1995

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Published In
Bank of Zurich Trust, Zurich.

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On the State, the Market, and the Responsible Individual
by Allan H. Meltzer

A few years ago, a popular subject for discussion among the policy class was a book by Francis Fukuyama called The End of History. The main idea is that the end of the cold war, the collapse of the Soviet Union, and the release of Eastern and Central Europe from Communism have produced a lasting solution to the long struggle between democratic capitalism and totalitarian socialism. Democratic capitalism has emerged as the victor in the struggle. For the foreseeable future, Fukuyama claims, democratic capitalism will flourish everywhere.

Several critics rejected this reasoning. The principal criticism is that the book ignores the rise of Islam and other political challenges to democratic capitalism. I believe the principal failure of Fukuyama's argument lies elsewhere. He neglects very important differences within democratic capitalism that will be a source of conflict over trade, taxes, the welfare state, organization of society, and other central issues.

Collective Action and Individual Freedom

In practice, both democracy and capitalism cover a wide range. Democratic practices in Japan, Korea or Singapore are very different from practices in the Western Europe or North America. The Swiss tradition of using referenda to decide contentious issues is an example of an important difference in democratic practice that leads to a significant difference in the power of elected officials to raise tax rates, subject its citizens to the rules of international bodies like the European Commission, or increase the size, power, or influence of the state.

Customs, constitutions, and traditions have a large role in setting the boundaries between collective action and individual freedom. Collective action typically involves coercion; the group has the authority to impose its judgment on the individual. Freedom implies that individuals must accept the consequences of their own actions, the working of chance, and the effects of others actions.

A free society cannot progress or advance unless it requires individuals to be responsible and self-reliant. Rational action and purposeful endeavor require that
individuals be accountable for their decisions and actions and be rewarded for their achievements. Managers and workers must cooperate in production; teachers and students cooperate in education; husbands and wives cooperate in raising children. Each party has responsibility for particular actions. When combined with the actions of others, solutions are obtained to everyday problems and rewards are distributed. This is an efficient system for solving problems. It is not perfect; it relies on the actions and cooperation by individuals.

The Role of the Market

The powerful insight of Adam Smith was to recognize the great forces of responsible individuals cooperating in the production of goods and services and in the conduct of human affairs generally. He called this process division of labor and relied on the incentives in the marketplace to produce harmony and progress.

One of the lessons of this century is the power of individuals in a market economy to improve their lives and the lives of their children. In the past fifty years, more people in more countries have experienced larger increases in standard of living or income than at any time in recorded history. Life expectancy has increased dramatically, particularly in many of the countries that were poor at the end of World War II. Individual effort, working through the market system, produced what is often described as a miracle.

There has been no miracle. It is the ordinary working of the market system that produced these gains. The market system encourages people to improve their product or service as a way of increasing their income or making it more secure. The same process encourages people to want to learn and improve their skills, just as it encourages others to save, invest, invent, and innovate to improve the quality of the capital and tools available. These decisions are left to responsible individuals acting on their own initiative, following signals from the marketplace.

The postwar decades constitute a great experiment in the properties of systems of social organization. The results of the experiment are as clear as are likely to be found in the social sciences. Where the market system and individual decision making
have operated, typically economies have developed, standards of living have increased, education and health have improved, and democracy has been encouraged. Progress and freedom have increased together. Where some form of centralized, socialist planning has been tried, the typical outcome has been economic stagnation and political repression. There is less sustained progress than in the market economies and less political freedom also.

The clearest comparisons, and the most useful experimental evidence, come from those countries where we can hold constant factors that may affect the pace of economic development, such as habits, history and culture. Taiwan, Hong Kong, and Singapore, together or separately, can be compared to the People's Republic of China. West Germany can be compared with East Germany, South Korea with North Korea. In these comparisons, differences in history and culture are insignificant, while differences in economic and social institutions, in the roles of the individual and the state, are much wider and more important.

Fifty years of differences in economic and social arrangements produced enormous differences in each of these country comparisons. Crude comparisons suggest that in Hong Kong and Singapore average income is now eight to ten times higher than in China. Korea is probably similar. For former East and West Germany, at the time of unification, average income was between two and three times higher in the West.

Hong Kong and China are of particular interest, since Hong Kong's population includes large numbers of immigrants who fled from China in the years after 1949. At the end of the war, per capita income in Hong Kong was less than $1000. It is now above $20,000. Life expectancy at birth is 69 years in China, 78 years in Hong Kong. People live longer, live better, more productive lives, have more freedom and more opportunity in market economies. We now know that they also have better health, and less pollution and environmental degradation.

Law and Property Rights

How do we explain these differences? I want to call attention to two factors.
One is the rule of law; the other is the right to own property. The two work together. Property rights are not secure where the rule of law is absent.

The rule of law means that the group accepts that the state has a duty and responsibility to protect persons and property, to enforce contracts or agreements, to provide a commercial code, to establish a financial framework, an accounting framework, and systems of standards that, taken together, I call the Hayekian infrastructure. The Hayekian infrastructure permits the market system to work effectively. Where it is largely absent, as in Russia today, the system does not produce the desirable outcomes found in a well-functioning market economy.

The postwar years saw a significant extension of the rule of law. Just as the nation states of the middle ages developed rules for trade and markets that enforced contracts and protected property, the nation states after 1948 developed rules for trade and payments. These rules, the rules of GATT and now the World Trade Organization, provide for market opening and global competition. Nineteenth century trade disputes might be resolved by sending armies. In the late twentieth century we send lawyers and negotiators instead.

This extension of the rule of law enabled countries to choose development strategies based on export-led growth. It enabled individuals to seek opportunities for profit in a world market. Economies of scale and scope, previously impossible, became common. Firms specialized their products by concentrating on those things they did best. Whole industries disappeared from some countries and reappeared elsewhere. But very often, industries did not disappear in response to competition. Individuals found ways to lower cost, increase productivity and compete.

For a time, firms in developing countries could improve the quality of their products or services by copying the best technology available in the world. Later, many firms in these countries reached the technological frontier. To maintain or improve competitive position, resources had to be used for invention and innovation. This is a costly, time consuming process. The highest skills of individuals are called upon to think about what has never before been done, to learn how to improve products and processes in new ways. These challenges required investments in
education and the development of human potential. In many newly developed countries, women began to be educated for the first time. Growth provided both the resources for improvement and opened opportunities for responsible individuals.

Export-led growth requires someone to import. Importers gain better quality, lower prices, and new designs. As imports increase, domestic firms are forced to compete by specializing at what they do best. They, too, are pushed to innovate and improve.

Property rights and individual initiative are the driving forces behind this process. Relatively secure ownership leaves no doubt about the rewards. The rewards go to those who contribute most, and the rewards -- both financial and non-financial -- are the stimulus that encourages innovation and progress.

Fredrich Hayek helped us to recognize that in a society where progress occurs, there must be inequality in wealth and income. The rewards for innovation, risk-taking, and superior performance put some in the vanguard. A consequence of this system, as Hayek noted, is that the luxuries of the past become the standard commodities of the present or future. Our own experience after fifty years of growth in living standards demonstrates the truth of this proposition.

A remarkable feature of this system is the degree to which we become capable of using machines of great complexity without any knowledge of what makes them work. Few of us understand much about the internal combustion engine, jet propulsion, microelectronics, or the computer. Yet most of us can drive automobiles, fly in airplanes, send faxes around the globe, or use a computer to write a letter, do some calculations or play a game. I am often surprised when a four or six year old child -- often one of my grandchildren -- instructs me on the correct way to perform some operation on a computer.

The market system allows tools of the most extraordinary complexity to become available for everyone. The individuals who design and improve these systems receive high rewards. But their rewards can only come if they sell their products to the rest of us. And we, in turn, improve our ability. We can travel farther, fly more quickly, compute with extraordinary speed. We can call on information that is more extensive
and complete than anything that was available to the most learned scholar who lived fifty or a hundred years ago.

This tremendous force for progress and improvement depends on the maintenance of secure property rights and the rule of law. These provide and protect the incentives that produce effective innovation out of the process of search. Without them, there is less incentive to create, improve, sell, and prosper. There may be more uniformity, more equality of outcome, but there is less progress.

This is a main lesson of the last fifty years. At first small differences in growth rates may seem trivial. Socialist countries for a time appeared to grow faster than market economies. This was an illusion created by the way we count output. When the Soviets built their dams, steel mills, and factories, they (and we) counted the output as if it were as valuable and as useful as our own. But it was not. The factories were inefficient, often poorly located based on arbitrary political decisions. The work force was untrained and with few incentives to improve productivity. The capital proved to be unproductive.

We did not learn this right away. This led to gross mistakes in the west about the capabilities in the east. As late as 1989 Western experts thought East Germany had become almost as rich as many western countries. It was illusion. We now know it was not so.

The Continuing Challenge

Why did socialism appeal to so many people in the west? Why does its appeal continue? Why did so many intellectuals apologize repeatedly for socialism's failures to achieve improved merits in living standards and personal freedom?

I believe that part of the answer is the utopian view that a well-intentioned government, using coercion, can achieve greater equality of outcome without sacrificing freedom or living standards. This idea, often called social justice or fairness, is more clearly described as wealth redistribution. Making outcomes, incomes, and wealth more equal, is supposed to improve society. The loss to the rich is thought to be less than the gain to the poor. An extreme form of redistribution occurs
under socialism; people are not allowed to own property because ownership, in the jargon of the socialists, gives the right to exploit workers. This right, under socialism, belongs to the state.

A capitalist market economy differs from this extreme, but here, too, there are many restrictions on the use of capital. The boundary between what owners are permitted to do and what is restricted or forbidden changes. Some of these restrictions reflect valid social concerns about costs imposed on others. Other restrictions on ownership reflect payments for shared benefits. Police and defense are examples. However, most taxes and restrictions on capital arise from the desire of one group to gain at the expense of another.

Modern democratic politics is foremost about who pays and who receives. Those who do not succeed in the marketplace often go to the voting place for assistance. Companies that are in danger of failing ask for support to maintain employment. Laws favoring one group are paid for by all others. Organized groups gain at the expense of the unorganized, so it is advantageous to be organized. Government, the state, assumes a larger role.

Germany is an example of the change in the role of government. Under the banner of the social market economy, postwar German governments have grown in size and power. At the beginning of the twentieth century, tax revenues were less than 5% of the value of Germany's output. By 1930, pre-Hitler, this share was still below 10%. As we leave the twentieth century, the German governments' share will be at least 40%. In this century, the German governments' tax share has increased 8 to 10 times faster than the economy.

Germany is not unique. With modest changes in the numbers, the same is true for all western countries. Moreover, these numbers understate the growth of government. Promises to provide future pensions, health care, and social transfers to aging population cannot be paid without much more rapid growth of output or higher future tax rates.

The increased role of government in providing pensions or paying for health care and social services is so widespread that no one asks why this happened. The
government cannot provide pensions. Doctors, nurses, hospitals and drug companies provide health care. All government can do is to shift the cost of those pensions from one group to another. In many countries, the largest benefits went to the first recipients. They paid little or nothing. Later generations paid. The only advantage of government pensions over privately funded pensions is the ability to redistribute the cost to some other group or some other time.

Redistribution is not free. The costs are greater than the amount transferred. Shifting the cost to others means that users do not see the cost and, most often, do not care about it. Pensions, health care, and other social benefits become rights with demands for service that rise. The demand for these services increases. Price controls and rationing by waiting lines or other inefficient means have become common in many countries as ways of limiting demands for health services. These inefficiencies are unnecessary additions to the cost society pays for the service.

These are not the only costs. In many countries, pensions and health care are partly financed by payroll taxes. Each worker pays part of his or her wage to a general fund. In Germany, the combined wage tax is 36% of the wage compared to 21% in Switzerland, 29% in the United States and 41% in France. These taxes, whether collected from the employer or the worker, must be borne by the worker. Employers cannot for long pay workers more than the value they produce. Costs of employment, including wages, benefits, and all taxes on the use of labor, must be earned by the worker.

There are three additional costs of redistribution -- unemployment, reduced self-reliance and personal responsibility, and lower personal saving rates. Most western countries have experienced one or more of these problems.

Unemployment is most apparent in western Europe. A married French worker with two children who is paid 10,000 francs, receives only 8800 francs in his paycheck. The employer's cost is 12750 francs, so the employer's cost is 45% more than the income the worker takes home. In Germany, a similar employer pays 52% more than the worker takes home. Since both countries have generous unemployment benefits, the return to work is low, especially for the young and unskilled, and the costs of hiring
labor are so high that it pays to use capital and save labor.

The worker loses not only employment but the opportunity to develop skills on the job. We all learn important skills at work. As we acquire new skills, we advance. Without these skills, we remain beginners or trainees lacking skill and unable to advance.

Particularly in the European Union, the unemployed become wards of the state. In 1993, 40% of Germany's unemployed had been unemployed for 12 months or more. In France, the long-term unemployed are 34% of the total, but in Italy, Spain or Belgium, 50% to 60% are long-term unemployed. In the United States, the comparable percentage is 12%. Benefits are lower, taxes on the use of labor are lower, so the unemployment rate is lower.

Permanent or long-term unemployment removes both personal and social responsibility. The individual looks to the state for a handout. If he or she works at all, it is in the underground economy where no taxes are paid to support the system that supports them. The system not only destroys individual dignity, it has corrosive long-term effects on society. People live outside of the law, they violate laws repeatedly without punishment.

Among the most important reasons for personal saving are to provide for old age and poor health. When the state takes over these functions, there is less reason for individuals to save. Personal responsibility is replaced by collective responsibility. As Joseph Schumpeter warned in *Capitalism, Socialism, and Democracy*, the cultural foundations of capitalist society are weakened when personal responsibility declines.

Looking back, the proponents of the welfare state must be disappointed. The weakening of personal responsibility leaves all western countries, to greater or lesser extent, faced with large social problems. Drugs, illegitimacy, and crime, have increased with the welfare state and redistribution. The tax burden has risen, and the governments' promises to pay for health care and retirement look ever more doubtful. In many countries, these promises will not be fully honored.

The costs of redistribution have been high, the benefits modest. Sweden is often an example of a country that has made major efforts to redistribute income.
According to the World Bank, in Sweden, the poorest 20% of the population receive 8% of household income. This is much higher than in Denmark, 5.4%, Norway, 6.2%, or France, 5.6%. In the United States, usually cited a country with very modest amounts of redistribution, the poorest 20% received about 4.7% of household income.

Suppose the United States were to match Norway by redistributing an additional 1.5% of household income to the lowest 20% of the population. This is an extraordinary change. The income of the lowest 20% would increase from about US $5400 per capita to $7100. This is, of course a static comparison that makes no allowance for the effect of the higher taxes required to finance the redistribution. If output growth slowed by only 1/10 of 1% for five years, the cost of the transfer would be $25 billion in lost output.

Suppose instead that the redistributive programs remain unchanged, but tax rates are reduced and personal incentives increased. More of the welfare recipients work productively. If the growth rate increases by one percentage point to 3.5%, the income of the poorest 20% would increase by $1700 in less than 8 years.

In 8 years, the average income of the poorest 20% of the U.S. would rise by the amount they would receive if the U.S. adopted Norwegian style redistribution. The comparison does not end there. The society is richer because growth raises everyone's living standard. And if the higher growth continues, both the poor and the rich continue to gain.

As Nobel laureate Robert Fogel has pointed out, the great gains in living standards, health, life expectancy, and education have come from growth not redistribution. This lesson has been neglected. We are all poorer for having neglected it, and the poorest among us have lost both opportunity and the sense of personal worth that can only come from personal achievement, self-reliance, and personal responsibility.

Not just economic, but social problems also, improve with self reliance. As a teacher for more than forty years, I know that students only learn if they choose to learn. Learning requires effort and motivation. It cannot happen without discipline, especially self-discipline. Nor can we develop responsible citizens if we fail to develop self
reliance and personal responsibility.

In this century, the western world has won great victories for liberty and property over totalitarianism. It is in danger of losing the self reliance and responsibility that made those victories possible.