE EXPLANATIONS HAVE BEEN OFFERED FOR DECLINING TRUST AND CONFIDENCE**

- The role of the media, including 24/7 news programs, and a more critical, adversarial posture
- Decline in social capital: less civic activity and engagement
- Globalization and the loss of national control
- The belief that government has become too large, distant and intrusive
- Government performance and the quality of services have deteriorated
- Rising expectations out pace the capacity of government to satisfy citizen demands
- Rise in individualism and decline in authority

# WHEN ALL IS SAID

THE KEY TO REPAIRING  
THE BUDGET CONTRACT  
IS TO BALANCE  
CITIZEN EXPECTATIONS  
AND  
GOVERNMENT CAPACITY