IS STATE INTERVENTION IN THE ECONOMY INEVITABLE?

Ongoing economic woes demand drastic reduction in state intervention into free market, says **Peter Boettke**

Given the prevailing ideology of our age, and the alignment of incentives within modern democratic governance, the *intervention* of the state in the economy (and in all walks of life) *is not inevitable* but *highly probable*. And that is unfortunate.

In this essay, state intervention refers to *discretionary* acts by government to intervene in the market economy. Such intervention violates the general operating rules of social interaction that were agreed upon in establishing the framework of governance. The good society is one where the framework of governance enables individuals to realise the gains from social cooperation under the division of labour, and therefore experience the benefits of material progress, individual freedom, and peace—a society of free and responsible individuals who participate and have the opportunity to prosper in a market economy based on profit and loss, and who live in and are actively engaged in caring communities.

The great expansion of trade and technology in the twentieth and twenty-first centuries has produced a level of material wealth that enabled the cost of government intervention to be offset, and remain largely hidden to many observers. This possibility is not a new phenomenon. Adam Smith pointed out long ago that the power of self-interest exercised in the market economy is so strong that it can overcome a 'hundred impertinent obstructions with which the folly of human laws too often encumbers its operations.' But it is important to stress that the great material progress realised over the past 100 years was not caused by the expansion of state invention into the economy but in spite of those interventions. And the tipping point is when the number of 'impertinent obstructions' grow from hundreds to thousands so that the market economy can no longer hide the costs of the folly of human laws.

These follies are a consequence of ideas and interests. We need to first address the ideas that demand state intervention and then the institutional environment that structures incentives in the policymaking process. Mario Rizzo recently listed three big threats to the argument for a free market unencumbered by government intervention: (1) externality environmentalism, (2) the resurgence of Keynesianism, and (3) behavioural economics. But these are just the most recent manifestation of arguments that strive to undermine the laissez faire principle. As these arguments gain in strength, the probability of state intervention into the economy will also rise. The task of the economist committed to the laissez faire principle is to lower that probability.

Government's growth in terms of both scale (expenditures as a percentage of GDP) and scope (increasing responsibilities of the state) in the twentieth century has been astronomical. In the twenty-first century, this growth has accelerated as the Western democracies have had to deal with perception of tensions due to globalisation and the widening income gap between the 'West and the rest.' But as the fiscal situation in

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Europe and the United States has demonstrated so clearly over the past few years, the current scale and scope of government is unsustainable.

Government spending in Western democracies as a percentage of GDP has grown from about 12.7% in 1914 to 47.7% in 2009.* Spending has increased even more since 2009 in the effort to boost aggregate demand in the wake of the global financial crisis. Government spends because the economy is weak, and the economy continues to perform poorly because government spending is crowding out productive private investment. It is a vicious cycle that has to be broken by re-evaluating the role and scope of government in a society of free and responsible individuals. The important political/intellectual activity of our age is not to starve the state of resources but build the intellectual case that we can starve the state of responsibility.

Society can in fact provide the necessary framework and acts of compassion to render state actions needless. But before that, it is necessary to demonstrate that the justificatory arguments for the state are not as airtight as imagined, and that the supply and demand for state action actually has its sources elsewhere.

Moral intuitions and the moral demands of the extended order

One of the greatest challenges to the unhampered market economy is the belief that the wealth discrepancies as a result of ill-gotten gains are destructive to social order. Class war breeds real war, as the downtrodden rebel against the injustice. Analytical egalitarianism (striving for a politics characterised by neither discrimination nor dominion) becomes a political demand for resource egalitarianism, and the step from one to the other is taken without much thought.

This claim of injustice is deeply rooted in our evolutionary past. As James Buchanan put it, the great contribution of the classical political economists was the demonstration that autonomy, prosperity and peace could be simultaneously achieved by the private property market economy. But it was precisely at the high point of the empirical confirmation that the private property market economy was criticised as an illegitimate form of social organisation because of the injustice it permitted. The development of the marginal productivity theory of wages did not stop the spread of the moral belief that capitalism was unjust. The cold logic of economics clashed against the hot emotions of moral injustice.

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Why does this tension exist? Economics is a scientific discipline that offers conjectures about how the world works, while moral theory passes judgment and suggests how the world ought to be. But what if our moral intuitions are at odds with the institutional demands that must be met so individuals can flourish? Hayek postulated that this tension between our moral intuitions and the moral demands of the extended order was a product of our evolutionary past. Culturally, human beings were conditioned by social norms that were appropriate for small group living. But with specialisation and exchange, the norms of the intimate order must give way to norms more appropriate for the interactions with anonymous others.

Our dilemma is not how to ensure a fair division of a fixed amount of income but deciding what rules we can live by that will allow strangers to live better together by realising the gains from trade with one another. Small group morality must be replaced by large group morality. Instead of moral sympathy, we need general rules that are equally applicable—rules for anonymous interactions. Deirdre McCloskey argues that this shift from the morality of the ancients to the ascendancy of the bourgeois virtues resulted in the miracle of modern economic growth and improved the lives of billions in Europe, the United States, and eventually throughout the world.

* *The Economist* (19 March 2011), special report on 'Taming Leviathan.'

The state is not required to intervene to rid injustice with respect to income discrepancies that result in a truly free market economy. Individuals earn profits by satisfying the demands of consumers—the lure of profit not only alerts the entrepreneur to opportunities for beneficial exchange but also gains from technological innovation. Competition drives costs down while improving product quality, so businesses can earn higher profits only by better meeting the demands of their consumers. Ultimately, consumers decide the profitability of commercial venture by buying or abstaining from buying. There is nothing unjust about such a distribution. Yes, Bill Gates has greater wealth than I do, but only because he better met the demands of a far greater multitude of individuals.

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Curbing private predation, creating public predation

The idea of curbing private predation is used to justify the very existence of the state: without a sovereign to define and enforce property rights, the state would devolve quickly into a war of all against all, and life would be 'nasty, brutish and short.' Everyone would be better off if they cooperated with one another, but the opportunists would be even better off if everyone else cooperated and they could confiscate the wealth created from everyone's cooperation. The only way out of this predation equilibrium is to establish a strong third party enforcer.

But such entities are also capable of far greater and more menacing public predation than private predators. Research done in the past 25 years shows communities can curb private predation by making rules that (a) limit access, (b) assign accountability, and (c) institute graduated penalties for violators. In small group settings, this is mainly done through reputation and ostracism, but in larger group environments, where the actor is not clear, deterrence and effective punishment must be instituted without recourse to a government entity, or at least without expanding the role of government.

While humans have historically exhibited a propensity for violence (rape, pillage and plunder), we have also found ways to overcome that propensity and realise the benefits of peaceful social cooperation (truck, barter and exchange). The worlds that cater to our cooperative propensity grow rich and create healthy and wealthy people, whereas worlds that cater to our violent propensity subject their people to a life of ignorance, poverty and squalor.

The state as the geographic monopoly on the legitimate means of coercion is put in the advantaged position to predate and violate the human rights of its citizens and impoverish the population. Empowering the state to curb private predation creates the possibility of public predation. As David Hume stressed, when designing governmental institutions we must assume that all men are knaves, and that the appropriate constraints are built in to ward off knavish behaviour even if knaves are in power. A robust political economy, similar to what the classical political economists wanted to establish, is one that builds in constraints on the predatory ability of government such that bad men if they somehow got in power could do least harm.

Market failure becomes justification for impediments to market adjustment

Market failure theory provides the economic justification for government intervention into the unhampered market economy. The four basic market failures are: (1) monopoly, (2) externalities, (3) public goods, and (4) macroeconomic instability. To classical economists, monopoly power was a creation of state intervention, not of market forces. This definition gave way in the late nineteenth and late twentieth centuries to the theory that monopoly power was an outgrowth of competitive capitalism. Despite empirical evidence and theoretical developments proving that the definition of classical political economists is the more coherent explanation of monopoly power, the idea that monopoly power is an outgrowth of unbridled capitalism dominates.

Classical economists argued that public goods did result in a demand for increased state intervention into the economy. Roads and bridges, for example, would not be provided by the market economy because individuals could benefit from them but due to their nature could avoid paying for that benefit. The 'free rider' problem would impede the ability of firms to profitably provide that service. This intuition developed into a pure theory of public goods. But there are technological solutions to the 'free rider' problem and numerous examples of Coasean bargains that enabled private solutions to public good problems throughout history.

According to the theory of external effects, the market economy will often overproduce economic 'bads' and underproduce economic 'goods' because the social costs and private costs in decision making are not aligned. The 'invisible hand' fails to reconcile the differences. But the primary reason for the breakdown is the inability to define, assign and enforce property rights. Pollution is one example, where because of the confused defining and poor enforcing of property rights, individuals will overproduce, but if we could clarify the rights then the internalisation of the externality would reduce pollution to its optimal level. Today's inefficiency represents tomorrow's profit opportunity for the entrepreneur who can address the inefficiency effectively. State intervention, on the other hand, thwarts that process of discovery and market adjustment by individuals and instead offers a political solution.

The most significant claims for state intervention into the economy in modern times come from the argument about macroeconomic instability. The unhampered market economy is unstable and suffers from periodic crises; it brings uncertainty about the future and unemployment and thus poverty. The Great Depression destroyed an entire generation's faith in the market economy in Western democracies. The global financial crisis has once again challenged it. But in both instances, government policy was responsible for the economic distortions that led to the current economic crisis. The length and severity of the recovery is due to failed monetary and fiscal policies, and increased regulations and restrictions that inhibit the market adjustment process.

Public choice problems rather than market failure are the reason for intervention

Even if the counter-arguments and evidence for non-intervention are persuasive, standard public choice arguments will lead to state interventions into the market economy because of the erosion of constraints on democratic action.

Independent of any intellectual argument demanding state intervention, the political process is governed by the vote motive (on the demand side) and vote-seeking behaviour (on the supply side). Policymakers will favour policies that have immediate and easily identifiable consequences over policies that have only long term consequences even if those are wealth enhancing. But as multiple studies of the conservation of natural resources within a setting of well-defined and enforced property rights have demonstrated, the market economy will effectively allocate investment funds over time.

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Government by definition holds a geographic monopoly on the legitimate use of coercion, and as such there is a strong incentive for interest groups to capture this powerful entity to benefit themselves at the expense of others. Government can be, and will be, used by interest groups to benefit themselves at the expense of others unless effectively constrained from doing so.

A politics without discrimination or dominion

James Buchanan divides the economic role of government into three distinct categories: (1) the protective state, (2) the productive state, and (3) the redistributive state. A wealth creating society will empower the protective state (law and order) and the productive state (public goods such as infrastructure), and will constrain the redistributive state. The churning state will unleash the redistributive state (rent-seeking) and thwart the wealth creating capacity of the protective and productive state. The puzzle of modern political economy, according to Buchanan, is to find constitutional rules that will enable a wealth creating society.

Adam Smith argued long ago that governments ancient as well as modern had a strong proclivity to endlessly engage in the 'juggling trick' of running deficits, accumulating public debt, and debasing the currency to monetise the debt. Bankruptcy, on the other hand, Smith argued, was the least dishonourable and least harmful policy but rarely followed. In the current crisis, this endless cycle of deficit, debt and debasement continues to plague European and US economies.

Faced with 'juggling tricks,' the only way to constrain the state is to tie the decision-maker's hands or take away the juggler's balls. So we need to establish binding rules for monetary and fiscal policy or take away the responsibility from the state. We cannot talk about fiscal policy outside the sphere of state action but we can do something about monetary policy, which can and has historically been outside the domain of state action for certain periods and in certain countries. So some combination of binding constitutional constraints, fiscal decentralisation, and denationalisation of money may empower the policy regime and constrain it effectively.

Without such drastic restraining steps, the demand for state intervention into the economy will be constant. Not inevitable but probable. We need a rejuvenated defence of the classical liberal argument for binding rules on government. Only then can we reduce the probability of state intervention and unleash the wealth creating power and creative energy of the free market.