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International Perspectives on Economic Growth

by Ronald D. Utt and William Orzechowski

It has been over 200 years since Adam Smith wrote his classic book *An Inquiry into the Nature and Causes of the Wealth of Nations.* Judging from the economic conditions of most nations today, however, Smith's message would appear to have become the world's best-kept secret. Nation after nation has succumbed to policy prescriptions precisely the opposite of Smith's wise advice. In general, they have ignored his dictum that economic prosperity goes hand in hand with limited government and moderate taxation, carrying government expenditures and taxation to exorbitant levels. Many nations are now suffering the consequence that Smith predicted—economic stagnation.

The Wealth of Nations

In articulating his views on the proper role of the state, Smith attacked the prevailing economic doctrine of his time—mercantilism, which equated a nation's wealth with its accumulation of precious metals or gold. Mercantilists contended that an inflow of gold stimulated the economy by boosting the overall demand for goods and services. In order to promote gold inflow, they argued, protectionist policies ensuring a trade surplus were necessary. These policies, in turn, made necessary a prominent role for the state in imposing high taxes on imported goods.[1]

"Today there is considerably more evidence than five years ago that economic performance varies inversely with the size of government."

In contrast to the mercantilists, Smith argued that wealth consisted of real goods and services and that a nation was rich or poor according to the size of its annual production in proportion to its population.[2] Smith saw the growth of aggregate supply as the very nature and cause of wealth. He stressed aggregate supply rather than aggregate demand because he believed that the demand for most products was "indefinitely extensible." He found no limit to the expansion of consumption in "civilized commercial societies, where societal pressures made for the expansion and multiplication of wants, and self-interest prompted the receivers of money to spend or promptly invest it."[3]

Smith always emphasized that positive incentives for both labor and capital were keys to enhancing production or aggregate supply. The mercantilists, by contrast, gave little attention to positive incentives; in fact, they often argued for high taxation on the grounds that it would keep workers out of the ale houses.

In accordance with the primacy he gave to individual incentives, Smith developed a set of fiscal principles for enhancing the supply of labor and capital, thereby promoting economic growth. Foremost among them was the admonition that government not overreach itself through excessive spending and high taxation. Smith argued that government should restrict itself to a limited set of activities and a low or

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Ronald D. Utt is deputy chief economist and manager of the Economic Policy Center at the U.S. Chamber of Commerce. William Orzechowski is director of federal budget policy at the Chamber.

In This Issue

Book: Economic Planning Doesn't Work

National economic planning in any form is an unworkable and ultimately reactionary policy that can only disrupt the process of social and economic coordination, argues Don Lavoie in his new book, *National Economic Planning: What Is Left?*

Lavoie offers an original and insightful development of the "knowledge problem" that faces all would-be planners—how to effectively use all the knowledge in society to produce the goods and services that individuals want. He then demonstrates how such proposals as aggregative planning, economic democracy, and industrial policy all fail to solve the knowledge problem.

Lavoie's book is being published simultaneously in hardback by Ballinger Publishing Company and in paperback by the Cato Institute.

Building on the work of F. A. Hayek, Michael Polanyi, and Karl Popper, Lavoie demonstrates first how Marx's

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Editorial

Promoting Democratic Capitalism

We at the Cato Institute spend quite a bit of effort criticizing the government of the United States and recommending major policy changes. This is obviously appropriate to our role as an American public policy institute. But as we look at the world in a broader sense, it is clear that the sins of the United States government, great as they are, pale in comparison with those of the rest of the world. We Americans are richer and in many ways freer than any other people on earth now or ever in history.

Caught up in our important battles to preserve and expand freedom in the United States, we sometimes forget that much of the rest of the world remains in misery. The contrast between the relative freedom and prosperity of the capitalist democracies and the poverty and oppression of the Second and Third Worlds is so stark as to be hardly imaginable. Every American, of course, has been touched by the pictures of famine victims in Ethiopia, but the temptation is to set that aside as an occurrence more extraordinary than it really is.

Two other recent depictions of Third World poverty brought this lesson home to me. Jonathan Kwitny's descriptions in his book *Endless Enemies* of the bleakness of life in Africa and Afghanistan are heartbreaking. And the Cambodia portrayed in the movie *The Killing Fields*, even before the victory of the murderous Khmer Rouge, is a place where life seems hardly human to an American.

Another way to comprehend the gap between the capitalist democracies and the Third World is to look closely at the complaints about life in the United States. A recent country song features a lament by a "working man" who has "four bald tires on my pickup truck and no credit left on my credit card." Imagine trying to explain his sad plight to a Nicaraguan or a Zairian.

Clearly we would do far more for the cause of global freedom and justice by bringing the Third World into the democratic capitalist world than by moving the United States closer to the ideal of freedom. (Of course, the latter may well be the best way to accomplish the former.)

Military intervention seems to have failed. Even when the United States was successful in installing or maintaining friendly rulers in Third World nations, its chosen representatives hardly advanced our stated values of democracy and free enterprise: consider the Shah of Iran, Somoza in Nicaragua, Marcos in the Philippines, Mobutu in Zaire. When the United States backs autocrats like the Shah and Somoza, is it any wonder that intellectuals and others in society are driven into the arms of Marxism or radical Islam? Besides the risk of war for the United States, military intervention is an ultimately futile way to promote our values in the Third World.

More recently, many Americans have endorsed a government effort to "foster the infrastructure of democracy" overseas, in President Reagan's words. The chosen instrument for this effort is the National Endowment for Democracy. It has given money, for instance, to the Nicaraguan newspaper *La Prensa* and to Polish emigré journals. Now, because we yield to no one in our enthusiasm for such publications, we must ask, do we really want *La Prensa* to become known as a CIA front? That will be the result of U.S. government support for it, and there will then be *no* respected independent voice in Nicaragua.

Ideas garner more respect in the Third World when they do not appear to be put forward by a government that has a long history of unwarranted meddling around the world. Advocates of capitalism and democracy should work to spread their ideas through as many non-governmental means as possible. The Cato Institute has endeavored to spread its ideas beyond the United States, notably with its 1982 book *Solidarity with Liberty* distributed widely in Poland. At our last two Summer Seminars in Political Economy, we have had participants from more than a dozen foreign countries, including not just Canada and Western European nations, but Nigeria, South Africa, Ecuador, Brazil, and Guatemala, as well as American citizens born and educated in Korea and Iran. These efforts are important and should be expanded.

As usual, the words of Thomas Jefferson are a good guide for us: "Peace, commerce, and honest friendship with all nations—entangling alliances with none." Cultural and economic relationships with the nations of the world will help us spread our ideas and our values; military and political entanglements have tragically failed to do so. If we care about peace, prosperity, and freedom around the world, we must live up to our values, not try to export them by force.

—David Boaz

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CATO INSTITUTE

England, Ely Defend Private Deposit Insurance

Cato News

As the Ohio and Maryland banking crises cast a dark shadow on the idea of private deposit insurance, the Cato Institute sponsored a Policy Forum to consider the merits of such insurance. Speaking were Catherine England, a senior policy analyst at the Cato Institute, and Bert Ely, a private financial consultant.

England opened the forum by summarizing her recent Policy Analysis, "Private Deposit Insurance: Stabilizing the Banking System." She began by arguing that any attempt by the government to define the business practices of an industry and to limit the competition faced by industry participants eventually leads to disaster. Such extensive regulation leaves industry managers legally and temperamentally unable to adapt to change.

Catherine England addresses Cato Policy Forum on deposit insurance.

England noted that several analysts have recently proposed federally administered variable-rate insurance premiums as a substitute for current oversight. But problems arise whenever a politically administered monopoly proposes to "mimic the market" through pricing its services, England argued.

England then concluded that the way out of the dilemma was an increased reliance on market disciplines, including private deposit insurance. Private insurance, England argued, would have several advantages over the federal variety. In particular, private guarantors are capable of exhibiting additional flexibility in monitoring and controlling the risk undertaken by individual institutions, and private insurers have the incentive to move more quickly in the event that problems do develop.

Bert Ely proposed a specific type of private depositor protection. He argued that risk-sensitive premiums must be established in a competitive marketplace and that depository risks are most effectively monitored by those who have equity capital at stake—i.e., stockholders or insurers—because they have something to lose in the event of an insolvency loss.

Then Ely suggested that rather than looking to the insurance industry for private deposit guarantees, we should look to the banking industry itself. Ely proposed a system in which each depos-

(Cont. on p. 4)

Replacing Regulation with Insurance

Modern life seems to present ever-increasing risks, both physical and economic. Recent deposit insurance fund failures in Ohio and Maryland have led consumers to take a hard look at their supposedly safe financial assets. As technical knowledge increases, scientists appear to identify new threats in familiar products on a daily basis. Disasters like that in Bhopal, India, raise questions about the safety of industrial plants around the corner.

With economic and physical threats on every side, it is tempting to call on the federal government to "do something," to protect us through regulation. But growing dissatisfaction with extensive federal regulation should give pause to those who feel more government is the answer.

The Cato Institute recently sponsored a one-day conference that explored an alternative to additional regulation. The speakers and participants—academics, regulators, insurance industry representatives, and consumers' advocates—were asked to consider the role that private insurers play in controlling the behavior of businessmen who place third parties at risk.

Catherine England, a senior policy analyst at the Cato Institute, and Fred Smith, president of the Competitive Enterprise Institute, emphasized in a joint paper the need to develop a flexible risk-management mechanism that could adapt to changing conditions and incorporate new information as it became available. They argued that the rigid nature of traditional command-and-control regulation unnecessarily introduces further risk by limiting the ability of businessmen and consumers to explore alternatives to government regulation. Private insurance and in-

(Cont. on p. 4)

Catherine England addresses the opening session of Cato's risk management conference as Gerald P. O'Driscoll of the Federal Reserve Board and Fred Smith of the Competitive Enterprise Institute listen.

Insurance (Cont. from p. 3)

itory institution would protect all its deposits with cross-guarantees from other depositories so that the insolvency loss arising from a failure would be dispersed over many guarantors.

England and Ely disagreed on the need to require full deposit insurance. England argued that consumers should be allowed a choice, allowing the market to develop an acceptable range of depository instruments and protections for consumers. Ely maintained that the system would be made more stable by requiring all depositors to be fully protected.

In a June 18 article in the *Wall Street Journal*, England examined the record of the Financial Institutions Assurance Corporation, a quite successful private deposit insurer that has been badly damaged by consumer and government reaction to the Ohio and Maryland cases. ■

Conference (Cont. from p. 3)

surer monitoring of business behavior, they said, was a potential solution. With their own funds at risk, private guarantors should have both the incentive and the means to discourage excessively risky behavior.

Gerald O'Driscoll, a senior economist for the Federal Reserve Bank of Dallas, outlined the advantages of private bank-deposit guarantees and oversight. James Barrett, president of International Technology Underwriters (INTEC), explained how his firm put together insurance packages for space-shuttle associated commercial ventures and influenced the design and testing of equipment employed by NASA and private companies. His company's great advantage, Barrett claimed, was the opportunity to work without any of the regulatory baggage that other potentially innovative insurers must carry. Tom Lenard, Federal Trade Commission economist, discussed insurance in areas involving health and safety regulations.

The day's discussion provided few final answers, but important questions were raised. Both scholars and industry participants left with new perspectives on the role the nation's insurance industry could and should play in managing the risks faced by all of us. ■

Four continents are represented in this picture from Cato's Summer Seminar. From left to right are Philippe Nataf of France, David Boaz of Cato, Alexandre Guasti of Brazil, David Butler of England, and Craig Fynn of South Africa.

Seminar Draws Worldwide Interest

The Cato Institute sponsored its eighth annual Summer Seminar in Political Economy from June 29 to July 6. Seventy-five people representing 10 countries gathered at Dartmouth College to participate in a week of lectures and discussions on classical liberalism.

Stuart Warner, a newcomer to the seminar faculty and professor of philosophy at St. Mary's University–Notre Dame, began the week with lectures on ethics, liberty, and classical liberal philosophy. John Gray, a lecturer at Jesus College at Oxford University, discussed the ideas of Karl Marx and F. A. Hayek. Economists Israel Kirzner of New York University and Don Lavoie of George Mason University explained spontaneous order, the market process, the role of the entrepreneur, and central planning.

The renewed interest in classical liberalism—as a philosophy and a movement—has clearly spread beyond its immediate origins in the United States and England. The Summer Seminar provided a unique opportunity for libertarians from all over the world to discuss important issues in classical liberal thought. Varying perspectives on world politics were provided by 24 participants representing such wide-ranging nationalities as Sweden, Norway, Belgium, France, England, Canada, South Africa, Ecuador, Venezuela, Brazil, Argentina, Korea, and Iran. ■

Mario J. Rizzo of New York University looks on as Gerald P. O'Driscoll Jr. of the Federal Reserve Bank of Dallas autographs a copy of their new book, *The Economics of Time and Ignorance*. O'Driscoll and Rizzo, both Cato Adjunct Scholars, discussed the themes of their book—subjectivism and the centrality of individual choice in economic analysis—at a Cato Policy Forum.

Too Many Resources Devoted to Farming, Studies Say

As part of the debate over the 1985 revision of agricultural policy, the Cato Institute has published three Policy Analysis studies examining the agricultural crisis and suggesting reforms.

The first of these, entitled "What Is the 1985 Farm Problem?" is written by J. Bruce Bullock, chairman of the Department of Agricultural Economics at the University of Missouri at Columbia. His paper argues that 50 years of federal farm programs have generated a significant overinvestment in the land, labor, and capital resources devoted to agriculture. Thus, the problem is one of excess abundance, not shortage. As a result, Bullock concludes that federal policies should be directed to encouraging farmers to exit from agriculture, rather than trying to keep them there.

The second paper, "Government Crops Programs: High Cost and Few Gains," is by Clifton Luttrell, an economist retired from the St. Louis Federal Reserve Bank. Luttrell notes that existing programs have served to price U.S. farmers out of world markets while encouraging domestic consumers to turn to substitutes. Attempts to control the supply of corn, wheat, rice, and cotton have proven largely ineffective. Each time floor prices are raised, more capital and human resources are encouraged to enter the farm industry, increasing supply and placing new downward pressure on produce prices.

John Datt of the American Farm Bureau listens as agricultural expert Stuart Hardy of the Chamber of Commerce answers a question at Cato Policy Forum on the 1985 farm bill.

Finally, in "Dairy Policy and Public Interest: The Economic Legacies" James Thompson and Frank Edwards, professors at Murray State University, examine the impact of federal price supports on the dairy industry. Thompson and Edwards explain how laws designed to protect dairy farmers have led to an overabundance of milk and milk products and to higher dairy prices for consumers.

Together these papers make two broad points. First, the incomes of farm families do not diverge significantly from the incomes of urban families. Thus, the welfare aspect of the farm program should be identified as such and separated from other program goals.

Second, in the absence of significant market-oriented changes in current agriculture programs, farmers will continue to struggle to make ends meet. As long as the government continues to support prices above world market levels while offering farmers subsidized loans, farmers will be left unable to compete abroad and an excess supply of agricultural products will be created at home. For the agricultural sector to prosper in the future, it must become more responsive to market signals dictating a significant reduction in resources devoted to farming. ■

Centralists Battle Pluralists in Education Reform

A great battle is being fought over education reform at the state level, says Lawrence A. Uzzell, a Washington education consultant. The battle is between two major factions, "neocentralists" and "neopluralists."

Uzzell outlined his thesis in a Cato study entitled "Contradictions of Centralized Education" and at a Policy Forum in May, his first public speech since his controversial resignation from the Department of Education as special assistant to the secretary for parental choice.

The neocentralists, who have controlled the direction of education policy for the past two decades, view education as a natural monopoly. Education, they argue, must be administered by the "right people" in a single public school system.

By contrast, the neopluralists believe that "education policy ought to be made by parents, teachers, and principals in daily contact with real children." These are the people who support alternative schools, tax credits, and other pro-choice policies.

While neopluralists see excellence attained only through decentralized decision making, neocentralists are "deeply embedded in the system" and seek incremental reform. Their solutions concentrate control and decision making at the state level through comprehensive state reform plans and bigger budgets.

Commenting on Uzzell's speech was Greg Humphrey, special assistant to the president of the American Federation of Teachers. While admitting that the AFT has moved to more decentralized approaches to education, including student choice within public school districts, Humphrey argued that the best route for reform is within the system.

"We believe," Humphrey continued, "that it is possible to rebuild the public education system [to] provide for the educational and cultural needs of most people in society, except those who have a genuine religious or other preference that a public institution . . . will never be allowed to satisfy."

But it is this centralized monopoly system that is the cause of the "rising tide of mediocrity" in local education, said Uzzell. State government spending on education has outstripped both federal and local spending. "And it is naive to think," he continued, "that as long as decisions are made by a monopoly, the most important member of that monopoly is not going to be the state government."

Uzzell's paper is part of the Cato Institute's Policy Analysis series and is available for $2.00. ■

Poole, Pirie Defend Privatization in U.S. and Britain

"There's a large body of empirical research that shows that when you have competition rather than monopoly, when you have market pricing rather than taxation as a source of revenue, when you have private incentive rather than bureaucratic incentive, what you tend to get is lower cost, more innovation, and better service."

With these words, Robert Poole, president of the Reason Foundation and author of *Cutting Back City Hall,* launched the first of two Cato Policy Forums on privatizing federal programs.

Poole cited a number of important studies, published by the Cato Institute, the Heritage Foundation, the Pacific Institute, the Grace Commission, and other groups, that have established the necessary groundwork for privatizing such activities as Social Security, fire protection, forest maintenance, and garbage collection.

Poole listed four things that had to be done before privatization could occur in the United States. First, "we must change the rhetorical focus away from a cutting-the-budget approach to . . . solving problems [and] providing better services to people than can be gotten from unresponsive government monopolies." Second, more studies must be produced to make it "politically feasible for people in government . . . to propose such measures." Third, privatizers must be willing to make coalitions that can effect change, such as the one built to push airline deregulation in the late 1970s. Finally, more politically acceptable techniques and strategies must be developed to respond to critics, something that the Thatcher government in England has been very successful at.

Commenting on Poole's speech, Harry Hatry of the Urban Institute warned that privatization has often resulted in fraud and corruption, particularly in contracting out. Recent problems with nursing homes also indicate, Hatry argued, that the private sector's zeal to cut costs may impair the quality of services. In addition, private firms are subject to strikes and bankruptcies, which may further diminish the quality of their services.

The second Policy Forum on privatization featured Madsen Pirie, president of the Adam Smith Institute, and focused on the case of Great Britain.

Much of Thatcher's success, stated Pirie, has resulted from convincing the major constituent groups that they would gain from privatization. Managers "quite happy running a large public monopoly are even happier at the prospect of running a large, profitable, private monopoly." Employees can be pacified as well by giving them an opportunity to buy ownership rights in nationalized companies. Most important, the numerous new stockholders of the industries and services that are successfully transferred to the private sector make future nationalization of these industries almost impossible.

Free Trade, Not Aid, for Dictators

The United States should pursue a policy of "benign detachment" toward all Third World dictatorships, writes Ted Galen Carpenter in a Cato study.

Carpenter, foreign policy analyst for the Cato Institute, proposes that the United States avoid military and political entanglements with all such regimes but pursue cordial diplomatic and economic relations with them, no matter what their ideological orientation.

Rejecting the call of both liberals and conservatives for American intervention in the affairs of other countries, Carpenter writes, "The United States has no holy writ to destabilize the governments of Cuba or Nicaragua because it finds them repugnant, nor to preserve autocratic systems in South Korea or Zaire because it considers them congenial. By the same token, America has not been anointed to overthrow the Pinochet regime in Chile or reform the South African government, even though zealous liberals might think such actions would promote human progress."

Carpenter warns that "it is debilitating for a society that honors democracy and fundamental human rights to embrace regimes that scorn both values." We must not let our values of capitalism and democracy be associated with repressive regimes that are proclaimed "friends" of the United States.

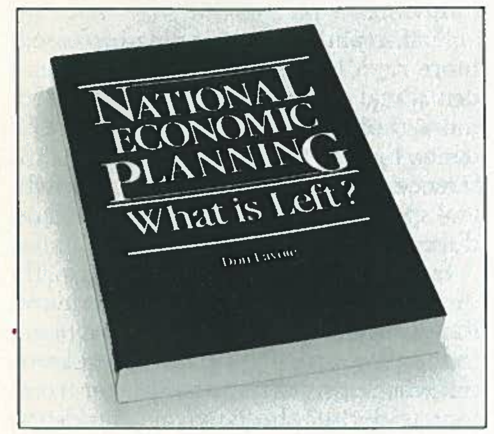
Carpenter reviews the history of U.S. relations with the Third World, takes issue with Jeane Kirkpatrick's view of "friendly" autocrats, and argues that an even-handed policy toward all regimes—democratic, autocratic, royalist, or Marxist—would ultimately enhance the spread of democratic capitalism in the Third World.

Carpenter's paper, "The United States and Third World Dictatorships: A Case for Benign Detachment," is part of the Cato Institute's Policy Analysis series and is available from Cato for $2.00.

Cato chairman William Niskanen greets James C. Miller III, chairman of the Federal Trade Commission, at Cato luncheon where Miller briefed business representatives on FTC issues.

Planning (Cont. from p. 1)

idea of comprehensive planning would be utterly incapable of sustaining a modern economy. Leaving aside the problem of giving such tremendous power to corruptible humans, he writes, "For purposes of this argument one can suppose that the planning apparatus will be staffed by persons possessed of the moral stature of a Mohandas Gandhi combined with the mental capacity and creative genius of a



Leonardo da Vinci. . . . The problem is not that people will be insufficiently motivated to do the right things but, more fundamentally, that they will not know what the right things to do *are.*"

This is because "a modern economy can generate and disperse the knowledge its operation requires only by permitting a competitive process to operate in an unplanned manner."

A unique feature of Lavoie's approach is his appeal to radicals and leftists. Lavoie expresses his agreement with "the primary *goals* of radicalism, to transcend—through principled and concerted social action—war and militarism, political oppression, and special privilege, and to set in motion progressive forces that will begin to solve such difficult human problems as poverty, disease, and environmental decay." He concludes that "the ultimate *ends* of the radical movement will almost certainly be frustrated if national economic planning is chosen as the *means.*"

After developing his theoretical arguments, Lavoie takes on the specific proposals of such writers as Wassily Leontief, Robert Reich, Felix Rohatyn, Martin Carnoy and Derek Shearer, Tom Hayden, and Michael Harrington.

In the final chapter Lavoie argues that "the real fathers of planning, *as it has actually been practiced in this century,* are neither Marx and Engels or Lange and Lerner, but Bernard Baruch, David Lloyd George, and General Erich Ludendorff. It was in their efforts to mobilize, respectively, the American, British, and German economies for the purpose of fighting World War I that the specific procedures for implementing a noncomprehensively planned economy were first ironed out." He concludes by urging radicals to "complete the American revolution" by establishing "the unplanned free-market economy as a radical ideal."

Lavoie's book drew advance praise from such scholars as F. A. Hayek, who wrote, "We shall learn much from studying this systematic exposition of the present state of our knowledge of the problems." John Gray of Oxford University calls it "an immensely powerful case . . . of interest to economists, political scientists, philosophers, and all those concerned with current trends in public policy," while Jennifer Roback of Yale University declares it "absorbing reading."

Lavoie is an assistant professor of economics at George Mason University and a research associate of the Center for the Study of Market Processes there. He is the author of *Rivalry and Central Planning: The Socialist Calculation Debate Reconsidered* (Cambridge University Press, 1985.)

National Economic Planning: What Is Left? is available from Ballinger for $25.00 cloth and from Cato for $9.95 paperback. ■

Simon Says Immigrants Help U.S. Economy

In an important new book, Julian L. Simon explodes a number of myths on immigration. Simon, a professor at the University of Maryland, argues that contrary to popular belief, immigrants raise, rather than lower, our standard of living.

How Do Immigrants Affect Us Economically? has been published jointly by 10 diverse organizations: the Cato Institute, the Center for Immigration Policy and Refugee Assistance at Georgetown University, the American Immigration Lawyers Association, the American Jewish Committee, the Hebrew Immigrant Aid Society, the Immigration and Refugee Program of the Church World Service, the Lutheran Immigration and Refugee Service, the Migration and Refugee Service of the U.S. Catholic Conference, the National Council of La Raza, and the U.S. Committee for Refugees.

Simon's book covers all immigrants, both legal and illegal. Following are some of the highlights of this study.

By historical standards, the rate of recent immigration is low. In fact, the yearly flow of immigrants today is only about a sixth as large, relative to our population, as it was at the turn of the century.

A major survey by the Census Bureau shows that immigrants pay much more in taxes than the cost of the welfare services and schooling that they use. This is because most immigrants are young and strong, and a large proportion are well educated and have high earnings. Every year, the average immigrant family pays about $1,500 more in taxes than it receives in government services.

Because illegal immigrants are afraid of being detected, they rarely use government services despite paying taxes.

Immigrants do not worsen unemployment. In fact, by spending their earnings, they create jobs. They also create jobs by opening new businesses.

Throughout the book, Simon reminds us that immigrants are strong, courageous, vigorous, entrepreneurial types who enrich our economy and civilization with their drive and creative powers. Immigrants, past and present, are the very success story of America. ■

Interns Needed

The Cato Institute seeks paid and volunteer interns throughout the year. We are currently accepting applications for fall 1985 and spring 1986. Contact David Boaz at Cato. ■

The Growth of Government

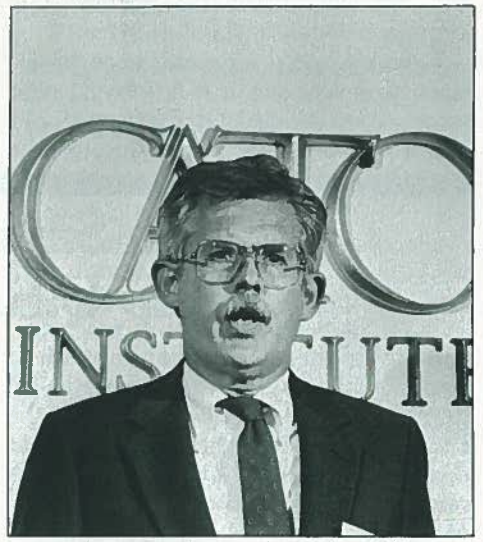
by William A. Niskanen

In late November 1972, Governor Reagan convened a small group at the Century Plaza in Los Angeles. In his opening remarks, he observed that conventional politics, including the recent reelection of a Republican president by a large majority, would probably not be sufficient to slow the growth of government. Several other speakers summarized what little we knew about the reasons for the growth of government. My own remarks focused on the erosion of the constitutional restraints on the powers of the federal government, powers that were specifically enumerated in Article I, Section 8, of the Constitution and specifically circumscribed by the Tenth Amendment. Governor Reagan then asked us to consider the feasibility and desirability of a constitutional limit on the total tax and spending power of the state.

That meeting was the genesis of the contemporary tax-limitation movement in the United States, a movement whose history is not yet complete. The group formed in Los Angeles later drafted and promoted the first major proposal for a constitutional limit on the total tax and spending power of a state, a proposal that was appropriately termed "Proposition 1." The early record of this movement was not encouraging. Proposition 1 was defeated in California in 1973, and a similar proposal in Michigan was defeated in 1976. The year 1978, however, proved to be a watershed for the tax-limitation movement. General limits on state taxing authority were approved in Tennessee and Michigan, and property taxes were substantially reduced in California and Massachusetts. Since that time, general tax limitations have been approved in an additional half-dozen states, and the legislatures of 32 states have called for a similar amendment to the federal Constitution.

For state and local governments, a limitation on or reduction in taxes can be an effective limit on government spending because most such governments are constrained to have a balanced budget on their operating accounts. For the federal government, however, tax limitation is not sufficient to constrain spending because the federal government has, effectively, unlimited authority to borrow. An effective restraint on federal spending, thus, must constrain both taxing authority and borrowing authority.

A proposed amendment to the federal Constitution that would change the voting rules on tax and borrowing authority was approved by more than two-thirds of the Senate and by more than a majority of the House in 1982 and is being considered in the Senate again this year. For those of us who are concerned about the long-term growth of the federal government, approval of this proposed amendment should be the highest priority.



William Niskanen: "Liberty depends on limiting the role of the state to the common defense and the general welfare."

The election and reelection of President Reagan, however, have somewhat defused the pressure for more general restraints on the powers of government, based on a plausible belief that the election of the most conservative president in our lifetime would be sufficient to slow the growth of government. Governor Reagan knew better; real (inflation-adjusted) state spending in California grew more rapidly during his terms as governor than during any other equivalent period. President Reagan should know better; real federal spending increased about as rapidly during his first term as president as during the Carter administration.

Moreover, there is no general evidence that the growth of government spending depends on the party in office. An examination of federal spending during the years since World War II, based on some research that I completed early this winter, indicates the following.

First, real defense spending increased more rapidly under Democratic presidents, real domestic spending increased more rapidly under Republican presidents, but there was no significant difference in the growth of real total federal spending from one party to another during this period.

Second, the composition of the growth of federal spending under President Reagan was significantly different from that under other Republican presidents but was not significantly different from that under all the postwar presidents taken as a group.

Third, the amount and composition of the federal spending share of GNP can be explained almost entirely by three conditions: the level of real per capita GNP, the number of U.S. armed forces overseas, and the unemployment rate. Controlling for these conditions, federal spending was independent of the party of the president, the party that controlled the House, and the party that controlled the Senate.

A fourth observation bears on two competing hypotheses of the relation between federal spending and federal taxes. One view, shared by Milton Friedman and Ronald Reagan, is that reducing taxes will reduce spending. The contrary view, shared by James Buchanan and Herbert Stein, is that reduced taxes will increase spending by reducing the perceived price of government services. Over the postwar years, controlling for the three conditions mentioned earlier, federal spending appears to have been independent of federal tax receipts. In other words, a reduction in federal tax receipts, for a given level of GNP, increases the deficit by a roughly equal amount.

One interpretation of this evidence is that our political system is working quite well, responding to a change of preferences represented by both parties but independent of the governing party. Another interpretation is that our political system is not working very well, due to common biases in the behavior of elected officials of both parties. For the moment, the available empirical tests are not sufficient to choose between these contrary perspectives. My own perspective is that our political system does not serve us very well, a view that has been strongly shaped by my own government experience and by the developing contributions of the public-choice scholars.


Niskanen talks with Beryl Sprinkel, new chairman of the Council of Economic Advisers.

The major biases in our political system are now more broadly perceived. Most people have little incentive to invest in information about government or, for that matter, to vote. Concentrated interests have more incentive to invest in political activity than the broader community of consumers and taxpayers. The regional basis for representation in Congress elevates regional concerns relative to more broadly shared national concerns. Elected officials have an unusually short time horizon, given their limited terms of office and the erosion of party control. The incentives of bureaucrats are not consistent with either the efficient supply of government services or the optimal level of these services. The elected officials and bureaucrats who set the agenda for subsequent decisions have unusual power over the outcomes of these decisions.

These major biases, however, have been inherent in our political system since the dawn of our republic, and they do not explain why the federal share of GNP has increased from 2.5 percent in 1929 to 25 percent in 1985. What does explain it is the erosion of the constraints on the powers of the federal government, a change in our effective constitution without any change in our formal constitution. This change is the most important political development in our lifetime.

James Madison, the primary architect of the Constitution, described the powers of the federal government in the *Federalist*, no. 45, as "few and defined . . . to be exercised principally on external objects, as war, peace, negotiation, and foreign commerce." Thomas Jefferson, in his first inaugural address, described the powers of the federal government as limited to "the external and mutual relations only of these states." In 1936, however, the Supreme Court ruled in *United States* v. *Butler* that "the power of Congress to authorize appropriations of public money for public purposes is not limited by direct grants of legislative power found in the Constitution." The Court, apparently, paid no attention to Madison's defense of the proposed Constitution in the *Federalist*, no. 41, where he argued that "the idea of an enumeration of particulars which neither explain nor qualify the general meaning, and can have no other effect than to confuse or to mislead, is an absurdity." After his retirement as president, Madison wrote that the general welfare clause slipped into the Constitution as a consequence of "inattention to phraseology occasioned doubtless by its identity with the harmless character attributed to it in [the Articles of Confederation] from which it was borrowed." My own reflections on this issue, summarized in an article in 1975, concluded that "at the present time, the enumerated functions do not even command lip service. The U.S. Constitution, in terms of its effectiveness in constraining the functions of the federal government, is a dead letter."


Ed Crane talks with Deputy Energy Secretary Danny Boggs and Heritage Foundation president Ed Feulner.

Moreover, no coherent theory of the state has been substituted for the formal constitutional restraints. During the 1950s, economists developed a theory of the state, described as "welfare economics," based on the provision of public goods and the correction of externalities in market transactions. This theory— formulated by Arrow, Bator, Baumol, Samuelson, and others —provides a satisfactory framework for the role of the state, but only if government officials are all-knowing saints.

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William A. Niskanen, former senior member of the Council of Economic Advisers, recently assumed the position of chairman of the Cato Institute. This is the text of his inaugural lecture.

Government (Cont. from p. 9)

Welfare economics overlooked the fundamental insight of our constitutional founders: that government should be so structured that the behavior of government officials in pursuit of their private interests also serves the public interest.

In any case, welfare economics did not provide any effective restraints on the developing functions of government. Many government activities are not public goods. Many government activities create additional externalities. Much of the activity of the modern state, like that of imperial Rome, consists of providing various forms of bread and circuses, goods and services that are adequately supplied by the market.

For some of you, this may be your first exposure to the Cato Institute. What can a small nonpartisan policy institute, operating in a city fascinated with power, do to address these issues? The role of Cato, like that of similar institutes, is based on the premise that changes in government policy should be based on informed consent. In pursuit of that role, we document the effects of a wide range of government activities and develop alternatives that will better serve the interests of a free community. Most important, we try to shape the perspective by which people address policy issues. Does a specific policy increase personal choice? Does it reflect the consent of those affected? Does it respect the considerable diversity of the American community?

As with other institutes, we bring a number of analytic perspectives to bear on these issues. Some of our resident and adjunct scholars have been influenced especially by the Austrian economic tradition, best represented in the writings of Mises and Hayek. Others have been more influenced by the neoclassical tradition or the developing field of public choice.

We differ from many other institutes primarily in our political values. These values have been characterized as "radical conservative" by the liberal press, as "anarchist" by the conservative press, and sometimes as "libertarian." I am personally uncomfortable with any of these labels. We share the values of Locke, Smith, and Mill—people who were known as Whigs and, later, as Liberals in British political thought. We share the values of Jefferson and Madison, the authors of the leading charters of American liberty, people who called themselves both Republicans and Democrats. We will differ from the dominant political traditions primarily when they try to use the powers of the state to impose their particular values on the larger community. We will oppose contemporary liberals when they fail to distinguish between a virtue and a requirement. We will oppose contemporary conservatives when they fail to distinguish between a sin and a crime.

This perspective—libertarian, if you wish—reflects a shared set of political values among people who may have widely different personal values or religious beliefs, a perspective, I contend, that was and is the essence of the original and continuing American revolution. The terms that are used to describe this perspective are not important. We ask you to read our publications. We will value any contribution you can make to our funding. Spell our name correctly, and call us what you will.

Governor Reagan was prescient in recognizing that the reelection of a Republican president by a large majority would not be sufficient to slow the growth of government. That is still the case. President Reagan will earn our support when the actions of his administration are consistent with his long-held convictions. He will deserve our opposition when they are not. The cause of liberty is not especially dependent on which party or person is elected to political office. It is more dependent on the views shared by both parties on the importance of limiting the role of the state to those activities that serve the common defense and the general welfare. ■

George Washington University economist John W. Kendrick talks with Federal Reserve governor Martha Seger.

Miguel Herrero, opposition leader of the Spanish parliament, talks with Georgetown University professors Earl Ravenal and Frank Winters after a Cato luncheon. Herrero discussed Spain's role in NATO and the European Community with a group of government officials, scholars, and journalists.

Economic Growth (Cont. from p. 1)

moderate rate of taxation. High marginal tax rates, he maintained, "obstruct the industry of the people and frequently afford a smaller revenue to the government than what might be drawn from more moderate taxes."[4]

Smith's fiscal principles became the orthodoxy of most of the classical economists who followed him, and they were often the basis for the fiscal policies of nineteenth-century and early twentieth-century Britain. William Gladstone even claimed that he had "carried out for the first time in fiscal and commercial history" Adam Smith's fiscal principles and accomplished "in 20 years what Adam Smith had deemed well-nigh hopeless."[5] Gladstone, of course, is credited with the powerful economic expansion that took place in Britain through the middle and late nineteenth century. During that time Gladstone did much to reduce the heavy burden of taxation and government expenditures that had been the legacy of mercantilism and the Napoleonic wars.

The Public-Sector Boom in Modern Europe

Given Smith's warning that economic prosperity is jeopardized when government overreaches itself in taxation and spending, it is not difficult to understand the economic problems of modern-day Europe. By any measure, most European nations have clearly overstepped the bounds of fiscal responsibility. Table 1 reveals the massive and relentless rise of the European public sector.[6]

Table 1
Revenues and Government Expenditures (% of GDP)

Country	Revenue 1962	Revenue 1982	Spending 1962	Spending 1982
U. S.	27.0	32.0	28.8	37.6
Japan	21.6	30.2	19.0	34.5
West Germany	36.6	45.3	35.6	49.6
France	36.6	46.9	37.0	50.7
U. K.	33.1	43.7	34.2	47.4
Italy	29.1	41.1	30.5	53.7
Canada	27.0	39.0	30.0	45.8
Austria	34.0	46.7	33.6	50.3
Belgium	29.2	45.4	30.5	56.6
Denmark	28.2	50.7	28.1	60.7
Finland	30.1	39.7	27.4	41.3
Netherlands	34.4	55.8	35.6	63.7
Sweden	35.5	59.7	32.4	67.3
Switzerland	23.9	33.2	18.5	30.0
OECD Europe*	32.7	45.7	32.5	50.9

Source: *OECD Economic Outlook* (December 1984).
*OECD Europe includes the European countries listed above and Greece, Ireland, Iceland, Luxembourg, Norway, Portugal, and Spain.

Just two decades ago, the size of the public sector in Europe was moderate by today's standard. At that time, total government revenues and expenditures as a percentage of GDP averaged 32.7 percent and 32.5 percent respectively, similar to the rates now prevailing in Japan and Switzerland. By 1982, these percentages had grown to 45.7 percent and 50.9 percent, with several governments spending in excess of 60 percent of GDP.

Table 2
Average Real GDP Growth for OECD Europe

Period	Annual Average (%)
1965–69	4.42
1970–74	4.14
1975–79	2.50
1980–84	0.96

Table 2 reveals the devastating effects of the public-sector boom in Europe. Though Europeans could brag about brisk economic growth during the 1960s and early 1970s, their economies now breed stagnation. With a smaller public sector, real economic growth averaged 4.4 percent from 1965 to 1969 and 4.1 percent from 1970 to 1974. A burgeoning public sector caused average real economic growth to fall, however, to 2.5 percent for the period 1975–79. In the 1980–84 period, real economic growth has plummeted to less than 1 percent. While other factors, such as increased energy prices and the world recession, have certainly affected European economies, the persistence of economic deterioration in Europe long after the advent of vigorous recoveries in the less heavily taxed United States and East Asian countries suggests that government absorption of resources and high marginal tax rates are indeed the primary problem.

Stagnation and Government Growth

The process by which an economy deteriorates as a result of excessive government growth follows a general pattern that, in its later stages, becomes nearly irreversible. It begins with government accepting broader responsibilities that necessitate an increase in government spending as a share of national income. This leads to greater government budget deficits and/or higher taxes. If central banks print more money in a vain effort to offset the impact of the deficit, then inflation worsens, driving up tax receipts even further as rising nominal incomes confront progressive income tax systems.

At some point, the rising tax burden begins to create a strong disincentive to work, invest, and engage in entrepreneurial activity, contributing, in turn, to a slowing of economic growth and job creation. Unemployment begins to rise, other social problems emerge, and the demand for government services and support increases. Government spending continues to rise as do the taxes necessary to fund it, and the process repeats itself, but this time with greater vigor because the worsening economic environment deepens the perceived need for greater government services. Eventually, tax rates rise so high that tax revenues fall due to declining economic growth. As a consequence, the public-sector deficit widens. The process repeats itself until there emerges a situation like that in Sweden or the Netherlands, where government accounts for about two-thirds of the economy, and public employment is the main source of job growth.

Table 3
Average Real GDP Growth for the Seven Major Industrial Countries*

Period	Real Growth (%)
1965–69	5.04
1970–74	3.62
1975–79	3.28
1980–84	1.84

Source: OECD.
*U.S., Japan, West Germany, France, U.K., Italy, Canada.

The Major Industrial Countries: A Comparative Analysis

Up to now we have focused on the general relationship between economic stagnation and the growth of the public sector in Europe. A similar pattern emerges upon examination of differences in the performance of the seven

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Economic Growth (Cont. from p. 11)

major industrial countries. Table 3 lists the average annual GDP growth of these countries for five-year intervals beginning in 1965.

Differences in performance over time among the top seven industrial nations correspond closely to relative tax and spending burdens, particularly over the past few years when highly taxed Europe has been slow to recover while less-taxed Japan, the United States, and Canada have experienced strong business expansions. Indeed, without the powerful U.S. recovery, which has drawn in abundant imports from abroad, the European situation would be even more anemic. Table 4 ranks the industrial-production performance of the same seven countries for the period 1980–84. Note the complete correspondence between industrial decay and government encroachment.

Table 4

Indexes of Industrial Production (1980 = 100)

Country*	1981	1982	1983	1984
Japan (7)	101.0	101.4	104.9	116.5
U.S. (6)	102.6	94.2	100.3	111.1
Canada (5)	100.9	90.1	95.5	103.8
U.K. (4)	96.3	98.0	101.9	102.8
West Germany (3)	98.4	95.4	96.2	99.6
France (2)	96.8	95.3	96.5	98.6
Italy (1)	99.8	97.5	91.8	95.2

Source: U.S. Department of Commerce.

*Figures in parentheses indicate each country's rank according to the government share of spending in the economy as measured in Table 1.

It should be noted, in passing, that this relationship has implications for the current domestic debate over the strong dollar's effect on U.S. industry. Some of the critics of the dollar's rise relative to other currencies argue that it is leading to the "deindustrialization" of the United States and the economic benefit of our international competitors. Ironically, as Table 4 illustrates, it is those countries whose currencies have declined the most against the dollar (Italy and France) that are experiencing the severest industrial problems.

Table 5

Index of Employment (1977 = 100)

Country	1980	1982	1984
U.S.	107.7	108.0	113.9
Canada	110.8	110.2	113.8
Japan	103.5	105.5	107.9
Italy	102.9	103.0	102.7
France	100.2	99.6	98.3
West Germany	103.0	100.3	98.3
U. K.	100.8	95.4	95.9

Source: U.S. Bureau of Labor Statistics.

Perhaps the clearest measure of differences in national economic performance, at least in human terms, is in the number of jobs created from country to country. As Table 5 shows, the lower-tax and -spending countries have outperformed the others in creating new employment opportunities. Indeed, several of the higher-tax and -spending countries have experienced actual declines in total employment over the past several years.

Since Table 5 does not distinguish between jobs in the public sector and jobs in the private sector, it actually overstates the employment-creation performance of the European countries. Between 1960 and the present, a period during which all countries gained in total employment, Belgium, the United Kingdom, Italy, and West Germany all *lost* jobs in the private sector. In other words, what job growth did occur in these countries occurred in the public sector. However, even European countries that have created private-sector employment over the last 25 years began to experience a deterioration during the 1980s that could, in turn, lead to a net loss in private employment within the next several years. In the United States, by contrast, jobs in the private sector expanded by 50 percent over the same period.

Employment growth is one measure of job opportunities. Another measure is the unemployment rate. Here again, the United States and Japan are doing well, although some international comparisons tend to be distorted by the extent to which governmental jobs programs maintain "employment" when stagnation occurs. While the U.S. unemployment rate has been stabilized at 7.3 percent over the past several months, European unemployment rates have stayed above 10 percent for the last few years. The Netherlands heads the list at 16 percent, with Italy second at 14.2 percent, followed by Belgium at 14.1 percent. The rate for the United Kingdom is 13 percent, up from 12.5 percent a year ago despite the gradual improvement in the British economy.

Table 6

Per Capita GDP Based on Purchasing Power Parities (U.S. = 100)

Country	1975	1980	1984
U.S.	100.0	100.0	100.0
Canada	101.8	100.3	95.6
Japan	65.5	71.2	75.6
France	77.5	78.9	75.8
West Germany	77.3	81.8	78.5
Italy	60.5	63.7	59.7
U. K.	70.2	67.4	65.9

Source: U.S. Bureau of Labor Statistics.

In the end, what really matters from the point of view of the average citizen is his standard of living. Although a difficult measure to record and compare, standard of living can be indicated at least in the aggregate by real per capita income. Not unexpectedly, trends in real per capita income in the industrialized countries closely track, in an inverse fashion, the growth of government intrusion in the various economies.

Table 6 illustrates the changes that have occurred recently in the real per apita incomes of the seven major economies. The data are presented in terms of "purchasing power parity" exchange rates to avoid distortions caused by wide swings in exchange rates. Otherwise, the U.S. lead would be even greater as a result of the dollar's appreciation against other currencies.

With the exception of Japan, which has maintained firm limits on the growth of government spending and taxation, all the major industrial countries have seen their real per capita incomes fall relative to that of the United States. The striking correspondence between government growth and economic deterioration can be seen by comparing Table 5 with Tables 1 and 2. The real per capita income of Canada, for example, which matched that of the United States in the 1970s, slipped as Canadian government spending grew at a rate 65 percent greater than ours during the last 20 years. It is not at all clear whether Canada's government, or the governments of the other nations surveyed here, has recognized excessive taxation and public spending as the problem. On the contrary, Canada's new Progressive Conservative government, confronting a budget deficit almost twice the size of ours in proportion to the Canadian economy, has opted to raise taxes as part of the "solution." It has proposed a 5 percent surcharge on corporate income tax obligations and a 5–10 percent surtax on households with incomes of $40,000 or more. A surtax, of course, is particularly destructive of economic incentives because it directly raises marginal tax rates.

Taxation, Fiscal Responsibility, and Economic Growth

There are basically two major arguments in support of increased taxation. The first maintains that higher taxes, combined with budget cuts, will lead to a smaller deficit and lower real interest rates. The second maintains that increased taxation, more "visible" to the individual than deficit financing or money creation, will increase the fiscal awareness of the public. In this view, increased taxation would make it easier for individuals to reckon the true cost of big government, with the result that they may vote for a smaller public sector.

The European experience raises serious doubts about the use of taxation as a method of solving fiscal problems. As government expenditures escalated throughout the 1970s, the clamor for fiscal responsibility also rose, and all the major European industrial countries raised taxes. Taxes as a percentage of GDP in OECD Europe stood at 32.7 percent in 1962; by 1982, they had soared to 45.7 percent. And the result? Rather than decreasing, European deficits have soared along with taxes. Revenues and expenditures were in balance in 1962, but by 1982 the European deficit was in excess of 5 percent of GDP. (See Table 1.)

Analysis by economist Alan Reynolds confirms that budget deficits have been consistently higher in high-tax countries, with the exception of Japan, than in lower-tax countries. (See Table 7.) According to Reynolds, "while total government debt was unchanged in the U.S. from 1970 to 1984, relative to GNP, debt burdens outpaced economic growth in all of the overtaxed countries. Higher tax rates are the cause of permanent budget deficits, not the cure."[7]

Table 7

Government Deficits and Debt (% of GNP)*

Country	Deficit 1980–84	Debt 1970	Debt 1983	Debt 1984
Sweden	4.6	31	67	
Netherlands	5.9	51	61	
Belgium	10.5	73	116	
Italy	11.4	44		85
Denmark	6.6	11	63	
France	2.2	29		37
West Germany	2.9	18		41
U.K.	3.0	86		55
Austria	2.1	19	45	
Canada	4.0	54		58
Finland	0.1	16	19	
U.S.	2.6	46		46
Japan	3.5	12		67
Greece	9.5	21	42	
Ireland	11.4	NA	NA	
Spain	4.5	14	31	
Australia	1.5	42	25	

Source: Vito Tanzi, "The Deficit Experience in Industrial Countries," in *Contemporary Economic Problems*, ed. Philip Cagan (Washington: American Enterprise Institute, 1985); *OECD Economic Outlook* (December 1984), p. 32; Morgan Guaranty, *World Financial Markets* (December 1984).

*Figures include federal, state, and local government outlays.

The fact that rising taxation is associated with rising deficits indicates the importance of the incentive, or supply-side, effects of taxation. Rising tax rates have reduced the reward to labor and capital and have increased incentives to resort to tax shelters and the underground economy. The effects of higher taxes— reduction in economic growth and a decrease in the tax base—are especially pronounced in high-tax countries. Reynolds found that from 1975 to 1982 real tax revenues rose at substantial rates in moderate-tax countries but actually fell in many high-tax countries. For example, real revenues rose 71.5 percent in Portugal and 75.7 percent in Japan, and fell 6.6 percent in Sweden and 3.2 percent in Germany.

Similarly, far from inspiring Europeans to vote for smaller public sectors, rising taxation has served merely as the fuel for runaway government spending. Government expenditures now surpass 50 percent of European GDP, compared with about 32 percent in the early 1960s. The notion that rising taxation reduces spending by increasing the visibility of the costs of government is therefore unsubstantiated. Those costs may remain hidden to the average European anyway, since European governments rely heavily on the value-added tax, a tax embedded in the price of the commodity itself.

The European experience brings home the fact that the true measure of the public sector's burden is not its budget deficit, but the percentage of national output it takes in and spends. The only meaningful way to restore and sustain economic growth is to reduce both taxation and government spending.

The Less-Developed Countries

Perhaps the most compelling evidence of the disincentive effects of high taxation and excessive government spending comes from the less-developed countries, where wide differences exist among national fiscal policies. In many less-developed countries, for example, tax brackets for individuals with incomes of less than $5,000 exceed 50 percent. On the other hand, in several Third World countries even very high incomes are subject only to very low marginal tax rates.

The effects of widely divergent Third World fiscal policies have been carefully analyzed by economists Keith Marsden and Alan Reynolds, who have found, in general, a strong relationship between marginal tax rates and economic growth. Countries that impose high taxes have experienced sluggish, even negative, economic growth over long periods of time. By contrast, countries relying more on the private sector and lower marginal tax rates have had robust economic growth.

Marsden has found that in most cases the economic growth rate in low-tax countries has been three times that in high-tax countries.[8] He has also found that lower marginal tax rates result in a greater supply of labor and capital. (See Table 8.) Reynolds corroborates Marsden's analysis. (See Table 9.) His findings show that tax revenues fell as tax

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Economic Growth around the World

World Economic Growth: Case Studies of Developed and Developing Countries, *ed. Arnold C. Harberger (San Francisco: Institute for Contemporary Studies, 1984), 508 pp., $22.95/$9.95.*

World Economic Growth is a compilation of 21 essays that attempt, in the words of the editor, Chicago economist Arnold C. Harberger, "to explore the connections between economic policy and economic growth." The essays cover a great deal of ground, focusing on both developed and developing countries. The statistics on growth, wage rates, capital formation, and other variables are digested into readable tables and graphs, providing an excellent general reference source.

The first five chapters discuss the postwar performance of Great Britain, West Germany, the United States, Japan, and Sweden. Focusing on macroeconomic policy and such general indicators as inflation and unemployment, these case studies provide interesting analytical contrasts.

The chapter on Great Britain, for instance, consists of general observations concerning the institutionalization of the English economy through unions and policies that maximize short-term rather than long-term benefits. In another chapter, Swedish economist Ulf Jakobsson emphasizes the structural changes that have resulted from the politicization of the Swedish economy and the burgeoning of the public sector after 40 years of socialist rule. Sweden no longer produces what its export market demands.

The developing countries of Tanzania, Ghana, Indonesia, Jamaica, Taiwan, Mexico, and Uruguay illustrate the failure of interventionist policies to sustain, let alone advance, economic progress. The cases of Ghana and Tanzania explicitly demonstrate the economic damage and distortion brought about by state intervention. Mexico pursued policies that allowed its budget deficit to reach 8 percent of GDP. Mexico's economic growth slowed, inflation increased, and, despite the oil boom, the country suffered two balance-of-payments crises. Indonesia, on the other hand, pulled out of economic malaise by pursuing such responsible macroeconomic policies as a noninflationary monetary policy and a balanced budget.

The essays in *World Economic Growth* clearly demonstrate the superiority of flexible economies in promoting and sustaining growth, but they are not a ringing endorsement of free markets. The arguments are, rather, that *too much* intervention occurred, that the

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public sector expanded *too far* into the economy, and that there is *too much* regulation. Though they seem to have given up on the microeconomy, the authors are still willing to try their hand at fine-tuning the macroeconomy.

Most of the analysts, then, do not take their own evidence seriously enough. The East Asian economies of Taiwan, Hong Kong, and Japan demonstrate, in this volume as well as in other studies, the overriding importance of flexible, adaptable economies for promoting and sustaining economic growth and prosperity.

Deregulating the Airlines, *by Elizabeth E. Bailey, David R. Graham, and Daniel P. Kaplan (Cambridge: MIT Press, 1985), 243 pp., $19.95.*

For 40 years—1938 to 1978—the airline industry was in the tight grip of the Civil Aeronautics Board (CAB). The rationale was that the industry was a natural monopoly, in other words, that free competition would involve a wasteful duplication of facilities among many airline competitors. To avoid such waste, the government limited the number of firms and assigned routes. Since existing companies were thereby insulated from competition, the government naturally had to control their fares to avoid excessive pricing.

During the sixties and seventies a number of studies questioned the appropriateness of the assumptions underlying government regulation of the industry. Among the most receptive officials in Washington were the three authors of *Deregulating the Airlines,* all of whom worked for the CAB. Their book provides an extremely thorough account of the effects of deregulation in the airline industry.

Deregulating the Airlines compares the state of the industry in June 1978, immediately prior to the removal of rate and route controls by the Airline Deregulation Act, with its state in June 1981. The authors found that much greater efficiency and a higher level of performance were being achieved in the more competitive environment. In 1981 sophisticated pricing strategies, such as peak-load, quantity discounts, corporate discounts, and frequent-flyer discounts, were being used to match passengers with capacity. The structure of routes had shifted from inefficient and expensive point-to-point direct lines to hub-and-spoke operations, which accumulate people for the full utilization of capacity. These improvements and many others led to cheaper fares, which, though not manifest in 1981 due to rapidly increasing fuel costs, have been implemented since.

Overall, *Deregulating the Airlines* is excellent, but one wonders why the authors leave all indication of their own position on regulation to the end. Structuring their arguments neatly along the lines of economic theory, they attempt to show that the airline industry approaches the competitive model and therefore should not be centrally controlled. In their concluding comments, however, the authors relate a basic insight of which the airline experience is only an illustration: "Regulation, by definition, substitutes the judgment of the regulator for that of the marketplace. Just as analysts were unable to forecast fully how the deregulated airline industry would perform, the regulator cannot know what the full effect of its regulation will be . . . . The competitive marketplace is the only truly effective regulator of economic activity." This conviction should have been brought out into the open earlier, and then used along the way to draw out the general lessons that the case of airline deregulation surely teaches. ■

Economic Growth (Cont. from p. 13)

rates were boosted in several high-tax countries, while high-tax countries that have reduced marginal tax rates experienced higher growth rates.[9] Recent cases of the latter include China, India, and Finland.

The Key: Government Restraint

In 1980, when the United States first gave serious consideration to substantial tax cuts and firmer limitations on government spending, proponents of this course of action had to rely on the logic of their arguments and the instincts of the electorate to win their case. Now, five years later, there is considerably more evidence, albeit largely anecdotal, that economic performance varies inversely with the size of government. Future studies and additional data should bring further confirmation of what has long seemed only too obvious on an intuitive level: the key to economic recovery and progress lies not in big government and expansive government intervention in the economy, but in government restraint in taxation and spending. ■

Table 9
INDIVIDUAL TAX RATES AND ECONOMIC GROWTH

Country	Top Individual Tax Rate (% @ $)	Social Security Tax	Annual Growth in Real GDP (%) 1975–79	1980–83*
Paraguay	0	Yes	9.5	5.9
Hong Kong	25 @ 5,100	No	10.5	7.0
Singapore	45 @ 344,300	Yes	7.5	8.6
Malaysia	60 @ 41,000	No	7.2	6.6
Thailand	65 @ 73,500	No	7.8	5.5
Botswana	60 @ 27,400	No	11.3	11.0
Philippines	60 @ 25,300	Yes	6.6	3.2
Ireland	65 @ 19,800	Yes	4.7	2.2
Malawi	50 @ 14,300	No	5.8	1.9
Greece	57 @ 15,500	Yes	5.3	0.4
Zambia	80 @ 11,100	Yes	–1.3	2.0
Papua New Guinea	50 @ 4,200	Yes	1.7	0.4
Western Samoa	50 @ 4,700	No	4.8	–3.9
Costa Rica	50 @ 2,300	Yes	5.5	–3.6
Jamaica	58 @ 2,800	Yes	–2.1	–0.9

SOURCE: Price Waterhouse (1984); IMF, *International Financial Statistics: Supplement on Output Statistics* (Washington, 1984).
*Tax thresholds are adjusted by market exchange rates on December 31, 1984. Real GDP growth figures are from 1980–82 for Jamaica, Costa Rica, and Paraguay.

Table 8
COMPARATIVE PERFORMANCE OF SELECTED LOW- AND HIGH-TAX COUNTRIES

Country	Per Capita Income Groups (1979 $)	Real Average Annual Growth Rates, 1970–79 (%) GDP	Labor Productivity	Share of Gross Domestic Investment in GDP (%) 1960	1979
Malawi (low)	200–300	6.3	4.1	10	29
Zaire (high)		–0.7	–2.8	12	9
Cameroon (low)	500–600	5.4	4.1	—	25
Liberia (high)		1.8	–0.8	28	27
Thailand (low)	500–600	7.7	5.0	16	28
Zambia (high)		1.5	–0.9	25	21
Paraguay (low)	700–1,100	8.3	5.2	17	29
Peru (high)		3.1	0.1	25	14
Mauritius (low)	1,100–1,300	8.2	—	30	38
Jamaica (high)		–0.9	–3.1	30	18
Rep. of Korea (low)	1,400–1,700	10.3	7.5	11	35
Chile (high)		1.9	0.0	17	16
Brazil (low)	1,700–2,100	8.7	6.5	22	23
Uruguay (high)		2.5	2.4	18	17
Singapore (low)	3,800–5,950	8.4	5.7	11	39
New Zealand (high)		2.4	0.3	24	22
Spain (low)	4,300–6,350	4.4	3.3	19	20
U.K. (high)		2.1	1.8	19	19
Japan (low)	8,800–11,950	5.2	3.9	34	33
Sweden (high)		2.0	1.7	25	20
U.S.	10,630	3.1	1.3	18	19

SOURCE: Keith Marsden, "Links Between Taxes and Economic Growth," World Bank working paper no. 605 (Washington, 1983).

[1]See Robert Keleher and William Orzechowski, "Supply-Side Fiscal Policy: An Historical Analysis of a Rejuvenated Idea," in *Supply-Side Economics: A Critical Appraisal,* ed. Richard Fink (Frederick, Md.: University Publications of America, 1983).

[2]Thomas Sowell, "Adam Smith in Theory and Practice," in *Adam Smith and Modern Political Economy,* ed. Gerald P. O'Driscoll (Ames: Iowa State University Press, 1979), p. 4.

[3]Joseph J. Spengler, "Adam Smith's Theory of Economic Growth—Part II," *Southern Economic Journal* 26 (July 1959): 10.

[4]Adam Smith, *The Wealth of Nations,* vol. 2 (Chicago: University of Chicago Press, 1976), p. 414.

[5]Keleher and Orzechowski, pp. 140-42; Alvin Rabushka, *From Adam Smith to the Wealth of America* (New Brunswick, N.J.: Transaction Books, 1984).

[6]See also William Orzechowski, "International Perspectives on Tax Policy and Economic Growth," *Economic Outlook* (Washington: U.S. Chamber of Commerce, October 1984).

[7]Alan Reynolds, "The World: On the Wrong Side of the Laffer Curve," paper presented at the conference "The Flat Rate Tax—Is It an Idea Whose Time Has Come?" (Tallahassee: Florida State University Policy Sciences Program, March 14–15, 1985); and idem, "The Urgency of International Tax Relief," *Supply-Side Analytics* (Morristown, N.J.: Polyconomics, Inc., April 1985).

[8]Keith Marsden, "Links Between Taxes and Economic Growth: Some Empirical Evidence," World Bank working paper no. 605 (Washington, 1983).

[9]Reynolds, "The Urgency of International Tax Relief," pp. 14-18.

"To be governed..."

Profiles in courage

"I'm for austerity," [Rep. Jack Kemp] adds, "but I'm not for austerity for Buffalo."

—*Wall Street Journal*, May 1, 1985

Read page 1 again

The Israeli Cabinet . . . announced tonight a series of new steps in response to mounting evidence that the country's economy is continuing to deteriorate.

The measures included a proposed increase from 15 percent to 17 percent in the value-added tax . . . and a doubling of the tax on Israelis who travel abroad.

—*Washington Post*, May 25, 1985

Digging in deeper

The United States is prepared to join with other nations to lend Argentina up to $450 million to help the financially embattled nation pay off $1.2 billion in overdue commercial bank debts.

—*Washington Post*, June 7, 1985

Random sampling

During the train ride [from Washington to Baltimore, Sens. Charles] Mathias and [Claiborne] Pell handed out questionnaires to about 200 passengers, asking how they viewed Amtrak's prospective demise. "They all said, 'Don't cut off this train. Don't stop the funding for Amtrak,'" a Mathias spokesman said later.

—*Washington Post*, April 20, 1985

Honesty in government

Agriculture Secretary John R. Block said yesterday that the administration will give away up to $2 billion worth of government-owned surplus farm commodities in an unusual new subsidy program to increase farm exports. . . .

The secretary acknowledged in an interview that the new program "is not good policy" and runs counter to the Reagan administration's professed adherence to free trade.

—*Washington Post*, May 16, 1985

Subsidizing the rich

Half [of Americans] oppose government subsidies to artists, a Media General–Associated Press poll indicates. . . .

Respondents with more education tended to visit art museums more. . . .

The wealthier and better educated were also more likely to support government subsidies for artists than the poorer and less educated.

—*Washington Post*, May 13, 1985

And no more selling chocolates to fat people

New York Mayor Edward Koch believes an answer to the city's pervasive graffiti problem may be a ban on hardware stores selling spray paint to minors. . . . "We think it would be appropriate for those stores to keep these cans under lock and key and to only sell to adults."

—*Washington Times*, June 7, 1985

More of an ethic of taking

Affluent Washington is skinflint city when it comes to raising funds for local causes, ranking last in philanthropic resources among seven metropolitan areas across the nation. . . .

"There never has been an ethic of giving in this community as in other communities," said Mallory Walker, chairman of the Eugene and Agnes E. Meyer Foundation.

—*Washington Post*, April 25, 1985

The American Dream revised

Baillie Manufacturing Co. of Gibson City, Illinois, could easily have been exhibit number one for those who can't see the opportunities in Illinois' changing economy. . . .

The recession of the early 1980s took hold, and employment at Baillie Manufacturing dropped to 11 workers.

However, Duane Baillie . . . has . . . an essential quality of an entrepreneur—tenacity.

Today, Baillie employs nearly 100 workers and holds two Defense Department trailer contracts worth more than $8.5 million. He's expanded production through Small Business Administration financing and a $450,000 loan through the Illinois Department of Commerce and Community Affairs.

"It's working out really well now," says Baillie. "The big thing is learning the system."

—*BusinessWeek*, Illinois special advertising section, May 13, 1985

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