THE REID ORATION 2013
BALANCING GOVERNMENT AND THE MARKET

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Introduction

I would like to take this opportunity to thank the organisers for inviting me to deliver the 2013 Reid Oration.

It is an honour to speak at an event commemorating such a distinguished scholar as Gordon Reid. Gordon was an acknowledged leader in the public life of Australia both at the national and state level.

When I was asked to think about a topic, I decided to speak on an issue that is central to public economics and policy and which I think receives too little attention in the public debate: the size and growth of government, the balance between government and the market and the way that rent seeking and entitlements shape modern government and its expenditure decisions. It is a topic I think Gordon would find some affinity with. In 1966 he published the "Tolitics of Financial Control: The Role of the House of Commons " in which he suggested that "it is not difficult today to envisage, and even to observe, how the power of an assembly may be 'evaporated' by rules; and how the 'obstinate and overbearing' may gain their ascendancy through rules." His conclusion was that parliamentary financial control is not very effective. The players in my presentation may be different – interest groups and rent seekers - but for many jurisdictions the end result is still essentially the same.

Increasingly I perceive a noticeable disconnect between the roles ascribed to government in public economics, and more broadly welfare economics, and the way government is considered in the public domain.

For many people the government is the "go to" player. Hence policy debates become simply "the government needs to do more in the area of….?" Or "government needs to do more for ….?. I am sure you would be able to fill in the last two lists. Usually of course ''do more'' equates to spend more. These views sit side by side with the contrary view that "government is too large', "taxes are too high", or, to quote from a US protest slogan, "government is not the solution to the problem, government is the problem". Sometimes of course the citizenry express both views, a point made with some considerable foresight by US political sociologist Daniel Bell in his 1970s book "The Cultural Contradictions of Capitalism". Bell argued that US citizens would increasingly be reluctant to pay taxes, but would increasingly argue for and accept greater entitlements.

It is the inherent conflict between these simplistic approaches to government and the legitimate role of government as it arises in modern public economics that I want to highlight in this presentation.

Any discussion of government in modern economies needs to commence with a consideration of the size of government. I will give an overview of the debate on government size and present some evidence on where we are at the moment with respect to the size of government and its impact on economic growth.

More specifically I want to consider a class of models - citizen over state models of government that have been offered to explain the growth and size of government and the specific role assigned to interest groups, rent seeking behaviour and entitlements demands in defining modern government, in influencing financial outcomes and potentially diverting resources, at least at the margin, away from productivity enhancing activities.

I will finish with a comment on areas where public economics offers insights into the way we should deal with policy formulation when rent seeking and entitlements are considered and a brief assessment of how Australia compares with other jurisdictions in this area.

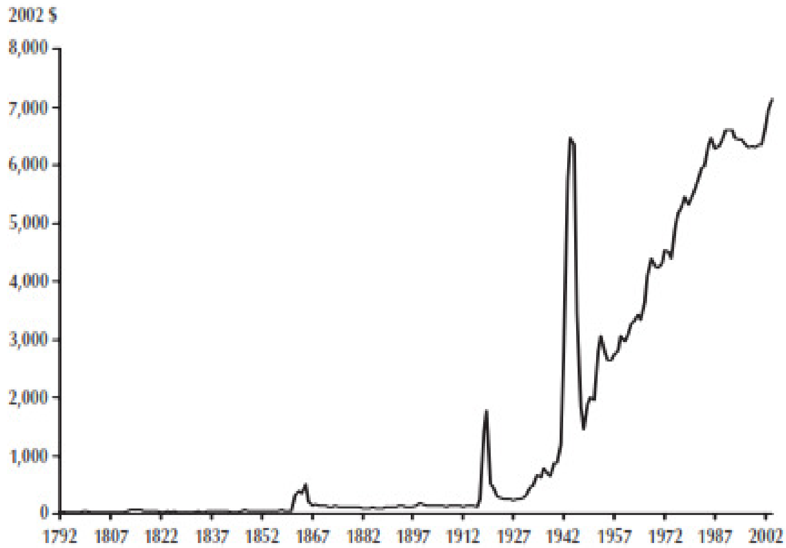
The role of government in modern mixed economies

In an important sense there are no successful free market economies in the modern world, if by that you mean laissez faire economies. Successful modern economies are all mixed economies descended from Adam Smith via a long tradition of work that makes the market the primary vehicle for achieving efficient resource allocation, but recognizes that unfettered markets are likely to be welfare reducing rather than welfare enhancing.

Certain key activities, most notably the operation of the legal system, have to be the responsibility of government. Markets depend on the ability to transparently and efficiently transfer property rights. The role of government in defining and supporting property rights through the legal system is fundamental. Beyond this, government involvement in the market economy is based upon the wider recognition of market failures and some of these, for example environmental degradation, are in turn based on the notion that appropriate property rights cannot be defined to allow for efficient market allocation of the resource.

Whilst everyone, or almost everyone, acknowledges the mixed nature of modern economies, it is worth remembering that the modern mixed economy, and consequentially government as we know it, is a relatively recent phenomenon. Figure 1 illustrates this with data for the US, but the pattern applies equally well to all modern mixed economies.

Figure 1; US Real Per Capita Federal Expenditures: 1792-2004



Source: Garrett, T and Rhine. R. Federal Reserve Bank of St Loius Review 2006. January 2006

The pattern is illustrated by the formation of US government Departments that sits alongside the growth in Figure 1. The departments of State, Treasury Justice and Defence all were formed in the late 1700s, agriculture in the late 1800s, Commerce and Labour in 1913. Then nothing for forty years. Health and Human Services was formed in 1953, Housing and Urban Development in 1965, Transportation in 1966 and the Environmental Protection Agency in 1990.

Broadly speaking this growth in dollars and departments aligns with the emergence of the modern welfare state post WWII and corresponds with two important developments in policy and expenditure, both of which are neatly reflected in the pattern of US departmental formation just mentioned. First there emerged a general acceptance that government could enhance social welfare through policies aimed at improving market outcomes. This linked government directly to policies dealing with competition law, the provision of public goods, the development of regulations to deal externalities. This alone drove sustained government expenditure growth in health, education, transport and planning with additional roles added as market failure assessments dictated including, for example, environmental and natural resource management.

Second, government assumed a direct role in redistribution and equity. Fundamental to this was the basic idea that government could or should insure people against a range of market risks through the creation of appropriate entitlements including unemployment benefits, health benefits and aged and other pensions.

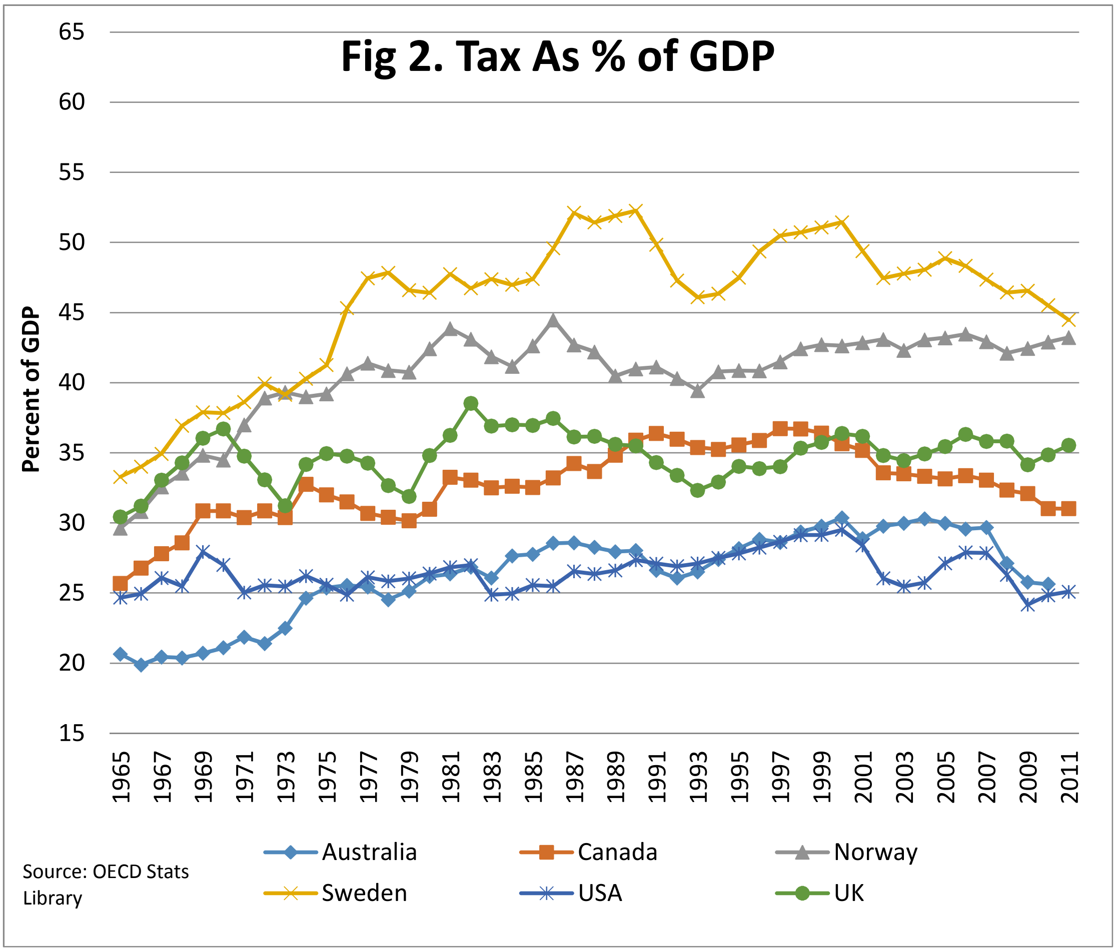
Essentially the latter expenditures became entitlements. By entitlement I am referring to a legal provision that establishes the right of a beneficiary to public funds as distinct from other government expenditures.

This is a critical distinction because expenditure on entitlements is mandated by law, whereas other expenditures such as expenditure on the environment, police or transport infrastructure, are governed by budgets and annual appropriations. Put simply changes in entitlements expenditures will be determined by the number of eligible beneficiaries, and perhaps indexation, not annual budget deliberations. With growing and ageing populations it is not surprising that entitlements now account for a much larger share of public expenditures than they did thirty or even ten years ago. Some jurisdictions have labelled them as uncontrollable expenditures because they are not managed through the normal budget process. They can of course be controlled through legislative change. However, this is difficult to do in most jurisdictions. Entitlements are mostly cash benefits and cutting them is a transparent income cut.

Given this evolution of expenditures it will come as no surprise that economists have devoted considerable effort to understanding the growth of government over time and whether government and the market find an approximate equilibrium in modern mixed economies.

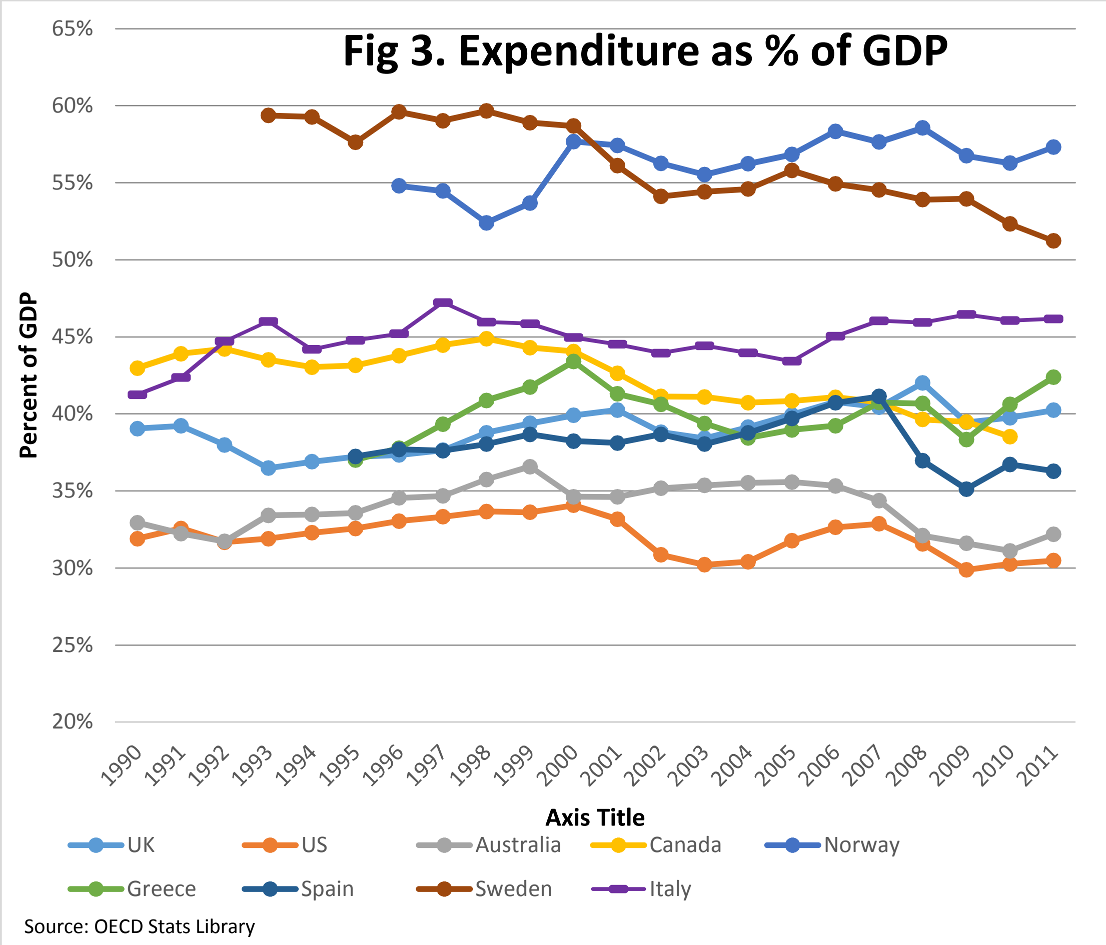
In this presentation I will focus on the size issue as opposed to the various explanations for the growth of government.

If we are going to consider size, a size measure is required. Tax revenue and public expenditures as a per cent of GDP are both relevant. Trends in government tax revenue as a share of GDP is shown in Fig 2 for a selection of successful mixed economies. The spread is around 25% to 30% yet all, from Norway at the top and the US at the bottom are acknowledged long term successful economies. Australia is comparable to the US and clearly at the low end.



Expenditure to GDP for a larger group of economies is shown in Fig 3. This is an almost identical picture to that for tax revenue , but of course the expenditure ratio is generally higher because tax is not the only source of finance for expenditures. Again the spread is around 25% to 30%. Again the usual suspects are there – Norway and Sweden at the top, Australia and the US at the low end.

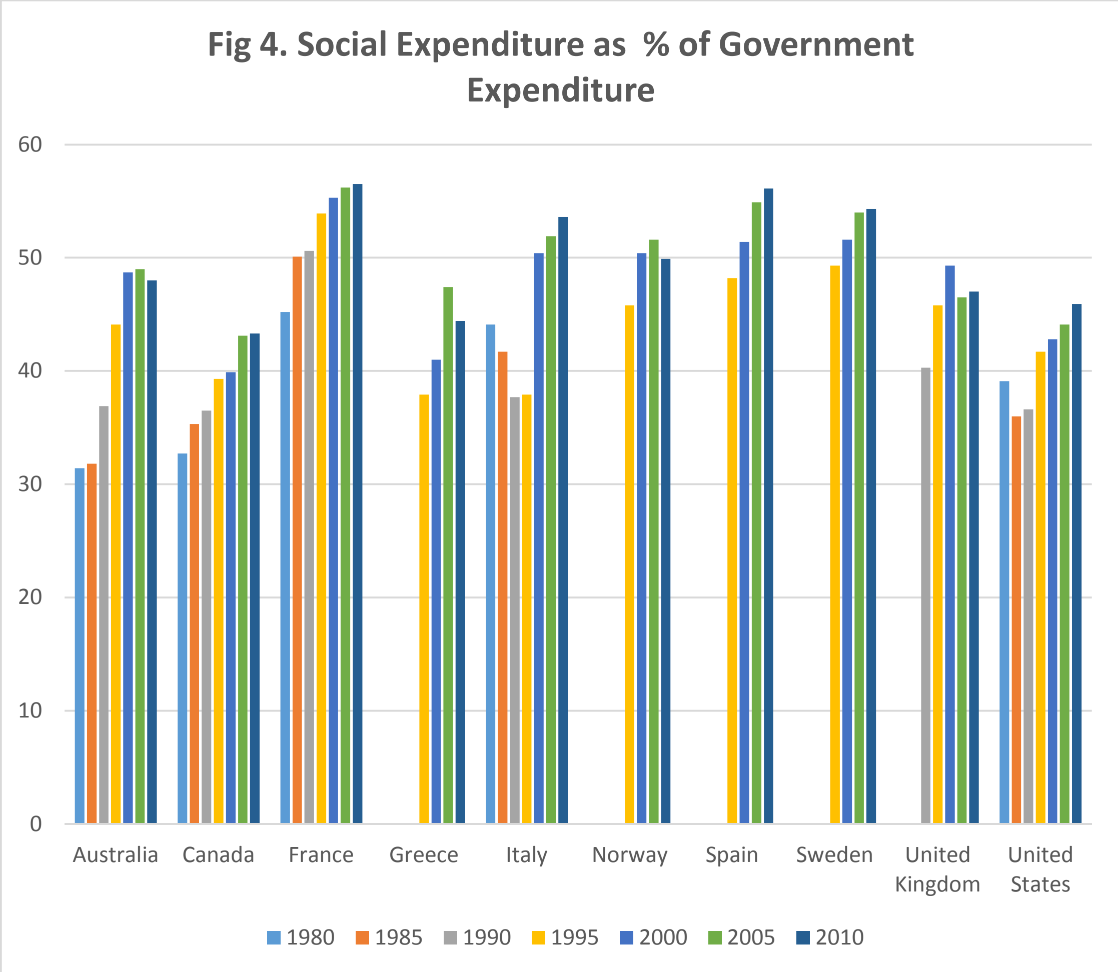
At least on this overview reading, it appears that success is not related to size.



Of particular note in this graph are Italy, Greece and Spain, countries recently characterised, along with Ireland and Portugal, as the PIIGS. Again on a simple size of government measure they do not look noticeably different or out of place.

If overall government expenditures vary across countries but are relatively stable what about social expenditure? Is its shares different or relatively stable?.

Social expenditure as a per cent of government expenditure is shown in Figure 4.



Source: OECD Stats Library

Again what we note is a similar pattern across countries with social and entitlement related expenditure having increased recently in most jurisdictions pushing toward 50% and above. Note the PIIGS are again not particularly noteworthy.

Before moving on to what I believe is the real problem behind these data I would like to briefly consider the role of interest groups on government activities and the influence of size on economic performance.

Citizen versus State

Economic explanations for government expenditures divide broadly into citizen over state and state over citizen models.

Citizen-over-state theories of government size and growth focus on market failure and redistribution. As economies become more complex, especially through urbanisation, citizens demand government programs to deal with market failures – externalities, asymmetric information, public goods and monopoly power. Median voter theories with majority voting have been central to explaining this demand for government provided public goods. In essence it is voters who decide which goods and services the government will provide. By attempting to secure the necessary votes for election politicians, at least at the margin, need to allocate expenditures in ways that will secure the median voter.

An important element of citizen over state models and one which interfaces well with the median voter theory is the idea of changing tastes and preferences. One of the most important ideas here is that over time as economies become more open and competitive, citizens' preferences will support more risk reduction programmes such as generous unemployment benefits or aged pensions that help smooth income over a lifetime. Many of these programmes of necessity take the form of entitlements.

In contrast state over citizen theories posit that the size of government is supply driven rather than demand driven. Government is bigger because it has higher costs and lower productivity, because bureaucratic incentives are for larger government and because the true size of government and taxes can be disguised (known as fiscal illusion) from voters. Hence government can grow independent of the demands of citizens through the structure of incentives facing the bureaucracy and the type of government.

Whichever of these theories we use to encapsulate our understanding of size and growth, the graphs presented indicate that the government share has been remarkably stable in the last few decades.

When you consider the range of countries for which this is broadly the case, we might argue that seeking to define an optimal size for government, one that applies across countries is a fruitless exercise.

Yet to define optimal size for single country alone raises the question of how to define the counterfactual. What for example would Australia look like with a smaller or larger government sector and what would such an outcome mean for overall social welfare?

Whilst countries can learn from each other, put simply Norway is not Australia and Australia is not Norway. Societies need to find the right mix for their individual mixed economies, a mix that reflects their own societal views about the relative merits of government and the market and, perhaps importantly, their own views about what defines fairness and equity.

Nevertheless some respected commentators like Vito Tanzi, former Director of the Fiscal Affairs Department of the International Monetary Fund and Undersecretary for Economy and Finance in the Italian Government, have suggested that there is a 'correct' answer to the size question. In his view optimality is around 30% of GDP. A similar share was recently suggested by the Centre for Independent Studies in its Target 30 publication.

However, these arguments about optimal size often appear more as normative arguments about what should be or as ex post rationalizations applied to particular "preferred" countries rather than analytical assessments of optimal size based on an analysis of the marginal benefits and costs of government size variations.

I would argue that the more interesting question is whether these size variations are important in the sense that they correlate with economic performance. If size is correlated with economic performance then bigger or smaller might actually be better.

Although there is still much debate on this issue, recent evidence is indicative of a negative relationship between government share and economic growth among rich countries, with a higher government share implying a lower growth rate. The order of magnitude is that an increase in government size by 10 percentage points is associated with a 0.5 to 1 per cent lower annual growth rate. However, even this conclusion needs to be treated with some caution. When restricted to rich countries that have a commitment to democracy and economic freedoms based on transparent property rights and laws, the evidence for the negative correlation is weaker.

Moreover, several countries (e.g. Norway) with high taxes/expenditures seem able to enjoy above average growth. Two reasons have been offered for this. First, countries with higher social trust levels are able to develop larger government sectors without harming the economy. Second, countries with larger governments are able to compensate for the consequential high taxes and spending by implementing market-friendly policies (meaning productivity enhancing policies) in other areas.

On balance we do not have an obvious answer to the question of optimal size. Perhaps these approximately stable shares should simply be interpreted broadly as equilibrium shares for the designated countries. If you like government size just is what it is.

If this interpretation is reasonable, why does size of government relative to the market so concern many commentators? Why for example are some commentators asking whether the US is becoming Greece?

Is there as we say an elephant in the room? Arguably yes. Namely the rise in the number and sophistication of interest groups and, potentially at least, the growth of entitlements, threaten to distort both the mix of activities and the balance between expenditure and taxation with negative consequences for both efficiency and equity.

The benign interpretation of interest groups are that they are but one source of the demand for government services to deal with market failure.

The less benign interpretation is that they primarily operate as rent seekers on the demand side and capture parts of the bureaucracy on the supply side.

Interest groups can affect both the size and activities of government. They affect both of these by organizing group members and applying political pressure more effectively than individual citizens. Increasingly rent seeking policy is initiated through public discourse. Successful behaviour in this regard might to have a policy effectively determined before it is able to be thoroughly assessed against any reasonable social welfare criteria.

In simplistic terms, the interest group represents individual voters (or businesses) who have similar policy preferences. The objective of representation is to obtain the desired policy outcome. This delivers direct benefits for the interest group members, but the costs, and there are always opportunity costs, are spread more thinly. In the most general case, direct government expenditure or tax expenditure benefits the specific group but the costs are spread across the entire population of taxpayers.

This disconnect between costs and benefits is critical to the incentive to lobby. It results in inefficient levels of government expenditures—that is, the societal costs of the policy will be greater than the societal benefits. If overall government expenditure is constrained a sub optimal mix of activities results, as competing interest groups effectively play a zero sum game with each other. Potentially more damaging, it may result in increasing net debt as shifting the costs to future taxpayers may be an effective interest group strategy.

Of particular note, while economic theory says little about how interest groups form, many papers have been produced that document both theoretical and empirical evidence for a positive relationship between government size and interest groups.

Much of the focus on interest groups and entitlements has been on the US, where the complexity and scale of the federal system invites this behaviour.

Consider the following example. A recent report by the Congressional Research Service highlights one important aspect of interest group impact – tax expenditures. Tax expenditures are defined in the Congressional Budget Act as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability." As with tax expenditures in most countries, the individual expenditures are small but in aggregate they are significant. In 2008, revenue loss attributable to these tax expenditures in the US totalled $1.2 trillion – larger than the total direct discretionary spending (defence and non-defence combined) of the US government. The tax expenditure for the deduction of mortgage interest was larger than the entire budget for the US Department of Housing and Urban Development (HUD).

Where does this lead us? Well, principally into debt.

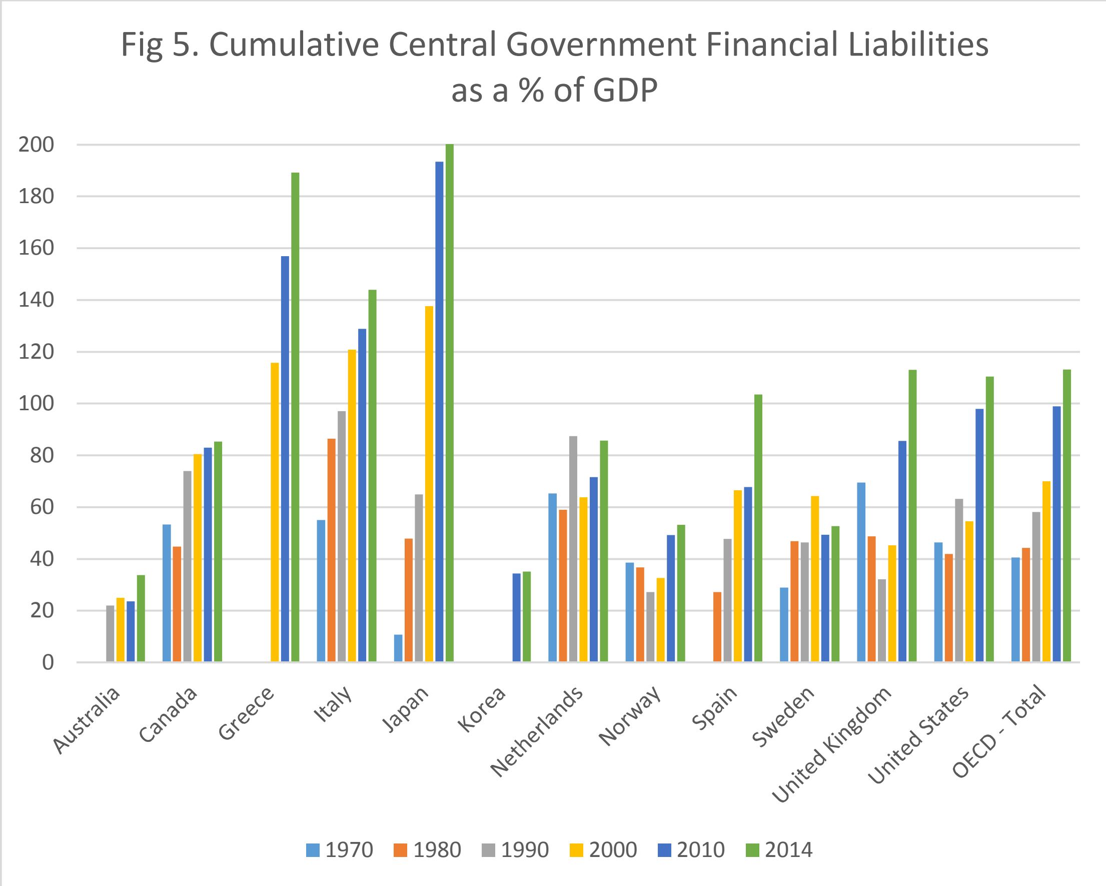
Milton Friedman emphasized expenditure as the critical decision element defining government. The financing of the expenditure is a consequential decision. However, to the extent that government allows entitlements and other government expenditures to become disconnected from tax collections, it raises net debt, constrains future policy and imposes costs on future taxpayers.

Even before the GFC many countries, but not all, had allowed debt to expand dramatically on both an annual and cumulative basis. Figure 5 illustrates this.

In my view it is difficult to escape the conclusion that in some countries the combined effect of interest groups and difficult to control entitlements has resulted in a willingness to expand debt as a first choice policy compared to raising taxes.

Given the data we have presented earlier, it is difficult to see government as the sole source of the problem in Italy, Greece, the US, Japan, Spain or the UK, unless you interpret government in its broadest sense to include the relationship between citizens and the State and the way that this relationship is structured across a range of institutions that generate a systematic incentive for interest groups to rent seek and grow or at least lock in entitlements.

The key problem is that rent seeking behaviour has driven debt not just expenditure - taxes are bad, social expenditure is good.



Source: OECD Stats Library

The ongoing PEW Research Centre surveys of US citizens' attitude toward the economy capture this issue nicely. In the 2010 survey, 70% said the deficit was the most pressing economic issue. Around 75% said that raising taxes, reducing funding to the states, lifting the Medicare contribution were totally unacceptable. 60% said that raising the retirement age, having a national sales tax and eliminating major tax expenditure concessions like mortgage interest were just plain unacceptable. I'm sure you'll be pleased to hear that freezing public sector salaries was OK.

Arguably, apart from Greece, all of the economies in Figure 5 can manage their debt if they are able to better manage the competing claims of citizens and balance them against coherent tax policies. If not, in the long run debt will constrain productive public investment and impose consequential costs on future tax payers.

A look back at the previous data will show that some economies sustain large government size, large social spending and modest debt. Norway and Sweden maintain high taxes and high expenditure and reasonable growth. Australia sustains a much lower government size and a low debt ratio. In all three a key feature is a high trust level in the policy framework that previous studies have shown to be essential for good outcomes. But let me reiterate, Norway is still not Australia.

How does Australia rate in this scenario?

By most measures, not too badly, at least at this point in time.

Compared to most other OECD countries our budget position is decidedly better than all others as indicated in the previous graphs.

Australia places a greater reliance on income based means testing for welfare benefits than all other comparable countries. We have a lower incidence of tax expenditures than most OECD countries.

We also have the most progressive welfare system in the OECD based on the ratio of benefits received by the poorest quintile to the richest quintile.

Up until the late 1990s there was a broad balance between expenditure generating and expenditure saving activities in the budget.

Yet based on Treasury analysis of budget data since 1997/98 changes have been occurring. The expenditure share has grown slightly, but real expenditures have grown significantly since 1997/98, in part because terms of trade improvements have pushed up the nominal value of GDP.

There has been an increase in the number of programmes and their average value.

Savings measures have declined as a percent of total programme measures and the value of savings measures has shrunk.

There has been a shift toward entitlements expenditure. Over the longer period since the early 1970s, spending on social security and health in real terms have grown substantially faster than other areas of Australian Government that include productivity enhancing infrastructure investment.

So, while on balance the broad position looks attractive and positively rosy compared with many countries, Australia is not immune from the same expenditure and budget pressures that have arisen in other countries. But in dealing with them we start from a much stronger position.

Summary

In summary, looking across jurisdictions size of government per se is not the issue. High quality expenditure and tax policies are the key and need to be based on a clear articulation of the appropriate balance between measures that promote productivity and growth and those that promote equity.

In turn this requires clear community held understanding about what constitutes a fair and reasonable society and what is the appropriate role for government in achieving it.

There are some clear pointers in economics.

In addition to the obvious requirement in economics for evidence based policy and the assessment of all expenditure and tax changes with comprehensive benefit cost analysis, there are some clear points emanating from this discussion.

The use of tax expenditures should be minimized.

More specifically, insofar as rent seeking is concerned, the focus should be on uniformity of policy with the corollary of stricter controls on lobbying. Special cases should not be the norm. They should be the exception.

There should be a focus on opportunity cost. This means expenditure decisions should be based around changing priorities on the reallocation of resources and not incremental spending unless commensurate tax changes are implemented. Shifting costs to future generations of taxpayers should not be the norm.

Would this be enough? Or doable? Arguably in Australia, yes. However, for a significant number of other countries (e.g. the PIIGS) the jury is out. Those most at risk of getting the size and mix of government activities wrong are those where the political system is incapable of dealing with these issues, where competing interest groups have a realistic expectation that their demands will be met, preferably with tax expenditures funded by debt.

However, it is not simply a matter of economics. Political governance structures, voting systems and the way that these interact to produce government size and expenditure are central to the debate need to be given more serious consideration. This would I think be an agenda for debate that would very much appeal to Gordon Reid, whose dedication to understanding and improving political systems and public life for the benefit of all Australians is the very reason this lecture exists.

Thank you

References by Gordon Reid

Reid, G. The Politics of Financial Control: the Role of the House of Commons. London: Hutchinson, 1966.