The Decline of the Liberal Economy

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Those who find the Wealth of Nations relevant for the present day are inclined to accept as true the statement that an economy in which resources are allocated in markets promotes efficiency and freedom. Not only do we accept the statement as true, we take pleasure in reminding ourselves about the beauty of the analysis leading to the conclusion. Indeed there are many in our profession who admire the beauty as much as the truth.

The striking fact is that proposals to achieve a society based on the economic principles enunciated by Smith, as elaborated and developed in the past 200 years, have not been greeted with public enthusiasm and have not proved a firm base for political economy. One of Smith's principal recommendations was that government be limited to a few tasks such as external defense and protection of persons and property. One searches in vain for a government so limited in responsibility and power. Nor can we take satisfaction from the progress we are making toward the goal of a state in which the liberal principles of efficiency and freedom are respected and honored in practice.

Turning to Smith's more specific recommendations — those directed toward increasing the wealth of nations — we become aware that mercantilism survives at the end of two centuries. Promotion of exports and restrictions on imports are common. One can look at either fully developed or less developed economies to find policies designed to promote exports and restrict imports in the name of economic development. All such policies conflict with Smith's main conclusion — that wealth increases if the restrictions are removed. Or, compare Smith's canons of taxation to the set of complex regulations found in almost every tax system.

* I am indebted to Karl Brunner for many discussions of this topic, to William Poole for a stimulating exchange of letters on the topic, and to Peter Korteweg and Johan Myrhman for providing some of the data used in the paper. This paper was written during my stay at the Fundação Getulio Vargas/EPGE and owes many debts to my hosts and colleagues there.

We need not stop with Smith. Other economists have not fared substantially better. Scores of papers proving that user charges are an efficient and even optimizing devices for controlling pollution have not produced a large number of applications. Regulations and controls are a much more common approach to the pollution problem.

Everywhere we look, the state is large or growing. Regulation, control and central direction of economic activity increase from decade to decade. Deregulation and a return to liberal principles is exceptional, not commonplace. The powers that the state acquires are not often surrendered. There are many example that could be added to the list of recommendations, based on economic theory, that would increase efficiency and freedom if adopted. To this list we should add the many industries that have become part of the public sector in all or most countries.

Adam Smith warned against profligacy and saw the spending power of the state as a threat to efficiency. His principal arguments against the state were that growth of state power would waste resources. He was remarkably clear in his analysis of the costs of fighting colonial wars relative to the benefits to be gained. Smith also understood that the state could use its power to encourage monopoly, and his argument against the use of state power to enforce monopoly privileges of the guilds and merchant companies is well known.

Looking back after two centuries we can see that the power of the state has grown in ways that are more diverse than those Smith anticipated. It is true that wars have provided an opportunity for the expansion of the public sector relative to the private sector, but the growth of the state has occurred in peacetime as well as wartime. It is true, also, that, grants of monopoly powers and franchises by the state foster inefficiency in production. The provision of social services, control of prices, restriction of competition and other type of restrictions have been achieved in ways far more diverse than imagined by Smith.

With the benefit of 200 years of additional experience, we can fault Smith for failing to see the threat that government posed to freedom and to the liberal
society that he favored. At the time that he wrote, governments were relatively small. Taxes of all kinds in Europe were estimated to have been on average, no more than 8% of national income(1).

In Great Britain, the share of income taken in taxes may have been somewhat lower. Gregory King's estimate of the national income of Great Britain in 1688 is 44 million pounds, and Dietz estimates that taxes in 1640 were approximately 140 thousand pounds, about 3% King's estimate of national income(2). These numbers are not very different from the estimates for the United States, Sweden, and Holland at the beginning of the twentieth century that I present below.

The limited and crude rate that are available suggest that tax collection rose relative to national income during the Renaissance, as nations states became organized and the opportunities to broaden the tax base grew(2). From the sixteenth to the nineteenth or early twentieth century, the share of national income taken in taxes grew very little and perhaps declined. Since that time, the size and power of the state, measured by taxes, has grown in most developed countries.

I treat the share of taxes taken by the state as a very crude measure of the power and influence of the state. There are many reasons for not using the tax share in this way(3). It is clear that some states have been both despotic and relatively frugal as long as nations states have existed, so there is not a unique relation between the share of income taken in tax collections and measures of power, despotism or the absence of freedom. On the other side, gross comparisons of the kind I have made depend on a correlation between revenues and economic power and influence that, I believe, few will deny.

I.- Defining the problem.

These are two ways to discuss the issue of growth of government. One is to try to explain why government grew relative to the rest of society from the tenth or eleventh century to the sixteenth or seventeenth and thereafter, retained a relatively constant or perhaps a declining share of national income until the nineteenth or twentieth century. Much work has been done on the political theory and the history of the organization of states that suggests in one way or another that protections or defense from internal and external enemies was a principal reason for organizing governments. There is some data, and even more anecdotal evidence, suggesting that booty, plunder, ransom and theft were not unusual means of redistributing income. The Robin Hood legend is but one of many examples. A most interesting example is a clause in the ancient laws of Wessex (England) that distinguishes various types of forcible attack. Theft occurs if fewer than seven men attack; if between seven and thirty-five are involved, they are a gang; if more than thirty-five, the group is a military expedition(5).

The growth of government as a solution to the problem of protecting persons and property is widely recognized as the type of collective action justified by economic analysis. Protection or defense eliminates an external diseconomy. We have no problem accepting this explanation of the origin of nation states.

A much greater problem, in the light of subsequent events, is to explain why governments grew very slowly, or declined, in relative power and influence until the nineteenth or twentieth century. The decline in the relative size of the state, or its failure to grow, appears to have begun before the Wealth of Nations was published. The influence of Smith cannot be neglected, particularly in the elimination of government sponsored and sanctioned monopolies, even if the relative size of government, measured by the share of income taken in taxes stopped growing before his influence was felt.

I have no explanation for the development of liberalism in the 19th century. I suspect that the limitations placed on voting rights in many places may have been of considerable importance. This explanation has the virtue of consistency with the explanation I present when I consider the second problem: the decline of the liberal society sometime after the middle of the 19th century.

Before turning to that problem and my attempt at explanation, I want to make a clear statement of the problem as I see it. Many attempts to explain the growth of the public sector relative to the private sector consider only the costs and benefits as seen by the bureaucrats and regulators. Theories of bureaucracy and the behavior of bureaucrats, whatever their other merits, cannot explain the growth of government adequately. Self-interest of bureaucrats may be an entirely adequate explanation of their desire for the growth of government. It does not explain public acquiescence. Citizens of countries in which governments are chosen by popular vote have an opportunity to stop or reverse the process. Nowhere is this done.

Two centuries ago Adam Smith understood that producers prefer monopoly to competition in the markets in which they sell. Governments, as suppliers of services, seek to monopolize the markets in which they provide services either by rules that prohibit

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(2) These figures are from Cipolla, op. cit., pp. 40 and 46.
(3) Cipolla, op. cit., pp. 45-47 presents some evidence on this point. The tax collections should be adjusted for inflation and population growth.
entry or by pricing below cost of production. Again, the question occurs: Why does the public permit the restrictions on entry and loss of efficiency to persist and even to grow?

Bureaucracy, the inefficiency and growth of government are everywhere a subject for discussions and complaint. Dissatisfaction with the high cost and low quality of government services or the arrogance of public employees is the campaign platform for such strange bedfellows as Ronald Reagan in the U.S. and Enrico Berlinguer in Italy. Yet, neither in the United States, nor in Italy, is there any prospect that the share of resources controlled and directed by government soon will decline in absolute or even relative size.

Let me emphasize that the problem is to explain the public demand for government services, not the willingness of government bureaucracies to supply more service. Suppose there is a popular demand for health care. Why are the services produced or controlled by government?

How the services are supplied makes considerable difference for efficiency and freedom. A law that requires everyone to have health insurance but permits the purchaser to choose the supplier of insurance encourages more efficiency than a law that socializes the delivery of medical services or the insurance fund. Again, there is a difference between a system that requires retirement pensions for workers but permits the worker to choose the administrator of the fund and a system that concentrates the administration of the fund in a single government agency.

Liberals may object to the use of coercion to require health insurance or pensions, but the coercion becomes far more burdensome when it is accompanied by monopoly power to allocate saving, fix prices or regulate the quality of the services that the public receives. Yet, it is now commonplace to find that the state has acquired control over a large share of private saving by assuming tasks that, according to economic theory, would be supplied more efficiently by competing private producers. Economic freedom and efficiency are reduced not only by the coercion that forces individuals to acquire particular services or goods but by the monopoly power given to public enterprises that supply the service.

One can more easily explain the use of coercion than the growth of bureaucracy and monopoly. Smith in the Theory of Moral Sentiments discussed the development of norms and community standards. Charity was well-known in the Middle Ages, and available estimates suggest that in the 16th and 17th centuries the rich gave as much as 5% of their consumption expenditure to the poor. In addition, wealth was left to the church, and a small fraction was then given to the poor.

The difficult problem is to explain the growth of government relative to the private sector in the past one hundred or more years. There is, I believe, a rational explanation of the growth of government in advanced industrial societies with representative governments. The same explanation applies in other societies in which there is a sizable middle class if political representatives are elected by popular vote.

II.- Why governments grow.

The government grows faster than the private sector whenever the cost of government can be diffused and the benefits concentrated. Diffusing cost and concentrating benefits creates incentives for expansion and disincentives for reductions in the size of government. The principal reason is that politicians can organize supporters at lower cost by offering new programs than by offering either tax reduction or elimination of existing programs.

A candidate for elective office must organize support by offering programs that appeal to a plurality. He can find a group that is willing to accept the programs he offers, or he can search for a following by suggesting programs. Each new program attracts and repels some potential followers. If a sufficient number is attracted by a particular program, the program becomes part of the candidate's platform.

Each time a candidate opposes a program, those who benefit from the program have an incentive to vote for the opposition. Some voters will be attracted and will pledge their votes. Generally, fewer votes will be gained than lost because the gain to an average voter from eliminating a program is smaller than the loss to the beneficiaries. And this is so whenever benefits are concentrated and taxes are diffused. If taxes were concentrated and benefits diffused, a coalition in favor of tax reduction would be organized to eliminate programs, reduce taxes and the relative size of government.

Candidates often run on programs favoring tax reduction, efficiency in government, elimination of waste and the «crushing burden» of regulation and taxation. Once in office the promises may be repeated, but they are not enacted. Again, the reason is that coalitions in favor of tax reduction or efficiency are costly to maintain. Because taxes are diffused, each of us gains a little from tax reduction or cost saving. Some of us can gain much more if taxes are maintained and programs are adopted that benefit us. The benefits from new programs can be concentrated to help the voters who supported the candidate or promise to support him in the future.
Coalitions in favor of benefits are, therefore, more efficient than coalitions in favor of tax reduction. They can be organized and maintained at lower cost.

A competitive political process sustains efficient coalitions and eliminates inefficient coalitions. The members of a group favoring tax reduction and smaller government can be bid away by finding benefits that reward the members. Such benefits include specific tax reduction, subsides, regulation of competitors, tariffs and licensing. It is not accidental that many of the once strong liberal political parties in Europe have either disappeared or abandoned classical liberalism.

An efficient private enterprise provides an opportunity for someone to buy the assets, improve their use and capture the gain. Waste and inefficiency can be converted into wealth, and the gain can be captured by those who acquire the assets.

The political process does not offer comparable opportunities. A coalition has little incentive to eliminate inefficiency, reduce the size of government and cut taxes. The gain must be shared with those who contributed little or nothing to the coalition. The benefits must be diffused.

If I am correct, there is a flaw in the operation of representative government. The flaw produces the growth of government. The government grows, faster at times slower at times. On average, government grows.

The argument does not depend on a particular type of tax system. A graduated income tax may facilitate the growth of government by fostering the belief that the 'rich' can be made to pay a disproportionate share of the cost. But, government grows or remains large in countries like Italy, where income taxes are said to be difficult to collect and in Britain or the United States where evasion is more difficult. Moreover, government in the United States grew more rapidly than the private sector in the 19th century when the income tax was unconstitutional.

Tax diffusion can be achieved by using sales or value added taxes or by taxing imports. Tariffs on imports were a significant source of revenue in the 19th century United States, and much political activity was directed toward tariff issues. Coalitions formed to secure two types of benefits. One restricted competition from foreign suppliers. The other prevented restrictions on imports of raw materials. Low tariffs on goods purchased and high tariffs on goods sold appealed to manufacturing interests. By making the tariff sufficiently complex, the benefits could be concentrated. The direct costs paid by the user were hard to detect, and the economic costs resulting from the elimination of competitions, restriction on choice and reduced efficiency were more diffuse.

Industrialized countries in which governments are elected by popular vote are particularly likely to have the cost of government diffused over a large part of the population. The reason is that, in modern industrial society, a wide range of specialized skills and talents are employed. Compensation of skilled workers, managers, and professionals pushes much of the population away from the extremes and toward the center of the income distribution. As the middle class grows relative to the extremes, the base of a broad tax system develops.

A wide distribution of skills, talents, interests, products and attitudes provides opportunities for political activity. As the number of identifiable groups increases, the opportunity to develop political programs that appeal to specific groups increases. As tax rates rise, individuals have more to gain from tax exemption and services provided by government at the expense of general taxpayers. The gains from political activity increase.

Smith generalized from the pin factory to economic activity when he developed his famous proposition that division of labor is limited by the extent of the market. We may extend his proposition to include political activity. The number of specialized programs that can be offered depends on the number of identifiable group interests in the community. The number of such groups increases with income and the size of the market.

There are other, related reasons for the relative growth of government. As per capita income rises, the cost of engaging in political activity increases. Time spent on political activity is time withdrawn from work or leisure. Again, there is an opportunity for the group to gain from division of labor. Political organizers encourage the formation of interest groups and, for a salary of fee, seek to make the group interest a matter of public interest.

Two elements appear to be critical. One is the system of representative government. The other is the distribution of income.

A direct democracy that required citizens to consider and approve programs would make the organization of effective minority coalitions much more difficult. Information about the beneficiaries of government programs would be widely disseminated, and voters would be required to vote taxes to pay for programs. Direct democracy is costly to operate and maintain, however.

Societies with a few rich and many poor rarely sustain representative government. The opportunity for the poor to tax the rich is too obvious to ignore and too attractive to avoid. Even if a majority recognizes that investment and economic development raise the future income of the entire group, there are opportunities for some to gain now by increasing their benefits and taxing the «rich».
concentrating benefits and directing costs to others raises the wealth and position of the successful coalition. While they hold power, they gain.

Of course, the taxes or exploited group need not be the rich. Any group that has property or labor can be taxed to pay for the benefits distributed to the members of the ruling coalition. The result of this process in many countries is a series of shifting coalitions that frequently ends with the establishment of dictatorship. Some non-elected government maintains power and redistributed wealth to its supporters.

Dictatorship is not the only outcome. Multiparty systems with shifting coalitions have governed in Italy, in France and elsewhere for long periods. If the governing coalition has a small majority, few new laws or regulations may be passed. The growth of government continues, however, by administering existing programs to benefit supporters. Crises occur when new taxes must be levied to pay for the additional costs of public programs. At such times, the multi-party coalition may break apart, and a new coalition must form. As economists we are accustomed to think of the liberal economy mainly in terms of markets. We recognize that political freedom is rarely achieved without a large measure of economic freedom. But the converse need not be true. The granting of one vote to each citizen grants power to redistribute and reallocate produced by the market. I know of no reason to expect that there is a stable, long-run solution consistent with large measures of economic and political freedom, majority rule and one-man, one vote.

III. Some evidence of the growth of government.

Most popular explanations of the growth of government differ from the argument I have advanced. They attribute the current size of government to some recent event or change in attitude. The depression of the 'thirties, war, the growing power of the military, urbanization of the population are all offered as explanations. None of these explanations is satisfactory. None explains why free men in countries all over the world permit the process to continue. Furthermore, the growth of government occurs in countries with both large and small military establishments, in countries with small armies and large, in countries differing along many dimensions. While these differences may help to explain differences in the rate of increase of government, they cannot explain a process that appears wherever governments are elected by some form of popular vote.

Some explanations of the growth of government could be dismissed more readily, if we knew more about the growth rate. There are no simple, unambiguous measures of the size of government, the growth of government or the power of government. Governments conduct diverse programs and engage in commercial and industrial activities. Governments may be relatively small but powerful, or large and benevolent. Power and size increase together, but not in a one-to-one relation.

I have recently developed two measures of the growth of government in the United States. Both are measures of relative growth, and both are imperfect. One compares the growth of tax payments, in dollars of constant purchasing power, to the growth of total income produced in the country, in dollars of constant purchasing power. If government takes a large share of income, government grows. The second compares the growth in the labor forces employed by government to the total labor force. Government grows, according to this measure, when the bureaucracy increases relative to the labor force. The table shows the various measures and the periods for which they have been calculated. All levels of the U.S. government—federal, state and local—are included.

Table 1

<table>
<thead>
<tr>
<th>Years</th>
<th>(1) Average Annual Growth of Taxes (%)</th>
<th>(2) Average Annual Growth of Income (%)</th>
<th>(1)/(2) Relative Growth of Govt. Labor Force (%)</th>
<th>(3) Annual Growth of Govt. Labor Force (%)</th>
<th>(4) Annual Growth of Total Labor Force (%)</th>
<th>(3)/(4) Relative Growth of Govt.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1901-74</td>
<td>5.39</td>
<td>3.17</td>
<td>1.70</td>
<td>3.46</td>
<td>1.62</td>
<td>2.14</td>
</tr>
<tr>
<td>1901-29</td>
<td>4.67</td>
<td>3.20</td>
<td>1.46</td>
<td>3.43</td>
<td>2.06</td>
<td>1.67</td>
</tr>
<tr>
<td>1929-51</td>
<td>7.17</td>
<td>2.92</td>
<td>2.46</td>
<td>3.40</td>
<td>1.26</td>
<td>2.70</td>
</tr>
<tr>
<td>1951-74</td>
<td>4.55</td>
<td>3.37</td>
<td>1.35</td>
<td>3.56</td>
<td>1.57</td>
<td>2.27</td>
</tr>
</tbody>
</table>

Roughly, the U.S. government has grown twice as fast as the economy during this century. The columns labelled «Relative Growth of Government» show that taxes have increased at a rate that is 1.7 times greater than the growth of the economy on average for this century, and employment in government has increased more than twice as much as the labor force. At times, especially in 1929-51, the years of depression and war, the government grew substantially faster, as much as 2.5 to 2.7 times faster, than the growth of the economy and the labor force. Recently, the rate of increase of taxes may have fallen, but real tax burdens continue to rise relative to income.

Federal government tax collections are available for the U.S. from 1972 on, so we can compute the annual average growth of the Federal government during more than 180 years since Washington became president. From 1972 to 1974, taxes paid to the Federal government during more than 180 years since Washington became president. From 1972 to 1974, taxes paid to the Federal government rose 5.1/2 percent a year after eliminating the estimated effect of inflation. I am reasonably certain that this rate of increase is above the growth rate of income. Per capita income in 1792 would have been only twenty dollars if per capita income and taxes had increased at the same rate. Twenty dollars per capita is too low to be a correct estimate of income in the early years of the U.S. republic.

At the beginning of the century, taxes absorbed 8 percent of income and government employed 4 percent of the labor force. By 1929, the share of income taxed away was 11 percent, and six percent of the labor force was employed by government. By 1974, 32 % of income was taken in taxes and 15 % of the labor force was employed by government at all levels. If recent rates of growth continue, the government will absorb 50 per cent of income and employ 25 per cent of the labor force by the end of the century.

Comparison with other countries is instructive. Computations for Sweden show a substantial change in the relative growth of the private and public sector in the last quarter of the 19th century. From 1792 to 1870, per capita taxes in constant prices rose at an average rate of 0.14 % per year. At this rate of increase, real per capita tax collections double about every 500 years. From 1870 to 1974, per capita real tax collections rose 4.35 % per year, a rate of increase that implies a doubling every 17 years. The rate of increase has not been constant during the past 100 years and, as in the United States, was highest during the period of depression and war. For the years 1901-74, and for the most recent quarter of the century, per capita taxes at constant prices have increased at a compound annual rate of approximately 5.3 %.

The rate of increase in per capita taxes should be compared to the rate of growth of per capita income. For Sweden, data for the twentieth century as a whole show a growth rate of the public sector 1.8 times greater than the growth of per capita real domestic product. The relative rate of growth of the public sector during subperiods is shown in Table 2.

Comparison of the relative rates of growth of government in Sweden and the United States shows a very similar pattern. There is acceleration during the years of depression and the Second World and deceleration after the war. Throughout the century government has grown faster than the private sector.

The Netherlands provides my third and last set of data. Tax data are for the central government only, so they underestimate the percentage of income taxed. Nevertheless, they suggest the trend in the relative growth of government. The share of national income taken by the central government increased from 6.5 % in 1900, a number within the range estimated for the Renaissance, to 9.3 % in 1929, to 24 % in 1951 and 39 % in 1974. These data are accompanied by similar data showing increases in the share of the labor force absorbed by government. The latter has doubled in the last half century.

<table>
<thead>
<tr>
<th>Years</th>
<th>(1) Growth Per Capita Taxes at Constant Prices</th>
<th>(2) Growth Per Capita GDP at Constant Prices</th>
<th>Relative Growth of Public Sector (1)/(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1901-74</td>
<td>5.38</td>
<td>2.92</td>
<td>1.8</td>
</tr>
<tr>
<td>1901-29</td>
<td>3.38</td>
<td>2.43</td>
<td>1.4</td>
</tr>
<tr>
<td>1929-51</td>
<td>8.11</td>
<td>3.14</td>
<td>2.6</td>
</tr>
<tr>
<td>1951-74</td>
<td>5.27</td>
<td>3.29</td>
<td>1.16</td>
</tr>
</tbody>
</table>
I am sure that data of this kind showing the relative growth of government in recent years is not surprising. What seems surprising is that there is evidence that the government has grown faster than the private sector during most of the twentieth century.

As the size of government grows, the costs of slowing the growth increases. More of the population is employed by government, and there are more votes for candidates that promise programs that increase the power and influence of government officials and the income of the bureaucrats. There is an ever increasing number of recipients of aid and subsidy who see their interest allied to the interest of the bureaucracy. As tax rates rise, the value of government «benefits» to a recipient increases if the benefits are exempt from tax. The programs absorb labor into the government, so average tax rates rise, but redistribution occurs. The winning coalition improves its position, at least in a relative sense, by expanding the programs it favors.

A principal redistribution is from taxpayers to government employees. The percentage of the labor force employed by government has increased along with the percentage of income taxed and, in the United States, the two ratios increased at approximately the same rate. Both have doubled and redoubled in this century. A sizeable fraction in the labor force, and in the voting booth, benefit directly from programs that increase their income and the power and influence of government.

CONCLUSION.

The present size of government does not appear to result from some short-term aberration or change in attitude. The process has continued throughout the century, at different rates, but in the same direction. Wartime expansions were followed by contraction but the postwar size of government was generally larger than the pre-war size of government and governments continued to grow.

I have argued that to explain the growth of government, we must recognize that there is a flaw in the system of representative government. Voters form groups or coalitions to redistribute benefits to themselves. Generally more is gained by promising to increase benefits selectively than by reducing taxes or eliminating programs. No party or coalition can remain in power permanently, but parties can expect that opponents will use power to gain selective benefits without reducing benefits to others.

The government grows as a result of rational behavior. Individual and groups concerned with their own interests seek benefits that, however real, must for many be temporary. Yet, the loss that many experience from the continued growth of government does not produce a winning coalition that gains from reducing the size of government.

Nothing about the process is inevitable. The growth of government could be brought to an end by constitutional limitation. That limitations of this kind have not been imposed, may tell a great deal about the cost of organizing, persuading and uniting a group large enough to accomplish that goal.

Adam Smith warned about public profligacy and recognized that kings and ministers — governments we would say — are always the greatest spendthrifts. Smith recognized, too, that men may seek to gain by establishing monopoly positions. He failed, however, to see the potential conflict between market freedom — based on individual choice and the given distribution of wealth — and political freedom, based on one man, one vote at the ballot box. This failure is, I believe, a principal reason that this system has not become the most prevalent system in the world but is now declining in importance even in these places where liberal principles are still espoused.