

How Big Should Government Be?

Richard A Epstein

NEW ZEALAND BUSINESS ROUNDTABLE



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Richard A Epstein

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His books include *Skepticism and Freedom: A Modern Case for Classical Liberalism* (University of Chicago, 2003), *Cases and Materials on Torts* (Aspen Law and Business, 8th edition 2000), *Torts* (Aspen Law and Business, 1999), *Principles for a Free Society: Reconciling Individual Liberty with the Common Good* (Perseus Books, 1998), *Mortal Peril: Our Inalienable Right to Health Care* (Addison Wesley, 1997), *Simple Rules for a Complex World* (Harvard, 1995), *Bargaining with the State* (Princeton, 1993), *Forbidden Grounds: The Case Against Employment Discrimination Laws* (Harvard, 1992), *Takings: Private Property and the Power of Eminent Domain* (Harvard, 1985) and *Modern Products Liability Law* (Greenwood Press, 1980).

Professor Epstein has written numerous articles on a wide range of legal and interdisciplinary subjects. He has taught courses in civil procedure, communications, constitutional law, contracts, corporations, patents, individual, estate and corporate taxation, Roman law, criminal law, health law and policy, legal history, labour law, property, real estate development and finance, jurisprudence, land use planning, torts and workers' compensation.

How Big Should Government Be?

Do we need government at all?

The question I have been asked to address is ‘How big should government be?’. My temptation is to start with the position that they who govern best govern least. But that apt phrase leads to the conclusion that there should be no government at all, which I regard as an untenable solution to the problem of ordered liberty. So, in casting about for a title that summarises the tension in my own position, I would substitute one that is in the same breath both clumsier and more accurate, namely: ‘Why small governments are enormous, and how can we prevent them from getting even larger?’. Some explanation is surely needed.

As a liberal of the classical variety, I start with a strong presumption against the imposition of public authority into ordinary human affairs. Even with this caveat, it turns out that the set of legitimate government functions is large. Having acknowledged an irreducible, indeed substantial, role for government, it is also incumbent that we recognise that today governments commonly arrogate to themselves many tasks above and beyond what we need them to do. Most of these extensions result in failure. As an administration expands its range of activities, personnel are diverted from essential tasks and directed toward functions that should not be undertaken at all. Unwisely stretching human resources thinly over multiple activities will result in greater inefficiency. The problems are of scope and mission design: undertaking tasks that should not be done makes it impossible to excel in the tasks that should be done.

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The 'span of control' problem is very important. The United States offers an example of a hyperventilating political system. Senators and congressmen in Washington DC each have hundreds of issues on their agendas. Within a voracious institution like Congress, the average senator or congressman will typically serve on multiple committees and subcommittees: frequently two or three of these meet simultaneously. Occasionally, the only elected official present is the head of the committee. The others present are the ubiquitous staffers, who increase in number with each passing year. The centripetal forces ever at work leave politicians simply no room for the division of labour or specialisation required to develop expertise in any of their many tasks.

Rather than lament the inadequacies of the current system, however, I propose to perform the mental exercise of starting over, that is, of building a model government from scratch. This experiment requires us to start with no particular form of political or social organisation. The exercise will lead us to conclude that, when serious government functions are taken seriously, the size of government will be considerably larger than we might have hoped, but far smaller than the bloated governments of today.

It is difficult – and ultimately unhelpful – to prescribe exactly how large government should be in dollar or percentage terms, because the right share of public expenditure in any economy depends in good part upon the local environment and the external situation at any given point of time. After the terror attacks of September 11, 2001, a broad consensus concluded sensibly that the size of many governments in the West had to increase, at least temporarily. A rigid requirement that only a fixed percentage of national income should be spent on public affairs would hamper the efforts of nations to respond to such situations. Some release mechanism is needed to allow rapid responses to sudden shocks.

Yet at this moment, I do not want to dwell on these transitional issues. Instead, the first question in our mental experiment is to establish whether and why we need government at all. My friend and law and economics colleague David Friedman from Santa Clara University in California, who recently visited

New Zealand, is by temperament an anarchist who believes the optimal level of government is close to zero. For someone like him, there is not much point distinguishing among different public functions: there is next to nothing for a sound government to do. His alternative to government rests fundamentally on a series of multilateral contracts that bind individuals to groups and these groups to each other. The argument begins with the familiar observation that when people are in a state of nature, they are likely to commit harmful actions against one another. As individuals, they will be powerless to stop these actions from occurring. Therefore, they will form alliances and coalitions with like-minded people, paying voluntary dues to an organisation that will protect them against both their own members and outsiders, whether acting alone or in groups.

This system of competitive protective associations results in the emergence of many independent groups, operating side by side, without clear territorial boundaries. If dispute resolution between individuals could be effectively handled by these groups, this scheme would obviate the need for taxation by foreclosing any debate on the proper size of government. However, coordination within and among these groups would be extremely difficult to facilitate. If someone joins an association and does not pay the dues, will that person be expelled? Will they be left powerless and unprotected? What model of criminal prosecution does this system contemplate? When the nature of an offence and the identity of an offender are known, prior contracts might give rise to an acceptable solution. But who controls the prosecution of unsuccessful unlawful actions? Who enforces the contracts? When the assailant is unknown, or the crime is not of a one-on-one variety, who will investigate, and how will they secure the cooperation of members of other groups, some of whom may have an interest in shielding their compatriots from scrutiny?

Attempting to answer such questions leads us quickly to the Coasean conclusion that the transactional difficulties of coordinating business among these unstable associations are sufficiently great that it would be preferable to lurch to the other extreme, by creating a monopoly of force – a government. Indeed, the gains from centralised coordination are so great that these private voluntary associations could not coexist over the long haul. The

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choices are rather more stark. If sensible individuals do not use coercion against holdouts to organise a government on their own terms, then some thug will quickly fill the void. Despotism, not liberty, is, regrettably, the necessary consequence of anarchy.

What should a government look like?

Having concluded that some government is necessary, we must consider what tasks this government will undertake. Let us start with a very simple model of the world – one that is invoked by most classical liberals. Unlike anarchists, classical liberals believe in small government based on an astonishingly small number of principles that seem to work effectively over a very broad range of human activities.

The first principle is self-ownership, or autonomy, with respect to labour. Here, one should not be too literal in interpreting self-ownership, for clearly the relationship that any person has to their body is different from that person's relationship to an external thing. But the phrase does signal that individuals have the right to bodily integrity on the one hand, and exclusive control over their own labour, on the other. Ordinary ownership, with the rights to exclude, use and dispose, can then develop over tangible forms of property. Suitable modifications can take place to patents, copyrights and other forms of intellectual property. In general, we prefer a system of private property and voluntary exchange that limits forced exchanges to narrow cases where transactional obstacles, such as those that surround the formation of government, prevent the emergence of markets. The markets that emerge by the consistent application of these rules in turn require a limited government, the chief purpose of which is to ensure the rules of the game are not opportunistically broken or bent by any individual for private advantage. As with clever advertisements, a huge amount of knowledge about this very complicated system can be compressed into just a few words, so people can easily grasp the way it operates.

However, my task here is not to compress information by using advertising slogans, but to do the opposite. To gauge how large government should become, we have to deconstruct seemingly simple tasks that a

government has to perform. Once we look at each part closely, we shall reveal a pattern in which government has to assume a widening range of roles, each with its own complications.

Domestic law and order

As noted above, the nutshell theory of government requires that the state be able to limit the use of private force. The various permutations associated with simple injunction, however, turn out to be legion. The most obvious cases involve physical aggression by one person against another. Nobody believes wrongdoers should be allowed to escape all consequences for actions that bring loss and misery to others. The stemming of aggression requires the development of criminal and tort law, both of which initially take on an after-the-fact (*ex post*) perspective and mete out civil sanctions, fines or criminal punishment. The purpose of this system is to create incentives for people not to engage in those coercive activities. We believe that penalties or compensation *ex post* will have a powerful deterrent effect before the fact (*ex ante*).

Usually, this simple equation holds. The overriding question, however, is whether any system limited to *ex post* sanctions will prove resilient enough to prevent or limit adverse occurrences. The alternative says that this *ex post* system must be supplemented by some form of *ex ante* protection – such as a police force or some similar institution. There is little suspense in answering this question. Every legal system on the planet has abandoned a strategy of pure *ex post* punishment for wrongs. Each in its own way adopts other systems to minimise these adverse occurrences from the *ex ante* perspective.

However, the choice of an appropriate system of prior restraints is immensely complicated. Some remedies are privately enforceable, such as a dispute between two neighbours where one constantly hurls rocks at the other's property or dumps polluting waste on it. Private injunctions could be used against the offender to stop them. But in situations where we do not know who the offender is, or the people whom they will target, private injunctive remedies will not suffice.

So the scope of state power expands with the establishment of some sort of police force, whose institutional design is no mean task. We – and who 'we'

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are has to be specified – need to decide how to hire, deploy and discipline the police force, and how to allow it to provide security against crimes that may be about to take place and to run investigations into offences that have already occurred. The body of law associated with criminal procedures is large and complicated. Yet, there is no way I can see to eliminate these functions from the purview of government. In our daily world we have left the realm of simple legal theory that tells us ‘this is a right’ and ‘this is a wrong’, but little else. Instead, we find ourselves stranded in uncharted waters with a large number of actors and a great deal of uncertainty. To cope with these institutional details, we need intelligent principles of government administration. Even in the private sector where market incentives keep agents in line, the transaction costs of monitoring behaviour can be high. Because the incentives of a police department or investigative agency are harder to structure, the demands on public management will be great and the dangers that state agencies might misfire will be large. These institutional costs are troublesome even in the most minimalist of states.

Licensing systems

A police force, however, is one component of a comprehensive system of social control. In addition, every legal system has to organise some form of licensing or permit system. The gist of this system is that people are allowed to engage in certain activities only if they first obtain a permit from the state. If you want to keep a lion on your premises you will need to obtain a licence, which will be difficult to do if you do not run a zoo. Most adults hold a driver’s licence, which shows they have gone through a government test to obtain permission to drive a car on a public road. Licences and permits are used for construction, medicine, law, marriage, hunting and many other activities too numerous to list – or ignore.

Each licensing system that the state creates has to be administered. Although it is widely underappreciated, one of the major functions of every government is maintaining lists of licence-holders. Such lists need constant updating because of new licences being granted, existing ones being suspended, people dying, corporations dissolving and so forth. As with domestic law and

order, any licensing system is open to abuse because licences are a form of power. Individuals can bribe officials to obtain licences – a private subversion of the system. For every private abuse of that sort, there is the symmetrical abuse by the government, of which the most common is the demand for bribes before licences are issued.

Even if we put the insistent challenge of corruption to one side, however, someone has to decide which licences should be granted, which withheld, and why. Licences are rarely issued on demand; certain conditions have to be satisfied. But which? Here it is easy to identify common situations where inappropriate conditions are attached to licences. For example, the government may only allow doctors to practise medicine if they agree to spend a week every year at a clinic owned and operated by the state. Or the importation of goods is allowed only if certain taxes are paid to the government, or if the goods are shipped in certain kinds of containers.

Licensing private activities, then, requires a massive administrative structure, which in turn must follow a powerful body of constitutional principles. It is irrelevant whether such principles are part of a formal constitution, as in the United States, or informal, as in New Zealand. The key point is that licences cannot be used as a stick with which the government can destroy lawful occupations practised by private individuals. How do we distinguish legitimate from illegitimate conditions? The key question is how to respond to the two forms of error that arise under uncertainty: blocking activities that should be allowed – the false negatives – or allowing activities that should be blocked – the false positives.

We can illustrate the approach by starting with a simple case of domestic violence. Here the libertarian prohibition against aggression is inadequate to the task. This shortfall does not result because the model starts with the wrong moral instincts, but because it does not address the question of uncertainty that would help us decide what to do when we cannot identify in advance wrongdoers and innocents, the extent of the potential harms, or where offences may take place. Dealing with these uncertainties is a quintessential management problem that drives us away from something that looks like a minimalist government. In this case, does one remove a husband from the house because

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he is likely to commit aggression? Put children into foster care, and expose them to other risks? Allow a woman to take refuge in some public shelter? Recognise that sometimes the woman is the aggressor in these relationships? My job here is not to solve these questions, but to indicate that they are the kind of questions that no one can avoid.

The same sort of issues can arise in economic contexts, whether we deal with drilling for oil or selling pharmaceuticals from abroad. In these contexts, there is one constant risk against which sound governments should guard. The licence is understood as a means of preventing certain kinds of actionable harms before they occur. Thus, we stop or regulate the operation of the power plant because of the emissions that it might cause. But we do not stop the construction of that plant because it will provide service more cheaply than the current dominant firm. We keep out foods from foreign countries because they are contaminated with pesticides. But we do not refuse to license the importation because they are of higher quality or sell at a lower price. The examples can be multiplied at will, yet the basic point is simple but insistent. The control of force is a key government function; the prevention of competitive entry is the major government failure. Licences should be denied only for those reasons that would justify the imposition of a sanction if the threatened act were completed. Hence, we can enjoin pollution or contamination but not competition. The difficulties in administration arise because sometimes an ounce of pollution prevention is worth a pound of competitive exclusion. In dealing with these cases of dual justification, the sensible government does not pretend that strong police power justifications for licensing do not exist. But it takes great efforts to see that the conditions imposed are not designed to thwart competition in the name of protecting health and safety.

External security

In one sense, New Zealand is blessed. Unlike, say, Jerusalem, New Zealand is not a location where people congregate to brew trouble. The level of security here is rightly lower than that of many other nations. In the United States, even before September 11, 2001, and certainly since, there is a high level of

concern about foreign aggression and terrorist activities. Taking action against Al Qaeda after an attack is obviously not an adequate strategy. It has been necessary to adopt preventive measures. The US national security budget now runs into hundreds of billions of dollars on an annual basis.

This security problem keeps growing. The initial aim of preventing direct threats requires stopping the movement of people who might engage in these sorts of attacks, which in turn means checking everybody who gets on an aircraft, into a train, or goes near a significant target. Then immigration and naturalisation services must be changed to try to ensure that the right people are let in and kept out. Private organisations now find that obtaining immigration clearances for key overseas personnel carries a significant cost in terms of money, time and frustration. Similar things occur elsewhere. On national security grounds, each bank in the United States must monitor every cash transaction undertaken with it to prevent money laundering and support for terrorist cells and operations.

I noted that criminal law has always recognised the inadequacy of remedies after the fact. That is why there is a body of law on attempts, another on conspiracy, and a third on aiding and abetting. The government must seek to prevent such activities by means other than just prosecutions. Even very narrow libertarian theories acknowledge that terrorist activities are criminal and every state ought to deal with them. What is socially necessary and beneficial can also be the subject of abuse and oppression. Sorting out how to maximise benefits and minimise harms is difficult, especially in the international arena. So just the control of force is a large government function that cannot be reduced to modest dimensions.

Security of trade

We have examined the systems required to convey the distinction between what is mine and what is yours, and to deal with issues involving aggression. However, a system of property rights that solely addresses exclusivity of possession prevents trade and commerce. It affords no way to take advantage of the division of labour because it supplies no mechanism that allows individuals to exchange labour or

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property. Every liberal system in history has recognised that a body of property rights must also include rules governing trade. If we examine the standard accounts of Roman law, we discover that early on, rights of disposition are included within the comprehensive definition of property.

This gives rise to a new dimension of security – the security of exchange. If two individuals simultaneously exchange something in a transaction, the enforcement function will be relatively trivial. For the most part, these ‘spot’ transactions, usually of money for goods, work out well. How many times have you experienced serious altercations when buying a newspaper? Escrow arrangements are unnecessary for low-value, repeat transactions.

However, the extent of the gains from trade depends on three elements. First, each side has to be confident that it can increase the amount of value, in either cash or property, that it is willing to put at risk. Second, the temporal dimension must be exploited – we need to provide not just for spot transactions but also ones that play out over time. Third, we have to take steps to expedite multiple transactions. This means that each person has to have the ability to make agreements with many different people at one time – and maintain, when desired, some parity among them. Or, it means that the rules must allow for a person to resell or reconvey the goods that they have just received from one person to another. Manufacturers deal with distributors, who deal with retailers who in turn deal with consumers – so long as each adds value to the transaction. Stated otherwise, the rules have to allow for the rapid velocity of transactions among multiple players. It is necessary to see, therefore, how any discrete transaction is embedded in a rich fabric of relationships.

The elements all require the development of a strong legal infrastructure to facilitate voluntary transactions. One of the great reform statutes of England in the seventeenth century was the Statute of Frauds, passed in 1677. Its major purpose was to update the rules governing commercial instruments, particularly deeds dealing with the transfer of real property. Shortly after the statute was passed, John Locke wrote that the central function of the state was to regulate property. I have little doubt that he referred to the writing and recordation requirements that the statute introduced to facilitate voluntary transactions. These rules allowed commerce to modernise itself to take

advantage of technologies that had become available in the seventeenth century, including printing presses and public offices. It is a reform that has never been undone, even as it has been updated to deal with the challenges of modern technology, such as electronic transfers.

Maintaining the extensive legal infrastructure is thus a further function of government. But just keeping deeds in order raises serious logistical problems, given the easements, covenants, mortgages, leases and liens that can attach to a single plot of land. But the dividends are large: increasing the security of transactions allows parties to implement deals involving large amounts of money. However, we also need to know who owns what at any particular time. Hence, the government has to develop a unified system of recordation. There is no way to organise a recordation office other than by state monopoly, because everybody must know the one place to obtain information about rival ownership claims. Once established, private firms should be allowed to take the records and put them into a more useable form. If firms create their own databases, they can sell the information to consumers, often by bonding their reliability by selling title insurance to cover any errors they have made. These institutions are typically ignored by economists, and by lawyers as well. But that is a sign of their strength. The system is reliable enough that litigation is relatively infrequent. There is little reason to tamper with success.

Networks: law and geometry

Law schools traditionally spend an inordinate amount of time teaching about the forms of private property that can be commoditised and handled in ordinary types of voluntary exchange. But that is not the whole story. Every legal system must figure out what to do about infrastructure – assets of enormous value that raise very difficult problems for owners and regulators alike.

I like to consider infrastructure through the prism of a ‘new’ branch of law that I shall call ‘law and geometry’. Think of the world of infrastructure (such as telecommunications and roads) as a neural network, much like the one found in the human body. Just as you must have some cells that produce energy and make specific proteins or hormones, so you also need a way for cells and organs in different parts of the body to communicate with each other. In

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an organism with no interpersonal conflicts of interest, all the nerves turn out to be long and skinny and all the energy-producing cells and organs turn out to be relatively compact. The body does not need to buy rights of way so that the nerves can move conveniently from one location to another; it simply creates, through evolution, a complicated lattice that allows the required interconnections to take place.

The social fabric faces exactly the same challenges. Small farms and factories produce goods and services. Generally speaking, no one wants to organise a factory with a footprint 60 metres wide and 300 kilometres long – the dimensions appropriate for a national motorway. We want it to be compact to allow equipment and goods to move around quickly. But then anybody who wants to engage in trade must find a way to get their goods and services into the social neural network. The skilful entrepreneur will take advantage of rivers, beaches, roads, railways and telecommunications networks. The conspicuous physical characteristic of every one of these networks is that their length-to-width ratio is completely different from that of a farm or factory. This is strictly necessary to create an adequate network, that is, one that allows any person located at any node to reach any other node by making their way through these open interconnections. The courier that picks up goods at one location can deliver them to any other.

The interconnections that bind have a downside, because the very features that link the entire system together make it extremely vulnerable to disruption. In general, factories and farms work in competition with one another. This tends to eliminate the monopoly problem. The greater the number of firms involved in an industry, the more likely it is to be competitive, the more difficult to form a cartel, and the harder it is to interfere with overall service by knocking a single unit out of commission. But, if a network is run by multiple operators, then the refusal of just one operator to deal can disrupt universal service across the board. Several critical failures can bring the system down in its entirety. The multiplicity of firms that is so welcome in ordinary competitive industries creates genuine problems of coordination.

Fortunately, there are many networks that are created by nature, so that no human acts are needed to assemble parcels under separate ownership. Yet even these natural networks have to be guarded against blockade. The usual rule, therefore, is that no user of a lake or river may privatise it. These natural arteries remain held in common, neatly cutting down on the coordination problem. But in some cases, there is no natural network so that one has to be created by conscious human action, as with most roads and railways. Unfortunately, the moment several people with property next to each other try to create a common pathway, they are likely to quarrel over how much each benefits from the project and how much each should pay to construct or maintain it. Overcoming these coordination problems usually requires government coercive power to be invoked through some kind of public works legislation to acquire land for the network upon payment of just compensation to the current landowners. Once the necessary land is assembled, the government also needs to decide whether to manage the resource through public or private ownership. Looking at the immense troubles that have hit every network industry from railways to aviation, it is clear to me that it is difficult to hit on the correct system of ownership and control.

The telecommunications industry in the United States provides a textbook study of government failure in integrated network design. The great reform introduced by the 1996 Telecommunications Act was designed to overcome the 'last mile' monopoly – the single line that runs from the local switching office to the individual subscriber – that was held by the local exchange carriers. In retrospect, that proved unnecessary because the technology for cellular phones, voice-over internet and cable transmission was only a few years away, so much so that today there are about 30 million fewer landlines in the United States than when the Act was passed. But working on the assumption that the wireline network constituted an effective monopoly, the 1996 Act provided for many different companies to be linked together in two ways. The first was through interconnection agreements that the state would oversee in the event that the parties could not agree on terms. Each incumbent local exchange carrier had to allow interconnections with other firms that had built

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their own separate facilities. That interconnection agreement obligated each carrier to accept the traffic initiated by any other carrier, and called for them to work out the finances privately if possible, but backstopped that arrangement with government oversight if the parties could not agree on terms. That side of the business has worked out reasonably well, because one obvious focal point is a 'bill-and-keep' solution, where each carrier keeps all the charges for calls initiated on its portion of the network and receives none for calls initiated elsewhere.

Yet the other side of the programme, which allows new carriers to purchase various 'unbundled network elements' at a state-determined valuation, became an absolute disaster. The explanation here is that these elements were hard to price, but the stated objective of the Federal Communications Commission was to jump-start competition by pricing them well below their historical costs. The incumbents, therefore, cut back on their investments as they fought the transfers, while the new entrants found it wise to avoid investing in their own facilities. But they obtained little competitive advantage because other new entrants had the same favourable deal. The situation resulted in over-investment by subsidised firms coupled with substantial losses for established firms. The matter was further complicated by the utter lack of day-to-day cooperation between these unwilling partners who had countless low-level arguments with each other. It was not until eight years after the passage of the Act, in 2004, when the US Court of Appeals for the District of Columbia limited sharply the occasions on which these elements could be purchased, that the bloodletting stopped. It was no way to run a railway - or a telecommunications system. The moral is that there are better and worse ways to design a network. All of them involve the use of some coercion against business parties. The trick is to find the solution that minimises the harmful side effects that this coercion always brings about. The libertarian model does not provide any set of private, consensual solutions that will handle this particular problem. But the choice of remedy problem - interconnection versus component sales at public valuation - is in this context of major importance.

Putting these three things together – matters to do with the control of force, contractual freedom, and network industries – we find we have probably consumed, in many circumstances, 20 or 25 percent of the resources of any developed economy. However, that sombre conclusion does not require that all businesses in those categories be government-run. The network industries, for example, often operate best when privately owned, perhaps subject to (the right form of) government regulation. However, it is very difficult to think of a way of performing any of these functions without having some state engagement.

Competition and antitrust law

There is a sixth government function that I regard as having the weakest justification, but probably one that just passes muster. That is the control of cartels and monopolies. The antitrust tradition of the United States and competition policies elsewhere show the same tendencies that we see in every other area. When the worst cases of misconduct, such as cartelisation, are punished, some substantial social benefits accrue. However, using their non-stop legal imagination, energetic firms try to extend the scope of the antitrust laws to the point where they become perverse. Competition may be attacked as predatory pricing. All sorts of product innovations may be attacked as abuses of market power by the dominant firm. This risk highlights a familiar story: a legitimate government function administered unwisely turns out to be enormously costly. But even if you assume that just the core monopoly control functions are legitimate, you are dealing with a very complicated body of law that could take dedicated students and practitioners a lifetime to master at the ground level. This is not a small system to operate. On balance, a sensible competition policy is welcome. In practice, it has proved difficult to obtain, consistently and across nations.

The modern state: of redistribution and cross-subsidies

In some ways, the modern state is designed not to execute these particular functions sensibly, but to frustrate their operation at every turn. I exclude the

matters of force and fraud from this comment. They are legitimate grounds for government intervention. However, many laws are designed to limit the ability of people to transact voluntarily with each other in competitive markets, as the discussion of licensing has illustrated. But the problem extends to all forms of direct regulation. According to every serious form of analysis, the labour market could work perfectly well under ordinary contract principles without compulsory unionisation, the minimum wage, or anti-competitive safety laws. The modern state has made exchange more costly, contrary to the traditional government functions of standardising deeds and recordation arrangements, which facilitated exchange.

As a general proposition, unless you can show large external benefits or harms to third parties, there is no reason to regulate voluntary transactions between contracting parties. Unfortunately, that idea has not gained sufficient traction as part of the modern legal outlook. Starting from the wrong premise, we have brought over from the monopoly area – common carrier rules in particular – a huge body of law that makes it impermissible for a firm to refuse to deal with certain customers or employees. In effect, state coercion forces people to come together on terms that one side would rather not accept. Win/win becomes win/lose.

Age discrimination law is a classic illustration of such a market distortion. It forces employers to hire certain people and makes relationships problematic because aggrieved workers can always count on state protection against dismissal. This dismissal can only be done for cause before some third party who knows little of the dynamics of the plant or office. In effect, the entire human rights industry in New Zealand and elsewhere is designed to ensure freedom of contract cannot survive in the labour market. The industry has killed off employment for many older workers, just as its counterpart in the United States, the anti-discrimination laws, has done. Why hire an older worker and run this serious legal risk if the arrangement does not work out? This body of law should simply be purged from the statute books.

When it comes to network issues, we encounter more serious difficulties. The objective of a system of interconnections is essentially to overcome hold-out problems when people seek to impose blockades. However, if we look at

any of the relevant statutes, we find that coercion is not directed consistently toward this one major problem. Once again, the 1996 Telecommunications Act provides an illustration. Many of its provisions dealing with universal service create a massive system of implicit transfers through disguised subsidies. There are typically huge subsidies in every system of transport and telecommunications for various special interests – rural, consumer, school, library and other groups. A telephone line that costs \$1 to install in a business and \$5 in a home will actually cost \$10 in the business and \$6 in the residence. Because of these disguised transfers, resources are misallocated and the community is left poorer than it would have been otherwise.

The same pattern of outcomes occurs with antitrust regulation, where the theory is to break up monopolies and make them behave like competitive industries. However, by the time this goal is twisted into something like the price discrimination laws, antitrust law is protecting inefficient, current competitors against innovation by newer competitors. In the United States, the anti-Wal-Mart sentiment is largely driven by firms that will be displaced in head-to-head competition with an efficient firm. Uneasy competitors will do anything to stop firms like Wal-Mart from entering the market – using every device in the book from land use control to labour statutes, pickets, demonstrations and so forth. Government interventions of this kind must be stamped out. Superior competitors should be allowed to have their way unless and until their rivals manage to improve their performance, which they are likely to do if only to survive. But that is where the energy should be focused – not on obstruction.

I have mentioned how every legitimate body of law may be hijacked for illegitimate purposes. However, there is another area that is probably more important than any I have mentioned, particularly for New Zealand. This is the entitlement business where people are guaranteed access to goods or services at little or no cost, with everybody else footing the bill. If you want to find the road to perdition, look for the signpost bearing the words, ‘a right to’, referring to a positive right to have a house, a certain level of income, medical care, education and so forth. Under classical liberal theory, a ‘right to housing’ meant your right to buy housing from a willing seller. Now it means the government is under a duty to provide housing for you at a rate below what it would cost

in the marketplace. The hidden cost is borne by others under a system of cross-subsidies. This is a game that many can play, but the second set of cross-subsidies does nothing to eliminate the first, and only complicates the problem. Carried out consistently and over the long run, the entitlement policy is as ruinous as it is popular. For every government scheme in which a given person emerges a winner, there will be 20 where that same person loses out. That cycle exists in New Zealand and the United States alike.

Even if you got rid of the entitlement problem, there are powerful intellectual pressures for the concept of wealth distribution from those who have to those who do not. The case has been made in a thousand words and a thousand pages, but I will distil it to one sentence: the value of the marginal dollar to the rich person is less than the value of the marginal dollar to the poor person. It follows that if you could just pluck dollars from the first and give them to the second, you could increase utility without decreasing production. That is the theory. However, the impediments along the path of implementing that scheme are formidable because it often turns out you tax the wrong people and give benefits to the wrong people: agricultural subsidies that go to corporate farmers, and special benefits to unionised workers are two examples. Redistributing income sensibly is much harder to do than it sounds.

My advice to a modern society thinking about redistribution is this: do not think first of providing everyone with a 'fair go'. In designing your social institutions, think about redistribution *last*. If you have a government that performs its basic functions well, cuts out the excrescences, and gets rid of positive rights, you will create sufficient overall wealth that the actual need for redistribution will be relatively small. If, however, you reduce the size of the cake by pushing governments into counterproductive activities, your actions will push more people into poverty and you will find it necessary to expand redistribution in order to stave off utter disaster for some people. The result – another vicious cycle.

On balance, the classical liberal approach seems to work well in explaining how to think about the role of government. I am not going to provide you with a number on how large that size should be. But I will give a list of functions that a sensible government should seek to discharge. It should be

sure to facilitate individual choice in personal and business decisions. It should provide for a clear definition and rigorous enforcement of private property and voluntary contracts. It should make sure that there is sensible financing and management of key systems of social infrastructure. It should have a modest antitrust law that concentrates on the control of monopoly and cartels. It should think about a humane system of redistribution last, not first. By sticking to its mission it should create the conditions whereby individuals are able to generate their own prosperity, and thereby improve the prospects for happiness and wealth of everyone around them.

Questions

Countries seem to start with relatively small government that then grows and grows, although there are constant attempts to retrench through activities such as privatisation. How do countries reach the tipping point and start reversing the process?

Privatisation seems to have been fairly successful. The former socialist countries have certainly used privatisation to cut back the state share of their economies.

In cases like these, the tipping point has been reached through a total breakdown. The aura of desperation makes the process of correction very difficult. Privatisation can be simply an enormous giveaway to political insiders, although it may actually be worth bearing even that cost because the new owners tend to run the business more efficiently. As with much else involving government, privatisations are extremely difficult to get right.

In Western democracies, the level of property protection is insufficient to prevent democratic majorities from imposing major wealth transfers. Let me give you an example. A visitor from England recently told me he wanted to move to Chicago. He said, 'They are passing a statute in England that will be retroactive to the time that it was introduced so all transactions conducted in the interim will be affected. In the United States, with a constitution protecting property rights, nothing like that could happen.' I said, 'Funny you should mention that', and then cited three cases involving the government undermining pension guarantees that adopted just that strategy. The attitude of the Supreme Court was, 'We protect property rights under our constitution but when the government thinks there is a serious risk that pension funds will be insolvent, they can suspend property rights in exactly this fashion.'

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In New Zealand, you have an unwritten constitution with vague property protections. The US Constitution is written, with fairly explicit protections. Yet the limits on government powers to expropriate are pretty much the same in both places. Neither government might be able to occupy somebody's farm but both can restrict the way a farmer uses the land, even when issues like run-off and pollution are not involved. The political economy of state regulation in any democratic society is pretty much the same, regardless of formal institutional structures.

Why? The answer has nothing to do with legal arrangements, but relates to public understanding. Most people do not see market transactions as having any positive value and so do not see any particular reason to protect them. Speaking in Wellington recently, I realised that most critics of the classical liberal position there did not believe voluntary exchanges produced mutual gain. If you do not believe that, what do you believe? Either they are static transactions - nobody gains, so who cares - or they are exploitative transactions, with one winner and one loser, which must be stopped as theft. If that is a dominant, popular mindset, you will reap what you have sown. One reason why increasing public understanding is very important is to break that mindset so that, when faced with regulatory schemes that appeal to a false notion of fairness, people will realise these regulations would hurt themselves and their fellow citizens. That was the genius of Ronald Reagan. For a brief, shining moment in American life he was able to reverse the presumption that additional government regulation was, on balance, desirable. That view did not survive the first Bush presidency.

How then to proceed? Here is an experiment. If you declared, 'I am opposed to every new regulation that is advanced in the entire world', you would be right 95 percent of the time without knowing anything. The moment you start thinking about specific cases you will make mistakes. Because most countries have gone so far in one direction - relative to the optimum - taking a hard line probably produces the right result. If you were dealing with a society that had the right balance, the situation would be different, and this presumption would be untenable. Regardless of the

particulars of legal institutions, I think the quality of policy making, in the regulatory area and others, depends largely on the outcome of the normative and cultural battles. Laws and constitutions are in second place.

Let me give you an example of a battle that happened to be successful. One of the great issues with the takings power in the United States has always been the extent to which it can be used to benefit one private firm at the expense of the public at large. There was a famous case (*Poletown Neighborhood Council v City of Detroit*, 304 NW 2d 455 (Mich 1981)) in which General Motors wanted to build a plant in the tight-knit Poletown community in Detroit. The city leaders condemned several hundred private homes and businesses in this neighbourhood, saying the taking was, as the Constitution required, for public use because the plant was more important than the homes and communities. The city did not pay fair value for the acquired properties. As is par for the course, all of the subjective benefits that people had from living in that community were ignored in the calculations of the market values in question. Ironically, it was private property, not state action, that served the values of community.

Many people with liberal views correctly saw this outcome as an excellent example of abuse of the eminent domain power. The project was wrecking many people's lives. A number of us mounted a strong and sustained campaign in which we did not talk about the economics of public use, as a lawyer would, but showed pictures of people being dragged from their homes so that some fat cat could build on their land. We reminded people that the General Motors plant, when it was finally built, could never deliver on the promises of jobs that it had made some years earlier, before all the homes were destroyed. Fortunately, in this case, the tide was turned. Just recently, the Michigan Supreme Court forged a left-right coalition and overruled the *Poletown* decision, which is a tremendous reversal of precedent. At least in one state - and there will clearly be reverberations throughout the United States - juggernaut politics will be much more difficult. And, in 2005, the same issue will be before the US Supreme Court in a case (*Kelo v New London*) that arose out of a misguided urban redevelopment programme in

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New London, Connecticut. A number of homeowners, represented by the Institute for Justice, are fighting their eviction under an urban redevelopment plan whose architects still have no idea what to do with the land once it is taken over by the City.

In thinking about the aggressive actions of government, it is important to remember that it is not firms that usually originate the push to throw people off their land. What frequently happens is that the local government decides it wants to entice a major enterprise to set up in town. It condemns all the homes and then offers the vacant plot of land to the highest bidder. What company could stay out of the bidding when their competitors are willing to move in? It will follow from the Michigan Supreme Court ruling that states and local governments cannot do that anymore. They will have to figure out how to make their jurisdictions attractive to businesses by being efficient suppliers of necessary infrastructure and public goods, and by keeping the burden of taxes and regulations low. It will be a most welcome shift.

What are your thoughts on rolling back the expansion of government using mechanisms like constitutional limits, judicial review processes and other options of that kind?

The unravelling of an existing state of over-expanded government is never a question of first principles. In this lecture I started from a blank slate and deliberately allowed the government to get bigger and bigger, so I could indicate where I think you should draw the line between proper and improper state functions, and why. The problem of transitions is much more case-specific. You need to know who is in power, what the relevant statutes look like, what interests will be adversely impacted when you make a change, and what the political opportunities are for reversal.

My job as an academic is to advise people whether something is worth unravelling. This, by the way, is not a trivial task. It is then for people with strong local instincts to figure out whether and how to go about this job. I can subsequently help to evaluate whether a particular proposal is worth fighting for.

I have never seen any effective programme to roll back government that has worked universally. Unfortunately, the specific schemes become highly individuated after they have been put into place and it is extremely difficult

to eliminate them even with a blunderbuss. This is an issue that arose during a recent lecture I gave on the Treaty of Waitangi, because it was intended to create a transitional regime between two systems of property rights coming together in a single nation. It has obviously morphed into something far more permanent and, to my way of thinking, ill-advised.

Suppose somebody proposed abandoning the Employment Relations Act 2000 because of its meddlesome structures. It would be wrong to repeal the statute and override existing contracts. Instead, you would probably want all agreements that were valid under the current regime to run their full term. The same principle applies to zoning restrictions. Suppose a suburb of Christchurch had zoning restrictions that said everybody could only build a single family home on a section. You could simply remove the restrictions and allow everyone to build what they wanted, but that does not get you back to the status quo ante. Why? Because if you had not had the zoning restrictions, you might well have had some kind of restrictive covenants in their place. You could, therefore, decide to require two-thirds of the votes of designated residents to undo the restrictions, either in whole or in part, and you could stipulate that they would not apply to vacant land, or at least land in the hands of a private owner who could impose subdivision controls.

As a lawyer, I spend a lot of time on these sorts of issues. There are no perfect solutions, but it is a fatal error to proceed on the blithe assumption that the current regime was never in place. That relentless approach just shatters too many settled expectations. Politically, it is a doomsday machine and you create legitimate claims of injustice when you disturb existing property rights. Figuring out how to undo these situations is a gradualist art.

This first insight, however, should be balanced against another. When Roger Douglas spoke several years ago at the University of Chicago about New Zealand's 1980s reforms, he explained that he wanted to remove privileges across the board. He was after the really big targets: import quotas, subsidies, tariffs. His attitude was: 'I have to deal with them seriatim. I cannot afford to lose momentum because if I do those benefiting from the privileges will regroup and take me out.' I think the reason why that approach worked for international trade and not for employment contracts is that in markets for

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goods, past and future are already effectively separated. The goods that came in under the old system were made under the old rules. Knock that system down, and there will be new goods for the new system. People will reorient very quickly. In the labour market many contracts are long-term – it is not a series of elaborate spot transactions. The re-equilibration in the traded goods markets was quick. People understood the game. Formerly protected manufacturers cut back on production and changed pricing schedules. In the labour markets there was fierce resistance. The 1991 Employment Contracts Act was a great success, but it did not go far enough, in part because it did not negate the right of action for ‘for-cause’ dismissals.

Of course, the other difference is that in New Zealand during the 1980s there was a national consensus that fortress policies were ruining the economy. There has not been a similar level of national consensus on employment issues. In 1991 the government got 75 percent of it right. The rate of unionisation since then has fallen from around 55 percent to close to 20 percent of the workforce. That is a big change. Since the Employment Relations Act was introduced in 2000, unionisation has only gone up by a point or two. The current Labour government is unlikely to push extremely hard on this issue because its members would have to persuade themselves they would get some advantage from the political heat they would take. And if they got such a weak increase in unionisation from the first reform, what makes them think they would do better with the second one?

The game of transitional politics is infinitely complicated. As an outsider, I would never want to tell people how to get through the thicket. It is just like when somebody from a small town in Nebraska says, ‘I want you to be my lawyer’. My attitude is, ‘Sure, I’ll be your backseat lawyer, but you had better first hire a small town lawyer from Nebraska who knows the local ropes because if you don’t, we will get killed.’

The flipside of the role of government is the role of the individual. New Zealand lacks a US-style written constitution. In terms of individual rights, how do we compare with the United States and its written constitution? Is it correct that entrenching individual rights is the last thing we would want to do, because it sets so much in stone?

I do not think anything has been set in stone in the United States. On property issues, the Constitution guarantees that private property shall not be taken for public use without just compensation. Yet this provision has been, at a guess, 70 percent nullified by judicial interpretation. We have an analogous provision preventing Congress from passing any law abridging the freedom of speech. The difficulties in this area are also legion. In some cases there have been bizarre interpretations of what counts as freedom of speech. The American Civil Liberties Union has had some success arguing that freedom of speech includes the right to defame other individuals wilfully and in effect ruin their businesses. Then there is the Campaign Financing Act, based essentially upon a progressive vision that 'money always corrupts'. A very compliant Supreme Court upheld that particular statute.

On balance, the United States constitutional provisions have achieved less than one would hope. However, in such a sprawling country where factions can become impassioned and behaviour ugly, people are better off having the Constitution than they would be without it. For the most part, the truly egregious errors have come from a failure – rather than an excessive willingness – to strike legislation down.

Two cases demonstrate this point: *Plessy v Fergusson* and *Brown v Board of Education*. The first was an 1896 decision that dealt with the great trifecta of race relations. In one decision, the Supreme Court upheld laws that limited the freedom to marry, segregated public modes of transportation, and segregated schools. It justified the decision by saying that the state police power was very broad and included actions to separate the races to ease possible tensions. The statutes were defended on the rather grotesque grounds of racial harmony. The regime lasted for 58 more years. The 1954 ruling in *Brown v Board of Education* said the older legal regime of 'separate but equal' was unacceptable, so it was struck down.

There is no question that the constitutional foundations for both the *Plessy* and *Brown* decisions were rickety. But if we consider the social consequences of the decisions, *Plessy v Fergusson* was catastrophic and *Brown v Board of Education* was moderately helpful. The latter decision did not do the whole job. There was also a need for the Civil Rights Acts to root out government-

sponsored segregation and discrimination, and to facilitate genuine and overdue changes in the federal funding of education. Even with the decision and those changes, it took 20 years to overcome massive resistance in the South. All things considered, the *Brown* decision probably advanced race relations by a decade. The social forces against segregation were getting stronger. If *Brown v Board of Education* had not occurred, something else would have happened 10 years later, I suspect.

Plessy v Fergusson upheld government power against liberty. How many decisions can you find that have upheld liberty against government that have turned out to be serious mistakes? I can think of only one, and that involves abortion. The right to procure an abortion does not strike me as a fundamental liberty, given the interest of the foetus, whose protection falls under the narrowest definitions of the police power. The Supreme Court's decision to allow the practice in *Roe v Wade* created an immense, continuing backlash. Without the decision, some states would have legalised abortion, just as New York had done at the time. Once something is legal in a few states, preventing the practice in a federal system becomes impossible – people can simply travel interstate. This decision was probably a mistake. However, for the most part, it is difficult to find cases where the protection of liberty under the Constitution has been harmful, whereas it is easy to find cases where the failure to protect against regulation of liberty or property has produced fairly catastrophic results.

However, I doubt this approach would work in New Zealand with a unitary government. Any constitution adopted today would be poison for this country, for two reasons. You would now get an update of the Treaty of Waitangi, which would be very difficult to live with. It would create a system marked by two rival sovereignties co-existing in an uneasy truce. I do not believe that would be a good solution for any nation. Secondly, I have spoken to enough people in this country to realise there is still strong belief in the myth that positive rights come for free, so I suspect your constitution would be liberally endowed with positive rights, which would be a genuine block on economic and social advancement.

People sometimes ask if I would like to amend the US Constitution and insert my theories of property law into it. My response is to say I would be

sadly outnumbered. I would rather stick with the text we have and defend that. I certainly do not want to open up the argument. That is what has happened in Canada, where every liberty in the world has been protected except for contractual liberty for businesses and private property against state regulation. That is not where you want a constitution to end up.

The best advice is to let sleeping dogs lie. You should not yearn for a high-level constitutional discourse because you are not going to get a James Madison and his contemporaries to do the job this time around. I know who you would get, and I would not want to entrust my fate to the people and policies that would prove ascendant.

The single great and controversial constitutional amendment in the United States in the last 40 years was the Equal Rights Amendment, which occurred just when the Supreme Court had taken the existing guarantees of equal protection, which were probably meant to deal mainly with race, and said they seemed to apply to sex as well. They decided to be cautious because many examples of racial divisions were odious, whereas the comparable sex divisions were not particularly troublesome. Racially segregated public facilities do not do anybody much good; sexually segregated facilities seem to be fine. You do not want the Constitution to say that if you desegregate toilets on the grounds of race, you have to do the same in the case of sex. What came to be known as the 'differential standards of review' were respected.

By contrast, the Equal Rights Amendment said, 'nor shall equality of rights be abridged on account of sex'. No provision was made for overriding the guarantee. There was a great sense of self-congratulation when this amendment was proposed. It whizzed through the Congress and had to be ratified by the states. Within a year or two it had been approved by 20 or so out of the required 38 states. Finally, somebody asked, what on earth did this amendment actually mean? Would it require women to be drafted alongside men? After they were drafted, would women have to go through the same physical regime as men? When men join the army they receive butch haircuts – did the Equal Rights Amendment require that women also have butch haircuts, or that men have pigtails? If such decisions relied on interpretation, who was the interpreter?

The realisation dawned that approving this amendment was like buying a pig in a poke. Nobody knew what would emerge. The whole movement ground to a halt. Not only could no more states pass it, but some states that had supported the amendment in one legislative session withdrew their support in a later session. The end result was that the Equal Rights Amendment was not passed. And this is essentially the template that any wholesale constitutional convention would follow. The thought of going down that particular road is most ill-advised.

What would I do? I would look for a case where there was a visceral public reaction that a major injustice had been perpetrated. Just as in the *Poletown* case, I would get a court to overturn the injustice and bring back some semblance of normalcy. That seems a relatively sensible way to do business.

Two strategies are required. You need a broad theoretical sweep to figure out the legitimate ends of government and its proper functions, and how these ought to be organised. This calls for genuine management skills inside government so that it cannot simply be reflexive or fail to act. Undoing past mistakes is a completely different art and often you have to go much more slowly (and much more opportunistically in some cases). However, there is no uniform rule because sometimes exactly the opposite strategy will apply. The difference in dealing with trade barriers and employment relations illustrates this point. The implementation of change is a time-consuming activity. There is no level of government where this can be avoided. Ronald Coase said that transaction costs are 50 percent of the total legal universe. When you are dealing with government, make that number 70 percent.