



Good government: What it does, why we need it and why small government doesn't work

Ian McAuley, March 2022

Over the last 40 years, since the election of Ronald Reagan in the US and Margaret Thatcher in the UK, much of the “western” world, including Australia, has been subject to “small government” ideology.

In response to the pandemic “big government” has come back. Public health responses have required restrictions on movement and association as severe as are imposed in wartime, and in order to stave off a deep recession, government spending has reached levels not experienced for the last 75 years.

So it may seem strange that The Balmain Institute has invited Miriam Lyons and me to talk about the case for government. We now have “big government”, and while most people accept and understand the need for a strong response to the pandemic, they yearn to return to “normal”, without public health restrictions and without the need to rely on government payments to keep businesses afloat and individuals out of dire poverty.

In Australia’s case that “normal”, as seen by the federal government, is a return to the “small government” model that has served us poorly, leaving us with an economy lacking the strength to adjust to the challenges and opportunities of climate change, and with inequality in income, wealth and opportunity worse than have been seen in our modern history.

I am not here to put the case for “big government”. Rather, the case is for public policy that assigns to the private sector what markets can do well, to the public sector what governments can do well, and to the community sector what people through their voluntary association can do well.

The pandemic: spending without purpose

When a crisis threatens to plunge the economy into a deep recession – a global financial crisis, a pandemic – the usual government response, overriding any “small government” ideology, is to loosen monetary and fiscal conditions. That means dropping interest rates and increasing spending. When the pandemic came to Australia – it was on March 19, almost exactly two years ago, when the Ruby Princess came into Circular Quay – our governments swung into action, led by the states with the federal government following.

There was little scope for the Reserve Bank to drop interest rates, because they were already very low. It’s easy to forget that before the pandemic the Australian economy was already performing poorly. Labour productivity, the basic indicator of an economy’s capacity to maintain its material living standard, had been falling for seven years (ever since the Coalition was re-elected in 2013), and real wages had stagnated.

Covid-19 provided the Morrison government with a convenient distraction from our underlying economic weaknesses – weaknesses resulting, in large part, from successive governments under the thrall of “small government” having neglected the task of economic reform. Covid-19 has allowed the Coalition to push aside evidence of deteriorating performance, and to maintain the myth about its economic management credentials.

The fiscal boost was massive – \$291 billion by the Treasury’s estimate.¹ That’s hard to imagine. Think \$22 000 per household. Think three years of total expenditure by the New South Wales government.

Such spending to stabilise the economy has been an established function of government for 90 years, ever since governments heeded Keynes’ advice on getting out of the Great Depression and avoiding future booms and busts. Even though Keynes ranks somewhere near Lenin and Marx in conservatives’ lists of undesirables, they apply his prescriptions without shame or recognition of his wisdom.

No reasonable person would criticise the Coalition for having stimulated the economy in anticipation of a severe Covid-19 recession. The temporary boost to income support was particularly welcome, and allowed many people access to basic necessities of life which had been beyond reach on the punishingly low “Jobseeker” payments that preceded Covid-19. (The exclusion of migrant workers and students from this payment was one of many shameful exceptions over the course of the last few years).

But when one considers the sheer volume of money that has been spent what we see is waste and the disappointment of opportunities forgone. As the virus slowly recedes (we hope), what do we have to show for all that spending? We have incurred the liabilities, what is there on the asset side of the balance sheet? Apart from a big boost to corporate profits (the share of profits in our GDP is at a record level) and a vastly inflated housing market, there is nothing to show for it.

Did the Commonwealth use this as an opportunity to invest in our human capital – to restore funding to universities, to spend on disadvantaged schools, to improve the lot of workers in precarious situations? Did it use it as an opportunity to restore and protect our environmental capital – to return cleared land to native vegetation, to rehabilitate the Murray-Darling system, to protect ecosystems from the effects of climate change? Did it use it as an opportunity to invest in our degraded physical capital – to upgrade stressed public transport systems, to build a network of freight and high-speed passenger railroads, to complete all-weather and safe roads between our population centres? Did it use it as an opportunity to boost structural change – to de-carbonise our economy, to invest in transmission lines linking our renewable-energy hotspots?

We know the answers to these questions. In some areas, such as universities, there has been deliberate neglect: in others, such as environmental protection and public transport, there have been no more than miserable token outlays.

While some areas were neglected, in others there has been waste on a massive scale, particularly on “Jobkeeper” payments to firms that didn’t need it, and on support for the fossil fuel industry. Covid-19 presented us with a chance for a twenty-first century New Deal, but instead all we are getting is a return to the worn-out old deal.

¹ Treasury, [Economic Response to Covid-19](#).

The Commonwealth has failed to spend on things that, on economic grounds, governments should do, and is spending on things that should be left to the market. Where, for example, is the market failure that requires the government to spend \$600 million on a gas-fired power station and even larger amounts to help companies develop gas reserves? Why is it so determined to keep coal-fired generators running, when the market is pushing for their rapid closure? The Commonwealth's energy policy looks more like a Soviet-style Gosplan than the policy of a government that sets a boundary between state and market based on economic principles.

Maybe it is naïve to expect any government, faced with the opportunity to spend big, to do anything other than to spend on its mates. Give the Liberal and National Parties access to public funds, and as audit reports confirm they will be spent on car parks, shooting ranges and other boondoggles where they are not needed. That's in line with the economic philosophy known as "public choice theory", heavily influenced by Friedman and Hayek, and evoked by Reagan when he said "starve the beast" to stop government from wasting taxpayers' hard-earned money. The theory says that, given access to taxpayers' money, governments on the right adopt crony capitalism, while governments on the left waste money on incentive-destroying social security programs. That's the case for "small government".

The Coalition's path back to "small government"

Supporting this dismal interpretation lies a belief that governments are intrinsically corrupt and incompetent: it's the idea of "good government" as an oxymoron. Hardened cynics suggest that conservative governments deliberately bring us bad government so that the virtue of "small government" is established in people's thinking. The right-wing satirist P J O'Rourke said "The Republicans are the party that says government doesn't work and then get elected and prove it".

There is the simpler possibility, that conservative governments just don't understand the economic value of government. This is spelled out specifically in the Liberal Party's *Statement of Values* "... businesses and individuals – not government – are the true creators of wealth and employment".²

A little reflection reveals the absurdity of that statement. A teacher in a private school does something useful, while her counterpart in a state school is just a burden on the community? A private security guard contributes to our wellbeing, while a member of the state police force is just decoration? Some might say that the Liberal Party's statement is just another example of thoughtless political drivel and shouldn't be taken seriously.

But it helps explain the idea, expressed by New South Wales Premier Perrottet, that it's OK to overload the health sector to the point of breakdown, as long as that means the private sector can get the economy moving. The health sector may not be a complete waste, but in an imagined trade-off between "the economy" and "society", it can be sacrificed to the greater good of private sector activity.³ Nurses, doctors, and people seeking treatment must

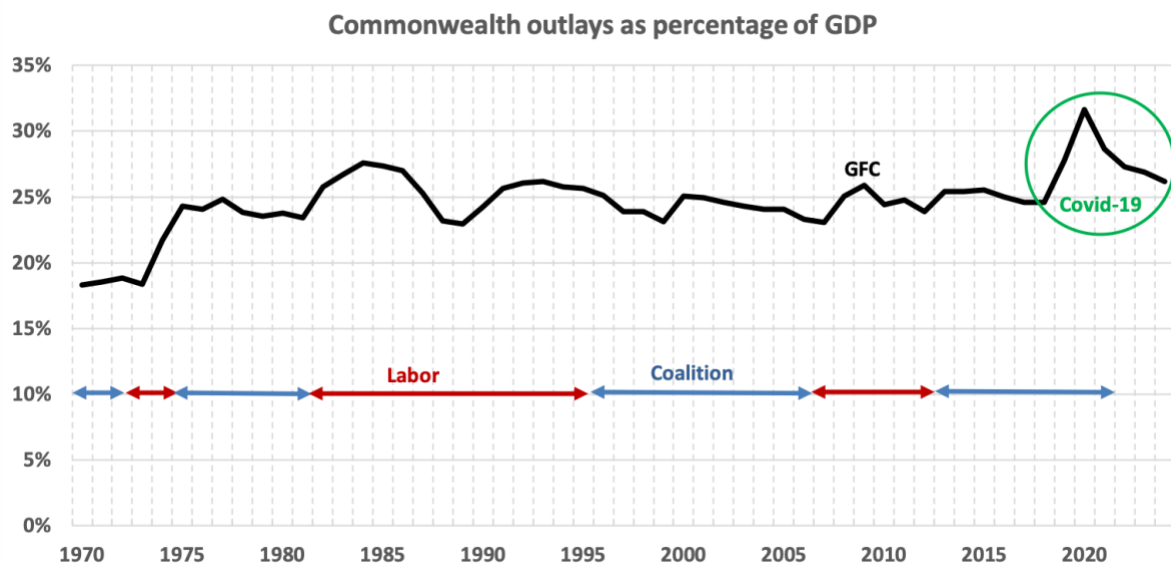
² Liberal Party [Our Beliefs](#).

³ This separation of the economy and society is a false dichotomy, because, as Miriam neatly explains "the economy is a wholly-owned subsidiary of society". For a more expansive explanation, relating particularly to health, see [How Covid-19 is reshaping the way we see health care](#).

make sacrifices so that bars, nightclubs, casinos, advertising agencies, Botox clinics, pubic hair removers, mortgage brokers and real-estate agents, all in the private sector, can make their contributions to the “real economy”.

It also explains why the Morrison government is reluctant to spend on anything enduring, such as adequately funding the aged care sector or the National Disability Insurance Scheme. If government expenditure is simply a waste, or a concession to unreasonable voters who want silly things like publicly-funded hospitals, schools and a basic redistributive welfare system, then it’s best to get back to “small government” before people become conditioned to expecting these things.

The graph below, constructed from recent Commonwealth records and projections (December 2021), shows where public expenditure has tracked over the last 50 years and where the current federal treasurer wants to take it – back to “normal”. In fact the Coalition has a magic number “23.8” as the percentage of GDP the Commonwealth should collect in taxation, and therefore the amount it should spend over the long run – a number with less logical basis than Douglas Adams’ “42” in *The hitchhiker’s guide to the galaxy*.⁴



Note that from 1984 to 2007, a period of both Labor and Coalition governments, there was a downward trend in Commonwealth expenditure as a share of GDP. Further on I argue that sustaining the trend, and therefore the 23.8 percent aspiration, is unrealistic, because of long-term demographic and structural factors. But first, a consideration of what should guide public policy regarding the “size” of government, with emphasis on the economic role of government, starting with international comparisons.

Australia stands out for small government and poor economic performance

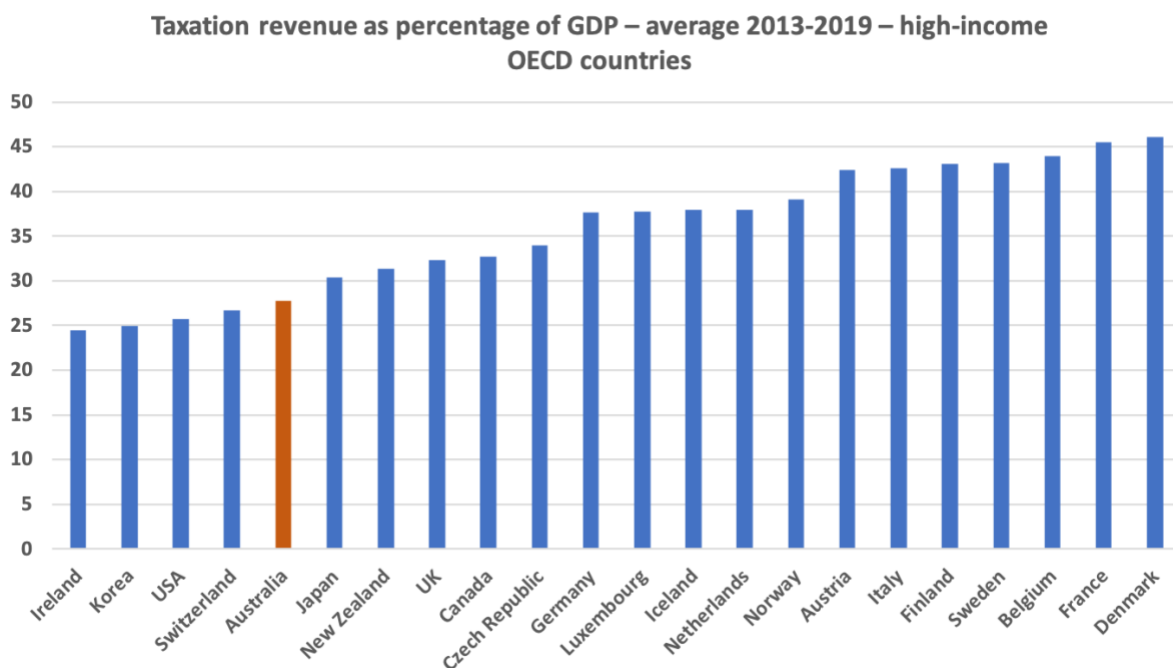
There is a huge range of examples on the “small government” “big government” spectrum. At one end is an anarchy, a nation without a government, or a failed state. Afghanistan may be the closest to that model at present, thanks to the epic failure of its occupiers to engage

⁴ At least “42” carries less spurious precision than “23.8”.

in sustainable state-building. History is full of examples of governments which exist not for the people, but for the survival of a ruling elite, with expenditure limited to maintaining a military force. At the other end is the entirely centrally-planned economy, North Korea being about the only remaining model. Incidentally, although they are at opposite ends of the size of government spectrum, Afghanistan and North Korea vie for the last places on the Economist Intelligence Unit’s democracy index of 168 countries.

There’s not much point in comparing Australia with countries on the extremes of the spectrum: rather it’s worth having a look at other high-income “developed” countries to see how they get by.

Ideally, as a measure of the economic reach of government, it would be necessary to bring together government expenditure, taxation, other revenue (mainly revenue from government-owned businesses), and some index of governments’ regulatory influence, but there is no such index. An indicator that’s least subject to definitional problems, and for which the OECD keeps a consistent time series, is taxation as a proportion of GDP. That’s a reasonably good proxy for expenditure over the long run. The graph below shows this for high-income OECD countries averaged over the period 2013 to 2019 – i.e. before the Covid-19 burst of expenditure, and therefore what would be considered as “normal”.⁵ Australia is down there among the “small government” countries.⁶



In these countries, there are at least three overlapping approaches to the economic scope of government – minimalist, the mixed economy, and social democracy.⁷

⁵ This is the subset of OECD countries with per-capita incomes above \$US 40 000 in 2020.

⁶ Note that the OECD data on which this graph is based shows all taxation revenue, federal, state and local.

⁷ Ideological corruption of language presents a definitional problem. The economic model adopted in many European countries was called “socialist” for a long time, but right-wing politicians, in their endeavour to

1. Minimalist

A prevailing philosophy in “small government” countries is that governments should do only what the private sector cannot do and no more. That picks up services such as defence, criminal justice, regulation of the currency, enforcement of property rights, maintenance of a basic social security system to keep people out of dire poverty, and the establishment of standards and conventions.

To some in the Liberal Party that is an aspirational ideal. John Howard’s criterion of what should be in and out of government was that if the function was to be found in the Yellow Pages it could be handed to the private sector, if not for funding, then at least for provision. (It’s not a guiding principle for the National Party, however.) Perhaps the US comes closest to realisation of that model.

2. The mixed economy

Abraham Lincoln (a Republican we should remember), articulated a role of government:

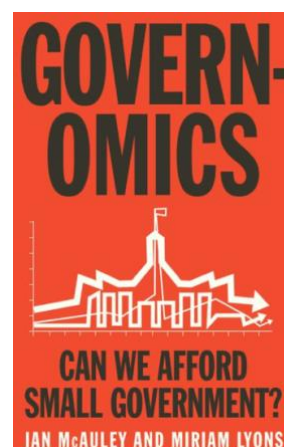
The legitimate object of government is to do for a community of people whatever they need to have done, but cannot do at all, or cannot do so well for themselves, in their separate and individual capacities.

The crucial term, distinguishing this from the minimalist approach, is the clause “or cannot do so well for themselves”. The private sector can fund and provide health care through private insurance, for example, but it’s a high-cost and inequitable way of doing what a tax-funded national health insurance scheme does more efficiently and at lower cost. Firms can build and operate toll roads, but as Sydney people know, there are huge distortions when toll roads are mixed with an otherwise “free” road network. The well-off can pay for private schools for their children, leaving the government to provide for the less fortunate, but such a division results in unrealised human talent and social division.

In our 2015 work *Governomics: can we afford small government?* Miriam Lyons and I were concerned that in Australia we were drifting from the mixed economy model to the minimalist model, and that this was at a cost to long-term prosperity.⁸ Our concern has not abated.

We wrote it for politicians, public servants, and people in community associations so that they can realise that public sector funding and provision of certain services is not some “left” ideology (although the “left” generally embraces it), but that it’s also good economics.

Too often those who seek better funding for public education, the retention of public transport in public hands, preservation of the ABC, and provision of public housing, do so only from a perspective of equity or fairness. These and other services do have equity



promote “small government”, equated the word “socialist” with communism and the brutality of Stalin’s USSR.

⁸ [Governomics: can we afford small government?](#)

benefits, but public education, public broadcasting and public housing, by the criteria of mainstream economics, are all better funded and provided in the public sector.

Governomics presents the standard economic content of a public finance text, in a form easily understood by the reader who has not endured a three-year course in economics. Although this theory is well-known to economists, it's not likely to come to mind for a lobbyist seeking to have a government enterprise privatised, or for a right-wing politician who is comfortable in the unquestioned ideology that "businesses and individuals – not government – are the true creators of wealth and employment".

Importantly, by pointing out what should be in government, we implicitly pointed out what *should not* be in government. If Miriam and I were writing it today we would stress that latter point more strongly, because our current federal government seems to have no guiding principle about the private-public division. It's as if public revenue is just a big bucket of money to be splashed around in order to maximise the Coalition's opportunity for re-election.

3. Social democracy

If we look at the countries on the right-hand side of the graph, all prosperous European democracies, we see a group of countries, particularly the Nordic countries, where the public sector is quite large or even dominant in the economy. The underlying philosophy, described in works such as *The Nordic edge: policy possibilities for Australia*, goes well beyond the conventional economic theory in basic textbooks, and therefore beyond what we wrote in *Governomics*.⁹ There are sound reasons to do with monopolisation, information deficiencies, scale economies, external benefits, discount rates, consumer perception of risk – all in the economic texts – that justify public funding and provision of health care, education, care for the aged and many other services. But there are overriding considerations in many societies: we choose certain things we want to fund collectively. In some domains of our lives we are all for free enterprise, in others we are socialist.

An economist could mount a logically strong argument for allowing us to sell our right to vote, but we exclude it from the market. We wouldn't be too enthused about a scheme that allowed convicted criminals to buy a shorter prison sentence or clearance of their criminal record.¹⁰ We draw a line around what should be in and out of markets.

We like markets – they're great places if we want avocados, haircuts, SUVs, designer curtains, the choice of 40 varieties of coffee – but we want to keep them in their place. As the philosopher Karl Polanyi pointed out in 1944, from time immemorial we have subjugated the market to human needs. We live in a society, not in a market, but he presciently warned that the market would come to intrude in all aspects of life, unless we contain it.¹¹

⁹ See a [review of *The Nordic edge: policy possibilities for Australia*](#), which includes references to other works describing the applicability of the Nordic model to Australia.

¹⁰ Although, *de facto*, this is the outcome of an expensive legal system.

¹¹ Karl Polanyi, *The Great Transformation*, 1944, with several reprints, including an [online version](#) by INCT/PPED.

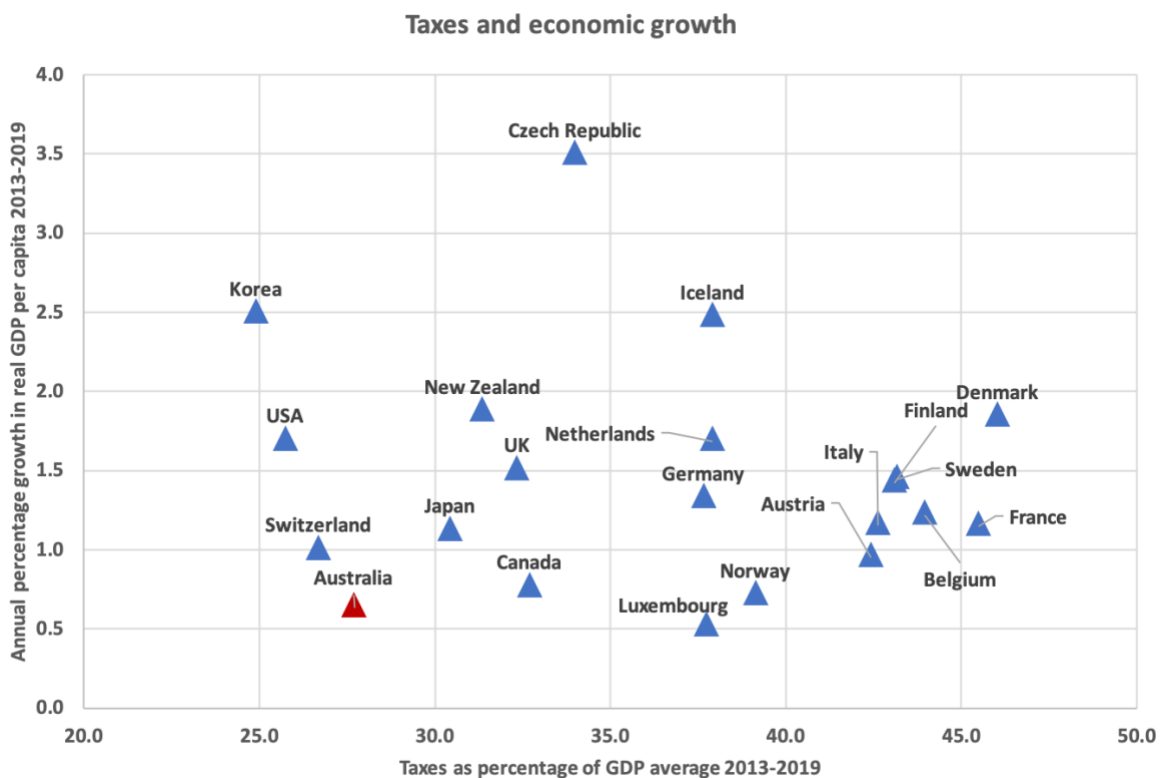
The Nordic people seem to have been most effective in keeping the market in its place, while in the anglosphere we have tended to let the market dominate, as if it has some moral virtue not present in government arrangements to share funding and provision of services.

But does allowing the scope of government to expand impede economic performance?

Hearing the rhetoric in our political debate, we might believe that those countries with big government are paying a high price in terms of poor economic performance. Surely the “burden” of high taxes comes at the expense of allowing the private sector to get on with its job of making us all richer.

There is no evidence to support such a belief.

The graph below, constructed from OECD data for the same group of high-income developed countries, shows taxes and per-capita economic growth over the 2013-2019 period.¹²



Australia is down there near the bottom-left corner. To put it simply (Miriam and I explain at length in *Governomics*), in yielding to the “small government”/“low tax” fetish we have failed to make the investments in education, infrastructure and other services that can sustain our economic strength and therefore our ongoing prosperity. That’s one reason our labour productivity has been on a long-term downward trend.

¹² Ireland has been left off the chart because its national accounts recorded [huge growth](#) over this period mainly because Apple, in a paper transaction, re-structured its Irish subsidiary, an accounting legerdemon described by Paul Krugman as “leprechaun economics”. If it were plotted it would show taxes at 24 percent of GDP (probably accurate) and per-capita growth at 8.5 percent a year (meaningless).

In fact, at the Commonwealth level, our public sector has been so badly enfeebled that the government has lost its administrative capacity. For some with a partisan axe to grind, it is politically tempting to heap on Prime Minister Morrison all the blame for failures to inoculate residents and staff in nursing homes, and for being tardy in ordering rapid antigen tests, for example. His government has hardly excelled in dealing with the pandemic. But decades of budget cuts, privatisation, staff ceilings and contracting to private consultants have left us with an administratively incompetent public sector, particularly at the Commonwealth level. No wonder the military have had to be called in to help clear the mess in nursing homes.

The only competency left in the senior ranks of the Australian Public Service seems to be the provision of secretariat services to executive governments, writing speeches and press releases for ministers, all with a partisan spin, while the task of providing policy advice is assigned to highly-paid private consultants, who have only a shallow knowledge of public administration, public finance, or public policy, but who have great skills in producing elegantly beautiful websites and glossy reports for the prime minister to wave in front of television cameras.

A warning about the Commonwealth's loss of competencies came with the failure of the Rudd Government's home insulation program where four people unnecessarily died, but in a heated partisan atmosphere we ignored its basic lesson about the politicisation and emasculation of the public sector, and in spite of several hundred avoidable deaths in nursing homes, the Morrison government is still ignoring that lesson.¹³

Although we need to lift public expenditure, and therefore the taxation revenue to fund it, as stressed in the next section, a basic need is restoration of policy and administrative capacity. Our case is not for "big government", but for competent and well-funded government.

The case for competent and well-funded government

There is a great deal of talk, across the political spectrum, about "re-imagining" government. Maybe there will be such a re-imagining, prompted by the experiences of the pandemic, but at this point the case is simply the need for a restoration of the mixed economy that served Australia so well in the past and is serving many other countries – where the public sector does those things it does best, and the private sector does those things it does best.

This does not mean re-nationalising Qantas and Telstra, or restoring the pre-GST tax system that saw the government paternalistically determining what were "luxuries" and "necessities". Technologies and markets move on, but the basic principles which should govern the private-public division don't.

It does mean, however, that unless we are to slip into the "minimalist" model, perhaps as we see in the US, there needs to be an expansion of government in Australia. That

¹³ The need for a restoration of administrative and policy capacity in the Australian Public Service was described in the [Independent Review of the Public Service](#), known as the *Thodey Review*, commissioned by the Turnbull government in 2018. It was completed in 2019, and the Morrison government, in rejecting most of its recommendations, brought the public service even more closely into the function of providing political support to executive government.

expansion will not necessarily be into new roles: rather it has to be to properly fund those functions to restore an adequate level and quality of services and a decent social security system.

One may look at that graph on page 4, noting that in the 1970s and to a lesser extent in the 1980s, there was a lift in the Commonwealth's taxation as a share of GDP, and ask why we now need more funding to provide much the same level of services.

Part of the answer lies in demographics: our society is ageing, and the aged place demands on pensions and health systems. Generally this effect is overstated, however, because at the same time people are leading longer lives with good health – mainly due to modest government investments in public health and medical research in earlier times. Public health is one of those areas of public enterprise we take for granted because the best of public services do not come with the noisy hoopla of the market.

Mostly the answer lies in technological and geo-economic developments over the long term. The things we buy in private markets, particularly manufactured goods, have become cheaper and cheaper in real terms. Think of what our parents or grandparents paid for a car or a television set fifty years ago, for example. The shift of manufacturing to low-labour-cost countries, and the adoption of labour-saving technologies, including transport and communication technologies, have brought down the price of cars, clothes, electronic equipment, furniture and many other household goods. Overseas travel, once reserved for the rich, has become just another holiday option. Computing and communication technologies have seen once-costly luxuries, such as long-distance phone calls, become virtually free. The services we can get on a cellphone or smart watch were either non-existent or prohibitively expensive just a generation ago.

That's all in private markets, that have served us well. But most of what we get from or through the public sector is in the form of human services. Education, health care, care of the aged, and policing, to take four of our most significant public services, are intrinsically labour-intensive. Computing and communication technologies have done their part in bringing down the administrative costs of providing these services, but at their core these services remain labour-intensive. Also they generally cannot be shifted offshore.¹⁴

Nowhere is this more evident than in aged care, where a slow-burn problem of underfunding and underpayment of staff, as well as inappropriate privatisation, has been elevated to a crisis by the pandemic. Unless we are going to sentence our frail aged to misery and unnecessary danger, or to rely on an exploited underclass of foreign workers (a proposition we rejected at Federation), we will have to pay more for aged care.

The same goes for most other government services, particularly those delivered by state and local governments (hospitals, school education and policing), and funded in large part through taxes collected by the Commonwealth.

This long-term trend for public services, if their standard it is to keep pace with standards in private markets, to cost more, is known as the "Baumol effect", after the economist William Baumol who first described it in the 1960s.¹⁵ The Baumol effect goes a long way towards

¹⁴ Perhaps the Medicare schedule could be modified to cover the cost of travel to a country with lower labour costs for hip or knee replacements, but by the time a "developing" country reaches a level that it can provide such services safely it is well on the way to having high costs.

¹⁵ Although the right generally calls it "Baumol's cost disease".

explaining the observation that countries with higher incomes are also countries with relatively higher taxes and government expenditure. As our needs for private goods and services become satisfied, we accept the need to pay more for public services, and that means diverting a higher proportion of our income towards paying for those public services.

That means we have to face up to the need to collect more taxes. In the present pre-election period it's something of a taboo topic, with Labor still smarting from the scare campaign Morrison and his minders raised around its modest and economically-reforming proposals in the 2019 election.

There are non-partisan voices calling for tax reform, but they are hardly coherent, because while some are calling for a fairer and less distorting system of taxes, others are irresponsibly calling for tax cuts, exploiting the myth that Australia is a highly-taxed country.

Tax reform is a huge topic in itself. It suffices to point out that there is plenty of scope to collect more taxation revenue, not only through higher rates, but also through removing many unjustified and distortionary breaks and privileges in our tax system. There are capital gains tax breaks for real-estate and share speculation (while there are penalties for long-term investment). There are no inheritance or wealth taxes. There is an outrageously generous set of tax exemptions for well-off retirees. Almost anyone with an Australian Business Number can set up a trust to spread business income among family members: our personal income tax system is fair in itself, but in effect it applies only to PAYG taxpayers. GST exemptions carry unintended distortions.

No doubt, in the weeks leading up to the election, members of the Morrison government will make up stories about how a Labor government would impose all sorts of enterprise-destroying taxes. In fact they have already started. Partisan journalists and those trying to score a "gotcha" on Labor spokespeople ("will you rule a tax on X" in or out?) will be of no help.

Tax reform has to be based on thorough policy analysis rather than people's gut feelings revealed in a political party's focus groups. More basically, as former Treasury head Ken Henry stresses, it has to be comprehensive, rather than piece by piece, because for each specific reform a coalition of opposition can be mobilised, whereas a well-designed package can be fair to all. Advocacy for or against specific taxes is not the road to reform, and can result in a resistance that stymies reform.

A pre-requisite for reform, so far little discussed, is to bring together the way we talk and think about taxes and public services so that people can more fully see the connection. As we point out in *Governomics*, if a researcher goes doorknocking or cold-calling, asking if people would like to pay more tax, he or she will be subject to a torrent of abuse. But if the same researcher asks if we should pay more tax for certain government services, the response is usually positive. In the most recent surveys, as the pandemic reveals stresses on an underfunded hospital system, health care scores top ranking, but education, environmental protection and transport always get high rankings. If people can see a connection between the taxes they pay and the government services they receive, they are

much more likely to accept the need to pay taxes. In fact people are generally highly supportive of taxes tightly linked to specific services.¹⁶

In an era where trust in government has reached depressingly low levels, it is hardly surprising that people don't trust governments with their taxes. They may be quite happy to pay taxes to spend on needed public goods, but they understandingly balk at the idea that their taxes may go to boondoggles to help re-elect an already not overwhelmingly popular government.

That means, if tax reform is to gain political support, governments must act in a way that restores trust in government. It also means a change in the way we think and talk about taxes, not as a "burden", the word many commentators use, but as an opportunity to fund those things we wish to share with one another, either for hard-headed economic reasons, or because we want to live in a civilised society rather than a market. As the US jurist Oliver Wendell Holmes said, in words carved over the doorway to Washington's Internal Revenue Building:

Taxes are what we pay for a civilized society.

¹⁶ Called "hypothecated taxes" in economicspeak. Although they are only loosely committed to specific expenditures, the Medicare Levy and the NDIS Levy are generally well-received.