Toward a Limited State

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This article focuses on the criteria that help delineate the optimal scope of government and on the questions regarding the relationship between the individual and the state. I begin with some clarifications regarding the concept of the state, as many structures conventionally recognized as "states" fall short of even the elementary requirements put forward in the normative debates about what the "state" should do. The article concludes by arguing that the classical vision of the limited state is optimal in the sense of providing the best defense of economic liberties and personal freedom.

The Institutional System and the State

History shows that every large and lasting territorial group of people has had a set of interpersonal rules and, in more modern societies, a system of organizations that govern cooperation, resolution of conflicts, and defense. Some of those institutional systems are called "states." Which group has a state and which one has a stateless institutional system obviously depends on the definition of the state. The most widely used is Max Weber's definition: The state exists whenever there is a special apparatus that has a monopoly on the use of force in a given territory (Weber 1922: 29–30).[1] Structures that do not meet this condition are not recognized as states. For example, a charity is not a state, but a "welfare state" is. By Weber's definition, structures in which the ruling group commits crimes against other members living in the same territory would still be called a state,

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[1]Creveld (1999: 1) narrows down the Weberian definition by requiring that the state have a separate legal identity.

albeit a predatory one (e.g., the former Republic of Zaire under Mobutu Seko–Seko).

As a starting point in the debate on the optimal scope of the state's activity, one can turn to Robert Nozick's concept of a *minimal* state—that is, one limited to the "functions of protecting all its citizens against violence, theft, and fraud, and to the enforcement of contracts" (Nozick 1974: 26).

Are Optimal States Different for Different Societies?

Does the vision of an optimal state depend on the characteristics of existing states or on the features of the underlying societies? For example, should the state do more (or less) in poorer countries than in richer ones? Or does the optimal scope of the state's activity depend on the ethnic composition of the population and the resulting extent of intrasocietal tension?

Another issue is whether the optimal scope of government emerges from the democratic process. If so, one could argue that the optimal scope of the state in some societies includes more redistribution at the cost of economic growth while other societies prefer less redistribution and more growth. However, taking majority rule as the criterion for judging the state's actions is risky, because it implies the necessity of accepting any decision of the majority, including the prosecution of minorities, expropriation, and confiscatory taxation. Hence, majority rule has to be constrained, which highlights the need for other criteria for delineating the scope of the state.

The response to the question of whether the optimal state is different for different societies largely depends on whether individuals in various communities are fundamentally different. I think that there are sufficiently strong motivational and cognitive invariants constituting human nature, so that the optimal scope of the state is broadly similar across communities. Policies based on the opposite view—for instance, proposing that poorer societies need a more interventionist state because poor farmers do not respond well to the standard economic incentives—have been a major reason for the perpetuation of poverty in the Third World (Bauer 1976, Schultz 1980). A much more dramatic mistake has been committed by Marxism, which assumed that the elimination of private ownership would produce a new and better individual.

A more recent version of the statist fallacy refers to informational deficiencies of markets (i.e., individuals) in poorer societies as the rationale for a more regulatory state. This recommendation is puzzling because the extent of actual regulations in the developing world is widely in excess of what could be justified by any efficiency considerations (Djankov et al. 2002). Also, one should consider the possibility that some of the functions belonging to the optimal set of state activities may be transferred to external bodies, such as international organizations. We would then face the question of the optimal distribution of this set of state activities and the related issue of the changed role of the nation state. Such issues are at the heart of the constitutional debate in the European Union (Creveld 1999: 402–21; Mathews 1997: 50–65).

Criteria for Delineating the Optimal State

The standard economics approach to delineating the optimal set of the state's functions is unsatisfactory.[2] In particular, when economists such as Joseph Stiglitz (1988: 24) indicate that "a primary role of government" is to provide the legal framework "within which all economic transactions occur," not much is said about the desired content of the laws, and how it might affect the desirability or efficiency of their enforcement. Besides, there is typically no mention of nonstate enforcement mechanisms and their relationship to those of the state. The impression is created that all conflict resolution in economic life is in the unavoidable domain of the state. That impression is in contrast with the empirical evidence (see, e.g., Greif 1997, Gow and Swinnen 2001, and Waldmeir 2001).

This confusion is related to the use that is made of the concept of public goods as being nonrival in consumption and nonexclusive (Samuelson 1954: 387–89). If these goods are to be provided at all, taxes and the related state's coercion are necessary. However, which goods are truly public? Is the justice system the domain of the state because the relevant services are a public good? Clearly, that cannot be said of all such services. Then, which "justice services" constitute a public good? Is the lighthouse, the favorite textbook example of a public good, a public good? Ronald Coase (1974) has shown that lighthouses in 19th century Britain were operated and financed privately. This finding, however, has not prevented the lighthouse to continue serving as the primary example of a public good in many textbooks (e.g., Stiglitz 1988: 75).

[2]I focus on Stiglitz's book (1988) as it represents the highest quality within this approach. Other writings would give rise to more objections.

There may be fewer public goods in real life than typically assumed. As a result, the necessary (or desirable) scope of the state's activity may be narrower, too. Some of the goods declared "public" may in fact be private goods, pushed into the state's domain by public intervention that has eliminated or undercut the possibility of voluntary private financing of these goods. In other words, some uses of the theoretical concept of public goods may inadvertently constitute ex post justifications for the results of previous expansion of state activity.

The concept of "externalities" suffers from similar weaknesses. It is all too easy to suggest that social benefits are larger than private ones (positive externalities) or that social costs exceed private costs (negative externalities) and demand public intervention. It has been established that at least some externalities may result from institutional imperfections, that is, inappropriately specified property rights (Mises 1949: 654–63). In such a case, the solution would not be additional state intervention but the elimination of obstacles blocking the development of private property rights. That may require abolishing some previous state interventions. And the Coase Theorem (1960: 45–56) points out the possibility that some externalities may be dealt with by direct negotiations between the interested parties.

It is not surprising that Charles Wolf Jr., an economist at the RAND Corporation, ends his comprehensive analysis of the treatment of market failures in the economics literature by stating, "There is no formula for establishing the essential minimum threshold of government activities and outputs" (Wolf 1988: 153). This agnostic conclusion is a fair summary of the literature's position on the optimal scope of the state's activity.

Back to Basics

Amartya Sen (1999: 27) identifies the main reason why economics has been so ambiguous on the desirable scope of the state: "The discipline of economics has tended to move away from focusing on the value of freedoms to that of utilities, incomes and wealth. This narrowing focus leads to an underappreciation of the full role of the market mechanism."[3] Like F. A. Hayek (1960), Sen thinks that economics has moved too much in the direction of judging the state's actions only in light of their expected consequences, at the cost of

[3]Sen is using the word "freedom" in its classical sense, i.e., as basic liberties. In other parts of his book, Sen reshapes the meaning of this term in such a way that it includes other goods. This enlarged usage obscures the meaning of freedom.

weakening the intellectual case for basic individual liberties as criteria for delineating the admissible and desirable scope of state activity.

Economic freedom is defined as the "absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself" (Beach and O'Driscoll: 2003). The central elements of economic freedom are secure rights to legally acquired property, freedom to engage in voluntary transactions inside and outside a nation's borders, freedom from governmental control of the terms on which individuals transact, and freedom from governmental expropriation of property rights (Rabushka 1991, Hanke and Walters 1997). There are two basic types of restrictions of economic freedom: restrictive regulations and taxes that go beyond the level necessary to finance the scope of the state's operation required for the protection of classical economic (and other) liberties.[4]

Developments during the 20th century have seriously weakened the intellectual and constitutional position of economic freedom in the West. I focus on two examples indicative of a broader tendency. First, in his widely quoted and admired book, John Rawls (1971) forcefully argues for the "principle of liberty" as the most important criterion for shaping the social life and the role of the state. However, he excludes some basic elements of economic liberty (e.g., freedom of entrepreneurship) from the list of freedoms that should have priority. Not surprisingly, Rawls concludes that market socialism can be the ideal institutional system. But market socialism can only be maintained if people are deprived of their private property rights and thus the liberty to create private firms. Capitalism does not require the legal prohibition of nonprivate enterprises (e.g., nonprofit organizations and co-operatives). Rather, when people have the choice between putting their money, time, and energy into a private firm or into a cooperative, they overwhelmingly opt for the former. Thus, the essence of capitalism is freedom of choice, while market socialism requires prohibition on private enterprise (Balcerowicz 1995b: 104–10). How then could these two systems be regarded as equally compatible with the "priority of liberty"?

Another example of the weakened position of economic freedom in the West relates to the constitutional developments in the United States, the country with the strongest tradition of limited government.

[4]These are definitions of the restrictions of economic freedom, and not the substantive statements about what restrictions (if any) are justified. For more on what constitutes restrictions or interventions, see Hayek (1960: 220–23).

Since the 1930s, the Supreme Court has subordinated economic liberties to other liberties, contrary to the original interpretation of the American Constitution (Dorn 1988: 77–83). By weakening the constitutional safeguards protecting economic freedom, it paved the way for increased regulation. Years later the consequences of this regulation were critically analyzed in the economics literature, but few scholars have linked the increased regulation to the previous weakening of the constitutional defenses of economic freedom.[5] Even George Stigler (1971) in his seminal article on economic regulation did not mention such a link.

As these examples indicate, the philosophical concept of the "priority of liberty" is a very weak intellectual defense against an expansionary state, if economic freedom is excluded from the list of liberties, or if economic freedom is relegated to a secondary place. The way toward increased economic regulation is then wide open.

Further damage is done if the concept of individual rights is radically reshaped to include "social" or "welfare" rights. The classical notion of liberty as a zone protected from the intrusion of other people's actions is then merged with the concept of entitlement to other people's money enforced by the state through increased taxation.[6] The result is conflict between these two very different kinds of rights, and the danger of a further weakening of economic liberty because of growing taxes resulting from expanding social transfers.

[5]Glaeser and Shleifer (2003) argue that increased regulation of business in the United States at the beginning of the 20th century might have been "an efficient response" to the subversion of justice in the courts by the newly emerged large corporations. Whether courts are more easily subverted than legislators and regulators is a tricky empirical issue. Even if it appears that during a given period courts have been "captured" by big business it is not certain that the best strategy is to enact specific regulatory legislation and to create special regulatory bodies instead of strengthening the courts operating within a framework of more general legislation. I presume that in the view of the rise of regulation and the subsequent deregulations, even the proponents of the regulatory response would probably agree that stronger constitutional safeguards protecting economic freedom would be appropriate. On a more general note, I would stress that the issue of courts versus regulators is secondary to the question of what should be the limits on economic liberty or what factors should override property rights (see Mises 1949: 654–61; Nozick 1974: 178–82).

[6]Holmes and Sunstein (1999) point out that both types of rights cost money; therefore, the distinction between liberty rights and welfare rights is not fundamental. However, nobody denies that the protection of individual liberties requires some spending on the police and courts, so it is hardly a discovery. The basic difference between liberty rights and welfare rights lies elsewhere. In the first case the taxpayers' money is used to protect individuals from aggression and intrusion from other people, in the second for redistribution. Also, the two types of rights usually have a very different impact on individuals' behavior and consequently, on economic development. For other differences between liberty rights and welfare rights, see Lomasky (1987: 84–110).

The state is best contained when basic liberties are anchored in an effective constitution.[7] This is the main argument of constitutional economics (Buchanan 1988). Abandoning or weakening this framework will be negatively perceived by all those who think that liberty, including economic liberty, has an intrinsic value, and this is why a limit should be set on the scope of the state's activity, regardless of the consequences. However, for some other people it may be the consequences that would serve as the main or ultimate criterion for judging alternative institutional systems, including alternative state regimes.[8] There are also some people who are susceptible neither to intrinsic nor to instrumental value of individual economic freedom. They consider the state's (nation's) power of intrinsic value (or the free market of negative value), regardless of the consequences.[9]

Limited and Expanded States and Their Consequences

Are there tradeoffs between economic liberty and such variables as economic growth, the related eradication of poverty, and the extent of phenomena such as the share of actions declared as crime or corruption? Do we need state-imposed restrictions on economic freedom in order to get more of good things or less of bad ones?

Let me take as a benchmark a limited state that focuses on the protection of basic liberties, including economic ones. If this state is democratic, then the operation of majority rule is restricted by these liberties, which presupposes that they are included in an effective constitution. The definitional requirement that the state is concentrated on the protection of basic freedoms implies that it cannot expand in the forms and directions that would restrict these freedoms, so it has to be limited.[10] However, the limited state is active in

[7]Hayek (1960: 216) emphasizes that given technical change, "no list of protected rights can be regarded as exhaustive." Therefore, "a reign of freedom" is defined by a general requirement that "the free sphere of the individual includes all action not explicitly restricted by a general law."

[8]Probably the most famous contemporary example of this instrumental (or "pragmatic") approach to the choice of institutional arrangements is provided by Deng Xiaoping's dictum that it does not matter whether the cat is white or black; what matters is whether it does the job.

[9]This category included a disproportionate number of intellectuals in the West. For the explanation of this interesting phenomenon, see Schumpeter (1950), Mises (1956), and Nozick (1997).

[10]Meeting this definitional requirement—i.e., creating and maintaining a limited state—requires special institutional arrangements, such as effective checks and balances, control

its constitutive function of protecting individuals' basic liberties against the intrusions from third parties.

There are many possible states that represent more or less radical departures from this model. I focus on three broad categories: (1) an extended, quasi-liberal state, (2) an extended, illiberal state, and (3) an extended, anti-liberal (communist) state.

In the first case, the extensions consist of various combinations of regulations and redistribution, which imply some loss of economic freedom, without, however, undermining it. This is why I call this model quasi-liberal. The restricted economic liberty is reasonably well protected by the judicial system.

In the extended, illiberal state, economic liberty is more constrained by regulations than in the previous case, but private entrepreneurship is not banned. Social transfers, in turn, are lower. The level of the state's protection of the remaining economic freedom is much lower than in quasi-liberal states.

Finally, in the communist state, private entrepreneurship is banned, and this ban is largely effective because of the harshness of the state enforcement. The effective ban of private business creates a vacuum that must be filled by the state command economy. The anti-liberal communist state must therefore be hugely extended. This is a functional necessity (Balcerowicz 1995b: 51–54). In contrast, it does not need to include a special system of large social transfers. Indeed, in the Maoist version they were quite limited.

Let us now use this typology to make some observations about the impact of various restrictions of economic freedom on long-term economic growth and the related eradication of poverty.

There are nowadays few examples of a limited state (Hong Kong has been the closest empirical approximation). Historical evidence strongly suggests that market-liberal regimes, in which government was limited by law, displayed very good growth records (Rabushka 1985).

Developed economies all fall into the category of extended quasi-liberal states but represent various combinations of regulations and redistribution. They also differ in the intensity of various negative phenomena. Take, for instance, long-term unemployment and ask the basic question: Can such unemployment be linked to the operation of the market? Or, rather, are they linked to public interventions

over the state's apparatus of repression (police, prosecutors, tax administration), an independent and effective judiciary, a free press, and a constitutional court. It is far from easy to create and sustain these institutions. In fact, it is much easier to expand the state than to keep it limited. And once expanded, it is difficult to roll it back.

typical of extended quasi-liberal states? The market-failure view tries to explain unemployment by the alleged tendency of employers to set wages above the market-clearing level, thus causing unemployment (Akerloff 1982). However, this theory cannot explain why the level of long-term unemployment differs so much across OECD countries. The second view, whereby this unemployment results from state intervention (i.e., from government failure) is much more convincing. Indeed, there is a large empirical literature that links long-term unemployment (and the level of employment) to such salient features of the extended state as generous unemployment benefits, high taxation (resulting from large social transfers), wage rigidity produced by collective bargaining structures created with some state support, and legal restrictions hampering the entry of new firms and the operations of the labor, housing, and product markets.[11]

Long-term unemployed people belong to the category of the most disadvantaged persons whose interest, according to Rawls (1971), should be a priority. Yet, it is ironic that interventions typical of the extended quasi-liberal welfare state expand unemployment. I am not saying that any possible variant of that state necessarily produces long-term unemployment. This certainly does not have to be true, as shown by the recent performance of Great Britain, the United States, Denmark, and Ireland. What can be said is that stepping beyond the limited state (i.e., weakening or abolishing mechanisms that constrain the expansion of a state) creates the risk of interventions with various undesired effects,[12] while falling short of the declared goals.[13]

Most developing countries have a quasi-liberal or illiberal regime, and they differ widely in the extent of economic freedom and in the level of the state's protection of that liberty. The debate on the reasons for the differences in growth performance is not completed, but I think there is little doubt that a broader scope of well-protected

[11]The OECD has done substantial work on the causes of structural unemployment. For a summary, see Keese and Martin (2002); also Nickel (1997) and Lindbeck (1994).

[12]Mises (1949: 716–858) and Hayek (1960: 253–376) thoroughly analyzed these dangers. However, their works were given little notice in mainstream economics, at least until recently.

[13]Tanzi and Schuknecht (1997) show empirically that profligate states tend to achieve a lower level of prosperity as measured by various welfare indicators than small spenders. Feldstein (1997) presents evidence that the deadweight loss of increased taxes is much larger than shown by previous calculations. Gwartney, Holcombe, and Lawson (1998) link reduced economic growth to the increases in public spending as a share of gross domestic product. There is also massive evidence that state-imposed redistribution schemes are often "captured" by the better-off and do little to help the poor (Tanzi 1998b). It was found that product and labor market regulations stifle productivity and economic growth (Scarpetta et al. 2002).

economic freedom is good for growth while massive, state-imposed restrictions of that freedom produce disastrous consequences (see Scully 1992, Hanke and Walters 1997, Keefer and Knack 1997, Dollar and Kraay 2000). In the developing world, there is no tradeoff between economic liberty and welfare—sacrificing freedom means sacrificing welfare. The same conclusion can be drawn from the experience of transition economies (Balcerowicz 2002).

A small group of developing economies in East Asia have achieved extraordinarily fast economic growth and provided a testing ground for various hypotheses about the relative role of the state and the market. Can these economic miracles be explained by some special illiberal state interventions (e.g., directed credit and state-led industrialization)? Such a view is easily refuted. The "miracle" regimes differed in the extent of such interventions, but have one thing in common—an extraordinary accumulation of economic fundamentals typical of a limited state: a relatively open economy, low taxation, and private entrepreneurship (Balcerowicz 1995a: 26–27; for the empirical findings, see Quibria 2002).

The Marxist view that private property and free markets are obstacles to economic development has been ruthlessly falsified by experience. There is no single case of a nonmarket, state-dominated economy that has turned out to be a success. The largest sacrifice of liberty has led to a huge sacrifice of welfare. One can only wonder how so many economists could support the claim of the economic viability and even superiority of socialism and disregard the warnings coming from Mises and Hayek.[14]

I have focused on the links between the restrictions of economic liberty and some aspects of economic performance. However, there are other important variables, such as the amount of crime, corruption, and tax evasion, as well as the size of the shadow economy. How do these variables relate to the type of the state?

Let us turn to the notion of elementary crimes, as a catalog of actions declared as crimes in every modern society (murder, assault, robbery, and rape). Expansion of the state tends to create a menu of secondary crimes (Friedman and Friedman 1984: 136). Restrictions banning the supply of a good in strong demand not only produces secondary crimes but also some induced elementary crime (e.g., gangsters killing each other and the police). Prohibition in the United States in the 1920s is a spectacular case in point. Increased social

[14]I must say that knowing the experience of real socialism I was shocked by the lack of realism displayed by the mainstream economists in the debate on the economic efficiency of socialism. I have analyzed this debate in Balcerowicz (1995b: 35–50).

transfers, the main reason for the explosion of public spending in Europe after World War II, raised taxes, increased the scope of tax-related crimes, and created a shadow economy.

Communism represented an extreme case of criminalization of human activity: any private business activity was declared a major crime, and independent political activity was criminalized as well.[15] The Communist case shows in a dramatic way that law enforcement is not a value in itself. The question is—enforcement (protection) of basic liberties or enforcement of restrictions of those liberties?

In addition to the ethical question about the content of law and the value of its enforcement, there is the problem that an overburdened judicial system, enforcing numerous restrictions on economic freedom, will be unable to prevent further erosion of economic liberties. A limited state not only gives individuals the broadest possible economic freedom but also is able to better protect that freedom than a highly regulatory state.

Let us now turn to corruption. Massive empirical research has linked the extent of corruption to various combinations of factors that characterize at least some types of extended states: restrictive regulations and the related discretionary power of politicians and public bureaucrats, high nominal tax burdens, and the large scope of public purchases (see Rose-Ackerman 1999, Tanzi 1998a, and Djankov et al. 2002). The single most important factor is probably the extent of restrictive regulations and administrative decisions, which may be a product of populist (or corrupt) politicians and be related to the large discretion enjoyed by the public administration. What especially restricts economic freedom and thus harms growth is at the same time very conducive to corruption.[16]

The relationship between taxes and corruption is more complex. Large nominal and effective tax burdens may coexist with a relatively low level of corruption if the regulatory burden is light and the

[15]The ban on economic freedom required, as a functional necessity, a ban on political liberty. With free political competition, a political party calling for the elimination of the prohibition of private entrepreneurship would be organized, and, given the deficiencies of a command economy, it would succeed; that is, at least some elements of economic freedom would be introduced (Balcerowicz 1995b: 131–33).

[16]Anti-liberal regulations include those that prohibit or restrict markets in education and health by creating a monopolistic or quasi-monopolistic public sector that offers "free" services, that is, is legally banned from accepting consumers' payments (prices) for these services. In some environments, hidden consumers' payments to some people employed in the public sector emerge, and they are considered "corruption." Such payments are especially likely when the demand is strong and the supply is limited because of the shortage of budgetary financing or mismanagement, say, in hospitals.

bureaucratic discretion is limited. Scandinavian countries best illustrate this relationship. However, raising taxes from already high levels may create in the longer run a danger of corruptive complicity between some tax officials and some taxpayers. Besides, high nominal taxes tend to produce considerable tax evasion that, in part, stems from the unrecorded activity belonging to the shadow economy (Schneider and Enste 2000: 77–114). Finally, massive social transfers, which are behind the large tax burden, tend to produce on their own, or jointly with this burden, various undesirable developments such as reduced labor supply, lower private savings, the misuse of public funds by beneficiaries, and a culture of dependence (Niskanen 1996, Hanson 1997, Arcia, 2000).

While high nominal and effective taxes may be associated with a relatively low level of corruption, an effective tax burden that is much lower than the nominal one is strongly related to massive corruption. The reason for that is simple: effective taxes are low because bribe payments to tax officials (and possibly their patrons) partly replace tax payments. In addition, officials "in charge" of regulations demand further bribes. Therefore, a highly regulatory and discretionary state tends to produce both a low effective tax burden and large bribe payments.[17] This is why low effective taxes do not need to be strongly correlated with fast economic growth. What matters for growth is not the effective tax burden alone, but the sum of effectively paid taxes and bribes. The composition of this sum differs sharply across various state regimes and may serve as one of the indicators of their nature.

Let me summarize this section with the following points:

- Restrictions on individual economic freedom are difficult to justify by improved economic performance. The opposite seems to be true: the more radical such an expansion is, the greater economic damage it produces. Large sacrifices of economic liberty bring about a large loss of welfare. This is true beyond any reasonable doubt of communist states but also of illiberal regimes of many developing countries. One of the main features of these regimes is overregulation of a predatory nature (Djankov et al. 2002). The right question is how to restructure these states so that they stop generating poverty, inequality, and corruption.

[17]One can imagine a regime producing both high effective tax burdens and large corruption. This would occur if nominal taxes were high, the tax apparatus was very efficient and not corrupt, while other parts of public administration were using the regulations to extract a large amount of bribes. However, such a combination is not stable: sooner or later corruption would spread to the tax administration. Besides, an economy burdened by both high taxes and large bribes would collapse.

Even in the case of quasi-liberal systems, typical of the West, long-term unemployment, a serious social pathology, is related to various state interventions.

- Various forms of state expansion can be also linked to an increased share of individuals' actions declared criminal, to corruption, to tax evasion, and to a shadow economy.
- Restrictive regulations may be more harmful than redistribution. Massive regulations necessarily produce economic paralysis and widespread corruption. They may also weaken the state's protection of those economic liberties that still remain. Leaving ethical questions aside, one can say that the rational limit to redistribution is determined by the requirement of fiscal soundness and by the knowledge that government transfer payments may reduce the supply of labor. The latter implies, for example, that it is better to spend a given sum on elementary education than on unemployment benefits.
- Many deviations from a limited state increase the number of disadvantaged people because excessive government produces poverty and long-term unemployment. Believers in the Rawlsian principle, whereby the interests of such people should have priority, ought to be weary of extended states.

Is the State's Expansion Filling in the Gap or Crowding Out Nonstate Activity?

These critical points regarding the expansion of the state's activity can be met with two related objections:

1. The expansion was a response to a need; therefore it is in some sense justified. For example, Richard Musgrave (2000: 231) claims that "the decline of family bonds, the vagaries of business cycle and changing market" created a "growing need for new institutions to provide support," and thus "the rise of the public sector has been a responding rather than an initiating factor."
2. Without the state's intervention there would be a vacuum: certain needs would not be met, and people would be worse-off.

The first point is about the reasons for the state's expansion, the second about its effects. The problem with the first assertion is that even with such an elastic concept as "need" it would be absurd to explain more drastic forms of the expanded state, such as communism or Mobutu's dictatorship. However, the need theory of the state's expansion is also problematic with respect to the transition from limited to quasi-liberal regimes. Whose needs are supposed to be the driving force and how could we measure them? How can one relate the uneven growth of regulations and transfers to the needs? It is striking that social transfers in developed countries have not grown gradually but exploded during certain short periods (Tanzi and Schuknecht 1997). Similar shock dynamics are also characteristic of certain types of regulations, especially those regarding the financial system (Allen and Gale 2000). It is doubtful that any sensible concept of needs can explain such a pattern of growth of transfers and regulations. The need theory of the state's expansion is an unconvincing attempt to explain this fact by recourse to pseudopsychological or pseudomarket concepts. At worse, it borders on the apology of the expanded state.

The second point that without the state's intervention there would be "a void" making people worse-off is a manifestation of the welfare economics approach to the issue of the optimal scope of the state's activity. I have already discussed the problems of the practical applications of the theoretical concepts of public goods and of externalities. Here, I add two points. First, nonstate activity cannot be reduced to profit-oriented market transactions. It also includes various self- or mutual-help arrangements. Both, profit-oriented market transactions and mutual-help arrangements involve voluntary cooperation. Therefore, even if one can show that the market cannot perform a certain useful function, it does not necessarily follow that the state should perform that function.

Second, state expansion restricts the scope of institutional experimentation (Hayek 1960). Economists agree that the state's expansion produces detrimental crowding-out effects in less drastic cases, not to mention anti-liberal or illiberal regimes. Take price controls, which lead to shortages and the rationing of goods. This is a primary public intervention. If the resulting rate of return falls below the threshold expected by the private investors, public investment will fill the void. This is the secondary intervention. The void does not preexist the public intervention; it is created by it. A typical example is housing where rent controls generate "social" housing.

Generalizing, one can sketch a simple model of a self-expanding state's activity that starts with primary intervention resulting from various interplays of political pressures related to statist ideologies and interest groups. Once introduced, this intervention often leads to secondary ones because of functional necessities—that is, pressures operating regardless of prior decisionmakers' intentions. For example, if primary intervention eliminated the profitability of private investment in housing but dwellings were still needed, public investment in housing would be needed.

This simple scheme may help explain the crowding out of private activity in those fields where conventional economics usually takes the state's presence for granted because of "market imperfections." Take education. Before the introduction of the "free" and compulsory schooling in public schools, England and Wales and the United States had an extensive network of fee-based elementary schools, financed by working parents and the church. The percentage of net national income spent on day schooling of children of all ages in England in 1833 was approximately 1 percent. By 1920, when schooling had become "free" and compulsory, the proportion had fallen to 0.7 percent (West 1991). "Free" (i.e., tax-financed) public schools had captured the demand for education and, as a result, the supply of fee-financed nonstate educational services collapsed. This "capture" of demand also blocked innovative, nonstate educational developments. Edwin West (1991) stresses that "with the exception of Marx and Engels, the political economists up to the mid-19th century were in favor of providing schooling in a free and private market," because they regarded fee-paying as "the one instrument with which parents could keep alive desirable competition between teachers and schools." John Stuart Mill recommended compulsory examinations but not compulsory schooling.

Or consider individual risks such as unemployment. Such events are often presented as the rationale for state-financed "social" insurance. This claim is usually strengthened by reference to capital market imperfections. However, the elementary step is to reduce all those massive individual risks that are not produced by nature. Massive individual risks are generated by the policies of expanded states that bring about fiscal or financial crises, high inflation, and high unemployment. Preventing such policies, via the transition from an expanded to a limited state, is the best and indispensable social insurance.[18]

Furthermore, such a reform would accelerate the growth of individual incomes and savings and thus enhance people's ability to cope with various risks. In addition, empirical studies show that in poor countries there exist a variety of informal "coping strategies" (e.g.,

[18]Stiglitz (1989) stresses that "the distinctive strength of government—its universal membership and its power of compulsion—are also its greatest liabilities," because "the mistakes that are made with concentrated power may be far more disastrous than those which arise in a society with decentralized decisionmaking." This is clearly an argument against the expanded (i.e., more powerful) states and for more limited ones.

reciprocal exchange of gifts and loans, and remittances from the migrant family members), and a surprisingly large potential for more modern, nonstate institutional arrangements that promote savings and provide insurance and micro-credit (Morduch 1999). Voluntary insurance associations had been spreading in western countries until the introduction of compulsory social insurance. For example, in Britain the registered membership of friendly societies was 2.8 million in 1877, 4.8 million in 1897, and 6.6 million in 1910 (Green 1985). It is stressed that "programs operated directly by governments tend to have inherent difficulties in generating compliance by participants," and that "this has proved disastrous for the long-term sustainability of public credit programs" (Morduch 1999: 201).

Expansion of state-financed, social insurance could crowd out traditional arrangements and block the development of more modern ones. This danger is explicitly recognized in a recent World Bank report (2002: 24): "Competition by the government in providing social transfers may drive out private institutional arrangements . . . which can be targeted more effectively to the poor than more arm's-length's (public) social assistance." This is what has actually happened in the West due to the rise of the welfare state.

State-imposed social transfers can be partly captured by those who are better off and may crowd out voluntary arrangements that benefit the poor. As a result, it is conceivable that state-run transfer schemes in poor countries could worsen the plight of the poor. In such a situation the welfare state drives out the welfare society. One should also remember that increased taxation financing social spending is likely to hamper economic growth and the related job creation.[19]

Finally, the growth of financial regulations clearly illustrates how some primary interventions lead to secondary ones, thus generating a large dose of the state's regulations, the optimality of which is open to debate. The role of primary intervention may be ascribed to the generous deposit insurance that largely eliminated the discipline of the market (i.e., the incentive of depositors to monitor banks with respect to the level of their capital and to require full disclosure). The created gap generated a wave of secondary regulations, such as risk-sensitive capital adequacy ratios, portfolio restrictions on banks, and the use of subordinated debt as a monitoring device (Bhattacharya et al. 1998, Dowd 1996, Benston and Kaufman 1996). These prudential

[19]One may recall Hayek's (1960: 305) warning regarding the rise of the "welfare state": "While in former times the social evils were gradually disappearing with the growth of wealth, the remedies we have introduced are beginning to threaten the continuance of that growth of wealth on which all future improvement depends."

regulations are, in principle, a rational response to a situation created by primary public intervention.

Conclusion

Economics does not give a clear answer to the question of what the state should do. The proximate reason for this is the difficulty in applying its basic theoretical concepts, those of public goods and externalities, to the real world. A deeper reason is the neglect of basic economic liberties, as the framework to determine the limits of the state's activity. Even in Western countries, the intellectual and constitutional position of economic liberty was seriously eroded during the 20th century, which paved the way toward the expanded state.

The expansion of state activity—that is, the growth of state-imposed restrictions on economic freedom—is difficult to justify by improved economic performance. The opposite seems to be true: the more radical the expansion, the greater the economic damage. Various forms of state expansion can also be linked to corruption, tax evasion, the shadow economy, and the weakening of the state's protection of remaining economic freedom. Many deviations from a limited state tend to increase the share of the most disadvantaged persons, such as the long-term unemployed.

It should not be taken for granted that if the state remained limited (i.e., focused on the protection of basic liberties), certain services would not be provided and people would be worse-off. The potential of voluntary cooperation, which includes both profit-oriented market transactions and mutual-help arrangements, should not be underestimated. There are also various individual coping strategies. In fact, the expansion of the state might have driven out much nonstate activity and blocked the development of new, potentially beneficial private arrangements. There is, therefore, a strong case for recognizing that a limited state is the optimal one.

The last 20 years have witnessed a tendency to move away from expanded states toward more limited ones. This shows that the task of limiting the scope of the state's activity and thus releasing the potential of voluntary cooperation and individual initiatives is not impossible, even though the transition is far from completed and fraught with difficulties. There will always be some people who see benefits (power and economic rents) in limiting other people's freedom. And there will always be some ideologues that attach an emotional value to the state's power or distrust voluntary cooperation.

One should use every appropriate moment to anchor a vision of a state constrained by the framework of basic individual liberties in an effective constitution. There are other limits on the state's discretion that are surrogate defenses of individual freedom. Institutionalized fiscal constraints can help to limit the growth in public spending and, therefore, in taxation. Central bank independence blocks the recourse to inflationary financing of budget deficits and thus protects individuals against the imposition of inflation taxes. Membership in the World Trade Organization limits the countries' use of protectionist measures and helps protect domestic taxpayers and consumers. These and other second-line defenses should be introduced or strengthened.

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