

What First World Governments Can Learn From The Third World Recent Economic Thinking About Public Spending

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Summary

The current financial crisis, and the economic contraction appearing in its wake, is seeing a massive destruction of financial and physical capital. Less well understood is that the current crisis is a crisis for a generation of economic policy making and academic thought. We are also therefore witnessing a massive destruction of intellectual and policy capital. Nowhere is this more evident than in thinking about fiscal policy.

The problem is that for at least a decade or more serious thinking about fiscal policy has moved on from what is now presented as prudent government policy by state and federal treasuries, and in political rhetoric. The critique of this position comes from across the spectrum of economic thought. For aficionados of public economics and fiscal theory, it is unfair to summarise two decades of important research, into two conclusions. But with this caveat, we do know that rule-based targeting of short-run fiscal outcomes tends to encourage:

1. the delay and reduction of capital expenditure on infrastructure, or the shift the expenditure off-balance sheet (such as via PPP contracts). Both the underinvestment in infrastructure on the one hand, and the large contingent liabilities created (from non-compete clauses and effective profit guarantees via take or pay agreements) on the other, have proven costly to economic growth and state revenues.
2. an under-expenditure on re-current areas of education and health care (because public budgetary accounting conventions treat them as having no long-term effect) at the same time as evidence shows that these expenditures are important to long-term economic growth and social order.

The current economic downturn is emphasising the important role of government in moderating recessions, through the use of counter-cyclical fiscal policy. Both the SA and Federal governments have announced infrastructure spending increases in coming years. In many ways, however, these programs are just beginning to address a serious infrastructure deficit that has arisen in Australia over the last fifteen years, which fiscal deficit reduction policy has helped to create. These measures are therefore welcome and long-overdue.

The current downturn is also a moment to re-open the wider question of how we understand the long-term economic importance of public services. The overwhelming evidence both internationally and in Australia suggests that private capital simply has not, nor can it take up the task of providing high quality education, health and other public services for the general community at low cost. We know that high quality infrastructure and a healthy and well-educated population are good for societies and good for an economy. The just-released Bradley Report (2008) on higher education is just the latest in a growing series of studies and reports making this point. The fact that the benefits of such spending are difficult to measure should not make us shy away from trying to measure their effects, or from spending money to achieve them.

It has been said that the fiscal deficit is little more than a number in search of a concept. Insiders concede that the budget deficit is a largely accounting category, with little economic content, and a relic of colonial government reporting. But it was focused on by a generation of economists and politicians, and used as a basis for economic policy because it was measurable and seemed to offer what Kotlikoff termed an illusion of meaning where none exists. Fiscal targets, like the budget deficit, are not therefore a mark of fiscal conservatism, but a sign of lazy 1990s style populism. They are in short bad economics. We will only make ourselves poorer if we needlessly cut spending to meet fiscal policy targets that are populist politically, but economically meaningless.

1. Introduction¹

“There are real problems to be concerned about, but the...deficit doesn’t measure those problems.” Laurence Kotlikoff

“It is an absurd matter of dogma that deficits are necessarily bad and that we have to do something to reduce them.” Robert Eisner, former president of the American Economics Association

Some significant shifts are underway in thinking about government fiscal (spending and taxing) policy. For at least a decade and a half, it has been generally accepted policy wisdom, and successful populist politics, that good government involves targeting the government’s net fiscal balance. Deficit reduction and cutbacks in recurrent and capital expenditure have been *sine qua non* of this approach. The rationale for such a policy approach was simple enough – in a period of economic instability reducing the government’s claim on an economy’s scarce investment resources would free resources for the dynamic sectors of the private sector.

Yet fiscal retrenchment (especially cutbacks in physical and human capital enhancing spending) and deficit reduction have been subject to critique by economists for at least a decade and half. There is now widespread agreement amongst economists that targeting a short-run accounting residual like the current net fiscal outcome is simply bad economics. But until very recently, that critique was largely a discussion between academics. Political rhetoric and government policy-making remained largely immune to the recasting of fiscal theory that was occurring.

It has been the fear of a recession caused by the U.S. sub-prime financial crisis that seems to have provided the catalyst for change in the prevailing wisdom. This paper provides an overview of those changes in thinking about fiscal policy with a view to current debate in South Australia about government spending. While the focus of debate has so far been about the role of government spending during the current slowdown/contraction, the argument extends to the wider role of government in economic and social policy.

¹ The author would like to thank Dr Roger Ham and Professor Raja Junankar for comments on an earlier version of this paper. Sabrina Ong helped with the graphics and layout. The usual caveat applies concerning any remaining errors and omissions.

At present, political rhetoric in Australia remains firmly in the grip of the old deficit targeting paradigm. Even though it has become clear that the federal government and some state governments have moved to use fiscal policy to stabilise the economy, political discussion about government taxing and spending in Australia remains closely tied to the 1990s populist economics of deficit reduction². One of the interesting developments in the re-thinking in fiscal policy is that it is much more advanced in areas of development policy institutions like the IMF and World Bank, than in the economic policy making departments of governments like Australia. It may be time for some first world governments to learn from experiences in third world countries, where the full effects of earlier policy thinking have played out so badly.

2. Public Spending - Growth and Stability

Before proceeding to review developments in fiscal policy, a brief comment on fiscal accounting is warranted. Government accounting conventions treat money spent and received as either annual/recurrent or capital. The annual budget therefore is comprised of two accounts – the annual cash account and the capital account. The intuition here is that recurrent expenditure is what governments do to keep society going on an annual basis, whereas the capital account records activities such as infrastructure construction that have longer term effects. This approach probably made sense during colonial times when the two accounts recorded the two different funding sources – recurrent fiscal deficits were funded by the colonial treasury, capital expenditure was funded by bond issuance. But in an era of democratic self-government, and when human capital is the engine of growth, treating education and health care as recurrent expenditure with no long-term effects reflects partly the dominance of historical accounting categories, as well as the difficulty of measuring the effects of education and health. The federal government and some state governments have moved from cash to accrual accounting, in part to reflect the multi-year effects of spending and taxing, but accrual accounting still fails to take into account the longer term effects of spending on health and

² The recent SA budget was explained thus:

“The Treasurer says that this will be his seventh State Budget and the seventh he has handed down in surplus. The Budget will deliver a net operating surplus of: \$160 million in 2008-09; \$356 million in 2009-10; \$434 million in 2010-11; and \$424 million in 2011-12.

We fought hard to win our AAA-credit rating and I am not about to give that away through reckless spending or tax cuts. The ongoing uncertainty in world financial markets means that, in addition to building for the future, we must manage potential risks. The Budget also [therefore] sets new savings targets across portfolios of: \$25 million in 2009-10; \$75 million in 2010-11; and \$150 million in 2011-12.” SA Treasury Budget Overview 2008

education. We will return to these issues shortly in the context of how these accounting categories have created serious economic effects.

In the 1990s, orthodox economic policy for restoring growth required both reducing the 'drag' of government and freeing up the engines of growth in the private sector. As Easterly recently observes "A popular phrase during the era of macroeconomic stabilization of the 1990s was 'adjustment with growth' (2008, 37).

Adjustment was to be achieved by rebalancing the economy away from the public to the private sector, and deficit reduction was commonly seen as a principal focus for fiscal policy to achieve this end. *Growth* would come from releasing more resources to sectors which will be more efficiently used, and deployed in a more growth-oriented fashion. The intuition of such policy was immediately appealing to those charged with managing fiscal policy during a period of macroeconomic uncertainty. It was also appealing to a generation of populist politicians (and their advisers) in providing a focus to a problem that could be measured, and seemed to correspond to notions of prudent household responses to economic uncertainty (i.e. balancing the family budget).

This policy approach has been extremely influential both in the developed and especially in the developing countries, where access to international development assistance (such as from the IMF) was tied to adoption of such fiscal austerity measures. William Easterly, a former World Bank economist, has recently provided a critique of the fiscal austerity programs of developing countries during the 1990s (Easterly et.al. 2008). It will be recalled that in a range of Latin American countries, facing economic contraction, international aid was accompanied by a range of conditional economic and fiscal policy measures, especially a focus on government expenditure retrenchment.

In particular, Easterly et.al. have argued in the context of an analysis of Latin America that:

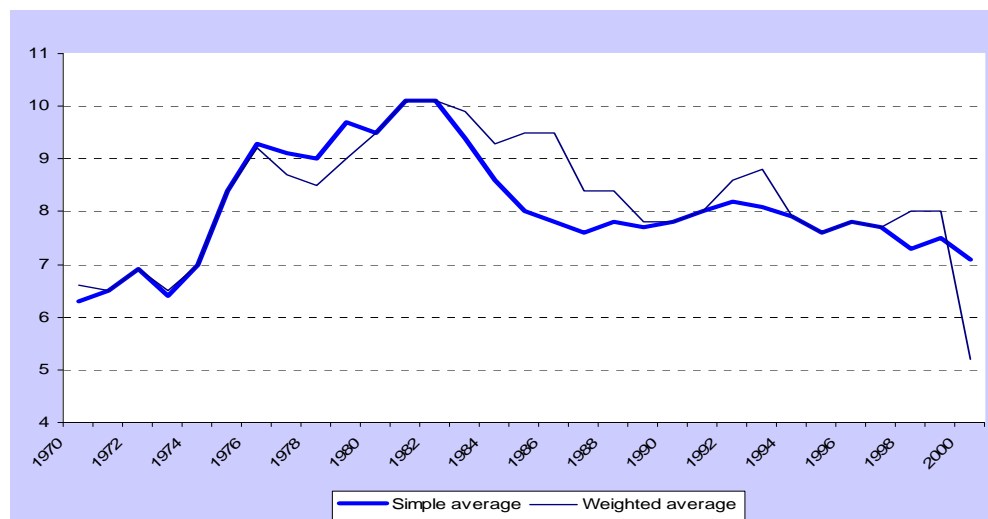
"...the evidence suggests that in most infrastructure sectors in most countries, private investment did not offset public sector retrenchment." (2008, 39)

Importantly, they add:

"the international evidence suggest that Latin America's experience is the rule rather than the exception. Declines in infrastructure spending often account for the lion's share of fiscal deficit reduction." (20078, 39)

Chart 1 shows that across the developing world, from about the early to mid-1980s public investment in infrastructure stagnated and declined from around 10 percent of GDP to less than 7 percent in 2000. Measured this way, fiscal policy was successful in reducing the share of government capital expenditure in the economy. The problem was that the much hoped for surge in private capital expenditure failed to materialise, except for some countries in East Asia. For the remainder, much needed infrastructure has simply not been built, further exacerbating economic and social problems in those countries.

Chart 1 - Public Investment in Developing Countries 1970 – 2000



Source: Everhart and Sumlinski, cited in Roden 2008

In Australia, the 1990s were also marked at both federal and State government levels by an economic consensus that deficit reduction was good, and a key symbol of sound economic management. While recent public spending announcements seem to have superseded this position in fiscal practice, political rhetoric remains anchored in a discourse that rule-bound deficit targeting remains a sound principle of economic management.

A problem with policy that targets short-run trends in an accounting-based fiscal residual category like the cash deficit is that there is little or no economic motivation to justify it. Academic research since at least the late-1980s has been highly critical of the whole agenda of fiscal austerity and especially the focus on short-term changes in annual budget balances as a meaningful goal of economic policy. The criticism has been broadly based, and damning, but has gone largely unheeded. Mounting empirical evidence supporting this

critique in terms of the negative effects on developing countries and the current financial downturn are, however, helping to build toward a significant re-thinking in orthodox fiscal policy.

The key points of interest from the research on focusing on short run fiscal targets such as a budget deficit include that:

- little empirical evidence has been found to support any connection between budget deficits, savings and investment, or productivity growth rates³,
- yet it encourages under-investment in infrastructure or shifting the spending off balance sheet (such as via PPP contracts),
- the deficit is largely an accounting category (largely a relic from colonial accounting practices) with little economic meaning,
- little account is taken of the role of inflation in financing it,
- there are many worthwhile government activities that do not improve short-run fiscal balance that are still worth undertaking,
- focus on a year to year deficit treats recurrent spending as having no long-term benefits. It therefore ignores the assets and long-term income earning capacities that may be generated from public spending on things like education and health care and therefore the increased economic base for financing it,
- focus on the deficit ignores the different distributional burdens of financing public spending, both currently and inter-generationally, and
- focussing on deficit reduction during a recession is likely to accentuate the degree of downward economic fluctuation, and may also therefore accentuate financing problems and slow long-term economic growth.

The re-thinking of fiscal policy and the role of government is coming from some surprising sources, including from the key international development institutions like the IMF and World Bank, and even from leading conservative economists. In surveying the scholarly research, former World Bank economist William Easterly and his colleagues, conclude that:

“...some types of fiscal austerity not only fail to bring growth, but they may not even bring ‘adjustment’ in the long run” (2008, 37)

³ Some of this research has, paradoxically enough, emerged in the context of Barro’s proposition about fiscal financing. It was thought for a while that, following a comment of Ricardo, deficit financing would be self-defeating because people would adjust their spending to anticipate higher future taxes to repay borrowing. On this basis, fiscal policy could be held to be largely ineffective and de-facto budget balance a reasonable rule of thumb. This proposition, known by economists as the ‘Ricardian equivalence theorem’ has had mixed empirical support.

It is possible to see this change of thinking about the role of government occurring in at least two directions:

- The first is the re-discovery of the counter-cyclical role of government expenditure,
- The other is wider role of government expenditure in economic growth and social policy.

The paper now deals with each of these briefly in turn, and the final section of the paper attempts to consolidate the lessons from each strand of research in terms of current debates in Australia, and SA in particular.

2.1 Fiscal Policy and Economic Stability

“Now is not the time to worry about the deficit” Nobel Economics Laureate Paul Krugman 2008a

“Glenn Stevens [RBA Governor] suggested people should get over the hang-up that one dollar of budget surplus is good and one dollar of budget deficit is bad. The danger was that governments might pull back from ‘worthwhile’ infrastructure projects because both their own revenue and private partnership financing were drying amid the economic crisis. NSW springs to mind. Government rejection of ‘prudent borrowing’ to finance worthy public investment could mean that fiscal policy amplified rather than evened out the ups and downs of the business cycle. It would be pro-cyclical. And it would be like talking ‘ourselves into unnecessary economic weakness’” Michael Stutchbury 2008

For a generation of economists, it has been an article of faith that inefficient state activities have ‘crowded out’ the possibility of more efficient and growth-oriented private sector activities. Often then, economic policy responses to an economic downturn was to reduce government spending (to restore fiscal solvency) and permit private capital investment. But this is an empirical as much as a theoretical proposition. An important strand of research has considered the experience of governments that have undertaken such policy approaches. And as Easterly and others have found, the outcomes have been often to make economic recessions deeper and long lasting, and even to undermine longer- term fiscal positions of governments.

In short, the empirical evidence has shown that governments can play an important counter-cyclical role. Recent policy responses by governments in

Australia and elsewhere suggest that fiscal practice has absorbed some of those lessons. But the research also opens up wider issue of the relationship between government and economic growth.

2.2 Government Spending and Growth

“Solvency assessments based on debt and the cash deficit implicitly treat all public expenditures in the same way, because they all pose the same claim on today’s resources. This blurs the distinction between public investment and public consumption and, more precisely, between expenditures that yield future fiscal benefits and those that do not – even though they may have radically different implications for tomorrow’s public revenues...” Easterly et.al. 2008, 41

“The privatisation of the South Australian electricity industry has reduced the net worth of the public sector...the interest savings on the sale price will fall consistently short of the earnings foregone through privatisation. This is consistent with most Australian experience of privatisation” John Quiggin, (2003, 68).

Developments in the economics of growth and empirical research based on those developments have re-opened the relationship between government activity and economic growth. Some of this relates to issues such as whether and what types of government spending are growth enhancing.

This area remains a very lively area of research, and it would be wrong to impose a consensus on a field of economics where none currently exists. But what is clear is that economic theory now no longer permits easy generalisations about government activity and its relationship to economic growth. Notions of government activity ‘crowding out’ private, or acting as a drag on growth are not economic statements, but empirically testable propositions. The evidence of such testing is mixed, but we do know that for instance that there is support for propositions that healthier and better educated societies, with well-endowed and efficient infrastructure are more productive economically, and more cohesive societies.

We also know from a generation of outsourcing and public private partnerships that private capital finds it very difficult to deliver high quality low cost public services to the general public, and that this is not simply a contracting problem.

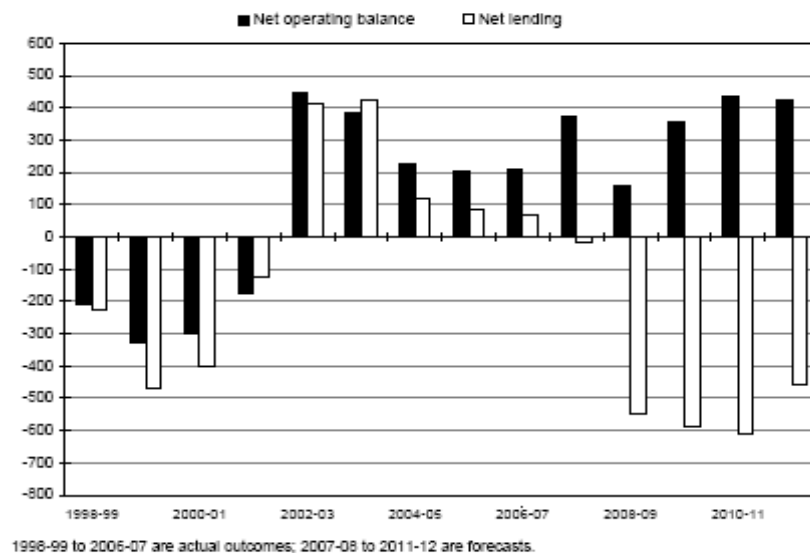
While this research therefore is not conclusive, it suggests that there is considerably more scope for economically useful public activity than is often

presented in political discourse. Perhaps the crucial general conclusion from this research is that answers to most of the relevant economic questions we face are not likely to emerge from policy that focuses on a short-run fiscal accounting-based outcome.

3. What are the lessons for SA?

The paper has so far showed that there has been a growing gap between serious thinking about government economic and fiscal policy, and how it is being practised and discussed publicly in Australia. Chart 2 shows the trends in fiscal policy in South Australia since 1998. While the budget does not define it as a deficit (it employs categories of net operating balance and net lending consistent with the shift to accrual accounting), our discussion has direct implications here.

Chart 2 - SA Budget Net Operating Balance and Net Lending 1998-2011,



Source: SA Treasury 2008

The SA government fiscal strategy is stated to have the following **primary** fiscal targets:

- at least a net operating balance⁴ in the general government sector in every year, and

⁴ Net operating balance is defined as: "...a measure of whether revenues are sufficient to meet the expenses incurred by government in delivering current services to the public, including expenses for future obligations like long service leave."

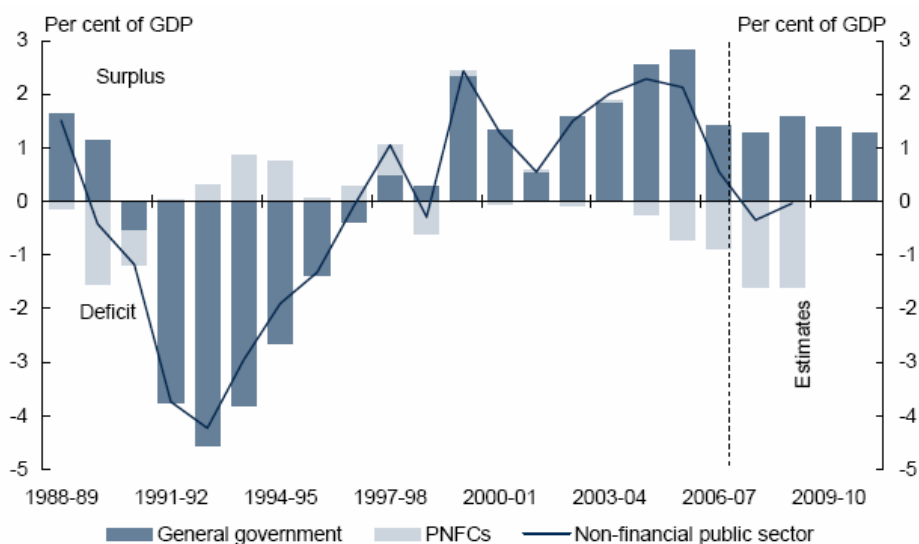
- net lending outcomes⁵ that ensure the ratio of net financial liabilities to revenue continues to decline towards that of other triple-A rated states. (SA Treasury Budget Overview 2008)

According to the SA Treasury overview:

“It is necessary for the long-term financial stability of the state that positive net operating balances [and net lending] are achieved – this underpins the triple-A credit rating”.

It is clear from these primary fiscal targets that government policy in SA remains locked into the targeting of short-term fiscal outcomes. The purpose here is not to suggest that SA is particularly obsessed with deficit reduction. The 3 charts below provide trends in federal and state budget balances, derived from current Commonwealth Budget Papers. It can be seen that the trends across government as a whole and between federal and states is only a matter of degree. Deficit reduction remains the stated objectives of all government treasuries in Australia. Importantly also, it shows the extremes of this policy approach in that despite the well-known deficits in infrastructure and human capital accumulation, governments have become accumulators of net financial assets as shown most clearly in Chart 5 below.

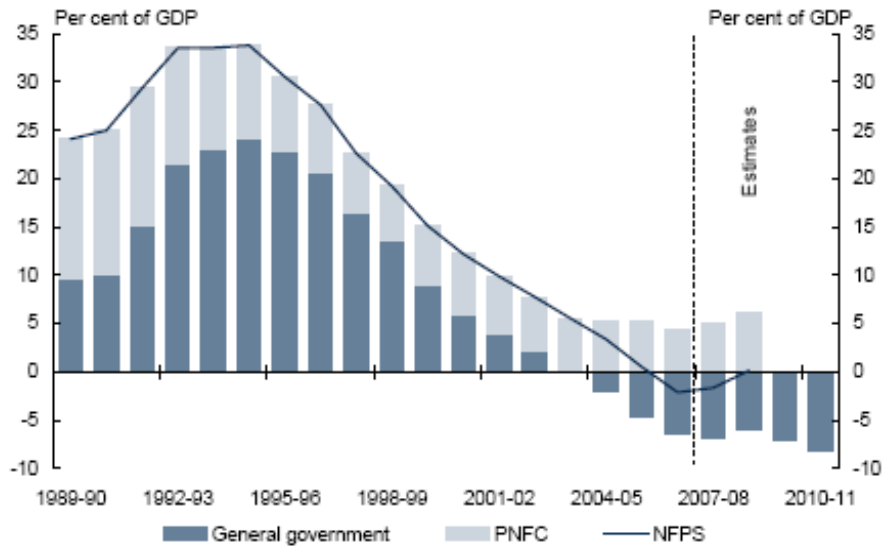
Chart 3 - Government Net Fiscal Balance – General Government 1988-2010, percent of GDP



⁵ Net lending is defined as: “...a measure of whether revenues are sufficient to cover expenses and net capital investment. A net lending deficit means that operating and investment expenditure has been funded from sources other than revenues, resulting in increased liabilities [emphasis added]”

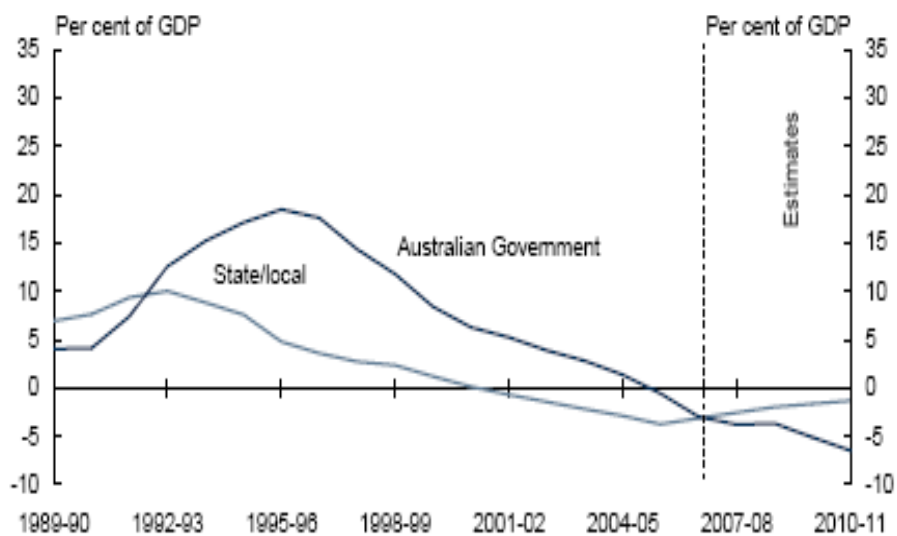
Source: Commonwealth Treasury Budget Papers 2008-2009

Chart 4 - Trends in Australian Government Consolidated Public Debt, percent of GDP



Source: Commonwealth Treasury Budget Papers 2008-09

Chart 5 - Government Debt by Level of Government 1989-2010, percent of GDP



Source: Commonwealth Treasury Budget Papers 2008-2009

4. Summary and Conclusion

“Under current conditions, there’s no trade-off between what’s good in the short run and what’s good for the long run; strong fiscal expansion would actually enhance the economy’s long-run prospects.” Krugman 2008 b

The current financial crisis, and the economic contraction appearing in its wake, is seeing a massive destruction of financial and physical capital. Less well understood is that the current crisis is a crisis for a generation of economic policy making and academic thought. We are also therefore witnessing a massive destruction of intellectual and policy capital (Engelen et.al. 2008). Nowhere is this more evident than in thinking about fiscal policy.

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- an under-expenditure on re-current areas of education and health care (because public budgetary accounting conventions treat them

⁶ According to a recent ABC report, “An Auditor-General’s report this week showed that the [NSW] Government must pay the [Sydney Harbour] tunnel operator the difference between the tolls collected and those guaranteed under the contract. The payments made this year were \$58.9 million or more than a million dollars a week. Over the life of the contract that would add up to \$1.1 billion, twice the original construction cost.” (ABC 2008)

as having no long-term effect) at the same time as evidence shows that these expenditures are important to long-term economic growth and social order.

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