RAJA CHELLIAH MEMORIAL LECTURE SERIES

The Termites of the State : Why the Normative and Positive Roles of Governments Differ

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ON THE DESIRABLE OR NORMATIVE ROLE OF THE STATE

When Raja Chelliah and I worked together for a few years at the IMF in Washington 30 or more years ago, we did not worry much about potential differences that could exist between the advice that we were giving to the government of countries and the implementation of that advice; or between what could be called the **normative** and the **positive** roles of governments. If a country had a level of taxation that was lower than its "taxable capacity", determined on the basis of various statistical methods, we advised the country's government to raise taxes. If the country's tax system was not seen to be progressive enough, as determined by tax incidence studies, we advised the government to introduce progressive income taxes. If the country's investment was too low, we advised it to raise taxes and to generate a surplus over current expenditure in the budget to allow it to increase **public** investment. If some social groups were not benefiting from the country's growth, we recommended more social spending. That was a simpler and easier world for economists. Normative advice carried the day; worries about implementation or possibly, about negative reactions to the advice and about the policies needed to implement the advice were secondary or even non existent.

In the three decades since Raja left the IMF it became progressively more apparent that the advice given, even when a government claims to follow it, often does not produce the expected, desired result. Taxes do not increase, or they do not become more progressive. Public investment does not go up; or, if it does, it does not produce the hoped for impact on growth. Higher social expenditure often does not lead to clear improvements in the standard of living of those it was intended to help. This lecture, dedicated to the memory of Raja Chelliah, speculates on some of the reasons why this is so.

In today's world, especially in countries that have democratically elected governments and that rely largely on market economies, such as India, citizens (and economists) see the government and the public sector as important agents that can improve the quality of their lives. Governments are required and expected to adopt policies that should lead to improvements in the living standards of the population.

Following the seminal work of Richard Musgrave, 1959, academic economists have established **general** categories in which they place the objectives and the policies that governments promote. The first of these categories is **stabilization**. Through its policies the government is expected to prevent excessive fluctuations in the levels of output, employment, and prices. Economists define stability as the absence of excessive changes in some relevant, indices for these variables. They focus on the fluctuations in macro-variables and pay much less attention to the fluctuations of the specific components that make up these indices. For example, the inflation rate reflects the **average** of the changes in many prices. The growth rate focuses on the behavior of national income, national saving, and national investment.

In recent years it has become increasingly evident that the behavior of these macro-economic indices or averages may hide wide fluctuations among the elements or the **components** of the averages. For some significant sections of the population the changes in the specific components may be more important than the fluctuations in the averages. For example, some significant sections of the populations worry less about the behavior of the **average** price index, the one that attracts most of the attention of economists, than about the prices of particular products that are important to these sections, such as rice, bread, gasoline, and some others. When people are so poor that they spend a large share of their income on these specific products, fluctuation in their prices may be far more important for them than fluctuation in the general price level. Yet most policies recommended by economists, and most of their analyses, are directed at the general price level.

The same is true for some of the other macro-economic variables that also attract much of the economists' attention, such as national income and employment. For some groups of citizens the performance of particular industries, or sectors, or regions, may be as important, or even more important, than that of the national averages. Therefore, real-life governments are often pushed to intervene, with their policies, in specific areas. These interventions are at odd with those recommended by economists that generally deal with the macro-variables. They are thus criticized. Perhaps, Lord Keynes bears some share of the blame in pushing economists to focus accessibly on the macro-variables.

A second category of intervention, closely linked to the first, includes policies that deal with the allocation of resources. This category often also pushes governments in pursuing policies that conflict with those recommended by economists. In his 1959 famous book, Richard Musgrave, did not list **economic growth** explicitly among the objectives to be pursued by governments. He focused rather on the **allocation of resources**, to deal with externalities, the provision of public goods and other market failures. Growth was seen as the passive outcome of that allocation and not an objective that could be explicitly promoted by the government. However, we observe that the governments of most countries almost always engage in various forms of "industrial policy"; or in the assistance to so-called "national champions", that is to enterprises that are too important or too large to be allowed to fail or to lose ground in the international competition. These and other presumably growth-related interventions by governments go against the views of most orthodox economists who believe that governments should not second guess the market and should intervene **only or mainly** to correct for market failures. Prominent among economists who took this view were Adam Smith, Friedrich Hayek, and Milton Friedman. Hayek referred to the "fatal conceit" of policymakers in believing that they could do better than the market could.

However, it is politically difficult or even impossible for governments, that are expected to be responsive to the requests of the citizens in a democratic environment, **not** to intervene when citizens' demands become strong. Policies that aim at promoting a higher, **national** (that is **average**) employment rate may not be considered sufficient by citizens, especially when the additional jobs created are not broadly distributed among different groups.

The "well being" of **particular groups** which, for a variety of reasons, may not benefit from the policies aimed at raising the **national** employment rate, may not be improved by the raising of that rate and may require policies **specifically directed toward those groups**. These groups may include the handicapped, the women, the young, those from particular ethnic or social backgrounds, and some other so-called minorities. In democratic societies, these individuals create pressure groups that prod the government to pursue the **particularistic** policies that economists may see as going against the broad, general public interest and against the choices that a free market might make. "Affirmative action", or "preferential hiring", are examples of these particularistic policies. They seem to exist in most countries.

A third and most important category of policy objectives is that of promoting an **income distribution** that is more conformed with the preference of "society". Such an income distribution is often at variance with the one generated by the market and thus requires explicit government policies. Governments are expected and pushed to introduce policies that inevitably seem to interfere with the market and that in so doing create disincentives and distortions that many economists believe reduce economic growth. An extreme version of these policies is the promotion of so-called welfare states.

The policies required to promote a better income distribution may be directed at raising the consumption of (and at improving the economic opportunities for) the poorest citizens. Or, alternatively they may be focused on the reduction of the spending power of those who are at the top of the income distribution (the 'rich'), while using the resources thus collected to finance **general** government spending. Both of these policies could promote a more even distribution of income, as, for example, measured by the Gini coefficient. However, they might be accompanied by different impacts on incentives and on the "poor". The former option would allow a government to appropriate some of the incomes of the rich, say with progressive income or wealth taxes, and use the resources so obtained to help **specifically** the poor **through targeted subsidies or programs**. It would thus require more particularistic policies.

In pursuing the above policies the government would have to consider not only their short run effects but also their long run impact on the economy. If these policies reduce the growth rate **over the long run**, as feared by economists who believe that economic growth should be the main objective, the government might be generating a more even income distribution (lower Ginis) but reducing absolute incomes over the long run for the population. Politically, the short run is almost always more important to governments and to some sectors o f the population than the long run. A higher standard of living **today** may be more attractive especially to very poor people than a higher one in the future. The reason is that the poorer are the people the higher is their rate of discount (*see* Tanzi *et al*. 1974).

The objective of income redistribution becomes more ambiguous about the policies to follow when it is guided by, and relies on, statistics that measure the income distribution for the whole population, such as the Gini coefficient, rather than by the share of the total income going to the poorest groups (say the bottom 20 percent of the income distribution) and to the highest group (say the top five or even one percent of the distribution). Policies that may impact on these specific groups are easier to identify though not always easier to implement. How policies that aim at redistributing income affect the broadly-defined "middle class", the large group between the very poor and the rich, is much more difficult to determine. The Gini coefficient limited to this group can also be large. The government can focus, as described above, on policies that increase the consumption of the poorest and reduce the incomes of the rich; or on policies that have an impact on the whole population. These two approaches will require significantly different policies and will reflect different pressures on governments.

Whatever the expected or the normative role of the government is, the government will have to determine **not only the policies to be adopted but also how these policies** will be implemented. Sometimes the policies that are easier to be adopted are more difficult to be implemented and vice versa. The **determination** of the policies receives more attention, especially by economists, than the **implementation** of those policies. The government must decide on the instructions to be given, the form in which these instructions are given (through laws, regulations, administrative guidelines, informal instructions, etc.), and to whom to be given. It also must make sure that the instructions given are followed and generate the hoped for results. Performance budgeting has been receiving more attention in recent years.

In the **determination** of these policies two practical considerations become important because they may create what could be called "termites", in the actions of governments. These termites generate gaps between the "normative", or theoretically-desirable policies, as advocated by economists, and the actual policies, adopted by policymakers.

The first consideration, i.e. the **determination of the policies**, has received attention over the years by economists, including Mancur Olson, Gary Becker, and others, some associated with the school of public choice. However, it is often ignored in much of the writing by economists. Well organized groups are more successful in eliciting policy responses favorable to them than calls by the general population for the promotion of the "public interest". The interests of groups are easier to define than those of the general population. Real life policymakers are continually exposed to, and are bombarded by the demands of, pressure groups. They are rarely bombarded by the "public interest". The pressure group are better organized and can promise to deliver votes, or other forms of contributions, to politicians. They have louder "voices". This explains why tax incentives and tax preferences, the policies that promote the interests of particular groups, enterprises or sectors, receive more attention and support than proposals for genuine tax reforms. **Particularistic** policies often prevail over **general** policies. **Economic policy ends up becoming the "summation" or the "integral" of several particularistic, or "specific interest", policies** rather than the promotion of the public interest.

Given that the time horizon of policymakers in democratic societies is often relatively short (being determined by the timing of elections) the second consideration is that **policymakers tend to give priorities to policies that are more likely to have some impact in the short run**, **especially on some groups**, rather than those that may benefit the whole country in the long run. Short run policies are more likely to be connected with the interests of more vocal sub-sections of the population. They tend to benefit specific groups.

In the "normative" theories of government behavior, it is implicitly assumed that the citizens are the "principal" and the policymakers that form the government are the "agent" that faithfully and efficiently carries out instructions received from the citizens and develops the right policies and sets up the right institutions and incentive systems to promote and deliver the desired results. Unfortunately this idealistic and optimistic view of how governments operate is, often, not consistent with reality. In the following sections we discuss what can go wrong. We shall show that much can go wrong in the various links of the chain that connect the citizens' desires and expectations with the long run results of the government's actions. Principal agent problems can develop at different stages.

In section II we shall present a brief discussion of the "principal agent relationship" between citizens' and the politicians who represent them in the government. In section III we shall identify the main policy tools that governments have available to them to promote their policies. In section IV, we shall discuss various "noises" or "termites" that create leakages and or distortions between the signals sent by the policymakers and the actions taken at the policy front, that is at the point where the policies directly impact the citizens. Section V will be a brief summing up and concluding section.

CITIZENS' INTERESTS AND POLICYMAKERS ACTIONS

In democratic countries the citizens are supposed to have the role of "principal". It is the "principal" that instructs the "agent" (the government) to promote the principal's (i.e. the citizens') interests. It would be convenient if the instructions from the principal could come in a transparent, direct, coordinated, and unequivocal way. Unfortunately, there is no single, legitimate, representative spokesman for the citizens that can convey those instructions. The citizens tend to aggregate themselves in groups, or in parties, with conflicting interests and competing objectives among them. Each of these groups tries to push the government to promote its own interest. Some of these groups have or acquire far more power and "voice" than others. Some groups vote in larger proportions to their numbers than others. Some are better informed and better financed than others.

Because of the above reasons, the policymakers in the government receive many and often conflicting requests or instructions from the public, some more specific than others, to which they are expected to react. Of course, the most important instructions should be those conveyed through the electoral results. However, these results are often influenced by emotional issues, issues that may have little to do, at least directly, with economic policies.

The politicians, in turn, have difficulties in absorbing and interpreting the confused signals that the electorate sends them and that are accompanied by a lot of "noise". Furthermore, for their electoral campaigns, the politicians need commitments of votes or money that some particular groups or individuals are more capable of providing than others. As a consequence, pressure groups and lobbies acquire strong influence on the politicians' decisions. These influences may lead to policies that are in conflict with both the electoral results and those promoted by normative economies.

Another significant consideration is that the **economic literacy** of the politicians in general, and of the policymakers in particular, also plays a role. Some policymakers have no training in economics and rely on their gut feelings or their ideologies for making economic decisions. Some may be influenced by the views of dead economists, as John Maynard Keynes famously wrote. Some depend on the advice they receive from their advisors, who may have been chosen for their ideology or for their technical knowledge; or, even, to represent the interests of specific groups. Furthermore, as the "school of public choice" has stressed, the policymakers and their advisors are almost inevitably influenced by their own biases and their social backgrounds.

The more limited is the economic literacy of the policymakers and the stronger are their biases, the poorer, in general, will be the policies enacted and the, explicit or implicit instructions that they will send to the public employees, those in charge of implementing the policies. It would be ideal if the policymakers had the wisdom of Solomon, the knowledge accumulated in Google, and the honesty and compassion of Mother Teresa. Unfortunately, such policymakers do not exist in the real world. Policymakers are normal human beings with the mixture of virtues and defects that characterize all human beings.

In conclusion, some "termites of the state" may be present in greater or lesser extent **at the very top**, when political biases, pressures from well organized public interest groups, poor economic literacy, focus on the short run, and attention to specific, particularistic policies, influence the policymakers. Another important "termite" is **political level corruption**. **Political** corruption will be discussed later, together with a broader discussion of corruption as one of the important "termites" of the state.

TOOLS AVAILABLE TO POLICYMAKERS

In their goal of promoting the welfare of the citizens, the policymakers have available various tools. The relative importance of these tools changes over time, some becoming more important and others less important, at different times and in different places. The policy tools can be grouped into three main categories: **fiscal tools; regulatory tools; and other tools**.

Economists focus mainly on fiscal tools that are the ones associated with government budgets and tax systems but the other tools are also important. In democratic countries the use of fiscal tools almost always requires the approval of the legislative branch. That requirement complicates matters, because legislative approval takes time and the use of political capital. Furthermore, often what comes out of the legislative process is different and generally more complex than what goes in. The reason is the numerous and significant amendments to the original proposals sent to the legislature by the executive that are introduced during the legislative approval process. The fiscal tools include **public spending, taxes, public debt and public loans**.

With some assistance from fees, sales of public assets, fines, public borrowing, seignorage receives from central banks and, possibly, dividends received from public enterprises, **taxes** provide governments with most of the financial resources that they use to hire public workers, to buy goods and services from the private sector, to provide subsidies to enterprises, pensions and subsidies to individuals, and to service the public debt. Various features of the tax systems (rates, tax bases, tax incentives, “tax expenditures”, etc.) can be used to promote specific objectives. These features make the tax systems a flexible tool for both macro and micro government policy. The same is true with features of public spending.

The size and the maturity characteristics of public debt and of public loans can also be used to promote objectives that go beyond the provision of spending money to the government. An example is the maturity structure of the public debt. The same is true for publicly-provided loans to the private sector that often imply some element of subsidy to those who receive them. For example loans to students or to farmers can be important in promoting education or agricultural development, and can replace direct budgetary subsidies.

Regulations and authorizations are important government tools that can and often do replace spending and taxing. See Tanzi, 1998. They do not require public resources, except for those needed to hire the public employees that must monitor and enforce the regulations and must decide on whether authorizations will be given to those who ask for them. Regulations and authorizations are powerful tools that governments have traditionally used to promote particular objectives; or to favor particular enterprises or individuals. When tax revenue is limited, because of a country’s low “taxable capacity”, governments tend to make more use of their regulatory and authorizing power, as they did during the "mercantilist period" criticized by Adam Smith in **The Wealth of Nations**. Regulations have played large roles in the labor market, the housing and land market, the credit market, the product and service market, the foreign trade market, and in influencing the activities of public enterprises. Economists have often taken a negative or at least a skeptical look vis-à-vis the use of regulations.

Beside the fiscal tools and the regulatory and authorizing tools, governments have at times relied on less orthodox tools. The most important of these are: **the power of conscription, the ownership and use of real resources, the use of contingent liabilities**, and the use of "**nudging**" or "**cajolement**". Economists have paid less attention to these other tools even though they have occasionally been very important.

Conscription was very important in the distant past for making public investments or in the creation of monuments and other public structures, and, more recently, for military service. The assumption of **contingent liabilities** and the use of **nudging** have become more important in recent years, the latter especially as a consequence of results from experimental economies. Contingent liabilities have been associated with an increasing role of the government in guaranteeing deposits in the financial sector and with an increasing role of the private sector in the creation of major infrastructures, through the use of public private partnerships (PPPs). In these PPPs the private sector puts up the money needed to build new infrastructures and runs them (toll roads, bridges, port, airports, etc.) while the government guarantees an agreed rate of return for the private investors' investment. This guarantee creates a risk for the government if the rate of return to the private investors in the investment is less than contracted. It saves to the government the financial resources that it would have provided if the infrastructures had been built with public money. Many infrastructures have been built in many countries in this way in recent years. In some cases, the governments have been presented with large liabilities when the new infrastructures did not perform as expected (*see* papers in Polackova Brixi and Schick, 2002). The tool of **nudging** is also attracting a lot of attention in the most recent years (*see* Thaler and Sunstein, 2008).

Termites may enter in the decisions made in connection with the use of all of these tools and particularly on those concerning regulations and authorization, and contingent liabilities. These termites make the results different from the expectations.

GOVERNMENTAL ACTIVITY AND THE TERMITES OF THE STATE

If the activities of the state were determined and carried out (using a single policy tool) by a single agent and that agent had the combined capacities and characteristics of Solomon, Google, and Mother Teresa, there would not be "termites" in the operations of the government. At most, there would be random errors due to unanticipated events of the "black swan" type or to other random factors. However, reality is far from that ideal.

Policymakers and politicians in general do not have the wisdom of Solomon, the knowledge accumulated in Google, and the honesty and compassion of Mother Teresa. And they use a multiciplicity of policy tools. Furthermore, the activities and the responsibilities of the public sector are not concentrated in a single agent but are spread over many jurisdictions, agencies, institutions, offices, and a very large number of individuals. This complexity makes it likely that various problems develop in the **formulation** of policies, in the **transmission** of the decisions to those who implement the policies, and in the actual **implementation** of the policies.

We have given the name of "termites" to these potential problems because, like their biological counterparts, they can distort and damage, often significantly, but not transparently, the normative role of the state, the role that a government in the ideal world of theoretical economists would perform. The more powerful are the "termites", the greater becomes the gap between ideal and actual performance.

There is not enough time in this talk to discuss in details about these termites. Therefore, the presentation is limited largely to a listing of them, accompanied by comments and references to some of the relevant but limited literature. I hope that other economists will follow and expand this line of inquiry.

Ignoring the limitations mentioned earlier, in terms of economic literacy and lack of identification by the national leaders with the genuine interests of the citizens, that could be considered as a first termite, the second termite can arise from the **fragmentation of decision making** at the top. The implicit assumption of a **unified** government, or of a **nerve center** within the government, where all the important economic decisions are made, and from which the relevant signals are sent to those who will implement the policies, is clearly not realistic. In all countries there is a greater or lesser **fragmentation of the decision-making process**. This fragmentation creates opportunities for promoting conflicting policies, or at least for promoting non coordinated policies. This is a much more frequent problem than is realized.

Ignoring the difficulties created by complications that may enter at the stage of the legislative process, the fragmentation may have to do with the fact that the ministers and the other policymakers within the government, that should operate harmoniously, may come from different parties, from different geographical areas, or from different economic and social backgrounds. Thus, they will have different objectives. This may predispose them to favor and push some policies over other. Conflicts between finance and spending ministers are also common. The former favors less spending while the others favor more spending. Depending on their relative political power, some policies will be preferred over others. The fragmentation may also be connected with the federal structure of a country, a structure that makes different regions, and those who represent them, push for policies that are more favorable to them. In this situation regional governments may promote policies that generate negative externalities for other regional governments; or they may prevent the introduction of policies that would be beneficial to the whole country. For example, problems of this kind have prevented Brazil and India from introducing a clean, efficient, and national value added tax (*see* Rao, 2011; and Rezende and Afonso, 2002).

Except for some literature on fiscal federalism, a literature that has more often stressed the **favorable** contributions of fiscal decentralization to welfare, there has been relatively little discussion of this potential "termite" except perhaps in the literature on "the political theory of fiscal policy". The latter has concluded that because of their greater power of coordination, presidential governments are more effective at reducing public spending and at controlling fiscal deficits than parliamentary forms of governments, and especially parliamentary governments with proportional representation (*see*, *inter alia*, Persson and Tabellini, 2004). That literature has stressed that important economic decisions should be approved by the minister of finance who should have veto power over policies that he/she does not like.

Policy decisions are normally made by the policymakers who constitute the narrowly-defined "government" (president or prime minister and ministers) and are approved, often with changes, by the legislature. The laws produced by the legislative branch (the laws that become the laws of the countries) contain or should contain the directives (the signals) to the bureaucrats (who become the agent) and to the citizens on particular actions that they should undertake. We have thus, here another instance of the principal agent problem where the agent is not the bureaucrats and the public employees. The laws are often not specific enough and need to be accompanied by regulations that aim at giving practical or operational content to them. In today's world the laws are not carved on stone, as they were a long time ago, when they had to be short and clear. Now they are, often, thousands of pages long and are written in a language that leaves some scope for different interpretations.

The length and the complexity of the laws create easier opportunities for lobbies to influence those who write them, in order to insert innocent looking wording or even hidden clauses, that can benefit the lobbies. Or, they can create opportunities for those who administer the laws, to interpret them in ways that are favorable to some groups. This discretion creates a strong likelihood of biased interpretations, by both those who are responsible for enforcing them and occasionally those (the citizens) expected to follow them. Therefore, **complexity in the legislative output must be considered an important termite** (*see* Tanzi, 2010). It allows citizens to interpret in their favors the intentions of the policymakers, and the public employees to use the discretions that they have, in the interpretation or in the application of the laws, to favor some groups of citizens over others. This problem, while it is especially common in tax legislation, exists also in regulatory decisions (*see* Tanzi, ibid; and Tanzi, 2007). There is a lot of evidence, some even quantitative, that supports this conclusion.

Another important termite, that reduces the legitimacy of governmental actions and changes the role of the state, away from its normative and presumably benign role, is corruption. The word "corruption" comes from the Latin verb for "to break". It refers to the breaking of norms, rules, or principles. In the definition normally given for corruption, it refers to the "use of public power for private gains". Corruption exists also in the private sector when operators acquire "public power" but the concept is more often associated with the behavior of public employees, or that of politicians. The first is defined as **bureaucratic** corruption while the second is defined a **political** corruption.

Political corruption has been much in the news recently, because of events in Tunisia, Egypt, Algeria, Libya, and other countries. Bureaucratic corruption started to attract general attention on the part of the international community in the mid-1990s. It has continued to do so since then. An institution located in Berlin – Transparency International – publishes annual results of surveys that try to measure the "perception of corruption" in countries. It publishes an index called "corruption perception index" or CPIs. The index is now available for around 150 countries including India. Transparency International has issued various reports on **political** occupation and the World Bank has also been active in this area trying to assess the incidence of corruption in countries.

As a convenient analogy, we may think of a hydraulic system in which water is gathered in a reservoir from which it is channeled, through pipes, to different destinations, to achieve specific objectives (irrigation, providing water to families, to fountains, etc.). It is easy to see how the final distribution of water may diverge from the intended ones as there are leaks in some of the pipes. The greater are the leaks, the greater is the divergence. Acts of corruption have similar effects. Through their acts, public employees may create leaks so that some of the money spent by the government ends up in their pockets while the policies get distorted. Therefore, the final outcomes of the policies diverge from those that the policymakers had intended them to be. The greater is bureaucratic corruption, the greater are the leaks in the pipes of the government's hydraulic system and the greater is the difference between the effective role of the state and the normative or the intended role. When corruption becomes high, it may be better to scale down the role of the state unless policies can be introduced that can control corruption.

The leaks may, of course, exist in the reservoir itself, **at the political level**, distorting the actions of the policymakers and of the politicians, even before, or during, the process of designing reforms. It is common knowledge that some political leaders accumulate millions or even billions of dollars in secret foreign bank accounts, dollars that they could not have saved out of their often meager, official salaries. Policymakers or high level bureaucrats may approve public investments that benefit them or their close associate or family members rather than the country. Thus public money is wasted on "white elephants" (*see* Tanzi and Davoodi, 1998). This behavior is less likely, but not impossible, in democratic countries. In these countries the diversion of the resources toward the pockets, or the private interests, of particular policymakers is more subtle and more difficult to identify. When it is identified, it can lead to severe penalties for the perpetrators. At times it is the relatives of the policymakers, or the "keepers of the gate" those who control access to the policymakers, that use their strategic positions to distribute favors and to appropriate opportunities that make them rich. They also distort what should be the ideal, normative role of the state. Economic research has indicated that countries that produce mineral resources or those that receive significant foreign aid, seem to be more exposed to these problems. Of course the worse situation exists when political corruption is accompanied by bureaucratic corruption. This combination can easily lead to "failed states".

Another important termite of the state is **inefficiency in the use of resources**. Inefficiency can arise when the wrong output is produced efficiently, or when the right output is produced at too high costs. Of course it is also possible to produce inefficiently the wrong output. The fact that governments do not operate in a competitive environment, and that government operations are not guided by the need to generate profits, often creates an environment in which the pursuit of efficiency by those who operate government programs is not an important guide to decisions or to behavior and performance. Public employees do not feel that they have to work at their maximum capacity and that they have to economize on time and on the use of resources.

Habits that slow down the work and that distort the outcome progressively develop creating growing inefficiency. For example school teachers who often miss classes or employees that claim to be often sick. At times bad habits become workers' rights and are defended by unions of public employees that may become politically powerful and push also for excessive wage increases, as happened in some of the European countries that ran into financial difficulties in 2009-2010, such as Greece, Portugal and others. The outcome of this is that the positive generation of relevant socio-economic indicators (indicators that are important to society and that the government wants to maximize through its spending and other actions) is obtained at much higher expenses than would possible in a more efficient environment.

There is a growing literature that has provided some empirical evidence of this inefficiency. It has attempted to measure the public sector performance (PSP) in delivering particular, desirable socio-economic indicators, such as more equal income distribution, higher literacy, low poverty, low infant mortality and so on. Governmental action and especially public spending should aim at improving these indicators. When inefficiency becomes high, more public resources are needed to generate given levels of such indicators. A measure of public sector efficiency (PSE) can be obtained by relating the public sector output, the PSP, measured by some relevant indicators, to the cost, in terms of public spending as a share of GDP, of producing that output. In some countries the differences between the public sector performance and the public sector efficiency can be large (*see* Afonso, Schknecht and Tanzi, 2005 and 2010).

SUMMARY AND CONCLUSIONS

This lecture has discussed a topic that has not been addressed directly in the literature, although anyone who has worked in the area of economic policy has some awareness of its significance. It is the difference often observed between what is prescribed by theory or recommended by economists ad what happens in practice; or between the normative and the positive role of government. We have tried to identify various reasons that contribute to that difference and have called these reasons "termites of the state".

A first reason, or first "termite", is that normative prescriptions are often excessively general or too macro. This is the case for policies that are directed to macrovariables such as investment, saving, national output, rate of inflation, and so on. Because of various pressures on them, policymakers are often pushed to promote particularistic or micro policies that benefit particular groups and not the whole population. These policies often conflict with the free operation of the market.

A second reason, closely linked to the first, is that policymakers cannot escape from various biases, lack of economic literacy, or, even occasionally, lack of integrity that makes them favor policies different from those that economists believe would promote the "public interest". To this it must be added that the rate of discount of policymakers is often high making them choose policies with short run impact over those with a longer run impact. All of these are "termites" that affect the **formulation** of policies.

A second set of termites may be relevant for both the **formulation** of policies and for the **transmissions** of the signals or instructions connected with the policies to those who implement the policies: the higher level bureaucrats and the public employees. In this area the **fragmentation in decision making** may create principal-agent problems, between the government, as a whole, and specific elements, say some ministers or general secretaries, within it. Fragmentation of decision-making may be accompanied or facilitated by the **complexity** in the policies; and, again, occasionally, by lack of integrity. Both of these will damage the quality of the policies.

Finally principal agent problems can become significant at the point of implementation of the policies, by public employees. Complexity of laws, that creates discretion for public employees, inefficiency, and corruption at the bureaucratic level may all combine to generate results from policies that are distant from the hoped for outcomes.

The removal of the termites is never easy. It requires paying attention to (a) the question of fragmentation of decision making; (b) the generation of systems of accountability that minimize both political and bureaucratic corruption; (c) paying attention to the need for transparency in legislation; (d) the introduction of incentive systems that encourage efficiency and reduce corruption; and (e) reducing the economic role of the government to the level that can be administratively and effectively controlled. When the role of government exceeds the government capacity to control actions at all levels, failure follows. A government that aims at doing too much may end up contributing too little to the true welfare of the citizens. Governments should set their operations in line with their ability to formulate good policies, to be able to send clear instructions to those who will implement the policies, and with their ability to monitor the results.

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