

HOW TO DOUBLE GOVERNMENT SPENDING IN 10 YEARS

Policy initiatives are a major driver of increased government spending, and resisting them is key to getting spending under control, writes **Robert Carling**

In the last 10 years, Commonwealth government spending has nearly doubled to \$350 billion in 2010–11. This expansion has far outstripped the rate of inflation, resulting in a real increase of almost 50%, which in turn has outstripped growth in the population (17%) and the size of the economy as measured by Gross Domestic Product (35%).¹

Spending surged as a result of the fiscal stimulus measures of 2008 and 2009, but it was growing briskly even before the stimulus was applied. The Rudd government took fiscal profligacy to a level not seen since the early 1970s, but didn't invent it. The Commonwealth government has been on a spending spree for a long time. Doubtless this behaviour has led to waste, but the spend-up appeared to be financially sustainable at least for a time. Now the chickens have come home to roost, with a deficit that is too large for the prevailing economic conditions and a tax burden that is set to resume its long-term upward trend after taking a breather in recent years.

There is a vast amount of literature on the theories of government growth.² This article is less concerned with those theories than with analysing how the Commonwealth came to

double its spending in 10 years, and with drawing policy lessons for the future. Any decade, or indeed a longer period, would serve as a basis for study, as the growth of government intervention through taxation, expenditure and regulation is a long-term trend. The most recent decade, however, is more relevant to current circumstances, and it stands out as a period of the fastest real growth in Commonwealth spending since the 1970s.³

(Mis)managing government spending

Governments often talk about spending 'cuts,' but the reality is that while spending on particular programs may sometimes shrink or even be eliminated, total government spending never falls other than in the most exceptional circumstances such as the aftermath of a major war. Certainly in the last 40 years, Commonwealth spending has never fallen in

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nominal dollar terms. Even in real (inflation-adjusted) terms, it has fallen in just three years out of 40—most recently in 1988–89. But there have been large variations in the growth rates of spending—in the last 10 years, for example—from as high as 16% to as low as 4% in nominal terms, and from 13% to 1% in real terms.

The more passionate believers in smaller government would like to see absolute reductions in nominal dollar spending, and there may well be a case for that at current bloated levels of spending. But in practice, in the past managing government spending has meant managing its growth rate. ‘Cuts’ are only made relative to a rising benchmark. Whether the objective is to eliminate the deficit or create fiscal space for tax cuts, a great deal can be achieved by managing the growth rate of spending even if absolute cuts are off limits for political reasons. Cutting the level of spending is the fastest way to smaller government, but cutting the growth of spending can achieve the same end, albeit more slowly.

In the last 10 years, the growth of spending has not been managed well, as a result of which the Commonwealth budget has gone from a small surplus to a sizeable deficit, and there is upward pressure on the tax burden. Lowering the growth rate of spending and keeping it low for a number of years can produce large dividends. If Commonwealth spending had grown just one percentage point per year less over the past 10 years and nothing else had changed, spending would have been \$32 billion lower last year than it actually was. The deficit would have been that much smaller or taxes that much lower, yet real spending would still have grown at a similar rate to the economy and twice as fast as the population.⁴

The Gillard government plans to balance the budget and achieve a small surplus over the next few years in part through a large increase in tax revenue but also through curbs in the growth of spending. The latest budget envisages five consecutive years during which the growth of spending in nominal and real terms will average the lowest rates recorded in any of the past

10 years. Whether such restraint actually materialises is another matter, but it serves to illustrate the leverage governments have over the fiscal bottom line and the tax burden through their capacity to vary the growth rate of spending. The key question is how easy or difficult is it to reduce the growth of spending in practice, and I plan to illustrate this with reference to the experience of the past 10 years and to the sources of growth in spending over that period.

Government spending, inflation and economic growth

Shortly after the change of government from Coalition to Labor in 2007, the Commonwealth Treasury published a study of trends in Commonwealth spending.⁵ Focusing on the years 1997–98 to 2007–08, this study was a thinly veiled critique of expenditure management by the Howard government. Little did the Treasury know what was to happen under the new government, but even so it found enough in the defeated government’s record to be unusually pointed in its criticism, at least by the standards of a published departmental paper.

In the past managing government spending has meant managing its growth rate.

The most commonly used measure of the relative size of government is expenditure as a percentage of GDP. In the 10 years to 2010–11 this percentage hardly budged, from 25 to 25.2. Government’s share of the economy didn’t shrink, but at least it didn’t expand significantly either, making the growth of spending appear benign. One of the key points of Treasury’s 2008 analysis was to expose this as a myth. It criticised the usefulness of the expenditure/GDP ratio in circumstances of large shifts in the terms of trade (ratio of export prices received to import prices paid), which cause inflation as measured by the GDP deflator to diverge from inflation as measured by the Consumer Price Index (CPI). The historic uplift in Australia’s terms of trade in recent years has

caused the GDP deflator (which includes export prices) to increase significantly more than the CPI (which does not). In such circumstances, the expenditure/GDP ratio masks the increase in real government spending and the underlying size of government, and Treasury advocated adjusting nominal spending for inflation using the CPI—a measure it said ‘more effectively represents the government’s call on real resources.’ Commonwealth budgets have emphasised CPI-adjusted growth rates of spending since 2008.

From 2003–04, which is when the uplift in the terms of trade began, spending growth adjusted by the GDP deflator averaged 3.1%, while growth adjusted by the CPI averaged 4.5%. This gap results in a large cumulative difference after eight years. On the first measure, spending did not significantly exceed economic growth, but on the second measure it did so by a wide margin. Table 1 takes a long-term view, showing the decade averages for CPI-adjusted spending growth over the past 40 years, and comparing them with average real GDP growth. The 1970s saw spending grow well in excess of GDP, followed by two decades of relative restraint, and then a resurgence in the 2000s.

Table 1: Real growth in Commonwealth spending and GDP

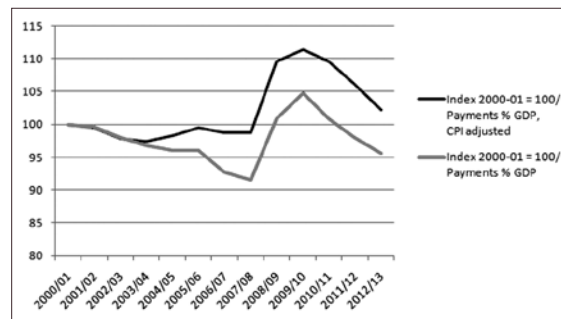
Average annual real growth (%)		
Ten years to:	Commonwealth spending	GDP
1980–81	6.0	2.9
1990–91	2.7	3.1
2000–01	3.4	3.6
2010–11	4.0	3.1

Sources: Commonwealth Budget Paper No. 1, Statement 10 (2011–12), 10–6; Australian Bureau of Statistics, Australian National Accounts, Cat. No. 5206.0.

For those who prefer government expenditure/GDP ratios, it is possible to construct a synthetic series, expressing nominal government spending as a percentage of GDP inflated by the CPI instead of the GDP deflator. The Treasury did this in its 2008 analysis of trends. Figure 1 replicates those results and updates them to 2010–11 (actual) and 2012–13 (as projected in the Commonwealth budget).

Figure 1 shows that the unadjusted spending/GDP ratio in 2010–11 was the same as 10 years earlier, and is projected to fall in the next two years. By stark contrast, the more meaningful synthetic ratio was still close to a 10-year peak in 2010–11, well above its level through most of the decade, and although projected to decline in the next two years it will remain above the level of 2000–01.

Figure 1: Commonwealth payments as a % of GDP 2000–01 to 2012–13



Sources: Commonwealth Budget Paper No. 1 (2011–12), Statement 10, 10–6; Australian Bureau of Statistics, Australian National Accounts, Cat. No. 5206.0.

It is illuminating to examine the cumulative difference that alternative growth paths for Commonwealth spending over the last decade would have made to the level of spending by the end of the period. Table 2 shows these cumulative differences under various scenarios.

Table 2: Savings under different spending growth patterns

Real spending growth over 10 years:	Spending in 2010–11 lower by:
Equal to real GDP growth	\$30 billion
2% (the cap under current government policy)	\$61 billion
Equal to population growth	\$75 billion
Zero real growth	\$112 billion

The amounts are staggering, considering that they are the potential expenditure savings *per year* after 10 years of restraint under the various scenarios, not the sum of annual savings over 10 years. Such amounts would clearly have provided the key to major tax cuts. But to turn this arithmetic into something more relevant to policy, we must examine how Commonwealth spending grew at a 4% real rate for 10 years, and how easy or difficult it would be to curb growth.

Spending on the same old things versus spending on new things

One key to analysing the sources of spending growth is the distinction between growth resulting from policy activism—in the form of new spending or saving initiatives—and growth resulting from the rising cost of existing programs. The more spending that comes from policy activism, the more flexibility governments have to curb spending growth by not doing new things. In principle, the same spending can be avoided either by cutting existing programs or by not doing new things, but it is politically more difficult to take away a benefit that already exists than to avoid giving new benefits. This is a political reality; it is not to say that existing programs should be protected from scrutiny or that savings cannot be made from them.

The startling fact is that most of the growth in spending comes not automatically from the rising cost of existing programs but from government activism in taking costly new initiatives. Government budgets are not just passive victims of demographic and other forces driving up the cost of services and programs.

The rapid growth of spending is largely of government’s own doing. For the growth rate of spending to be reduced and kept down for a long period, government will need to change its entrenched ways. Government will need to curb its activism or become much more active in finding savings in existing programs year after year.

The 2008 Treasury study referred to above analyses the results of policy activism from 1997–98 to 2007–08 in great detail. It showed that the number of policy changes (or ‘budget measures’) made each year increased from fewer than 400 in the late 1990s to more than 700 after 10 years. In the 10 years to 2007–08, there were more than 6,000 policy measures, with price tags ranging from the thousands to the billions. This includes saving measures, but these were always in the minority and had fallen to a miniscule proportion of total measures by the end of the period, both in number and in value. Not only was the number of new spending initiatives high, the proportion of ‘big ticket’ items increased over time.

As a result of this frenzy of policy activism, by 2007–08 the cumulative cost of spending measures (net of savings measures) since 2000–01 was \$44 billion per year. With this impact included, total Commonwealth spending grew by 6% per year; without it, the growth would have been half that. Thus, according to the Treasury, policy activism contributed 3 percentage points to spending growth, which represented nearly all of the real growth in those seven years. Given this, can anyone really claim that containing the growth of government spending is any more difficult than containing political urges?

Unfortunately, the Treasury study has not been updated since 2008, and it is difficult to replicate its methodology. My own study of the last 10 budgets does, however, come up with a similar conclusion for the 10 years to 2010–11: new initiatives contributed almost 3 percentage points per year to total spending growth, although this contribution represented a smaller proportion of total spending growth, which accelerated to a 10-year average of 7%. This suggest that if the Howard, Rudd and Gillard governments

had done nothing to change policies since 2000–01—no new programs, no new benefits or discretionary increases in benefits, and no savings measures—real spending growth would have averaged slightly more than 1% per year instead of the 4% actually recorded. With growth of only 1%, real per capita spending would have fallen slightly. This is a striking finding: leave things alone, and real spending per capita actually falls. After 10 years under that scenario, Commonwealth spending would have been \$85 billion lighter in 2010–11.

Government activism accounted for more than half the real growth in spending.

The other side of that finding is that government activism accounted for more than half the real growth in spending. This was the net effect of new policy initiatives and offsetting savings measures. New policy initiatives are too numerous to list, but by example they include measures such as increased family tax benefits, the baby bonus, paid parental leave, child care benefits, increases in pensions above automatic indexation, increased foreign aid, and the various tranches of stimulus spending announced in 2008 and 2009. Such actions by governments from both sides of politics contributed almost 3 of the 4 percentage points in average real spending growth.

One lesson is that if the deficit is to be closed and/or room created for net cuts in taxation (as distinct from revenue-neutral tax reform), governments will need to be less active in devising new ways of spending money, or become much more active in finding offsetting expenditure savings. If new spending initiatives continue to be taken at the rate of the last 10 years and savings measures remain as timid as they have been, Commonwealth finances will be on a path to much higher debt burdens or tax burdens or both. Governments of both persuasions will need to resist the political temptation and sectional pressures to keep piling new initiatives on top of new initiatives.

It is not that governments should never take policy decisions that require spending more money. Such decisions are sometimes unavoidable or have a compelling justification. As the country becomes richer through productivity growth, it is normal for some of the productivity dividend to be spent on new public goods and social services. But over the last 10 years, despite the pronounced weakening in productivity growth, government spending has continued growing—and even accelerated—as if we were still in a productivity boom. It has been sustained only by the terms of trade gain.

In the 2011 federal budget, gross expenditure savings measures were small in aggregate and on their own do not deserve to be characterised as ‘tough.’ But what gives the budget some claim to toughness is the leanness of new spending measures. The net effect of new spending and savings is close to zero, which is ‘tough’ by the standards of the last 10 years. This is how the government plans to keep real growth in spending below 1% for three consecutive years. If it manages to do that, those three years will be the leanest for federal spending since the late 1980s. But to achieve that result, it will need to keep the lid on new spending measures not just this year but for several years in a row, which will require a fundamental change in political behaviour.

How much government spending is enough?

As a theoretical proposition, all the growth in spending that has occurred could be warranted, in the sense that it results in economic or social benefits in excess of the costs of funding it. In practice, this is hardly likely to be the case.

Anecdotal evidence of waste and ineffectiveness in government spending is well known, particularly in the context of the stimulus spending. Even if one accepts the proposition—which is subject to dispute—that increased government spending in a recession does not ‘crowd out’ private spending, wasteful and ineffective public spending comes with an opportunity cost in the form of the higher return that could have been obtained from alternative uses of the resources consumed.

In normal conditions, public spending does ‘crowd out’ private sector spending through taxation, interest rate, exchange rate, and other mechanisms. The economic cost of taxation is not confined to the tax dollars raised, as there is an additional ‘excess burden’ cost resulting from changes in taxpayer behaviour in response to taxes. Compliance costs magnify the economic costs. On average, each tax dollar raised imposes an economic cost of more than one dollar, and at the margin the cost per dollar of additional revenue raised is larger still. This means that incremental government spending must be of very high quality in economic or social terms to justify the tax cost. The higher the levels of government spending and tax revenue, the harder it is to justify further expansion.

Economists debate the appropriate size of government within this framework. As with many economic issues, there is no agreement, but there is a large body of opinion that as government intervention and expenditure have broadened and deepened in developed countries such as Australia, the benefits have diminished while the tax costs have risen. This means not only that the quality of the spending base is deficient, but that new spending initiatives that add to the base are even more likely to be of low quality, particularly in a period of rapid spending growth. The problem is worse in some other developed countries, where government spending represents higher shares of the economy than in Australia.

Implications for policy

Without a change in political behaviour or institutions, we should expect more of the same in the future—more new spending initiatives, a timid approach to savings, and upward pressure on taxes and borrowings. As the government’s intergenerational reports make clear, demographic change will generate additional spending pressures and drive up the cost of existing programs at a higher rate than in the past.⁶

Changes in political behaviour are required both from governments and the governed. Voters have a right to expect governments to do what they do with efficiency, economy and effectiveness, but they will need to expect and

demand less in the breadth of government intervention if they are unwilling to bear a rising tax burden. For their part, governments need to see political success as the reward for doing things well rather than doing more and more. In the prevailing mindset, bringing down a budget that proposes no new spending initiatives is unthinkable, but it should become the new benchmark.

Seen from another perspective, expenditure policies ultimately determine the required tax burden, but cause and effect can also work the other way; tax policies help determine the level of expenditure that can be responsibly financed. The latter is consistent with the ‘starve the beast’ view of government size, which holds that the best way to curb expenditure is to cut taxes, even if this involves taking risks with the deficit in the process. The policies of Ronald Reagan and George W Bush in the United States are often characterised in this way, but have given the ‘starve the beast’ doctrine a bad name because their policies contributed to chronic deficits without shrinking the size of government. That outcome is at least partly due to the divided structure of US government.

Starving the beast may have a better chance of success in the Australian system.

Starving the beast may have a better chance of success in the Australian system. Governments could be bolder than they ever have been in committing to a program of tax reduction over a long period, which would help limit possibilities for new spending. If the Howard government, for example, had embarked upon a long-term program of tax reduction much earlier in its term, it could have spent much less while still running surpluses. For any of this to happen, however, the leadership of both government and opposition will need to give greater recognition to the intellectual case for a lower tax burden and put it at the centre of their policy platforms. Such recognition is conspicuously lacking in the current political contest. Not surprisingly, when tax cuts are thrown into the ring the

electorate views them cynically as election-time bait. The economic, social and moral case for a lighter tax burden gets little attention.

Fiscal policy rules can also play a part in limiting expenditure growth. In the second half of the 1980s, the Hawke government's 'fiscal trilogy' of rules for outlays, tax revenue, and the deficit helped produce the largest cuts in Commonwealth real spending in the last 40 years. The current government has a rule that caps growth in real spending to 2% per year until the budget returns to surplus. Although not particularly ambitious, even this rule would improve the long-term prospects for responsible fiscal policy with a lower tax burden if it were made permanent. A return to surplus should not be the signal for constraints on spending to be relaxed.

Another powerful fiscal rule, if adhered to, would be one that requires every new spending initiative to be offset by an equivalent saving from existing program. This would force political minds to focus much more strongly on priorities and expose both new and existing programs to closer scrutiny. If such a rule had been in force over the last 10 years, real spending growth would have been less than half of what it was. Fiscal rules are a form of self-discipline and are not enforceable in a legal sense, but they are meant to strengthen political commitment to a pre-determined course of action, and to raise the political cost of deviating from it. The experience of countries using fiscal rules is that they can be effective in strengthening fiscal discipline.

Institutional change would help bring about greater scrutiny and review. At present, the key review mechanisms are largely within the executive government: departments, Cabinet and the Expenditure Review Committee. The experience of parliamentary estimates committees and other committees suggests that they are not a strong enough counter to the power of executive government in their role as part of the review and approval processes for expenditure.

The time is ripe for an independent fiscal agency that would, among other functions, scrutinise both existing programs and new spending proposals, and make public assessments of their benefits and costs. Elsewhere Stephen

Kirchner and I have advocated an independent fiscal commission that would have this function.⁷ It should be emphasised that cost-benefit analysis of spending proposals is an activity that goes well beyond the more familiar one of costing parties' election promises, which is a narrow accounting exercise. An independent fiscal agency would play a similar role to the Tariff Board and its successors in exposing the economy-wide costs of industry protection and assistance in the past.

These are some ideas for change that would improve the prospects for government expenditure restraint. No doubt there are many more possibilities.

Conclusion

Commonwealth government spending has just completed another decade of strong real growth. The average quality of spending has most likely diminished, and the economic costs of the taxes needed to pay for it exceed the benefits. Most of the growth has come not from the rising cost of inherited programs carried forward, but from new spending initiatives. In the future, the cost of programs carried forward is likely to increase at a faster rate due to demographic change, making expenditure management more challenging.

This means that unless governments refrain from taking new spending initiatives at the same rate as in the past, as well as making savings in existing programs carried forward, there is likely to be upward pressure on deficits and taxes in the future. The financial consequences of rapid spending growth in the past decade have been muted by the leap in Australia's terms of trade, but that increase will not continue indefinitely and some reversal is likely in the years ahead.

Behavioural changes are needed. Voters need to expect less in the way of new benefits while demanding quality in government spending; governments and oppositions need to emphasise good management of existing programs rather than seek political success through continual expansion of the scope of government. The growth of spending would also be better contained under a regime of relevant fiscal rules, institutional reforms to subject expenditure to greater scrutiny, and a more strategic approach to reducing the tax burden.

Endnotes

- 1 All references to spending, expenditure or outlays refer to actual payments under budget appropriations. They exclude so-called tax expenditures resulting from concessions from benchmark tax policies. Tax expenditures have also increased rapidly during the periods referred to in this article, but are a separate topic of study.
- 2 My CIS colleague Stephen Kirchner recently reviewed the theories of government growth in *Why Does Government Grow?* Policy Monograph 117 (Sydney: The Centre for Independent Studies, 2011).
- 3 Another reason for starting the analysis in 2000–01 is that it was the first year of the Goods and Services Tax (GST) and associated payments to the states. Comparisons with any earlier year would be less meaningful because the arrangements for Commonwealth payments to the states were different.
- 4 Some economists would argue that if the government had spent less, the economy and therefore tax revenue would have been smaller. I am willing to concede that this is possible over short periods of time, but I do not accept it as a longer run proposition. In fact, over the longer run a larger government sector is likely to curb economic growth, not promote it.
- 5 Kirsty Laurie and Jason McDonald, *A Perspective on Trends in Australian Government Spending*, Economic Roundup, Summer 2008 (Canberra: Commonwealth Treasury, March 2008).
- 6 The Treasury, *Intergenerational Report* (Canberra: Commonwealth of Australia, 2007).
- 7 Robert Carling and Stephen Kirchner, *Fiscal Rules for Limited Government: Reforming Australia's Fiscal Responsibility Legislation*, Policy Monograph 98 (Sydney: The Centre for Independent Studies, 2009).