**WEALTH OF NATIONS OR WHY LOTS OF TAX CAN BE REALLY, REALLY GOOD**

**Robin Brown and**
**Nicholas McSpedden-Brown**

There seems to be a tendency these days to suggest that a nation's engine of wealth generation is business and only business. The current government seems to be arguing that the only way to really grow our wealth is for it, government, to be doing less and less and for the resources it uses to be transferred to business. That is that we should reduce our already minimal tax revenue so that more of our money circulates around markets and does not spend time in the public sector – that is in all our hands collectively. At about 27% of our GDP our tax revenue is one of the lowest among developed economies. Sweden has a GDP per capita figure about the same as ours so is as economically successful but its tax revenue is around 45% of GDP. Proponents of reducing our public sector seem to be displaying a limited understanding of economics and seem to have a restricted view of what wealth actually is.

Contemplating what one would be least happy to do without, or alternatively what one considers most precious, is a good way to think about wealth. There will of course be differences amongst us, but probably not be very great. High on the list of things most of us would find precious would probably be our loved ones and friends. Other things most of us are likely to value highly, in no particular order, might be:

- The knowledge and the information we have acquired and access for everyone to the collected knowledge and information of our nation and humanity at large.
- Our health and fitness and thus what we need to sustain that being enough safe, nutritious food, clean water, sanitation, clean air and a clean environment generally and adequate shelter and clothing and protection from fires, and floods and other disasters human and nature caused and from those who would do us harm be they our fellow citizens or other nations.
- A community in which we can repose a high degree of trust so that we can expect to be treated fairly and faithfully in transactions with others.
- Large areas of natural environment with healthy communities of things living independently of humanity.

Obviously we would want our loved ones and friends to benefit from these things too. Many of us would want humanity in general and indeed other creatures to have these benefits. We will call this our A list wealth.

Pretty much everything else which we will call our wealth B list - nice possessions, nice holidays and nice dinners out - would be of lesser value to most of us. For example most of us would probably swap living in a nice house for an ordinary house before we gave up these things. That is few of us would choose to live in a grand mansion in somewhere like Syria where we would need a big fence and probably a small private army and spare cash for bribes rather than a modest house in Australia.

Our B list wealth is probably largely the result of the efforts of business – the private sector, but with supporting infrastructure and good governance (including especially things like the privilege of a law that minimises the personal financial risks of owners of corporations) produced by government – the public sector.

In our A list, the wealth that is our loved ones and friends is, to an extent, wealth that just happens as result of our own efforts and the efforts of our loved ones and friends, but making and maintaining friendships is greatly facilitated by other things in our A list. Those other things in our A list wealth clearly result from the composite, sometimes cooperative, sometimes competitive, efforts of the public sector, the private sector and the community sector (voluntary community organisations). However, we suggest that the heavy lifter is the public sector – schools, universities, hospitals, water, sewage, transport, communication and energy systems, police, emergency services, defence forces and regulation to limit risks (there are many from pesticide residues in food to financial mismanagement).

Now you might say that is all very well, but all this could be done with a much smaller public sector than we have. We very much doubt that it could. Australia is a pretty successful nation. With a couple of stalls it has advanced and advanced in a way that until the last couple of decades has been pretty fair to all. In terms of income, it is, per capita, very, very rich. Only a few small countries exceptionally rich due to oil or other special circumstances are richer. Our fairness is slipping though and about ten or more countries with developed economies have a better distribution of income by Gini coefficient. Ours is about 30 which is a long way behind Nordic countries with about 25. Sadly, the OECD has recently shown that we have 14% of our fellow citizens living on less than half our median income. The OECD average is 11% and surprisingly, we think, Britain's figure is 10%. There is no developed economy worse than the richest country, the USA, with its Gini of 45 or more so let us not pay heed to those who say that is a place to emulate.

Who would dispute that nations with poor governance are likely to be pretty unsuccessful in both increasing their wealth and doing it fairly? So does it not follow that, even though we have been lucky in many ways, we must have been pretty well governed? And it then follows that, since we spend less on government than nearly every other developed economy, our governance must have been very efficient. So we ask is there really an argument for cutting down our slim public sector and reducing our already very low tax take.

Dr Julie (Mikayla) Novak (Canberra Times 6 September 2014) of the Institute of Public Affairs suggested that "Most of the empirical literature, especially more recent studies relying on better datasets and improved econometric techniques, draws the conclusion that relatively larger government slows down economic growth, and this has significant implications for the achievement of material aspirations of ordinary people." Dr Novak's PhD thesis, *Economic Consequences of the Size of Government in Australia,* does suggest, with the use of various econometric tools, such a negative correlation. The IPA, with its unabashed advocacy for smaller government, supported this PhD.

Econometrics can be useful in development of economic theory and policy, but it is far from being a perfect science. It can be used to prove all kinds of things, provided you use the right data sample, the right model specification and the right variables. As one late Nobel-prize winning economist once famously noted "if you torture the data long enough it will confess" (Ronald Coase). Another Nobel-prize winning economist famously pointed out that the exploitation of statistical relationships based on historical data for policy purposes should be done with great care, as estimated regression coefficients are likely to change when agents' preferences adapt to new policies (Robert Lucas). As yet another famous economist noted - who died before economics was considered worthy of Nobel prizes - pointing to one of major difficulties of econometrics, said: "if two variables are correlated with each other, this does not mean that variations in one necessarily *cause* variations in the other" (John Maynard Keynes' critique of Jan Tinbergen). And perhaps most importantly, econometrics is prone to major, embarrassing errors: we are reminded of the fall from grace of Harvard economists Ken Rogoff and Carmen Reinhart when their 'scientific' proof of a negative correlation between high debt-to-GDP and low growth, which had become the intellectual backing of austerity policies the world over, was shown to be completely baseless thanks to a spreadsheet error, and was subsequently entirely rebutted.

These caveats aside, econometrics is still one of the least-bad scientific tools we have for interpreting relationships between statistical variables and estimating their effects, to help give some insight into potential policy implications. And as with any science subscribing to Karl Popper's criterion of falsifiability, the more independent econometric analyses arriving at the same results, the more we can be sure of those results.

It is true that several studies have shown a negative correlation between the size of government (measured either as the ratio of tax revenue to GDP or of public expenditure to GDP) and growth. It is also true that some studies (although fewer) have shown a positive correlation between the size of government and growth.[1] But what Dr Novak is saying is that big government *causes* low growth. This is much harder to prove. Causality may indeed sometimes run the other way, as governments tend to spend more during recessions. There are econometric techniques that help to control for such factors and attempt to prove causality – the main one being the 'instrumental variables' technique – but they are still in their infancy. As a recent World Bank study indicated "*Although many studies find a negative relationship between government size and growth, no consensus has emerged on whether big government is harmful to growth*."[2]

This being said, it still makes sense to at least hypothesise that big government causes low growth, if we are to pay serious attention to and try to explain the negative correlation observed in many studies. But this also means gaining a better insight into those specific samples of countries over time for which a negative correlation applies that are relevant for comparisons with Australia, and investigating what underlying factors may be at work.

First, fast-growing developing countries often have lower tax revenue-to-GDP or public expenditure-to-GDP ratios simply because they are yet to put in place those public institutions characteristic of developed countries (e.g. public education). It therefore makes little sense to compare Australia's size of government to that of developing countries when trying to determine to the right size of government for growth.

Second, it is certainly true that size of government *up to a certain point* is in all cases conducive to growth, and it is certainly true that size of government *beyond a certain point* is in all cases detrimental to growth. Most would agree that government must at least be big enough to allow for the essential institutions of a market economy to be put in place (such as the rule of law, including the establishment and enforcement of property rights) and that it cannot be so big that it crowds out all private investment. Just like the Laffer curve for tax rates and total tax revenue, the Armey curve embodies the idea of a non-linear relationship between the size of government and growth, and by extension the existence of an optimal, growth-maximising size of government. Determining this bliss point has been the subject of a number of studies, but achieving consensus has been difficult. It is also possible that different optimums prevail for different sets of institutions. In any case, as there are economies which have grown more quickly than Australia's in recent times while maintaining bigger governments, it is not unlikely that Australia's optimal, growth-

---

[1] For an overview see Bergh, Andreas and Magnus Henrekson, *Government Size and Growth: A Survey and Interpretation of the Evidence*, IFN Working Paper No. 858, 2011

[2] World Bank, *Golden Growth – Restoring the lustre of the European economic model*, 2011.

maximising size of government is yet to be attained.  This is confirmed by the same World Bank study mentioned above, which includes an analysis of a panel of advanced and emerging economies over the 1995-2010 period that shows that "*the impact of government size on growth is negative for the countries with initial government spending of 40 percent of GDP or more, but positive (and mostly insignificant) for countries with smaller government sizes*" (Australia's public expenditure-to-GDP ratio is about 35%).

Third, focusing on the size of government alone, either in terms of public expenditure of tax revenue, obscures a deeper understanding of the effects of different types of public expenditure and tax revenue on growth. The World Bank study again points out that "*the literature fails to agree on which categories of public spending are likely to be growth-friendly*". On the one hand, it is possible that social transfers are negatively correlated with growth, as the study suggests, and that income taxation (as opposed to e.g. consumption taxation) is also negatively correlated with growth, as others have suggested. Yet this needs to be contrasted with the growth-enhancing benefits of higher equality. Research recently promulgated by the IMF shows that countries with higher levels of equality have, over time, actually enjoyed higher levels of economic growth, even if those countries are generally those with larger government sectors where more of the national income is taxed and redistributed to the less well-off.[3] And on the other hand, as the World Bank study indicates, much economic literature has shown that public investment as a form of public expenditure more often than not supports growth.

Finally, there are some key, major outliers to any cross-country study purporting to show a negative correlation between growth and the size of government: the Nordic countries. These countries have enjoyed high growth rates even throughout the 1990s and 2000s, despite some of the highest public expenditure and tax takes in the world. Research shows that two key underlying factors may be at play: quality of government and social trust. The World Bank study shows that big government is generally correlated with both better quality of government (measured according to dimensions as diverse as 'regulator of the private sector'; 'facilitator of economic openness'; 'manager of its resources; 'enabler of voice and accountability'; and 'enabler and provider of public goods') and social trust (measured in terms of trust in other people; more tolerance of diversity; the opinion that government should take more responsibility; and the view that claiming benefits is justified). Nordic countries have effective and efficient public sectors and transparent governments (for example, they are consistently ranked at the top of both Transparency International's Corruptions Perception Index and the World Bank's Ease of Doing Business Index), while survey data indicate that in the Nordic countries, about 60% agree that most people can be trusted, compared to the OECD average of about just 40%.[4] It is not clear what relationships each of these variables bear among each other and with growth, but it is likely that both better quality of government and higher social trust are correlated at the same time with both big government and growth, and that that is what has enabled the Nordic countries to maintain high growth rates. Australia is also well ranked in terms of quality of government and social trust (although not as high as the Nordic countries), so there is reason to believe that it too can reconcile growth and big government.

All of these observations demonstrate that the right econometric regressions have yet to be done to truly get to the bottom of this, and we may have to wait a while yet for them. But it is also clear that, in stark contrast to Dr Novak's contention, there is no credible case for reducing the public sector in Australia in order to achieve higher economic growth. If anything, there is evidence that the size of government may be sub-optimal from a growth perspective, particularly if the right types of public expenditure and/or tax

---

[3] Ostry, Jonathan D., Andrew Berg, and Charalambos G. Tsangarides; *Redistribution, Inequality and Growth*, IMF Staff Discussion Note, February 2014.

[4] See the various waves of the World Values Survey.

revenue are pursued, and if efforts are made to sustain high quality of government and high levels of social trust in parallel. And importantly, as shown above, there are other priorities that would sometimes coincide with, but often compete with economic growth, such as increasing our A list wealth and fairness in our society, for which big government is likely to be a strong precondition. Any potential drawbacks of big government for economic growth therefore need to be weighed against its advantages in furthering other, probably more important goals.

It makes sense that public policy and programmes be implemented to ensure all citizens reach their intellectual potential, such that a nation is maximising the productivity of its human capital. The current government is arguing that the aim should be for all citizens who possibly can need to be "lifters" rather than "leaners". That is absolutely right, but it is absolutely wrong to take away what some need to lean on to become lifters. And those who think they are strong enough to keep on lifting might pause and listen to Bill Withers' song:

Lean on me when you're not strong
And I'll be your friend, I'll help you carry on
For it won't be long
'Til I'm gonna need somebody to lean on

In this country it seems that many, when they see a fellow citizen who is leaning and not lifting, ask "What is wrong with him/her?" It is nearly always more useful to ask "What should we change in our society, how should we invest our common wealth and how much so that fewer of us need to lean?" It is actually not that we cannot afford to make this kind of investment, rather we cannot afford not to as nations that are will leave us far behind.

**Robin Brown is Deputy Chair Foundation for Effective Markets and Governance (www.femag.org.au) and holds a Master of Public Policy degree from ANU's Crawford School.**

**Nicholas McSpedden-Brown is a member of the Foundation and holds a Master of Public Policy and Development degree from the Paris School of Economics**