

The growth of the state

## Leviathan stirs again

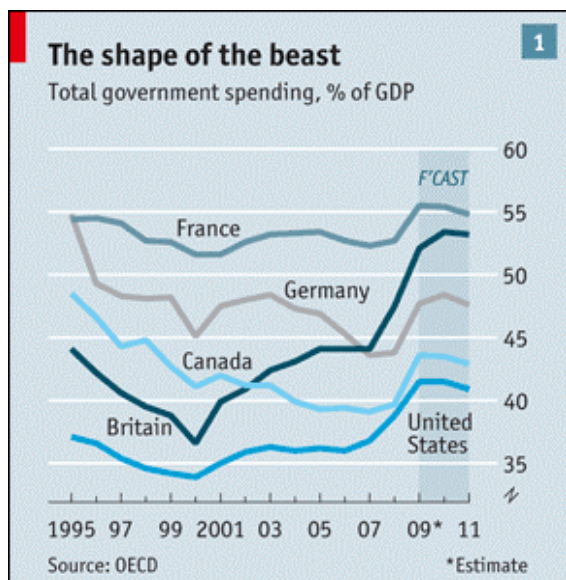
**The return of big government means that policymakers must grapple again with some basic questions. They are now even harder to answer**

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FIFTEEN years ago it seemed that the great debate about the proper size and role of the state had been resolved. In Britain and America alike, Tony Blair and Bill Clinton pronounced the last rites of “the era of big government”. Privatising state-run companies was all the rage. The Washington consensus reigned supreme: persuade governments to put on “the golden straitjacket”, in Tom Friedman’s phrase, and prosperity would follow.

Today big government is back with a vengeance: not just as a brute fact, but as a vigorous ideology. Britain’s public spending is set to exceed 50% of GDP (see chart 1). America’s financial capital has shifted from New York to Washington, DC, and the government has been trying to extend its control over the health-care industry. Huge state-run companies such as Gazprom and PetroChina are on the march. Nicolas Sarkozy, having run for office as a French Margaret Thatcher, now argues that the main feature of the credit crisis is “the return of the state, the end of the ideology of public powerlessness”.

“The return of the state” is stirring up fiery opposition as well as praise. In America the Republican Party’s anti-government base is more agitated than it has been at any time since the days of the Gingrich revolution in 1994. “Tea-party” protesters have been marching across the country with an amusing assortment of banners and buttons: “Born free, taxed to death” and “God only requires 10%”. On January 19th Scott Brown, a Republican, captured the Massachusetts Senate seat long held by the late Ted Kennedy, America’s most prominent supporter of big-government liberalism.

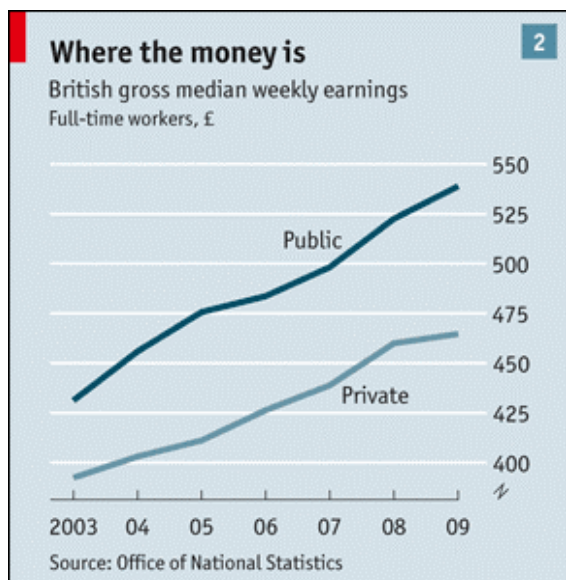


Many European countries have devoted a high proportion of their GDP to public spending for years. And many governments cannot wait to get out of their new-found business of running banks and car companies. But the past decade has clearly produced changes which, taken cumulatively, have put the question of the state back at the centre of political debate.

The obvious reason for the change is the financial crisis. As global markets collapsed, governments intervened on an unprecedented scale, injecting liquidity into their economies and taking over, or otherwise rescuing, banks and other companies that were judged “too big to fail”. A few months after Lehman Brothers had collapsed, the American government was in charge of General Motors and Chrysler, the British government was running high street banks and, across the OECD, governments had pledged an amount equivalent to 2.5% of GDP.

The crisis upended conventional wisdom about the relative merits of governments and markets. Where government, in Ronald Reagan’s aphorism, was once the problem, today the default villain is the market. Free-marketeers such as Alan Greenspan, the former head of the Federal Reserve, have apologised for their ideological zeal. A line from Rudyard Kipling sums it up best: “The gods of the market tumbled, and their smooth-tongued wizards withdrew”.

Yet even before Lehman Brothers collapsed the state was on the march—even in Britain and America, which had supposedly done most to end the era of big government. Gordon Brown, Britain’s chancellor and later its prime minister, began his ministerial career as “Mr Prudent”. During Labour’s first three years in office public spending fell from 40.6% of GDP to 36.6%. But then he embarked on an Old Labour spending binge. He increased spending on the National Health Service by 6% a year in real terms and boosted spending on education. During Labour’s 13 years in power two-thirds of all the new jobs created were driven by the public sector, and pay has grown faster there than in the private sector (see chart 2).



In America, George Bush did not even go through a prudent phase. He ran for office believing that “when somebody hurts, government has got to move”. And he responded to the terrorist attacks of September 11th 2001 with a broad-ranging “war on terror”. The result of his guns-and-butter strategy was the biggest expansion in the American state since Lyndon Johnson’s in the mid-1960s. He added a huge new drug entitlement to Medicare. He created the biggest new bureaucracy since the second world war, the Department of Homeland Security. He expanded the federal government’s control over education and over the states. The gap between American public spending and Canada’s has tumbled from 15 percentage points in 1992 to just two percentage points today.

## The public’s demands

The expansion of the state in both Britain and America met with widespread approval. The opposition Conservative Party applauded Mr Brown’s increase in NHS spending. Mr Bush met no significant opposition from his fellow Republicans to his spending binge. It was clear that, when it came to their own benefits, suburban Americans wanted government on their side. A banner at one of those tea-parties sums up the confused attitude of many of the so-called anti-government protesters: “Keep the government’s hands off my Medicare.”

The demand for public services will soar in the coming decades, thanks to the ageing of the population. The United Nations points out that the proportion of the world’s population that is over 60 will rise from 11% today to 22% in 2050. The situation is especially dire in the developed world: in 2050 one in three people in the rich world will be pensioners, and one in ten will be over 80. In America more than 10,000 baby-boomers will become eligible for Social Security and Medicare every day for the next two decades. The Congressional Budget Office (CBO) calculates that entitlement spending will grow from 9% of GDP today to 20% in 2025. If America keeps its distaste for taxes, it will face fiscal Armageddon (see chart 3).



The level of public spending is only one indication of the state's power. America's federal government employs a quarter of a million bureaucrats whose job it is to write and apply federal regulations. They have cousins in national and supranational capitals all round the world. These regulators act as force multipliers: a regulation promulgated by a few can change the behaviour of entire industries. Periodic attempts to build "bonfires of regulations" have got nowhere. Under Mr Bush the number of pages of federal regulations increased by 7,000, and eight of Britain's ten biggest regulatory bodies were set up under the current government.

The power of these regulators is growing all the time. Policymakers are drawing up new rules on everything from the amount of capital that banks have to set aside to what to do about them when they fail. Britain is imposing additional taxes on bankers' bonuses, America is imposing extra taxes on banks' liabilities, and central bankers are pondering ingenious ways to intervene in overheated markets. Worries about climate change have already led to a swathe of new regulations, for example on carbon emissions from factories and power plants and on the energy efficiency of cars and light-bulbs. But, since emissions are continuing to grow, such regulations are likely to proliferate and, at the same time, get tighter. The Kerry-Boxer bill on carbon emissions, which is now in the Senate, runs to 821 pages.

Fear of terrorism and worries about rising crime have also inflated the state. Governments have expanded their ability to police and supervise their populations. Britain has more than 4m CCTV cameras, one for every 14 people. In Liverpool the police have taken to using unmanned aerial drones, similar to those used in Afghanistan, to supervise the population. The Bush administration engaged in a massive programme of telephone tapping before the Supreme Court slapped it down.

Illustration by Steve May

Another form of the advancing state is more insidious. Annual lists of the world's biggest companies have begun to feature new kinds of corporate entities: companies that are either directly owned or substantially controlled by the state. Four state-controlled companies have

made it into the top 25 of the 2009 Forbes Global 2000 list, and the number is likely to grow. Chinese state-controlled companies have been buying up private companies during the financial crisis. Russia's state-controlled companies have a long record of snapping up private companies on the cheap. Sovereign wealth funds are increasingly important in the world's markets.

This is partly a product of the oil boom. Three-quarters of the world's crude-oil reserves are owned by national oil companies. (By contrast, conventional multinationals control just 3% of the world's reserves and produce 10% of its oil and gas.) But it is also the result of something more fundamental: the shift in the balance of economic power to countries with a very different view of the state from the one celebrated in the Washington consensus. The world is seeing the rise of a new economic hybrid—what might be termed “state capitalism”.

Under state capitalism, governments do not so much reject the market as use it as an instrument of state power. They encourage companies to take advantage of global capital markets and venture abroad in search of opportunities. Malaysia's Petronas and China's National Petroleum Corporation run businesses in some 30 countries. But they also use them to control the economy at home—to direct resources to favoured industries or reward political clients. Politicians in China and elsewhere not only make decisions about the production of cars and mobile phones; they are also the hidden hands behind companies that are scouring the world for the raw materials that go into them.

The revival of the state is creating a series of fierce debates that will shape policymaking over the coming decades. Governments are beginning to cut public spending in an attempt to deal with surging deficits. But the inevitable quarrels over cuts will be paltry compared with those about the growth of entitlements. America's deficit, boosted by recession, is already hovering at a post-war high of 12% of GDP, and the American economy depends on the willingness of other countries (particularly China) to fund its debt. The CBO calculates that the deficit could rise to 23% of GDP in the next 40 years if it fails to tackle the yawning imbalance between revenue and expenditure.

Crises can be the midwives of serious thinking. The stagflation of the 1970s prepared the way for the Reagan and Thatcher revolutions. More recently, several countries have dealt with out-of-control spending by introducing dramatic cuts: New Zealand, Canada and the Netherlands all reduced public spending by as much as 10% from 1992 onwards.

In the early 1990s Sweden faced a home-grown economic crisis that foreshadowed many of the features of the global crisis. The property bubble burst and the government stepped in to save the banks and pump up demand. Public debt doubled, unemployment tripled and the budget deficit increased tenfold. The Social Democrats were elected in 1994 and re-elected twice thereafter on a programme of raising taxes and slashing spending.

This points to an irony: a crisis which promotes state growth in the short term may lead to pruning in the longer term. In Britain power is almost certain to shift from Labour to the Conservatives, who are much keener on cutting public spending. In America the Republicans will make big gains in the mid-term elections and Mr Obama, already sobered by his loss in Massachusetts, will have to move to the centre.

But pruning will still be more difficult than it has ever been before. Getting the public sector to do “more with less” is harder after two decades of public-sector reforms. Across the OECD more than 40% of public goods are provided by the private sector (thanks to privatisation and contracting out) and 75% of public officials are on some sort of pay-for-performance scheme. The ageing of the population makes earlier reforms look easy. Governments will have to ask fundamental questions—such as whether it makes sense to let people retire at 65 when they are likely to live for another 20 years.

The rise of state capitalism is fraught with problems. It may be hard to argue with China’s 30 years of hefty economic growth and \$2.3 trillion in foreign-currency reserves. But subordinating economic decisions to political ones can come with a price-tag in the long term: politicians are reluctant to let “strategic” companies fail, and companies become adjuncts of the state patronage machine. Giving the imprimatur of the state to global companies is also fraught with risks. America’s Congress prevented Dubai from taking over American ports on grounds of national security.

## **Anatomising failure**

The most interesting arguments over the next few years will weigh government failure against market failure. The market-failure school had been gaining strength even before the credit crunch struck. The rise of cowboy capitalism in Russia under Boris Yeltsin persuaded many people—not least the Chinese—of the importance of strong government. And the threat of global warming is an obvious example of how government intervention is needed to deter people from overheating the world. Advocates of market failure have also been advancing a broad range of arguments for using the government to “nudge” people’s behaviour in the right direction.

But the fact that markets are prone to sometimes spectacular failure does not mean that governments are immune to it. Government departments are good at expanding their empires. Thus a welfare state that was designed to help people deal with unavoidable risks, such as sickness and old age, is increasingly in the business of trying to eliminate risk in general through a proliferating health-and-safety bureaucracy. Government workers are also good at protecting their own interests. In America, where 30% of people in the public sector are unionised compared with just 7% in the private sector, public-sector workers enjoy better pension rights than private-sector workers, as well as higher average pay.

The public sector is subjected to all sorts of perverse incentives. Politicians use public money to “buy” votes. America is littered with white elephants such as the John Murtha airport in Jonestown, Pennsylvania, which cost hundreds of millions of dollars but serves only a handful of passengers, including Mr Murtha, who happens to be chairman of a powerful congressional committee. Interest groups spend hugely to try to affect political decisions: there are 1,800 registered lobbyists in the European Union, 5,000 in Canada and no fewer than 15,000 in America. Mr Bush’s energy bill was so influenced by lobbyists that John McCain dubbed it the “No Lobbyist Left Behind” act.

These perverse incentives mean that governments can frequently spend lots of money without producing any improvement in public services. Britain’s government doubled spending on

education between fiscal 1999 and fiscal 2007, but the spending splurge coincided with a dramatic decline in Britain's position in the OECD's ranking of educational performance. Bill Watkins of the University of California, Santa Barbara, calculates that, once you adjust for inflation and population growth, his state's government spent 26% more in 2007-08 than in 1997-98. No one can argue that California's public services are now 26% better.

"The question that we ask today", said Barack Obama in his inaugural address, "is not whether our government is too big or too small, but whether it works." This is clearly naive: with deficits soaring, nobody can afford to ignore the size of government. Mr Obama's appeal for pragmatism has some value: conservative attempts to roll back government regulations have led to disaster in the finance industry. But left-wing attempts to defend entitlements and public-sector privileges willy-nilly will condemn the state to collapse under its own weight. Policymakers will not be able to give a serious answer to Mr Obama's question of whether "government works" without first asking themselves some more fundamental questions about what the state should be doing and what it should be leaving well alone.