Reflections on 'Razor Gang', Thatcherism and Reaganomics: A Critical Evaluation of the Contempory Sport of Public Sector Bashing

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The public sector's role in the economy is currently under strong attack in the western developed world, particularly in the Anglo-Saxon component of it. This is illustrated in the United Kingdom with the development of Thatcherism as a new type of economics, in the United States with the election of President Reagan and his new deal in economic policy formation, and in Australia with Fraserism, fed currently by the official advice proffered by public choice theorists, and nurtured in the past by misunderstandings about the nature of unproductive labour. This phenomenon which has led to the slogan that "small is beautiful" has an important application to the government sector, that "big" government is now the enemy and that in fact nearly all of the country's economic problems - unemployment, inflation, low productivity growth, low growth of output, high interest rates - can be attributed to the ferocious monster of government spending created by a power hungry, self-interested and totally inefficient bureaucracy. The ideological nature of this attack on the public sector needs very little documentation but to set the scene as it were, a few illustrations drawn from speeches of the leading political exponents of this new doctrine may be illuminating.

> Only individuals have full knowledge of their own needs, wants and priorities; politicians, officials and bureaucrats neither have this knowledge nor can ever have it. This is why government must not be intrusive and why strong and efficient government must not grow into big and bureaucratic government.... Fortunately, Australia's experience of big government has been comparatively slight. We had a taste of it between 1972 and 1975. In those years the Commonwealth Government's claims on the nation's earnings rose from 23.8% of GDP in 1972-73 to 30.1% in 1975-76. Between June 1972 and June 1975 the number of Commonwealth Government employees rose by 52,000 and the number of State employees rose by 114,000. It is not surprising that towards the end of this period, private sector employment fell. It fell because the growth of government produced a massive loss of confidence and private enterprise was crowded out. Government was taking up too much room. Since the 1975 election, the government has been making a historic turnaround ... [because]... smaller government means eliminating waste, duplication and unnecessary costs of government. It does not mean austerity. The benefits of our program are now visible for everyone to see."
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> (Hon. J. M. Fraser, Prime Minister, Ministerial Statement, Review of Commonwealth Functions, 30 April, 1981, Canberra, AGPS, pp. 2-3).

> I will now outline and give in some detail the principal parts of this program for economic recovery ... This plan is aimed at

reducing the growth in government spending and taxing, reforming and eliminating regulations which are unnecessary and counter-productive .... If enacted in full, our program can help America create 13 million new jobs ... It will also help us gain control of inflation. It is important to note that we are only reducing the rate of increase in taxing and spending ... We will continue to fulfil the obligations that spring from our national conscience. Ineffective targeting, wasteful administrative overhead - all can be eliminated by shifting the resources and decision-making authority to local and state government ...

(President Ronald Reagan, Address to Joint Session of Congress, 23 February 1981, official text from USICA, pp. 3,6,7,8).

At the heart of the medium strategy is the need to return to a more sensible level of public spending, and to see taxes and government borrowing reduced .... The process of securing social economy cannot be painless ... It is a strategy for the restoration of prosperity by the encouragement of enterprise ... It is a strategy for the defeat of inflation ...

(Sir Geoffrey Howe, Budget Speech, 26 March 1980, on the occasion of the second "Thatcher" Budget).

Stripped of the rhetoric, these political pronouncements embody a number of propositions derived from the "new" public sector economics which can be summarised as follows:

1... Government is inherently wasteful and unproductive: because it interferes with freedom of choice;

2... Big government spending is the cause of inflation and unemployment because it crowds out private sector activity, because it saps private initiative, and because it increases the money supply.

3... Tax cuts restore private initiative, create full employment, raise national output, encourage investment and thrift and benefit everybody.

4... Central governments have the duty to return as many responsibilities to State or local government as is feasible.

5... Government borrowing is inflationary and pushes up interest rates. The public sector borrowing requirement must therefore be reduced as much as possible.[1]

None of these propositions are particularly new: in many ways they were part of the canons of prudent public finance in the nineteenth century and the early twentieth century, until they were partly discredited by the Keynesian revolution and more importantly, by historical experience in the western developed world. During the 1970s, they experienced a wholesale revival largely engineered by right wing economists from the university of Chicago, the Virginia School, Stanford, MIT and even that old bulwark of liberalism, Harvard.[2] These ideas have also been developed in the British context by the Institute of Economic Affairs, and in Australia are strongly embedded in the School of General Studies at the Australian National University, Monash, and also at Adelaide, and in the Sydney based Centre for Independent Studies. Their faith in the market demands deregulation and the dismantling of public enterprise; their faith in private initiative, thrift and accumulation demands tax cuts; their faith in public choice demands

weak government through the reduction of the share of national output going to government and through weakening central government; small government will also reduce inflation and increase employment and growth. In short, reducing the public sector is a universal panacea for all our economic and social ills.

This paper cannot of course address all these issues. What it can do is to briefly analyse the manifestations of the phenomenon, particularly with respect to the new "supply" or incentives approach to tax cuts. It also provides some critical comments on the consequences of the "razor gang report" and the new departures in Fraser's federalism policy announced in May and June 1981. This discussion demonstrates that the evidence for all these propositions is very weak. It also links the cries for efficiency in taxation to questions of income distribution.

I

The relationship between rapid public sector growth, inflation, unemployment and stagnation which are drawn by the economists of the new right is based on three different but interrelated arguments. The first of these was developed by the British economists, Robert Bacon and Walter Eltis in the context of U.K. experience during the mid-1970s and links inflation, stagnation and unemployment to the "unproductive spending" inherent in the growth of public expenditure.[3] The second argument, quite widespread in Australia as indicated in the quotation from Malcolm Fraser at the start of this paper, is the revival of the old Treasury view, or the Hayekian buckets-in-the-well theory, now better known as the crowding-out of private investment by excessive public spending. The third is the crude monetarist view, expounded by Friedman which argues that in modern conditions, government policy is the source for excessive increases in money supply, and that this leads in turn to inflation and unemployment and declining economic activity.[4] The second of these arguments is briefly discussed in the next section dealing with the neo-right's attitudes to public capital formation, the first and third arguments can be critically evaluated in this context. As indicated, there is considerable overlap between these three positions.

The Bacon-Eltis position rests on a simple rediscovery of classical national income accounting, as developed by Quesnay and Adam Smith in particular,[5] combined with the more modern growth theory of Harrod and Kalecki. This approach divides the national product into two parts: the necessary expenses for reproduction which must be recovered in order to allow the system to continue to reproduce itself; the second part is the disposable surplus or net product of the economy. This surplus is available in the twentieth century for three main purposes: to finance productive private investment and hence to secure expanded reproduction or the growth of national product; or to finance exports thereby stimulating economic activity and growth; or to finance the "unproductive consumption" of government through increasing public expenditure, particularly that on welfare. The greater the proportion of surplus absorbed by the public sector, the less will be available for investment and exports, the lower will be the rate of economic growth and the greater the likelihood of balance of payments problems. Generally speaking, and with only one exception, this argument has to be accepted as basically correct.

Since this paper is concerned with the public sector, the only part of the argument which must be further explored are the mechanisms by which the surplus is transferred to the public sector for "unproductive consumption". Three mechanisms are possible here: taxation, funded borrowing and non-funded borrowing.[6] In the case of the latter - which is popularly known as printing

press financing - the necessary consequence is inflation and the costs of such inflation are largely borne by the private sector. This arises from the following: (a) workers recover their loss of real income through inflation by wage increases which squeeze profits and thereby reduce productive investment; (b) inflation through the overstatement of profits for taxation purposes further imposes a squeeze on profits and investment[7]; while (c) it is "well known" that inflationary expectations create an unfavourable climate for investment either directly through the wilting of business confidence or indirectly through the effect of inflation on interest rates. With funded borrowing, that is, through the issue of marketed securities, the effect is more direct: the public sector reduces the share of the investible surplus available for private investment - classical "crowding out" - as well as raising interest rates and thereby lowering the rate of private investment. Finally, the taxation mechanism argues that the incidence of most taxes is on business and investment. Taxes on goods and services, by feeding directly into the cost of living index (CPI), are immediately recovered by workers through wage increases; similarly, Bacon and Eltis argue, the growth of bargaining for after-tax wages has meant that a great deal of personal income tax is shifted to employers in the private sector. Hence even tax financing reduces the surplus available for investment and is inimical to growth.

It is clear that this argument rests on a number of false premises. First, there is the unwarranted assertion that public expenditure is necessarily unproductive. Although the argument has wide popular appeal it flies in the face of historical experience, particularly in a country such as Australia. As Noel Butlin has shown for the 19th century[8], Australian economic development then was largely made possible through public capital formation; in the same way it can be argued that much of public spending is still directly productive of output (infrastructure investment) or else indirectly, expenditure on education and scientific research for example.

The second weakness in the argument is related to the assumptions employed in discussing the distributional consequences between capital and labour of both inflation and taxation, which clearly are not in harmony with the facts. Although it is true that powerful sections of the working class can maintain their living standards in the face of inflation through taking industrial action, this applies only to a relatively small minority of the workforce. Partial indexation, now abandoned, has ensured a substantial loss in real earnings for the vast majority of Australian workers. The costs of inflation do not therefore exclusively fall on capital as the theory suggests. Similarly, the argument that taxation falls largely on business must be rejected on the evidence available. Although after-tax wage bargaining has become more important in the 1970s, it is confined to only small sections of workers who have the industrial power to enforce it; the majority of workers who relied on indexation for their wage increases have not preserved their real after-tax incomes, a loss in living standards enhanced by the fluctuating practice of the government in personal income tax indexation (now, as from 1982-83, formally abandoned though introduced in May 1976 as the greatest tax reform since federation). It is also well established that the government desired to exclude effects on the CPI from government policy (that is, increases in the taxation of goods and services and government charges) for the purpose of wage indexation, and that this appeal to the Arbitration Court has become increasingly accepted by the full bench. In addition, it can be said that much of the effect of indirect taxation on business is passed back to the government through business tax deductability of expenses (the workers have no such mechanism available to them) while in

addition, the evidence on the incidence of tax avoidance and evasion suggests that the cost of these anti-social practices is largely met by wage and salary earners.[9]

The third part of the argument, the association between increased government spending, inflation, business confidence and "crowding out" is best discussed in the context of the crude monetarist attack on "big government" expounded by the Friedmans. After establishing a historical association between money supply and the rate of inflation (Free to Choose, op.cit., pp. 298-309) they hedge their bets on the question to cause and effect, the theoretical point at issue (see especially, p.306).[10] In modern twentieth century society, it is government which controls the money supply: directly by its control over the note issue and the central banking system, indirectly through the effects of government spending on money supply. (ibid., pp. 309-311). Not only is government therefore to blame for inflation, Government is also described as the major gainer from inflation because of the effects of inflation on unindexed tax scales, and the reduction in the cost of borrowing through inflation induced low real interest rates and the gradual erosion of the real value of the public debt. (ibid., pp.313-316). A critique of the sloppy evidence on which these assertions are based cannot be undertaken here for reasons of space; needless to say, even the link between government and inflation just summarised is based on weak statistical evidence and neglects many crucial factors.[11]

It is interesting to note that some of those whose work on the "evils" of public sector growth has been briefly examined here, rarely analyse the situation and experience in public sector growth of the developed "western" member countries of the OECD despite the wealth of evidence available for such an analysis. If conducted, such an analysis would disclose evidence which goes strongly against the casual empiricism of the public sector "bashers". Some factors of considerable relevance in this context have recently been explored in a comparative study of real public sector growth in the major OECD countries.[12]

Two features of this excellent statistical analysis stand out. First, Beck convincingly shows that an examination of real public sector growth (money growth deflated by an appropriate price index) clearly demonstrates that there has only been a relative increase in public expenditure on goods and services over 1950-1977 in four of his sample of thirteen OECD countries. In the other nine countries the income elasticity of government spending was less than one, indicating that spending by government grew at a lower rate than GDP. (Beck, op.cit., Table 1, p.315).

The other important feature of Beck's analysis is that he conclusively shows that the growth in the public sector has been invariably due to the growth in the welfare state. In all thirteen countries, including conservative Switzerland, the income elasticity of government transfers was close to 3, and it is interesting to note that the Anglo-Saxon countries where welfare bashing is now a serious occupation of the politicians (i.e. the U.K. and the U.S.) are at the bottom of the league with Greece, Finland and Germany. With an elasticity of 2.07 as compared with Germany's 2.06 the British welfare state cannot be charged with being the major cause of British economic problems (as Bacon and Eltis implicitly do, and following them, Margaret Thatcher). This is even more relevant when it is remembered that transfers include subsidies to business as well as social security cash benefits, and that the former are very prevalent in Britain (with its "lame duck" industrial assistance policy) and virtually non-existent in the German

Federal Republic.[13] It should be remembered in this context that transfer payments are not a reduction in the resources available to the private sector; they constitute simply a redistribution of resources within the private sector. European and general OECD experience therefore illustrates that there has been little crowding out in the post-war period through excessive public expenditure growth.

It should also be pointed out that this experience in the OECD countries does not easily correlate with inflation rates, growth rates and unemployment rates, as the new right so readily assumes in its arguments. All these phenomena are far more complex than such a simple explanation suggests. In summary, therefore, it can be stated that the case against the public sector presented by Bacon, Eltis and the Friedmans on the ground that it constitutes the cause of inflation, unemployment and slow growth is not proven. This is not to say that under certain circumstances and in certain countries, these phenomena cannot be related. What is contended here is that the views of the right on this subject need to be substantiated with serious historical and statistical analysis.

II

A specific aspect of the problem, associated with the increasingly heavy attacks in Australia on public borrowing must also be investigated. This attack is of course based on the proposition, now continuously put by the Federal Treasurer, that public borrowing and public investment constitute a danger to anti-inflationary monetary policy, and that, by causing the upward shift in interest rates, they are to blame for the problems of the housing industry and, potentially, for crowding out private investment for manufacturing and especially, mineral resource development. This refrain is increasingly sung by Mr. Howard, particularly in the context of relations with the States. As he put it in press releases in June (Numbers 106 and 109):

> The basic point, quite simply, is that for resources to be released to permit the rapid expansion of the private sector now in progress to continue, the public sector must grow less rapidly .... The plain and inescapable truth is that there is no way that <u>all</u> these private and public sector capital expenditure plans for 1981-82 can be accommodated: the resources are simply not available. To attempt to implement them ... would have serious inflationary effects and increase upward pressures on interest rates.

This amounts to a complete endorsement of the views of the Federal Treasury on the need to curtail public borrowing.[14]

Part of the argument presented by the Federal Treasurer concerns the effect on the money supply of public sector borrowing requirements which are too large. Only if the public borrowing is unfunded does it add to the money supply, if it is financed by the issuing of securities taken up by the non-bank sector of the economy, the manner in which most Australian semi-government and local government securities have in fact been taken up, there is no effect on the money supply whatsoever. Similarly, a budget deficit, if financed through loans from the non-bank sector, has no effect on the money supply.[15] This is no answer for the monetarist who easily trumps that argument. If increased borrowing is financed by securities, then ceteris paribus, the price of these securities falls in the market and the yield rises.

Look at the empirical evidence: the growth of the public sector borrowing requirement (as documented in the Budget Speech 1980-81, Statement No.6, p. 283 - where incidentally it appears for the first time) has been accompanied by rises in the yields of government securities as reflected in the increased yield of tap-stocks and the semi-derived but government determined interest structure of semi-government securities.

Given the ceteris paribus, the monetarist scores a hole in one. However, ceteris is not always paribus and there are other influences on interest rates apart from changes in government borrowing. First of all, there are very high interest rates overseas, particularly in the United States, and the Australian capital market is not totally isolated from such rates. Secondly, there are the effects of the partial deregulation of interest rates which have taken place over the last twelve months. The partial deregulation of interest rates has set up a systematic upward spiral of interest rate increases where increased deposit rates in the name of competition lead to increases in lending rates, and where the end of this process is not yet in sight.

There is, however, a more fundamental weakness in the argument of linking public borrowing in this way to interest rates. This is the argument, endemic in simple partial equilibrium analysis, that a reduction in public borrowing will ipso facto increase the supply of savings (loanable funds) which will be available for other borrowers, such as private business. This is crowding-out, or Hayek's bucket-in-the-well theory or the old Treasury view and is, as Keynes pointed out in the 1930s, incorrect because it ignores the effects of such public borrowing, and the associated capital works, on the level of economic activity and hence future levels of saving. It is an important proposition of Keynesian theory that when there are idle resources and excess capacity, increased investment (including public investment) generates its own savings to finance the investment.

This last argument is linked to the symbiotic relationship between public and private spending which was postulated as the end of section I of this paper. The real declines in public investment which have taken place since 1975-76 have serious consequences for future economic development which should not be ignored, while they will also affect the living standards of future generations. Although it is not easy to get detailed statistics on this matter, a number of examples can be given: housing, particularly welfare housing, has had significant cutbacks over the period since 1975-76: in 1976-77 the Commonwealth provided $375 million to the States for this purpose, the 1980-81 estimate was $166.5 million, in real terms this amounts to a reduction of nearly two thirds on this important social function.[16] Capital advances for railway upgrading, for urban and regional development including the sewerage programme have virtually disappeared. Finally, in electricity supply many States have barely sufficient generating capacity, a position which will be worsened when the projected aluminium smelters commence operation. A striking example of the long term consequences of a programme of systematic starvation of public works is provided by the State railway systems, which from the beginning of the great depression of the 1930s obtained virtually no upgrading till the end of the 1960s. It should be pointed out that total funds for capital purposes, general and specific, which the Commonwealth pays to the States, have continuously declined since 1975-76.[17]

It is not difficult to explain this war of attrition on public capital works. If it is desired to lower public spending for one reason or another,

capital spending is the easiest target. Its consequences are not immediately felt in the community, so that there is minimum political backlash. Secondly, since most capital spending creates employment outside the public sector, public servants can be assumed to happily recommend such measures, since it does not affect their employment prospects and opportunities. It is, however, strange that a government allegedly dedicated to aiding the private sector, makes the most savage cuts in those areas of its activity which are most beneficial to the private sector. Such are the ironies of the "new" public finance.

III

The purpose of this Gladstonian frugality in public housekeeping is to provide tax cuts. As the Treasurer put it in his statement on taxation of 12 March, 1981[18], "Taxation cannot responsibly be reduced unless the room for those reductions is provided by reductions in government spending ... It seems on occasions that the only area in which there is broad agreement is that taxation should be reduced."

The need for tax cuts has clearly become an overriding concern with this government, as it has been with the Thatcher government in the United Kingdom and the newly elected Reagan administration in the United States. One of the reasons for this policy is its undoubted electoral appeal, tax cuts are not likely to lose votes. A second, and more important reason, is that the new economists of the right are now presenting arguments which indicate that substantial tax cuts can be engaged in by governments without detrimental effects on the economy. This is the new Reaganomics, or supply side economics or incentive economics, which has been developed by United States tax economists such as Feldstein, Boskin, Laffer and others. Put simply, this theory states that tax cuts need not lead to a loss in revenue (so that they need not be accompanied by expenditure cuts), because of their effects on productivity, on thrift, on capital accumulation and hence on economic growth. In this new economic doctrine, which transforms the dismal science of scarcity, we can now have our cake and eat it.[19]

What is the rationale for the new economics of taxation? Broadly speaking, it is as follows. With regard to personal income tax, the high marginal rates involved in its progressive rate structure act as a disincentive to work by subsidising leisure at the margin. Lower these rates, work effort will be increased, and with it productivity and national output. At the same time, the increased disposable income for households and business from reductions in personal income tax will raise the flow of household saving and hence lower interest rates and facilitate investment. The argument is also applied to taxes which are seen to bear particularly heavily on investment. In a paper in the National Tax Journal in June 1978, Feldstein and Slemrod presented a domonstration that a reduction in the rate of capital gains taxation had a number of favourable effects. By reducing the costs of switches in share portfolios, it increased the mobility of capital and hence ensured a more efficient allocation of investors' funds. This in turn stimulated the volume of share transactions, that is the potential tax base of capital gains taxation, and thereby increased revenue. Further in the area of business taxation, it is argued that the current depreciation provisions in the tax act are insufficient for the needs of business, that more use should be made of accelerated depreciation and investment allowances, and that the discrimination against depreciation on buildings should be abolished. Again, the advantages of such a policy are described in terms of faster rates of growth through the encouragement of business investment.

What evidence is there for these propositions on which the new "free" society is to be constructed? It has to be stated that there is surprisingly little. First of all, there is still no real evidence of the effects of high marginal income tax rates on incentives (at least within the range in which Australia has kept these rates) and the major studies on the subject in the post-war period[20] regard the evidence as inconclusive. A recent study for the United Kingdom[21] argues that the disincentive effects of progressive income tax has strengthened between the mid-fifties and the end of the sixties and that these disincentive effects are higher, the higher the income group. This result may not be unassociated with the greater value people place on leisure with rising living standards, and is also influenced by occupations, so that it is difficult to isolate the specific tax factors in the work/leisure choice. There is more evidence for the effect of high marginal tax rates on saving, since a reduction in such rates (and consequently the average rate of tax) leads to reinforcing income and substitution effects on the flow of saving. A shift from income to consumption taxes - as done in the 1979 British budget (see p.2 above) - is even more favourable to saving.

The issues associated with business taxation are far more difficult to assess. Integration of company and personal income tax to eliminate the double taxation of dividends is difficult in Australia with its substantial foreign ownership of investment; non-resident shareholders would get remission from company tax and face no personal income tax liability (except through the small dividend withholding tax). Exemption of non-residents from integration would be difficult because of double taxation agreements with most countries which provide the greater part of foreign investment. It is also highly doubtful whether the removal of this penalty on dividends will restore the era of the small investor, as some of its proponents seem to think. Finally, the aim of this policy of restoring neutrality to the investment decision appears to depend on the integration proposal being combined with comprehensive capital gains tax as part of the personal income tax.[22]

It is equally difficult to pontificate on the effectiveness of investment subsidies through the taxation system, since once again the evidence on this is conflicting. It is of course clear that more generous depreciation allowances or investment allowances increase the cash flow of companies, and that they can be conceived as raising the after-tax rate of return. Whether they actually increase the volume of investment over the longer term is a different matter; the empirical research on the investment allowance of 1975 suggests that an investment allowance, particularly a temporary one, only affects the timing of investment.[23] Again, issues of foreign taxation are involved in Australia, since much of such general tax benefits would accrue to non-residents. This, as Fitzgerald showed,[24] was one of the problems with the generous tax concessions for the mineral industry which applied in the early 1970s and which after their partial abolition in the 1973 and 1974 Crean Budgets have since then been partly restored.

It is also clear that the new supply side economics, as its name implies, ignores the role of effective demand. Its intent, as many of its supporters explicitly argue, is anti-Keynes and anti-Keynesian. This has created problems in the United States with the Reagan tax cuts, since the Democratic majority leaders in the House of Representatives, who were brought up on the belief that tax cuts are inflationary and only to be used in times of recession, unsuccessfully opposed the Reagan policy on the ground that it would worsen inflation. The "supply-siders" do not appear to have a ready

answer for this: they have never been able to show that the supply effects of such tax cuts precede the demand effects, though here the regressive impact of the cuts, which would favour saving rather than increased consumer spending, may be of assistance. This last proposition is however rarely explicitly stated.

The economic evidence for the effects of tax cuts promised by supply side economics is inconclusive, to say the least. Most importantly, the distributional consequences of the tax cut packages which have been designed or implemented in Australia, the U.K. or the U.S.A. are generally geared to favour the wealthy, with occasionally some special compensations for the poor, but with the burden squarely placed on the middle income earners, that is, those on or below average earnings.

IV

With this background discussed, it is time to present a brief evaluation of the Review of Commonwealth Functions, or, as it is more commonly known, the "Razor Gang Report". This report proposed transfers to the private sector (pp. 6-10), some deregulation (pp. 10-15), some (marginal) removal of industry assistance (pp. 15-17, F1-F2), some general principles of rationalisation and methods of putting them to work (pp. 36-40) and, the transfer of a number of functions to the States. The last links the "razor gang" to Fraser's new Federalism, which I have earlier described as a device for curtailing the public sector largely on ideological grounds. The "razor gang" exercise is also not unrelated to the health financing changes announced in April and the tax statement by the Treasurer made in March 1981.

The first task is to assess the report on its own terms. As the Prime Minister candidly explained at the end of his statement, "immediate expenditure savings" were not in general "the principal objective". In spite of this, he described it as "an important contribution to the objective of further reining in government spending, to make room for private sector growth and pave the way for significant reductions in the burden of taxation." (pp. 40-41). The document in quantitative terms was less "optimistic", there would be "an eventual on-going saving" of $560 million, that is, about 1½% of estimated outlays for 1980-81, or one eighth of the increase in Commonwealth outlays projected for 1980-81 over 1979-80. In addition, there were tax increases of some $130 million. The gradual removal of the export incentives scheme plus the tax increases accounted for the greater part of the savings.

This is not to say that the report is an unimportant document which can be ignored. As Anne Summers put it perceptively in the Financial Review headline, "it is a report for the future". The transfers to private enterprise, many of which will be costly in terms of spending, show the government's clear ideological commitment to the proposition that the "socialisation of losses" is the only acceptable state enterprise policy, the Country Party's interests of course always excepted. Some of the deregulation proposals may also have serious consequences for the future, while the policy of dogmatically across-the-board cutting of public servants raises a number of interesting contradictions.[25]

The most interesting aspects of the document relate to the proposed changes in federalism which it reiterates as an article of faith. These are reflected in the alterations in the hospital cost sharing arrangements,

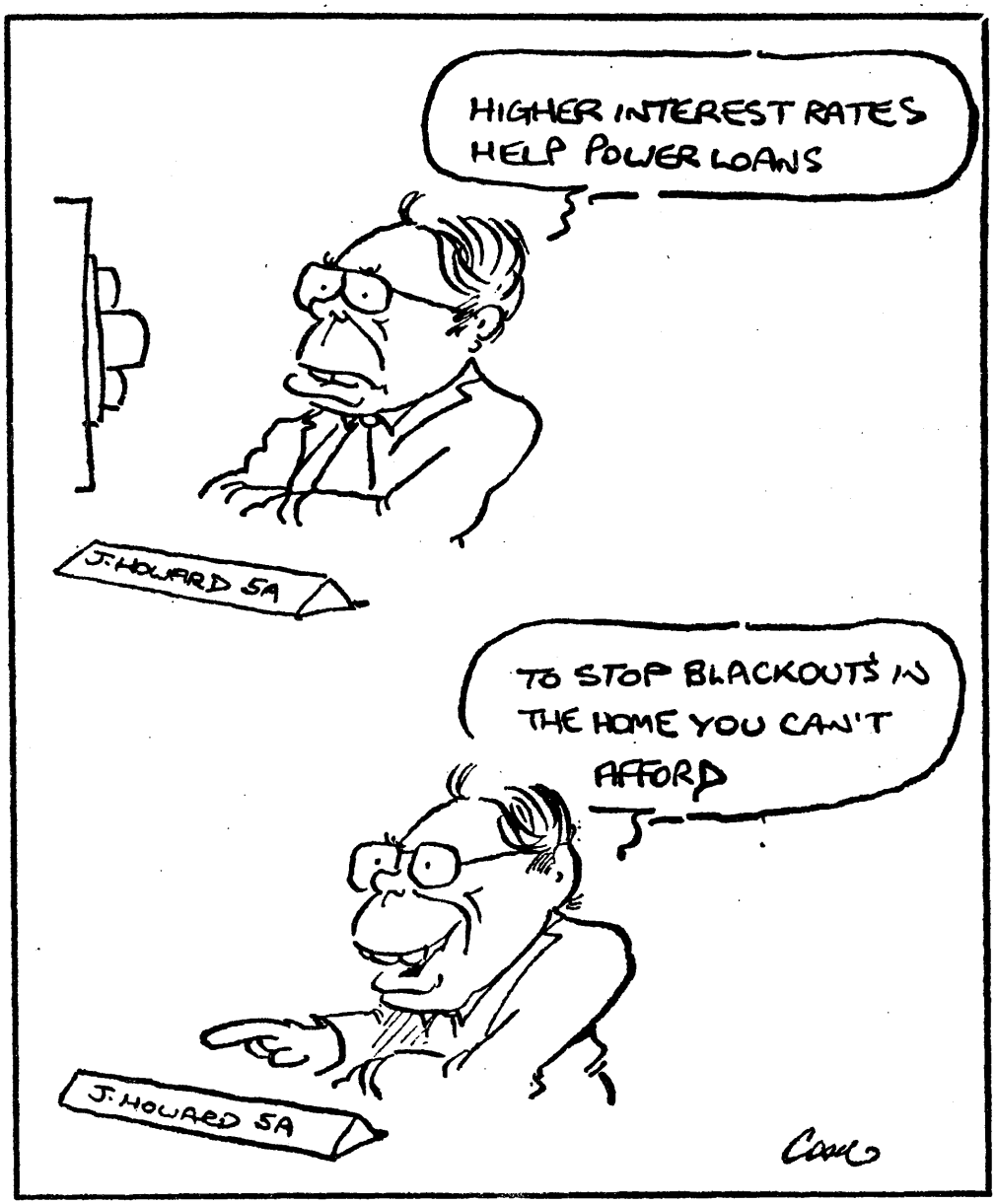
projected changes in the sharing of education costs at secondary and tertiary level (but not for the private sector) as well as the less noticed but nevertheless important proposed transfers on soil conservation, quarantine, railways, national parks and wildlife services, and Aboriginal sacred sites (the last two of which may not be unrelated to the demands of the mineral industry and their representatives in the legislatures of Queensland, Western Australia and the Northern Territory).

This transfer of responsibilities to the States is in line with point 4 of the issues raised on p.2 of the introductory part of this paper, and is also in harmony with the Liberal-Country Party's 1975 federalism policy which, among other things, announced a desire to reduce specific purpose payments to the States and their replacement by general revenue assistance. In the words of that document, and also in the words of the "razor gang report", these responsibility transfers are designed "to strengthen the bond of federalism between the Commonwealth and State Governments." (p.19). These policies are designed to strengthen the bonds of the State Premiers by further curtailing their access to Commonwealth funds and thereby further limiting the degree of freedom of the States in sponsoring independent expansionary public sector policies.[26]

The original new federalism policy as implemented in 1976-77 replaced general revenue assistance by a system of personal income tax sharing underwritten by the "Whitlam guarantee" which implied that income tax shares going to individual States would never fall below the revenue they would have been entitled to if the financial agreement signed in June 1975 was adhered to. The Premiers in 1976 accepted this proposal, since it gave them indirect access to the major federal growth tax: personal income tax. With full indexation introduced in May 1976 (although altered in subsequent years to less than full and now abandoned) and with an expressed desire by leading federal government spokesman to reduce the relative weight of personal income tax by means of a move to taxation of goods and services, the Premiers became less enamoured with this arrangement, particularly when the Whitlam guarantee (which had underwritten the general revenue assistance on several occasions) expired at the end of 1979-80. They therefore demanded the extension of the revenue sharing arrangements to embrace all Commonwealth taxes, not just personal income tax. To this the Commonwealth agreed as from next fiscal year.

General tax revenue sharing has therefore become the new federal arrangement of revenue assistance at the May 4, 1981 Premiers' Conference. However, the Commonwealth had changed its tax policy thereby making general tax revenue sharing a less attractive proposition than personal income tax revenue sharing. These changes were the abandonment of serious thought of introducing comprehensive taxation of goods and services in order to reduce personal income tax, plus the abandonment of personal income tax indexation from 1982-83 onwards. These changes would ensure a faster growth of personal income tax revenue as compared with taxation revenue as a whole.[27] In addition, the May 4 arrangements imply a further financial disadvantage for the States. The percentage in which revenue is to be shared is to be determined by the revenue grants decided for 1981-82 and the tax collections for 1980-81. The general revenue assistance for the States for the current financial year embody the lowest rate of increase since 1975 whereas tax collections in the financial year just ended were exceptionally high with respect to company taxation, non-paye personal income taxation, and even sales taxation, because of the relatively high growth rate during part of that financial year and other abnormal factors. The resultant percentage (20.62%) is nearly two percentage points below the average of the five preceding years (22.39%) which, on 1980-81 revenue, involves a loss to the States of well over $500 million. In view of the revenue inelasticity of most State taxes, this provides an effective constraint on

This paper has also argued that much of the scientific basis for the attack on big government rests on very spurious logical and empirical grounds. Frequently its foundations rely on little more than the anecdotal, which makes it all the more dangerous because it is simple and embodies a degree of truth which the average person can appreciate. This is not to say that the public sector can grow without limit or that there are no problems associated with such growth. Such problems do exist and need further and more detailed study, but such study is not encouraged by the fairy tales passing for the new public economics. The swindle in this area conducted in the name of freedom is a fraud to hide the greed of the more affluent sections of the community. It also illustrates Marx's maxim that tax struggle is the oldest form of class struggle.



increases in State spending. Once again, the Fraser government has used its federalism policy to exercise control over the growth of the public sector as a whole.[28]

The "razor gang report", the announced tax policy changes, the Commonwealth dominance over the Loan Council which has meant substantial real reductions in State loan programmes, and the implications of the changes in revenue sharing mean that the Commonwealth can implement its anti-public spending policies over the whole of Australia, and thereby enforce its "public economy" measures and the curtailment of public services even within the area of State responsibilities. This is a substantial victory for Treasury policy to restrain the economy, and similarly a triumph for the public choice ideologues currently advising the Prime Minister.

The potential for government expenditure cuts implied in this strategy has a number of additional advantages for the federal government. In the first place, it can now pass the political odium for some expenditure cuts to the States even though such cuts may not be of their choosing. Secondly, if in the name of supply side economics, the federal government desires to reduce the weight of business taxation, it will have the pleasure of knowing that part of the revenue cost will be borne by the States without any direct advantage to them. The difficulties of restraining total public expenditure in a federal system have therefore been largely removed by the cunningly devised policy package introduced since the beginning of March 1981.[29]

V

A crisis in capitalism as that experienced since the mid-seventies in the western developed world always requires a scapegoat lest the system be blamed. Such scapegoats have not been lacking - the oil sheiks of the Middle East, the militant trade unions - but most of their explanatory value has been rather short lived. It is also well known that crises of this nature bring forth a host of cranks, many of whom revive ideas of the past as universal solutions to present day ills of society. Such a solution is found in the attacks on big government which not only shift the blame for the crisis away from faults in the system but which also have some additional by-products which are of use to business. These additional consequences sharpen the vigour of the attack on the public sector.

As shown in the previous sections, the attacks on big government as the cause of inflation, unemployment and stagnation are combined with pleas for tax cuts, to be largely achieved through the reduction of the degree of progressivity of the personal income tax, the elimination or reduction in rates of capital gains tax, and general reductions in business taxation to aid incentives to work, save and invest. In addition, the crusaders against big government use the promise of tax cuts to sell profitable public enterprises to private business, to deregulate in order to reduce business costs and enhance profits (irrespective of the longer term social costs which may be involved) while in addition they see an opportunity to reduce the welfare spending to which most have been opposed because of the tax burdens it imposes. In order to disguise this mercenary motive, the opportunity of direct profits is rarely explicitly stated: all these actions are conducted to increase competition and hence efficiency and to enhance individual freedom through the reintroduction of genuine public choice and consumer sovereignty. Examples are provided by the voucher system for education (which can only benefit the private education sector) and the changes in health financing which have followed the abolition of the Medibank concept.

FOOTNOTES

1. See on this point, John Howard's address to the Premiers' Conference and Loan Council meetings of 4 May and 19-20 June, 1981.

2. A good survey of this new economics is presented by Time Magazine, 27/8/1979, pp. 42-56; see also Milton and Rose Friedman, Free to Choose, Penguin Books, 1980, the whole thrust of which is an attack on "big" government. The supply side economics implies a return to "Say's Law", as demonstrated by George Gilder, 'Keynes vs. Say', Economic Impact, No. 35, 1981, pp. 17-19.

3. Robert Bacon and Walter Eltis, Britain's Economic Problem. Too Few Producers, London, Macmillan, 1976.

4. Milton and Rose Friedman, Free to Choose, especially chapters 9-10. The "scientific" monetarist view expounded by the Nobel laureate in the learned journals must be distinguished from this crude exposition for popular consumption.

5. Walter Eltis has himself written first class expositions of the classical growth models of Smith and Quesnay, and his indebtedness to these classics is acknowledged explicitly in the preface to his joint book with Bacon, op.cit., pp. v, ix.

6. The fourth method, higher charges for public services - which appears now to be in vogue with Australian Treasury circles - raises prices directly through its effect on the CPI, and indirectly through raising business costs and wage costs when workers recover the loss of real income through wage increases.

7. These issues were canvassed in Part II of the (Mathews) Report on Taxation and Inflation, Canberra, AGPS, 1975.

8. For example, N.G. Butlin, Australian Domestic Product, Investment and Foreign Borrowing 1861 to 1938/39, Cambridge at the University Press, 1962, especially p.4 where he talks about the "exceptional importance of government capital formation" in Australian economic development, particularly in the context of railway investment which absorbed the greater part of public resources in the 19th century.

9. See the statistical "proof" of this as presented by R.L. Mathews, 'The Structure of Taxation', January 1980, reprinted as No. 34 in the Centre for Research on Federal Financial Relations Reprint Series, Canberra, 1980, pp. 27-31.

10. They infer, however, that money is the cause, and state it explicitly in their even cruder summary at the end of the chapter (ibid., p.329). This casual attitude to historical evidence characterises the work of these "objective" social scientists. The prize example is p.298, first paragraph, where communism in Russia and China, nazism in Germany are blamed on inflation, as is, irony upon irony, the fall of the Allende government. There is no reference to the post-war (1947) inflation in West Germany, which led to no such phenomenon, the argument that the post-civil war inflation in the USSR led to communism is of course sheer nonsense, nor, interestingly enough, does "historian-Friedman" refer to the paper money inflation in Pennsylvania in the 1760s (which

Franklin analysed) because presumably it is not politically attractive to a Republican to link the embryonic United States to communism or fascism in the eighteenth century.

11. An excellent critique is provided by Kaldor, 'Monetarism and U.K. Monetary Policy', Cambridge Journal of Economics, Vol. 4, No. 4, December 1980.

12. Morris Beck, 'Public Sector Growth: A Real Perspective', Public Finance/Finances publiques, Volume 34, No. 3, 1979, pp.313-343.

13. Time prevented the testing of this explanation.

14. Analysed in my forthcoming 'Fiscal Crisis of Australian Federalism'.

15. The money supply effects of large deficits are not now the only detrimental consequence of this much maligned phenomenon: a large deficit creates inflationary expectations or accelerates inflationary expectations and thereby destroys business confidence. This is now official government policy, as John Stone, the head of the Treasury, pointed out at a seminar on the budget deficit at the University of New South Wales in 1979.

16. See Payments to the States, the Northern Territory and Local Government Authorities 1980-81, 1980-81 Budget Paper No. 7, Canberra, AGPS, 1980, p. 145.

17. Ibid., p. 6.

18. 'Taxation', Ministerial Statement made by the Treasurer, the Hon. John Howard to the House of Representatives, 12 March, 1981, pp. 1-2.

19. This argument is illustrated by the famous Laffer curve, which of course provides no explanation of the phenomenon. See my 'Problems and Prospects of Public Sector Growth in Australia from the 1980s Onwards', ANZAAS, section 24, May 1980, also given at the Fifth Political Economy Conference, Melbourne, 1980, p. 3 and n.6.

20. The standard study is that of L. Godfrey, Theoretical and Empirical Aspects of the Effects of Taxation on the Supply of Labour, Paris, OECD, 1975.

21. Michael Beenstock, 'Taxation and Incentives in the U.K.', Lloyds Bank Review, October 1979, No. 134, pp. 1-15. The estimated Laffer curve shows that the maximum tax rate for Britain is 60% with the actual estimated average rate at 40%. As the author explains there are a number of statistical difficulties in this estimating procedure, despite the good statistical fit, and he argues that in such an analysis, "precise numbers are less important than the qualitative significance of the approach".

22. See P. D. Groenewegen, 'Australian Taxation Policy', in F.H. Gruen (ed.), Surveys in Australian Economics, Vol. 3, section 4.2.1 and the references there cited.

23. Ibid., section 4.2.2, esp. pp. 86-87.

24. T. Fitzgerald, The Contribution of the Mineral Industry to Australian Welfare, Canberra, AGPS, 1974 and see Groenewegen, 'Australian Taxation Policy', op.cit., section 4.3.3.

25. The reported cut in the staff of Taxation Office will undoubtedly interfere with the administration of the tax avoidance measure of which the Treasurer so frequently boasts.

26. For a more detailed discussion, see my 'Fiscal Crisis of Australian Federalism', op.cit.

27. The growth potential of personal income tax is further enhanced by the wage rises expected in the wake of the resources boom and the abandonment of wage indexation. This cunning strategy of restoring the restraining influence of fiscal drag while reducing the leakage to the States by nearly 50% is undoubtedly the brainchild of Treasury officials.

28. Stage 2 of the new federalism policy, the right of States to unilaterally determine surcharges (or rebates) on personal income tax is made politically even more unattractive for State governments by the federal revitalisation of personal income tax growth through the policy changes mentioned.

29. Although the manner of implementing is different, both the United States and the United Kingdom are fighting a bitter war against the lower levels of government. Reagan (as shown on p.2) also wishes to convert open-ended conditional grants to fixed block grants under the guise of improving federalism and freedom of choice, while really reducing aggregate public sector spending. The Thatcher government is using its grants powers to prevent local government from increasing its spending, so far quite unsuccessfully, since many Labour controlled councils have raised taxes on business instead.