



# Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

transcript of a talk by  
**Professor Michael Mainelli, Executive Chairman, Z/Yen Group**  
at  
**Gresham College, Barnard's Inn Hall, Holborn, London EC1N 2HH**  
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Good evening Ladies and Gentlemen. I'm pleased to see so many of you turn up for a lecture on political fairy tales. You may not be so glad that I chose Goldilocks And The Three Bears as the basis of this talk because I may need three chances to tackle this complex subject, so brace yourselves.

### Magic Beancounters

Tonight I would like to examine why government has a tendency to grow, how we might measure an optimal level of government in commerce and the importance of communities. So we might as well start with fairy tales.



## Outline

- Magic beancounters
- Public, private or in-between?
- Contracting with the people
- Global contracting
- The Government Optimeter
- The Competition Optimeter
- The Community Optimeter
- Do you really, really believe in smaller government – the Bear-est recipe?



“Get a detailed grip on the big picture.”  
*Chao Kli Ning*

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## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

Once upon a time, 1995 to be exact, a young beancounter was trying to figure out how to conduct a 'prior options' study for a government department. The beancounter was intelligent, handsome and, at that time, single. Not a million miles from the current speaker just over a decade ago. Now a 'prior options' study is a fascinating UK ritual. This ritual emerged from the "Next Steps" agency programme of the late 1980's and is designed to review all government agencies at regular intervals, typically every five years, though sometimes more frequently. Each review evaluates the performance of an agency and its governance and re-appraises the prior options considered before the agency was created. The options include abolition, privatization or contractorisation, including market testing and rationalization.

Prior options studies originally began as a way of ensuring that agencies were subjected to scrutiny about their existence, rather than just continuing to exist from year to year. The prior options process goes through a number stages:

1. Is the function needed at all?
2. Must the public sector be responsible?
3. Must the public sector provide the function itself?
4. What is the scope for rationalisation?
5. Where a function remains within the public sector after rationalisation, how will the function best be managed?

In practice, we sometimes find that if something weren't done we might need to invent it for political purposes, e.g. a taskforce on this subject or a cultural centre for that country, but on the whole 'prior options' is a good process designed to control the scale of government.

Anyway, this young beancounter realized that he needed some help in deciding what criteria determined whether a function fell in the public or the private sector. He realized that he needed an economic wizard. Now this young beancounter knew that the best wizards had the finest sherry cupboards, somewhere up near a cattle crossing called Ox-Ford, so the beancounter arranged for a coach and horses to take him to see one of the Master Wizards at the finest college. The young beancounter arrived at the magical college around mid-morning. The Master Wizard was delighted to see the young beancounter. The young beancounter blurted out his question, "how do we determine what is best in the public sector and what is best in the private sector?", but the Master Wizard just put his fingers to his lips. "Hush", he said, "Let's start with a snack."

Well, they had a snack, then they had some lovely canapés, followed by a delightful game pie and some savouries, for the beancounter didn't like sweets, followed by some cheese. Of course, you can't discuss wizardly things and snack without quaffing a few glasses of Chablis, followed by some claret, washing down the cheese with some port. In order to help the digestion, it was important to wash down some of this food with some tea. And cucumber sandwiches. Naturally, the whole purpose of these exercises was to prepare the palate for the high point of the visit – the late afternoon raid on the sherry cupboard. During the rather brief intervals in the digestive schedule the beancounter and the Master Wizard, in the terminology of the Wizard of Oz, "hobnobbed" with each other. Hobnobbing consists not just of partaking of exquisite biscuits, but also in lobbing questions and observations at each other. The questions might take the form of, "is there anything the private sector can't do?" or "is there such a thing as bureaucratic economics?", while observations might be snippets such as "competitive standards are a free market response to regulation" or "the Pareto optimal Phillips equilibrium might well not apply".



## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

The hobnobbing continued delightfully and the beancounter felt almost like a fellow wizard. The Master Wizard too was delighted with the quality of the hobnobbing as, according to the arcane rules of the craft, it was of sufficient quality to justify a significant depletion of sherry resources. As twilight drew close, the Master Wizard escorted the beancounter to his coach and horses, and his patient, somewhat haughty driver. They parted most amicably with fond best wishes to each other and many promises of future toasts to come. It was only then, bouncing in the coach on the way home, that the beancounter realized that they had never answered his question, “how do we determine what is best in the public sector and what is best in the private sector?”. The beancounter leaned back and smiled. Perhaps answering the question might justify a future raid on a wizard’s sherry cupboard.

The whole point of the story is that we really have yet to determine what should be done in the public sector and what in the private sector. There are many theories and many schools ranging from Marxist to anarchist.

### Public, Private Or In-Between?

We find the number “three” in numerous fairy tales. Three billy goats, three magic beans, three beautiful sisters, three wicked witches or even three bothered bears. So what might be the three elements of commerce?

We tend to think of markets as either centres of innovative wealth-creation, or nests of self-centred profit-maximizing capitalists. We are equally schizophrenic about government as a benevolent enforcer of equality or a Bureaucratic Big Brother Bogeyman. We often forget that governments compete not just nationally, but also at numerous local, municipality and regional levels. One view of the future is contained in Ian Angell’s The New Barbarian Manifesto where the winners in our knowledge economy will construct their own ‘smart regions’ from among today’s governments founded on their own libertarian principles and self-interest.

Our vocabulary falters on the Third Sector and we often overlook this large field of choice, frequently defined by what it isn’t – not-for-profit organisations, non-governmental organisations or more positively as charities, voluntary sector organisations, activist organisations or even the increasingly trendy post-modernism, “beyond profit”. Nevertheless, we are just as two-faced about charities as either caring humanitarians organised for the common good, or interfering self-righteous busybodies.

Looking at society through commercial eyes, it is easy to conclude that there are three fields of choice - markets, governments and not-for-profits. Easy, but perhaps wrong? A glance at basic economic statistics might quickly dispel the number three and get us to focus on the public-private divide alone. The not-for-profit sector is, despite much growth recently, still the Cinderella of commerce at a couple of percentage points of GDP and about the same in employment, though it is very hard to estimate the contribution of volunteer time. John Hopkins’ Center for Civil Society Studies provides enough information to guess that even with volunteer time perhaps 5% of labour activity might be in the not-for-profit sector. I shall return to the increasing importance of the not-for-profit sector in future lectures, but for this evening we focus on a private sector employing nearly 80% of the workforce and a public sector employing 20%.



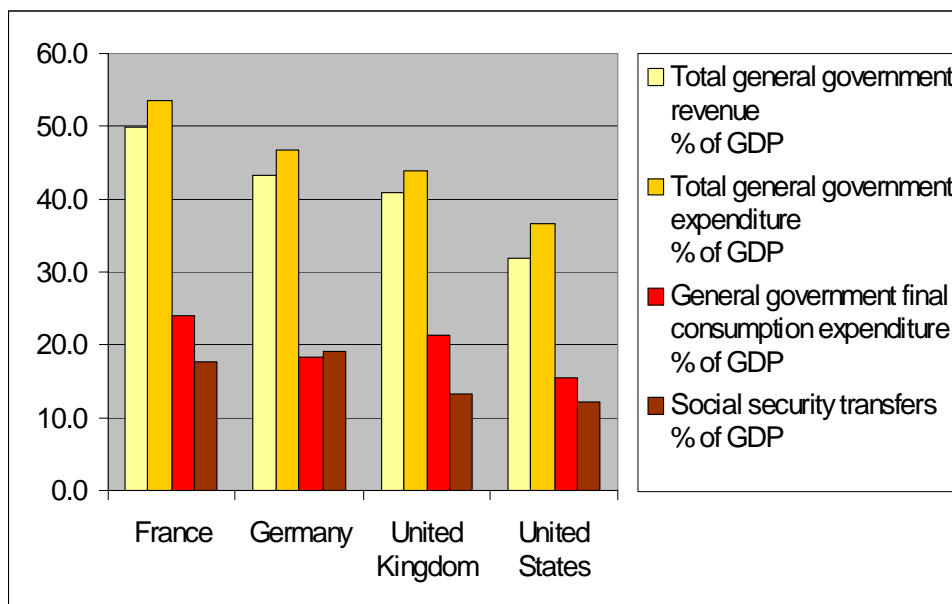
## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

We could spend time looking at the theoretical underpinning behind notions of wholly state-controlled commerce versus the idea of wholly private commerce, yet I'm anxious not to spend a lot of time rehashing political philosophy. Discussions of the role of the state pre-date Socrates. It seems that skilled political philosophers can justify either extreme of the government versus private sector debate. Interested listeners are welcome to refer to John Rawls' classic 1971 defence of principles underlying redistribution, A Theory of Justice, and a government role of some scale, or to a former teacher of mine's, Robert Nozick's, equally classic 1974 work, Anarchy, State and Utopia, that only grudgingly admits a minimal government.

I'd like to start by looking around us and wondering about the value of a pragmatic viewpoint. It's intriguing that we often complain about the scale of government but people are broadly in agreement about what government ought to provide. For instance, I asked a budding 15-year-old economist his thoughts on the role of government. Off-the-cuff he was very clear – government should provide no subsidies, let firms go bust, set minimum taxes and not interfere with legal activities, BUT government should provide education, health, laws and policing.



## Government In The Economy



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We can look at expenditure and see that the public sector in the UK spends over 40% of GDP. About half of this expenditure consists of transfer payments such as welfare or pensions, hence I would draw your attention to focus either on the slightly more than 20% of general government final consumption expenditure or on the 20% of the workforce in government employment indicating that at least that 20% of the economy is under public sector decision-making. We can get controversial. Should we count all public expenditure? Public expenditure requires either taxation or borrowing or inflation. Should we count only real expenditure, and ignore transfer payments such as social security or interest as

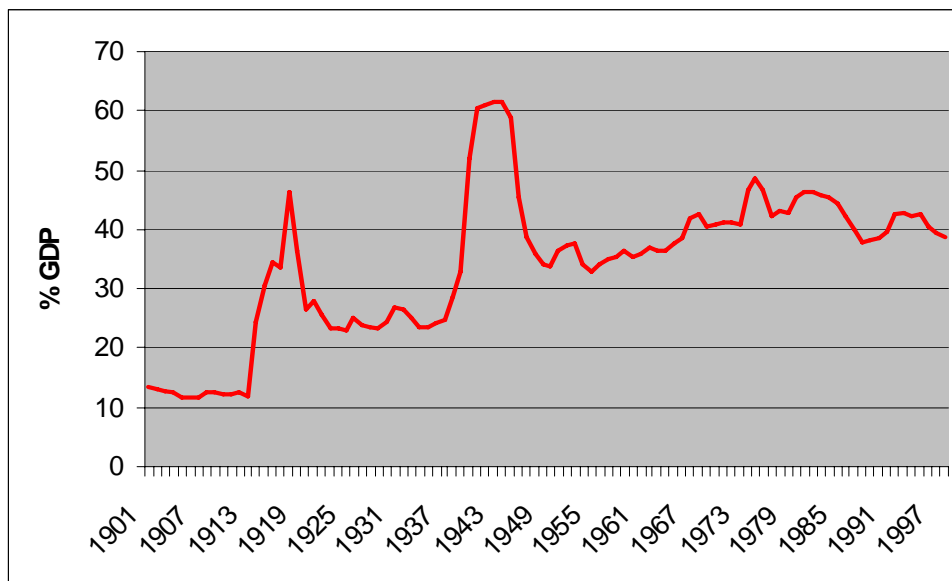


## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

decisions about equity of distribution? Then we could focus in on the scale of government choice in the economy. Should we count only expenditure that is *not* in the market? Here we are mostly counting work done by government employees, around 1 in 5 people work in the UK public sector, though one could argue that they too are in a larger labour market. It is difficult to examine government expenditure without realising that much expenditure is circular, back within the private sector. It is as if we are constantly opening a series of Russian dolls, one within the next, where each doll has within it other private and public sector dolls.



### General Government Expenditure As % GDP 1901 to 1998



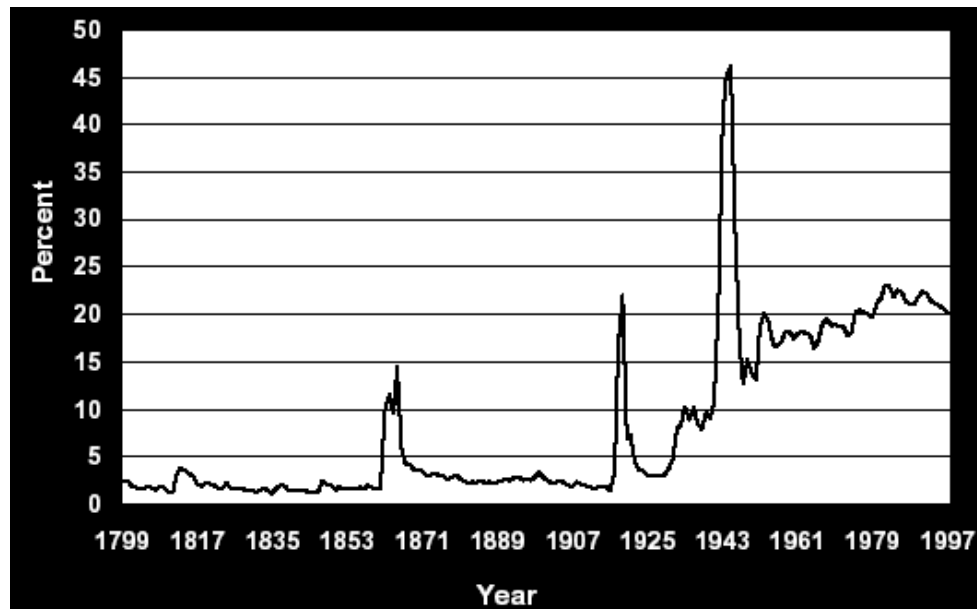
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[Source: Office of National Statistics]

Well this might sound like a normal state of affairs, but an interesting trend to examine is the long-term growth of the public sector over the years. You see here a graph of long-term general government expenditure as a % of GDP. Clearly the wartime periods result in a steep climb, followed by a decline, but there is no denying that one of the most important changes of the 20<sup>th</sup> century was the trebling of government expenditure in the UK as a % of GDP over the past 100 years.



## Federal Spending As % of GNP/GDP 1799 to 1997



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[Vedder and Galloway, 1998]

Nor is this trend of increasing government expenditure confined to the UK. We like to imagine that the USA is more free-market, but the same effect is obvious there. If anything, the growth in USA federal spending has been more rapid over the past century, rising by five times in the past 100 years. Of course, this rise in the scale of government leads to the natural question – is this good or bad? We can proclaim all the theory we like, but when it comes to practice, OECD economies exhibit a wide range of supposedly orthodox structures. Empirical studies show that in most ways, the scale of government is a matter of choice. Government can be anywhere in a range of 15% to 50% of the economy, without much ability to distinguish one form of economy from another on most measures of performance. The only factor that seems to be negatively affected by large government is GDP growth, though even that is a slightly contested area. Now constraining GDP growth because of too much government is very important in the long-term, but it is not a compelling short-term measure to get people to cut the scale.

We seem to dress up a huge number of theories and studies and get very close to Nupe sand divining. The Nupe are a people in West Africa who have developed a very sophisticated system of prophecy based on patterns in sand. Our theories of public versus private bear some strong similarities to Nupe theories of prognostication. As one anthropologist studying the Nupe noted back in 1954:

“The most striking feature of Nupe sand divining is the contrast between its pretentious theoretical framework and its primitive and slipshod application in practice.” [Nader, S.F., *Nupe Religion*, 1954, page 63 from Feyerabend, 1988, page 50]



## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

For instance, the USA's Office of Management and Budget (OMB) Circular Number A-76, "Performance of Commercial Activities", was first issued during the Eisenhower Administration. At the core of A-76 is the fundamental precept that government should not compete with the private sector in providing services considered to be "commercial activities," i.e., work that is not considered inherently governmental and can be provided by the private sector. Observing this long-term expansion of government since 1900 in Europe and America, into what can only be enormous commercial gaps, it is reasonable to ask, does the public sector have an inbuilt bias for over-expansion?

Well, there are quite a few fairy tales supporting public and private biases. Let's start with the private sector argument against the public sector. The public sector acts, often simultaneously, as manager, regulator and steward for a variety of technological, natural and operational public assets, all within a politically-charged environment. Society expects more and more from the public sector, but the means used to achieve societal expectations are crude, either direct provision or feeble recommendations or daunting legal and regulatory mechanisms. There are disasters galore in management of public assets and services – health, education, transportation or the environment, just to get you warmed up – all showing that the power to impose does not necessarily come with the wisdom of what to impose. Untrammelled power leads simultaneously to the frontiers of despotism and the borders of ignorance, leading critics to demand a return to raw market forces.

A number of economists have put forward arguments that the public sector might have a malignant, inbuilt propensity to grow beyond an optimal level. Starting at least as far back as Charles Dodgson (Lewis Carroll) in the 1800's, scholars have pointed out that majority voting systems can have inbuilt biases that can make them unfair for certain types of decisions. Adolf Wagner back in 1883 noted that industrializing countries' public expenditure would increase in absolute terms and relative to the rest of the economy, his 'law of increasing state activities'. H R Bowen in 1943 and K J Arrow in 1963 wrote papers considering whether majority voting decisions on spending and taxes have an inbuilt creep upwards. It is clear that voters underestimate the costs of public expenditure. Surveys show that voters are confused over capital versus long-term running costs, such as Private Finance Initiative (PFI) programmes; over the apparently small direct costs to themselves of any specific programme and the large price tags they read; and between direct tax rates such as income tax versus the myriad of other taxes they face directly or indirectly, such as excise taxes, VAT, corporation taxes, national insurance contributions or inheritance tax. Further, voters are confused by the extent of public borrowing and its effects on their future tax payments or inflation. Finally, as the public sector grows, more voters depend on the public sector sustaining them and may well vote to maintain or increase its size.

A number of arguments have been labelled the 'public choice' school, i.e. arguing for a more rigorous setting of thresholds before things are allowed to move into the public sector and an aggressive campaign of reducing the scale of the public sector to an optimum level, presumed to be somewhat below its current size. Paul Starr summarises the public choice school: "In short, starting with an individualistic model of human behavior, the public choice school makes a series of empirical claims: (1) that democratic polities have inherent tendencies toward government growth and excessive budgets; (2) that expenditure growth is due to self-interested coalitions of voters, politicians, and bureaucrats; and (3) that public enterprises necessarily perform less efficiently than private enterprises."



## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

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Lester Thurow warns, “Societies are not merely statistical aggregations of individuals engaged in voluntary exchange but something much more subtle and complicated. A group or community cannot be understood if the unit of analysis is the individual taken by himself. A society is clearly something greater than the sum of its parts.” [Lester Thurow, *Dangerous Currents*, 1983, pages 22-223] Though even critics think that free market economics can overcome its current focus on individuals over communities - “we do believe that economics can rethink its theories from the viewpoint of person-in-community and still include the truth and insight it gained when it thought in individualistic terms.” [Daly and Cobb, page 8]

On the other hand, let’s look at arguments against a simplistic view that private sector operations are intrinsically superior to the public sector. It is very possible that voters are not aware of the scale of the benefits that they receive. J K Galbraith pointed out that private goods and services are more aggressively promoted than public goods and services. Many benefits, such as the beauty of national parks, are intangible; many benefits, such as long-term welfare provision, are spread over long time periods.

Government economists trot out, almost by rote, the justification for government intervention, such as the recent, hastily-withdrawn, “Operating and Financial Review” statements for UK companies (OFR). Government initiatives were required because of “market failure – externalities, information asymmetries and agent problems”. Well these charges can be laid at any market. Almost any market has externalities, there is never perfect information symmetry and markets of any scale typically require agents to function.

In a review of a book by Benjamin Friedman, Joseph Stiglitz remarks:

“American economists tend to have a strong aversion to advocating government intervention. Their basic presumption is often that markets generally work by themselves and that there are just a few limited instances in which government action is needed to correct market failure; government economic policy, the thinking goes, should include only minimal intervention to ensure economic efficiency.

The intellectual foundations for this presumption are weak. In a market economy with imperfect and asymmetric information and incomplete markets - which is to say, every market economy - the reason that Adam Smith’s invisible hand is invisible is that it does not exist. Economies are not efficient on their own. This recognition inevitably leads to the conclusion that there is a potentially significant role for government.” [Stiglitz, 2005]

It may be that voters just don’t like free markets. As the editor of the Economist, Bill Emmott, summarised, “capitalism is forever under challenge, forever being questioned”, that he classified along four channels - unpopular, unstable, unequal (both nationally and internationally), and hitherto unclean (environmentally).

On the other hand, arguments for government intervention seem to have no natural curb. In the wild world of the internet one could imagine the need for a “National Internet Access Service” (NIAS), ensuring that everyone in society gets at least a minimum “safety net” level of internet access to ensure we are all included in society. You could call this the British Internet Corporation or the Citizens’ Internet Bureau. Obviously the NIAS is



## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

needed because of externalities (one person's heavy traffic may inconvenience another), information asymmetries (connection costs are much lower than operators would tell you) and agent problems (purchasers of bulk bandwidth are well-known for favouring firms that give them conferences in exotic locations). Suddenly we find ourselves nationalising all telecommunications. Sounds a lot like British Telecom in the 1970's, or French Minitel in the 1980's?

Despite the political rhetoric of privatisation, private finance and public-private partnerships, over the past four decades you can see that a number of European countries seem to have stabilised at around 40% of GDP being spent by the government, and the United States of America, while a bit less, has also accepted a rather significant part of the economy coming under public control.

### Contracting With The People

One of the hottest topics for millennia has been the idea of representative democracy versus true democracy. I shall nod respectfully, very respectfully indeed, at Plato, Aristotle, Spinoza, Hobbes, Locke, Rousseau, Jefferson, Hamilton, Madison, ... but it is interesting that the issue in former times was the structure of government and the right, or lack thereof, of people to extract 'rent' from society due to a position of privilege, whether the position be monarchy, nobility, monopoly or clergy, while the modern position is to take government as a given but to wonder about the scale.

Joseph Schumpeter wrote that the kernel of democracy was an "institutional arrangement for arriving at political decisions in which individuals acquire the power to decide by means of a competitive struggle for the people's vote." The Oxford historian John Dunn draws a keen distinction between democracy, which Plato loathed, and Aristotle's view that government by the many, as a "*politeia* (polity or, more informatively constitutional government)", could "elicit a correspondingly broad range of sympathy and loyalty".

"Economies are permanently at the mercy of rulers. Private property, the foundation on which a capitalist economy operates, must be nurtured by political prudence, and can be jeopardized or even dissolved by the clumsiness or dishonesty of rulers or public officials. Currencies rise and fall, and economies thrive or disintegrate, through the good senses and scruple, or the cynicism and folly, of those who govern. No government can make a country prosper; but any government can ruin one; and most today are in a position to do so very rapidly and extremely thoroughly." [Dunn, page 135]

There is obviously real tension between democracy and markets. John Dunn notes Plato's thoughts in *The Republic* [Dunn, page 45], "The principle of democratic rule is equality, the presumption that, when it comes to shaping a community and exercising power, everyone's judgement deserves as much weight as everyone else's. That presumption in turn implies that there can be no lasting shape to a democratic community, and nothing reliable about the ways in which power is exercised within it. What this means, as Thomas Hobbes pointed out two thousand years later, is that in a democratic community there can be no real security for anyone or anything except by sheer fluke." Dunn highlights the tension in democratic approaches between the "order of egoism" and the "order of equality". The order of egoism needs consistency over time and durable property rights, while the order of equality never delegates sovereignty in participatory democracy to any sub-group.



## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

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During the French Revolutionary upheaval, the Conspiracy of the Equals attempted a coup in 1796. One of the key figures in this confused plot was a Tuscan aristocrat Filippo Michele Buonarroti whose account of the Conspiracy inspired Marx. As Dunn explains, “the main motif in Buonarroti’s account was his insistence on equality as the Revolution’s deepest and most transformative goal, and on the profound gulf between the true defenders of equality and their sly and all too politically effective adversaries, the partisans of the order of egoism, or ‘the english doctrine of the economists’...” [Dunn, page 124]

In many ways, democracy needs markets and markets need democracy – but the relationship can only thrive if democracy provides stability of contract for the markets. Therefore, markets need to be able to contract with society. The key advantages of a republic in the 18<sup>th</sup> century were seen to be its ability to handle greater numbers of citizens and greater distances. However, not so explicitly stated is that a republic tends to be more stable over time than a true democracy. Federalist Paper Number 10 and Federalist Paper Number 51 are generally regarded as the most influential of the 85 Federalist Papers; 10 advocates a large, strong republic while 51 explains the need for separation of powers. As Dunn observes, “To delegate government to relatively small numbers of citizens but also insist that they be chosen by most, if not all, of their fellow was a cunning mixture of equality and inequality.” [Dunn, page 128] The reason that the Lockean principle of the American Revolution, individuals delegating their power thus allowing social compacts, provides more stable markets than the Rousseauan principle of the French Revolution, the majority expressing individual rights, is that under a republic with checks and balances it is easier to be more certain of long-term contracts.

One of my favourite Benjamin Franklin quotes is: “Those who would give up essential Liberty, to purchase a little temporary Safety, deserve neither Liberty nor Safety”. Franklin meant, of course, that even seemingly minor or transient curbs on freedom should not be tolerated. Yet, American representative democracy required a compact with markets that did give up some essential liberties in order to purchase a little temporary safety. This contract was recognised as new. Madison notes in The Federalist Papers (Number 45 – “A Further Discussion Of The Supposed Danger From The Powers Of The Union To The State Governments”) “The regulation of commerce, it is true, is a new power; but that seems to be an addition which few oppose, and from which no apprehensions are entertained.”

On the other hand, it is clear that Hamilton and Madison (Number 56 – “The Same Subject Continued In Relation To The Same Point” – “The Total Number of the House of Representatives”) did not foresee that the regulation of commerce might grow remarkably - “A proper regulation of commerce requires much information, as has been elsewhere remarked; but as far as this information relates to the laws and local situation of each individual State, a very few representatives would be very sufficient vehicles of it to the federal councils. Taxation will consist, in a great measure, of duties which will be involved in the regulation of commerce.”

Of course, if we revel in noting that markets seem to emerge anywhere humans stand to gain from exchange, we have to take note of markets that emerge outside democracies, regardless of the fact that we may at this point in time view markets and democracy as the most sophisticated form of social organisation. It may be that the key criteria for successful government and market interaction is stability of contract. For instance, the Chinese government has done more over the past two decades to reduce poverty than probably any



## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

single entity. However, it is not democracy that makes this possible, just a reasonable certainty over a reasonable length of time that markets are able to contract with the Chinese government. To give Dunn the last word:

“The winning offer from rulers to ruled is not a fixed sum, but a highly plastic, and always partially opaque, formula. It blends minimal recognition with quite extensive protection of the institutional requirements of the order of egoism. It ensures property law, commercial regulation and a due balance between taxing enough to provide the protection and protecting enough against all forms of expropriation (very much including taxation itself) for the order of egoism to proceed buoyantly on its way. The scope of recognition offered and the degree of protection provided are each renegotiated endlessly.” [Dunn, page 146]

### Global Contracting

It is interesting to note that in an age of global trade, in an age of global privatisation of assets such as the right to pollute air, we see the conflict of an open system within a closed system. The closed system is the earth, a biosphere that is effectively closed except for the injection of energy from the sun and the radiation of energy into space. The open system is the market. The market system has two salient characteristics that create dissonance with the biosphere system; the market is anthro-centric and it relies on extensive, enforced property rights. Conflict arises from not recognising effects not valued by humans today and from not being able to enforce property rights such as emissions protocols – who is going to send in the gunboats to the island that decides it’s going to receive every wayward tanker and export electricity while polluting away? Dissonance is evident in the fact that most human life outside the tropics is, given today’s technology, unsustainable in the tense environment. Large-scale human life outside the tropics may be low-impact, but it is as yet unsustainable. Conflict is predictable, for even if carbon sequestration made life outside the tropics sustainable, it is highly likely to depend on exports of carbon to developing countries, i.e. enforceable trade and contracting over long-periods of time or radical changes in economics, e.g. sustainable technologies significantly reduce demand for oil.

We are taking baby-steps towards addressing some of the big issues of our global ecosystem. Market advocates fervently believe that enforceable property rights and trade will achieve an optimal distribution of activities. Government advocates believe that the ultimate solutions are political, nation to nation. To date, the markets have only weakly embraced ideas such as emissions trading and governments have done daft things on property rights, such as levying windfall taxes on energy, thus harming investment in sustainable energy at the same time, or muttering that they might increase emissions quotas, thus damaging the value of early purchasers or emissions quotas. Yet Dunn’s logic leads one to recognise that the scale of global-ish government must increase if these communal problems are to be solved.

### The Government Optimeter – or Ogremeter – Half Full or Half Empty?

I’ve been in Germany a lot recently and learned much. For instance, did you know that the Germans have a word-of-the-year? What a great idea. The word-of-the-year for 2005 was ‘Bundeskanzlerin’. That mouthful is the German word for female chancellor, referring of course to the appointment of Angela Merkel. The formation of Angela Merkel’s government was a protracted process, lasting 65 days. An ogre-friend of mine in Germany



## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

runs a construction firm in the south. He remarked that during the formation process government officials were indecisive to the point of doing nothing about planning inspections, rule changes or inspections, basically giving permission for things just to go on as they were. He made an ogre-like aside that these officials had had to work very hard to do less, yet his firm got as much done in 65 days without government interference than they did during the course of a normal year.

Now it's easy to carp about the scale of government. It's easy to carp about slow, mindless, expensive bureaucracies, yet I certainly don't want to live in a lawless society, at the moment the Congo comes to mind. I want a nice, safe, civil society with a respect for law, order and private property. I also want a say in society, some form of democratic representation. Yet my German friend's comment got me thinking – wouldn't it be nice to have a handy-dandy meter for government.

Ideally, we'd like a meter for our genuine national wealth. But Hamilton writes in The Federalist Papers (Number 21 – “Other Defects of the Present Confederation”):

“The wealth of nations depends upon an infinite variety of causes. Situation, soil, climate, the nature of the productions, the nature of the government, the genius of the citizens, the degree of information they possess, the state of commerce, of arts, of industry, these circumstances and many more, too complex, minute, or adventitious to admit of a particular specification, occasion differences hardly conceivable in the relative opulence and riches of different countries. The consequence clearly is that there can be no common measure of national wealth, and, of course, no general or stationary rule by which the ability of a state to pay taxes can be determined.”

Germans have a popular expression – “Vertrauen ist gut, Kontrolle ist besser” – “Trust is good, control is better.” Instead of trying to measure national wealth, perhaps we need something to control government. Let's call it the Government Optimeter. If the Government Optimeter goes red, we have too much of the economy swallowed by government. If the Government Optimeter goes green, we are in an optimal range. The Government Optimeter should also go red if we had too little government. Given that our Optimeter is, using % of GDP as the measure, already hovering above 40%, I think an initial target setting ought to be below 35%.

What an appealing, even seductive, idea! We just set out our key measure and it's highly likely that, even if politicians don't immediately enthuse about it, we manage through the discipline of voting to get them to come round. Of course, I'm hardly the first person to consider this. For instance, we have a variety of “tax freedom day” or “work freedom day” measures; take a typical year, when do we stop working for society and start working for ourselves? In the UK, the date in 2005 when you stopped working for the taxman and started working for yourself was calculated as 31 May, a bit earlier at 27 May in 2004. Supposedly the USA celebrated a tax freedom day on 11 April while most of the Continent had to wait till the end of June.



## Mixed(up) Economy

### Types of Goods

- Public (non-rival; non-excludable)
- Club/toll (non-rival to a limit; excludable)
- Quasi-public (rival; excludable; externalities)
- Common pool (rival; exclusion possible)
- Private (rival; excludable)
- Merit wants (information absent or too complex for consumer)

### Forms of Provision

- Public sector without charge
- Public sector with charges
- Public sector with charges and vouchers or grants
- Public contracts for private supply with or without charges, vouchers or grants
- Public/private mixed production and/or finance
- Private sector production with private finance

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[S. Paul, "Privatization and the Public Sector", Finance and Development, 1985, Volume 22, Number 4, pp 42-45.

Unfortunately, and much as I'd like to be able to specify a Government Optimeter, there are a number of significant measurement problems. Just to get you started, a number of issues mean that this date might be exaggeratedly late, such as the scale of the informal sector or black economy, the scale of tax evasion or corruption, how we account for public involvement in commercial operations, the receipts we get from government and the scale of benefits such as public education or health. On the other hand, the Government Optimeter could be optimistically early, by not taking account of price controls, regulations, licences and permits, barriers to competition, barriers to ownership, tariffs or indirect administrative overheads such as tax collection and rule enforcement imposed on businesses. The Government Optimeter may not be 'sustainable' if we fail to take borrowings into account – as Sir John Hicks pointed out, "the purpose of income calculations in practical affairs is to give people an indication of the amount which they can consume without impoverishing themselves". The Government Optimeter might also be easily influenced by changes in demographics, e.g. construction activity will fall, and thus GDP, in future as people need fewer living quarters, yet the administration of pensions by the state may naturally increase.

Moreover, how is one to analyse the sheer variety of mixed economy models? For instance, we have government franchises for services, nationalised industries, Government-Owned-Contractor-Operated (GO-CO) companies, government-backed companies, insurers-of-last-resort, trusts, agencies, quangos, government-funded charity work, grants, vouchers, tax rebates, subsidies, tolls, service charges and many other permutations of private and public. We truly have a mixed, and mixed-up, economy. Finally, the Government Optimeter could be easily skewed if it turned out that we are consuming future income in increasing debt or by handling resources in a non-sustainable way. Whew! It's not easy.



## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

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### The Competition Optimeter

Further, competition plays a very important role. We could achieve a tremendous move of resources from the public to the private sector, yet find that we have not provided competition. Early in my studies I encountered the Tudor proliferation of monopolies and patents on things such as salt or soap. While Tudor monopolies were largely in the private sector, the value of the monopoly derived from the lack of competition. As we look at privatization movements we see that there are a number of theoretical arguments supporting the case for privatization, such as the ‘public choice’ school’s criticism that the incentive structure of the public sector is inefficient or the ‘property rights’ school’s criticism that public ownership does not stimulate efficiency. While there are many difficulties of comparing like for like, it turns out that, while there are typically lower costs of production in the private sector and that asset values are higher under private sector ownership, in industries where there is competition or the threat of real competition there is relative efficiency, regardless of ownership. In many ways, the UK has been a leader in developing regulated, but competitive markets. My predecessor, Professor Persaud, warned of the dangers of regulatory capture and there are some difficulties in practice with the UK’s regulatory starting point, “retail price inflation minus X%” (RPI-X), but overall the key to successful privatization has been to privatize into a competitive market.

One moves fairly rapidly to realising that we need a Competition Optimeter for areas outside government. There is little point in privatising a section of government without introducing competition. Perhaps we could introduce a Competition Optimeter for areas inside government. Why can’t we have two Passport Offices, three health and safety inspectorates or four Inland Revenues? So we’re rather cold on the likelihood of a Government Optimeter and a Competition Optimeter should be very hot; now I’d like to direct your attention to the idea of a Community Optimeter. A Danish friend once remarked to me that Danes were the most associative people in the world; they belonged to the most clubs and societies and were most active in local organisations. I don’t doubt him, but I often wondered how we might measure this associativity.

“...community is precisely the feature of reality that has been most consistently abstracted from in modern economics. The need is not for one more theorem squeezed out of the premises of methodological individualism by a more powerful mathematical press, but for a new premise that reinstates the critical aspect of reality that has been abstracted from – namely, community.” [Daly and Cobb, page 43]

### The Community Optimeter - Markets & Communities – Did We Ever Leave Them?

Of course, it’s easy to quip that Communities are not the realm of Commerce. Well, I happen to think that this Mercers’ Memorial School Chair of Commerce is well-named. “Catallactics,” Hayek said in the 1940’s, “was derived from the Greek verb *katallatein* (or *katallasein*) which meant, significantly, not only ‘to exchange’ but also ‘to admit into the community’ and ‘to change from enemy into friend’.” Someone who studies exchange or commerce might be called a “catalactist” rather than an “economist.”

This idea that we should look at the totality of exchange, commerce as both markets and communities, rather than just private sector economics is not just a discussion of the 1940’s.

In the 1980’s Buchanan suggested:



## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

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“... that we stop worrying so much about the allocation of resources and efficiency thereof, and, in place of this whole set of ideas that we commence concentrating on the origins, properties and institutions of *exchange*, broadly considered ... The approach to economics that I have long urged and am urging was called ‘catalactics’, the science of exchanges, by some nineteenth century proponents ... This approach to economics, as the subject matter for inquiry, draws our attention directly to the *process* of exchange trade and agreement, or contract.” [Buchanan, J M, Liberty, Market and State: Political Economy in the 1980s, Harvester Press, 1986, page 20]

One interesting observation is that the Interstate Commerce Commission, which was founded in 1887 to control competition in the monopolistic rail industry, was an important agent of social change to eliminate discrimination in communities – naturally I emphasise Commerce and Community.

It is difficult to define a community. One can start with the idea that communities define themselves, e.g. “I am an accountant”, “I am an academic”, “I work with banks”, “We belong to the Gresham network”, “My firm reports to X regulator” or “Our family has ties with Y”. However, this illustrates the complexity - people belong to multiple communities, some voluntary, some imposed, some of which they’re proud, some of which they wouldn’t consider communities. Daly & Cobb set out four characteristics of a community - (1) people consciously belong (2) there is extensive participation by members in decisions (3) the community as a whole takes responsibility for the members (4) responsibility includes respect for the diverse individuality of the members. Too often we look at the level of central or federal government and forget that not only are there many levels of government but also many levels of community that solve many problems that might otherwise go to government.

In his incisive look at American society in 1835 Alexis de Tocqueville also noted the importance of community – “the influence of customs that produces the different degrees of order and prosperity which may be distinguished in the several Anglo-American democracies”. In 1982 Edward Schwarz lamented that “Unfortunately, most political leaders and writers today have forgotten these communitarian concerns of Jefferson, de Tocqueville, and early Americans in general. The irony is that a wide range of evidence is now affirming empirically what these traditional theorists could assert only instinctively. It now appears certain that a strong, local community is essential to psychological well-being, personal growth, social order, and a sense of political efficacy.” [taken from Daly and Cobb, 1989, 1994, page 17]

It is too often assumed that the only way of managing common resources is via government. The academic arguments began when Hardin [1968] reified the “tragedy of the commons” using a number of topics, such as pollution and overpopulation, to illustrate his point that we needed to submit to “mutual coercion” on our activities in former areas of freedom such as waste disposal or breeding. Hardin’s influential paper has polarised subsequent debate. At one extreme of the debate, public assets must be publicly governed. Coercion via government is a natural enforcement mechanism, and ultimately all use of public resources must flow from government. At the other extreme, only by allocating property rights over formerly public assets will people care enough, in their own selfish interest, to defend and maintain assets. Old battle lines - socialism or capitalism?

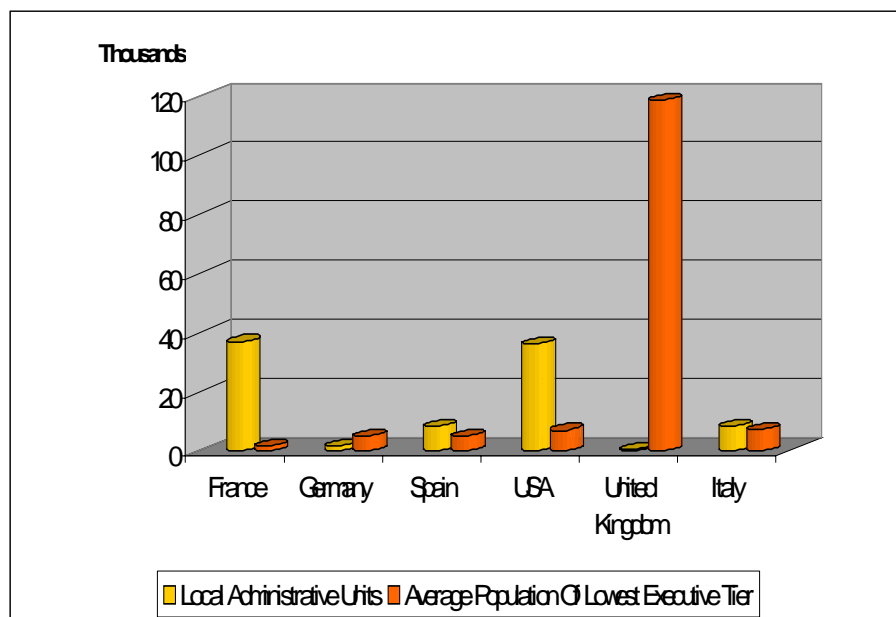


## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

What is interesting is that when we look at communities and how they handle common resources, we realise that they can be effective if they have control of the market locally. An influential academic, Elinor Ostrom, assembled empirical research on a number of long-term common-pool resource management systems such as agriculture, fishing, forestry and water, showing that not only was there an alternative to the old battle lines, but that the alternative had been around for some time. The common-pool resource management systems she studied ranged from a minimum of 100 years in age to well over 1,000 years in age, including communal tenure in Switzerland, common lands in Japan, the *huerta* irrigation institutions of Spain and the *zanjera* irrigation systems of the Philippines. She pointed out that there are many, enduring, alternative approaches that are neither socialist “Leviathans” nor privatisation. Ostrom derived eight design principles for systems that successfully manage common-pool resources, viz: clearly defined boundaries, congruence between appropriation and provision rules and local conditions, collective-choice arrangements, monitoring, graduated sanctions, conflict-resolution mechanisms, recognition of rights to organize, and the use of nested enterprises. Basically, communities can do much through their own control of markets. It should be no surprise that “ever closer union” in Europe began with a common market and a European Community.



### A Lack Of Locality



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[Jenkins, Big Bang Localism, 2004]

But communities today may be in peril. In Bowling Alone, Robert Putnam questions whether society is weaker with fewer interactions and an increasing social-capital deficit:

“Television, two-career families, suburban sprawl, generational changes in values-- these and other changes in American society have meant that fewer and fewer of us find that the League of Women Voters, or the United Way, or the Shriners, or the monthly bridge club, or even a Sunday picnic with friends fits the way we have



## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

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come to live. Our growing social-capital deficit threatens educational performance, safe neighborhoods, equitable tax collection, democratic responsiveness, everyday honesty, and even our health and happiness.” [Robert Putnam, Bowling Alone, Simon & Schuster, 2000, page 367]

Here in the City, within the Corporation of London we have arguably the oldest continuous representative body in the world, the Court of Aldermen and the Court of Common Council, sometimes referred to as the ‘grandmother of parliaments’. It can be difficult to appreciate just how far centralisation and loss of the principles of local community have gone outside the City of London. Simon Jenkins makes some telling points about the scale of movement in the UK from elected officials to central government appointees. He notes that France, for example, has one elected official for every 116 electors, Germany has one for every 250. In the UK the figure is one for every 2,605. A total of 22,745 people serve on Britain’s local councils, which is only between five and ten per cent of the number one might predict would serve using other countries as the basis for estimates. It is interesting to note that the USA has the “most governments” and yet some of the lowest tax take. To see how much things have changed just take London. In 1900 Londoners elected 12,000 citizens to run public services, councils and boards. In 1997, Londoners voted for 2,000 officials, but some 10,000 people were appointed by central government to boards and quangos.

### **Do You Really Believe? Do You Really, Really Believe In Smaller Government? The Bear-est Recipe**

It is difficult without some clear principles to force activities into either the public sector or the private sector. One would hope that by keeping the scale of government under discussion one at least keeps people aware of the issues. However, is there anything that one can recommend to help society stay close to an optimal level of government? Some people might be satisfied with leaving these discussions to political settlement. Others might find it disturbing that one of the greatest tools for resource allocation, the market, fails to make its case vigorously and that our economic analytics fail to provide us with an optimal setting. Yet markets work well with communities - “The market does only one thing: it solves the allocation problem by providing the necessary information and incentive. It does that one thing very well, when supplemented by enough community or collective action to maintain competition, restrain self-interest and deal with public goods and externalities.” [Daly and Cobb, page 59]

So what might we conclude about the public sector versus private sector divide? I think there are a few simple items:

- ◆ we need to find more ways to give communities genuine power and genuine responsibilities, including bearing the consequences of their actions. The increasing centralisation of power at the national level reduces the variety in our economy. We don’t see local solutions, or local failures, to local problems. We don’t have local responsibility;
- ◆ our political positions need to be re-mapped. A number of people have tried to gain acceptance for mapping political positions on more than one axis, to get away from a one-dimensional view of politics as a spectrum ranging from anarchists through Marxist Socialists, Social Democrats, Fabians, Liberals, Conservatives and Fascists. Why can’t we have parties that recognise the feasibility of huge numbers of responsible, overlapping and competing communities within a market society, or parties that

recognise that while there is no such thing as a global community, globally-dispersed communities do exist today?

- ◆ metrics are crucial. We should encourage the development of more sophisticated measures of government scale, competition and community, and publicise them.

“Happily ever after” is perhaps how fairy tales should finish, right? Well, an old economics pun is that if you start using Keynes, you’ll leave Marx. As Nozick noted, Marxist exploitation is mainly exploitation of people’s ignorance of economics. I believe that if you start using Markets, you’ll join Communities. As with Dorothy in the Wizard of Oz, our quest for an overall optimizer shows us that there is ‘no place like home’, it all starts in your own backyard. Like Goldilocks and her three bowls of porridge, we need all three optimizers - a Government Optimizer, a Competitiveness Optimizer and a Community Optimizer. How many economic priorities are being allocated in competitive environments close to communities? Perhaps its not too much to ask a government of ‘Daddy Gordon Brown Bear’ or ‘Cuddly Cameron Bear’ to foster these local communities and give them genuine power to make meaningful decisions?



## Discussion

1. Is a single measure of optimal government scale impossible?
2. Can more local democracy help keep overall government slim?
3. What other forces can help control the scale of government?



“Get a big picture grip on the details.”  
*Chao Kli Ning*

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Thank you.



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## Further Discussion

1. Is a single measure of optimal government scale impossible?
2. Can more local democracy help keep overall government slim?
3. What other forces can help control the scale of governments?

## Further Reading

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## Further Surfing

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## Goldilocks Government and the Market Not Too Little, Not Too Much, But Just Right

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### Thanks

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