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The Politics of Public Expenditure

A week is a long time in politics. It seems even longer during a political crisis.

The global financial crisis has forced some dramatic changes in government thinking in only a few months. Decades of economic reform have suddenly been discarded in the rush to reinvent government to try to cope with the crisis.

In essence western governments have returned to running economies rather than leaving economies to the market. The general public – at least for the moment – have lost confidence in some of the workings of the market and so politicians are spending large sums of money trying to revive the economy.

Extensive government expenditure is back. In reality, of course, it never went away. British Prime Minister Margaret Thatcher (1979-1990) reinvented the role of government by cutting back (she claimed) in government expenditure. Her privatization and corporatization reforms were an inspiration for the Hawke, Keating and Howard Governments (1983-2007).

But the actual government slice of GDP was simply reinvented – rather than dramatically reduced. She certainly got rid of many government subsidies and government enterprises. However, “transfer payments” – where government transfers money from, say, tax payers to welfare recipients – had to increase to pay for all the additional unemployment. British voters liked her getting rid of inefficient government enterprises but they still expected her to take care of the casualties of change.

Now the Brown Labour Government is putting the clock back. It has, for example, nationalized the first British bank for over a century. The Rudd Government is increasing expenditure, such as on infrastructure. The US Obama Administration is creating the most ambitious peacetime public expenditure programme in US history. Governments are claiming simply to react to public anxiety and so have little choice but to spend big.

This article examines the politics involved when using the public purse and who pays in the short and longer term. It identifies five issues of controversy in the years to come.

First, while the market system has been shown to have some defects, what guarantee is there that government can do any better? The academic discipline of economics is different from the natural sciences partly because in those sciences there is a sense of progress, whereas in

economics it is more a matter of a pendulum swinging back and forth. Once scientists had proved, for example, that the earth really did go around the sun, no scientist reopened the debate a few decades later by claiming that the earth was the centre of the universe.

Unfortunately, in economics old debates never quite seem to go away. Adam Smith in 1776 argued that the economy would be better off without extensive government and church regulation and that there was an “invisible hand” at work via the market. If he were alive today, he would soon feel at home in the current controversy over what is an appropriate level of government expenditure and involvement in the economy. Similarly Lord Keynes (1883-1946), who advocated a greater government intervention in the economy and whose writings were discarded by government from the 1970s onwards, is now coming back into fashion.

Second, there is the problem of “incrementalism”. This term, from political science, refers to the way in which large-scale reforms may be achieved gradually. A series of steps are taken, each one seemingly very small but it is only when the full set is seen in perspective that it is obvious that a major change has taken place. The process may also create “unintended consequences” – results that were not foreshadowed at the beginning.

President Reagan did not, for example, set out to destroy the US banking system when he began deregulating it in June 1982. But it is only by viewing the small changes of reducing the regulations that grew out of the Great Depression and the Roosevelt New Deal Era (from 1933 onwards), that it is possible to see how each seemingly small step reduced the safeguards that were imposed to protect bank customers.

Incrementalism also works in terms of increasing government involvement in the economy. Again it is done in a series of small steps, each seemingly useful at the time. But after a few years, government will once again be heavily involved in the economy with extensive public debt.

There is no automatic mechanism to halt the incrementalism process. It just keeps creeping along until a new leader with a very different vision – usually responding to a fresh crisis – feels they have a mandate for dramatic change.

Party labels are not necessarily indicative of policy when in office. Australian Governments (Labor and Liberal-National), starting with the post-war Chifley Labor Government, became far more involved in running the economy. This continued through to the Labor and Liberal-National Governments 1983-2007. Coincidentally the similar reduction in government involvement began with Labor in Australia (Hawke) and New Zealand (David Lange), while conservative leaders led the charge in Britain (Thatcher) and the US (Reagan).

Party labels are irrelevant. Political leaders respond to the mood of the times, media debate and the intellectual fashions of the day - rather than any particular party ideology. For example, Paul Keating was the Treasurer in the Hawke Labor Government and he argued for a

reduction in government involvement and the end of the Chifley heritage. But while he was learning the art of politics, his NSW political father-figure had been Jack Lang (1876-1975), the most important Australian politician in 1930s and an early advocate of Keynesian economics. Keating as Treasurer ditched the Lang tuition and moved to the other end of the spectrum.

Third, who should actually spend the public money? The issue here is how far should political involvement extend? Should government simply provide public funds for others in the private sector to spend – or should it take over the “commanding heights of the economy”? Should, for example, government get back into planning the economy?

A current US controversy is that the Obama Administration is planning to spend US\$1 trillion propping up the US banking system. But a range of political viewpoints in Congress are opposed to the money going simply to the Federal Reserve to spend how it sees fit. These politicians claim that the Reserve Bank is too close to US banks and finance houses and that it is not subject to Congressional oversight. Under their proposed Federal Reserve Transparency Act these politicians want to bring the Federal Reserve under closer scrutiny by Congress and the Government Accounting Office.

Fourth, how should the money be spent? A risk with allowing politicians to spend money is that they will use the funds to suit their own local voters rather provide any overall economic benefit for the country. For example, farming subsidies in western Europe, US and Japan have been justified for decades on the grounds of supporting traditional ways of life and encouraging people to stay on the land rather than abandoning it for life in the cities.

But politicians often cannot be trusted to spend money objectively. All politics is local – and foreigners don't vote in my constituency.

Therefore farming subsidies now distort the over-growing of food in developed countries, which then supply cheap food to developing countries, whose own farmers therefore lose the incentive to produce food. A good way to assist economic progress in developing countries would be to stop cheap western food from flooding into those countries.

However, it is very difficult to cut back on the subsidies because of potential adverse reaction from voters. Western European farmers receive about 35 per cent of their income from government subsidies. It is often easier to lobby politicians for subsidies than it is to work on the land.

A western European cow has a higher income, so to speak, than the average African. A cow receives about US\$2.50 per day in government subsidies, while about a billion people worldwide struggle to survive on a US\$1 per day.

Even in the US, allegedly the home of free enterprise, subsidies are politically important. About US\$4 billion is provided each year for cotton subsidies – more than the total

worth of the crop itself. Politicians from cotton growing areas are influential in Congress and can keep moving money in the direction of their constituents.

Similarly, tobacco is also subsidized to support local growing in politically significant constituencies. Some tobacco farmers are paid not to grow tobacco in years of surplus growth. Movie star John Wayne used to earn some years more money from the government not to grow to tobacco than he made from Hollywood movies.

Doubtless President Roosevelt (1933-45) would argue today that these distortions were “unintended consequences” of his New Deal policies of the 1930s and 1940s. He never set out to create these distortions. But once politicians get their hands on public funds it is very difficult to give up the habit.

There is nothing so permanent as a temporary government initiative. Ideally all government programmes should have “sunset clauses”, which would specify when a temporary measure should end. But politicians do not like having their hands tied. In due course, each temporary measure acquires its own lobby group with a vested interest in the measure continuing.

Finally, a particular risk of political involvement is “moral hazard”. This occurs when, for example, people undertaking a financial activity are insulated from the consequences of their bad decisions. A circus performer with a safety net might take greater risks than a performer who does not have one and who knows that an error will send them plunging to the hard ground.

Individual life in the 19th century could be harsh, with the risk of poverty for people who acted irresponsibly (for example they became addicted to alcohol). They had no safety nets other than their families and charities. But some people seem to have misfortune through no fault of their own; they were just in the wrong place at the wrong time.

During the 20th century’s rise of the welfare state there was the socialization of risk. This meant that a person falling on hard times (such as unemployment or the loss of a breadwinner) could receive government assistance. Taxpayers contributed to the welfare of others, via the government’s system of transfer payments, well aware that the safety net existed for them if they should ever need it.

A problem arose when such safety nets encouraged risky or irresponsible behaviour and so there have been debates over how welfare should be rationed to the deserving poor and not “welfare cheats”. What seemed a good system for people who acted responsibly (and yet still incurred misfortune) could be abused by others.

A similar process was also underway in the business community. The market system was seen in the 19th and early 20th centuries as a way rewarding good behaviour and punishing

irresponsible behaviour. It had a cleansing impact of washing away business failures and rewarding those that had acted carefully.

But after the Great Depression government provided safety nets for economic activities. Gradually (as we have seen in the example of subsidies) government provided an increasingly diverse range of safety nets and there was some abuse of the system.

Banking has also benefited. Banks are now seen as too big to fail. In 1982, the Reagan Administration ended the New Deal's tight regulations over Savings and Loans (essentially, by Australian standards, local building societies) and there was a crash in S&Ls in the early 1990s – which the US government had to underwrite. Similarly the US government had to step in when Long Term Capital Management collapsed in the late 1990s.

But the Bush Administration refused to help Lehman Brothers and the bank declared bankruptcy on September 15 2008. The Administration let it be known that it wanted to demonstrate its zeal for the cleansing nature of markets.

This rediscovery of 19th century market zeal didn't last long. The shock waves from allowing Lehman to collapse forced the Bush Administration to do more to protect other US banks, including a US\$700 billion rescue package. The UK, Swiss and Swedish governments also acted promptly around this time to save their own banking systems.

The safety nets are back in place. Thus, we are now having to reopen old debates over the wisdom of government intervention in the economy. The more things change, the more they seem to remain the same.

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