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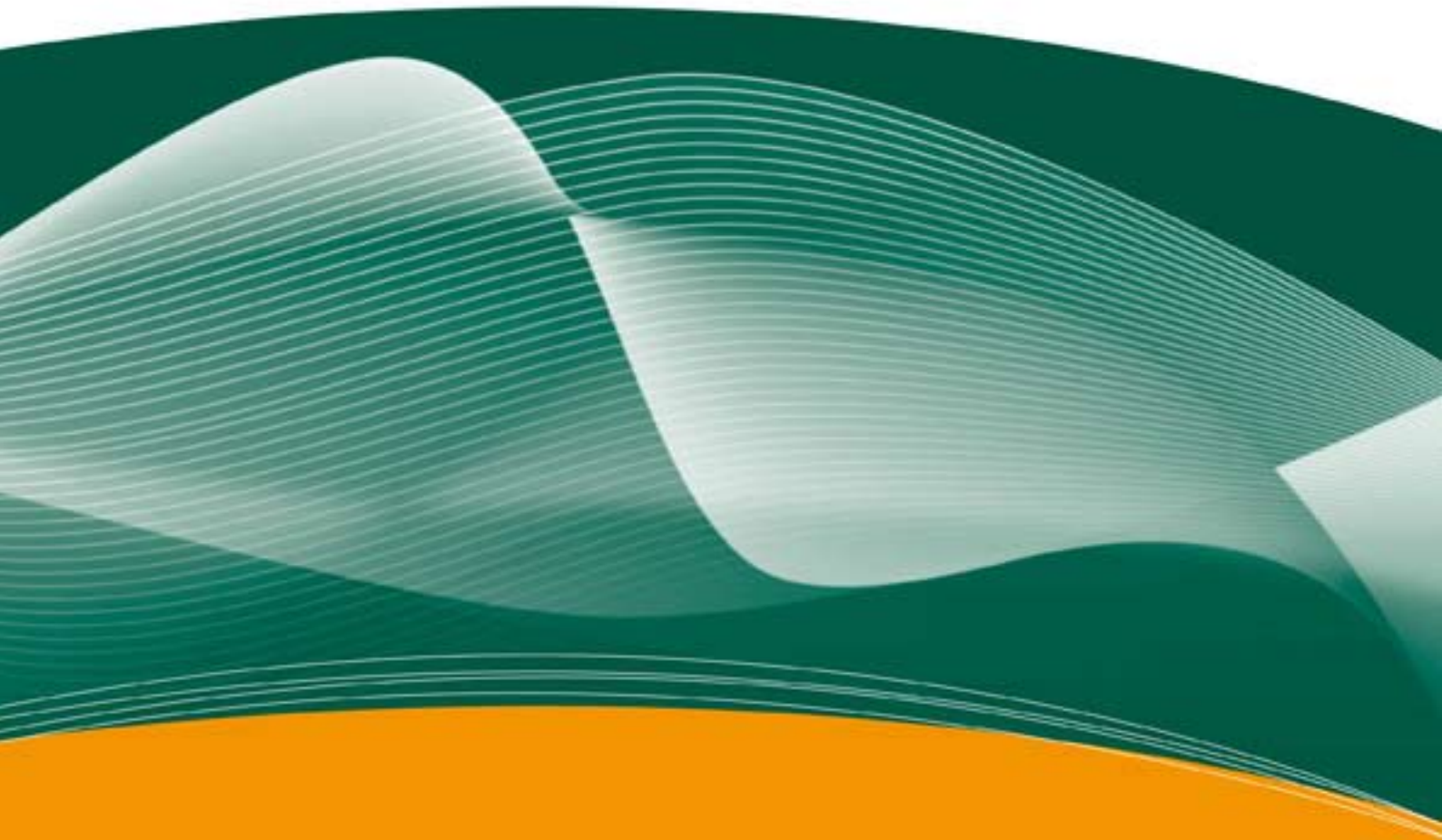
Why Does Government Grow?

Stephen Kirchner



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Why Does Government Grow?

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'The era of big government is over.'

— President Bill Clinton, State of the Union Address, 1995

'Today big government is back with a vengeance: not just as a brute fact, but as a vigorous ideology.'

— *The Economist*, 21 January 2010

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Contents

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Executive Summary

- The size and scope of government has grown considerably since the beginning of the twentieth century in most developed countries.
- The government's spending share of the Australian economy is relatively small by international standards, but Australia nonetheless shares in the international trend towards bigger government since around 1900.
- The growth in the size of government in Australia is subject to relatively little scrutiny or debate.
- Existing theory and evidence provide only partial explanations for the stylised facts about growth in government.
- There are problems in reconciling theories of government growth with theories of government size.
- Many of the theories of government growth are observationally equivalent, making it difficult to distinguish empirically between different hypotheses. These hypotheses also need not be mutually exclusive.
- The relationship between government growth and economic efficiency is more complex than many classical liberals would like to believe.
- There is a robust negative correlation between government size and economic growth, although establishing the direction of causality is a more complex issue.
- Economic growth may slow as countries reach a more advanced stage of economic development that also sees an increase in demand for government, but without a causal connection.
- Growth in government can also drive a search for greater efficiencies on the part of reform-oriented politicians, making government growth more sustainable and increasing the efficient size of government.
- The expected negative relationship between government and economic growth will be weakened to the extent that governments successfully adopt market-oriented policies designed to ease the revenue and other constraints on their expansion.
- Classical liberals have traditionally been concerned with growth in the size of government because of its potentially adverse implications for economic efficiency and living standards.
- However, they also recognise that growth in government can weaken the rule of law and undermine the voluntary relationships that constitute civil society.
- To the extent that classical liberals have mainly focused their advocacy on policies that promote economic efficiency, they may have unwittingly contributed to an induced expansion growth in the size and scope of government by easing the revenue and other constraints on government growth.
- Classical liberals need to locate arguments for more efficient tax and spending policies within a broader framework of advocacy for rules and institutions that promote limited government.
- This broader framework needs to be based on an understanding of the powerful forces driving growth in government.

Introduction

The size and scope of government has grown considerably since the beginning of the twentieth century in most developed countries. The government's spending share of the Australian economy is relatively small by international standards, but Australia nonetheless shares in the international trend towards bigger government since around 1900. As the quotes on the title page suggest, a consensus that was increasingly sceptical of big government in the 1990s has now turned into resignation to a further expansion in the size of government in the wake of the recent global financial crisis.

The growth in the size of government in Australia is subject to relatively little scrutiny or debate. According to former Australian Treasury Secretary Ken Henry, 'the close to 6 percentage points of GDP [gross domestic product] expansion in government expenditure during the Whitlam Government has never been reversed. And I think I can safely say that it never will be.'[1] The Treasury's *2010 Intergenerational Report* (IGR3) projects federal government spending to rise to 27.1% of GDP by 2049–50 on a 'no policy change' basis, which is 4.75 percentage points higher than the low point assumed for 2015–16. At the same time, IGR3 assumes that the federal tax share of GDP remains constant at its 2007–08 level of 23.5% of GDP, consistent with the current government's undertaking not to increase the overall tax burden.[2] The implied fiscal gap of 2.75% of GDP by 2049–50 will need to be closed through either an expansion in the tax share of GDP (contrary to the government's stated policy), a retrenchment of existing and prospective spending commitments, or some combination of the two.

The growth in the size of government in Australia is subject to relatively little scrutiny or debate.

Henry flagged what he views as the more likely outcome in the context of his review of the tax system when he noted that 'the tax system needs to be prepared for the probability that, in order to finance the government-provided goods and services demanded by the community, revenue needs will grow strongly in the longer term ... it would be prudent to plan on the basis that the tax system will, over time, have to generate revenues to meet substantially larger fiscal costs.'[3] Henry maintains that future growth in government will be demand-driven, but leaves unquestioned whether these demands are best met through increased public as opposed to private provision, favouring the former.

This monograph briefly examines some of the trends in relation to the growth of government in the Western world generally, and Australia in particular. The focus is on explaining the growth in government in general, rather than explaining cross-country differences in government size. It then reviews some of the main theories that have been advanced to explain long-term growth in the size of government. Existing theory and evidence provide only partial explanations for the stylised facts about growth in government. There are problems in reconciling theories of government growth with theories of government size. Many of the theories of government growth are observationally equivalent, making it difficult to distinguish empirically between different hypotheses. These hypotheses also need not be mutually exclusive.

This review of theories of government growth raises more questions than answers. However, it will also show that the relationship between government growth and economic efficiency is more complex than many classical liberals would like to believe. There is a robust negative correlation between government size and economic growth, although establishing the direction of causality is a more complex issue.[4] Economic growth may slow as countries reach a more advanced stage of economic development that also sees an increase in demand for government, but without a causal connection. Growth in government can also drive a search for greater efficiencies on the part of reform-oriented politicians, making government growth more sustainable and increasing the efficient size of government. The expected negative relationship between government and economic growth will be weakened to the extent that governments successfully adopt market-oriented policies designed to ease the revenue and other constraints on their expansion. As we shall see, the Henry tax review process and recommendations

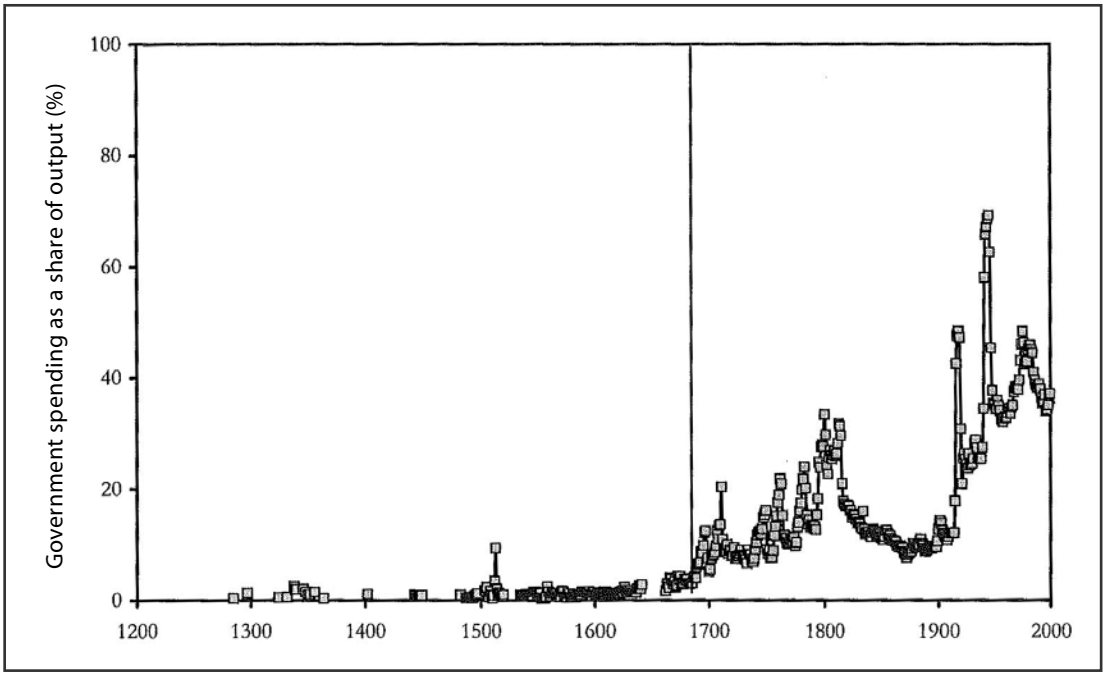
can be interpreted in this light. These efficiency gains have led some social democrats to claim that growth in government has been a 'free lunch.'

Classical liberals have traditionally been concerned with growth in the size of government because of its potentially adverse implications for economic efficiency and living standards. However, they also recognise that growth in government can weaken the rule of law and undermine the voluntary relationships that constitute civil society. To the extent that classical liberals have mainly focused their advocacy on policies that promote economic efficiency, they may have unwittingly contributed to an induced expansion in the size and scope of government by easing the revenue and other constraints on government growth. Classical liberals need to locate arguments for more efficient tax and spending policies within a broader framework of advocacy for rules and institutions that promote limited government. This broader framework needs to be based on an understanding of the powerful forces driving growth in government. This monograph will hopefully promote a better understanding of these forces and some of their implications.

Stylised facts about growth in the size of government

The stylised facts in relation to the growth of government in the Western world are effectively captured in the following chart, showing the government share of output in England from 1285 to 2000.

Figure 1: Government command of output as a percentage of GNP in England (1285–2000)



Source: Greg Clark, *A Farewell to Alms: A Brief Economic History of the World* (Princeton: Princeton University Press (2007), 149.

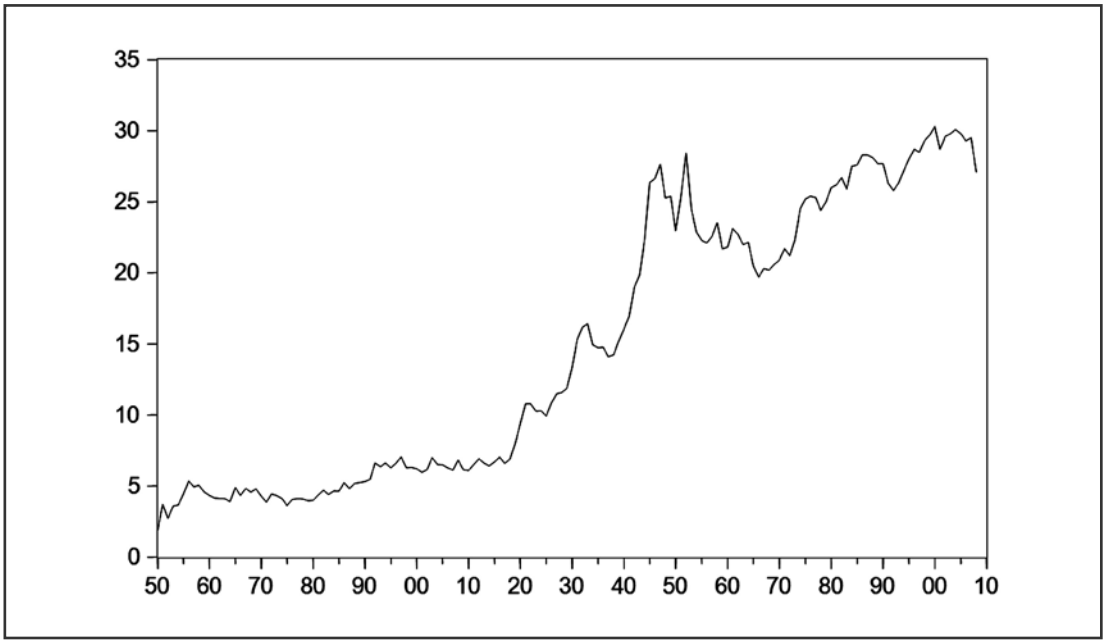
The size of government as a share of the economy has been on a rising trend since the Glorious Revolution of 1688–89, which established Britain as a modern constitutional democracy.[5] International conflicts such as the Napoleonic Wars and World Wars I and II had a ratchet effect, with the government's share of the economy remaining above its pre-War level in the wake of these conflicts. An important exception to this overall trend was the nineteenth century, during which the government's share of national income declined from its Napoleonic Wars peak to levels of more than a century before. The period after 1815 was an era of relative international peace and increased globalisation. The world economy was in some ways more integrated in the late nineteenth century than at any time since, given the general absence of border controls and the considerable international mobility of labour and

capital. However, we will see that globalisation has mixed implications for the size of government. The brief trend to smaller government in the nineteenth century was reversed from around 1900 onwards, aided by the two world wars, the Great Depression, and the rise of the social welfare state in the post-World War II period. The growth of government spending in the twentieth century was documented by Tanzi and Schuknecht, who noted that countries with relatively smaller governments have economically outperformed their bigger government counterparts, without underperforming on a broad range social, environmental and other indicators. This implies that many governments throughout the developed world likely surpassed their efficient or optimal size from around 1960 onwards.[6]

Growth in the size of Australian government

Historical data on Australian public finances are of poor quality and subject to numerous methodological breaks that make meaningful comparisons over time difficult. However, it is possible to derive a reasonably consistent time series for the tax share of GDP for all levels of government since 1850 from various sources (Figure 2). This series ignores non-tax revenue, which is a small share of overall government revenue. The government expenditure share of GDP is more difficult to compile given changes in the way expenditures are classified, but since the government's long-run budget constraint requires that revenue must equal expenditure, the tax share of GDP provides a reasonable proxy for the size of the government's share of the economy over time.

Figure 2: Taxation as a % of GDP: All levels of Australian Government (1850–2008)



Sources: Alan Barnard, 'Government Finance' in Wray Vamplew (ed.), *Australians: Historical Statistics* (Sydney: Fairfax, Syme & Weldon Associates, 1987). OECD.

The stability of the government share of GDP for much of the second half of the nineteenth century is remarkable. Indeed, the tax share of GDP even declined slightly from the mid-1850s until around 1880, consistent with the trend in Britain at the time. Even so, in the half-century leading up to Federation in 1901, the tax share of GDP increased more than threefold from 1.9% to 6%. The size of government was still modest at the time of Federation compared to the five-fold increase in the tax share of GDP over the following century. It is noteworthy that the government's small share of the economy in the nineteenth century did not hinder economic development. Australia was on the frontier of global living standards with a per capita national income in 1850 that was higher than that of the United States and only slightly below that of the United Kingdom. In 1990 prices adjusted

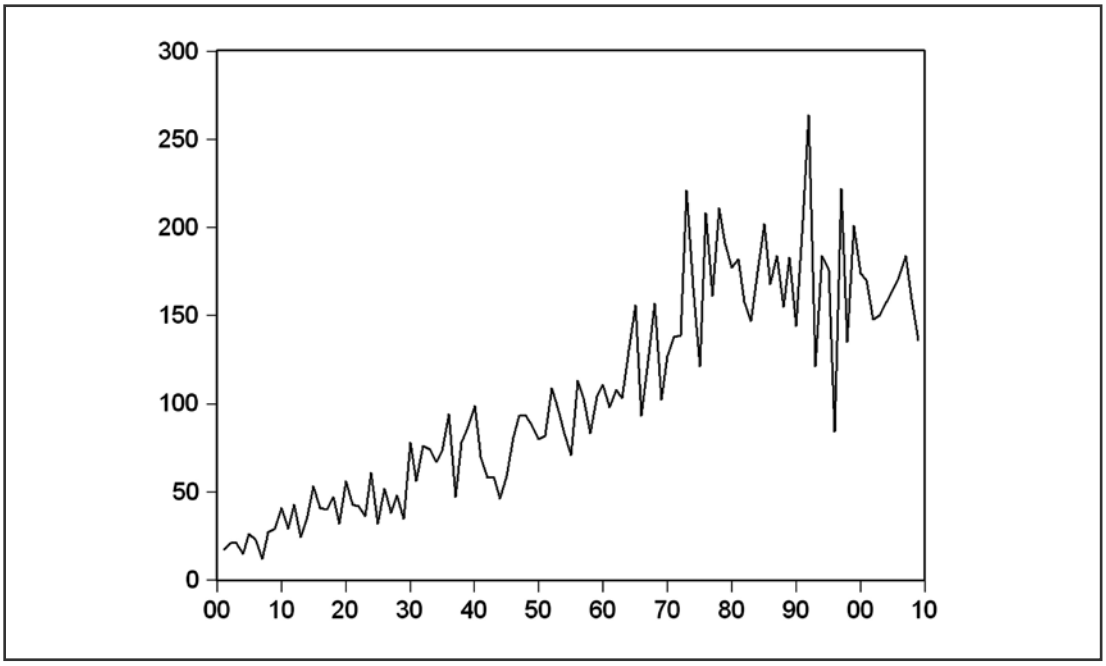
for international purchasing power, Australian real GDP per capita was $1,975 in 1850 compared to $1,807 in the United States and $2,330 in the United Kingdom.[7] By the time of Federation, Australia had fallen behind the United States, but remained comfortably above the average level of real GDP per capita in Western Europe.

The number of pages of legislation has also increased over time, especially since the early 1970s.

An alternative approach to measuring the size and scope of government is to consider growth in legislative outputs. Acts of federal Parliament are among the most important outputs of the political process. New federal government policy initiatives and programs typically require enabling legislation. To that extent, legislation can be viewed as a complement to government spending. However, legislation may also be a substitute for budgetary measures in reallocating resources. Legislative outputs may capture elements of both the size and scope of government activity not otherwise captured by the growth in government spending. The qualitative dimension of legislation is harder to measure, but we can also construct a crude measure of legislative quality.

Figure 3 shows growth in the number of Acts passed by federal Parliament for every calendar year since 1901.

Figure 3: Acts of federal Parliament (1901–2009)

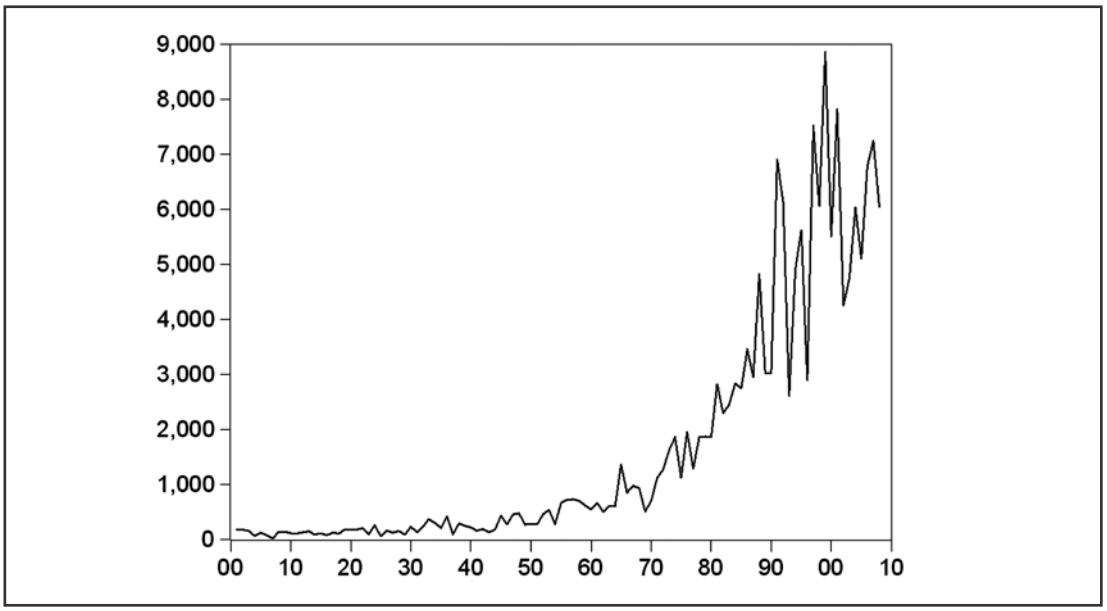


Source: *House of Representatives Practice*, 5th ed. (Parliament of the Commonwealth of Australia, 2005, and as updated in online edition).

The chart shows steady growth in legislative output from 1901 until the early 1970s, before stabilising in a very broad range more recently. It is remarkable how little legislation was required to constitute a working federation after 1901. In 1907, the federal Parliament passed a mere 12 pieces of legislation compared to the record 282 bills enacted in 1992.

The number of pages of legislation has also increased over time, especially since the early 1970s (Figure 4).

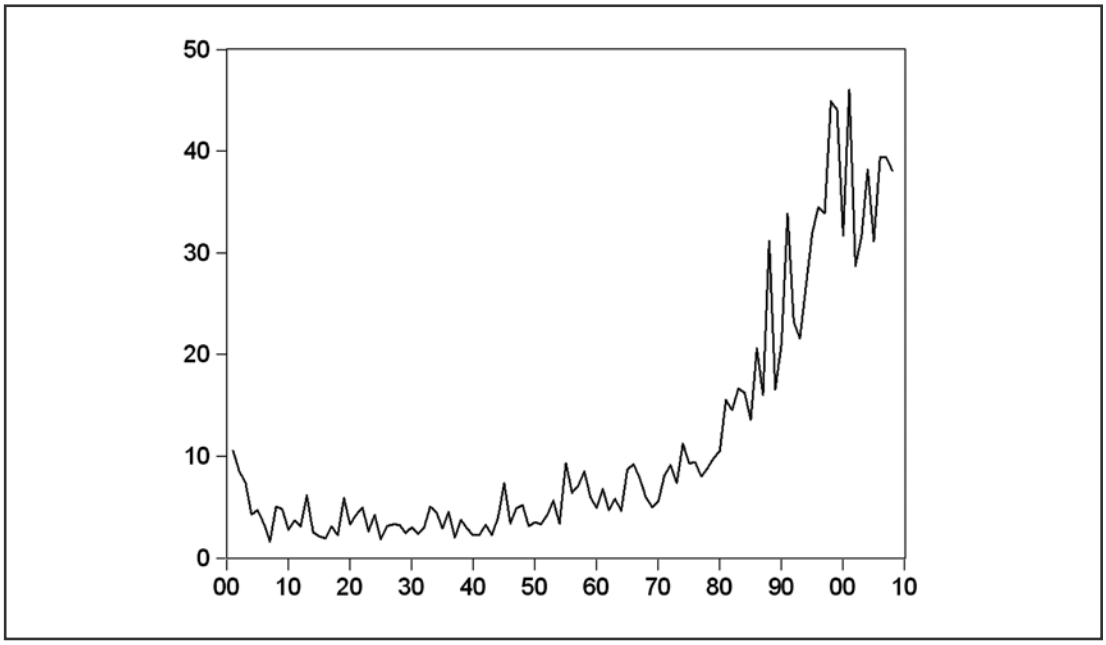
Figure 4: Pages of federal legislation (1901–2008)



Source: Chris Berg, *The Growth of Australia's Regulatory State: Ideology, Accountability and the Mega-Regulators* (Melbourne: Institute of Public Affairs, 2008).

Dividing the number of pages of legislation enacted by the number of acts yields a proxy for legislative complexity, shown in Figure 5.

Figure 5: Legislative Complexity: Average number of pages per Act (1901–2008)



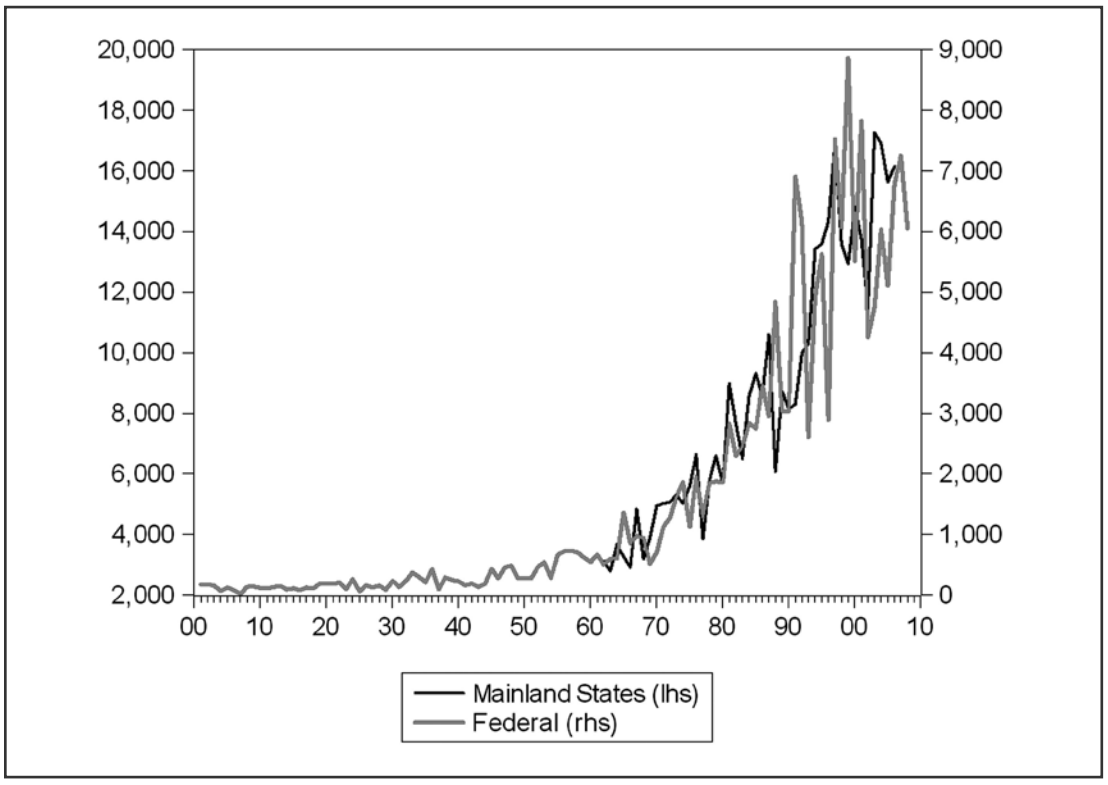
Source: Derived from the previous two series.

The increase in the quantity and complexity of federal legislation points to an expansion in the size and scope of government. It may also be symptomatic of ad hoc decision-making and the unintended consequences of past legislative interventions giving rise to further demands for legislative activism. The rule of law requires that legislation be kept simple and general in application, with infrequent changes to ensure that the law is predictable and certain. The trends reviewed here show that legislation is becoming not only more voluminous, but also more complex and less certain. As Ken Henry noted, growth in tax legislation alone has resulted in a tax system that 'vastly exceeds human scale ... Australia's system now has no fewer than 125 taxes. It turns out that there are more taxes in Australia than there are northern hairy nosed wombats.'[8]

The growth in federal legislative output reflects increased centralisation of power in the hands of the federal government at the expense of other levels of government.

It might be argued that the growth in federal legislative output reflects increased centralisation of power in the hands of the federal government at the expense of other levels of government. Figure 6 plots the total number of pages of federal legislation against the total number of pages of state legislation for all mainland states (New South Wales, Victoria, Queensland, Western Australia, and South Australia) over the period for which comparable data are available.

Figure 6: Total number of pages of federal and state legislation (1901–2008)

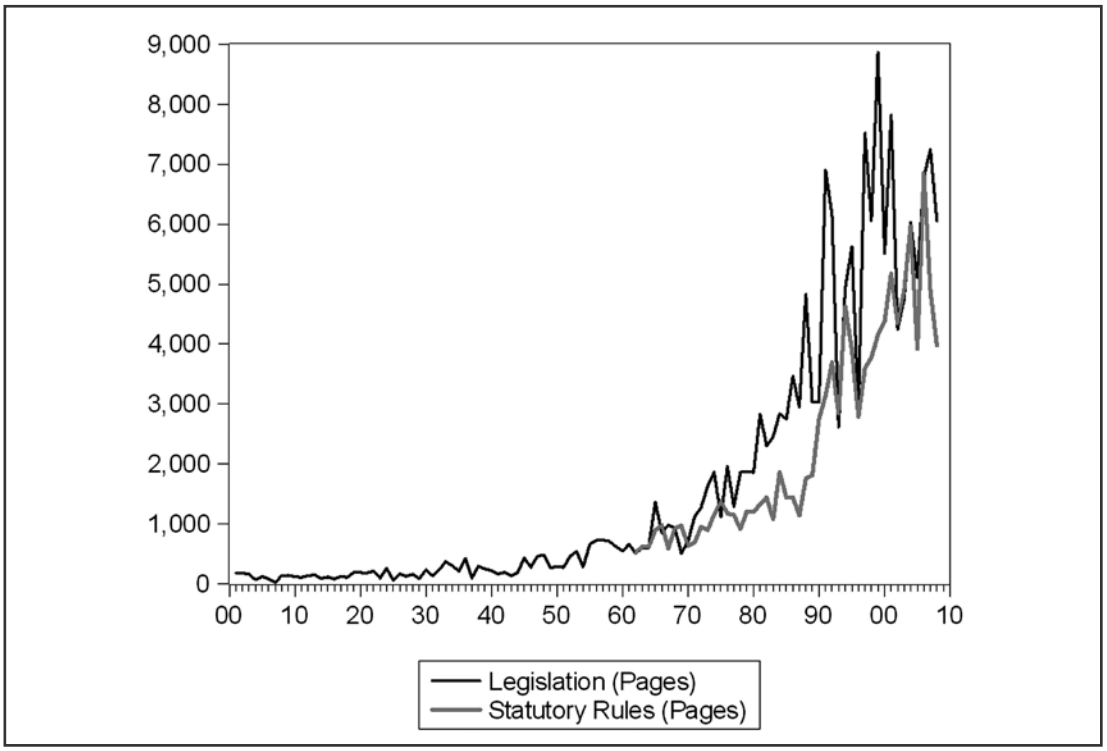


Source: Chris Berg, *The Growth of Australia's Regulatory State: Ideology, Accountability and the Mega-Regulators* (Melbourne: Institute of Public Affairs, 2008).

Federal and state legislative output exhibit similar trends over the period for which data are readily available, suggesting that growth in federal legislation has generally been in addition to, not a substitute for, state legislation.

It might also be argued that legislative instruments are less important than the delegated legislation or the regulations made under those instruments. Figure 7 shows the number of pages of federal statutory rules against the number of pages of federal legislation over time.

Figure 7: Pages of federal legislation and pages of statutory rules (delegated legislation), 1901–2008

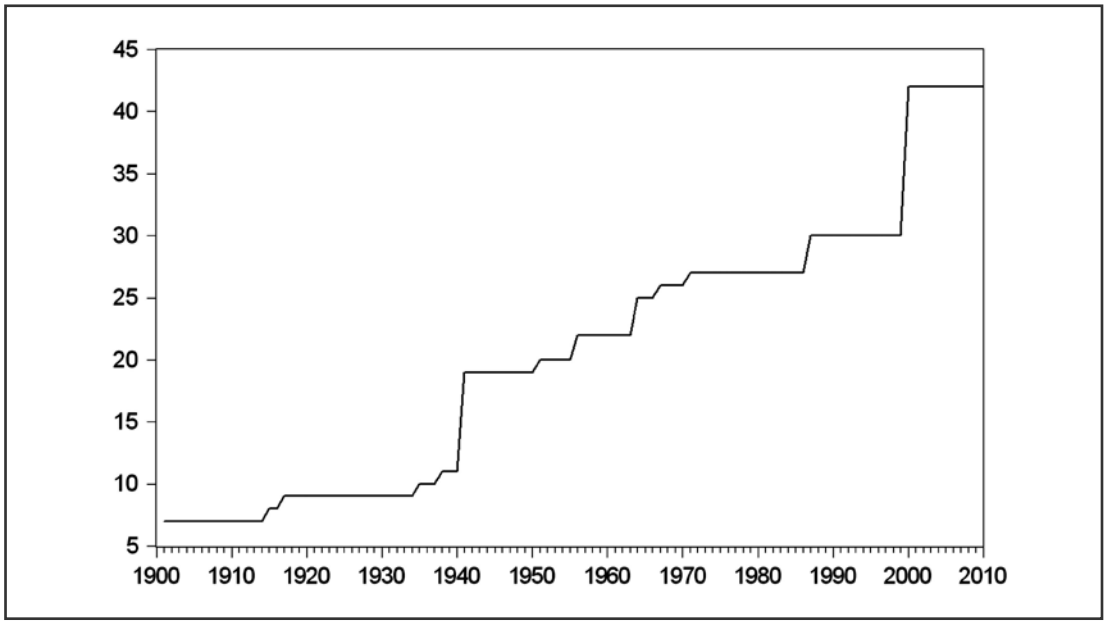


Source: Chris Berg, *The Growth of Australia's Regulatory State: Ideology, Accountability and the Mega-Regulators* (Melbourne: Institute of Public Affairs, 2008).

The growth in statutory rules is broadly in line with growth in the number of pages of legislation under which those rules are made, suggesting that growth in the latter can also proxy for the former.

In addition to these legislative outputs, growth in the size and scope of the federal executive can be measured by the number of ministers of state under sections 64–66 of the Constitution, as determined by statutory variations to the Ministers of State Acts (Figure 8).

Figure 8: Federal ministers of state under sections 64–66 of the Constitution since 1900



Source: *House of Representatives Practice*, 5th ed. (Parliament of the Commonwealth of Australia (2005), Appendix 9.

The first Barton ministry in 1901 consisted of seven portfolios: External Affairs, Attorney-General, Home Affairs, Trade and Customs, Treasury, Defence, and Postmaster General, with Prime Minister Barton holding the external affairs portfolio. There was no need for a 'kitchen cabinet,' since the entire ministry could quite literally meet in an average-sized kitchen. The 42 ministers provided for under the most recent *Ministers of State and Other Legislation Amendment Act 2000* is more than double the 19 ministers under the wartime legislation enacted in 1941, when the federal government ran something close to a command economy. The expansion in the size of the federal ministry is indicative of a growing need for executive and administrative capacity to support federal government programs and policies. The current scope of federal government activities is also illustrated by the 230 separate federal government departments and agencies listed in the current edition of the Commonwealth government directory (see Appendix).

All these measures point to a steady expansion in the size and role of government over time. The next section considers some of the theories that have been advanced to explain the expansion in the size and scope of government in the developed world.

Theories of government growth

The brief review of the stylised facts suggests that any theory of government growth faces a heavy explanatory burden. A complete theory would need to answer the following questions:

- Why did government growth take off throughout the Western world around 1900?
- Why did government continue to grow 110 years later?
- Is there an optimal (that is, economic growth, efficiency or welfare-maximising) size of government?
- Is there an equilibrium size of government (that is, a stable size of government on which countries will tend converge)?
- If there is an optimal or equilibrium size of government, why aren't we there yet? Or are we?

It is generally assumed that the efficient size of government that maximises economic growth or welfare is some positive share of GDP. Government has a role to play in the provision of public goods, lowering transaction costs and solving collective action problems that might otherwise stand in the way of the private sector capturing potential gains from trade. However, modern governments typically take on functions that go well beyond these basic functions by reallocating resources, redistributing income and wealth, and promoting some private activities while suppressing others. Technically, the government share of GDP could exceed 100% if government transfers are re-taxed and re-transferred multiple times, although the efficiency costs of such repeated fiscal churning would be considerable. The efficient size of government will always be a matter for dispute, but very few would be prepared to advocate unlimited government. It is just as incumbent on the advocates of big (or bigger) government to identify the limits to government growth as it is for classical liberals. Otherwise, there is a risk of overshooting what even big government advocates might view as appropriate. It is thus useful to think in terms of the economically efficient (or optimal) size of government and what a long-run equilibrium size of government might look like, even if we cannot identify these conditions very precisely.

The expansion in the size of the federal ministry is indicative of a growing need for executive and administrative capacity to support federal government programs and policies.

The optimal size of government is distinct from the concept of optimal taxation, which seeks to identify the tax structure that will minimise the economic cost of raising revenue taking the overall revenue-raising task as given. As Brennan and Buchanan note, most conventional

analysis of taxation presumes that governments require 'some exogenously determined amount of revenue per period, with the analysis having as its purpose the identification of that taxing arrangement that will generate such revenue most effectively.'[9] The optimal size of government is usually discussed in terms of the revenue share of GDP, which approximates the economy-wide average tax rate. Yet a given average tax share of GDP could be consistent with a wide range of tax structures with very different implications for overall economic efficiency.

It would make sense to address the issues of optimal government size and optimal taxation jointly, but in practice, they are mostly treated separately in public policy debates. For example, the Henry tax review did not address the size of government, taking the expenditure side of the budget and its likely future growth as given. As Brennan and Buchanan note, 'the policy stance that emerges from the conventional treatment, and that is now taken for granted in virtually all professional discussion of tax policy, leads inexorably to broader tax bases and correspondingly larger potential tax revenues.'[10] An important contribution that classical liberals can make to public policy debates is to tie the issue of optimal taxation more closely to the issue of the optimal size of government, stressing that the latter issue is the conceptually prior and more important one.

The efficient size of government will always be a matter for dispute, but very few would be prepared to advocate unlimited government.

Expansion in the size of government may drive a search for greater efficiency in revenue collection but also market-oriented reform more generally, easing the revenue and other resource constraints on the size of government. A more efficient tax structure could conceivably increase the optimal size of government by lowering the economic cost of the overall revenue take. There is evidence to suggest that more efficient tax systems are associated with larger governments, with causality running from tax structure to government size, although it could also be that larger governments adopt more efficient tax systems because these efficiency gains are increasing in the amount of revenue raised.[11] For example, the change in Australia's tax mix with the introduction of a goods and services tax (GST) in 2000 may have induced an increase in government spending by easing the government's revenue constraint. The resources and terms of trade boom since 2003 has had a similar effect in the absence of a change in tax regime, although proposals for a new resources rent tax can also be seen as an attempt to further ease the government's revenue constraint. As Becker and Mulligan note, analysis of the economic gains from tax reform often takes government spending as given and ignores the increased welfare costs arising from the induced expansion in the size of government that may follow from a more efficient tax system. Once the economic costs of induced government spending are taken into account, the supposed efficiency of even lump-sum taxes is called into question.

Buchanan's taxonomy

Buchanan suggests a division of theories of government growth into two broad perspectives: '*government by the people*' (sometimes referred to as *citizen-over-state*) and '*government against the people*' (or *state-over-citizen*).[12] The classical theory of democracy is consistent with the former perspective, which views government as demand-driven, and to that extent, welfare-enhancing. The second perspective suggests that government is supply-driven, serves its own interests, and to that extent is welfare-reducing, at least in aggregate. Public choice theory is often associated with the latter perspective, but rational choice models of collective decision-making straddle both perspectives. Other theories of government growth do not fit neatly into Buchanan's taxonomy. These include *deterministic* or *path dependency* theories, as well as what we will call *zeitgeist* theories. The following sub-sections review some of these theories and their explanatory limitations.

Citizen-over-state

One of the most enduring theories of government growth in the citizen-over-state tradition is 'Wagner's law of increasing state activity,' named after the German socialist economist Adolf Wagner. Wagner wrote in the late 1800s and early 1900s and effectively anticipated the growth in government that followed over the next century. Wagner's law has no definitive formulation, but the basic thesis argues that the demand for government increases with economic development (as proxied by real GDP per capita) and related factors such as industrialisation and urbanisation.[13] The more complex and impersonal society becomes, the greater the demand for collective provision of some goods and services. In empirical studies, Wagner's law is often interpreted as a national income elasticity of growth in government greater than one, thereby accounting for growth in the government share of national income over time as real GDP per capita increases. Despite extensive empirical testing, Wagner's law remains underspecified theoretically. Lindert has characterised 'the notion that income growth will raise taxes and government spending, including social spending [as] the most durable black box in the whole rise-of-the-state literature.'[14]

The more complex and impersonal society becomes, the greater the demand for collective provision of some goods and services.

Tests of Wagner's law have focused on the relationship between government spending or taxation and national income in both cross-sectional and time series settings (see for example, Ram 1987; Easterly and Rebelo 1993; Oxley 1994). Potential endogeneity between government spending, revenue, and economic growth has been a significant complication for empirical work. Durevall and Henrekson's recent review of the literature finds that 35% of studies obtain unqualified support for Wagner's law, 35% fail to find support, while 30% find support conditioning on other variables or specific categories of government spending.[15] Empirical tests of Wagner's law in the Australian context have been inconclusive.[16] My own research shows there is a long-run equilibrium relationship between growth in the Australian legislative output (reviewed in the previous section) and the level of real GDP per capita that is consistent with Wagner's law.[17] While the results from empirical studies are mixed, there is enough evidence for Wagner's law to be taken seriously as a plausible explanation for long-run growth in government. However, we will see that Wagner's law is observationally equivalent with a number of other theories of government growth, making it difficult to distinguish between competing hypotheses.

Also within the citizen-over-state tradition are a number of rational choice and median voter models that view growth in government as driven by voter demands for increased public provision or redistribution. The literature focuses mainly on redistribution, since this has been the main contributor to the growth in the size of government. Growth in government would be difficult to explain empirically if it were mainly concerned with the provision of public goods, which have become an increasingly small share of government spending in most developed economies.[18] Anthony Downs's *An Economic Theory of Democracy* (1957) was an early contribution to this tradition.[19] Downs maintained that government could conceivably be undersupplied relative to voter demands, a proposition more plausible in the late 1950s than it is today.[20] Later contributions in the rational choice-median voter tradition examined interactions between growth in government and median and average incomes, income inequality, and the extension of the electoral franchise.[21] These models maintain that growth in government is the outcome of collective decision-making processes that aggregate individual preferences. Whether these collective choices are welfare-enhancing depends on how efficiently the decision-making process aggregates these preferences. Extensions of Coasean transaction cost economics to the domain of politics suggest that the political process can lead to efficient outcomes.[22] Brennan notes that 'there are ... circumstances ... in which electoral competition operates somewhat like an "invisible hand," both aggregating the interests of the "suppliers" of public policies to give citizen-voters what they want.'[23] This perspective suggests that growth in government may be more conductive to economic and other forms of efficiency than classical liberals would like to concede. However, it should be noted that

most of these rational choice/median voter models depend on restrictive assumptions for their results. As the discussion of *zeitgeist* theories will argue, there are also questions over the extent to which rational choice models provide a good model of political choice.

State-over-citizen

The state-over-citizen tradition is perhaps best exemplified by Franz Oppenheimer's 1908 *The State*, a work of political sociology roughly contemporary with that of Wagner.[24] Oppenheimer had an influence on American libertarianism via the writings of Albert Jay Nock.[25] Oppenheimer saw the evolution of the state as the product of coercion and predation, distinguishing between the economic and political means of sustaining a living, or more colourfully, between 'work and robbery.'[26] While this is a compelling perspective on the initial rise of the state, it is less informative on the long-run drivers of growth in government in modern constitutional democracies.

Mancur Olson maintained that as groups become larger, the disconnect between the interests of the individual and the collective would increase, with small but powerful distributional coalitions coming to dominate the majority interest, undermining economic growth.[27] Olson made an important contribution to the rejection of the traditional view in the political science discipline that interest groups were a benign influence in a democracy. Olson used his model mainly to explain differences in economic performance between countries rather than the generalised growth of government observed in developed economies. For example, Olson thought that the destruction of incumbent interest groups in Germany, France and Japan during World War II explained their economic outperformance in the early post-War period compared to the United States, the United Kingdom and Australia. While this was superficially plausible at the time of writing in the 1960s to early 1980s, subsequent developments have not been kind to Olson's interpretation: Germany, France and Japan have chronically underperformed the Anglo-American economies in recent decades. Later in his career, Olson came to embrace institutional explanations for cross-country differences in economic performance.[28]

The most obvious way in which the economy provides a check on the expansion of the state are the efficiency costs of taxation (or deadweight losses).

While the state necessarily expands at the expense of the economy and civil society, the economy and civil society also impose limits on the expansion of the state. Olson noted that unlike roving bandits, 'stationary bandits' or autocratic rulers needed to limit their predatory activities to leave enough worth stealing in their domain. The most obvious way in which the economy provides a check on the expansion of the state are the efficiency costs of taxation (or deadweight losses). Brennan and Buchanan model government as a revenue-maximising Leviathan subject to constitutional constraints such as federal systems of government, although as they note, a federal system of government can also form a revenue-raising cartel.[29] Tanzi and Schuckneckt's review of the growth in public expenditure during the twentieth century suggests developed country governments exceeded their efficient size during the 1960s at around 20% of GDP.[30] This is also suggested by attempts to estimate econometrically the point at which the government share of the economy begins to subtract from rather than add to economic growth. Studies along these lines for the United States and New Zealand find that the economic growth-maximising size of government is likely to be somewhere in the range of 19% to 23% of GDP.[31] If these estimates are accurate, then most developed country governments have exceeded their optimal size. If governments were concerned mainly with revenue-maximisation, they would choose the tax structure that maximises the size of the economy and thus the tax base. Smaller government as a share of the economy could yield bigger government in an absolute sense through increased revenue, although as noted previously, the induced expansion in the size of government from greater tax efficiency may have ambiguous implications for overall economic efficiency and well-being.

The model of government as a revenue-maximiser offers insight into the growth of the state during the twentieth century. The shift in production out of the household sector and into organised markets due to changes in production technology, the growth in the division of labour, specialisation, and trade has served to expand the potential tax base available to government and eased the governments' revenue constraint. In particular, the growing opportunity cost of household production has seen a dramatic increase in female labour force participation, expanding the tax base as well as government spending on social services such as child care previously supplied by households or in informal markets. In Australia, the female labour force participation rate has increased from 44% in February 1978 to nearly 60% at the end of 2010, driving overall labour force participation to record levels.[32] Kau and Rubin estimate the elasticity of the US tax to GDP ratio to female labour force participation at around 4 for the period from 1920 to 1970, sufficient to account for almost all of the expansion in the size of the US government over this period.[33] Female labour force participation can explain 15% of the increase in the government spending share of GDP in OECD countries between 1960 and 1999.[34] However, this explanation is observationally equivalent with Wagner's law. The increased opportunity cost of self-employment and household production is a feature of economic development that is captured by the relationship between growth in government and growth in real GDP per capita. The increased labour market flexibility sought by classical liberals through their advocacy of labour market reform may have also served to expand the tax base and eased the government's revenue constraint.

The government as revenue-maximiser model helps explain the move to flatter and more efficient tax structures in many developed economies and other market-oriented reforms.

The government as revenue-maximiser model helps explain the move to flatter and more efficient tax structures in many developed economies and other market-oriented reforms. These reforms make growth in government more sustainable by lowering the efficiency costs of taxation and expanding the tax base through increased economic growth, easing the government's revenue constraint. The market-oriented reforms in Australia and New Zealand in the 1980s and 1990s and Sweden in the early 1990s are examples of reform programs that have served to increase the sustainability of their welfare states. As Bergh and Henrekson note, countries with a larger government share of GDP, most notably in Scandinavia, have seen greater increases in measured economic freedom and globalisation between 1970 and 2000. These market-oriented reforms have enhanced economic growth despite the government share of their economies remaining large.[35] Contrary to Becker and Mulligan, Peter Lindert maintains that improvements in tax and spending programs have made growth in government spending in the larger welfare states something of a 'free lunch.'[36] Similarly, David Alexander maintains that Australia combines relatively small government with a redistributive state in a way that makes both more sustainable.[37] The fact that social democratic parties in Australia, New Zealand and elsewhere have presided over microeconomic reform programs becomes readily explicable in this context. As noted in the introduction, Ken Henry sees the need to raise more revenue in absolute terms as an important motivation for his tax review, which was aimed at increasing the efficiency of the tax system. The potential welfare costs of the projected expansion in government activities anticipated by Henry are either assumed away or ignored.

The role of government growth in driving the search for greater economic efficiencies could be expected to weaken the observed negative correlation between government size and economic growth and attempts to test the direction of causality for this relationship. To the extent that governments successfully endogenise their optimal size through their choice of tax and other policies, we would not expect to observe a negative relationship between government size and economic growth, despite the potential for such a relationship. It is unlikely that governments do this consciously or with any degree of precision, but may

through trial and error move in the direction of a more efficient policy mix. Note that there is some observational equivalence with Wagner's law, because the efficiency of the tax system generally increases with economic development, as countries move away from trade taxes to taxes on income and consumption and as agriculture's share of total output declines (agricultural output was historically harder to tax before the development of formal or extensive markets).

The government as revenue maximiser model yields some insights into the growth of government as well as pointing to a long-run equilibrium size of government. Governments that push too hard against their economies risk collapse, as the former Soviet Union found. China's market-oriented reforms since 1978 have sustained and legitimised a government and economy that might otherwise have also collapsed. European Union governments are currently facing severe fiscal constraints likely to lead to sovereign debt defaults under the guise of debt 'restructuring.' Historical experience is that governments will test the limits of their expansion, with some over-stepping the mark, while others successfully reform in ways that make the growth of government more sustainable.

Deterministic and path dependency theories

Deterministic theories of government growth do not fit neatly into Buchanan's for-the-people/against-the-people taxonomy. In this perspective, growth in government is attributable to exogenous factors such as technology, productivity, globalisation, geography, demography, or urbanisation. The historical and economic determinism of Karl Marx maintained that the evolution of the state was a function of the underlying forces of production, and that the state ultimately 'withers away' once it has served its historical purpose. While the governments inspired by Marxism have for the most part withered, they have done so for reasons other than what Marx suggested and have certainly not been replaced with a stateless society. Taking his cue from Marx, Schumpeter foresaw an evolutionary process by which liberal capitalism would inevitably give way to democratic socialism, in part because the successes of capitalism would give rise to an intellectual class hostile to it.[38] Olson's theories, already discussed, had a similarly deterministic 'logic.'

Governments that push too hard against their economies risk collapse, as the former Soviet Union found.

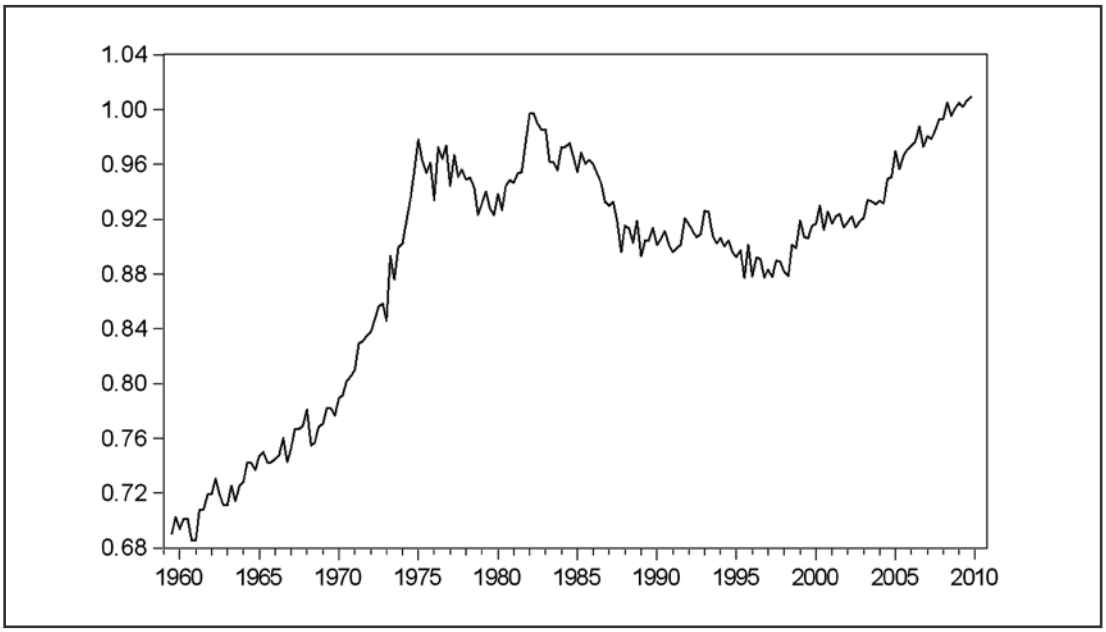
Demographic factors, particularly age dependency ratios, have a role in explaining growth in government. The prospective fiscal imbalance and expansion in the size of government identified in the Australian government's *Intergenerational Reports* are largely driven by population ageing and its effects on government health and other expenditures. The IGR projections assume that the increased demand for ageing-related expenditures will continue to be met through public rather than private provision, effectively foreclosing debate on the projected growth in the size of government. Given that growth in real GDP per capita is usually associated with a decline in fertility and an increase in longevity, it is difficult to distinguish the role of demography from Wagner's law. Some see Wagner's law as driven by demography,[39] but demographic factors can equally be viewed as being subsumed by the overall Wagner's law hypothesis. In Australia's case, with the major exception of the post-War baby boom hump, the share of the population aged 0–16 has generally been declining since Federation, while the share of the population aged 65+ has generally been increasing. The net effect has been for the overall age dependency ratio to decline, but the baby boom hump will see the old age dependency ratio rise in future with implications for growth in the size of government already noted. While the old age dependency ratio is positively correlated with the tax to GDP ratio, this would be true for a wide range of other indicators associated with the level of economic development.

Technology can be a liberating force, but advances in technology have also facilitated the growth of government. A plausible explanation for government growth since 1900 are the improvements in communications and transport that have extended the reach of government

as well as markets.[40] It is difficult to imagine the totalitarian regimes of the twentieth century being quite so total in the absence of modern technology. However, because of the strong correlation between improvements in technology and economic development, this hypothesis is also observationally equivalent with Wagner's law, although it may also provide an explanation for why Wagner's law seems to kick in around 1900, coinciding with major technological advances. Technology may also be difficult to divorce from growth in female labour force participation and its role in easing a government's revenue constraint, since labour-saving appliances in the home have been important in freeing up labour formerly tied to household production.

A related argument in relation to technical progress is 'Baumol's disease,' the idea that the relative price of government services increases over time because of lagging productivity growth in the public sector, which increases the government share of nominal GDP through changes in prices rather than quantities.[41] The ratio of the private and public consumption deflators (measures of price change for private and public consumption expenditure) can be used as a proxy for Baumol's disease. In Australia's case, Baumol's disease seems to have been prevalent from the late 1950s until the mid-1970s (around the time Baumol advanced the idea) but has shown no clear trend since, although it is notable that this ratio declines during the market reform period from the early 1980s to late 1990s (Figure 9). The private consumption deflator also includes a range of prices in sectors such as health and education subject to cost inflation due to inefficient government regulation, so this ratio may understate the extent of Baumol's disease.

Figure 9: Baumol's Disease: Ratio of Public to Private Consumption Deflators Australia, 1959–2010



Source: Australian Bureau of Statistics, National Accounts.

Another deterministic hypothesis is that growth in government is either contained or promoted by globalisation. Increasing globalisation in the nineteenth century expanded the possibilities for jurisdictional arbitrage and international competition, helping contain government growth until this process temporarily collapsed with the two world wars and the Great Depression. This leaves unexplained the continued growth in government in the late twentieth and early twenty-first centuries, despite a recovery in globalisation during this period. Indeed, Rodrik finds that small open economies typically have bigger governments, presumably to help insulate their citizens against the adverse consequences of external economic shocks.[42] Globalisation does not have straightforward implications for government size or growth.

The 'ratchet hypothesis' seems to fit the stylised facts reviewed in the first section in maintaining that governments expand on the back of wars and crises, but fail to fully reverse this expansion in the aftermath of these events. Peacock and Wiseman advanced this hypothesis in the early 1960s with respect to the United Kingdom[43] and Higgs applies the same idea in his review of the growth of government in the United States.[44] The recent global financial crisis may prove to be another of these historical episodes. Yet there have been many cases where war and crises have undermined rather than expanded government. The expansion in government in the United Kingdom and United States in response to World War II also saw the demise of totalitarian regimes in Germany and Japan. From the perspective of those who started it, World War II was a much less successful strategy for expanding the size and reach of government. Moreover, growth in the size of government has been at least, if not more, pronounced in countries that were non-combatants in World War II.[45]

With the exception of Marx's historical materialism, the various deterministic theories of government growth are notable for generally failing to yield firm conclusions about long-run equilibrium outcomes. Demographic factors such as the female labour force participation rate and age dependency ratios are ultimately bounded, so they cannot explain growth in government without limit, just as the efficiency costs of taxation would also lead us to expect growth in government to be limited at some point.

Zeitgeist explanations

Ideas and ideology may be important in driving long-run growth in the size of government. Survey evidence and opinion polls can measure trends in attitudes to government.[46] However, this only pushes the question one step back: what drives these changes in opinion and ideas? There is an obvious endogeneity problem with *zeitgeist* explanations. Do ideas drive growth in big government or do collectivist ideas emerge as a rationalisation of growth in the state? Bilateral causality is also possible. The liberalism of the nineteenth century gave way to an upsurge in socialist ideas that dominated the next century until the classical liberal revival of the late twentieth century, but it is hard to say whether these developments in ideas were causal or merely symptomatic of other trends, including trends in the size of government. *Zeitgeist* explanations are thus to some extent also deterministic theories in the absence of some explanation of what drives the development and propagation of ideas. Marx would argue that ideas are mere expressions of underlying economic forces. Schumpeter perhaps comes closest to fully endogenising a model of growing intellectual hostility to capitalism, which might in turn help explain growth in government.[47] Ideology is an important factor in Higgs's crisis-driven model of government growth, but he is compelled to treat ideology as exogenously determined in the absence of a better model.[48]

Do ideas drive growth in big government or do collectivist ideas emerge as a rationalisation of growth in the state?

Colin Clark published an article in *Economic Journal* in 1945 arguing that a tax share of national income above 25% was inflationary and therefore unsustainable. In his capacity as editor of the journal, John Maynard Keynes wrote to Clark:

> In Great Britain after the war I should guess that your figure of 25 per cent as the maximum tolerable proportion of taxation may be exceedingly near to the truth. I should not be at all surprised if we did not find a further confirmation in our post-war experience of your empirical law.[49]

It is remarkable that during the rest of the twentieth century, governments continued to expand to shares of GDP that were inconceivable even to Keynes, the most famous exponent of government intervention among modern economists. The Clark-Keynes correspondence provides anecdotal support for the view that ideas lag rather than lead growth in government.

Hayek argued that the growth of socialist ideas in the post-War period was partly attributable to a relative lack of intellectual engagement by classical liberals with the wider

public that deals in ideas.[50] Hayek maintained that support for socialism was an intellectual error that could be corrected; he probably did more than any other single figure in the post-War classical liberal revival to expose this error. Yet if socialism is no more than an intellectual error, it is still a remarkably persistent and widespread one. This sits uncomfortably with the assumptions classical liberals would prefer to make about individual rationality. Bryan Caplan relocates the traditional Downsian rational ignorance problem in relation to political knowledge to the realm of ideas in general to explain the prevalence of various anti-market biases.[51] If Caplan is correct, then public attitudes sympathetic to a larger role for government may be hard to shift because people are 'rationally irrational,' although this irrationality can be ameliorated through education, as Hayek would have also argued.

Zeitgeist explanations provide little guidance on future trends in the growth or size of government. Prior to the global financial crisis, collectivist ideas were seen to be on the back foot. Yet the crisis has shown that many of these ideas quickly resurfaced in opportunistic critiques of capitalism and markets, while governments reverted to interventionist policy solutions such as fiscal stimulus previously shown to be failures. The move from the late nineteenth to the early twentieth century shows that a dominant climate of opinion in favour of limited government can very quickly give way to collectivist doctrines. The growth in government in the twentieth century was paralleled by a decline in the prevalence of classical liberal ideas, yet the post-War revival of classical liberalism and its political expression in the Thatcher and Reagan governments of the 1980s has not arrested the continued growth in government, suggesting that these ideas have not been nearly as influential as might have been hoped. There are no guarantees about the outcome of the battle of ideas. It would be a mistake for classical liberals to assume that their ideas have an inexorable logic that, given enough time, will overcome competing ideologies. Hayek's stress on the need for greater engagement by classical liberals with the broader public that deals in ideas remains as relevant as ever.

Hayek's stress on the need for greater engagement by classical liberals with the broader public that deals in ideas remains as relevant as ever.

Conclusion

Growth in the size and scope of government has been a common feature of most developed economies since the beginning of the twentieth century. The recent global financial crisis has provided renewed impetus to the size and role of government, consistent with the historical experience with war and economic crises. While small relative to many comparable countries, the size and scope of government in Australia has increased over time on a number of the metrics: the tax share of GDP, legislative outputs, the size of the federal executive, and the number and scope of federal government departments and agencies.

Explanations for the growth in government can be broadly divided into demand- and supply-side models, as well as exogenous explanations that reference factors such as technology, demography, specific historical events, and ideology. The various hypotheses that have been advanced to explain government growth are often unable to yield predictions about the optimal or equilibrium size of government. By the same token, theories of government size struggle to explain long-run trends in government growth. Empirical testing of the various theories is complicated by the potential for observational equivalence among the various hypotheses, which need not be mutually exclusive. As Durevall and Henrekson suggest, the search for a 'grand explanation' of growth in government may be 'futile.'[52] However, many of the historical drivers of growth in government such as demographic factors are themselves bounded and growth in government is constrained by factors such as the efficiency costs of taxation. Governments like those in the United States, the United Kingdom, the European Union, and Japan are increasingly pushing the limits of these fiscal and other constraints, although it remains to be seen whether this leads to acute fiscal crisis, fiscal reform, and smaller government or secular stagnation based on muddling through under big government. While many governments have almost certainly exceeded their

optimal or efficient size, the long-run equilibrium size of government in developed countries such as Australia, if indeed there is one, remains unclear.

The absolute size of government is less important than the constitutional, legal and other constraints under which governments function. Growth in government is of concern largely because it is symptomatic of a relaxation of the constraints that have traditionally bound it. The relaxation of some of these constraints is welcome, for example, the expansion in the potential tax base associated with the growth of formal and more extensive markets and reduced household production. As markets and other voluntary interactions become more extensive and complex, the demands on government increase, but government effectiveness decreases as knowledge in society also becomes more specialised and dispersed. This argues against the increased centralisation power and decision-making that often accompany growth in government.

To be effective advocates of limited government, classical liberals need to acknowledge and better understand the forces driving the long-run growth in government. While classical liberals view government as being less efficient than markets in most contexts, governments may grow in part because they are successful in finding greater efficiencies in their activities. This in turn can be expected to undermine the negative correlation between government size and economic growth and weaken critiques of big government based mainly on efficiency arguments. Classical liberals have traditionally argued for policies that would improve the efficiency of specific government tax and spending programs, but such policies need to be located in a broader framework of advocacy for the rules and institutions that support limited government.

Appendix

Federal government departments and agencies, as listed in the Commonwealth government directory, January 2011. Source: http://www.directory.gov.au.

Aboriginal Hostels Limited (AHL)

Aboriginal Studies Press (ASP)

Administrative Appeals Tribunal

Aged Care Standards and Accreditation Agency Ltd

Air Force Headquarters

Airservices Australia

Albury-Wodonga Corporation

AMC Search Ltd

Army Headquarters

ASC Pty Ltd

Attorney-General's Department

AusIndustry

AusIndustry Hotline

Australia Telescope National Facility

Australian Agency for International Development (AusAID)

Australian Astronomical Observatory

Australian Broadcasting Corporation (ABC)

Australian Bureau of Agricultural and Resource Economics and Sciences

Australian Bureau of Statistics

Australian Centre for International Agricultural Research (ACIAR)

Australian Commission for Law Enforcement Integrity

Australian Communications and Media Authority (ACMA)

Australian Competition and Consumer Commission

Australian Competition Tribunal

Australian Crime Commission

Australian Curriculum, Assessment and Reporting Authority

Australian Customs and Border Protection Service

Australian Electoral Commission

Australian Energy Regulator

Australian Fair Pay Commission

Australian Federal Police

Australian Film, Television and Radio School

Australian Fisheries Management Authority

Australian Government Competitive Neutrality Complaints Office

Australian Government Employees Superannuation Trust

Australian Government Information Management Office

Australian Government Solicitor

Australian Hearing

Australian Human Rights Commission

Australian Industry Development Corporation

Australian Institute for Teaching and School Leadership Ltd (Teaching Australia)

Australian Institute of Aboriginal and Torres Strait Islander Studies

Australian Institute of Criminology

Australian Institute of Family Studies

Australian Institute of Health and Welfare

Australian Institute of Marine Science

Australian Law Reform Commission

Australian Maritime College

Australian Maritime Safety Authority

Australian Military Forces Relief Trust Fund

Australian National Audit Office

Australian National Maritime Museum

Australian Nuclear Science and Technology Organisation

Australian Office of Financial Management

Australian Organ and Tissue Authority

Australian Pesticides and Veterinary Medicines Authority (formerly National Registration Authority for Agricultural and Veterinary Chemicals)

Australian Postal Corporation
Australian Prudential Regulation Authority
Australian Public Service Commission
Australian Radiation Protection and Nuclear Safety Agency
Australian Rail Track Corporation
Australian Reinsurance Pool Corporation
Australian River Co. Limited
Australian Safeguards and Non-Proliferation Office
Australian Secret Intelligence Service
Australian Securities and Investments Commission
Australian Security Intelligence Organisation
Australian Sports Anti-Doping Authority
Australian Sports Commission
Australian Sports Foundation Ltd
Australian Taxation Office
Australian Trade Commission (Austrade)
Australian Transaction Reports and Analysis Centre
Australian Transport Safety Bureau
Australian Valuation Office
Australian War Memorial
Australian Wine and Brandy Corporation
Biosecurity Australia
Biosecurity Services Group
Bundanon Trust
Bureau of Meteorology
Bureau of Rural Sciences
Centre for Environment and Life Sciences
Centrelink
Child Support Agency
Civil Aviation Safety Authority
Coal Mining Industry (Long Service Leave Funding) Corporation
Comcare, the Safety, Rehabilitation and Compensation Commission, and the Seafarers' Safety, Rehabilitation and Compensation Authority
Commonwealth Director of Public Prosecutions
Commonwealth Ombudsman
Commonwealth Scientific and Industrial Research Organisation (CSIRO)
ComSuper
Copyright Tribunal of Australia
Cotton Research and Development Corporation
CrimTrac Agency
CRS Australia

Dairy Adjustment Authority
Dairy Australia
Defence Force Discipline Appeal Tribunal
Defence Force Remuneration Tribunal
Defence Housing Australia
Defence Materiel Organisation
Defence Science & Technology Organisation
Department of Agriculture, Fisheries and Forestry
Department of Broadband, Communications and the Digital Economy
Department of Climate Change and Energy Efficiency
Department of Defence
Department of Education, Employment and Workplace Relations
Department of Families, Housing, Community Services and Indigenous Affairs
Department of Finance and Deregulation
Department of Foreign Affairs and Trade
Department of Health and Ageing
Department of Human Services
Department of Immigration and Citizenship
Department of Infrastructure and Transport
Department of Innovation, Industry, Science and Research
Department of Parliamentary Services
Department of Regional Australia, Regional Development and Local Government
Department of Resources, Energy and Tourism
Department of Sustainability, Environment, Water, Population and Communities
Department of the Prime Minister and Cabinet
Department of Veterans' Affairs
Director of National Parks
Energy Technology
Equal Opportunity for Women in the Workplace Agency
Export Finance and Insurance Corporation
Fair Work Australia
Fair Work Ombudsman
Family Court of Australia
Federal Court of Australia
Federal Magistrates Court of Australia
Federal Police Disciplinary Tribunal
Fisheries Research and Development Corporation
Food and Nutritional Sciences
Food Standards Australia New Zealand
Forest and Wood Products Australia Limited
Future Fund Management Agency

Geoscience Australia
Governance and Reporting
Grains Research and Development Corporation
Grape and Wine Research and Development Corporation
Great Barrier Reef Marine Park Authority
High Court of Australia
Indigenous Business Australia
Indigenous Land Corporation (ILC)
Industrial Relations Court of Australia
Insolvency and Trustee Service, Australia
Inspector-General of Intelligence and Security
Inspector-General of Taxation
Inspector-General of the Australian Defence Force
International Air Services Commission
Ionospheric Prediction Service (IPS)
IP (Intellectual Property) Australia
Land and Water Australia
Marine and Atmospheric Research
Maritime Development
Materials Science and Engineering
Mathematics, Informatics and Statistics
Meat and Livestock Australia
Medibank Health Solutions Pty Ltd
Medibank Private Ltd
Medicare Australia
Migration Review Tribunal
Museum of Australian Democracy at Old Parliament House
National Archives of Australia
National Capital Authority
National Film and Sound Archive
National Gallery of Australia
National Library of Australia
National Marine Safety Committee
National Measurement Institute
National Museum of Australia
National Offshore Petroleum Safety Authority
National Transport Commission
National Water Commission
Navy
Northern Territory Fisheries Joint Authority
Northern Territory Land Councils

Office of Best Practice Regulation
Office of Film and Literature Classification
Office of Indigenous Policy Coordination
Office of National Assessments
Office of Parliamentary Counsel
Office of the Australian Information Commissioner
Office of the Inspector of Transport Security
Office of the Productivity Commission
Office of the Renewable Energy Regulator
Office of the Secretary and Chief of Defence Force
Office of Transport Security
Official Establishments Trust
Parliamentary Retiring Allowances Trust
Policy and Research
Produce and Grocery Industry Ombudsman
Productivity Commission
Queensland Fisheries Joint Authority
Questacon - The National Science and Technology Centre
RAAF Veterans' Residences Trust
RAAF Welfare Trust Fund
Refugee Review Tribunal
Remuneration Tribunal Secretariat
Repatriation Medical Authority
Reserve Bank of Australia
Resource Sharing and Innovation Division
Royal Australian Mint
Rural Industries Research and Development Corporation
Safe Work Australia
Safety, Rehabilitation and Compensation Commission
Screen Australia
Seafarers Safety, Rehabilitation and Compensation Authority (Seacare Authority)
Small Business Support Line
Social Security Appeals Tribunal
Special Broadcasting Service Corporation (SBS)
Statutory Fishing Rights Allocation Review Panel
Sugar Research and Development Corporation
Superannuation Complaints Tribunal
Supreme Court of Christmas Island
Supreme Court of Norfolk Island
Supreme Court of the Cocos (Keeling) Islands
Sustainable Ecosystems

Sydney Harbour Federation Trust

The Australian Learning and Teaching Council

The Governor-General

The Treasury

Therapeutic Goods Administration

Torres Strait Protected Zone Joint Authority

Torres Strait Regional Authority

Tourism Australia

Western Australian Fisheries Joint Authority

Wheat Exports Australia

Workplace Authority

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