THE GROWTH OF GOVERNMENT IN MARKET ECONOMIES SINCE WORLD WAR II

Market economies, especially Western democracies, have witnessed the following major changes since World War II:

1. Rapid growth of real income and output per capita, which has been made possible by rapid technological progress. Both economic growth and technological progress have probably been faster than ever before in history.

2. Even faster growth of world trade and economic integration. This is the "globalization" of production and technology, which is now facing some pushback. However, the trend to rising specialization and trade is at least 800 years old.

3. Rapid growth of the *share* of GDP passing through the government budget. Government has grown relative to the rest of the economy, although this relative expansion may now be over. The fastest growing category of government expenditure has been the provision of social insurance and welfare benefits—the "social" part of the social market economy.

Reasons for #3 appear on pp. 83-87 of *Market and State in Economic Systems.* Most of this growth occurred before the mid-1980s. Since then, there have been efforts to make the public sector more efficient—in part, by privatizing portions of it, and in part, by introducing competition into the provision of publicly-financed goods and services. Efforts have also been made to raise productivity. Three basic tendencies have been toward charging "user fees" for services that used to be free, while tying payments to benefits received; toward introducing competition between non-government suppliers of products that are purchased by government, and toward allowing the ultimate users of these benefits to choose directly between suppliers and products.

One change has been to "let the money follow the user" rather than take the more conventional approach of "letting the user follow the money." “The article, “Effect of Vouchers,” on this website shows one advantage of the former, and another advantage is that suppliers compete for customers, resulting in more competitive prices. Consider the financing of hospitals in Germany vs. their finance in Ontario. Ontario lets "the patient follow the money." Money is given to hospitals, and patients must go to a hospital with a vacancy. Patients have little or no choice, and there are long wait times for elective surgeries.

In Germany, by contrast, the money follows the patient. Patients needing hospital care choose which hospital they want to go to. Information about hospitals is available to aid in this choice, which results in a better matching of patient needs and hospital supply capabilities. Moreover, hospitals compete for patients because they can only obtain money by attracting patients—the money follows the patient. About 70% of hospitals are privately owned—and this percentage is growing—and wait times have either disappeared or are short for every type of surgery. Many hospitals have excess capacity, but costs are lower than in Ontario.

In general, there are two alternative views of the relative expansion of the public sector. Differences in opinion are possible here because separate measures of prices and quantities of publicly financed services are often unavailable. All we know are the amounts that government pays for them. Neither do we know the opportunity costs of these products or their marginal values to users in many cases. The two alternative views are as follows:

(i). To some, government has become leviathan, exercising a growing monopoly power over its citizens. For these observers, the growth of government is mainly a price increase—in the sense that citizens pay higher and higher tax prices for publicly-financed products—plus a nationalization effect, in which services such as health care that used to be paid for privately come to be paid for, and in some cases to be supplied by, government agencies or enterprises. Such nationalization also leads to higher effective prices.

(ii). To others, relative prices of publicly-financed products may have risen, but quantity and quality increases have also occurred, well beyond what can be accounted for by the nationalization effect. To these observers, governments in liberal democracies have reflected voter preferences and carried out the wishes of their citizens.

When buyers face higher prices in the market place, they cut back on products whose prices have gone up the most and switch to substitutes. In this way, they economize. If the selection of available products is large enough, product demand curves will be elastic. A given percentage increase in price will be offset by a larger percentage decrease in quantity demanded, resulting in a lower total expenditure (price times quantity) on the good or service in question. A typical customer is then spending a smaller percentage of his or her income on the product whose price has risen. Customers are more successful at economizing when they have more choices available to them and therefore when there are more suppliers competing in the market, which leads to more elastic demand.

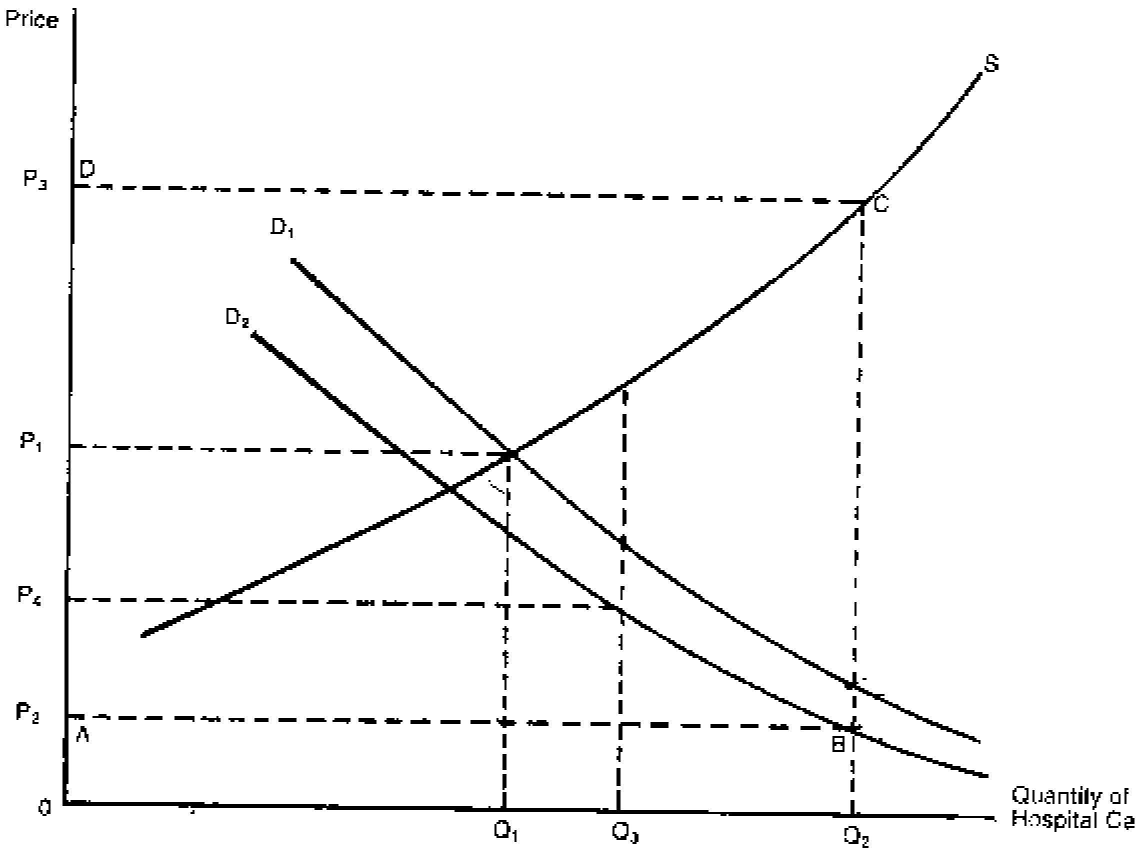
To the extent that the expanding share of national income accounted for by the public sector is a price effect, government is able to act like a supplier facing an inelastic demand curve, and in many cases, an upward-sloping demand curve. Inelastic demand results from government's role as a monopoly supplier and from the fact that higher prices received by sellers are not higher prices charged of buyers. Instead they take the form of higher taxes, which lower the disposable incomes of taxpayers, but don’t give them an incentive to economize specifically on publicly financed goods.

Users of publicly-financed products often pay very low prices for them or get them free. The public may vote the politicians who raised taxes and nationalized these services out of office, but it is also possible that more people will become better off as a result of nationalization and redistribution through the tax system than will be made worse off.

Thus politicians who vote to nationalize health care or other publicly-financed services may not feel pressured to de-nationalize as a condition of re-election. Government-financed health care is now a feature of nearly every western nation.

When a product such as hospital care is nationalized, most of the cost of this good or service is paid for by government and ultimately financed by taxes and payroll fees. As a result, the price to the ultimate user of the service drops dramatically, while the price received by the supplier increases, the difference being paid by government. This reduces the incentive to economize on insurance-financed services. That is, quantity demanded is likely to rise, since the increase in demand owing to the fall in price will normally be greater than the fall in demand resulting from the drop in disposable income caused by the rise in taxes and payroll fees. The latter has only an income effect on demand, whereas the fall in price has both an income effect and a substitution effect.

However, the price received by suppliers will rise (e.g., from P_1 to P_3 in the graph below), and most or all of this is paid for by government. This produces the effect of upward-sloping demand, since $P_3 > P_1$ and $Q_2 > Q_1$. When governments don't want to pay the total amount, $(P_3 - P_2)Q_2$, that this implies, they may supply less (say Q_3) in order to pay less. It is then that queues will form, although these queues are likely to be shorter with a "money follows the user" system than with a "user follows the money" system.



Governments can be divided into two broad categories, depending on whether they are chosen via free and fair elections with universal suffrage and competition between independent political parties. In this way, we divide political systems into "democracies" and "autocracies" or "dictatorships," with the former analogous to competition in the market place and the latter analogous to monopoly. Churchill said in a speech in the British House of Commons (on Armistice Day, 1947) that "Democracy is the worst of all possible forms of government—except of course for those others that have been tried from time to time."

However, we also divide democracies into "liberal" democracies (also called "inclusive" democracies) and "illiberal" democracies, with the latter in some ways more like dictatorships. According to Dani Rodrik, a "liberal" democracy has two types of institutions. These are institutions of representation, which translate popular preferences into government policy, and institutions of restraint—such as an independent and impartial police and judiciary, and a free press—which uphold basic rights and freedoms, including rights of minorities, and limit government abuse of its power, in part by publicizing such abuses. In particular, institutions of restraint enforce free and fair elections. They are the backbone of an inclusive political system.

"Illiberal" democracies have institutions of representation, but not effective institutions of restraint. In these countries, whose number has been growing, government is more powerful and can act with fewer restraints than face governments of liberal democracies. Elections are less likely to be free and fair when democracy is illiberal, and opposition parties face a variety of constraints that discriminate against them in electoral competition with the government.

State capitalism (see the article, “The Soviet-type Economy as State Capitalism,” on this website) usually goes hand-in-hand with either dictatorship or illiberal democracy. These political systems allow a government to rely on a relatively small number of insiders for most of its support—and therefore are not inclusive—and pay for this support by giving access to monopoly profits, as well as to bribes, subsidies, tax breaks, and other types of economic rent. The remuneration of insiders would disappear or be lower in a more inclusive political system.

Thus state capitalism involves an exchange of economic rent for political support. The government receives support from insiders, including the managements of state capitalist enterprises, while insiders receive rent in return. This exchange also links the political to the economic system—one does not operate independently of the other. Often economic reforms are not feasible because they would reduce the political support of the government in power.

The government of a liberal democracy is under more pressure to be sensitive to the wishes of its citizens than is a dictatorial government or the government of an illiberal democracy. The government of a liberal democracy is constrained by effective institutions of restraint and must face an organized opposition in free and fair elections, which allows it to be more easily be replaced for having ignored or misread citizen preferences. Citizens also have better access to information about government performance.

The government of a dictatorship or illiberal democracy retains power by erecting barriers to free and fair electoral competition and relying for support on insiders whom it pays with rents that are extracted by erecting barriers to competition and choice. For example, such governments often criminalize efforts to organize a political opposition or to publicize failures of government to promote the welfare of its citizens. The absence of effective institutions of restraint makes it possible to reduce the effectiveness of institutions of representation in turning popular preferences into government policy.

However one may view the postwar expansion of government, the fundamental difference between liberal democracies, on one hand, and illiberal democracies and autocracies on the other—or between inclusive and non-inclusive political systems—should be kept in mind.