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Distinguished Lecture

# Toward a Limited State

Leszek Balcerowicz

# About Leszek Balcerowicz

Leszek Balcerowicz was born in Lipno, Poland, in 1947. In 1970 he graduated with distinction from the Foreign Trade Faculty in the Central School of Planning and Statistics in Warsaw (now Warsaw School of Economics). In 1974 he gained an MBA at St. John's University in New York, and in 1975 he received his Ph.D. in economics at the CSPS.

Among his academic distinctions are visiting fellowships at the University of Sussex (1985) and Marburg University (1988). Since October 1992 Mr. Balcerowicz has been a professor at the Warsaw School of Economics, and since 1993 he has been a Chair of International Comparative Studies at Warsaw School of Economics. He has given many lectures and seminars around the world. He has published widely on economic issues in Poland and abroad. In 1992-2000 he was a chairman of the Center for Social and Economic Research based in Warsaw.

In September 1989 Mr. Balcerowicz became Deputy Prime Minister and Minister of Finance in the first non-Communist government in Poland after World War II. In this vital period in Poland's transition, he designed and executed the radical stabilization and transformation of the Polish economy. He retained his positions in the government until December 1991. From April 1995 to December 2000, he was the president of the Freedom Union. From 1997 to June 2000 he was Deputy Prime Minister, Minister of Finance, and President of the Economic Committee of the Council of Ministers.

He has received honorary doctorates from the following universities: the University of Aix-en-Provence (France), the University of Sussex (United Kingdom), De Paul University of Chicago (United States), the University of Szczecin (Poland), Staffordshire University (United Kingdom), Mikolaj Kopernik University (Torun, Poland), Dundee University (Scotland), the Economic University (Bratislava, Slovakia), Viadrina European University (Frankfurt, Germany), University of the Pacific (Lima, Peru), and Alexandru Ioan Cuza University (Iasi, Romania).

In 1992 he was awarded the Ludwig Erhard Prize from the Ludwig Erhard Foundation, Germany. In 1998 Mr. Balcerowicz received the Finance Minister of the Year award from the British financial monthly *Euromoney.* In 1999 the European Institute of Washington granted him the Transatlantic Leadership Award for the most outstanding European personality in 1998, and he received the Central European Award for the Finance Minister of the Year 1998 in Central and Eastern Europe. In 2001 he was awarded the Friedrich von Hayek Prize, Germany; in the same year he received the Carl Bertelsmann Prize for his achievements during the process of transformation of the Polish economy. In 2002 the Fasel Foundation honored him with a prize for his merits regarding the social market economy.

In January 2001, the Sejm of the Republic of Poland appointed him to the post of President of the National Bank of Poland.

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## Introduction

My intention in this paper is to focus on the criteria which help delineate the optimal scope of the state's activities and on the questions regarding the relationship between the individual and the state. I start with some clarifications regarding the concept of the state. This is not a trivial exercise, 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. Then I move to the question of whether the vision of an optimal state is different for different societies. Can what is best for one society be far from optimal for another?

The next section looks at the criteria for delineation of the optimal scope of state functions provided in economics. It finds them wanting, mainly because of problems in applying to real life the theoretical concepts of public goods and externalities. This is why I take a brief look at more philosophical approaches to the question of individual liberties and the scope of the state (in "Back to Basics"). It is noted that the intellectual and constitutional position of economic freedom in the West was seriously weakened during the 20th century, not to mention in Communist regimes and many developing countries, where it was destroyed. This phenomenon underlies the transition from a limited state to various forms of expanded states.

"Limited and Expanded States and Their Consequences" deals with the consequences of state expansion. It finds that many state interventions can

I obtained useful comments on the first draft of this paper from Simeon Djankov, Jakub Karnowski, Richard Messick, Jacek Rostowski, Andrzej Rzonca, and Andrei Shleifer. The usual caveats apply.

hardly be justified by their effects. Large sacrifices of economic freedom bring about large losses of welfare. Many negative phenomena, e.g., unemployment, corruption, tax evasion, and a weakened state's protection of the remaining liberties, can be linked to various features of expanded states.

"Is the State's Expansion Filling in the Gap or Crowding Out Nonstate Activity?" questions the claim that the expansion of the state is a response to "needs" or "demand." It also argues that some forms of state presence, usually considered unavoidable or desirable by conventional economics, might in fact be driving out actual or potential voluntary cooperation and individuals' coping strategies.

The paper concludes by stating the case for a classical vision of the state, which is constrained by the framework of basic liberties, anchored in an effective constitution. Institutionalized fiscal constraints, independence of the central bank, membership in the World Trade Organization (WTO), and other limits on the discretionary power of the state should be regarded as important second-line defenses of individual freedom.

Given space limitations, many important issues have been left aside. For example, I have omitted the question of the inequalities in wealth across individuals[1] and that of the relationship between the extent of those inequalities and long-run economic growth.[2]

1 The moral aspect of this question is thoroughly discussed by Nozick (1974, pp. 149 – 274).

2 Some authors argue that wealth and income inequality is inversely related to the rate of economic growth (see, e.g., Alesina and Perotti 1996; Li, Squire, and Zou 1996). Inequality is considered to produce distribution struggles and socio-political instability and these are held to reduce investment and thus economic growth. However, the inverse relationship between inequality and growth is likely to result from the basic fact that more economic freedom tends to produce both more growth and less inequality compared to less economic freedom (see Scully 1992; Hanke and Walters 1997; and for the post-Communist economies, Balcerowicz 2002). The policy conclusion would be, then, not to focus on redistributive schemes but on liberalizing the economy, i.e., on limiting the state.

# 1 The Institutional System and the State

History shows that every large and lasting territorial group of people has had an institutional system: a set of interpersonal rules (and in more modern societies, a system of organizations) which govern cooperation, resolution of conflicts, and defense. Some of the 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 definition is Max Weber's (1922, pp. 29-30): The state exists whenever there is a special apparatus that has a monopoly on the use of force in a given territory.[3] This monopoly is used to protect at least some members of the group against elementary crimes (e.g., murder, injury, robbery, theft). Structures that do not meet this condition are not recognized as states. In other words, a charity is not a state, while a "welfare state" is a state. By Weber's definition, structures whereby the ruling group commits elementary crimes against other members living in the same territory would still be called a state, albeit a "predatory" one. The former Republic of Zaire under Mobutu Seko-Seko is one example.

As a starting point in the normative debate on the optimal scope of the state's activity, one can use Robert Nozick's (1974, p. 26) concept of a minimal state: a state's activities include the "functions of protecting all its citizens against violence, theft, and fraud, and the enforcement of contracts." Many contemporary proponents of this nonlibertarian view believe that the state should do more.[4] But—to my knowledge—not many

3 van Creveld (1999 p.1) narrows down the Weberian definition by the requirement of a separate legal identity of "state."

4 For the modern version of the libertarian view, see Rothbard (1970). The libertarian position boils down to showing that a totally nonstate justice system is both possible and desirable. On that point see, e.g., D. Friedman (1984).

of the proponents of such a state acknowledge that a trade-off may exist between the quality of the state performing its constitutive functions and adding other activities to its realm.

## 2 Are Optimal States Different for Different Societies?

Does the vision of an optimal state depend on the characteristics of the present 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 would the optimal scope of the state's activity depend on the ethnic composition of the population and the resulting extent of intrasocietal tension? These are questions that deserve an extensive debate.[5]

The response to the question as to whether the optimal state is different for different societies depends largely 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 have been a major reason for the perpetuation of poverty in the Third World (Schultz 1980)—e.g., proposing that poorer societies need a more interventionist state because poor farmers do not respond well to standard economic incentives. A much more dramatic mistake has been committed by Marxism, which assumed that the individual's motivational characteristics are a function of institutional systems, i.e., 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

5 One of those issues is whether the optimal scope of the state emerges from the democratic process, i.e., the rule of the majority. One could then argue that the optimal scope of the state in some societies includes more redistribution at the cost of some economic growth while some other societies "prefer" less redistribution and more growth. However, taking majority rule as the ultimate criterion for judging a state's actions is a risky route, as it implies the necessity of accepting any decisions of the majority, including the prosecution of minorities, expropriation, and confiscatory taxation. Hence, the rule of majority has to be constrained, which highlights the need for other criteria for delineating the scope for state's actions.

6 For more on this, see van Creveld (1999, pp. 402-21); Mathews (1997, pp. 50-65).

rationale for a more regulatory state. This is a puzzling recommendation, given that 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, say international organizations. Then we would face the question of the optimal distribution of this optimal set and the related issue of the changed role of the national state. Such issues are, for example, at the heart of the constitutional debate in the European Union.[6]

# 3 Criteria for the Optimal State's Activity in Economics

What are the criteria for the delineation of the optimal set of the state's functions? Let me focus on the weaknesses of the standard economics approach.[7]

- Providing the legal framework "within which all economic transactions occur" is declared to be "a primary role of government" (Stiglitz 1988, p. 24). However, very little 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 theoretical concept of public goods.[8] If these goods are to be provided at all, taxes and the related coercion by the state are necessary. However, which goods are public? Is the justice system the domain of the state because the relevant services are a public good? Clearly, that can't 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? Coase (1974) has shown that lighthouses in 19th century Britain were not only operated but also financed privately. But this has not prevented the

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

8 For a strict theoretical definition of the public good (collective consumption good), see Samuelson (1954, pp. 387-89).

lighthouse from continuing to serve as the primary example of such a good in the textbooks (see, e.g., Stiglitz 1988, p. 75). There may be fewer public goods in real life than typically assumed in economics. 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—i.e., inappropriately specified property rights (see, for example, von Mises 1949, pp. 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, pp. 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 Wolf (1988) ends his comprehensive analysis of the treatment of market failures in economics literature by saying that "there is no formula for establishing the essential minimum threshold of government activities and outputs" (p. 153). This agnostic conclusion is a fair summary of the literature's position on the optimal scope of the state's activity.

# 4 Back to Basics

Sen (1999, p. 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."[9] Economics, in his view, has moved too much in the direction of judging the state's actions only in light of their expected consequences, at the cost of weakening the intellectual case for basic individual liberties as the criteria for delineating the admissible and desirable scope of state activity. This view has been argued earlier by Hayek (1960).

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'Driscall 2002).[10] Restrictions of economic freedom can be defined with respect to this yardstick. 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.[11]

Developments during the 20th century have seriously weakened the intellectual and constitutional position of economic freedom in the West. I

9 I must add that in the above quotation, Sen is using the word "freedom" in its classical sense, i.e., as basic liberties. In other parts of his books, Sen reshapes the meaning of this term in such a way that it includes other goods, too. This second, enlarged application obscures the meaning of "freedom."

10 The central elements of economic freedom are secure rights to property (legally acquired), freedom to engage in voluntary transactions inside and outside a nation's borders, freedom from governmental control over the terms on which individuals transact; and freedom from governmental expropriation of property (e.g., by confiscatory taxation or unanticipated inflation), (Rabushka 1991, quoted in Hanke and Walters 1997).

11 These are definitions of the restrictions of economic freedom, and not substantive statements on what restrictions (if any) are justified. For more on what constitutes restrictions or interventions, see Hayek (1960, pp. 220-23).

focus on two examples indicative of a broader tendency. First, in his widely quoted and rightly admired book, John Rawls (1971) forcefully argues for the “principle of liberty” as the most important criterion for shaping social life and the role of the state. However, he excludes some basic elements of economic liberty (freedom of entrepreneurship) from the list of freedoms that should have priority. Not surprisingly, Rawls concludes that the ideal institutional system can be some sort of capitalism or of market socialism! Market socialism can be maintained only if people are deprived of the liberty to create private firms. Capitalism does not require the legal prohibition of nonprivate enterprises (or nonprofit organizations), say cooperatives: if people have a choice between putting their money, time, and energy into a private firm and into a cooperative, they overwhelmingly opt for the former. Capitalism is thus based on choice, while any form of market socialism requires prohibition on private enterprise (for more on this, see Balcerowicz, 1995a, pp.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. And it was in this country that economic liberty was relegated to the subordinate position relative to other liberties as a result of the Supreme Court’s rulings in 1930s, and contrary to the original interpretation of the American Constitution (Dorn 1988, pp. 77-83). By weakening the constitutional safeguards protecting economic freedom, these rulings paved the way for increased regulation (and taxation). Years later the consequences of this regulation were critically analyzed in economic literature, but there have not been many people who have linked the increased regulation to the previous weakening of the constitutional defenses of economic freedom.[12] Even George J. 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 this 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.[13] 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.

12 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 view of the rise of regulation and the subsequent deregulations, even the proponents of a 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, however important, is secondary to the question of what should be the limits on economic liberty or what factors should override property rights (see, e.g., von Mises, 1949, pp. 654-61; Nozick, 1974, pp. 178-82).

13 Holmes and Sunstein (1999) point out that both types of rights cost money, and that therefore the distinction between liberty rights and welfare rights is not fundamental. However, nobody has denied that the protection of individual liberties—e.g., police and the courts—requires some spending, so it is hardly a discovery. The basic difference between liberty rights and welfare rights lies elsewhere. In the first case, taxpayers' money is used to protect individuals from

The state is best contained when basic liberties are anchored in an effective constitution.[14] 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.[15] 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.[16]

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 for economic development. For other differences between liberty rights and welfare rights, see Lomasky (1987, pp. 84-110).

14 Hayek (1960, p. 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."

15 Probably the most famous contemporary example of this instrumental (or "pragmatic") approach to the choice of institutional arrangement 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.

16 This category included disproportionately many intellectuals in the West. For an explanation of this interesting phenomenon, see Schumpeter (1950), von Mises (1956), and Nozick (1997).

# 5 Limited and Expanded States and Their Consequences

Are there trade-offs 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, which focuses on the protection of basic liberties, including economic ones. If this state is democratic, then the operation of the 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.[17] However, this limited state is active in its constitutive function of protecting individuals' basic liberties against 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:

- Extended, quasi-liberal state. 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

17 Meeting this definitional requirement, i.e., creating and maintaining a limited state, requires some special institutional arrangements, i.e., effective checks and balances, control over the state's apparatus of repression (police, prosecutors, tax administration), independent and effective judiciary, free media, constitutional tribunal, etc. It is far from easy to create and sustain these special arrangements. In fact, it is much easier to expand the state than to keep it limited. And once expanded, it is difficult to roll back.

model quasi-liberal. The restricted economic liberty is reasonably well protected by the state's justice system.

- 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.

- Extended, antiliberal (Communist) state. Private entrepreneurship is banned, and this ban is effective largely because of the harshness of the state enforcement. The effective ban of private business creates a vacuum that has to be filled by the state command economy. The antiliberal Communist state must therefore be hugely extended. This is a functional necessity (for more, see Balcerowicz 1995, pp. 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, China, has been the closest empirical approximation). All the historical evidence we have suggests rather strongly that these regimes displayed a very good growth record, and I don't know of any evidence to the contrary (for more, see 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 long-term unemployment and ask the basic question: can such unemployment be linked to the operation of the market (i.e., is it a market failure?) or rather to public interventions typical of extended quasi-liberal states? The first view is represented, I think, by the theory of "efficiency" wages, which tries to explain unemployment by the alleged tendency of employers to set wages above the market-clearing level, thus causing unemployment (see, e.g., Akerlof, 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 some combination of state intervention (i.e., public failure), is much more convincing. Indeed, there is a huge amount of empirical literature linking 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, legal restrictions hampering entry of new firms, and the operations of the labor, housing, and product markets.[18]

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 doesn't have to be true, as shown

18 Massive work on the causes of structural unemployment was done by the OECD. For a summary, see Keese and Martin (2002). See also Nickel (1997) and Lindbeck (1994).

by the recent performance of the United Kingdom, the United States, Denmark, Ireland, and others. What can be said is that stepping beyond the limited state (i.e., weakening or abolishing mechanisms which constrain the expansion of a state) creates the risk of interventions with various undesired effects,[19] while falling short of the declared goals.[20]

Most developing countries have a quasi-liberal or illiberal regime, and they differ very much 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 economic freedom is good for growth, while massive, state-imposed restrictions of that freedom, combined with its poor protection, produce disastrous consequences (see, e.g., Scully 1992; Hanke and Walters 1997; Keefer and Knack 1997; and Dollar and Kraay 2002). In the developing world, there is no trade-off 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, state-led industrialization)? Such a view is easily refuted.

19 These dangers were thoroughly analyzed by von Mises (1949, pp. 716-858) and Hayek (1960, pp. 253-376). However, their works have been given little notice in mainstream economics, at least until recently.

20 Tanzi and Schuknecht (1997) show empirically that states that are big spenders tend to achieve a lower level of various welfare indicators than small spenders. Feldstein (1996) 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 the public spending/GDP ratio. There is also massive evidence that state-imposed redistribution schemes are often "captured" by the better-off and thus do little to help the poor (see, e.g., Tanzi 1998). It has also been found that product and labor market regulations stifle productivity and economic growth (Scarpetta et al. 2002).

For the “miracle” regimes differed in the extent of such interventions, but had one thing in common: an extraordinary accumulation of economic fundamentals typical of a limited state: a relatively open economy, low taxation, private entrepreneurship, etc. (For more on this interpretation, see Balcerowicz 1995b, pp. 26-27; for the empirical findings, see Quibria 2002).

The Marxist view that economic freedom and thus the free market are fundamental obstacles to economic development has been ruthlessly falsified by experience. There is not a 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 the superiority of socialism and disregard the warnings coming from von Mises and Hayek,[21] just to name the most prominent defenders of economic freedom.

I have focused so far on the links between the restrictions of economic liberty and some aspects of economic performance. However, there are other important variables, such as the share of human actions declared as crimes, corruption, tax evasion, and a shadow economy. How do these variables relate to the type of state?

Let us return to the notion of elementary crimes as a catalog of actions declared as crimes in every modern society (murder, assault, robbery, rape,

21 I must say that knowing the experience of “real” socialism, I was shocked by the lack of realism displayed by mainstream economists in the debate on the economic efficiency of socialism. I have analyzed this debate in Balcerowicz (1995a, pp. 35-50).

etc.). Expansion of the state tends to increase this catalog (Friedman 1984, p.136)—i.e., it creates a menu of secondary crimes. Restrictions banning the supply of a good in strong demand can create a criminal underworld that produces not only secondary crimes but also some induced elementary crime (i.e., gangsters killing each other and the police). Prohibition in the United States in the 1920s is a spectacular case in point.

Increased social transfers, the main reason for the explosion of public spending in Europe after the Second World War, raised taxes and increased the scope of tax-related crimes (and the growth of 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.[22] The Communist case shows in a dramatic way that law enforcement is not a value in itself. Enforcement of what: enforcement (protection) of basic liberties, or enforcement of restrictions of these liberties?

Besides the ethical question about the content of law and the value of its enforcement, there is the following empirical issue: If the state justice system is busy enforcing numerous state-imposed restrictions on economic freedom, would it find enough time and motivation to protect adequately what remained of this freedom against intrusions from third parties? It is hard to

22 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 the state command-economy, it would succeed; i.e., at least some elements of economic freedom would be introduced (Balcerowicz 1995a, pp. 131-33).

imagine that a highly regulatory state could—in the long run—have a justice system providing good protection of the remaining economic liberty. In other words, a limited state not only gives individuals the broadest possible economic freedom but also may be able to protect this freedom better than could be the case with much reduced liberty in a highly regulated state.

Let us now turn to corruption. There are political systems officially recognized as "states" where the ruling clique is, so to say, "above" the distinction of corrupt—noncorrupt actions (see Charap and Harm 1999). North Korea and Zimbabwe illustrate this category. They fall short of a set of functions which define Nozick's minimal state. I will leave them aside.

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, the large scope of public purchases, etc. (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 degree of discretion enjoyed by the public administration. What especially restricts economic freedom and thus harms growth is at the same time very conducive to corruption.[23]

23 Antiliberal 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, i.e., 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 demand is strong and supply is limited because of a shortage of budgetary financing or because of mismanagement, say, in hospitals.

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 bureaucratic discretion is limited. This is best illustrated by Scandinavian countries. 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, which, in part, stems from the unrecorded activity of the shadow economy (Schneider and Enste 2000, pp. 77-114). Finally, massive social transfers that 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, misuse of public funds by beneficiaries, and a culture of dependence (see, e.g., Niskanen 1996; Hanson 1997; and 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 bribes paid to tax officials (and possibly to 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.[24] 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

24 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 would not be stable: sooner or later, corruption epidemics would spread to the tax administration. Besides, an economy burdened by both high taxes and large bribes would collapse.

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 the economic damage it produces. Large sacrifices of economic liberty bring about a large loss of welfare. This is true beyond any reasonable doubt in antiliberal Communist states, but it is also true in the 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. Even in the case of the 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.

- Large doses of restrictive regulations may be more harmful than certain doses and forms of redistribution. Massive regulations necessarily produce economic paralysis and widespread corruption. They may also weaken the state's protection of the remaining economic freedom. Leaving the ethical questions aside, one can say that the rational limit to redistribution is set, among other things, by the requirement of fiscal soundness and by the postulate that they do not 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 numbers of disadvantaged people, as they produce poverty and long-term unemployment. Believers in the Rawlsian principle, whereby the interests of such people should have priority, ought to be wary of extended states.

# 6 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 "demand" or a "need"; therefore it is in some sense justified. For example, Musgrave (2000, p. 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 is about its effects. The problem with the first assertion is that even with such elastic concepts as "demand" and "need," it would be absurd to explain more drastic forms of the expanded state, e.g., communism or Mobutu's dictatorship. However, the need (demand) 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 have 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 need can explain such a pattern of growth of transfers and regulations. The need (demand) theory of the state's expansion is an unconvincing attempt to explain this fact by recourse to pseudo-psychological or pseudo-market concepts. At worst, it borders on an apology for 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 a certain useful function cannot be performed by the market, it does not necessarily follow that the state is the only agency left.

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 antiliberal 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 private investors, public investment will fill the void. This is a 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 which starts with primary intervention resulting from various interplays of political pressures related to statist ideologies, interest groups' activity, etc. Once introduced, this intervention often leads to secondary ones because of functional necessities, i.e., pressures operating regardless of prior decision-maker's 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—at least partly—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, 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, non state educational developments. West (1991) stresses that "with the exception of Marx and Engels, the political economists up to the mid-19th century were in favour 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." J. Stewart Mill recommended compulsory examinations but not compulsory schooling.

Or take individuals' 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, which bring about fiscal and/or financial crises, high inflation, high unemployment, etc. Preventing such policies, via the transition from an expanded to a limited state, is the best and indispensable “social” insurance.[25] 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 exists a variety of informal “coping strategies” (e.g., reciprocal exchange of gifts and loans, remittances from migrant family members) and a surprisingly large potential for more modern, nonstate institutional arrangements that promote savings and provide insurance and microcredit (for an excellent overview, see 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 1988). 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, p. 201).

25 Stiglitz (1989) stresses that “the distinctive strengths” of government—its universal membership and its power of compulsion—are also its greatest liabilities,” as “the mistakes that are made with concentrated power may be far more disastrous than those which arise in a society with decentralized decision making.” This is clearly an argument against expanded (i.e., more powerful) states and for more limited ones.

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 (World Bank, 2001, p. 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 (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 the better-off, and they may crowd out voluntary arrangements that serve 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 to finance social spending is likely to hamper economic growth and the related job creation.[26]

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 monitoring behavior of depositors inducing competition among banks with respect to the level of their capital, disclosure of information, etc. The created gap generated a wave of secondary regulations, such as risk-sensitive capital

26 One may recall Hayek’s (1960, p. 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.”

adequacy ratios, portfolio restrictions on banks, the use of subordinated debt as a monitoring device, etc. (Bhattacharya et al. 1998; Dowd 1996; Benston and Kaufman 1996). These prudential 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 during the 20th century, the intellectual and constitutional position of economic liberty has been seriously eroded, and this has paved the way toward the expanded state.

The expansion of state activity, i.e., the growth of state-imposed restrictions on economic freedom, is difficult to justify by any improvement in 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, a shadow economy, and a 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, e.g., 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 twenty 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 complete and is fraught with difficulties. There will always be some people who see benefits (power, economic rents) in limiting other people's freedom. And there will always be some ideologues who 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 which 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 to protect domestic taxpayers and consumers. These and other second-line defenses should be introduced or strengthened.

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