HOW MUCH government?

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Foreword

Geoffrey Brennan

Jonathan Hughes, the distinguished American economic historian and author of *The Governmental Habit*, once shared with me what he called 'Hughes's first law' of public finance: 'everytime you look at government it's bigger'. Not, you might say, a very sophisticated or subtle remark — nor, one might add, it is properly to be attributed to Hughes, since his is merely a homespun version of a proposition first set forth by Adolf Wagner in the 1880s — but as a rough summary of the fiscal experience of virtually every Western democracy in the 20th century, it's not a bad approximation. For, by any reckoning, government has been **the** major growth industry of our time. In fact, the figures are rather staggering. In the US, for example, in the seven decades from 1900 to 1970, total government spending rose 60-fold in real terms, or 20-fold in real terms per head. And the Australian story is very little different. At the turn of the century, one in every 20 civilian employees was in government service; by 1980, it was more like one in four. Nor does this growth necessarily show sure signs of slowing down: for example, over the decade from 1969 to 1979, total civilian employment rose by 706 000 of whom 488 000 (or 70 per cent) were absorbed in government employ. Some commentators have referred to this process as 'socialism by stealth' — but it is doubtful whether there is anything 'stealthy' about a government that takes more than two out of every three additional workers.

Gradually, all this has begun to impinge on popular consciousness. The widely observed 'swing to the right', that has characterised US and British politics and (less stridently, perhaps) Australia's own, is arguably evidence of this emerging awareness. We are all nowadays, it seems, proponents of 'fiscal responsibility' and 'smaller government'. And yet, despite the political rhetoric, life does seem to go on much as before. Neither Reagan nor Thatcher, apparently deeply committed to smaller government, seems to have been able to deliver anything more than perhaps a slight easing of the growth rate of public spending. And as Michael James observes in this book, Hawke despite the trilogy commitment seems to have budgeted in 1986–87 for a real increase in the public sector share.

It is not therefore just the **fact** of government growth, nor the magnitude of the growth rates, nor the universality in the 20th century democratic experience, nor the size that governments have now achieved, that makes the phenomenon a source of concern. It is rather the

suspicion that the growth is something we can't ultimately do much about — that it may be essentially independent of electoral forces — that the whole process has taken on a life of its own. And this is a matter of concern for people of all ideological persuasions. For if it is true, as for example the Friedmans suggest in *Tyranny of the Status Quo* (1984), that political outcomes have become relatively insensitive to the manifest will of the people then our democratic institutions have indeed become bankrupt.

In short, the issue of big and growing government is extremely important. Equally, it is an issue charged with ideological significance — proponents of smaller government and their opponents tend equally to hold their views with a fervour that will not readily accommodate rational discussion. It is for this reason, as well as because the subject-matter is important, that Michael James's monograph on the topic is particularly to be welcomed. For James's purpose is precisely to examine the facts, and the various theories that purport to explain them, and the validity of the various claims about the consequences of those facts, all through the prism of cool, rational enquiry. The result is a measured and, in my view, balanced appraisal of the 'big government' question. James's own position is, to be sure, that government is now too large, and so a certain amount of his own orientation is towards seeing what measures are available to reduce the level of public spending. However, as James rightly emphasises, the issue at stake is not so much one of reducing the size of the public sector, as it is one of securing institutional changes that will ensure that the political process generates outcomes consistent with the preferences of the citizenry at large. In this sense, it is not so much that we want the 'good guys' to govern (whoever we happen to believe the good guys to be) but rather that we want institutional reforms that establish incentives for **all** to be 'good guys'. Or, to put the point a different way, the 'good guys' in politics become those who will address the issue of institutional reform and promote reforms that are appropriate, rather than those who will implement the policies I happen to like. The intellectual challenge is to discern institutional arrangements that **are** appropriate. The political challenge is then to find politicians who will seek to implement them.

In toto, Michael James's treatment of the various issues surrounding the 'big government/small govermnent' debate is thorough and interestingly written. He is to be complimented for providing such an excellent contribution to the discussion of a highly important and controversial matter.

March 1987

Executive Summary

1. Politicians of all parties agree that government is too big, but so far have had little success in cutting it back. In recent years, public sector spending in Western countries has been absorbing an additional 1 per cent of GDP per annum.

2. Australian general government outlays claim a relatively small share of GDP, but Australia's public sector also includes many public authorities, and imposes many costly regulations on the economy.

3. The impact of modern public sectors is very great, but is impossible to calculate exactly because of the multiple indirect effects both of each intervention and of the interactions between interventions.

4. Modern governments retard economic growth less by way of general expenditure and more by way of high taxation, budget deficits, and regulations working against the grain of the market.

5. Tax-transfer systems redistribute some income from rich to poor, but also return much revenue into the pockets of the taxpayers. Their effect is largely cancelled out by other interventions such as regulations and public service employment conditions.

6. Governments best promote freedom by upholding the rule of law. Big government may increase the freedom of some through income maintenance, but is likely to restrict freedom of choice. State supplies of public goods do not automatically reflect citizens' underlying preferences.

7. Government growth is the unintended outcome of established political commitments and processes. Especially important is the interaction between pressure groups, political parties competing for votes, and the absence of constitutional limits on public expenditure.

8. Some scholars believe that government growth will stop at some equilibrium point. But this implies a high, possibly unattainable, degree of certainty. Pervasive uncertainty in politics may generate a permanent tendency for government to grow.

9. Current policies withdrawing some government interventions (deregulation, privatisation) may not reduce overall public sector size but merely finance increases in general outlays.

10. Politicians committed to smaller government face a deep conflict between long-term public interests and short-term sectional interests, but with growing economic stagnation politicians have greater freedom to face down pressure from noisy lobby groups.

11. Permanent reductions in public sector size may eventually require constitutional change, but this does not remove the immediate need for political leadership to deliver the benefits of smaller government and to distribute them fairly.

Introduction

In recent years the intellectual case for smaller government has come to be accepted by an increasing number of Western politicians. In the English-speaking world in particular, the post-war Keynesian consensus favouring wide-ranging state intervention has been losing ground rapidly to arguments favouring lower public expenditure, lower taxation, and less regulation. In Australia, this intellectual counter-revolution, which occurred under the Liberal-National government of Malcolm Fraser, has been enthusiastically espoused by the Labor administration that came to office in 1983. Treasurer Paul Keating has earned a world-wide reputation as a free marketeer, and has openly committed himself to 'smaller government' (Keating, 1985/86:19-22). The Hawke administration has also taken the important practical step (under its ill-named 'trilogy' of fiscal commitments) of promising to limit, over the lifetime of the current parliament, Commonwealth government expenditure, taxation and borrowing to the rate of economic growth (though the status of those commitments is in doubt following the 1986 budget, which is based on a planned increase in taxation's share of GDP from 25.2 per cent to 25.5 per cent during 1986-87).

Yet, so far, there is little evidence that Western governments have seriously begun the process of 'rolling back the frontiers of the state'. Figures produced by the OECD (1986a:181) show that general government outlays in the 24 OECD countries, expressed as shares of Gross Domestic Product, rose in the decade following 1965 by almost eight points, from 30.6 per cent to 38.4 per cent; in Australia, the share stayed below the average level, but grew from 25.6 per cent to 32.7 per cent. In the decade following 1973, during which time the classical liberal critique of big government became much better known and more widely supported, this rate of growth accelerated. Government expenditure shares in all OECD countries rose during this period from 33.2 per cent to 42.4 per cent; in Australia the growth was slightly above the average rate, from 26.8 per cent to 36.4 per cent. Even Britain's Conservative government of Margaret Thatcher, which came to office in 1979 with an unprecedentedly strong and clear determination to reduce public expenditure, has failed to fulfill its promise. By 1984 government expenditure had risen to 48 per cent of the British GDP, more than five points above the level obtaining in 1979. Since then, the Thatcher Government has abandoned its original aspirations. After trying for a few years to hold public spending constant in real terms, it finally gave in to electoral considerations and in late 1986 announced that public spending would be deliberately increased over the following three years.

It is true that general government outlays represent only one measure of government size and growth. As is explained in more detail in Chapter 1, general outlays alone indicate neither the total size nor the total impact of the public sector. There have been significant and highly publicised reductions of government intervention in certain areas, through policies such as financial deregulation in Australia and privatisation of state-owned corporations in the UK. Yet the bald fact remains that general government expenditure is not only pre-empting more than two-fifths of the West's annual product but has in recent years been increasing its share of that product by about 1 per cent per annum.

In these circumstances it becomes important to understand how such expansion can occur despite the declared wishes of governments. This involves trying to fathom the connection between the 'small government' ideas that governments have brought to office and the political processes over which they preside, in the hope of arriving at some conclusions concerning the conditions under which such ideas can have a decisive influence on political outcomes. This monograph seeks primarily to contribute towards an understanding of these problems. Chapter 5 surveys the kinds of explanations of government growth that political scientists and others have propounded in recent years; it pays special attention to the 'public choice' explanation, which is now gaining a rapidly increasing hearing, not only among academics, but among politicians and commentators also. Chapter 6 examines the possibility of natural limits to the growth of government. Our evaluation of policies for controlling government growth will be crucially affected by knowledge of any counteracting forces that might spontaneously lead to an equilibrium size of government. The final chapter examines some of the apparent policy successes of 'small government' ideas and explores the strategies that policy-makers might adopt in securing support for further measures to reduce the scale of intervention.

The earlier chapters restate the case for smaller government and summarise the state of current research on the impact and the consequences of big government. Although Western administrations are now highly alert to evidence of 'government failure', and have incorporated the rhetoric of small government into their public statements, significant intellectual opposition to the idea persists, and not only on the political left. In the post-war era, big government was normally justified by reference to **efficiency** and **equity.** Government intervention was thought to be necessary to maintain effective demand and to cure 'market failure', thus promoting steady economic growth. It was also assumed to be a powerful instrument for redistributing income from the better-off to the worse-off, in this way 'correcting' the distributive outcomes of the market and satisfying the demand for more equality. More recently, the supporters of big

government have amended their case to accommodate the decline in economic growth rates since the mid-1970s and to counter the argument that this decline is a result of excessive intervention. While they deny that any clear inverse relationship can be established between public sector size and economic performance, they continue to defend big government in terms of its promotion of social justice, and, in some cases, of individual freedom.

All these claims are challenged in this study, and it is argued that such goals as sustained economic growth, equality of opportunity, individual freedom, and relief from poverty and insecurity can all be realised, and realised more effectively, with considerably less state intervention than we have at present. This does not, of course, by itself answer the central question: even if a consensus on smaller government were achieved, could it be successfully translated into actual policies? The public choice theorists would warn that, although we might well accept the intellectual case for such policies, our political behaviour is likely to be influenced by narrower, more self-regarding considerations. A politician who agrees that public expenditure is too high might still advocate a new spending program if he thinks it will increase his electoral support. Similarly, a voter who complains about the heavy burden of taxation might approve of a spending decision from which he directly benefits. Since we cannot quickly or easily carry out the political reforms necessary to enable us to realise our best long-term interests, we are likely to follow our interests as these are defined for us within the existing political structure. There is almost always a prima facie case for settling for the certainties of the status quo and avoiding the risks associated with reform. If there is ever to be any sustained demand for reform, then, this would have to be based on an intellectual grasp not only of the losses that the average citizen incurs as a result of oversized government, but also of the likelihood that the benefits of smaller government will be generally shared and not monopolised by powerful groups. The first four chapters are meant to contribute to such an understanding.

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Chapter 1

The Meaning of Big Government

The study of the growth of government has itself become a growth area in recent decades among economists and political scientists. Already several surveys of the literature have appeared, of which the most thorough is by Larkey, Stolp and Winer (1981). Among the methodological problems that have arisen is the fundamental one of defining big government. This question can itself be broken down into two separate ones. First, how are the various activities of government best classified for purposes of measurement and comparison? Second, if (as is the case with this study) government is deemed 'big' primarily by virtue of its profound and pervasive impact on society, how is this impact to be understood?

The Ingredients of 'Big Government'

A recent OECD study has made considerable progress towards answering the first of these questions, mainly by stressing the significance of the various 'off-budget' interventions undertaken by modern governments. These activities are, by definition, excluded from general government budget accounts but are to some extent a substitute for direct government expenditures. Saunders and Klau (1985:74-88) identify four types of such intervention: public enterprises, tax expenditures (i.e. the various forms of exemptions from tax), government lending and loan guarantees, and regulations. Off-budget activities are difficult to quantify and to compare internationally. But the Australian case provides a good example of their significance. It has been said that Australia's public sector is relatively small, since the share of Australia's GDP consumed by general government outlays ranks 18th among the 24 OECD

countries (Dawkins, 1986:3; see also Gruen, 1985:48-53, 60; Wilenski, 1986:27-8). Yet the percentage of gross capital formation in the Australian economy undertaken by public enterprises has been relatively high. Data collected by the OECD show that in the period 1975-79 it averaged 18.7 per cent per annum, ranking third out of the 16 countries compared, and only slightly below the highest percentage (19.8 per cent), which was achieved by Norway (Saunders and Klau, 1985:77).

Public enterprises largely explain the difference between the OECD's measurement of Australia's public sector and that adopted by the Australian government. Under the OECD definition, general government outlays include only those public enterprises 'which mainly produce goods and services for government itself or primarily sell goods and services to the public on a small scale' (OECD, 1986b:538). Australian Budget Statements, meanwhile, define the public sector as including **all** public authorities. Whereas the OECD (1986a:181) calculates that general outlays rose from 26.1 per cent of GDP in 1971 to 36.4 per cent in 1983, the measure preferred by the Australian government (1981:279; 1986:368) shows that total public sector outlays increased over the same period from 32 per cent to 42 per cent — a consistent difference of about 6 per cent of GDP per annum.

Regulations are another important kind of off-budget government intervention in Australia. Mancur Olson (1982:133) demonstrates that Australia and New Zealand have some of the highest import tariffs in the West, and calculates that 'their levels of protection are two to three times the level in the EEC and the United States and four to five times as high as those of Sweden and Switzerland ... The impact of protection levels that are uniquely high by the standards of the developed democracies is made even greater by the small size of Australian and New Zealand economies'. Australia also has perhaps the most highly regulated system of wage determination in the West. Some idea of the impact of regulations can be derived from a recent report of the Business Regulation Review Unit (1986), which calculates the annual direct and indirect costs imposed by business regulations in Australia (including those governing imports and the labour market) at between $40 billion and $80 billion, or between 15 per cent and 30 per cent of GDP. By far the greater proportion of this amount is accounted for by the cost of complying with regulations. The report makes no attempt to evaluate the benefits (and therefore the net costs) of business regulations, but it establishes the need to include this particular off-budget activity in any assessment of the size of Australia's public sector.

Research on tax expenditures and government lending and loan guarantees is still too rudimentary to permit international comparison. But a recent study of Australian tax expenditures has concluded that, although they have declined as a percentage of budget outlays from 13.1 per cent in 1970-71 to 6.4 per cent in 1982-83, they 'would still seem a

substantial component of public sector activity ... in 1982-83 the budget deficit was equivalent to 9.2 per cent of budget outlays, while tax expenditures, at 6.4 per cent of outlays, were roughly equivalent to two-thirds of the budget deficit' (Office of EPAC, 1986:9-10).

The Impact of Big Government

The second methodological problem encountered by the study of big government is that the impact of the public sector depends not only upon its size (whether conceived in absolute terms or relative to GDP), but also on its composition or pattern. A recent study by the Office of EPAC (1985a:5) has stressed the significance of this consideration in the following terms:

> The precise avenues through which government activities impact upon private sector economic decisions are numerous and varied ... All government initiatives have a **direct impact** on economic activity; government purchases, for example, influence the composition of resource usage and demand in the economy, as do the structure of taxes imposed to finance them. These both in turn affect the incomes of individuals, leading to further effects on spending patterns and — in combination with other measures designed more specifically for the purpose — have important effects on the distribution of income. The overall effects depend upon the precise level and composition of the spending and tax measures used.

The impact of a modern Western country's public sector on its private sector, both in its immediate effects and in successive rounds of indirect effects, is so great that no complete account of it would be possible. It is possible, however, to predict at least the direction of the immediate impact of a specific intervention: if this were not so, the intervention would not occur. For example, import tariffs are known to raise the price and to reduce the supply of imported goods. This is precisely the effect they are intended to have, even if no one can calculate by how much a given level of protection affects import prices and supplies. Some of the secondary and unintended consequences of intervention can also be predicted. Thus, import protection will, ceteris paribus, increase investment in import-substitution industries and reduce investment in export industries; and this may lead to the further unintended consequence that economic growth is reduced. But the further we can trace the consequences of an intervention, the less able we are to

quantify them, or to calculate the effects of their interaction with other interventions.

An important corollary of this is that we cannot predict in detail the consequences of the withdrawal of an intervention. Thus, the abolition of import controls would certainly be followed by an increase in imported goods and a movement of capital out of import-substitution industries, which would itself lead, in the short run at least, to increased unemployment in those industries and therefore increased welfare expenditure. But no one can predict precisely the more remote consequences of such changes, since the effect of import controls is precisely to stifle the market signals that would otherwise have indicated the direction of evolving consumer preferences and productive opportunities. Part of the case against big government is that the accumulation of interventions is such that their unintended and indirect consequences undo the benefits of the intended ones, or even make it impossible to know whether the intended effects are being realised. It is argued, conversely, that governments have a better chance of realising their goals if they reduce the scale of their interventions. In the ensuing chapters on the impact of big government on economic growth, income distribution, and individual freedom, we need to bear in mind not only that there are natural limits to our knowledge of, and control over, the effects of intervention, but also that we can learn to do better with such knowledge and control that are available to us.

Chapter 2

Big Government and Economic Growth

One of the major arguments against big government is that it inhibits economic growth. Several factors are commonly invoked to explain this connection, such as the disincentive effect of high marginal tax rates and welfare expenditures, the low productivity of the public sector in comparison with that of the private sector, and the reduction in private investment brought about by the 'crowding out' effect of the budget deficits that most Western countries have been running since the mid-1970s.

International Comparisons of Public Expenditure and Growth Rates

However, international comparisons of government size and rates of economic growth do not provide strong prima facie support for the argument. Evidence from extreme cases (such as Hong Kong and the Soviet Union) strongly suggests at least a tendency for economic growth rates to decline as government grows. But for the developed democracies no very clear statistical pattern emerges. Mancur Olson (1982:82) arrives at the following conclusion:

> The results so far are weak, showing only a tenuous and uncertain connection between larger governments and slower growth, with such strength as this relationship possesses due in good part to Japan, which has had both the fastest growth rate and the smallest government of the major developed democracies.

In the same vein, Samuel Brittan (1983:225-9) points out that even the UK, whose economic decline has been perhaps the most intensely scrutinised in world history, has experienced only average levels of government spending, taxation and regulatory intervention in the post-war period. Peter Wilenski (1986:30) notes that, although during the 1970s Australia fell from being the ninth to the sixteenth wealthiest nation in the OECD group, of the seven nations that overtook Australia only Japan had a smaller public sector (but here we should recall that the OECD defines 'public sector' in terms of general government outlays alone).

Several systematic and detailed inquiries into the link between public spending and economic growth have been conducted in recent years; but these tend to produce contradictory results. One study of the OECD countries has found a significant inverse relationship between public spending shares of GDP and economic growth rates for the period 1960-73. 'The regression estimates imply a reduction of close to one per cent in the rate of economic growth for each rise in the public expenditure share in GDP of six percentage points'. In the period 1975-81, however, 'this relationship is much weaker in magnitude and is no longer statistically significant' (Saunders, 1985:19). But a different study concludes, on the basis of OECD data on 19 industrialised countries for the period 1960–1980, that 'the initial share of government in the economy is inversely related to future economic growth'. In addition, this study claims that 'the share of social expenditure in the economy ... is also found to exert negative effects on economic growth' (Marlow, 1986:152).

Another of Marlow's findings is that economic growth is retarded by a rapid **rate of increase** in both public spending in general and social spending in particular. This corroborates the results of an earlier study based on 13 OECD countries for the period 1960-79. 'A moderately strong negative association is found in the data showing some tendency for countries with the fastest growth rates to have also the slowest growing ratios of public expenditures to GDP and vice versa' (Gould, 1983:47). But this conclusion is not supported by a study that compares the same variables in the same 13 countries plus eight additional countries between the periods 1960-73 and 1975-82, and finds that 'there is no immediately apparent relationship' (Office of EPAC, 1985a:10).

Some recent studies based on data derived from much larger samples of countries have likewise reported contradictory results. Daniel Landau, using data made available by the UN International Comparison Project, examines the connection between per capita GDP and the share of government consumption in no fewer than 104 countries over the period 1961-76. The latter variable naturally represents less than total government expenditure shares of GDP, but includes goods that may be

counted also as areas of investment, especially expenditure on education and health care. Landau finds a consistently negative relationship between the share of government consumption expenditure in GDP and the rate of growth of per capita GDP. He does, however, stress that the result should be regarded as 'quite tentative', because of both 'the limitations of the theory behind the variables chosen' and 'weaknesses in the data available'. He also notes that per capita output is not itself a measure of economic welfare (Landau, 1983:790).

Landau's findings are not borne out by Rati Ram's even broader cross-national survey. Ram divides the economy into two exhaustive sectors — government and nongovernment — and thus employs a more conventional and complete concept of government size. Using internationally comparable data on output, investment, consumption and government services from 115 market economies for the period 1960-80, he concludes that 'government size has a positive effect on economic performance and growth, and the conclusion appears to apply in a vast majority of the settings considered'. And while, like Landau, he stresses that 'several well-known caveats are needed in interpreting the statistical estimates obtained in such cross-country studies', he is confident that he has established 'at least the direction of the effect of government growth on economic performance' (Ram, 1986:202).

The Significance of Public Sector Structure

Even if the Office of EPAC is justified in concluding that 'the evidence provides relatively little support for the view that the links between the size and growth of government and economic performance are simple and self-apparent' (1985a:11), it does not follow from this either that big government has no impact on economic growth or that public expenditure can be expanded indefinitely without affecting economic performance. Research into the connection between economic growth and the **structure** of the public sector seems especially likely to bear fruit. There is, for example, some evidence linking the lower growth rates of the last decade to the widespread resort by governments to budget deficits over the same period, even though the long-term effects of budget deficits have yet to emerge (Saunders and Klau, 1985:189-202; Zandano, 1985:92-3). Budget deficits, we may surmise, are likely to be especially harmful to economic growth if they are used primarily to finance consumption at the expense of investment.

Emphasis on the composition of the public sector also brings back into view the various off-budget activities in which modern governments are involved. Evidence linking at least some off-budget interventions with low economic growth has been been sufficiently persuasive to give rise to the present trends towards privatisation and (in some areas)

deregulation. It has not, however, been strong enough to give rise to a consensus on the desirability of these trends. Against the increasingly widespread policy in Western countries of selling public enterprises to private investors, it has been claimed that there is in fact 'little systematic evidence to suggest that public enterprise will be less efficient than private enterprise' (Wilenski, 1986:36-7; see also Dawkins, 1986:4-5). Yet Australia provides at least two test cases that support the efficiency case for privatisation, and that are especially significant in that they facilitate comparisons between public and private enterprises operating under otherwise identical trading conditions. Under the two-airline policy, privately owned Ansett Airlines and state-owned Australian Airlines enjoy a near-perfect duopoly over interstate air travel in Australia. Kirby and Albon (1985) conclude that Ansett Airlines is the more cost efficient of the two (even though they argue that airline deregulation would lead to more efficiency gains than privatisation of Australian Airlines). The second case is the Commonwealth Banking Corporation, which differs from Australian Airlines in that, while publicly owned, it operates in an increasingly competitive environment. A recent study found that it performed notably worse than its main competitors in a number of crucial respects, and that it would be of more public value if sold by the federal government (GSMB Research, 1985). To be sure, the evidence from only two cases of public ownership is not decisive. But it does corroborate what most such studies conclude: that public enterprise is relatively inefficient. For example, one recent survey of more than 50 public enterprises in five countries found that their costs were between 10 per cent and 50 per cent higher than those of private enterprise (cited by Marchese, 1985:215).

As for deregulation, this tendency has been especially marked in the case of what Saunders and Klau (1985:153-9) refer to as **vertical** (i.e. economic) regulations, which (like Australia's two-airline policy) apply to specific sectors of the economy and are supposed to remedy the losses arising from non-competitive market conditions. Meanwhile **horizontal** (i.e. social) regulations, which (like environmental, consumer, and occupational health and safety regulations) set standards that all sectors are required to observe in their market decisions, have tended to expand.

Economic regulations are often criticised for hampering economic growth by sanctioning and perpetuating rigid practices that prevent the emergence of competition. It is in these terms, and above all with reference to import tariffs, that Mancur Olson seeks to explain Australia's relatively low rate of economic growth in recent decades. Olson's general theory is that countries that enjoy prolonged internal and external stability become slowly taken over by special interest organisations; these impose practices from which they benefit but which typically inhibit trade and so retard economic growth. Manufacturing

industries in Australia and New Zealand have achieved uniquely high levels of protection from foreign competition, which suggests that 'the theory fits these countries like a pair of gloves' (Olson, 1982:135). In a significant development of Olson's treatment of Australia, however, F. H. Gruen (1985:23-46) argues that while the theory does indeed fit Australia 'like a pair of gloves', it does so less by way of import protection (which, for many manufacturing sectors, has been falling throughout the 1970s and 1980s) and more by way of other rigidities, such as the centralised wage-fixing system. What seems beyond dispute is that, to the extent that big government can be shown to have retarded economic growth in Australia, it has done so very largely through a unique pattern of mutually reinforcing wage-fixing and protectionist regulations.

Certain recent studies that try systematically to trace the links between specific kinds of government intervention and economic growth resemble Olson in employing data not only from the OECD countries but from the developing countries as well. Keith Marsden's study for the World Bank selected 20 countries, grouped them into ten pairs with similar per capita incomes but contrasting tax levels, and compared their growth rates for the period 1970-79. In every case, the country with the lower tax burden achieved a higher rate of economic growth. Further comparative data led the author to propose a twofold explanation. First, lower tax burdens led to higher post-tax returns to savings, investment, work and innovation. Second, the low-tax countries provided incentives to shift resources from less productive to more productive activities, whereas in some high-tax countries the reverse was the case (Marsden, 1983:29-30).

One of Marsden's findings was that, in almost every case, exports from the low-tax country grew faster than those from the high-tax country in the period 1970-79 (the one exception was Cameroon, where exports fell by an average of 0.5 per cent per annum, while those of its high-tax partner, Liberia, grew by 2.3 per cent). But whereas Marsden associates high exports with enlightened tax policies (1983:15-16), a more recent comparison between two international regions, one fast-growing and the other slow-growing, suggests no clear relationship between export performance and government intervention. A paper by Jeffrey Sachs for the Brookings Institution (summarised in *The Economist*, 22 February 1986:53) shows that the slow-growing Latin American region was taxed only slightly more heavily than the fast-growing countries of East Asia (in 1982, 22.2 per cent of GDP as compared to 20.6 per cent). But whereas exports in the former grew from 11 per cent to 15 per cent of GDP between 1965 and 1983, in the latter they expanded from 13 per cent to 32 per cent.

Marsden, meanwhile, in his most recent study of this kind, continues to stress the significance of intervention in explaining

differences in economic growth rates. Comparing the performance of the 17 countries of East Asia and sub-Saharan Africa, Marsden finds that 'the key elements in development are the mobilization of domestic savings and access by the private sector to credit'. The fastest growing countries were those where the public sector's share of domestic credit was lowest, external public indebtedness was lowest, and the ratio of private domestic credit to the national product was highest (Marsden, 1985).

Giving Scope to Market Forces

This array of evidence linking various kinds of government intervention to slower growth seems to vindicate taking the composition of the public sector at least as seriously as its size. But what, if anything, follows from such evidence, especially when considered in conjunction with the absence of any clear correlation between government spending shares of GDP and economic growth among the OECD countries? One proposition that is at least consistent with the evidence and is also of practical significance is that countries with large public sectors can achieve reasonable growth so long as intervention is not all-pervasive but allows plenty of scope for market forces in at least some sectors. Sweden, where for several years government spending has been consuming well over half the GDP, is often cited as proof that big government need not destroy a country's prosperity. But what is overlooked in this claim is that Sweden's economy, being highly dependent on exports, is necessarily open and largely free from the rigidities that dominate the Australian economy and lower its potential for international trade. Small and medium-sized economies are unlikely to grow in today's world unless they can participate in world trade in manufactured goods.

The proposition that big government will not completely stifle growth if the economy is reasonably responsive to market disciplines also accommodates the finding that high real levels of public expenditure are themselves a consequence of economic growth. Marsden (1983:4) notes that in almost all the low-tax countries included in his study, 'growth expanded the tax base and generated increased revenues, which financed more rapid expansion of expenditure on government services such as defense, health, and education ...' Likewise, Gould (1983:49), in his study of public expenditure in industrialised countries in the period 1960-79, notes:

> There appears to be a positive relationship between economic growth and public expenditure growth in real terms ... This is as expected: countries with faster

> economic growth are obviously able to devote more real resources to public sector provision and, given the universal upward pressures on public sector services over this period, appear to have done so.

For countries that have built up extensive welfare systems, the message is clear: the real value of those systems can be maintained only by sustained economic growth. In Australia's case, this means giving priority to dissolving the structural rigidities that damage the economy's competitiveness. Fortunately, there is an emerging consensus that import protection must be drastically lowered, that the centralised wage-fixing system must be made more flexible, and that high marginal rates of income tax must be reduced. No such consensus yet exists on where public expenditure should be cut; and welfare programs will be stoutly defended by their beneficiaries and ideological supporters. But even if public spending were to continue to grow in real terms, its share of GDP could remain constant, or even fall, as economic growth picked up following remedial action on the supply side of the economy. Under such conditions, the budget deficit could disappear if tax revenues grew faster than expenditures, thus easing pressure on interest rates and encouraging productive domestic investment. The point here is not that a competitive economy can finance unlimited amounts of public spending, but that governments seem to do most economic damage when they intervene wholly against the grain of the market. Governments might justify their interventions in terms of the correction of 'market failures', but, as we shall see in Chapter 5, government is itself subject to failure if its decision-making processes are corrupted by special interests trying to have the national income redistributed in their favour.

Chapter 3

Big Government and Income Distribution

The Ideology of Redistribution

The belief that government needs to intervene on a massive scale in order to achieve its legitimate redistributive goals is a deeply rooted one, sustained by the old and potent image of a society sharply divided between a privileged, exploitative, 'rich' elite and a downtrodden mass of 'poor'. More recently, however, that imagery has been largely superseded by the spread of the notion of 'disadvantage'. Policy-makers have designated certain groups (such as aborigines, migrants, and women) as 'disadvantaged' and tried to give them preferential treatment in the distribution of welfare and opportunities. This idea implicitly recognises that the majority of the population enjoys roughly the standard of living that our present economic arrangements permit, and that the pursuit of equity nowadays means concentrating on groups that for various reasons have failed to share in the benefits of economic growth.

However, this chapter concludes that the larger and more complicated government interventions become, the more difficult it is to calculate the actual patterns of distribution they lead to, and the more unlikely that 'social justice' is actually achieved. Despite some strong prima facie evidence that welfare states do moderate the highest incomes and markedly supplement the lowest, the total impact of big government may well neutralise these effects. Conversely, governments are more able to realise preferred overall patterns of distribution to the extent that they intervene more sparingly and the impact of those interventions is more visible and controllable.

The Growth of Social Expenditures

It is indisputable that social expenditures have grown in recent decades and are a major component of 'big government'. Saunders and Klau (1985:16) summarise these changes for the period 1960–1982 in the following terms:

> The structure of government expenditure has ... shifted away from the provision of more traditional collective goods (defence, public administration and economic services) towards those associated with the growth of the Welfare State (education, health, and income maintenance) which provide benefits on an individual rather than collective basis and where redistributive objectives are more dominant.

Australia has shared fully in this general trend. Between 1962 and 1983 social services (comprising education, health, housing and community services, and transfers to persons) increased their share of total public sector outlays (defined as general government outlays plus the capital account of public trading enterprises) from 41.3 per cent to 50 per cent. This increase was almost entirely at the expense of economic services (public utilities, industry assistance, etc.), whose share fell from 25.7 per cent to 18.9 per cent. The shares of the remaining major categories — public goods and interest payments on the national debt — remained virtually unchanged (Office of EPAC, 1985b:17).

But has this expansion in welfare spending resulted in more 'social justice'? Peter Wilenski (1986:19) is confident that it has:

> The growth of government services has had an overall equalising effect and has provided to the less well-off a floor of essential services and opportunities that had not existed before ... Studies by a number of authors of various industrialised market democracies have concluded that the redistributive effect has been greatest when public spending is high and taxes are progressive ...

Recent systematic studies of entire welfare systems have indeed found evidence of some redistribution in favour of the worst-off; but rather less redistribution takes place than might be suggested by the total quantities of resources involved. Saunders and Klau (1985:203-28) examine the redistributive effects of direct and indirect taxes, transfers, and benefits from government services, in eleven developed countries (including Australia). The results in all cases are strikingly similar, and

point to three main conclusions. First, the most direct redistributive mechanism is the cash transfer, which reduces inequality by supporting the incomes of the lowest income households. Second, the redistributive impact of non-transfer government services is weak, and in some cases is regressive (tertiary education expenditures, for example, disproportionately favour the higher-income groups, so long as tertiary students are regarded as members of their parents' households). Third, tax systems have very little effect on income distribution, since redistribution through the progressive income tax is largely offset by the regressive impact of indirect taxes and social security contributions. These results indicate that a great deal of money is being simply 'churned around' by the welfare state. 'The net impact is that for the majority of households in the middle income ranges, the benefits from transfers and other public expenditures are broadly balanced by the total taxes paid' (Saunders and Klau, 1985:21).

These results are broadly mirrored in the most recent study of this kind in Australia. Ann Harding (1984:97-104), using data collected by the 1975-76 Household Expenditure Survey, finds that federal taxes have a barely progressive net effect, that redistribution is due almost entirely to cash transfers, and that expenditures on education, health and housing are distributed evenly across the entire income spectrum (she stresses, however, that this even distribution is strictly redistributive, since it provides a progressively greater **share** of the income of households in lower income brackets). But the overall redistributive impact of the Australian welfare state is more marked than that revealed in the cross-national survey undertaken by Saunders and Klau. Harding (1984:102) concludes:

> The net effect of all social outlays and an equivalent amount of taxes was to add $433 million to the lowest household income category and subtract $2032 million from the incomes of the richest households. The cross-over point occurred at the middle of the income range, with the bottom 50 percent of households emerging as net winners and the top 50 percent as net losers.

This conclusion is strengthened by Harding's additional finding that the redistributive impact of non-social federal outlays (e.g. defence, transport and communications, and industry assistance) is roughly the same as for social outlays, and therefore does not neutralise the net redistributive impact of the welfare state.

The Overall Distributive Effect of Intervention

All the authors cited here are acutely aware that their chosen method of analysis — 'net fiscal incidence' — is fraught with problems and that their findings should not be treated as final answers to the question of the overall redistributive effect of government. Incidence analysis compares the distribution of 'original' (pre-tax, pre-benefit) income with the distribution that emerges after the state has levied taxes and dispensed welfare benefits. But original income is itself very largely determined by the existence of government. Saunders and Klau note that 'the distribution of original incomes will not be independent of existing tax and expenditure policies, but will in part emerge as individuals adjust their behaviour in response to them'. For example, governments can greatly affect the original income distribution in their roles as employers and as purchasers of goods and services from the private sector. Evidence from the USA shows that some public servants earn higher incomes than they could obtain from private employment and that profits tend to be higher in industries involved mainly in supplying government orders. Saunders and Klau conclude that, although fiscal incidence analysis excludes redistributive effects of this kind and therefore 'cannot validly be used to indicate the overall effects on income distribution due to government', it is still useful in indicating the redistributive effects of the relatively marginal changes which government reforms of tax-benefit systems usually involve (Saunders and Klau, 1985:204-5; see also Harding, 1984:12-16, 22-5).

In the light of these problems, it seems safe to conclude that, as government grows, it becomes increasingly difficult to trace its total impact, direct and indirect, on the original income distribution, and, consequently, increasingly difficult to sustain the claim that big government promotes any particular pattern of income distribution, just or otherwise. Some of the most telling complaints about big government centre precisely on its unintended but perverse distributive effects. Public sector employees, as well as earning uncompetitive salaries, may enjoy security of tenure and subsidised pension schemes: luxuries beyond the reach of private sector employees. Import controls raise the incomes of employers and employees in import-substituting industries, but reduce the incomes of consumers. Centralised wage-fixing, in its present form, helps to maintain youth unemployment at three times the national average level. The welfare state may, to some extent, offset these effects; but the bigger government is, the more likely it is to generate such effects in the first place, and the less likely it is that the tax-benefit system will fully compensate for them.

Proportional Taxation and Cash Transfers

Conversely, there is more chance of **small** government effecting genuine redistribution, since the original distribution will itself be less affected by the existence of government and will therefore more closely approximate a pre-intervention distribution rather than merely a pre-tax, pre-benefit distribution. This will provide a more accurate benchmark against which to judge the true effects of redistributive policies. The main findings of Harding and Saunders and Klau concerning the impact of the various instruments of welfare policy could all be utilised in a system restructured in such a way as to capture the benefits of smallness and effectiveness. The welfare system elaborated over the years by Milton Friedman achieves this by embodying two main principles: proportional (flat-rate) taxation (1962:174-6; 1984:62-8), and redistribution primarily via cash transfers to the worst-off rather than via services available to all (1980:119-24).

The first principle — proportional taxation — would have less impact on the original distribution than existing tax arrangements and would be that much less likely to offset the redistributive effect of cash transfers. Taxation would thus cease to be an instrument of deliberate redistribution altogether. The problem with the progressive income tax is not just that it is balanced by regressive indirect tax and so has minimal redistributive impact. It tends also to be riddled with little-known loopholes, which both benefit the better-off and do not prevent governments from being able plausibly to take the credit for 'soaking the rich'. These loopholes have further effects (such as artificially inducing breadwinners to rearrange their affairs in a tax-avoiding direction and the rich in particular to acquire tax shelters) that are likely to render the original distribution more unequal as well as to retard economic growth. The flat-rate tax with minimal permissible exemptions, on the other hand, would have far less effect on the original distribution, since it would impinge on everyone in the same proportion and provide less incentive to tax-avoiding behaviour. The elimination of loopholes would, by leading to an increase in revenues, allow the rate itself to fall below the present standard rate; this would further reduce the incentive to substitute leisure for income, which is a feature of progressive rates, and, to the extent that this resulted in higher economic growth, it would enhance the community's ability to finance welfare policies.

The principle of effecting redistribution primarily via cash transfers to the worst-off (by measures such as the negative income tax) rather than via benefits and services available to all would eliminate some of the churning process whereby much of the income distributed by the welfare state returns to the original taxpayers (imposing administrative and compliance costs as it does so). This does not imply that the state

should simply end all involvement in services like health care and education. But it does suggest that state provision or financing of such services needs to be justified with more clarity and rigour than it is at present. If redistribution is the main aim, the state could start charging middle and upper income groups for those services it provided in kind, while continuing to supply them free to the worst-off. If the main purpose is to maintain the supply of goods that would otherwise not be purchased in sufficient quantities, the state is not bound to supply these exclusively in kind, but could allow competition from private producers, and assist consumers of market alternatives with vouchers or tax credits. These techniques of subsidising the consumer rather than the producer might also make for more efficient redistribution, since they would enable the state to direct additional resouces to those deemed most in need of them while avoiding the reverse redistributive effects of making services available to all.

Another effect of making services available by directly supplying the finance to consumers while allowing the market to supply the products themselves would be to expand freedom of choice. The link between freedom and smaller government, however, is properly the concern of Chapter 4.

Chapter 4

Big Government and Freedom

Hayek's 'Road to Serfdom' Thesis

Since World War II, serious thought about the connection between growing government and individual freedom has been conditioned very largely by F. A. Hayek's famous 'road to serfdom' thesis. In *The Road to Serfdom* (1944), Hayek argued that state intervention to achieve collectivist goals within liberal democratic systems was likely to lead eventually to the loss of fundamental civil freedoms. This was because collectivists misunderstood the self-defeating nature of interventionism and regarded its inevitable failures as proof of the need for ever more radical interventions, resulting ultimately in total control by the state over the lives of its subjects. More recently, Hayek has modified his views on the kinds of intervention that collectivists are most concerned to promote. In *The Constitution of Liberty* (1960:253-66), he notes that socialism in the old-fashioned sense of the common ownership of the means of production, distribution and exchange has been discredited by experience, and has been supplanted by the welfare state as the preferred method for achieving the ultimate goal of social justice. But Hayek has not changed his views about what the interventionist process itself will lead to unless checked. In his latest book, he predicts 'an impasse from which political leaders will offer to extricate us by desperate means', resulting in 'a totalitarian state' (Hayek, 1979:xiii). And despite distinguishing between socialist and welfarist interventions, his emphasis is still quantitative: more government means less freedom, or at least renders our basic freedoms less secure. Therefore there is as much need as ever to treat our economic freedoms as an essential safeguard of our civil and political freedoms.

Yet the 'road to serfdom' thesis has, over time, lost the urgency that attended its original formulation. Despite 40 years of steadily growing

government, no country has yet repeated the experience of Germany in 1933 and arrived at a condition of serfdom in the manner Hayek envisages. Indeed, some Western countries have experienced important gains in civil and political freedoms. In the mid-1970s, for example, Greece, Spain and Portugal became liberal democracies at a time when budget shares of their GDPs were growing. Nor has the recent experience of the more established liberal democracies justified the warning by Milton Friedman (1976) that freedom was on the point of extinction when public spending reached 60 per cent of GDP. In at least three countries — Denmark, Sweden and the Netherlands — that barrier has been breached without any dramatic losses in basic freedom occurring. This has prompted one defender of big government to pose the rhetorical question: 'are the Netherlands and Sweden ... notably less free than the USA?' (Heald, 1983:75). Even if one is inclined to reply that the USA **is** notably freer than those countries, it remains true that a number of basic and crucial freedoms have not yet vanished from the smaller European social democracies. No refugee from communism living in those countries would have any doubts about that.

Freedom as Autonomy

The growing implausibility of the 'road to serfdom' thesis has encouraged supporters of big government to turn that thesis on its head and to claim that intervention **increases** freedom. The argument is that intervention can secure for individuals the resources with which to undertake 'autonomous' action, in the absence of which freedom can be of little or no value to the individual. Supporters of this argument have proposed a variety of kinds of interventionist measures to promote autonomy. One involves a state guarantee of individual access to some basic minimum of resources. Another is designed to protect individuals from sources of power and coercion other than the state, such as economic monopolies. A third is intended to deal with those cases where individually rational choices may lead to the collectively irrational result of foreclosing certain options widely held to be desirable.

These arguments involve a concept of freedom that is 'positive' in that it refers not so much to the absence of deliberate, state-imposed constraints (the so-called 'freedom to starve', which is said by some to characterise laissez-faire) but rather to the presence of actual opportunities and resources needed to give effect to individual preferences. The meaning of freedom, however, is a complex issue over which philosophers have disagreed for centuries, and to which it is beyond the scope of this essay to contribute. The ensuing discussion is therefore limited to the question whether freedom in this positive sense really can be achieved only under big government and whether it would

in fact be threatened by a substantial reduction in the present scale of state intervention. These questions are ultimately more important than those concerning the effects of big government on economic growth and social justice. For if it could be shown that widespread state intervention was indeed essential for the realisation of individual autonomy, this would for many people constitute a decisive reason for accepting big government and for rejecting the argument advanced by Hayek and classical liberals generally that individual freedom is secure only where the power of the state is subject to strict limits.

The argument that government intervention is required to secure individual autonomy has been made most explicitly in recent times by Albert Weale. Weale (1983:50) conceives of autonomous action as 'action that is the outcome of deliberation about one's plans and resources within the constraints facing an agent'. Such action requires conditions of individual liberty in the sense that autonomous choices are 'the product of the deliberation an agent exercises over the options available within these constraints'. Liberty itself involves not only the physical ability to perform an action but also 'the absence of foreseen deprivation consequent upon performing that action' (1983:51). The latter component of liberty relates principally to the problem of economic coercion arising from inequality of wealth. 'The reason for the relative nature of economic power is that it is relatively greater ownership of economic resources that enables a person to control the consumption and employment opportunities of others, and it thus enables that person to structure the choices that face other persons in that society' (1983:54).

Weale puts forward two major policy recommendations. First, he proposes a guaranteed minimum income (a 'social dividend') that, while not necessarily resulting in equality of property-ownership, enables everyone to avoid having to make humiliating choices conditioned by the presence, or the threatened presence, of poverty. Second, he advocates a form of equal educational opportunity that avoids both the meritocratic principle that the most able should have privileged access to educational resources, and the egalitarian principle that everyone should be made to conform to a fixed standard of performance. 'In other words, the principle of autonomy leads to the conclusion that abilities should be equalised, but only within a specific range of subject-matter and only up to a specific level of competence' (1983:75-6). It should be stressed that Weale is here justifying these policies not in terms of social justice (even though they might well satisfy that principle too), but in terms of individual freedom.

The issue is whether individual autonomy conceived of as economic independence and educational opportunity requires government to be bigger rather than smaller. In the previous chapter, it was noted that the experience of welfare states shows that income maintenance can in

principle be achieved effectively, and with the least amount of intervention, by cash transfers rather than through the tax system or the provision of services in kind. This should hold true whether or not the absolute size of the minimum is to be established by reference to individual freedom rather than (or as well as) by reference to social justice. But what are the implications for state intervention of promoting educational opportunity? Weale argues that deschooling and universal private education must be rejected, since neither would ensure that each individual reaches the educational standard prescribed by the common curriculum that autonomy requires. But between the two remaining options — a regulated voucher scheme and state-provided education — he remains uncertain. 'Too many unresolved empirical issues intervene for us to to be able to say that equality of educational opportunity favours one scheme over the other' (1983:79). The choice should, presumably, await the results of a thorough and systematic comparison between the two systems. The voucher system embodies a wider range of options, but, interestingly, this does not lead Weale automatically to prefer it to the state-supplied system. Later in his book he clarifies his understanding of the connection between freedom as autonomy and freedom of choice by making two major points. The first is that the value of freedom depends not on the range of available options, but on the **quality** of those options; and the quality of choice does not necessarily increase with the number of alternatives from which a choice can be made. Second, Weale denies that freedom of choice always entails choice within markets, but asserts that it may be interpreted as 'the right to participate in social planning and collective decision-making institutions' (1983:115-16). From this we may infer that, for Weale, freedom as autonomy requires that any educational voucher system should operate only within a range of options determined by public policy, and that any state-supplied system should be subject to the constraints of democratic control.

Let's assume, with Weale, that freedom as autonomy does not mean the same as freedom of choice (e.g. if autonomy does require reaching a common standard of educational achievement, it precludes the choice not to be educated). Let's assume also that freedom can be exercised collectively through democratic institutions. How well does our existing state-supplied educational system promote individual autonomy? There is in fact widespread public concern about the effectiveness of state education, not only in Australia but in other English-speaking countries such as the UK and the USA. In Australia there exist no clear policy statements of the minimum standards that public education is meant to achieve, nor is there any systematic monitoring of the standards which are actually achieved. State educational policy is determined in a formally democratic manner, but it has so far remained almost wholly impervious to public disquiet and

demands for reform. No doubt democratic controls are open to improvement, but our growing knowledge of how modern democratic systems work (a subject examined in detail in the next chapter) suggests limits to the influence public opinion can exert through the political system over special interest groups such as teachers' unions. At the same time, a major factor bringing pressure to bear on the politicians to reform the system is the fact that parents are increasingly exercising their freedom to opt out of the state system and to select one of the privately produced alternatives.

The main problem with Weale's account of the connection between autonomy and educational policy is that it poses mutually exclusive alternatives between the regulated voucher system and the state-produced system. In reality, these systems can coexist and both benefit from the competition between them. Thus, the state could both maintain the existing system that supplies education direct to the public and subsidise the choices of those parents who preferred to send their children to private schools. Such a dual system could operate within an overall policy establishing a minimum educational standard of achievement, while at the same time encouraging continuous experimentation and improvement in the methods whereby that standard was actually achieved. It would be impossible to tell in advance whether this would result in a diminished role for the state in the production of education, but such role as it did have would be the outcome of individual rather than collective choices, and thus more accurately reflect actual preferences. The implications for other state-supplied services are obvious. Even if autonomy cannot be equated with freedom of choice, it must surely require some avenues through which citizens can seek alternatives to those state services they regard as unsatisfactory.

Freedom and Private Power

The second range of arguments to the effect that state intervention promotes autonomy stresses the threat to freedom posed by concentrations of non-state power. Peter Wilenski (1986:38-9) argues thus:

> There is an inevitable inequality in a free market society between those with capital and those without, and an inevitable tendency towards concentration of capital. The political power that this unregulated concentration generates will be used not only to frustrate market competition ... but also to maintain the income status and privilege of the economically powerful. It is the intervention of government that

> has on balance been the equalising and liberating force — and incidentally has often been necessary to ensure market competition, rather than oligopoly or monopoly concentration.

This passage stands in need of several qualifications. It is by no means certain that private capital 'inevitably' tends towards concentration. Some such concentrations are themselves the result of state intervention (e.g. the powerful position of Ansett Airlines within the Australian air transport system is the intended consequence of the two-airline policy). Several public enterprises are monopolistic (e.g. Telecom Australia). Yet ownership of private capital **is** unequally distributed, and this does generate a widespread conviction that individual freedom is weakened or threatened as a result.

The most fruitful way to approach this issue is to resurrect the distinction between **state** and **law**, a distinction that the growth of government has almost obliterated in the public mind. The arbitrary interventions of omnipresent government have encouraged the view that only power can conquer power: that only deliberate state intervention can protect society from private power-centres. Hence the fear that smaller government means turning society over to the 'law of the jungle' in which the weak are left defenceless against the strong. This line of thought not only overlooks the fact that the state is itself by far the most dangerous source of coercion (this is without doubt the most important single political lesson of the 20th century). It implicitly regards the law as no more than a weapon at the disposal of the state. In many countries this is no doubt true; but it is not so in countries whose legal systems include the common law, however indeterminate the scope and the principles of the common law have become as a result of the steady expansion of statute law. What distinguishes the common law from state power is that, ideally, it does not pursue any purposes of its own but imposes a framework of general and impartial rules protecting individuals from coercion from any quarter, and is subject to its own principles of interpretation and evolution.

Once the distinction between state and law is grasped, it becomes clear that the choice that confronts us is not between big government and social breakdown, but between big government and the rule of law, and that the rule of law, interpreted in a suitably libertarian fashion and enforced rigorously, is a more predictable and secure source of protection than is direct, purposeful intervention. The state could refuse to provide legal enforcement for agreements sustaining professional and producer cartels and other restrictions on freedom of entry into established markets. Producer monopolies would thus be permanently subject to the threat of potential competition. In the same way, the coercive power of labour monopolies would be diminished if the state removed all

obstacles to legally binding contracts between trade unions and employers, upheld the right not to join a trade union, and prohibited strike action by public servants and employees in essential services.

Governments constrained by the rule of law would also be debarred from interventions that favoured some business concerns and trade unions at the expense of others and so artifically increased their market power over their competitors. This would not only rule out the statutory monopoly status enjoyed by some public enterprises and protective regulations such as import controls and the two-airline agreement; it would also put a brake on arbitrary subsidies and tax concessions for favoured sectors of the economy, or at least ensure that such concessions were made available on a more general and impartial basis.

Finally, governments could formulate policies for encouraging the spread of property ownership. This would be a likely indirect effect of policies that increased the competitive potential of the economy and the rate of economic growth; for example, balanced budgets would reduce interest rates and thus make it easier for low-income earners to obtain home loans. But it could also be one of the intended effects of a reformed tax and welfare system. Lower marginal income tax rates encourage higher savings and investment. Some welfare payments currently paid in cash or in kind could be consolidated and dispensed as lump sums to individuals when they reach school leaving age. Whatever the practicability and plausibility of such schemes, the essential point is that encouraging the spread of property-ownership is one of the most effective ways in which the state can increase the freedom and independence of the individual from **all** centres of power, public as well as private, while simultaneously promoting individual autonomy by making available a wider range of practical options.

Are these essentially indirect measures really sufficient to neutralise completely the threat of coercion stemming from private concentrations of power? It is not difficult to find instances where more vigorous state intervention does seem to promote individual autonomy better than the marketplace. For example, some monopolies may arise in areas where it is technically most efficient to have single producers: obvious examples of such 'natural' monopolies are railways and water supplies. Here, monopoly power cannot be rendered vulnerable to competition from new entrants into the market since no such competition will be forthcoming. This consideration may justify government intervention to regulate the production and pricing of such goods so as to prevent exploitation of consumers.

Another example of active intervention that seems to promote autonomy is the regulation of consumer standards and of occupational health and safety. Consumer standard regulations are supposed to protect the public from fraud and enable them to make more rational choices

than would otherwise be possible. Regulation of occupational health and safety is likewise said to be necessary to protect employees from work hazards and from the possibility of exploitation by employers. But while it is true that governments may achieve the official purposes of such interventions, it is also possible that they may fail, or at least not perform over time as well as the market itself. Regulation of natural monopolies may inhibit the emergence of new technologies that undermine those monopolies by discovering fresh avenues and opportunities for competition. The agencies regulating consumer standards may end up restricting consumer choice if they impose costly regulations that reduce the supply of goods and raise their prices beyond the reach of lower-income groups; and the problem of standards may in any case be solved spontaneously over time by rising incomes and the growing sophistication of consumer preferences.

To be sure, government intervention does not necessarily lead to such unintended and harmful consequences. But the general point here is that the mere fact of market failure is no guarantee of government success. At the very least such intervention should be reversible, so that if and when it is judged to have failed, or to be inferior to solutions emerging in the market, it can be abandoned or modified. Once again, our knowledge of modern democratic processes should alert us to the possibility of intervention coming to serve not the public interest but the special interests of lobby groups (whether producers or consumers) who have most to lose from genuine freedom of consumer choice.

Freedom and Public Goods

The possibility that governments as well as markets can fail is equally relevant to the third kind of intervention that may be justified by reference to individual autonomy, namely, the state provision of goods that, for technical reasons, individuals acting rationally will not supply in adequate amounts in the marketplace.

This class of interventions addresses itself to the 'public goods' problem, which has always been a central concern of classical liberal political economy and in recent decades has been the subject of increasingly sophisticated economic analysis. The general problem is that some goods are by nature 'indivisible' (i.e. they cannot be divided into separate amounts for sale to private individuals) and consequently their consumption cannot be restricted to those individuals who pay for them. Since few entrepreneurs will be willing to risk supplying goods for which they cannot charge, the state must intervene (whether through regulation, through finance, or through direct production) to ensure that sufficient quantities are made available to the public. Traditionally, public goods have covered such 'public works' as roads and harbours.

More recently, the analysis has been applied to 'externalities' — costs that individuals can avoid paying by transferring them to the general public, such as pollution of the environment — thus sanctioning government intervention to make individuals 'internalise' such costs by taxing them or banning them outright. Over time, an increasing number of goods has come to be thought of as 'public' — including even the relief of poverty (Friedman, 1962:191) — resulting in a steadily growing agenda of state intervention.

The problem from the standpoint of this essay, of course, is not whether public goods theory is sound but whether it follows that public goods should be supplied by the state. The theory itself only identifies public goods; it remains strictly neutral as between different measures for ensuring their supply, such as state provision and the search for technologies that transform public goods into private ones. Unfortunately, however, the existence of public goods is widely viewed as an automatic justification for intervention. Peter Singer, for example, argues that public transportation is a public good that the state should not only supply but also make viable by banning private vehicles from city areas (1982:45-6):

> Suppose that ... a law is enacted prohibiting the use of private vehicles in a defined inner city area. In one sense the range of choices of transportation open to people has been reduced; but on the other hand a new choice now opens up — the choice of using a fast and frequent public transport system at a moderate cost. Most reasonable people, given the choice between, say, an hour's crawl along congested, exhaust-filled roads and 20 minutes' comfortable ride on a bus or train, would have little hesitation in choosing the latter.

If the choice were as Singer describes, perhaps most people would indeed prefer public to private transport. But **is** the choice as he describes it? The passenger rail service in some Australian states is in fact very poor — strike-ridden, unreliable, massively subsidised — in short, a striking example of government failure. Singer does not quite assume that the standard of government services can be absolutely guaranteed. 'Let us assume', he writes, 'that for economic reasons the possibility of choosing the quick and comfortable ride on public transportation would not have existed if private transport had not been restricted' (1982:46). But it is precisely this assumption that needs to be questioned. Could the congestion of the roads by private vehicles not be partly a **result** of the poor service provided by public transport? At least some of the causes of the latter — absenteeism, overmanning, the

right to strike with impunity — could be eliminated without any restriction on the use of private vehicles. The explanation for this particular case of government failure has much more to do with the substitution of producer sovereignty for consumer sovereignty in the public sector than with the externalities of private transport.

Another weakness in Singer's argument for restricting private transport in favour of the public variety is that it assumes that transport systems must be wholly public or wholly private. In reality, a wide variety of public–private mixtures is to be found in the cities of the world. Technical progress is indicating ways of eliminating the 'public' aspect of road use. Between 1983 and 1985 Hong Kong experimented with 'electronic road pricing' (ERP), a serious attempt to deal with traffic congestion by pricing each journey undertaken by each vehicle and charging the owner accordingly. Moreover, 'ERP offers the possibility of the private sector providing not only vehicles but also roads on which to run them' (Roth, 1986:15). Technical innovation nowadays renders the entire 'public goods' agenda of government wholly provisional.

Finally, is it really the case, as Singer believes it is, that the compulsory and effective provision of a public good by the state necessarily promotes individual freedom? This assumption is questioned by Frank van Dun, who argues that, if individual freedom is conceived in terms of certain absolute rights, then supplying a public good by taxation or (as in Singer's example of public transport) by banning private substitutes clearly restricts that freedom. It follows that any attempt to provide the good without limiting freedom must rely on selective rewards that modify the voluntary behaviour of individuals. 'To seek a desirable public good does not justify methods which are generally admitted to be unjustifiable when practiced in the pursuit of private goods. There is nothing in either the theory or the concept of a public good that requires us to abandon that objection to the invasion of individual rights and liberties' (Dun, 1984:29).

But what if we reject this particular conception of freedom, and prefer, like Weale and Singer, to view freedom as the availability of resources and opportunities that enable individuals to realise their preferences? As we have already noted, Weale (1983:115) insists that autonomy is promoted by increasing not merely the number of available options but their quality. The crucial consideration here, then, is whether the public good in question really is a **good**: i.e. whether the fact that it is not produced by voluntary cooperation is sufficient evidence that individuals regard its absence as a limitation of their freedom and therefore would welcome its production by government intervention. Singer treats it as virtually self-evident that private motorists would willingly surrender their freedom to drive private vehicles (with the attendant discomforts) if this were necessary to make public transport efficient. 'Most reasonable people', he writes, would

make that choice. But can we be so sure? Dun (1984:29-30) warns against the 'public goods mythology', which tells us that we can:

> It is quite illogical to move from the observation that people do not appear to co-operate in the provision of a public good to the conclusion that they would have been better off even on their own subjective evaluations if they had chosen to co-operate. Economists are rightly very reluctant to claim knowledge of people's valuations when not demonstrated in action, e.g., in their bids for various goods and services in the market. Yet this reluctance largely disappears in applying public goods theory ... The coercion that the public goods mythology claims to justify withdraws funds and resources from other projects. These alternative projects are not known to the government or its advisors — and neither do they know the value people place upon a public goods project relative to their own chosen personal projects.

Dun shows that government intervention to supply public goods will actually limit freedom-as-autonomy if its opportunity costs impose a net reduction in the quality of the options available to individuals. However unpleasant it might be to drive a private vehicle in a congested city centre, many drivers may still have their reasons for preferring to be free to do this rather than to be banned from city centres in order to make public transport viable, especially when public transport has to be subsidised with resources that taxpayers might prefer to be used otherwise. It does not follow from this that we can never know whether government provision of public goods promotes freedom, since individual preferences can be determined, in some cases at least, by devices such as the referendum. But it does follow that such intervention does not **automatically** promote freedom, even if it is the only way of making certain options available.

Economic Growth, Income Distribution and Freedom

This is a convenient point at which to summarise our findings about the connection between big government and the goals its defenders claim it serves, and to explore some of the policy implications that follow from those findings.

Economic growth. The most recent systematic empirical inquiries in this area fail to agree on the impact of either the amount of government expenditure, or its rate of increase, on economic growth.

There is more clear-cut evidence linking certain ingredients of big government with low growth rates, such as high taxation, large budget deficits, protective regulation, and public ownership. Countries that maintain high real levels of welfare expenditure finance these programs from the economic growth generated by open, competitive market sectors.

Income distribution. There are two main ways in which big government is likely to fail to achieve officially desired patterns of income distribution. First, the accumulation of welfare programs is likely to result in churning, whereby government returns much revenue to the taxpayers. Second, the distributive impact of many non-budget interventions is often highly regressive, thus offsetting some of the redistributive effect of welfare programs. As government grows larger, it becomes increasingly difficult to trace the total net impact of government on income distribution. Conversely, the impact of smaller government should be less difficult to monitor.

Freedom. Government can promote freedom most effectively by maintaining the rule of law and safeguarding rights. It can also to some extent promote autonomy by such direct interventions as a guaranteed minimum income and, less directly, by encouraging property-ownership. Big government is likely to diminish freedom and autonomy, most obviously by diminishing freedom of choice (but freedom of consumer choice could be introduced into at least some public services). Even those direct interventions that are officially supposed to improve the operation of the market can easily have the opposite effect.

An obvious implication of these findings is that steps to diminish the scale of government intervention will simultaneously promote economic growth and individual freedom, as well as permitting more effective redistributive policies. This conclusion is wholly at odds with the common belief that the policy goals of efficiency and equity are incompatible and lead inevitably to what one writer has called 'the big trade-off' (Okun, 1975). The incompatibility arises because, so it is claimed, the market, however efficient, naturally generates inequalities, and government efforts to alleviate these inequalities inevitably result in some loss of efficiency. But our findings suggest that the policy goals of efficiency, equity and freedom are to a very great degree mutually compatible. Economic growth and individual freedom both require the existence of competitive markets: the former because markets are an ingredient in all successful economies, whatever the level of government intervention, and the latter because at least some freedom of choice is a necessary condition for freedom-as-autonomy. Again, economic growth will, if its benefits are suitably distributed, enhance autonomy by raising incomes and enabling individuals to realise more of their preferences. Enhanced consumer choice in the distribution of welfare services should result in greater efficiency in their production. It is true that strongly

egalitarian policies would at some point impose levels of taxation that restricted economic growth and so forced a trade-off to be made. But it is also true that the resources currently consumed by the welfare state could result in a substantially more equal distribution if the problem of churning were to be overcome.

Our overall conclusion so far, then, is that the benefits big government is alleged to bestow could in fact be more effectively realised with a lower level of intervention. This conclusion does not by itself indicate any precise, ideal agenda of intervention. But it does raise the question, addressed in Chapter 5, why the size of government should be so much greater than it apparently needs to be to satisfy the policy goals in terms of which it is normally defended.

Chapter 5

Explaining Government Growth

If big government cannot be justified, why has government become so big? At first one is tempted to answer that the growth of government is the outcome of the spread of certain ideas about government, such as the belief that only increased intervention could eliminate poverty and disadavantage and ensure equality of educational opportunity. The British case provides persuasive evidence for this explanation. In the UK, the share of the national income consumed by public expenditure has been rising steadily during the 20th century, after falling throughout most of the 19th. This rise was preceded by a profound intellectual shift among a number of influential social philosophers and politicians away from the ideas of laissez-faire and limited government and towards a more interventionist role for the state in pursuit of collective goals. Likewise, the dismantling of the protectionist, mercantilist state during the 19th century was preceded by the emergence of classical political economy, embodied in the writings of Adam Smith and his successors. The fall and rise of big government in Britain over the last two centuries does indeed seem to be the outcome of changes in the prevailing political ideology.

The problem is that, as was noted in the Introduction, the disillusion with big government that has been increasing over the last 15 years or so has failed to halt or even appreciably to slow down the steady increase in the share of GDP consumed by government expenditure. This has prompted scholars and commentators to view government as a process rather than merely as a set of institutions promoting official goals. Although there now exists a bewildering variety of theories purporting to explain the growth of government, most of them agree that the phenomenon is an unintended consequence of established political commitments and modes of interaction between political actors. This does not mean that government growth is

necessarily irrational; however much governments might 'fail' to realise the goals collectively set for them, they might well succeed in promoting the goals that individuals pursue in their political roles.

This chapter is concerned principally with the 'public choice' explanation of government growth. This increasingly influential explanation stresses the role of special interest groups within the political process. But, by way of contrast, it might be useful first to examine another prominent explanation that, while leading to conclusions not inconsistent with those of public choice theory, proceeds from very different assumptions. This explanation is based on the so-called 'programme approach', which the political scientist Richard Rose has been developing for a number of years.

The Programme Approach

The programme approach involves 'disaggregating' the concept of government into its constituent elements, whose systematic interrelationships will reveal how government works. 'Constitutionally, a government may be unitary, but in policy terms a government is not a single actor using a single resource to produce an undifferentiated stream of pure utility. It is a conglomerate whose multiple institutions produce heterogeneous outputs' (Rose, 1985:6). Governments consist of a variety of **organisations**, which mobilise **resources** (laws, money and employees), and convert these into **programmes** delivering goods to the public (e.g. health, welfare, defence). Programmes may be classified according to the type of resources on which they primarily depend. Education and health programmes, for instance, are 'money-intensive' and 'labour-intensive' because they utilise large quantities of cash and large numbers of employees. Income-maintenance and debt-servicing programmes, meanwhile, tend to be money-intensive only; while law and order programmes are 'law-intensive' above all, involving little cash and few employees (Rose, 1985:10-14). This classification of programmes cuts across the descriptive categories of interventions employed by the OECD; for example, 'off-budget' programmes may be labour-intensive and/or money-intensive (public enterprises), or law-intensive (regulations). But it likewise brings to light the varying **patterns** of size and growth that governments display. Big government, where it exists, is not necessarily composed only of big programmes. 'When government is disaggregated into different programmes there is no necessary reason why all its programmes should grow at the same rate, or grow in the same direction. A government that is big in aggregate can be growing bigger in some programmes, while other programmes simultaneously remain static or contract' (Rose, 1984:12).

But how exactly does the programme approach help **explain** the growth of government? Rose examines a wide range of possible factors, but argues that the main factor is the 'upward bias' of the 'inertia of established commitments' (Rose, 1984:48-53). Modern governments find themselves trapped by the demands of programmes initiated in previous eras, which they have neither the time nor the will to challenge: Rose estimates that such programmes consume at least 75 per cent of public expenditures in Western countries. This inertia leads to government growth for a number of reasons, including the demand for new interventions to rectify the mistakes of earlier ones (this is, of course, the logic of Hayek's 'road to serfdom'). But the most significant reason is 'political compounding', or the tendency of originally small programmes to expand automatically with social and demographic change (old age pensions are an obvious example). Rose goes on to identify the main problems of big government as 'loss of effectiveness' (e.g. through contradictions between programmes) and 'reduction of popular consent' (e.g. through excessive taxation) (Rose, 1984:53-62). But he remains confident that modern Western governments will manage to finance their commitments without threats to civil rights or serious loss of legitimacy; and he concludes: 'Big government is here to stay. No popularly elected government is going to repeal the social, economic and defence programmes that make government big' (Rose, 1984:215).

This explanation is open to a number of criticisms. First of all, the expansion of government spending is not invariably a result of the 'inertia of established commitments'. One commentator has shown that public expenditure increases in Australia in the period 1983-86 are accounted for mainly by the introduction of **new** programmes during that period (Abrahami, 1986:31). Why exactly do politicians initiate new programmes in addition to maintaining existing ones? This is not to suggest that government growth is after all the intended outcome of public policy, but it does suggest that Australian politicians, at least, have more discretion over the rate of increase of public spending than Rose's 'programme approach' would allow. Second, and more importantly, the factors Rose identifies as the causes of government growth are themselves in need of explanation. One aspect of the 'inertia of established commitments' may well be that politicians try to rectify failed interventions; but why do they not rather abandon such interventions altogether? The concept of 'inertia' may have its uses in this context, but by itself it does not really explain why politicians tend to decide things in ways that increase rather than reduce government expenditure.

What seems missing from Rose's explanation is a systematic consideration of the range of institutional constraints within which politicians seek to realise their goals. These constraints, as public choice theory reveals, are constitutional and political as well as fiscal.

Rose does at various times refer to such constraints. He notes that theoretically, 'a new government could seek to repeal or alter the established commitments of government. But in practice there is little political incentive, for most established programmes create clients who expect these programmes to continue ... The expectations of voters are institutionalized within government by politicians, bureaucrats and ministries responsible for these programmes' (Rose, 1984:49). This passage suggests that the 'inertia of established commitments' is not the basic explanation of big government, since it can itself be explained by reference to pressure from groups of beneficiaries for programmes to be maintained. Yet a little earlier Rose downgrades (without completely rejecting) explanations in terms of 'wants and demands' (whether of voters, bureaucrats, politicians, parties or interest groups), and writes that, by way of contrast, 'theories that explain the growth of government by the inertia of political compounding start from the assumption that the present size of government ... is a byproduct of past decisions' (Rose, 1984:47). In fact, there is surely room here for a combination of the two kinds of theory, such that programmes initiated in response to demands from certain groups will display 'inertia' if they continuously attract fresh generations of beneficiaries who resist their abolition. But as Rose does not rigorously integrate these various explanatory themes, his 'programme approach' remains of use mainly in illuminating the patterns and processes of government growth rather than its causes.

The Public Choice Explanation

'Public choice' is the name of a relatively recent school of social science that applies to political phenomena the analytical tools of microeconomics. It thus strives to explain political phenomena in terms of the behaviour of rational, utility-maximising individuals. The assumption that individuals maximise their utility does not necessarily mean that they are exclusively self-serving, since most individuals, most of the time, are motivated to some degree by altruistic concerns as well as strictly selfish ones. But it is assumed that individual behaviour is rational in the sense that it is calculated to realise goals chosen by the individual himself.

This individualist method of analysis establishes significant historical and ideological links between public choice theory and classical liberalism, even though the work of some public choice theorists (including Anthony Downs, one of the pioneers of the method) has no association with the intellectual case for less government. But two of the best-known members of the school — James Buchanan (1975) and Gordon Tullock (1976) — have produced an explanation of

government growth that both concludes that modern Western political systems generate a higher level of government intervention than voters would collectively choose, and, correspondingly, identifies those aspects of the political system that need reform.

According to this theory, Western democratic systems tend not to permit genuine collective choices concerning government size. This is because democratic systems have come to be dominated by two processes — electoral competition between political parties and lobbying by special interest groups — which interact in such a way as to keep the issue of government size off the political agenda. Political parties have every incentive to offer minority groups various benefits (tax relief, subsidies, protection, and the like) and in this way to build up electoral support. Minorities have a corresponding incentive to organise themselves and press for an expansion of these benefits, which is likely to be forthcoming as parties compete against one another for the support of those groups. The result is that government grows beyond the size that the voters would collectively choose. Yet voters are unlikely to perceive this: or at least, if they do perceive it, they have no incentive to take it into account. With economic exchanges, the parties involved incur most of the costs and the benefits, and so take them both fully into account. But in the case of political deals, politicians and pressure groups can monopolise the benefits while the costs are automatically borne by the general public of consumers and taxpayers. This unbalanced distribution allows the beneficiaries of each government intervention to avoid most of the cost, thus generating a powerful and constant bias within the political system towards government growth.

An important element in this explanation is the constitutional framework within which the process takes place, since this will largely determine the balance of benefits over costs to the politicians. Generally speaking, the fewer the limitations on political initiatives, the greater will be the scope for profitable exchanges with special interests, and the faster government will tend to grow. Where governments have discretion over the money supply, they can and will use inflation to conceal some of the costs of their deals. Where they need not balance expenditure with taxation, they will also use budget deficits to transfer some of the financial costs to future generations of taxpayers. These devices increase the short-term balance of benefits over costs and further entrench the influence of special interests. Another constitutional factor is the size of the electoral coalition required to produce a legislative majority. Very often governing parties or party coalitions do not need an absolute majority of votes to form a government: this reduces the minimum size a coalition needs to achieve in order to win, and so makes the likelihood of a democratic system being taken over by such a coalition that much greater.

This explanation of government growth has been greatly reinforced by Mancur Olson's analysis of the formation and activities of interest groups. Like Buchanan and Tullock, Olson employs the public choice method. He arrives at conclusions strongly at variance with those of orthodox political science, which tends to be favourable, or at least indifferent, to the role of pressure groups in democratic systems. Richard Rose reflects this orthodoxy when he writes, in criticism of the public choice explanation of government growth (which he calls the 'simple interest group model'): 'If interest groups are more or less balanced, each cancelling out the influence of another, then their strength should tend to keep government of constant size' (Rose, 1984:46). Against this, Olson argues that an equilibrium between a multiplicity of pressure groups will lead to an expansion of government, as each group makes the receipt of special favours the condition of its consenting to similar favours for the others (Olson, 1971:124). Olson also notes that such an exchange of deals is likely to be inefficient, however fair, since the resulting interventions will usually be of the kind that protect their beneficiaries from market forces. In his more recent work, Olson refers to pressure groups as 'distributional coalitions' since they nearly always find that they can benefit more by **redistributing** the national product towards themselves through anti-competitive arrangements than by **increasing** the size of the national product by adopting efficient practices (1982:43-7). Olson's analysis thus supports the conclusion arrived at by Buchanan and Tullock: that modern democratic processes increase the scale of government intervention.

The explanation has also received strong empirical support from a recent study of the impact of interest groups on government size. Mueller and Murrell (1985) test the hypothesis that there is a positive association between the two on the basis of data drawn from the 24 member countries of the OECD. The preliminary results are unequivocal. 'The empirical results support the theory in that the number of interest groups is positively related to the relative size of government'. Mueller and Murrell also find that 'the percentage of the population voting ... consistently has a positive and significant impact on the size of government'. They stress that the results should be regarded as 'tentative' but believe that they 'indicate promising approaches to further research' (1985:31).

Several leading classical liberals have adopted the public choice explanation of government growth and incorporated it into their critiques of big government. Samuel Brittan has written of 'the economic contradictions of democracy', brought about by 'the generation of excessive expectations' and the disruptive effects of the 'pursuit of group self-interest in the market place'; these threaten to destroy liberal democracy itself (Brittan, 1975:129). F.A. Hayek now regards interest groups as the central force driving democracy down the 'road to serfdom':

'Democratic government, if nominally omnipotent, becomes as a result of unlimited powers exceedingly weak, the playball of all the separate interests it has to satisfy to secure majority support' (Hayek, 1979:99). Most recently, Milton and Rose Friedman (1984) have written of the 'iron triangle' of three classes of mutually supporting interest groups, namely, legislators, bureaucrats and beneficiaries; these impose a 'tyranny of the status quo', which prevents governments from implementing tax and expenditure cuts. The popularity of the explanation with liberals should come as no surprise. Public choice theory, to be sure, does not explicitly incorporate liberal values; indeed, its normative implications do not go beyond favouring constitutional consensus. But in this it effectively espouses the traditional liberal reform program. In the course of showing that the political process is by itself incapable of preventing the indefinite growth of intervention, it prescribes as the remedy a return to such liberal constitutional principles as the rule of law, limited government, and sound finance.

The Role of Ideology

The public choice explanation of government growth is more ambitious than Rose's, since whereas Rose presents a range of broad factors that in aggregate lead governments to grow rather than to contract, the public choice theorists postulate the precise mechanisms through which those factors determine policy outcomes, and determine them in such a way as to lead, unintentionally, to continuous government growth. The central assumption is that political actors are motivated primarily by self-interest: pressure groups and voters try to secure political favours for themselves, while politicians try to win the support of the voters. But is it realistic to assume that government growth is entirely the result of the free play of individual self-interest in the political world? Do not the collectivist ideologies that have accompanied the growth of government have some explanatory role to play?

At least some of the policies that Western governments have adopted since World War II and that have significantly affected the scale of government intervention do seem more readily explicable in terms of party ideology than the working out of various interests. In Britain, for example, the nationalisation of several large corporations by the Labour governments of 1945-51 and 1974-79 seems almost wholly the result of ideological conviction. The policy was certainly opposed, but never seriously hindered, by pressure from vested interests. And while it is true that the British people were never enthusiastic about nationalisation, they have always been much less concerned about the issue of ownership than about the standard of service offered by the corporations concerned. The suggestion is that governments that feel

sufficiently secure electorally have some latitude for indulging their ideologies, and sometimes do so. (Whether the current British Conservative government's policy of privatisation can be likewise explained as an ideological indulgence is more doubtful. Although an ideological element is certainly involved, the policy does have some electoral implications. The sale of state-owned homes to sitting tenants is believed to have contributed significantly to the Conservatives' electoral victory in 1983. Again, the financial proceeds of privatisation are being used to finance expenditure increases and tax cuts, both of which will affect the government's prospects at the next election. Privatisation, like nationalisation, has met little serious opposition from vested interests; but the threat of such opposition might have prevented the policy being extended to, say, the coalmines.)

But even if the present scale of government intervention is partly a result of governments pursuing their ideologies, it is the vested interests produced by government growth that have rendered so ineffective the ideological shift in favour of less intervention. It is this ability of special interest groups to frustrate the proposals of even the most determined governments to reduce their public sectors that gives public choice theory so much of its current relevance. Sometimes governments do manage to face down powerful pressure groups, as the British Conservative government did in 1985 when it insisted, against the wishes of the coalminers' union, that uneconomic coalmines would no longer be kept working with public subsidies. But special interests can sometimes successfully exercise their veto power in an equally spectacular fashion. In 1985 the Australian Labor government held a 'Tax Summit', at which it sought a consensus for its policy of shifting the burden of taxation from direct to indirect methods. The consensus that emerged was **against** that policy, which then had to be abandoned. Whether the policy really was in the public interest is questionable; but the point is that it was bound to be vetoed, since almost all the participants at the Summit represented small groups of taxpayers who definitely stood to lose in the short run from the proposed changes. The anonymous taxpayer, who might have gained from those changes, had only the government to speak for him. Yet it was the government that had to give way.

But even if it is true that the present level of government intervention can be adequately explained by the influence of special interests over the democratic process, it does not necessarily follow that such intervention must increase indefinitely until we have arrived at the end of the road to serfdom. The next chapter considers the arguments of some theorists who, while employing the methods of public choice, hold that the political process leads eventually, and unintentionally, to a more or less stable equilibrium size of government.

Chapter 6

Is There an Equilibrium Size of Government?

Are democratic systems capable of generating purely political checks on the growth of government? Might the costs of government become eventually so great that political actors could not avoid taking them into account, and so be compelled to take steps to prevent government growing further? Some scholars have taken seriously the possibility that government size might stabilise at some equilibrium point where the factors making for the continuing expansion of government are balanced by factors making for its diminution. This possibility obviously has important implications for the likely success of policy responses to the growth of government. Two 'equilibrium theories' are summarised here. While both of them are based on the public choice approach to political economy, they offer different accounts of the composition of the decisive political majority whose interests are best served by the equilibrium. The first treats government size as determined by the democratic choice of the voters rather than by special interests. The other theory agrees with Buchanan, Tullock and Olson in according a central role to special interests, but holds that, under certain conditions, special interests will cooperate to prevent the ultimate collapse of liberal democracy into totalitarianism. Finally, the plausibility of equilibrium theories is considered in the light of the objection that uncertainty is so pervasive as to make it impossible for equilibrium points to be known to the relevant actors.

A 'Rational Theory' of Government Size

In the 'rational theory of the size of government' which they have been elaborating in recent years, Allan Meltzer and Scott Richard (1981:924) explicitly question the assumption, central to the special interest

explanation, that voters are unaware of the true costs of government intervention:

> Our assumption that voters are fully informed about the size of government differs from much recent literature ... We acknowledge that that voters are ill informed about the costs of particular projects when, as is often the case, it is rational to avoid learning details. Knowledge of detail is not required to learn that the size of government has increased and that taxes have increased relative to output or income. Long ago it became rational for voters to anticipate this outcome of the political process.

Meltzer and Richard argue that government has grown despite the full awareness of its costs because of 'a decisive difference between the political process and the market process' (1978:117). The difference is that, whereas political rights are distributed equally, income is distributed unequally. Meltzer and Richard draw on Anthony Downs's *An Economic Theory of Democracy* (1957), which assumes that voters are distributed along a left–right spectrum on the fundamental issue of the extent of state intervention. Downs holds that each voter will rationally vote for the party that represents the position on the spectrum nearest his own; the parties meanwhile will take up positions on the spectrum that are likely to maximise their votes. The result is that, in a two-party system, both parties will gravitate towards the position occupied by the 'median voter', i.e. the voter who has an equal number of voters on either side of him on the spectrum and so can decide which of these two groups of voters becomes the majority.

Meltzer and Richard apply this theory to the income distribution scale, and infer that the politically decisive voter is the one with the median income, who has, by definition, equal numbers of worse-off voters on one side of him and better-off voters on the other. So long as his income is considerably less than the average, the median voter has an interest in redistribution; if he casts his vote accordingly, he will create a majority for that policy, and higher taxes will ensue. But higher taxes reduce incentives to work, thus lowering aggregate income and the potential gains from redistribution. The median voter begins to lose from further redistribution, and at some point short of equalisation he switches sides and creates a new majority that imposes limits on further government growth. The crucial variable in this model is the gulf between the median voter's income and the average income, since the size of this gulf directly determines the median voter's potential gains from redistribution and hence the size of government.

Meltzer and Richard claim considerable empirical support for their theory. They note that the present trend towards ever bigger government began with democratic reforms that moved the median voter lower down the income scale and widened the gulf between the median and the average incomes. In more recent times the extension of social security rights to more and more citizens has likewise increased the number of voters with an interest in redistribution. Conversely, an increase in the proportion of voters earning taxable income lowers the average income and reduces the number of votes for redistribution (Meltzer and Richard, 1981:924; 1983:412). They report the results of a test of their theory thus:

> We find that the ratio of government spending for redistribution to aggregate income, and the share of aggregate income redistributed in cash, rise and fall with the ratio of mean to median income and the level of (median) income. Redistribution in kind — the provision of education, health care, fire protection, and other services — also rises and falls with the ratio of mean to median income, but it appears to be independent of the level of income. (1983:412-13)

The message of the theory, then, is that although democracy may generate a demand for redistribution that leads to government being 'too big' from a classical liberal standpoint, it ensures that the median voter carries enough of the costs of redistribution to prevent the complete equalisation of incomes.

The theory is not without its critics. Gordon Tullock (1983:429), for example, has noted that, although the volume of transfer payments in the USA has greatly increased over time, the ratio between the median and the average income has not changed much, suggesting that some other explanation for the growth of redistribution is needed. On the other hand, Karl Brunner (1978:666-8) finds support for the theory in the fact that the overwhelmingly greater proportion of taxes in the USA is paid by the better-off 50 per cent; between 1970 and 1975 this proportion actually rose from 89.7 per cent to 92.9 per cent. Even stronger support comes from one of the subsidiary results of Mueller and Murrell's test of the hypothesis linking government size to the number of interest groups:

> The percentage of the population voting, which probably is closely related to the proportion of voters with incomes below the median, consistently has a positive and significant impact on the size of government. The Meltzer-Richard hypothesis that

> greater participation by low-income voters leads to more redistribution and greater government size is strongly supported. (1985:31)

Brunner, however, goes on to argue that the 'pure wealth transfer' theory is defective in two respects. First, it applies only to government transfers, whereas a complete theory of government size would need to account for the incidence of all kinds of state intervention. Second, the theory overlooks the fact that redistributive programs typically do not transfer tax revenue from 'rich' to 'poor' as such, but are directed towards specific minorities (Brunner, 1978:670-1).

Meltzer and Richard (1983:413) seem in the meantime to have taken these criticisms on board. After the report of the test of their theory they note: 'We neglect most features of the political process, including any influence of interest groups, bureaucrats, and other monopoly elements that affect "supply". We recognise that a useful extension of our model would incorporate the allocation of funds to specific programs and thereby incorporate "supply" factors'. But they insist that their theory 'explains much of the trend in the relative size of spending for redistribution and a considerable part of the annual variation observed in the United States during a recent forty-year period'.

Special Interests and the 'Optimal Rate of Exploitation'

Is it possible that the special interests involved in promoting the expansion of government are as susceptible to equilibrium pressures as are the voters who participate in democratic choice? This has been suggested by Norman Barry (1984:63-6) in a critical study of the 'road to serfdom' thesis. Barry adopts the special interest explanation of government growth, but modifies it by arguing that major special interests, rather than escalating their mutual competition to breaking point, may be able to cooperate to prevent the collapse of the mixed economy into totalitarian collectivism. Their incentive to cooperate lies in the fact that they benefit more from the mixed economy than from either laissez-faire capitalism or the rationally planned economy.

Barry illustrates this point by reference to the position of the British coalminers, who at present receive subsidies and protection enabling them to produce and sell coal at a price well above the one obtaining in the international market. These benefits, extracted as they are by political means from the taxable wealth produced by the unprotected and competitive parts of the private sector, are a measure of the political influence exercised by the miners' union within the existing liberal democratic system. But that influence could not be maintained in a fully planned economy, which would rationally consume more cheap imported

coal and so lower the incomes of British miners. Only in the mixed economy can the miners realise the 'optimal rate of exploitation' of the public; this should lead them to oppose the final steps towards serfdom. (This balance of interests naturally applies only to rank-and-file miners; their Marxist leaders remain ideologically committed to complete collectivisation.) The issue is whether the various special interests in the public sector can successfully cooperate to maintain the mixed economy equilibrium. Barry believes they can, partly because using their maximum political influence would be economically self-defeating, and partly because the bargaining process is sufficiently open to prevent any one special interest gaining benefits beyond the 'optimal rate' at the expense of the others. Barry concludes that there is no 'road' to serfdom in the sense of an unintended, step by step process, but that totalitarian regimes come about as the intended result of violent revolutionary action.

Like Meltzer and Richard, Barry has been criticised by supporters of the standard public choice explanation of government growth. John Gray (1985:29), for example, has serious doubts about the idea of an 'optimal rate of exploitation': 'Such an optimum is as much a theoretical fiction as the optimal tariff policy of international trade theory. It cannot be known by anyone, still less reached and held in practice'. John Burton (1985:74-6) insists that special interests are too numerous, and too widely dispersed throughout both public and private sectors, to be able to agree to cease competing against one another. (This criticism, if valid, would become ever more applicable with continuing government growth, to the extent that that process is accompanied by an increasing number of special interest organisations.) He also notes that the bargaining process between government and special interests is not nearly as 'open' as Barry assumes, but can involve numerous hidden favours that would easily undermine any equilibrium at an 'optimal rate of exploitation'. Burton goes on to rule out the possibility of any equilibrium size of government; only constitutional reform can halt what is otherwise an apparently 'irreversible' process of government growth.

One possible way of bolstering the equilibrium theories against these lines of criticism might be to explore systematic combinations of both the special interest and the median voter explanations of government size. One recent speculative attempt to do this, however, suggests that the two kinds of factors are together more likely to lead to continuous government growth than to reinforce one another's tendencies towards equilibrium. Mueller and Murrell (1985:32) observe that 'the possibility exists' that the combination of the voter-participation variable and the interest-group variable results in mutually offsetting redistributive pressures (voter participation promotes rich-to-poor transfers, while interest groups promote poor-to-rich transfers) but

in cumulative pressures on the size of government (as voters and interest-groups both try to recover what they have lost to one another). Interestingly, this hypothesis would explain the fact, which was noted in Chapter 3, that the expansion of public expenditures has had a limited overall effect on 'original' income distribution, but to a great extent returns income in the form of welfare benefits to the original taxpayers.

The Effects of Uncertainty

Is it the case, then, as Gray insists in opposition to Barry, that the free play of special interest groups is unlikely to lead to an equilibrium size of government because of uncertainty about the 'optimal rate of exploitation'? Likewise, are voters really able, as Meltzer and Richard's 'rational theory' of government size assumes they are, to identify the point at which further redistribution would lower their incomes? Alan Peacock (1985:144) has expressed doubts about the strength of 'built-in' factors restraining government growth; taxpayers are trapped, he writes, in an 'isolation paradox', since 'while they may generally be in favour of lower tax burdens, they have no incentive as individuals to forgo the benefits of public services they currently enjoy'. And if uncertainty is a problem, can we assess whether this is more likely to hasten than to retard government growth?

A public choice theorist who takes uncertainty very seriously is Anthony Downs, who, as noted above, uses the concept of the 'median voter' to explain the normal operations of democratic politics. Although Downs is not particularly concerned with government size as such, he tends towards the conclusion that uncertainty produces smaller government than would be the case in a perfectly informed world. Downs argues, first, that uncertainty usually renders the minority-coalition strategy too risky for political parties to follow, and second, that uncertainty restrains governments from redistributing incomes to the point of equalisation.

For Downs (1957:55-60), the strategy of seeking the support of coalitions of minorities rather than that of the median voter can succeed only where a number of conditions are fulfilled. The central conditions are: that most citizens are in the minority on some issues; that they feel more strongly about those issues than about those on which they share the majority viewpoint; and that the opposition party can always counter the incumbent party's policies with more popular alternatives. The problem is that it is virtually impossible to know whether these conditions actually hold. Downs admits that the strategy may be worth the risk if the incumbent party has enjoyed several consecutive terms of office, since by then many voters will have been alienated by that party's manifold decisions. But normally uncertainty about the voters'

preferences makes it rational for the opposition to compete directly against the government for the support of the majority. Downs proceeds towards his well-known conclusion that, in a consensual society with a two-party system, both parties will seek to represent the 'middle ground' of political opinion and, ideally, to promise the level of government intervention that satisfies the median voter.

As for income redistribution, Downs (1957:198-201) argues that there are three ways in which uncertainty prevents state-imposed egalitarianism. First, attempts to equalise incomes will have unintended effects likely to result in a lower level of output. Most voters, including poorer ones, sense that they will be net losers from complete income equalisation, and so oppose it; vote-maximising parties respond accordingly. (This argument clearly provides the basis for the 'rational theory' of government size elaborated by Meltzer and Richard.) Second, poorer voters prefer to live with the possibility that they may one day become rich: a possibility that income equalisation precludes. Finally, uncertainty over voter preferences prompts governments to accord special weight to the views of voters who can make their preferences known; since better-off voters can devote more resources to lobbying than poorer ones, they exercise more political influence, which they use to restrain the redistribution of income.

To some extent, the conclusions of these two exercises conflict with one another. If, as Downs believes, voters are unequal in their ability to communicate their preferences to governments, this should diminish the uncertainty that normally makes the minority-coalition strategy more risky than the median voter strategy. After all, it is precisely the visible lobbying power of well-organised minorities that lends such plausibility to the special interest explanation of government growth. The relevance of this objection is enhanced if we extend the factor of uncertainty beyond the simple tax-benefit mechanism of income transfer, which is Downs's primary concern, and apply it to government regulation. Pervasive uncertainty may well impose limits on direct income redistribution; but are governments similarly inhibited by uncertainty when it comes to redistributing income towards specific social groups by sanctioning restrictive and uncompetitive practices? Two of Mancur Olson's central conclusions are that 'stable societies with unchanged boundaries tend to accumulate more collusions and organizations for collective action over time' and that 'the accumulation of distributional coalitions increases the complexity of regulations, the role of government, and the complexity of understandings, and changes the direction of social evolution' (Olson, 1982:41, 73). If Olson is correct, then prolonged political stability will gradually overcome the uncertainty that inhibits politicians from pursuing the minority-coalition strategy, thus progressively increasing the attractiveness of that strategy vis-à-vis the median voter strategy. In this way Olson's

findings once again support the special interest explanation of the growth of government.

But even where uncertainty does reign, it may not necessarily be rational for governments to restrain in every respect their propensity to intervene. Downs sees political parties responding cautiously and passively to existing voter preferences to the extent that these can be established. But why shouldn't politicians use their powers of intervention to diminish uncertainty by experimenting with potentially vote-winning programs? Karl Brunner (1978:672) suggests that this is indeed what they do:

> Entrepreneurial competition thrives on a continued search for **new** proposals, **new** programs, **new** twists, modifications, or **extensions** of existing programs. It encourages a continuous search for suitable means to focus public attention. This is a necessary strategy for politicians to establish themselves in the competitive political market. Continuous market research and sampling of the public market with the aid of an expanding staff is therefore a competitive necessity for the politician.

If this observation is sound, it suggests that politicians will respond to uncertainty generally by increasing the level of state intervention. True, it does not follow from this that equilibrating forces do not exist, or that, if they do, they are too weak eventually to bring the growth of government to a halt. In the next chapter it is argued that some such forces are now operating on some of the components of the public sector, and are making for certain changes in the pattern of intervention. But it remains the case that the overall tendency is still for government growth to continue. It follows that attempts to stabilise the expansion of government by political action are unlikely to find much assistance from built-in forces making for an equilibrium size.

Chapter 7

The Politics of Smaller Government

The 'Ideas vs. Interests' Dilemma

In the Introduction we noted that a consensus in favour of smaller government might not by itself result in policies reducing the scale of government intervention; our political choices might well be determined by opportunities for self-advancement that could result in increased intervention. Chapters 5 and 6 have shown how likely it is that the immediate self-interest of political actors will indeed lead them to cooperate, however unintentionally, in making government bigger. The problem lies in the weaknesses that public choice theory has revealed in collective decision-making processes. But if the public choice explanation of government growth is sound, what prospect can there be of government ever becoming smaller? The dilemma presented by the theory has been summed up thus by Norman Barry (1985:42-3):

> The new 'economics of politics' has the implication that the reemergence of a genuine liberal order requires an **abandonment of self-interest** (such as the giving up of a political privilege) not envisaged in the original theory ... The pessimistic conclusion of recent liberal political economy is that the prospects of a reemergence of a liberal order by a process of natural or spontaneous evolution must be slim because no one political group has a direct interest in its maintenance or survival.

Barry describes this dilemma as arising from a conflict between ideas about small government and the interests generated, or at least protected, by big government. But we could as well describe it as a

conflict between our long-term interests (which would be served by smaller government) and our short-term interests (as these are defined by the incentive structures of existing political processes). This characterisation identifies the problem as the absence of any mechanism in politics equivalent to the 'invisible hand' of the market. Instead of guiding self-interested individuals towards a mutually beneficial accommodation of their purposes, politics leads them into an unending struggle between interest groups in which there must be losers as well as winners.

Stated thus, it does seem to follow that merely knowing that there must be a better way of doing things is insufficient to get us out of the mess, just as the universal desire for peace is insufficient to prevent war. Yet most of us would resist concluding that beliefs about how our interests are affected by government play no role at all in determining the size of government. In Chapter 5 we noted that the dismantling of the interventionist state in 19th-century Britain was preceded by the emergence of classical liberalism, and that the return to interventionism in the present century was preceded by the formulation and propagation of a collectivist critique of laissez-faire and limited government. Is the current revival of classical liberal ideas more than just a predictable response to the failure of big government to produce the combination of goods that its original social democratic advocates promised, goods such as full employment, economic growth, the end of poverty and of social disadvantage, and the caring and compassionate society? Could it really be an indication that the growth of government is about to slow down and go into reverse? No one knows; but we should at least consider the significance of those policy initiatives, such as deregulation and privatisation, that do seem to have been inspired by the new thinking about the potentially damaging effects of intervention.

The Changing Pattern of Intervention

The trend towards deregulation in Australia, the USA and elsewhere has indeed been treated by most of the media as a pure victory for 'small government' ideas. But a clue to the true significance of the trend is given by the fact that deregulation is espoused enthusiastically by some governments of the left. In Australia, the Labor government has gone further down the deregulatory road than its Liberal-National predecessor. This is most conspicuously true in the case of the financial system, which has been largely deregulated. The present government has also started lowering Australia's very high import barriers, as well as introducing more flexibility into the wage-fixing system. In some areas, such as consumer standards and occupational health and safety, regulation continues to expand steadily. But the present Labor

government is far more open intellectually to the case for deregulation than any government, right or left, in the post-war era. The reason is surely not, as the Labor left prefers to believe, that the Labor leadership is at heart 'conservative', but that it is fully aware that it can safely finance its expenditure commitments only from sustained economic growth, and has accepted, in an entirely 'pragmatic' sense, that a necessary precondition for such growth is a more flexible and internationally competitive economy. Its opportunities for deregulation are limited, in the short run, by the composition of its electoral base. But its basic commitment to the welfare state gives it every incentive to proceed with deregulation where it can.

As for the sale of public assets to private investors, this policy obviously presents no problems of justification for the present British Conservative government, which is notionally committed to 'rolling back the frontiers of the state'. That government has used the sale of public housing to sitting tenants, and the issue of shares in public corporations like British Telecom to millions of first-time small investors, as means towards realising the standing Conservative Party utopia of a 'property-owning democracy'. But privatisation resembles deregulation in that, by increasing the efficiency of the economy, it promotes the economic growth needed to finance welfare expenditures. Indeed, in the British case it is even more closely related to budget pressures than is deregulation. The British government prefers to treat the income from sales of public assets as reductions in the budget deficit rather than as a means of financing the deficit. Whatever the intrinsic virtues of privatisation, in Britain it is being used directly to finance levels of public expenditure that otherwise would have to be either cut back or financed by higher taxation.

However much deregulation and privatisation have been facilitated by small government rhetoric, then, their effect so far has been to change the **structure** of the public sector rather than to reduce its **size**: specifically, they amount to withdrawals of certain off-budget interventions that, in effect, allow general government expenditures to increase. Public choice theory would not necessarily explain these changes entirely by reference to a political preponderance of the special interests that stood to gain from increased public spending, since, despite Barry's account (quoted above) of the public choice dilemma, some interest groups protected by regulatory intervention may in time come directly to benefit from the withdrawal of such intervention. For example, Ian Harper (1986) has shown that financial deregulation in Australia was politically possible largely because the banks, the new non-bank financial institutions, and the bank employees all believed they would gain from it. But although it is important to understand the circumstances under which particular interests stand to gain from less rather than more protection, there is no reason to doubt the validity of

the general conclusion of public choice analysis: that the political processes of modern democracy lead on balance to more rather than less intervention.

The Role of Political Leadership

This suggests that government growth will not be brought to a halt unless and until the political processes are themselves reformed so as to render them less sensitive to special interests and more sensitive to the interests of the public as a whole. Several public choice analysts and classical liberal thinkers have advocated legal-constitutional restrictions on the fiscal powers of government, such as a balanced budget requirement and upper limits on taxation (Buchanan, 1984; see also James, 1985:41-52). Some quasi-constitutional rules designed to achieve similar effects have already emerged in response to the growing practical difficulty involved in financing modern public sectors. The present Australian government's 'trilogy' commitments, mentioned in the Introduction, are a notable example. But the success of such attempts (formal or otherwise) to modify the operation of political processes must depend largely on the ability of the politicians to demonstrate that such measures are in the public interest.

Although ideas play no causal role in the public choice explanation of government growth, that explanation adds up to a very powerful idea: that the promotion of special interests by political means is ultimately futile, since the value of the privileges secured by each group is more than offset by its share of the total cost of the privileges secured by the other groups. Olson (1982:44) characterises the situation with a colourful metaphor. 'The familiar image of the slicing of the social pie does not really capture the essence of the situation; it is perhaps better to think of wrestlers struggling over the contents of a china shop'. The implication is obvious: we would all be better off if we could stop playing the special interest game and start playing a different game in which the gains won by each did not impose losses on the rest. Olson notes, with deep irony, that if this were to happen it would amount to a refutation of his own theory, which predicts that individuals sooner or later will find ways of organising their special interests (1982:236; see also Barry, 1985:45). But there is surely nothing irrational about preferring or choosing to live under a regime that, by preventing or at least inhibiting the promotion of special interests, promises to secure the long-run interests of each individual. This is the context in which the influence of 'small government' ideas might be decisive.

The opportunities to make such choices are necessarily rare. But they need not be limited to formal constitutional amendment referendums. Politicians may make available such opportunities by

exercising leadership: they can seek to articulate the underlying popular disillusionment with big government by offering to govern with popular support against the tyranny of special interests. Public choice theory normally depicts politicians as hopelessly trapped by coalitions of pressure groups, and bound to do their bidding despite all the harm that follows. But as government grows, the subsequent losses to efficiency render many of the benefits that politicians dispense to pressure groups increasingly short-lived and illusory. Conversely, the potential gains to politicians from resisting special interests become greater. Samuel Brittan (1985:45) has argued that such a strategy would require a simultaneous surrender by the major special interests of their political privileges. This would both satisfy the demand that all groups be treated fairly and enable the benefits of the strategy to be realised reasonably quickly. What is doubtful is whether the process of granting privileges piecemeal could be prevented from recurring without the eventual implementation of some formal constitutional restrictions. But if ever such reforms were proposed and put to referendum, their chance of success would depend very largely on the extent to which politicians had been able to show that smaller government brings more substantial and more lasting benefits than bigger government.

Compensating the Losers

There is, however, a problem that is likely to loom large in any serious attempt to reduce the scale of government intervention. Is it the case that **everyone** would be a net beneficiary of smaller government? Just as there are some individuals, such as the poor and the unemployed, who do not belong to organised interest groups and would therefore be pure gainers from smaller government, may there not be some special interests who do so well under existing arrangements that they would be net losers after a general shedding of group privileges? Take the case of the farmers of the European Community. Their privileges under the Common Agricultural Policy are so great that they would almost certainly not be fully compensated as a result of a general trade-off of privileges of the kind recommended by Brittan. Why then should they agree to such a trade-off? In Australia, some members of the public service and academia who enjoy security of tenure are in that position. Abolition of tenure and a deregulated labour market could lead to some of them losing their jobs and many more having to take wage cuts: losses that may well not be made up by lower taxation and increased job opportunities elsewhere in the economy.

Nor is the problem really solved by reference to the fact that a majority would benefit from smaller government. In the first place, it would be morally questionable for that majority to promote its interests

by the outright expropriation of a privileged minority, however unjustifiable those privileges were. Second, a great many people would be simply uncertain whether they would gain from a group trade-off. A majority would benefit from smaller government — if this were not true, there would be no case for it — but some individuals would gain more, and gain it more quickly, than others. As noted, the unemployed, the poor, and the unorganised generally would be certain gainers; young people who had not made irreversible investments in particular careers would be likely net gainers; but middle-aged workers in, say, protected industries or the public service would face a much more uncertain future. Some of them would in fact be no worse off after adjustment; and some would be better off, as they responded to fresh employment opportunities and discovered hitherto unknown and unused talents. Some would be net losers. But most would be uncertain of their fate, and on that basis would be unlikely to agree to the proposed trade-off of privileges. In this way, a process from which the great majority of people would benefit may well fail to secure the consent of even a slim majority.

The obvious way out of the dilemma would be to secure the consent of the losers by compensating them for their losses. The gains from smaller government should be sufficiently great to be worth sharing with those who do not directly benefit from it. But compensation raises a number of fresh problems. If the balance of gains and losses to any one individual is uncertain, there may be no basis on which to calculate it in advance. But if compensation were to be made available during or after a period of adjustment to lower levels of intervention, there may be no way of preventing special interests using the political process to bid up the value of compensation to levels that threatened to consume in advance much of the value of smaller government. This would merely perpetuate the privileges of the previous system in a new form and bequeath the ultimate reckoning to future generations of taxpayers. An alternative possibility would be for the government to distribute a lump-sum payment to everyone. This would be 'unfair' in that the payment would go to the winning majority as well as the losing minority. But, since most people would be uncertain of how they would prosper under smaller government, the scheme might be welcomed as the least unfair available method of compensation. And if lump sums were taxable, at least the losers would do better out of them than the winners. (Financing the payments would obviously be a problem. A relatively painless method would be raise the requisite sums from the sale of state-owned enterprises. Alternatively, the lump sum could take the form of fully marketable shares in state enterprises and utilities. Both these methods would avoid the churning process which characterises the tax-transfer system and defeats so much of its purpose.)

Opting Out of the Public Sector

Whether some such transition to smaller government occurs, and whether it does so in a piecemeal fashion or as a result of a 'social contract' between special interest groups of the sort described above, depends to a large extent on the quality of political leadership and the imagination it displays in securing consent for smaller government policies. But as well as leading, politicians can also follow. They can take their cues from the steady decay of at least some major interventions — such as state education and health care — as an increasing number of citizen-taxpayers seek and find privately supplied alternatives. Continuous contact with one another and with importunate pressure groups no doubt leads politicians to have a more pessimistic view of human nature than can really be justified. The average citizen's experience of bureaucracy and of the mediocrity of many state services provides a basis on which politicians can appeal over the heads of special interests to the public at large.

There are, fortunately, signs that both the public demand for higher quality goods and services and their opportunities to choose private alternatives to state supplies are increasing. To the extent that mass education makes people more critical of their environment, it renders them less deferential to authority and less willing to accept the myth of big government as the universal provider (though it also enables them to pressure government more effectively for special privileges). Rising incomes enable and encourage people to become more sophisticated and discriminating in their consumption patterns, and to demand more scope for individual choice. One of the forces enabling these demands to be met is microtechnology. It is sometimes said that as society becomes more complex, more state intervention is necessary to supervise and coordinate the rapid changes that are taking place. But microtechnology, especially in communications, is enabling the market, which relies on decentralised information, to work more efficiently and at a speed that state bureaucracies are finding ever harder to monitor and regulate. The rigidity of the public sector is becoming increasingly evident as the flexibility of the private sector grows.

It does not follow from this that we are on a 'road to freedom', any more than the steady growth of government proves that we are on the 'road to serfdom'. But what is likely is that the costs of growing government will become increasingly obvious as consumer-taxpayers become more willing to avoid tax, to seek alternatives to state services, and even to emigrate as the gap between Australian living standards and those in faster-growing economies widens. Politicians and bureaucrats will no doubt try to cope with such problems in an ad hoc fashion; there is every reason to expect the current efforts to loosen up 'supply side' rigidities by deregulation, privatisation, and cuts in tax rates to continue,

so that the private sector can meet the demands placed on it by the public sector. Some kind of eventual balance between the two sectors, such as Barry postulates in his equilibrium theory of government size, is perhaps a more likely outcome than Hayek's 'serfdom', and hardly less likely than a steady withdrawal of state intervention to more justifiable levels.

Rather than ending this essay on a falsely optimistic note, then, it might be more useful to insist again that any politician who really wishes to serve the public has to distinguish between the **real** public — the sum total of private and anonymous individuals — and the **phoney** public — the sum of organised pressure groups whose interests are combined in, or patronised by, the 'public' sector. Such an understanding forges one of the crucial links between the intellectual success of 'small government' ideas and the policies those ideas entail.

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