



The Global Fiscal Crisis and the Future of Public Spending

By Roger Kerr

Foreword

The long lens of history shows that most events are not isolated or random, but the effects of powerful underlying trends over longer time scales than we commonly think about. In this speech, Roger Kerr of New Zealand's Business Roundtable brings together the recent financial crisis and its effects on different countries' fiscal capacities alongside the longer term forces of growing government, demographic changes, and globalisation. Kerr concludes that these forces are on a collision course.

The collision will involve shrinking work forces and growing dependency ratios at home, increasing competition from relatively low tax countries in Asia and Latin America, and the high expectations of government spending which have been built in western countries over the past several decades. Kerr predicts that the size of government—which has grown inexorably in most western countries for two decades now—will become a major political battleground in most western countries over the next several years. To draw an analogy, the global financial crisis was just the assassination of an Austrian Duke. The great war it will trigger is yet to come.

To some extent, Canada is in a stronger position than other countries in the West, thanks to a reduction in government spending as a percentage of GDP in the 1990's and, until very recently, prudent fiscal management which was reducing debt. However, while Canada may be ahead of some other western countries for now, it will be subject to the same underlying forces of demography, politics and globalization in the long run. In the demographic sense, Canada is more exposed to the dynamics Kerr describes because, as Brian Lee Crowley warns us in his book *Fearful Symmetry*, Canada had the most pronounced baby boom of all the Western nations. As such, Canadians too would do well to heed Kerr's warning.

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Hard on the heels of the global financial crisis (which, though stabilized, is far from resolved) comes the global fiscal crisis. Since Dubai World, Dubai's state-owned investment vehicle, defaulted on servicing its debt in November 2009, the world has been wondering who's next.

Greece is facing an economic crisis, with a budget deficit of around 12 percent of GDP and public debt expected to exceed 130 percent of GDP by 2011. Japan's debt already stands at 200 percent of GDP. In the United States the budget deficit has risen to around 11 percent of GDP, and debt is rapidly approaching 100 percent of GDP. In the United Kingdom, the budget deficit stands at over 13 percent of GDP, and debt, which in 2007 was under 50 percent of GDP, is rising rapidly towards double that figure.¹

The global financial crisis has certainly exacerbated the fiscal crisis, partly by triggering a recession that has shrunk tax revenues and expanded welfare payments, and partly, in some countries, by prompting huge government bail-outs of failing financial institutions. But even without the financial crisis, some kind of fiscal reckoning was on the way.

Public spending has been rising since the turn of the millennium in several English-speaking democracies, often undoing successful fiscal consolidations in the 1990s. In the United States, Britain and New Zealand, budget surpluses were irresponsibly turned into deficits at a time when economic growth was generating steady annual increases in tax revenues. In the Euro area, public spending is forecast by the OECD to be 51 percent of GDP this year. The OECD's figure for New Zealand, 46 percent, is not much lower. Even in Australia, where the Howard government of 1996–2007 ran a budget surplus every year and eliminated the federal government's debt, government spending—while much lower than New Zealand's as a share of the economy—is projected to be nearly 37 percent of GDP this year.

The fiscal outlook for New Zealand is a major concern.

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Excessive levels of government spending are crowding out the private sector, putting pressure on the exchange rate and the profitability of exporters, wasting resources and imposing high deadweight costs of taxation. Spending remains at far too high a level to be consistent with the government’s goal of catching up to Australian income levels by 2025. Budget deficits are in prospect for the foreseeable future; annual debt servicing costs are projected to nearly double (to \$4.6 billion) by 2014; and gross debt looks set to rise to nearly 40 percent of GDP by 2014, according to budget forecasts. Unless the government spending share of the economy is reduced in the medium term, taxes will have to rise. In the longer term, Treasury forecasts indicate further upward pressure on spending from the health and superannuation costs of an aging population.

The steady, long-term rise in the public spending share of GDP in most (not all) OECD countries is as big a part of the economic history of the last 30 years as is the withdrawal of governments from central control of the economy, the privatization of state-owned enterprises, and the spread of free trade. It gives the lie to the claim that a so-called neoliberal, market fundamentalist ideology has triumphed throughout the world.

On the contrary, big government has never really gone away. Even as governments were reducing their interventions in some sectors of their economies in the 1980s and 1990s, they were extending and expanding their welfare programmes, and doing so with popular support. Britain is a case in point. By the mid-1980s, when the policies of the Thatcher government were starting to have some success, public opinion had shifted back in favour of higher public spending. For years thereafter, public opinion polls in Britain and elsewhere purported to find popular majorities willing to pay higher taxes to finance higher spending on public services.

In practice the people turned out to favour higher public spending more than higher taxes. The political appeal of Britain’s New Labour, which emerged in 1994 when Tony Blair became Labour leader, was its promise to expand public spending without raising income tax rates and without reversing Thatcher’s economic reforms.

After using its first term of office to establish a reputation for sound economic management, the Blair government embarked in its second term, beginning in 2001, on a programme of big annual increases in public spending on the welfare state. These increases were financed not just by the annual increases in tax revenue delivered by a steadily growing economy, but also by a return to budget deficits of (until 2008) around 3 percent of GDP. Welfare benefits, largely in the form of means-tested tax credits,

were extended to more and more categories of recipient, including many middle-income earners. Most of the increased spending, however, went on education and health. It substituted for serious reform of these services, such as introducing private sector providers and consumer choice. The parallels with the last Labour government in New Zealand are obvious.

By 2007, the year in which Gordon Brown replaced Blair as prime minister, about a quarter of the British workforce was employed by the state. In the same year a British think tank, Civitas, estimated that 30 percent of British households were dependent on state benefits for half or more of their income.² Together, these two figures account for a big share of the voting public.

Now, with a looming general election, public opinion in the Britain has accepted the need for public spending cuts. The politicians are nervously trying to accommodate this sentiment. They know that voters who support spending cuts in principle will still resist cuts that affect themselves. The same political dilemmas will soon become acute in the United States. The debate will be about cutting spending (which will mean entitlement programmes) or raising taxes (and hence doing further damage to that country's economic dynamism and competitiveness).

The United Kingdom may be suffering from the most serious budgetary crisis among developed countries, but most OECD countries have experienced a similar tendency for the public sector to expand relative to the private sector. Since the economic reforms and onset of globalization in the 1980s and '90s, the economic model that has prevailed is therefore not that of 'neoliberal', small-government Hong Kong; rather it is more like that of social-democratic, big-government Scandinavia, where even conservative parties have gone along with the consensus that a large part of the national product is a common, available to be redistributed by the state in the light of goals and principles collectively determined by transient political majorities.

One response to this outcome is to hold that if people want to spend big and growing shares of their incomes on tax-financed services, that's a legitimate democratic choice. But there are good grounds for doubting whether high levels of public spending are in fact what electorates want. There is some evidence for this from Switzerland, where some public spending decisions are made by popular referendum, with the associated tax and other costs built into the available options. Swiss experience suggests that public spending tends to grow more slowly when spending decisions are made that way.

This is consistent with studies showing that, beyond a certain threshold, public spending ceases to promote human welfare.

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The United Nations Development Programme (UNDP) has drawn up a Human Development Index (HDI), which it describes as:

... a composite index that measures the average achievements in a country in three basic dimensions of human development: a long and healthy life; access to knowledge; and a decent standard of living.³

According to Vito Tanzi, a distinguished economist who formerly worked at the International Monetary Fund, there is little if any relationship between a country’s HDI score and the level of its public spending. Indeed, the divergence between the two is quite remarkable. Tanzi reports as follows:

[T]he four countries with the highest HDI ranks—Norway, Australia, Canada, and Ireland—have average spending levels of 37.6% of GDP while the four countries with the highest spending levels—Sweden, France, Denmark, and Finland—have an average [lower] HDI rank of more than 9. Their average spending is 53.5% of GDP.

Tanzi continues:

[A]round 35% of GDP should be sufficient for the government of a country to satisfy all the objectives that are realistically expected to be achieved by the spending action of a public sector in a market economy. If public spending is efficient and well focused, an even lower spending percentage might be possible.⁴

The experience of Hong Kong and Singapore, where government spending is typically below 20 percent of GDP, confirms Tanzi’s last point.

But Tanzi also argues that international tax competition in the context of globalization is undermining the capacity of developed countries to sustain high and growing levels of public spending. He claims that:

In the OECD countries taken as a group, the ratio of taxes to GDP stopped growing in the 1990s, even though large fiscal deficits in many countries would have called for higher tax revenue. In an increasing number of OECD countries, the average tax ratio has fallen in the current decade.⁵

Tanzi suggests that this stagnation of tax revenues reflects the erosion of governments’ power to tax as a result of the interaction between tax competition, globalization, and digital technology. He identifies five factors in particular: *electronic commerce* and *electronic money*, which are difficult for tax authorities to detect and trace; *intra-company transactions*, which multinational companies can manipulate so that they can declare more of their

profits in low-tax countries; *offshore financial centres and so-called tax havens*, in which taxpayers can in effect hide income from tax authorities in no-name accounts; and *complex financial institutions*, which enable high-income earners to avoid a great deal of tax.

Tanzi concludes from this that:

The current public spending policies of many European countries are likely to prove unsustainable in future decades because of the impact of demographic development on public spending and of globalization on government revenue. Demographic developments with unchanged policies will dramatically push up various public expenditures ... This increase in spending will come on top of already precarious public finances and high levels of taxation and public debt in several European countries.

He goes on:

The impact of globalization on government revenue and tax competition could make it impossible for many European countries to compete with countries such as China, India, Korea, Mexico, Vietnam and others while maintaining tax levels that are already very high and, in several cases, not capable of financing even today's public expenditure. The impact of the baby boom on social spending is yet to be felt fully, and the impact of globalization and tax competition on tax revenue has just started to make itself felt.⁶

Tanzi sees only one escape from future fiscal crisis: to reduce the spending role of the state in the economy, both by increasing the efficiency of the public sector and by increasing the efficiency of the private sector so that it can, as Tanzi puts it, "replace the government's role in covering some important economic risks that citizens face."⁷

Pursuing this direction involves reforms that would refocus public spending on the core government roles of providing genuine public goods—services like law and order and conservation—and a social safety net (including access to health and education services), while exiting commercial activities and services such as ACC (government insurance) that are more efficiently provided by the private sector.

For his part, Tanzi identifies three pillars on which to base reductions in public spending.

The first pillar would require individuals who can do so to take more responsibility themselves for the normal contingencies of life. Obvious examples are private insurance for accidents and health

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and greater self-provision for retirement with a more restrictive public safety net.

The second pillar would gradually replace all universal spending programmes with means-tested programmes targeted to the least well-off. Tanzi is aware that such a reform poses challenges connected with poverty traps that would need to be met.

The third pillar would be for government to exploit the opportunities presented by globalization to purchase on the world market services that are not available domestically or available only at a high cost, such as elaborate medical procedures and advanced technical training. In this way it could contain the cost of those services it continues to supply to at least some citizens.

To sum up: the worldwide economic reforms of the 1980s and '90s were followed by an unusually long period of stability and steady economic growth, lasting roughly a decade and a half, which financed steady increases not only in personal incomes but also in government spending. There are signs that in many countries government spending has become unsustainably large. New Zealand and Canada are no exceptions.

Countries like New Zealand and Canada with large welfare states and the tax burdens associated with them are going to find it increasingly difficult to prosper in the decades ahead. They will be facing international competition and competition for capital and labour from fast-growing countries like those in Asia and Latin America with smaller governments and lower taxes. Demographic trends mean spending pressures will grow while tax bases shrink. If our governments are serious about bridging the income gap with Australia by 2025, they need to think in terms of the freer and more flexible economies of countries like Hong Kong and Singapore, which are now much richer than we are in New Zealand, and indeed richer than Australia.

To respond to this challenge explicit statutory limits on the growth of government spending and taxation are needed. The Fiscal Responsibility Act (now part of the Public Finance Act) produced more discipline around deficits and debt but not around spending. Fiscal decisions by simple majority rule, we believe, are too exposed to the biases of special interests to reliably reflect genuine collective preferences. A 'taxpayer bill of rights' would limit increases in spending and taxation to the rate of inflation plus population growth; additional spending increases would need to be sanctioned by popular referendum. Under such rules the community should be able to obtain roughly the level of public spending it genuinely prefers. The same constraints should be applied to local government. The OECD endorsed these concepts in its last report on New Zealand.

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The global financial crisis and the ensuing fiscal crisis have the feel of watersheds. Not only were they widely unexpected, they also involve unprecedented quantities of borrowing and debt. The world is unlikely to look the same when the crises are over.

A recent lead article in *The Economist* was headlined 'Stop! The backlash against big government'. It was motivated by the electoral reactions in the United States to President Obama's 'stimulus' spending, bank bailouts, expensive healthcare legislation and cap-and-trade proposals. Even on present trends, health and social security entitlements will consume a fifth of America's GDP in 15 years, compared with 9 percent now. This outlook is economically unsustainable and politically explosive.

The Economist made the point that countries need a state of a certain size to work at all, as the disaster of Haiti demonstrates. Equally, however, it criticised Barak Obama's claim that the question is not whether government is too big or too small, but whether it works. "This is clearly naïve", it wrote. "With deficits soaring, nobody can afford to ignore the size of government."

I think *The Economist* is right to argue that a great battle about the state is brewing. We can expect political debate this year over efforts to make our fiscal and regulatory constitutions more rigorous. There is far more awareness in Australia than New Zealand of the looming demographic fiscal crisis: for one thing, the Rudd government has accepted the need to raise the superannuation age while ours has turned a blind eye to it. Unless the government faces up to the need to shrink government in its spending, ownership and regulatory roles, as advocated by the 2025 Taskforce, there is no chance that New Zealand will catch up to Australia income levels and every chance that we will fall further behind.

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SOURCES

Footnotes

1. The figures for debt are for general government gross financial liabilities as reported by the OECD in all cases.
2. <http://www.civitas.org.uk/press/prLimits.php>
3. UNDP, *Human Development Report 2007/2008*, United Nations: New York (2007), p225.
4. Vito Tanzi, 'The Role of the State and Public Finance in the Next Generation', *OECD Journal on Budgeting*, 8(2) (2008), pp 10–11.
<http://www.oecd.org/dataoecd/43/0/43410951.pdf>
5. *Ibid*, p 6.
6. *Ibid*, p 21.
7. *Ibid*, p 22.

FURTHER READING

October 2009

Times are Tough for (Almost) Everybody

<http://www.fcpp.org/publication.php/2979>

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Rapid Wage Growth for Federal Public Servants

<http://www.fcpp.org/publication.php/2973>

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ABOUT THE AUTHOR

When awarding **Roger Kerr** the NZIER Qantas Economics Award in 2001, the New Zealand Institute of Economic Research chairman Michael Walls said: *"No single individual has done more over the last 15 years to persuade important parts of the business sector to support economic policies which, though often contrary to the interests of individual firms, were in the interests of the country as a whole."*

Roger Kerr is the Executive Director of the New Zealand Business Roundtable. He has spent much of his career working to improve the quality of economic policy debate in New Zealand. As well as the NZIER Qantas Economics Award, Roger was presented with the Tasman Medal by the Melbourne-based Tasman Institute in 1994 in recognition of his contribution to public policy. He is a Fellow of the New Zealand Institute of Management. Roger is widely published both in New Zealand and abroad, and before his present role, Roger was a senior figure in both the New Zealand Treasury and the Ministry of Foreign Affairs. He was a director of the Electricity Corporation of New Zealand from 1986 to 1994, a member of the Council of Victoria University of Wellington from 1995 to 1999, and a member of the Group Board of Colonial Limited in Melbourne from 1996 to 2000. Roger holds an MA (Honours, First Class) from the University of Canterbury and a BCA from Victoria University of Wellington.

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The author of this study has worked independently and the opinions expressed are therefore his own, and do not necessarily reflect the opinions of the Board of the Frontier Centre for Public Policy.

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