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The Australian federal government is too big

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1 Introduction

Oliver Wendell Holmes Jr. famously claimed to like paying tax because that is how he paid for civilisation. Indeed, civilisation is not free, and somebody should have to pay for it. Yet when Holmes paid for his civilisation (in 1904) the tax burden in the United States was less than 10 per cent of income. The size of government has grown so much more since then. Perhaps we have become far more civilised?

According to this year's budget papers, Australian federal government revenue will exceed 25 per cent of national income. The states will add more to that figure, not to mention the levels of debt being accumulated at both the federal and state levels. Australia is becoming very civilised.

There are alternative explanations for that growth in government. We might not be becoming more civilised, but rather the price of maintaining our civilisation could be increasing over time. Civilisation could be becoming more expensive. Or our definition of civilisation is becoming more expansive. That view was first postulated in the late nineteenth century by German economist Adolph Wagner (1835 – 1917) who argued that as society becomes wealthier it will demand more from government, and the size and role of government will expand (Wagner's law).

Certainly, that view is consistent with the economic history of the twentieth century. The size and role of government has expanded. If more government has, in fact, resulted in more civilisation, that cannot be a bad thing. Yet, it is not obvious that increased government has resulted in more civilisation. As Deirdre McCloskey (2006: 50 – 51) has argued:

But anyone who after the twentieth century still thinks that thoroughgoing socialism, nationalism, imperialism, mobilization, central planning, regulation, zoning, price controls, tax policy, labor unions, business cartels, government spending, intrusive policing, adventurism in foreign policy, faith in entangling religion and politics, or most of the thoroughgoing nineteenth-century proposals for government action are still neat, harmless ideas for improving our lives is not paying attention.

It is true that human prosperity has massively accelerated over the past 100 years—but it is not clear that this has been due to an increase in the size and scope of government. Nonetheless, Holmes' view remains popular and widely accepted. Arguments to reduce the size of government are too often interpreted as arguments for no government at all, or for anarchy.

This paper investigates the notion of Wagner's law and argues that it is built on shaky foundations. Yes, government has grown, but not for the reasons that Wagner argued. The fact is that increases in government spending, in Australia, are associated with decreases in our prosperity. This is not an argument for no government at all. Rather it is an argument for less government.

2 Wagner's law and the growth of government

Wagner's law was formulated against the backdrop of the massive socio-economic change in Europe generally, and Germany in particular, in the second half of the 19th century. As Germany not only transitioned to a more industrialised society, but also unified into a single and centralised nation-state, Wagner observed that as economies grew and became more complex, the role and size of the government tended to increase. He theorised that economic development naturally leads to increased public spending, both in absolute terms and as a percentage of gross domestic product (GDP). To be clear, however, Wagner did not use that modern terminology. What he actually said was (Wagner 1883: 8):

The "law of increasing expansion of public, and particularly state, activities" becomes for the fiscal economy the law of the increasing expansion of fiscal requirements. Both the State's requirements grow and, often even more so, those of local authorities, when administration is decentralized and local government well organized. Recently there has been a marked increase in Germany in the fiscal requirements of municipalities, especially urban ones. That law is the result of empirical observation in progressive countries, at least in our Western European civilization; its explanation, justification and cause is the pressure for social progress and the resulting changes in the relative spheres of private and public economy, especially compulsory public economy. Financial stringency may hamper the expansion of state activities, causing their extent to be conditioned by revenue rather than the other way round, as is more usual. But in the long run the desire for development of a progressive people will always overcome these financial difficulties.

There are a number of considerations and hypotheses contained in that passage. As a result of industrialisation and urbanisation, the demand for public goods increases and the state (both central and local) grows to meet that demand. Initially this may result in budget deficits, but Wagner predicts that over time taxpayers will meet the increased financial obligations that are imposed by the expansion of the state. The famous public finance economist Richard Musgrave (1910 – 2007) described Wagner's law as follows (Buchanan and Musgrave 1999: 64):

That growth, as [Wagner] argued, was not a random event, but a "law" traceable to three major factors; structural changes in the economy, democratization of society, and an increased concern for social justice. Rising interdependence among sectors of the economy, urbanization, and technological change would expand the need for public services. The decline of the self-sufficient agricultural household and of the family as a self-supporting unit would add thereto ... There is thus an impressive array of "legitimate" factors to explain why the public sector should have grown.

Much like Topsy, the public sector has grown substantially over the past 140 years or so since Wagner first set out his 'law'.

Wagner's theory of the growth of the public sector can be thought of as being an 'economic efficiency' argument. The state has grown in size to facilitate further economic growth and consumers (citizen – taxpayers) have demanded that the public sector grow in size, and the growth that we see (and have seen) is a legitimate response to that change in demand. Certainly, this is an argument that legitimises the growth of the state. As Richard Tresch

(2002) has explained, the role of government is to enhance the performance of markets, and as markets have grown so the role and scope of government has grown too. In short, ‘Government activity gains its legitimacy through market failure’ (Tresch 2002: 8).

This view of the state and the size of government is contested. Musgrave describes it as follows (Buchanan and Musgrave 1999: 64 – 65) – it should be noted that Musgrave subscribes to the efficiency argument and is attempting to parody the alternative:

An alternative perspective views government as a self-aggrandizing Leviathan. Budget growth, or much of it, is seen in pathological terms, reflecting the fallacies of majority voting, the usurpation of power by self-serving politicians and bureaucrats, and fiscal illusion.

This can be thought of as the ‘public choice’ argument which explains the growth of the state and the functions of government over the past 140 years. The major insight of the public choice school is that public failure is just as likely (if not more so, given the absence of a profit motive) as market failure.

The challenge for outside observers of this debate is that the two approaches are not entirely mutually exclusive. It is likely that as the economy expands and technology increases, the range of resources available for economic use by government has increased. Similarly, the cost of providing economically useful infrastructure may too have increased. As such the net effect of a larger public sector is an empirical question. To that end, La Porta et al. (1999) have provided some intriguing evidence.

La Porta et al. empirically investigate the ‘quality’ of government, using a cross-section of 47 countries, including Australia. The quality of government can be assessed via any one of three different approaches: economic, political, and cultural. Economic theories of government quality tend to focus on issues of economic efficiency, while political theories tend to focus on issues of redistribution, and cultural theories focus on belief systems. After controlling for various confounding factors, they report (1999: 265):

Rich nations have better governments than poor ones. Ethnolinguistically homogeneous countries have better governments than the heterogeneous ones. Common law countries have better governments than French civil law or socialist law countries. Predominantly Protestant countries have better governments than either predominantly Catholic or predominantly Muslim countries.

Very importantly for our purposes, they report (1999: 266):

Finally, we have consistently found that the better performing governments are larger and collect higher taxes. Poorly performing governments, in contrast, are smaller and collect fewer taxes. This result does not of course imply that it is often, or ever, socially desirable to expand a government of a given quality, but it tells us that identifying big government with bad government can be highly misleading.

Taken at face value that seems consistent with Wagner’s law—richer countries have better quality governments that are bigger and collect more tax.

It is important to note, however, that there are two components to Wagner’s law. First, he makes a prediction and then second—and more importantly—he explains the mechanisms

that will drive that result. The first such mechanism is that public services are a superior good. That means that as income rises so individuals demand (proportionately) more goods and services be provided by the public sector as opposed to the private sector. By implication, those same individuals must be willing to pay a higher level of taxation to finance those public services. Then the public sector of the economy must experience Baumol's cost disease. This occurs when some parts of the economy are less likely to experience productivity growth but salaries for the individuals within that sector of the economy must grow in order to attract them to the sector. Finally, market failures (such as congestion) must rise as the economy grows.

There is some evidence that Australian politicians subscribe to the Wagner view of the growth of government. In his 2007 budget speech, former Treasurer Peter Costello made the following comment:

Our tax system exists to fund the decent services in health, education, aged care, and other services that Australians legitimately expect and are entitled to receive. If after we provide for those services, invest for the future, and balance our Budget, we can reduce the tax burden, we should do so.

More recently Craig Emerson (2022) has argued:

Australians are living longer—the sign of a successful economy and society. An increasingly large proportion of the population will be in retirement and aged care.

As the report of the royal commission into aged care points out, there were 4.2 working-age people for every Australian aged 65 years or over in 2019, but by 2058 this will have declined to 3.1 workers.

The 1.5 million Australians aged 85 years and over by then will vote, as will their children. They will demand and obtain better aged care.

In essence then, there are economically sound arguments—made by sensible people—that predict the growth in government over the past 100 years or so as being a democratic response to the demands of taxpayer-citizens. The question then is whether those arguments are empirically correct as opposed to being theoretically plausible.

3 Wagner's law under the microscope

Demonstrating the growth of government over the past 100 years is a straightforward exercise. The real challenge is in demonstrating the causal mechanisms: are public services delivered by the government a superior good? Are people willing to pay higher taxes to finance those services? Does Baumol's cost disease apply to government? Do market failures increase in severity as economies grow? All these questions are important economic issues in their own right.

The economist and Nobel Laureate James M. Buchanan (1968: 162) has posed the question: 'What goods and services should a community supply publicly through political-governmental processes rather than privately through market processes?'. The standard economic argument would be that goods and services should be provided by the public sector if and when the public sector could do so more 'efficiently' than the private sector. The

problem with that particular argument is that the meaning of the word ‘efficiently’ is value laden. Unfortunately, mainstream economic theory has propagated the notion that any violation, however trivial, of the stringent assumptions demonstrating the efficiency of the private provision of goods and services, must mean that the private provision of goods and services is inefficient.

There is, however, an economic theory that sets out when governments should provide goods and services. Adam Smith had argued (1776: 963):

The third and last duty of the sovereign or commonwealth is that of erecting and maintaining those public institutions and those public works, which, though they may be in the highest degree advantageous to a great society, are, however, of such a nature that the profit could never repay the expense to any individual or small number of individuals, and which it therefore cannot be expected that any individual or small number of individuals should erect or maintain.

Here there is a two-part test being proposed for government provision of goods and services. First, it must be ‘highly advantageous’ and second, it must be unprofitable to provide those goods and services. Many goods and services are never provided by markets simply because there is no demand for them. That is not what Smith is discussing here. He is implying that there are goods and services that are demanded but that no private individual or group of private individuals could profitably supply those goods and services.

The type of good and services that could be valuable but not profitable have two features. First, they are non-rivalrous and, second, they are non-excludable. Non-rivalry means that any one person’s usage of the good or service does not diminish another person’s ability to consume the good or service. Non-excludable means that no particular individual can be prevented from consuming the good or service. Goods and services that have these two features are defined as being ‘public goods’. Goods and services that the public thinks should be provided by the government but are not public goods per se are defined as being ‘merit goods’.

In his principles of taxation, Adam Smith (1776: 1103) also argues, ‘The subjects of every state ought to contribute towards the support of the government ...’. Citizens must be taxpayers and must pay for the public goods and merit goods that the government provides. Whether they should do so on a proportional or progressive basis is beyond the scope of this paper. This, however, raises the questions of legitimacy and coercion: is it legitimate to coerce people to pay for merit goods?

What are legitimate functions of the state? Adam Smith, for example, describes three functions of government being national security, justice, and the provision of public goods which he defines as ‘facilitating the commerce of the society, and those for promoting the instruction of the people’ (1776: 963). Basically, the provision of economic infrastructure and education—this could, however, also include the promotion of the arts and culture. Herbert Spencer (1843: 187) saw a more limited role for government; being ‘to defend the natural rights of man—to protect person and property—to prevent the aggressions of the powerful upon the weak—in a word, to administer justice’. Ludwig von Mises provides a similar perspective (1927: 30):

As the liberal sees it, the task of the state consists solely and exclusively in guaranteeing the protection of life, health, liberty, and private property against violent attacks. Everything that goes beyond this is an evil. A government that, instead of fulfilling its task, sought to go so far as actually to infringe on personal security of life and health, freedom, and property would, of course, be altogether bad.

That is not F. A. Hayek's view—he had a far more expansive view of the role of government. Hayek (1960: 332) sets out his view of the legitimate role of government as follows:

In so far as the government merely undertakes to supply services which otherwise would not be supplied at all (usually because it is not possible to confine the benefits to those prepared to pay for them), the only question which arises is whether the benefits are worth the cost. ...

A great many of the activities which governments have universally undertaken in this field and which fall within the limits described are those which facilitate the acquisition of reliable knowledge about facts of general significance. The most important function of this kind is the provision of a reliable and efficient monetary system. Others scarcely less important are the setting of standards of weights and measures; the providing of information gathered from surveying, land registration, statistics, etc.; and the support, if not also the organization, of some kind of education.

Contrary to popular belief, these economists imagined an extensive role for government in the economy. The distinction between these theorists and Wagner, however, was that Wagner subscribed to a majoritarian view of government. As Hayek (1960: 167) has argued, however, 'To the doctrinaire democrat the fact that the majority wants something is sufficient ground for regarding it as good; for him the will of the majority determines not only what is law but what is good law'. That insight, however, simply begs the question of what is a 'good law'? Hayek's view is that such laws are consistent with the Rule of Law (rules must be certain, known, general, and applied equally) and are characterised by the absence of coercion. Surprisingly, Hayek does not necessarily disagree with Wagner (1978: 111):

The basic principle of the liberal tradition, that all the coercive action of government must be limited to the enforcement of general rules of just conduct, does not preclude government from rendering many other services for which, except for raising the necessary finance, it need not rely on coercion. ... I am the last person to deny that increased wealth and the increased density of population have enlarged the number of collective needs which government can and should satisfy.

Hayek sets out three principles that could reconcile his views and those of Wagner: The government should not set up monopolies, taxation should be raised on a uniform basis and not be for redistributive purposes, and the community as a whole should demand those goods and services (and not just some special interest group). Hayek can imagine the conditions under which his views and Wagner's views are reconciled. Ludwig von Mises, on the other hand, does not. Mises writes (1927: 17):

One must be in a position to compel the person who will not respect the lives, health, personal freedom, or private property of others to acquiesce in the rules of life in society. This is the function that the liberal doctrine assigns to the state: the protection of property, liberty, and peace.

But, to remind ourselves (1927: 30), ‘Everything that goes beyond this is an evil’.

In practice, governments do violate Hayek’s conditions. Taxation is not collected on a uniform basis—rather taxation is collected on a progressive basis. This is not just the income tax—the fact is that the entire Australian tax system is itself highly progressive. Furthermore, it is not clear that the community as a whole demands additional government services *per se*.

Contrary to Musgrave, there are well-known problems with democratic voting as an institutional choice mechanism, there are self-serving bureaucrats and politicians, and there is a fiscal illusion problem. In those circumstances it is very likely that the size of government might expand to beyond that which the community of citizen-taxpayers may demand. Worse, the size of government may begin to impose unnecessary costs on the community.

4 Is there an optimal size of government?

As James M. Buchanan (1975) has argued, society stands between anarchy and Leviathan. Similarly, Andrei Shleifer (and his various co-authors) suggests that societies have to manage the trade-off between ‘disorder’ and ‘dictatorship’. Disorder relates to the ability of private individuals to inflict harm on others, while dictatorship relates to the ability of government and its bureaucrats to inflict harm on others. Writing in the mid-1970s, James M. Buchanan had identified several problems with having government both provide *and* enforce the rules that suppress disorder amongst individuals. This is the well-known ‘who will govern the governors’ problem (1975: 19 – 20).

Since the Great Depression, we have witnessed continuing and accelerating growth in our own Leviathan. Descriptively, we live in what might be called “constitutional anarchy”, where the range and extent of federal government influence over individual behavior depend largely on the accidental preferences of politicians in judicial, legislative, and executive positions of power. Increasingly, men feel themselves at the mercy of a faceless, irresponsible bureaucracy, subject to unpredictable twists and turns that destroy and distort personal expectations with little opportunity for redress or retribution.

...

There are demands from all quarters for a dismantling of bureaucracy, for a reduced governmental presence, for personal relief from accelerating tax pressures. By widespread agreement, the state has become too powerful, too pervasive in its influence over private affairs. At the same time, however, demands for extensions in public control abound. We observe government on the loose but at the same time the minimal order presumably secured by collective enforcement of rights seems to be disappearing.

The point that Buchanan is making is that government has become too large and has somehow slipped the bounds of democratic constraint. To that extent we can expect to observe behaviours inconsistent with simply maintaining the peace, enforcing contracts, protecting liberty. To the contrary, we would expect to observe the erosion of the Rule of Law, unequal taxation, rules being uncertain, unequal in their application, and specific. Taxation is likely to be non-uniform and used for redistributive purposes. While all these

effects are plain to see, they all impose costs on the economy and subsequently on the prosperity of society.

This intuition is captured in the so-called Rahn Curve, after the US economist Richard Rahn. He had postulated an inverted u-shaped curve describing the relationship between economic growth and the size of government (defined by spending). Rahn has speculated that the ‘optimal’ level of government spending was about 15 to 25 per cent of the economy. Similarly, the British-Australian economist Colin Clark had argued that the maximum level of taxation that an economy could sustain was 25 per cent of GDP. Beyond that level of taxation, the disincentive effects of taxation lead to reduced economic performance. In the 1990s the late Gerald W. Scully of the University of Texas at Dallas attempted to estimate the optimal size of taxation that maximised economic growth. Unfortunately, Scully’s approach had severe methodological flaws (as identified by Ted Sieper) and that research effort was something of a dead end (see Novak 2013 for a detailed discussion of this literature).

A similar concept to Rahn’s Curve is the Armey Curve named after the former US Congressman Richard K. Armey. Rather than spell out the relationship between economic growth and the size of government, Armey argued that we should examine the relationship between ‘economic prosperity’ and size of government. As he explained (Armey 1995: 92):

Certainly, we need government to keep the peace, prevent anarchy, run the national parks, and maybe do the odd job here and there. To this extent government bears some resemblance to its constitutional description as promoter of the general welfare and securer of the blessings of liberty. But at some point government becomes so large that it begins to smother prosperity and thus erode both our general welfare and our liberty.

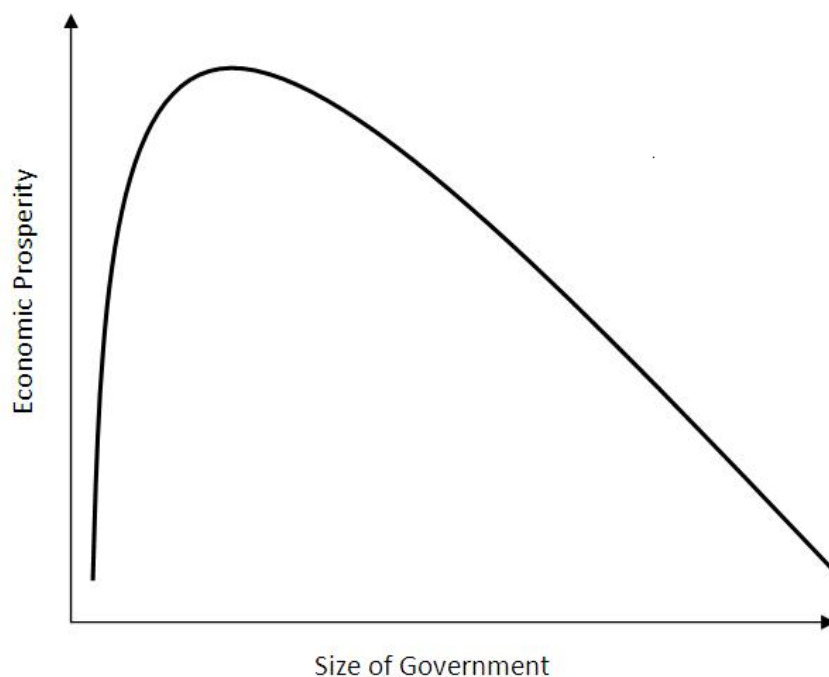


Figure 1: Armey Curve

Following Adam Smith, it is appropriate that citizen-taxpayers contribute to the provision of public goods and services that add to the economic prosperity of society. All the theorists that we have discussed agree that the use of coercion is legitimate in these circumstances. It is Wagner's view that the accepted definition of public goods and services will expand as society becomes wealthier. Hayek conceded that this is a theoretical possibility. It is, however, an empirical question.

We have already seen that Buchanan is of the view that government has become a leviathan (note he was writing in the 1970s). More recently, Arthur Seldon has opined (1998: 91):

What politicians maintain as the necessary costs of government are increasingly sensed as unnecessary costs of 'over-government'. And its taxes, originally seen by William Pitt as income tax, and accepted for a few years as payment for a good bargain, are being subconsciously but finally resented as too high for the quality and relevance of services available at lower cost and higher quality from competing suppliers in the market.

Reading both Buchanan and Seldon, it is not obvious that citizen-taxpayers are happy or comfortable paying for all the additional government that politicians and bureaucrats claim they are demanding. Certainly, as an empirical matter Stephen Kirchner (2012) finds no evidence that Wagner's law explains the growth of Australian federal government in the post-WWII era.

In her 2013 unpublished PhD thesis Mikayla Novak examined the growth of government since the colonial era and tests extensively to exclude Wagner's law as an explanatory variable. Incorporating the Rahn Curve into the Armey Curve by defining economic prosperity as real GDP per capita growth, she pursues several empirical strategies to establish the relationship between the increase in government and the change in real GDP growth. She does not attempt to calculate the optimal level or size of government—she simply attempts to estimate the long term-relationship between the two variables.

Depending on the empirical methodology, she finds that a ten-percentage point increase in the ratio of government expenditure to nominal GDP results in a decrease in real GDP per capita growth of between 1.2 and 2.5 percentage points. Australia is to the right of the turning point of the Armey Curve as shown in figure 1. Every increase in government spending that is not immediately associated with the provision of public goods and services is making Australians poorer.

The challenge facing Australia is set out in the latest Intergenerational Report (2023: 143):

Over the next 40 years, payments are projected to rise as a share of Gross Domestic Product (GDP) as cost pressures and demand for public services grow and the population ages. Total Government spending is projected to increase by 3.8 percentage points over the next 40 years, rising from 24.8 per cent of GDP today to 28.6 per cent in 2062–63.

Notice the implicit appeal to Wagner's law—costs pressures and public demand will drive this massive expansion of government over the next 40 years. If Novak's calculations are correct, that expansion in government will come at the cost of reduced economic growth. This raises a two-fold problem. In the first instance, that expansion in government must be

financed either immediately by taxation or by deferred taxation, i.e. debt. In the second instance, however, the deleterious impact that increased government has on economic growth, and the tax burden, is effectively increased. Higher taxes on otherwise poorer Australians (everything else being equal) is a huge price to pay for increased government.

There are few economic constraints on government within the Australian constitutional and political system. The constitution sets out that ‘money’ bills can only originate in the lower house after a letter of recommendation from the governor-general, that all moneys raised must be passed into consolidated revenue, and the like. The government can only expend money that has been authorised by an act of Parliament. These are all sensible and procedural matters—but they place no effective constraint on the size of government.

Traditionally it has been the political preferences of the electorate that has constrained the growth of government. It could be argued that Australians subscribed to what James M. Buchanan and Richard Wagner (1977 [2000]) called the ‘old time fiscal religion’. This is the view that budgets should be balanced (in practice this means a small surplus), government debt should be ‘low’, and government intervention in the economy strictly limited. Australian political rhetoric still subscribes to these views. No Australian Treasurer ever suggests that budget deficits are permanent or that public debt will continue to grow forever and will not be paid down. It is clear, however, that there is a growing gap between political rhetoric and the facts on the ground. As Davidson (2021: 85) argues:

It is not clear when or why the ‘old-time fiscal religion’ was abandoned. In late 2007, then opposition leader Kevin Rudd was able to campaign at an election with the slogan ‘This sort of reckless spending must stop’. In the years since, there is no evidence that the spending has stopped; to the contrary, spending has increased and so, too, has public debt.

The 2023 Intergenerational Report forecasts increasing budget deficits over the next 40 years, public debt at 32.1 per cent of GDP—lower than what was forecast by the 2021 Intergenerational Report, and as a ‘technical assumption’ the Intergenerational Report assumes that personal income tax in Australia will have to rise because indirect tax revenue is expected to fall over the next 40 years. The assumption in the Intergenerational Report is that the total tax to GDP ratio will remain at 24.4 per cent. The latest budget papers show that the current tax to GDP ratio is 23.1 per cent. Treasury is not anticipating personal tax reform that results in a lower overall tax burden for Australian taxpayers. The alternative is for the government to raise non-tax revenue—this, however, imposes a productivity loss on the economy.

The challenge Australians currently face is this: the political class subscribe to Wagner’s law, but the economy is already on the ‘wrong’ side of Armey’s Curve, and increases in government spending are reducing economic prosperity. The cost of financing those increases in expenditure are both high and becoming more expensive.

The Australian federal government is too big. The solution to that is not finding innovative ways to finance that bloat, but rather to reduce the size of government.

5 Is government inherently unproductive?

As we have seen in the preceding sections, Wagner's law is built on flimsy foundations. There is, however, another basis that could explain the increase in relative government size. That is Baumol's cost disease. Government is primarily a provider of services, and the argument is that productivity in the provision of services does not scale. This argument is known as Baumol's cost disease or the Baumol effect, after the American economist William Baumol. In the 1960s he offered a plausible explanation for why the cost of services, especially those provided by the government, tends to increase over time, often faster than the rate of inflation.

The argument is that service industries tend to be 'labour intensive' and the amount of time to perform a task does not diminish over time. For example, the amount of time for a schoolteacher to teach a class of pupils to read has not changed much over time. Indeed, over the past 100 years or so, the amount of time children are expected to spend at school has increased. By contrast, the working week has decreased over time from six days per week to five days per week. The argument being that in (some) labour-intensive industries technology cannot easily replace human labour resulting in productivity improvements that are much slower in those industries compared to the overall economy.

The problem arises when workers must be recruited to these lower productivity growth functions. In order to attract workers from the more productive sector of the economy, the government must offer wage rates that are in excess of productivity in those sectors. This implies that, over time, costs in the service sector rise faster than do benefits, leading to a relative increase in the size of the service sector.

It is often argued that government services are subject to Baumol's cost disease. The important point to note is that the relative inefficiency of government—according to this argument—is an inherent feature of government services and not something that can be remedied. The clear implication of this argument is that if individuals do demand government—to counter disorder costs for example—citizen-taxpayers must tolerate inefficiency and larger government than they would otherwise expect.

While seemingly plausible, this theory suffers from both theoretical and empirical defects. The empirical defect is that the Australian economy, for example, is predominantly a service orientated economy with many parts of the private sector being both productive and profitable. Many parts of the private economy are in direct competition with government services. Furthermore, many government services promote greater levels of employment as a policy objective and not as an inherent feature of the service being provided.

Then on a theoretical basis, the Baumol effect is a very subtle version of the labour theory of value. This theory (that in part forms the basis of the Marxist critique of capitalism) was discredited in the 1870s and, of course, by the events of the 20th century. The value of a service is not related to the productivity of the person producing that service. The value of a service is related to the willingness of a consumer to pay for its production. Government services are seldom reduced in scale, or withdrawn from being offered, or subject to a cost-benefit analysis. They are certainly seldom financed by willing consumers but rather by coerced citizen-taxpayers.

If the Baumol effect were to explain the growth of government, however, we would expect to observe that public sector wages (and conditions) would lag private sector wages (and conditions). That generally, however, is not the case.

6 Conclusion

There are two competing arguments that explain the growth of government. The efficiency explanation is that good government is expensive government, and that expense has been growing over time. Furthermore, most sensible people recognise the importance of government and take the view that the increasing burden of government is money well-spent.

The alternative perspective is that we are experiencing ‘over-government’. That the growth of government is due to a lack of democratic accountability due to the vagaries of majority voting and self-interest on the part of bureaucrats and politicians. The challenge with this latter view, of course, is to identify those aspects of government that should be maintained and those that should be discarded or privatised.

Citizens who would prefer smaller or less government would still prefer to have good government over bad government. Similarly, sensible people can disagree on what goods and services are truly public goods and which are merit goods. Those people who emphasise economic prosperity are likely to have a narrow definition of public good, while those who emphasise, say, cultural prosperity might have a more expansive definition.

The first step towards having a sensible public discussion on these issues, however, is a clear understanding of the status quo. As things currently stand, increases in government spending are reducing economic prosperity in Australia. That means in the first instance that public expenditure needs to be curtailed. How, when, and where those spending cuts occur should be the basis of intensive public debate.

Another step is to propose some fiscal limit on the extent of the government. The former Howard government, for example, always emphasised the importance of a balanced budget. By that they meant budgets with a small surplus, including over the forward estimates, and paying down debt. The Intergenerational Reports included assumptions as to the maximum (Commonwealth) tax to GDP ratio that the Commonwealth would collect. In 2002, the then Howard government assumed that this ratio would not exceed 20.8 per cent of GDP (and total revenue to GDP would not exceed 22.4 per cent of GDP). The former Rudd government proposed that tax to GDP would not exceed the ratio that they had inherited in 2007-08. The former Turnbull government proposed a tax-to-GDP ratio of 23.9 per cent. The latest Budget Papers show that the current government is just within that target, with the expected tax-to-GDP ratio being 23.8 per cent.

This highlights an important sleight of hand. Government does not have as much control over how much money they collect, as they do over how much money they can spend. The Australian federal government is too big because it spends too much money. The damage to the economy is incurred because it spends too much money, and because the cost of financing that expenditure is too high.

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