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THE EFFECTS OF SIZE AND STRUCTURE OF GOVERNMENT ON
ECONOMIC GROWTH: A COMPARISON OF EUROPEAN MODELS WITH THE
ANGLO-AMERICAN MODEL

by

Clarence Atwell Guider

A Dissertation
Submitted to the Graduate Studies Office
of The University of Southern Mississippi
in Partial Fulfillment of the Requirements
for the Degree of Doctor of Philosophy

Approved:

December 2007
THE EFFECTS OF SIZE AND STRUCTURE OF GOVERNMENT ON ECONOMIC GROWTH: A COMPARISON OF EUROPEAN MODELS WITH THE ANGLO-AMERICAN MODEL

by

Clarence Atwell Guider

Abstract of a Dissertation
Submitted to the Graduate Studies Office of The University of Southern Mississippi in Partial Fulfillment of the Requirements for the Degree of Doctor of Philosophy

December 2007
ABSTRACT

THE EFFECTS OF SIZE AND STRUCTURE OF GOVERNMENT ON ECONOMIC GROWTH: A COMPARISON OF EUROPEAN MODELS WITH THE ANGLO-AMERICAN MODEL

by Clarence Atwell Guider

December 2007

This paper investigates the effects of government size and structure on economic growth. It will employ the logic of the Armey Curve, which is similar to the Laffer curve, to explain the correlation between central government size and GDP. In short, government can enhance output versus an anarchical society, but too much of a good thing retards growth as government consumes more and severely retards the potential gains of the given incentive structure. Using OECD nations as a sample, a taxonomy of the sample countries is developed, based upon the extant literature. In each model of capitalism, the government and economy are examined in relation to spending patterns, regulatory environment, political/government structure, and legal system. We test for robustness for each model and then turn to assessing each model’s past growth as well as potential growth.
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These gentlemen have escorted me through a scholarly learning experience that is without equal in my life. I will always be grateful and will hold them in the highest regard.
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABSTRACT</td>
<td>ii</td>
</tr>
<tr>
<td>ACKNOWLEDGMENTS</td>
<td>iii</td>
</tr>
<tr>
<td>LIST OF EXHIBITS</td>
<td>v</td>
</tr>
<tr>
<td>CHAPTER</td>
<td></td>
</tr>
<tr>
<td>I. INTRODUCTION</td>
<td>1</td>
</tr>
<tr>
<td>Research Question</td>
<td></td>
</tr>
<tr>
<td>Hypothesis</td>
<td></td>
</tr>
<tr>
<td>Overview</td>
<td></td>
</tr>
<tr>
<td>II. REVIEW OF RELATED LITERATURE</td>
<td>8</td>
</tr>
<tr>
<td>The Historical Perspective</td>
<td></td>
</tr>
<tr>
<td>Critique</td>
<td></td>
</tr>
<tr>
<td>Marx and the Emergence of Socialism</td>
<td></td>
</tr>
<tr>
<td>John Maynard Keynes</td>
<td></td>
</tr>
<tr>
<td>Friedrich Hayek</td>
<td></td>
</tr>
<tr>
<td>Milton Friedman</td>
<td></td>
</tr>
<tr>
<td>Critique</td>
<td></td>
</tr>
<tr>
<td>Public Choice and the Size of Government</td>
<td></td>
</tr>
<tr>
<td>Government and Economic Growth</td>
<td></td>
</tr>
<tr>
<td>Critique</td>
<td></td>
</tr>
<tr>
<td>III. METHODOLOGY AND ANALYSIS</td>
<td>93</td>
</tr>
<tr>
<td>Stage 1</td>
<td></td>
</tr>
<tr>
<td>Stage 2</td>
<td></td>
</tr>
<tr>
<td>Discussion</td>
<td></td>
</tr>
<tr>
<td>Stage 3</td>
<td></td>
</tr>
<tr>
<td>Conclusions</td>
<td></td>
</tr>
<tr>
<td>IV. CONCLUSIONS</td>
<td>133</td>
</tr>
<tr>
<td>Implications and Findings</td>
<td></td>
</tr>
<tr>
<td>Limitations and Analysis for Subsequent Research</td>
<td></td>
</tr>
<tr>
<td>REFERENCES</td>
<td>139</td>
</tr>
</tbody>
</table>

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LIST OF EXHIBITS

Exhibit 1: Percentage Unemployment ................................................................. 34
Exhibit 2: Index of Economic Freedom Ranking .................................................. 35
Exhibit 3: The Climbing Burden of Government in Europe ................................. 57
Exhibit 4: American and European Per Capita GDP .......................................... 58
Exhibit 5: US and EU-15 Average Real Growth Rate ......................................... 58
Exhibit 6: US and Europe Long-Term Unemployment ....................................... 60
Exhibit 7: Burden of Government Consumption and Transfer Spending ............. 61
Exhibit 8: Aggregate Tax Burden ........................................................................ 62
Exhibit 9: Payroll Tax Rates .............................................................................. 62
Exhibit 10: Income Tax Rates ............................................................................ 63
Exhibit 11: Corporate Tax Rates ........................................................................ 64
Exhibit 12: Government Spending and the Economy (the Armey Curve) ............. 78
Exhibit 13: Growth of GDP, Household Consumption and Public Services .......... 88
Exhibit 14: The Rahn Curve ............................................................................. 91
Exhibit 15: Size of Government in OECD Countries 1960-2002 ....................... 97
Exhibit 16: Size of Government Growth Curve ................................................ 99
Exhibit 17: Increase in Transfer Payments and Net Interest Payments as a Percentage of GDP in the US ................................................................. 100
Exhibit 18: Increasing Government Expenditures in the US .............................. 102
Exhibit 20: Increasing Government Expenditures and Borrowing "Crowd Out" Investment .......................................................................................... 104
Exhibit 21: Change in Real GDP per Capita Growth 1960-2002 ....................... 106
Exhibit 22: Growth of Real GDP ...................................................................... 107
Exhibit 23: Size of Government and Economic Growth .................................... 109
CHAPTER I

INTRODUCTION

Research Question

As government activity increases as a percentage of Gross Domestic Product (GDP), will it exceed the point of optimal contribution and produce an inverse relationship to economic growth?

Hypothesis

Statement of Null and Alternative Hypotheses:

\( H_0: \) There is no relationship between government size and economic growth.

\( H_1: \) There is an inverse relationship between government size and economic growth.

This dissertation examines the nature of government and provides an answer to the question of the optimal size of government and its relationship to economic growth. These results provide the foundation for research that establishes a correlation between the size of government, economic growth, and the sustainability of the social model that is employed. The anticipated result is that past an optimal size, there is an inverse relation between the size of government and the sustainability of its social model. It is assumed that economic growth is the foundation of sustainability.

Anarchy is the most tenuous condition for human existence. Only the strong survive, and that is not a certainty. The emergence of government provides management and stability on a social level. The state provides
protection from threats, real or imaginary, both internal and external, and physical or moral values. Moral values are acknowledged as arbitrary and vary with the established mores of a society. Government enhances the pursuit of happiness by facilitating trade and mitigating the excesses of the market. Prosperity, security, and the quality of life flower in the presence of government. However, the fallacy of composition indicates that if a given amount of X produces an observed benefit in Y, there is no certainty the successive increases in X will result in proportional increases in Y. Indeed, the law of diminishing marginal returns often manifests, as increases in activity X produce decreases in benefit Y.

Varieties of capitalism and their corresponding social models indicate a divergence in theory as to the optimal amount of government and the composite of activities undertaken by government. The United States is characterized by high-risk/high-reward individualism, free-markets, and a restricted role of government in markets (Gersemann 2004). Europe favors a collective society. Large governments provide social insurance against risk and the inherent uncertainties and unavoidable misfortunes of life (Rifkin 2004). Within Europe, there is variation in interpretations of the nature of government, which produces distinct classifications of the European Social Model (Wolf 2006). Variances in social models and the relative size of their governments will be the basis for comparison and evaluation of sustainability.
Overview

In the nature of the social contract between government and those governed, there exists a reciprocity that is rooted in the writing and philosophy of John Locke (Locke 1689). According to the Lockean hypothesis, government is characterized as a benefactor, protector, and arbiter of disputes, as it provides the proverbial "level playing field" for all who are in pursuit of happiness and security. Government, in essence, acts as a parent, nurturing and guarding its offspring. Conversely, the metaphor applies to the governed in relationship to government. In the democratic societies of developed nations, the citizens are the parent and life-giver to a government that is brought into existence by their whim. The preamble to America's Constitution states this concept explicitly when it says, "We the people of the United States......do ordain and establish this Constitution for the United States of America." Government is created and granted powers by the people, and it is perpetuated and denied absolute power by the people. Chief Justice John Marshal acknowledged this when he wrote, "The people make the Constitution, and the people can unmake it. It is the creature of their own will and it lives only by their own will" (Priess 1984).

The allegory may be extended to reveal many shared characteristics between parent/offspring and people/government. When the child is behaving well, it is cherished and displayed with parental pride as the manifestation of all that is good in life and an indication of the genealogical superiority of its heritage. When the child is behaving badly, it confounds the existence of the parent and complicates, or eliminates, the potential pursuit of happiness. The prosperity of
the parent, both spiritually (socially) and physically (materially), may be jeopardized, diminished, or forfeited.

Implicit in this social contract is the discipline that democracy and the vote bring to bare on government. The people approve and encourage proper conduct in government by re-election of those who provide for the common good, and they discourage and modify, or eliminate, improper behavior through disapproval in the voting booth. In concept at least, the democratic process would provide an increasing opportunity of enhanced prosperity for the largest portion of its citizens.

The inherent appeal of democracy and the government this concept creates would seem to produce universal acceptance and adaptation. This has not been so. In its inception, democracy in the newly independent colonies was deemed to be totally unworkable by the feudal and despotic schemes that had been the lot of human endeavor for generations. Most Europeans, long accustomed to monarchy, withheld congratulations for those who could do as they pleased with government, because they waited to see the outcome of what we pleased to do. Ironically, much of Europe, the French in particular, would please to do as we did.

As the structure of the new social experiment formed and the function of a democratic society began to appear, the Industrial Revolution in Europe, and the changes it brought, offered an alternative to feudalism and its repression. Thomas Hobbes (Hobbes 1651) suggested that man was aggressive by nature, because he sought security for his person and his property. He would wage war
readily in pursuit of this security, but would more willingly enter into a social contract with others for mutual benefit. Adam Smith gathered the thoughts of Hobbs, combined them with the philosophy of the French surgeon/economist Francois Quesnay, and set the foundation of market economics. Quesnay deduced that even in the absence of a preconceived design, the conscious actions of many men in an economy produces results which are orderly, consistent with their separate interests, and superior to those which a group might achieve through deliberate planning. Adam Smith was among the first to realize that in the new world the Industrial Revolution was creating, labor was a commodity and consequently, was for sale. A man could not separate his work from himself and sell it to someone else without, at the same time, selling himself. In fact, according to Smith, everything was for sale. Life consisted of buying and selling, and money was the lifeblood of the market. Economic efficiency was dictated by what Smith called the “invisible hand” (Smith 1776). Businesses and workers, seeking to serve their own “self interest” and operating within the framework of a highly competitive market, would simultaneously promote their own benefit and that of the entire society. The prosperity of humanity resided in efficient buying and selling. The indication of efficiency was profit, which was measured in money, which was the goal of human endeavor. The modern market had formed.

Unfortunately, the new markets did not produce universal prosperity and a level playing field. The owners of the means of production (capitalists) became rich by exploiting labor to the point of producing abject misery for most laborers.
Karl Marx observed this and predicted the failure of capitalism in *Das Kapital* (Marx 1867). Later, he added an alternative and competing structure for human endeavor in his *Communist Manifesto* (Marx and Engels 1848). He predicted that capitalism would be replaced by the social perfection and egalitarian justice of communism. Exploitation, brutality, and wretched working conditions provided fertile ground for the germination and development of communism. The contrast between the two divergent philosophies is most stark in the function of the state. Adam Smith and his successors preached a *laissez-faire* role for government that limited market and workplace intervention. Markets were efficient and ultimately self-regulating.

As originally conceived by Marx and Engels and brought into existence by violent revolution, socialism was defined and implemented with state ownership and control of the means of production. A new and better way of life was promised through a grand experience in utopian human cooperation. All labored equally for the betterment of society and the provision of a classless culture in which each person received a proportion of production based upon the needs of that person. “From each according to his abilities and to each according to his needs” was the mantra of those who labored under this system. It was embraced by the poor and exploited as the most perfect, just, and satisfying form for human existence and endeavor. In the fashion that the worst vice of a fanatic is his sincerity, it became the enemy and opponent of market economics. The antagonists reconciled conveniently to defeat the greater threat of fascism and immediately returned to their contest of wills when victory over the common
enemy was secured. The contest has taken more than a century to resolve, with communism rejected as inefficient and unworkable.

However, the concept of government control of the economy did not perish with the end of communism. In reality, the former communist players have contrived new uniforms and changed the name of the game to socialism, which has adapted and evolved in grand Darwinian fashion. Today, we hear nothing of "central planning" or "production for consumption." The modern hymn of socialism is "social justice" and "poverty in the midst of plenty." The solution requires vastly expanded government programs of redistribution and confiscatory levels of taxation to support them. In the six decades since the end of World War II, governments of the developed nations, and most others too, have grown enormously in absolute size, power, and the scale of their intervention in their economies. Socialism by stealth is occurring.

This dissertation examines the relationship between an increasing size of government and economic growth. Implicit in the findings of this paper are an indication of the sustainability of the varieties of capitalism that exist and the perpetuation of their varied social models.
CHAPTER II
REVIEW OF RELATED LITERATURE

The literature review for this dissertation will be composed of three sections. The first section will present a historical perspective on the body of work, considering the size and scope of government that developed at the time of emergence and maturing of market economies. The philosophy of Adam Smith, Jeremy Bentham, John Stuart Mill, Karl Marx, and John Maynard Keynes will be discussed. Their contribution to the evolution of the divergent philosophies concerning the size and function of government will be examined.

The second section will describe the divergence of the United States and Europe, with the former adhering to the basics of market economics and the latter embracing socialism. A common characteristic of increasing government size will be revealed. The context will include the literature of Keynes Hayek, and Friedman.

Section three will contain the modern scholarly perspective concerning the optimal size and most beneficial activities to seek in the functioning of government. The discussion will be extensive, and in the name of objectivity, will include divergent views.

The Historical Perspective

Adam Smith is considered the father of economics. In The Wealth of Nations (1776), he described the potential of a market economy and identified the fundamental forces of self-interest and competition in the operation of a market economy. This work is distinguished by its combination of observations on human nature, history, theology, and pragmatic economics. The birth of
modern economics also brought with it a divergence of opinion concerning the appropriate scope and function of government in a market economy. A proper answer to the question of the optimal form of government has been elusive, and experiments in applied theory have spawned schemes that vary from *laissez-faire* to benign socialism. Smith believed in the self-regulation potential of markets and advocated a minimalist role for government. He considered large government and central planning an exercise in futility, due to the ineptness of the bureaucrat and the ego of the politician. Smith placed his faith in the natural harmony of the economic world and considered government interference unnecessary and often counterproductive. He reserved three roles for government and acknowledged their importance: (1) to administer justice through the provision of a legal system, (2) to provide for the national defense, and (3) to provide goods and services that could not be pursued profitably by the private sector. The invisible hand, which is ultimately the collective (ironic word) application of self-interest, the natural liberty of humanity, and the wisdom of God, would ensure the proper function of markets, without the intrusion of government. Smith wrote:

>The natural effort of every individual to better his own condition (self-interest), when suffered to exert itself with freedom and security, is so powerful a principal, that it alone, and without any assistance, not only is capable of carrying on the society to wealth and prosperity, but of surmounting a hundred impertinent obstructions with which the folly of human laws too often encumbers its operation; though the effect of these obstructions is always more or less either to encroach upon its freedom, or to diminish its security. (*The Wealth of Nations* Book IV Chapter V Section IV)
Two centuries later, Milton Friedman would offer a modern version of this perspective.

Jeremy Bentham was a contemporary of Adam Smith. In *Introduction to the Principles of Morals and Legislation* (1823), he brought qualifications to the concept of *laissez-faire*. Bentham injected the concept of utility, or the desire to satisfy wants, and insisted that not all members of the society would pursue their self-interest in a manner that would promote the public good. The presence of crime indicated that Smith's natural harmony was flawed and necessitated a larger, more active government which would intervene and ensure the alignment of private action and public interest. His approach was utopian in nature. Government should act to provide the greatest benefit to the largest portion of the society. It should not consider the displeasure of aristocrats if its actions brought benefit to a larger number of peasants. The welfare of a community was superior in consideration to any segment of the community. This concept exhibited the image, if not the form, of modern socialism.

John Stuart Mill was the next to bring modification to the standard of *laissez-faire*. In *Principles of Political Economy* (1848), Mill began to construct the framework for modern government and expanded its power far beyond the consideration of Adam Smith. In addition to the three basic functions of Smith's philosophy, he added the powers to tax, coin money, establish a uniform system of weights and measures, protect against exploitation, enforce contracts, and most importantly, protect property rights.
Mill recognized the primacy of incentives in human motivation, and he was a vigorous guardian of liberty. The conditions of the poor and opportunities available to them concerned him greatly. With varying abilities and social positions of entry, there is scant possibility of producing equality of income and living standard. However, Mill insisted that there must be equality of opportunity for all. The poor were wretched because they were poor; they were not poor because they were wretched. This resulted in Mill’s squaring the economic circle by embracing *laissez-faire* economics while proposing expanded powers for government. Equal opportunity for all would be accomplished through a central government that would introduce supportive intervention to augment and correct market forces. In addition to providing a fair beginning for all, Mill also proposed a fair end for all through taxation that would impose fairness in the result of social and market endeavors that were uncertain in outcome. He expressed the conviction that human beings should assist one another, and the assistance should be proportional to the urgency of the need. However, he recognized the possibility that the poor could become the responsibility and burden of the state. Mill saw grave consequences in the elimination of incentives and danger if the conditions of the pauper became the envy of the laborer. Assistance would not be given without compensation in labor by those assisted, and such labor would be more onerous than the least fortunate of unassisted laborers. He observed the growing momentum toward income redistribution to the poor and affirmed his support of such policies in the name of social justice. Mill’s endorsement may be the reliquary of the ancestral bones of modern socialism. Decades later,
Frederich von Hayek would imply that the road to economic hell was paved with good intentions when he wrote *The Road to Serfdom*.

Critique

There is a strong suggestion that the emergence of market economies, which thrived in freedom, also resulted in momentum toward centralized authority to mitigate the excesses of free markets. Altruistic sentiments sought respite for the unfortunate and protection from the harshness of outcome for those who embraced risk and lost. Advocates of social justice sought relief for those who were denied the opportunity to prosper due to poverty or exploitation. Philanthropy had spawned an alter-ego of market economies that would become a competitor and potential nemesis. Governments began to grow in size, regulatory power, and portion of economic activity, as they were called upon to structure an egalitarian society.

Marx and the Emergence of Socialism

In the interim between Adam Smith and John Stuart Mill, the United States won its independence, the French Revolution began the reordering of the social structure of Europe, and the Industrial Revolution began. The new “manufactories” would quickly become known as factories (Rifkin 2004) and would become the financial blessing of the capitalists who owned them and the scourge of the labor that worked to produce in them. Commerce and the trading of possessions was as old as humanity. However, the mechanization of the Industrial Revolution brought an exponential increase in production, trade, and prosperity that had no equal in human history. The manufacture and exchange of
goods led to the creation and exchange of capital, which in turn, led to a vast and interdependent economic network. This generated immensely powerful political and social institutions that would bring about a widespread transformation of the relationship between the public and private sectors.

Burchell (1975) traced the roots of the Industrial Revolution and the economic changes that it brought. A new social structure evolved with an aristocracy that cared nothing for lineage and titles of nobility. Capitalists accumulated monumental wealth and rivaled the old order in power and prestige. Their riches were generated by investing in the labor of others. Below the capitalists, a new "middle class" emerged and was composed of men engaged in commerce, civil service, shopkeeping, or professional services based on acquired skills. While the capitalists did not labor, the middle class did, but they earned sufficient income to participate in the new capitalist adventure. Both groups were primarily interested in the pursuit of profits, unhindered by interference from government. This endeavor became known as "free enterprise."

At the bottom of the social structure was a newly created pool of labor that would become known as the proletariat. The contrast between this wretched group and those above it was stark. Before the Industrial Revolution, society had been composed of aristocrats and peasants. The former owned the land, and the latter had lived on it in servitude as they tilled the soil and maintained livestock, generation after generation. The system was flawed, but it offered the peasants security and a sense of place and purpose. The Industrial Revolution destroyed
the feudal order. Mechanized farming changed old patterns, and the abolition of
serfdom released the peasants from bondage to the land. Unable to make a
living from the land and deprived of income from traditional crafts, the peasants
sought work in the cities that had become the centers of industrial production.
Factories and mines offered a new existence in which they were paid in wages
rather than in the output of their labor. Their existence was precarious. The
peasant of the farm became the laborer in a factory, but had done little more than
exchange one form of bondage for another. The changes that had freed them
from serfdom had also freed them to starve—and starve they did.

With no property of their own and obsolete rural skills, they were
completely dependent for their survival upon the capitalists who owned the
factories and mines. The owner could hire or fire at his discretion, and he drove a
hard bargain that was enhanced by a vastly superior bargaining position. When
he needed workers, he paid well, but when labor or goods were plentiful, he often
paid wages that produced appalling misery. Cities in which factories were located
grew rapidly and without plan. Between 1800 and 1900, the population of Europe
more than doubled. Living conditions for most labor were terrible, and often
worse than terrible. Epidemics of cholera, typhoid, and typhus were common.
Tuberculosis spread readily among the densely populated slums, and diseases
associated with malnutrition were endemic. In the sum of it, most workers of the
proletariat were born, endured some ghastly life, and died. Karl Marx would find
fertile ground for his message in this heap of misery, desolation and corpses, and
his message would be heard.
Society was split between those with everything and those with nothing. Under the feudal order, the landowner and the peasant saw each other and often communicated. The rich capitalist had scant contact with the workers. He lived in a different part of town with different living conditions. Few owners visited the factory or mine, and most believed that the workers' living conditions were their own responsibility. As they gathered their profits, the capitalist did not delve too much into the conditions of those who were the source of their wealth. They were adherents to the concepts of *laissez-faire* and free trade. The capitalists had secured the right to operate without government control, and they did not wish to forfeit any of their freedom. They argued that fluctuations in the economy were unavoidable and the result of the *Natural Law of Supply and Demand*, the *Natural Law of Diminishing Returns*, and the *Iron Law of Wages*. The latter was based on the concept that wages could not rise above the minimum required to keep the laborer in a bare existence. Any increase in wages above this bare minimum would lead to an increase in population. This resultant increase in the supply of labor would force wages back to the minimum subsistence level. The owners of capital believed that these laws were immutable, and if they were allowed to function without interference, would produce prosperity for all. This conviction was an exercise in practical expediency. Instead, greater profits for a very few and greater misery for the rest were the real results. Mistaking freedom from control as a license to exploit, the capitalists indulged in practices that took no notice of the desolation they created.
Karl Marx observed these conditions and began to formulate a new order. Contemptuous of the philosophers who had gone before him, and believing that they had only attempted to interpret the world and man's actions, he felt that the existing system was grossly unjust, based on exploitation, and worthy of complete destruction. Marx did not want to contemplate. He wanted to act and make changes. In the *Communist Manifesto* (1848), and later in *Das Kapital* (1867), he urged the workers of the world to unite. They would overthrow the capitalists and take back the fruits of their labor. The core of Marx's beliefs was based on his perception of the manner in which societies came into being and evolved their structure. He rejected the philosophical notion that ideas structure man in favor of the belief that economic reality was the basis of social structure and human action. The bourgeoisie and capitalists measured their wealth in money and would inevitably clash with the old aristocracy, due to incompatible economic goals and priorities. Marx also believed that conflict between the capitalists and labor, or the proletariat, was unavoidable. He called this class conflict the "dialectic" of history.

Marx was convinced that he had discovered another natural law of economics. The pursuit of maximum profits, which is the primary goal of capitalists, would eventually concentrate all wealth in the hands of a very few. The proletariat would become not only increasingly impoverished but increasingly large. A revolt by the proletariat would result, as they confiscated the means of production from the bourgeoisie. A classless society would be created. Marx encouraged this revolution and proclaimed that it could be achieved only through
violent revolution. The workers had nothing to lose but their chains, and the whole world was theirs to take. The ruling classes trembled. Property was their source of wealth and power, and they would not relinquish it without a struggle.

The motivation behind the composition of the *Communist Manifesto* was the observation of the living conditions of the working man. Marx felt that with the exception of a tribal society, which is collective in nature, all societies evolve to conditions of "haves" and "have-nots." Modern societies were not capable of providing all members a decent livelihood and becoming a society consisting mostly of "haves." However, Marx fervently believed that a society of only "haves" could be created by abolishing ownership of private property by the bourgeoisie. Ownership of the means of production would become public and collective. The factories would be owned by all through state monopoly of ownership, and all would share in the fruits of production. There would be no "have-nots." Humanity would return to the collectivism of a tribal society, only on a larger scale and at a higher level of development and production. Economic equality would be assured, and all would be granted a decent livelihood. History shows that Marx did not see, or ignored, the dictatorial/totalitarian potential of the state. It is the assertion of this dissertation that the capitalists did not see it either.

John Maynard Keynes

The stage was set for the great contest between market economies and socialism. Neither side would anticipate the direction of the contest. The ideas of Marx received little attention in Europe in his lifetime, and he died a pauper, sustained primarily by the generosity of Engels. The Great War brought
unprecedented devastation to Europe, and the Bolshevik Revolution established communism in the Soviet Union, which rose from the former czarist Russia. Capitalism did not self-destruct as Marx predicted, because it adapted and began to provide a better way of life for laborers. The living conditions of the working class were addressed because of the cold necessity of politics and a growing recognition that socialism was seductive to the poor. This was a time of social evolution. America was seen as a land of opportunity. There was no shortage of poverty, but there was an emerging middle class. The free markets of Adam Smith and classical economics seemed vindicated as the best model for human endeavor.

The Great Depression, which began in the United States in 1929, spread to Europe and the rest of the world. The euphoria of the 1920s was replaced by the despair of mass unemployment and the return of living conditions that resembled the beginning of the Industrial Revolution. The credibility of free markets and laissez-faire policy were severely tarnished. Classical economics had promised that full employment would be the norm of a market economy, which was the justification for laissez-faire policy. There was acknowledgement that occasional abnormal circumstances would create economic fluctuations. However, it was contended that automatic adjustment mechanisms within the market system would restore the economy to full employment. These adjustment mechanisms were based on the assumptions that underspending, or a level of aggregate spending insufficient to purchase total output, would not occur. If such underspending did occur, wage-price and interest-rate adjustments would
provide corrections to prevent a decline in real output, employment, and income. Capitalism was self-regulating, and government interference was unnecessary and probably detrimental.

The inconsistency between the promise of no unemployment and the reality of the Great Depression brought much criticism of classical economics. Foremost among those critics was John Maynard Keynes. In *The General Theory of Employment, Interest, and Money* (1936), Keynes attacked the core of classical theory and began a revolution in macroeconomics. He concluded that capitalism does not contain any mechanism capable of guaranteeing full employment. Markets were not efficient, and full employment was an accident and not the result of capacity of the market to "self-regulate." Keynes believed that macroeconomic events could overwhelm the micro-level behavior of the individual. He also concluded that an active government policy was the only effective mechanism for managing the economy. Rather than adhering to the minimalist role and balanced budgets of the classical model, Keynes advocated countercyclical policies that would stabilize the fluctuations of the business cycle. Government would spend in deficit during recession and time of persistent unemployment. In time of growth, inflation would be neutralized by increasing taxes or reducing government spending. Keynes' theory would result in decades of increasing government regulation, growth, and power. Ironically, he stated in the forward to the *General Theory* that his idea of aggregate production is much easier to adapt to the conditions of the totalitarian state than to those of a free market and *laissez-faire*. Keynes never addressed the potential for politicians to
use deficit spending for expanding the size of government or for blatant political expediency, even when his policies would find it inappropriate.

Friedrich Hayek

Friedrich Hayek was the antagonist of Keynesian economics. He had personally witnessed the enslavement of central Europe under the rule of fascism and wrote *The Road to Serfdom* (1944) in an attempt to halt the march toward government control of the economy and the socialism implied. There were many stimuli for his effort, but the most immediate seems to be the Beveridge Report (Beveridge 1943). William Beveridge was head of the London School of Economics in 1942 and a proponent of the welfare state. His report called for a massive expansion of the British government to attack five giants that stood as impediments in the road to reconstruction: Want, Disease, Ignorance, Squalor, and Idleness. The economic and intellectual thought of the day assumed that only the government could accomplish these goals. Beveridge offered the opinion that poverty could be eliminated by dividing the national income into more equal portions by means of redistributive taxes. He insisted that there would be no adverse effects on wealth creation or other deleterious economic consequences. The reasoning behind this facile assertion was disarmingly simple. The state would represent the entire nation and would exhibit common ownership of the means of production. The people would own everything through the state, and everyone would be a state employee. Socialism and the state would solve all problems of production and consumption by calculating what goods were needed and mandating their production.
Economic growth and production would be limited only by the availability of raw materials and labor. To that end, all mines, major industries, railroads, banks, and land would be nationalized. Income would be limited to a ratio of ten to one as contrasted by the wealthiest to the poorest. All education would become a public endeavor, and private education would be prohibited. This philosophy became the intellectual mantra, and few dared to offer any contrary opinion. Private property was the root of poverty, and one man’s wealth was another man’s penury. All economic transactions would be the manifestation of the collective will of the people. The perfection that socialism implied was so obvious that it required no supporting evidence and would tolerate no dissenting voice.

Hayek observed this evolution and offered *The Road to Serfdom* as a counterpoint in balance and caution. He argued against the assumptions of British economists and intellectuals in their movement toward what he contended could only end in a totalitarian state. The unity of purpose that had been demonstrated in a wartime environment was contrary to the norm of human existence. In peace, the human condition would be of infinite variety in wants, needs, and preferences. Any entity of state or person who possessed unlimited authority to interpret the whim of the people also had the power to dictate those desires and preferences. In order to achieve their ends, the planners had to create power, which would be power wielded by one man over another man. Socialists felt that by depriving power to private individuals and transferring it to the entirety of the society, they could extinguish the abuse of power. Hayek found the potential for evil in this scheme forbidding and almost without limit. He
insisted that totalitarian control would produce negative effects far beyond those produced by market-driven imperfections. By uniting power in the hands of a single body, that power was enhanced to an unlimited degree. Hayek believed that absolute power would corrupt absolutely.

The assertion that a central planning committee could calculate all that was needed by a population and economy was naive in Hayek's view. They would have to literally make millions of decisions to coordinate all components in the chain of production. Their basis for making these decisions would be without complete knowledge and would be arbitrary in nature. He believed that socialists were willing to make these irrational assumptions, because they had witnessed tremendous technological progress in their lifetimes and concluded that everything was within the possibility of human management. Their impatience and lack of historical perspective led to an arrogant belief that they could control human destiny. They were induced to take actions, which frequently had little positive effect and often made worse the very conditions they were attempting to improve.

The Beveridge Report saw the government as the source of income, security, and employment. This conviction had wide appeal for a population that had seen frequent fluctuations in the business cycle and widespread long-term unemployment. The concept possessed utopian appeal but was economically flawed. Hayek insisted that you cannot give everyone a job while disregarding the demand for what they produce. Inflation or wage fluctuation must be the result, which would require more government intervention. However, when the
government discriminates to the advantage of one group of workers, it must
discriminate to the disadvantage of another group of workers. Hayek felt that it
was beyond human ability to implement the stated goals of the Beveridge Report.

*The Road to Serfdom* goes beyond a simple rejection of the collectivist
ideas of socialism. Hayek also took note of the psychological and moral impact
on the British people. He perceived a change in character that he ascribed to the
insidious nature of socialist mentality. He felt that the historic quality of character
exhibited by the British people was grounded in independence and self-reliance,
individual initiative, and personal responsibility. There was tolerance for
difference, leavened with a respect for custom and tradition. They also
possessed an inherent suspicion of power and authority. Hayek saw this
evaporating as they sought uniformity with no tolerance for deviation. A
consistency of character was spreading over a land that had once been rich in
eccentricity. The State that was intended to eliminate poverty and social injustice
had left very little of importance for the people to decide for themselves
(Dalrymple 2005).

Hayek warned that socialism’s promise of a road to freedom and equality
was really the “road to serfdom.” He did not see difficulty in perceiving the
consequences when democracy detoured to the road of state-planning. The
goals of central planning would be described as serving the general welfare, but
there would be no description of the ends to be attained and no consideration of
the effect of the actions taken. Central planning would resemble a group of
people who agreed to make a journey without agreeing on a destination.
His work was widely distributed, but the seductive appeal of socialism trumped the warnings of Hayek. His message was disregarded for decades.

*The Fatal Conceit-The Errors of Socialism* was written by Hayek in 1988. It displayed the perspective of a half-century of observing the ascendancy of socialism and its fall from grace. He felt that history had vindicated him, but warned that socialism had adapted and evolved in grand Darwinian fashion. Today, we hear nothing of “central planning” or “production for consumption.” The modern mantra of socialism is “social justice” and “poverty in the midst of plenty.” The solution to social problems is vastly expanded government programs of redistribution and confiscatory levels of taxation to support them. This concentrates enormous power in government. Hayek deemed this unsustainable and insisted that an individualistic society, in which government activity is limited to establishing the rules of the game, is the best mechanism for allowing individuals to pursue their own interests. Free people will operate within the framework of free markets and participatory democracy.

Hayek asserted that collectivism was undone by the conflict between central planning and individual liberty, and in the test of time central planning was sacrificed rather than individual liberty. Hayek offered a second reason for failure, and it will be central to the research and findings of this dissertation. Collectivism is massively inefficient. Government is unable to manage efficient production and resource mobilization and descends into bureaucratic paralysis, confusion, corruption, and inefficiency. However, the exposure of collectivism as unsustainable has not checked the growth of governments. The focus shifts from
central planning to regulation of supposedly free markets and larger governments to administer a growing menu of transfer programs that ensure social justice and eliminate poverty. The function of government increasingly becomes a process of extracting taxes from one group so that benefits might be granted to another group. All of this is done in the name of social justice and eradication of poverty, but the result is often the appropriation of the proceeds by special interest groups and a ruinous level of taxation. Governments grow in size and power and spend an increasing percentage of the national income. Socialism always moves toward totalitarianism, as increasing power and control beget more power and control. The dissatisfaction of the governed is insufficient to halt the inertial momentum of accrued power.

Milton Friedman

Friedman (1962) believed in individual liberty and limits to the power of government. He was certain that freedom is impossible to sustain without government in that government is the ultimate protector of personal freedom. However, there is a delicate balance required, because the greatest threat to freedom is the concentration of power in government. Even though those who brought about this concentration of power are of good will and are not corrupted by their power, the very nature of power will attract those who will be corrupted and abuse the freedom of the people through their power.

The foremost objectives of government should be to protect individual liberties and to limit the scope of its own power. This is a difficult task. The protection of liberty flows from government power, and it goes against the grain
of human nature to forsake power. Friedman suggested that we can reap the benefits of government and avoid the threat to freedom by limiting the spectrum of powers granted to government. The major function of government would be to protect our freedom from threats of an external nature and from internal threats to freedom generated by our fellow citizens. Beyond this primary function, the power of government must be dispersed. The tenth amendment to the United States Constitution and interpretation of states’ rights are indications of this concern in America. Concentration of power in centralized government is fraught with danger. The allure of centralized government is that it will allow government to more effectively legislate and serve the public interest. While the concept is intrinsically correct, it produces a double edge sword that cuts in two directions. Concentration of power for good is also concentration of power to harm, and there is seldom a consensus on whether the actions of government are beneficial or harmful.

As socialism evolved from the failure of a totalitarian command economy, many who rejected that method because of restrictions to individual liberty found it expedient to proclaim that politics and economics are separate considerations and are largely unconnected. Individual freedom is the concern of politics, and material welfare is the realm of economics. The implication, again convenient, was that any method of political mechanism can be combined with any type of economic arrangement. Democratic socialism was embraced by those who rejected the restrictions on individual liberty imposed by totalitarianism, because they were convinced that it was possible to adopt the essential features of
totalitarianism while ensuring individual freedom through political arrangements. Friedman considered this approach delusional, because the worlds of politics and economics are joined intrinsically and cannot be separated or considered individually without regard for the other. He insisted that a society that is socialist cannot also be democratic in the sense of guaranteeing individual and economic freedom, because these freedoms are the core of total freedom. Collectivism and socialism, in whatever form, are incompatible with individual and economic freedom and are consequently mutually exclusive in the long run.

Critique

In the theater of human discourse concerning social structure and economic mechanisms, few debates have provided as grand a stage for passion and rancor as the contest between market economies and socialism. That platform has transcended a century and has been worldwide in scope. Both sides have claimed ascendancy, only to witness the phoenix-like rise of the other at a later date.

It is postulated that socialism has failed the test of time. That discredited economic endeavor was born of the desperate lives and deplorable working conditions spawned by the beginning of the Industrial Revolution. Feudalism and manorial life had been replaced by capitalism, the factory, and free markets. The structure of society and the nature of the human experience had changed monumentally. Faith was dethroned by reason, which gave way to ideology. Tasks and chores evolved toward jobs and progress, and quality was replaced by productivity. Wisdom and reason were mostly forfeit to the scientific method.
The sovereign was replaced by a capitalist owner for many who had abandoned the manor in pursuit of jobs and the new material abundance that was implied in the output of factories. However, not all had changed for the better, and some things grew worse. The plight of the poor and working class had grown much worse. Exploitation, brutality, and wretched working conditions provided fertile ground for the germination and development of socialism.

As originally conceived by Marx and Engels, and brought into existence by violent revolution, socialism was defined and implemented as State ownership and control of the means of production. A new and better way of life was promised through a grand experience in utopian human cooperation. All labored equally for the betterment of society and the provision of a classless culture in which each person received a proportion of production based upon the needs of that person. "From each according to his abilities and to each according to his needs" (Marx 1848) was the mantra of those who labored under this system. It was embraced by the poor and exploited as the most perfect, just and satisfying form for human existence and endeavor. In the fashion that the worst vice of a fanatic is his sincerity, it became the enemy and opponent of market economics. The issue is not resolved and will remain a work in process.

The Divergence of the United States and Europe

For centuries, Europe was the scene of frequent and bloody wars. The idea of peace and a united Europe was the province of dreamers and philosophers. The writer Victor Hugo wondered if the future would hold a "United States of Europe" (Europa 2005). Between 1870 and 1945, France and Germany
fought three wars that resulted in terrible destruction and horrendous loss of life. However, from the rubble of World War II, a new hope began to emerge. The people who had resisted the totalitarianism of fascism during World War II were determined to secure a lasting peace. A number of statesmen, among them Winston Churchill, Konrad Adenauer, Jean Monnet, and Robert Schuman, began the process of persuading their countries to enter a new era. They were convinced that the only way to secure a lasting peace was to unite their countries economically and politically.

In a 1950 speech inspired by Jean Monnet, the French Foreign Minister, Robert Schuman proposed integrating the coal and steel industries of Western Europe. A year later, the European Coal and Steel Community (ECSC) was established with six members: Belgium, West Germany, Luxembourg, France, Italy, and the Netherlands. The power to regulate and make decisions in these countries was placed in the hands of an independent commission called the “High Authority.” Jean Monnet was chosen as its first president. In countries that had recently fought others, the production of coal and steel would be pooled under a shared authority. This was a good beginning, but it was ironic in that the raw materials of war were being used as the tools of reconciliation and peace (Europa 2005).

In its infancy, the United States was weak both militarily and economically. It appealed to the powerful nations of continental Europe to pass and enforce legislation that would protect it from exploitation and abuse by Great Britain or any other nation with mercantilist designs. This action was the best among a list
of frail options. Ironically, our young nation did not hesitate to exercise power against the weaker people on the North American continent; however, when it came to dealing with European might, it complained and assailed the use of power, while appealing to international law and opinion. Two centuries later, America and Europe have reversed roles and perspectives (Kagan 2004).

As Europe slowly recovered and regained its economic capacity, there was promise of a new Europe that would bloom again and equal the United States in economic and military power. This did not happen. The evolution of the European Union produced an aggregate economy that was almost equal with the United States in terms of production, but Europe had become complacent under United States military protection. The increasing threat from the Soviet Union caused the United States to devote an increasing percentage of its national budget to military technology and production. European nations accepted this largess by minimizing military budgets and investing the accrued gain in social engineering. Europe promised “cradle to grave” care and embraced socialism as its military capabilities steadily fell behind those of the United States (Hoffmann 2003). This is the basis of the economic and philosophical differences that now separate the United States and Europe. The former maintained its faith in market economies, while the latter was seduced by the promises of socialism.

Economic theory suggests that market economies would not evolve in a homogenous fashion. Varieties of capitalism literature indicates that there is more than one way to organize capitalism in an attempt to achieve economic success and social justice (Campbell and Pederson 2007). Hall and Soskice
(2001) argued that there are two basic types of capitalism, and each one can perform successfully. However, there are different reasons for their success.

Liberal market economies (LMEs), such as the United States, Britain and Ireland, coordinate economic activity through corporate independence and therefore perform successfully, based on low cost production and technological innovation. The market environment of LMEs is highly competitive. They enjoy weakly regulated labor markets and a financial environment that allows high risk investments in pursuit of a high rate of return. These factors enable firms to minimize labor costs and vary the amount of labor utilization in proportion to market demand. Capital is mobile as firms move rapidly from one industry to another in a perpetual search for shareholder return. LMEs tend to embrace more liberal market environments that are characterized by deregulation, privatization of production, decentralization of government authority, and a minimal presence of the welfare state.

Coordinated market economies (CMEs), such as Germany, France, and Sweden, coordinate economic activity through non-market mechanisms, such as activist labor unions and government regulation. They compete on a basis of product quality and incremental innovation. In contrast to the highly competitive LME environment, the CMEs operate in an atmosphere of cooperative industrial relations, coordinated wage bargaining across firms, nationally applied vocational training programs, and financial markets that are long-term in perspective.

Hall and Soskice also argued that the capacity of any country to perform well is influenced by the ability of that country’s institutions to perform in a
complementary fashion. A greater complementary nature among institutions governing the economy will produce a more robust economic performance. This would position government as a key determinant in varieties of economic performance.

Gersemann (2004) examined the diverging nature of the economic performance of the United States and Europe and shed light on the distinctions between the two philosophies. Europe embraced "Comfy Capitalism" while the United States resisted the temptations of socialism and held close to a more market-directed economy that became known as "Cowboy Capitalism." Today America is outperforming Europe in almost every comparable economic category. Mr. Gersemann explained why this is happening and dispels quite a few myths concerning these divergent philosophies. He was objective in his presentation and did not gloss over the problems that America is experiencing at the present and might encounter in the future.

During the last years of the 1970s, the United States appeared to have entered a period of moral and economic decline that many predicted would be permanent. Malaise was the mindset of the many as Americans pondered the retreat from Vietnam and the debacle of the Watergate scandal. Numerous forecasts were dour in nature. The remaining forecasts were actually worse.

Most of America's European trading partners were experiencing some form of economic instability, with the exception of Germany, which seemed positioned for steady growth and dominance of European markets. Europe had experienced almost total destruction during World War II, and its recovery was
considered a miracle, particularly in the case of Germany. The combination of the
generosity of the Marshal Plan and the determination, ingenuity, and tenacity of
the people of Europe gave a solid foundation for this recovery. The phenomenon
known as the "catch-up effect" began to manifest as growth rates and
employment in the United States and Europe began to converge. This
convergence took decades to achieve, was not assured, and was all the more
impressive in light of the fact that the United States had not been destroyed in
World War II.

Convergence stopped in the early 1980s and actually became a process
of divergence. Theory among economic dilettante, both in Europe and the United
States, said that increased output per worker was the result of capital intense
production processes and would ultimately reduce the demand for labor. America
reacted with skepticism, while Europe mandated shorter work weeks and labor-
union contrived right-to-work laws. However, neither side ran out of work.
Technological progress eliminated agricultural jobs but created new jobs in
manufacturing to replace them. Many of those new jobs were new to human
experience.

The results of these divergent approaches between the United States and
Europe can be seen in the changes in unemployment experienced by the two
sides. In 1975 the unemployment rate in America was about twice that in France
and Italy and close to three times that of Germany. By 1984 France and Italy
exceeded United States unemployment rates, and in the early 1990s. Germany
joined them. Exhibit 1 illustrates what happened.
The reduction in the hours worked in Europe continued through the 1980s, 1990s, and into this decade. In 2002 the average Italian worked 1619 hours, while French and German worked substantially under 1400 hours. By comparison, the average American was working 1815 hours. Europe had embraced socialism and was paying a price in stagnant output and productivity.

In the 1980s, America began to reject the Keynesian model of big government. Taxes were lowered, markets were deregulated, union influence was diminished, and the welfare state was weakened. Europe had moved in the other direction and embraced socialism, which was characterized by powerful labor unions, a government-administered welfare state that required a high level
of taxation, and government intervention in, or regulation of, markets and the relationship between the employer and the employee. Rated by size of government (a low number is good, a higher number is worse), the United States is ranked 22nd in the world, while Germany ranked 107th, Italy ranked 96th, and France ranked last at 123rd. Exhibit 2 indicates the Index of Economic Freedom ratings for the four countries:

Exhibit 2: Index of Economic Freedom Ranking

The United States has a more mobile workforce since the government does not interfere as much in labor markets. This mobility allows workers to move in search of employment and smooths pockets of unemployment. Americans also show a higher tendency to innovate and evolve products (creative destruction), and they generally let inefficient or non-competitive enterprises fail without a government attempt to rescue them. Europe has
disdained this practice and has become economically stagnant. Their endemic malaise has become known as “Eurosclerosis.” This term was coined by the German economist Herbert Giersch to describe rigid, slow-moving labor markets in Europe in comparison to more dynamic markets in North America.

Alesina and Giavazzi (2006) stressed that Europe must take action to correct its deteriorating economic capacity or face the certainty that its economic and political future will decline. Without immediate and comprehensive reform, continental Europe’s overprotected and overregulated economies will slow, which will result in the marginalization of Europe as an economic and political power.

The message is coached in different prose than Gersemann’s, but the implication is essentially the same. The contrast between the performance and dynamics of the free-market American model and the public-sector dominated economies of Europe is stark in the comparison of their respective economic performance. Europeans work fewer hours, take more vacations, and retire earlier than Americans. They view job security and early retirement as fundamental rights, while Americans tolerate a high-risk environment because of the potential for high return. Europeans tend to hold the same job for a lifetime, while Americans mostly find this intolerable and change jobs frequently.

Europeans view a high tax rate as necessary to provide the social safety net and long-term security that is known as the European Social Model. Most Americans view tax increases as confiscatory and take political retribution upon politicians that enact them. In contrast, the Continental conviction is that social and economic inequalities are problems that are intolerable and thus should be
the immediate focus of government activity. Americans recognize that inequality exists and is increasing, but contend that individuals should be responsible for their own fate. Americans feel that competition is essential to the dynamics of a market economy, while Europeans prefer to be shielded from the uncertainties of the market by restraining market forces through government regulation.

As the former political and economic allies have diverged to the point of rancor, their philosophical differences have become stark in comparison and the source of unflattering commentary. America and the American form of capitalism has become the universal enemy of intellectual and social Europe. Alesina and Giavazzi provided comparative economics to show the results generated by these contrasting economic models. Europe emerged from World War II in economic chaos, with production that was about one-half of the United States. During the next thirty years, Europe increased Gross Domestic Production (GDP) until it was about 80 percent of American output. Then the process of convergence stopped, and Europe began to lose ground.

The authors offered two explanations for this decline. The first is political, and the second is economic. In the 1950s and 1960s, Europeans labored to rebuild their cities, countries, and lives. Leisure and consumption were not priorities. By the 1970s, this task was mostly accomplished, and the people of Europe turned to other priorities. They demanded less work for more pay, labor regulations against firing, free education, free healthcare, and generous pensions that could be accessed earlier in life. The people voted for those who promised to meet their demands. Economic growth seemed sufficient to sustain the lifestyle
provided by the European Social Model. Reality exposed this as wishful thinking. In the 1970s, the welfare state was paid for through tax increases, and in the 1980s, it was sustained by increases in public debt. From those years Europe inherited large governments and high taxes necessary to pay for a growing public sector.

By the 1990s, governments in Europe accounted for 50 percent of economic activity. The result was a depressed rate of economic growth. Ironically, a consistent rate of economic growth was necessary for the sustainability of their model. The second explanation offered by the authors is the decline in innovation and technological advance. These two factors were important contributors to the economic growth in the two decades following World War II. Rather than enhance their contribution, Europe erected obstacles to their continuance. Creative destruction was neutralized by government subsidies, onerous workplace regulations, and non-productive intrusions into labor markets. There is also the suggestion that Europe's dependency on America for military protection lessened research and development in Europe, because the drive for military supremacy is a source of innovation and technological improvement (Kagan 2004).

Varieties of capitalism literature exhibit no consensus concerning the superiority of one model in comparison to the other. A central theme insists that neither system is inherently more economically efficient, and both can make good use of their respective institutional comparative advantages. The coordinated market economy, with strong labor protection legislation and a more
generous social safety provision, implies a lower level of income inequality, a more egalitarian society, and a superior quality of life. This increased equality led a number of authors to reach conclusions that contrast starkly with Gersemann and Alesina.

The set of beliefs we call “the American Dream” underlies one of history’s great success stories in an unbroken cultural ascent lasting more than two hundred years. But how well are we doing today? Rifkin (2004) argued that the American Dream has turned into a liability that has us clinging to an outmoded past. Europe is progressing economically, socially, environmentally, and culturally, while America is regressing. Rifkin asserted that the governments of European Union countries are larger and more intrusive in their economies, but this will produce a more socially just society and a more desirable living standard than is possible in the United States. America can no longer claim to be the model for upward mobility for the world. Wages are barely keeping up with inflation. The $17.00-per-hour jobs lost to outsourcing have been replaced with jobs paying only $14.50. At the same time, corporate profits, as a percentage of national income, reached their highest level since the 1960s. America, it appears, is a land of opportunity for a small segment of high-income earners and a land of misfortune for most others.

According to Rifkin, wealth distribution, which is a measure of a country’s ability to deliver on the promise of prosperity, the United States ranks 24th among the industrial nations. Eighteen of the most developed European countries have less income inequality between rich and poor. There are now
more poor people in America than in the sixteen European nations for which data is available.

America is also a more dangerous place to live. The United States' homicide rate is four times higher than the European Union's. Even more disturbing, the rates of childhood homicides, suicides, and firearm-related deaths in the United States exceed those of the other twenty-five wealthiest nations, including the fourteen wealthiest European countries. Although the United States is only 4 percent of the world's population, it now contains one-quarter of the world's entire prison population.

Europeans often remark that Americans "live to work," while Europeans "work to live." The average paid vacation time in Europe is now six weeks per year. By contrast, Americans on average receive only two weeks. Rifkin felt that most Americans would also be shocked to learn that the average commute to work in Europe is less than nineteen minutes. When one considers what makes a people great and what constitutes a better way of life, the author believes Europe is beginning to surpass America. The European Dream, with its emphasis on large, active governments, inclusion, diversity, quality of life, sustainability, universal human rights, and the preservation of nature and peace is increasingly attractive to a world that is anxious to be connected and at the same time socially embedded. The author believes that Europe is best positioned between the extreme of individualism in America and the extreme of collectivism in Asia and will lead the way into a new age. The universal appeal of economic and cultural
stability will sustain the European Social Model, and it will prevail as the best scheme for providing a meaningful, comfortable, and just existence for humanity.

Reid (2004) believed that Americans have been sleeping through a European revolution that will have a profound effect on the next century and the balance of world economic and political power. The construction of a New Europe, with more than two dozen nations ceding much of their sovereign authority to a common central government, has a largely borderless federal union that is more than just another trading bloc.

The European Union was originally designed as an alternative to warfare, and it has achieved that goal with admirable success. The huge saving on military expenditures enables European Union nations to fund the world's most generous health, education, and welfare benefits. The author concludes that this justifies the presence of larger, more active governments. Reid was objective in his indication that this was possible because of the presence of America in providing the military defense of Europe. Adoption of a common regulatory apparatus and the advent of the euro, the world's strongest currency for much of its life, have made the European Union a financial and commercial superpower. The citizens of New Europe have built a common European culture that is especially strong among members of what he labels "Generation E"—the young people aged 18-40 who will run the European Union and its member states for the first half of the new century. A key element of this culture has been a powerful mood of anti-Americanism that is manifest in a fairly constant barrage of
America-bashing. For many Europeans, the familiar concept of "the West" as a transatlantic alliance is a relic of the last century.

Reid felt that it is tempting for Americans to tell themselves that unified Europe is doomed to fall apart. However, the essential forces driving the revolution in Europe, which are the deep yearning for peace and the intense desire to project influence and power in global political and economic affairs, have not diminished. Because of the sheer size of its market, and because European governments are more inclined to regulate than Washington or Tokyo, the European Union has become the global policeman for a vast array of agricultural, industrial, and financial products. Reid asserted that the rules which run the global economy are largely Brussels' rules.

As America's twin deficits (the budget deficit and the trade deficit) continue to rise, the European Union went in the opposite direction, holding government deficits to a fairly low level and maintaining a fairly steady balance-of-trade surplus. If traders and finance ministries see the rising euro as a more reliable currency than the falling dollar, it could spell the end of the dollar's long reign as the world's preferred reserve currency. The economic impact would be negative.

Alber (2006) offered a definition of the European Social Model (ESM) and compared its potential for economic performance with the United States. The author suggests that the ESM is frequently referred to in political speeches, but is rarely defined because of the complexity and variance of the subject one is attempting to define. Alber provided a broad definition and subdivided the definition into distinct elements. "The European Social Model is characterized by
a system that offers a high level of social protection and core values based on social dialogue and activities fostering social cohesion." According to Alber, the four core elements are as follows: (1) a high level of social protection and security provided by government services; (2) social dialogue, referring to coordinated policy-making with collective agreements negotiated by all social partners; (3) an emphasis on commonality and social cohesion; (4) a set of common core values based on the common interest in pluralism, non-discrimination, tolerance, justice, solidarity, and equality between men and women. Inherent and implied in this set of shared values is a commitment to a high level of employment, sustainable and non-inflationary growth, economic competitiveness, an elevated quality of life, and responsible stewardship of the environment. Alber felt that the holistic commitment of European culture distinguishes it from the United States. Comparisons that focus solely on economic performance are of little value and myopic in nature. Economic competitiveness is not the sole criterion for assessing which society is providing the best quality of life. Europe is superior in offering the growth dynamics of a market economy with the coordinating social dialogue of collective bargaining. The European Union is composed of free democracies, with redistributing welfare states that supplement the market with a second sphere of social safety mechanisms in which social inequalities are smoothed. European societies provide an opportunity to pursue happiness and promote solidarity bonds between individuals that strengthen the bonds of social cohesion. The claims of
European superiority are based on the provision of a society that combines economic dynamism with social justice.

Alber provided an objective comparison of the performance and potential of the European Union and the United States. Demography and population growth advantages are held by the United States. Where population is growing, there is growth potential for markets and attractive opportunities for investors. The European Union is below the replacement rate in the number of births, which implies that laborers will exit labor markets at a higher proportion than laborers will enter those markets. This problem is exacerbated by the European tendency to enter labor markets at a later age and retire at a younger age. The United States exceeds the replacement ratio by a slight margin.

In a seeming contradiction of previous statements, it is acknowledged that the United States clearly outperforms the European Union with respect to the provision of a standard of living. Measured at purchasing power parity, the GDP per capita of the United States is 50 percent higher than the European Union average. Only Luxembourg is on par with the United States. Employment statistics indicate that the gap between the United States and the European Union is in excess of 5 percent. In addition, European unemployment tends to be more structural in nature and more long term in duration. Twelve percent of unemployed American workers have been out of work for more than a year, while 36 percent of European workers have been unemployed in excess of one year. Two causes are offered for this gap: (1) European employment regulations make it difficult to discharge labor and induce reluctance in firms to hire additional
workers, and (2) employment benefits offered in the United States are limited in comparison. Alber suggested that inclusion of the imprisoned, in which the United States has a highly unfavorable advantage, would bring the relative proportions closer to balance.

The author insists that persistent unemployment is undesirable, but a low degree of social inequality and poverty in Europe are mitigating factors. Compared with the United States, European countries have a much more even distribution of income. Alber calculated that 17 percent of the United States population must subsist on income that is less than half of the national median income. That statistic is matched by no country in Europe, and many nations have ratios of less than 10 percent.

Alber reached a number of conclusions. The attempt to define the European Social Model must be imprecise and may be misleading, because it is based upon the assumption that a set of fundamental differences exists between the United States and Europe. His empirical analysis does not support this assumption. The range of variation separating the countries of Europe is frequently greater than the difference between the European mean and the United States. This finding supports a second conclusion that the notion of a European Social Model cannot be grounded on a set of common features that are shared by all member states. Impressive differences prevail between countries that are grouped in models which are based on supposed common characteristics. National priorities and cultural peculiarities assure that this will occur.
Alber insisted that the European Union does not have to become the mirror image of the United States to sustain its way of life. He has no doubt that Europe will have to change. However, there are different paths to sustainability, prosperity, and success. Similar policies may produce different effects in different cultural, political, and economic environments. One size does not fit all. A proposed policy must fit the institutional and cultural make-up of a given country. Convergence toward a “middle-way” with the United States is not the most promising path to success and may lead to more severe problems. European decision makers should adhere to a policy of collective and open coordination to provide meaningful economic evolution.

Sapir (2004) cited the historic success of the European Union and the challenges that must be faced in the near future. He called the thirty years between 1945 and 1975 the *trente gloriesus*. Europe witnessed an unprecedented period of growth, stability, and social cohesion. The European model evolved in an environment of sustained economic growth that reflected an implicit social contract, which guaranteed that the creation of new wealth would be fairly distributed. For twenty-five years, growth averaged 4.6 percent, and the standard of living in Europe approached that of the United States. Unemployment and inflation remained relatively low. Under those conditions, the cost of the welfare state remained manageable.

The oil shocks of the 1970s began to reveal structural deficiencies in the Social Model that might result in long term threats to sustainability. Sapir sensed additional challenges from changes both within and external to the European
Union. Rapid growth, macroeconomic stability, and the welfare state had been mutually supportive during the *trente glories*. The mixture of slow growth, macroeconomic instability, and a welfare system that was conceived under another set of circumstances will make these challenges more difficult to manage. This combination also accentuates the necessity for change. During the 1980s, the growth rate in Europe began to slow down, and the convergence with living standards in the United States began to reverse direction. At the same time, inflation increased to more than 11 percent and unemployment rose steadily from less than 3 percent in 1974 to more than 10 percent in 1985.

The combination of slow growth and high unemployment increased the demand for social protection and placed severe strains on public finances. By 1985, government expenditures had grown to 49 percent of GDP. A large portion of this increase occurred in social transfers and subsidies. The increased spending by government was funded by increased taxes and government borrowing. Public investment diminished. Europe was declining at an inertial rate. Lower growth and higher unemployment required increasing public expenditures, which required higher social contributions and higher direct taxes. This combination reduced the incentive to work and invest, which further reduced the potential for economic growth and increased employment that were necessary for recovery.

The dilemma was compounded by an aging population and the forces of globalization. In addition, Europe seemed politically unable to reform itself and establish a new social contract aimed at increasing growth and preserving social
welfare. Economic growth was the only solution, but this required adapting the social model to a new socio-economic environment.

Sapir emphasized that demographic trends will present a major challenge to the European Union, because the population is aging. The dependency ratio is defined as the number of persons aged 60 years old per one-hundred persons aged 15 to 59 years old. Between 1960 and 2000, that number rose from twenty-six to thirty-five in the European Union, but remained at a constant twenty-five in the United States. Sapir attributed this anomaly to a declining population growth. Europe’s average annual population growth dropped from 0.8 percent during the period 1950 to 1975 to 0.3 percent in the period 1975 to 2000. In contrast, population growth in the United States was 1.3 percent and 1 percent for the same respective periods. The underlying reason for the contrast in the two sides of the Atlantic is the fertility rate. In the European Union, the fertility rate dropped below 2.1 children per woman, which is considered the natural replacement rate for population maintenance. The United States maintained a fertility rate of 2.1 and was much more open to immigration. Sapir suggested that generous European retirement benefits have reduced the need for children as caregivers, and high taxes may discourage the young from assuming the added costs of children.

The combination of an aging population, early retirement schemes, and high unemployment were the driving forces in the growth of European governments in the 1970s and 1980s. Sapir warned that the demographic outlook is dismal and cites The United Nations Population Report forecast that
the dependency ratio in the European Union will reach forty-seven in 2020 and seventy in 2050. The European Commission estimates that taxes related to pensions and health care would have to increase by 8 percent to sustain the system.

Sapir argued that Europe has also fallen behind the United States in development and adaptation of information and communications technology (ICT), and this neglect is also a contributing factor to the slower growth rate in Europe. While the United States embraced and implemented ICT, pessimists in Europe predicted that the new technology would have negative effects in employment, wages, and income distribution. The actual result of the diffusion of ICT was skill-based technological change that decreased the demand for unskilled workers in the United States and Europe during the 1980s and 1990s. However, the two sides of the Atlantic reacted differently to this change and challenge.

In the United States, where labor markets are more flexible, skill-biased technological change produced stagnant or decreasing wages for unskilled workers and rising income for the more skilled laborers. The result was a surge in income inequality. In Europe, where labor markets are more rigid and wage floors are present, skill-based technological change tended to produce more long-term structural unemployment. Income redistribution mechanisms prevented significant increases in income equality, but reduced the incentive to adapt. These differences in labor markets and social security institutions slowed down the pace of ICT diffusion and creative destruction in Europe.
The third major trend challenging Europe is globalization. In the 1970s, the world economy entered an era of free trade that was characterized by labor and capital mobility. The emergence of Asia as a major producer and exporter of manufactured goods raised European fears of a negative effect on wages, employment, and income distribution. This led to an intense debate concerning the possibility that globalization was the cause of declining economic performance in Europe. Sapir felt that globalization had the same relative effects as the ICT revolution. In the United States, where markets operate efficiently, more wealth was generated, but income inequality increased. By contrast, in Europe, where the welfare state is more generous and markets less efficient, globalization generated less additional wealth and less income inequality.

According to Sapir, the intensity of the dilemma facing Europe will increase in the near future. The pace of technological change will accelerate, and the emergence of China and India will strengthen the effects of globalization. The combination of low growth rates and high unemployment will severely strain public finances and may prove incompatible with the fiscal responsibility required for a growing economy. The author feels that priority should be given to changes that would enhance economic growth, because the European model is not sustainable in its present form. Growth must become Europe’s number one priority—not only in the declarations of its leaders, but, first and foremost, in their deeds and actions. Ironically, social benevolence requires a strong economy, while the source of that benevolence (government) requires high taxes and
intensive workplace regulation, which weaken the economy (Samuelson 2005, June 15).

Mullally and O'Brien (2006) found that the performance of the European Social Model is at odds with its historically stated goals. Income growth for the poor is slowest in nations with the most extensive application of the social model. From 1995-2004, the income of the poorest 10 percent of the population has grown eight times faster in Ireland than in Sweden. As a result, the Anglo-Saxon economies of Ireland and the United Kingdom have smaller proportions of their population below the poverty line. Ireland cut public spending as a proportion of GDP, from 55 percent to 35 percent, while the tax burden for most of the rest of Europe increased. This economic reform produced accelerated growth in Ireland, which had been historically poor.

Europe is also falling behind in education. Twenty-nine percent of European citizens have a university education, compared with 39 percent in the United States. According to Mullally, seventeen of the world’s top twenty universities are found in the United States, and those universities currently employ 70 percent of the world’s Nobel Prize winners. Thirty percent of the world’s output of articles on science and engineering and 44 percent of the most frequently cited articles are produced by American universities. Only eleven of the world’s top fifty universities are located in the European Union, and eight of those are located in the United Kingdom.

Mullally complained that European leaders are doing little to prepare for severe demographic transition, which will put government budgets under extreme
stress. Endless posturing, arguing, and policy studies contribute nothing to the process of real change. Few moves are underway to reduce high implicit taxes on working beyond certain ages. Cuts in taxes have been modest. Reform of employment protection legislation, labor cost floors, and mandated labor benefits have been totally absent. Mullally concluded that the future for the European Union is not in the Social Model. That system has become unworkable and unsustainable. The future is in a lean but progressive state and a low tax economy that invests in a highly educated and more productive work force. This is the only strategy that has the potential to cope with the challenges that Europe will face in the near future.

Munkhammar (2006) reasoned that the welfare state is actually an unfair state. Europe is in deep economic trouble, and the root of the cause is a combination of the European social model and a lack of political will in European leadership. In countries that have riots because of economic and social failures, politicians call for economic patriotism. The more economically troubled economies, such as Germany, France and Italy, have urged the more dynamic economies, such as Ireland, the United Kingdom, and Spain, to raise their taxes to a more fair level. Munkhammar believed that this approach indicates a preference for dragging everyone down rather than embracing change for the better. Western Europe can move toward market-oriented reforms that decrease the size of government or keep the current social model and attempt to shield it through protectionist policies and anti-American diatribe.
Large governments and ruinous tax rates have plundered economic performance. High taxes on work indirectly punish workers and make hiring additional workers less attractive to businesses. By redistributing these taxes to an increasing number of workers who are not working, the unemployed are rewarded for inactivity. In many European countries, the difference between working and living off the welfare state is slight. The social model results in fewer people working and more living off of the labors of those who are working. The author deems this unsustainable.

Munkhammar argued that the social model makes it difficult to return people to the labor market because of a series of traps. An unemployment trap exists where the market wages are too low to offer an incentive to return to work. A wage rate that barely exceeds welfare benefits provides no motivation. This behavior can be modified by cutting benefits and reducing the duration that benefits may be received. An inactivity trap exists where employment is unattractive, because income-related benefits may be forfeited with a return to work. A spouse may remain unemployed, because the taxes on joint income would exceed the benefit accrued from a two-earner household, which is taxed at a higher rate. A low-wage or poverty trap exists where there is no financial incentive to work longer hours. An increase in gross income does not result in sufficient net income to make the additional effort attractive. The marginal benefit is taxed away (Watts 2006).

Munkhammar believed that reform is crucial. Although efforts have been made to make a return to work pay sufficient dividends to induce unemployed
workers to enter labor markets, there is still much to be accomplished to return the European Union to competitiveness. Tax reductions on personal and corporate income and a cutback in workplace regulations should be priorities.

The conviction that a smaller state is the better concept is shared by Marsden (2006). The author examined the question of which type of government gives its citizens the best services, the best standard of living, and the most socially just society. This study detailed the performance of ten OECD countries over the last two decades in twenty different economic performance fields. Canada, Ireland, New Zealand, Spain, and the United States are classified as "leaner" governments. France, Germany, Italy, Portugal, and the United Kingdom are labeled "larger" governments. The distinction between "leaner" and "larger" is the relative percentage of government spending as a proportion of GDP.

Advocates of larger governments claim that the prosperity of a nation and the welfare of its people cannot be left to the mercy of unrestrained market forces. This mandate gives government a duty to implement plans and programs which achieve social justice and harmony, defined by interpretation of those who are duly elected. They implement an egalitarian social philosophy and claim the resources necessary to achieve this end. Marsden credited the European Social Model with these attributes.

The question of whether big governments deliver on this broad social promise is answered through a comparison of descriptive statistics. The author suggests that big governments lack business acumen. They demonstrate little familiarity or sympathy with consumer needs. They fail to allocate resources as
efficiently as markets do, and the lack of profit awareness and the discipline of competitive forces make them poor stewards of the taxpayer’s money. Big governments discourage free enterprise and initiative by confiscating too much of the rewards accrued by entrepreneurship and risk taking, and they promote indolence by providing social protection to the point of discouraging work.

It is concluded that tax cuts stimulate entrepreneurial activity, higher levels of private investment, more work and jobs, faster productivity growth, and more resources available for government to apply to key public services. More income would be retained by households and businesses to dispose of in ways that they know best, which would generate more growth and a higher level of revenue for government. Smaller governments do not have to be “mean” in the sense that a smaller government would provide less services of a poorer quality.

The analysis is compelling. The leaner governments reduced their percentage of taxation, expressed as a proportion of GDP, by 6.5 percent over the last two decades. The larger governments increased their taxes by 4.8 percent over the same period. Spending for leaner governments averaged 37 percent of GDP, while larger governments averaged 49 percent. Per capita income was 12 percent higher in the countries with leaner governments. Some of the contrast in income can be explained by the relative rates of growth. Between 1997 and 2003, the leaner government economies averaged 4.1 percent growth, while the larger government countries managed only 1.9 percent. Leaner governments expanded their spending on public services at a faster rate than larger governments, and in terms of the United Nations Human Development...
Index (which is an indication of relative life expectancy, availability and quality of education, and the standard of living), lean governments performed better than larger governments.

The fiscal consequences of unrestrained government growth were described by Mitchell (2006). He warned that the growing burden of government will turn America into an uncompetitive European-style welfare state. According to Mitchell, evidence from Europe indicates that big governments impose very high economic and social costs. Living standards in Europe are much lower, unemployment is much higher, and growth is anemic. Globalization has made it much easier for labor and capital to migrate in a search for better economic and market conditions. This increased mobility of resources increases the reward for good public strategy, but imposes penalties for imprudent government activity. Europe provides useful lessons about the economic consequences of bigger governments.

The growth of government in Europe has resulted in considerable economic damage, because increases in government spending and increases in taxes undermine incentives to engage in productive behavior. Mitchell argued that increases in government spending encourage people to rely on handouts rather than personal initiative. Higher marginal tax rates needed to finance increased government spending reduce incentives to work, save, and invest.

Exhibit 3 shows that the burden of government spending relative to GDP has risen considerably in Europe, while the United States has avoided this mistake.
Exhibit 3: The Climbing Burden of Government in Europe

The author is not surprised by the contrasting results of these divergent policies. Exhibit 4 shows that per capita income in the United States is almost 40 percent higher than in Europe.

Exhibit 5 shows that from 1994 to 2004, the economy of the United States experienced a rate of growth that is 50 percent faster than the annual growth rate of the European Union.
Exhibit 4: American and European Per Capita GDP

Americans Earn Much More Income Than Europeans

Exhibit 5: US and EU-15 Average Real Growth Rate

U.S. Growing Much Faster Than EU-15 Nations

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At these growth rates, the United States would double its GDP in slightly more than twenty-one years, while the European Union would require almost thirty-two years to double its output. According to Mitchell, during the period 1994 to 2001, the economy of the United States accounted for over 60 percent of the cumulative expansion of world GDP. The European Union, with an economy comparable in size to the United States, contributed less than 10 percent.

Mitchell cited a Timbro study (Bergstrom and Gidehag 2004) to contrast the standard of living in the United States and Europe. Only West Virginia and Mississippi, the two poorest states, have lower living standards than the European Union, which has a living standard comparable to Arkansas or Montana.

Mitchell stated that in August 2006, unemployment in the European Union reached 8 percent, with 7.9 percent unemployment occurring in the group of nations that use the euro. Unemployment in the United States in that same month remained at 4.7 percent. However, this data indicates only the number unemployed compared to the number of workers in the labor force. In the United States, more than 70 percent of the working age population has a job, compared to less than 65 percent in the European Union.

Long-term unemployment is much more of a problem in Europe and is indicative of a lack of incentives to return to work and government regulation of labor markets that make it unattractive for European firms to hire new workers. A comparison of the percentage of unemployed who have been without a job for more than 12 months is 12.7 percent in the United States, versus 42.6 percent in
the European Union. Part of this disparity is explained by the fact that America has created fifty-seven million new jobs since 1970, while Europe has managed to create only four million new jobs during the same period of time. Mitchell added that most of Europe's new jobs were in government. Exhibit 6 indicates the wide gap between the United States and Europe in long-term unemployment. Almost 20 percent of the long-term unemployed in Europe are under the age of twenty-five.

Exhibit 6: US and Europe Long-Term Unemployment

![Long-Term Unemployment Is a Much Bigger Problem in Europe](image.png)

According to a European Commission report (Kok 2004), almost four hundred thousand European Union scientists resided in the United States in 2004, and only one in seven intend to return to Europe. Immigration to the United States increased by 16 percent in the 1990s, and there were half a million New York City residents who were born in Europe. The conclusion of the report is that lower tax rates and more opportunities created by an economy with less government is inducing Europeans to "vote with their feet" in favor of America's balance of work and leisure. There is no discernable flow in the opposite direction.

Exhibit 7: Burden of Government Consumption and Transfer Spending

Exhibit 7 illustrates the contrast in the size of government, taxation, and their relative devotion to transfer payments. In the European Union, government
consumption is 32.6 percent higher, and transfer outlays are 28 percent higher than in the United States.

Exhibit 8 indicates that the aggregate tax burden is almost 60 percent higher in Europe, while Exhibit 9 shows that payroll taxes are more than doubled.

Exhibit 8: Aggregate Tax Burden

Exhibit 9: Payroll Tax Rates
Exhibit 10 illustrates that in the United States, the top personal income tax rate is not imposed until income reaches $327,049. The top tax rates in Europe are generally imposed once income reaches twice the average wage.

Exhibit 10: Income Tax Rates

The United States experiences a competitive disadvantage in the application of the corporate income tax. The federal rate is 35 percent, and the application of the state level corporate income tax pushes the total rate closer to 40 percent. In addition, the United States is one of the few nations that impose an additional layer of taxes on companies that compete in global markets. The United States also imposes double taxation on many forms of income. Corporate
income is taxed at the corporate level. If after-tax income is invested in the company, the increase in the company's value is taxed as capital gains. If after-tax income is distributed to shareholders, it is also taxed as personal income. Exhibit 11 shows the extent of the United States' disadvantage.

Exhibit 11: Corporate Tax Rates

*The United States, the United Kingdom, and Ireland tax worldwide income.

Mitchell felt that the United States can learn much from Europe. Primarily, Europe serves as a warning about the consequences of big government. If American politicians allow the welfare state to expand, economic performance will suffer. Since demographic pressures and misguided policies have placed the United States on a path toward much larger government, this warning is particularly cogent and timely in nature. A European size government will mean European style stagnation.

Public Choice and the Size of Government

Klein (2005) suggested that government exists and grows in size because the people develop a love for government. Central authority creates a sense of togetherness and a common experience. It is this source of inclusiveness and shared concern which makes us feel American, or French, or Dutch. If people see government activism as a singular way of binding society together, they may favor any government intervention for the sake of communal experience. In The Theory of Moral Sentiments (1759), Adam Smith commented on the human need for shared emotion. He noted that “nothing pleases us more than to observe in other men a fellow feeling with all the emotions of our own breast. The man whose sympathy keeps time to my grief, cannot but admit the reasonableness of my sorrow.” Unequaled in power, permanence, and pervasiveness, the government is prominent, conspicuous, and uniquely focal. It draws the people to view its dominance as setting the boundaries which define inclusion to the group. Government establishes the common feeling with its morals and mores, and dictates the rules as it validates the games that its citizens can play.
Individuals may favor government for a variety of other reasons. They may view themselves as born to rule, or they may seek glory that may be acquired only through the scale of public works. Many revere the power that may be accessed through government, or they simply seek privilege and subsidy. The population may develop bias toward the government, because they are indoctrinated by the government to generate a favorable view.

Leftwich, Register, and Sharp (1988) sensed a dichotomy in human nature that produces ambivalence in perceptions of government. Most people do not object when they receive government services free or below the fair market price. However, they do object when others receive these services, and they must pay the taxes to provide these services to those others. The major concern of most taxpayers is the fairness or equity of the nature of the taxes they pay and the manner in which the tax burden is apportioned in the society. Sentiments range from a suspicion that government is too large and taxes are too high, to the belief that taxes are too low for some segments and too high for others. The authors have little doubt that the governments of the developed world are growing in size and at a faster rate than the rest of their economy. Additional light can be shed on the significance of this trend by distinguishing between government spending on goods and services and transfer payments. The former are consumptive of resources, but ultimately contribute to economic performance, while the latter are consume nothing, but contribute nothing to production. Transfer payments are payments to people who have made no contribution to current production. Most
of the growth of government in the last two decades has been in the category of transfer payments and subsidies.

According to Leftwich, an efficient level of government taxation and expenditures is one in which the net benefits to society are maximized or where benefits and cost are equal at the margin. Government expenditures should be increased when the marginal benefit per dollar spent in the public sector of the economy is greater than the marginal benefit per dollar spent in the private sector. Efficient and optimal government expenditures are reached when the marginal benefit per dollar spent in the public sector is equal to the marginal benefit spent in the private sector. The author cautions that while marginal-cost/marginal-benefit analysis has value, the benefits and costs of government spending can seldom be known and are frequently not considered. Politicians and voters may become enamored of programs that display a high potential for public benefit. This attraction is particularly acute when the costs are poorly defined or presented as long-term and seem to be minimal. At times the implied benefits are so seductive that the costs are ignored. Consequently, the optimal size of government is arbitrary in nature. Americans are endlessly suspicious of a growing government, while Europeans take great solace in a large and nurturing government.

An idea common in western economic thought is that tax justice ensures that taxpayers in equal economic circumstances should be treated equally. People in identical economic conditions (Leftwich acknowledged that this might be difficult to establish) would pay equal taxes. Real income is traditionally the
basis for tax rate determination and application. Taxpayers in different economic circumstances would be treated differently, and Leftwich labeled this the *relative tax treatment doctrine*. This concept divides the apportionment of taxes between two concepts: the *ability-to-pay principle* and the *benefits-received principle*.

The *ability-to-pay principle* of taxation implies that taxpayers with more ability to pay should pay more taxes. Leftwich stated that the question of how much more they should pay is unanswerable. Progressive and proportional tax rates are favored as the mechanism to resolve the issue because they increase the amount percentage paid as income increases. Regressive taxes, such as the sales tax, violate the *ability-to-pay principle*, since they are inversely related to changes in income.

The *benefits-received principle* of taxation attempts to apportion the payment of a tax to those who gain from the provision of a government good or service. Leftwich offered the gasoline tax as an example. The more a person drives, the more that person benefits from the roads provided. They also pay more in gasoline taxes. There should not be an excess burden generated by the implementation, payment, and collection of a tax. This implies that there should be tax efficiency in the administration of a tax and the payment made by the taxpayer. Taxes should be economical to collect and enforce, and they should be convenient and certain to the taxpayer (Galbraith 1973). Leftwich noted that recent increases in government revenue have been expended mostly in transfer payments and subsidies. The *ability to pay principle* is converging with the *benefits received principle*.
The ethical dilemma and moral consequences of redistribution of income were examined by Jouvenal (1952). He concluded that the most troubling result of income redistribution is the alarming growth of the state’s influence and power. Jouvenal argued that stripping the individual of discretionary income essentially renders him ineffective in opposing the power of the state. As the state gains control of the discretionary spending of its citizens, a new class of bureaucratic elites must evolve to administer the distribution of these funds. The individual is poorly matched against these legally mandated public managers. Jouvenal reasoned that redistribution requires that power be centralized in a manner which easily accommodates the development of tyranny. This conclusion seems to mirror the philosophy of Hayek.

Redistribution gained acceptance as societies became wealthier. There was an evolution from the sentiment of the past, where riches had been a scandal in the presence of poverty, to a mood of social responsibility, where poverty was a scandal in the face of riches. Jouvenal acknowledged the noble aims of redistribution, but he argued that the loss of personal liberty is more dire than the benefits gained. In the long run, there may be no gain at all. Government and social elites tend to overestimate the amount of excess income available for redistribution. This miscalculation leads to overly ambitious social programs and confiscatory levels of taxation that damage economic performance, while degrading the fabric of society.

Jouvenal sensed injustice in the denial of self-expression that is the result of redistribution. Income is not just a means of sustenance. The manner in which
we dispose of our income is an expression of the individual and his values. We teach future generations about what we hold important. When you appropriate the honest income that an individual has earned, you deny him the capacity to give expression to what is perceived as his purpose as a human being.

The elitist mentality of redistribution advocates leads them to mistrust the poor, who are judged as lacking the intelligence or wisdom to spend their income in a socially desirable manner. The poor will always prefer to spend their money on booze rather than Bach. The state takes over that responsibility for them. Here is the great danger according to Juvenal. What is redistributed is not income from the wealthy to the poor, but power from the people to the state. The individual no longer plans his own life and works hard to earn an income to pursue his dreams. His life is controlled by the state. As the state has grown stronger, the individual has become weaker. We are not only weaker in relation to the state, but as human beings, we are all weaker, because we no longer exhibit the qualities of personal responsibility and self-reliance. Juvenal summed his philosophy by stating, "The more one considers the matter, the clearer it becomes that redistribution is in effect far less a redistribution of free income from the rich to the poor, as we imagined, than a redistribution of power from the individual to the State."

Belloc (1913) observed the ease with which the many are subjugated by the few and predicted that this will ensure the destruction of capitalism. We are taught to resist the tyranny and oppression of the despot, but we are seldom warned of the insidious and gradual tyranny of the bureaucratic state. In
conditioning us to obedience, the state now makes greater claims upon the individual than does his family. The autocrat has been discredited, while the bureaucrat prospers by taking our wealth and regulating our lives. We are not certain of whom we are obeying, but we obey, because we are conditioned to obey. We are led to believe that the bureaucrat protects us from the autocrat.

Legislation has become the unrestricted will of the state, and that state labors incessantly in producing laws. Belloc offered an analogy. The legislator knows that you may pick roses at your whim. He also knows that the thorns on the rose may injure you. He enacts legislation that mandates imprisonment if you do not wear gloves. The gloves are produced by a factory in which he holds surreptitious ownership. Additional legislation dictates that you must cut your roses with scissors of exactly 122 millimeters. That factory is owned by a cousin of the legislator. A cadre of one thousand inspectors is created and funded to enforce the law and imprison any criminals who do not obey the law. This new bureau is populated mostly by friends and relatives of the legislator. The head of the new enforcement department is his brother-in-law, who draws a salary of four times the median wage. The servile state has evolved. The parasites know that they depend on the state, but many of the productive members who create the wealth that supports the parasites feel that their freedom is ensured by the state. Consequently, the state is unopposed in its management of the society.

A central component of the managed state is the welfare state, which cultivates a class of beneficiaries who are dependent on government and the apparatus that distributes their benefits. Expansion of the number of dependents
brings continuance for government and an increased capacity for social management. Government becomes the ultimate arbiter of justice and fairness, with the implicit understanding that it is wiser, fairer, and morally superior to its citizens. It will help the poor, because the more fortunate are engaged in pursuit of selfish pleasures (Monigue 2007).

Belloc reasoned that the result will be “an arrangement of society in which so considerable a number of the families and individuals are constrained by law to labor for the advantage of other families and individuals as to stamp the whole community with the mark of such labor we call the servile state.” He felt that the servile state was a return to the slavery that existed in Europe before the advent of Christianity abolished it.

The instability of such a system will require a “buying out” of capitalism by a collectivist state. This evolution will progress through socialism and ultimately end in totalitarian control by government. Belloc warned almost one hundred years ago that the prospect for freedom was grim if a society was willing to relinquish its freedom in exchange for the illusion of government-granted security and subsistence.

Blackwell (2001) expressed wonder at the number of economists who support the claim of the economic viability and even superiority of socialism, while disregarding the warnings of Mises and Hayek. The Marxist view that property and free markets are obstacles to development has been ruthlessly falsified by experience. There is not a single example of a non-market, state-
dominated economy that has turned out to be a success. The largest sacrifice of liberty has produced the largest measure of misery (Balcerowicz 2004).

He offered a reason for state expansion in the preferences of the public and its conviction that government is a superior good that can provide largess for the unfortunate, as the level of national income and general prosperity increase. Democratic societies appear to have a built-in ratchet-effect toward expanding governments. When a problem arises, the government courts popular sentiment by offering a solution through government action. The electorate, promised action, is encouraged to blame the government and demand further intervention when solutions are not found. Dependency on government becomes a way of life and creates a cycle that becomes self-perpetuating in nature.

Blackwell found four dangerous assumptions in the public fascination for government activism: 1) Public services, if provided by the state, are more likely to benefit the public is a widely held belief. Evidence, however, shows that services under government management lack the discipline of market competition and are likely to focus on managing the benefits of their internal hierarchy rather than the public good. They become dominated by producer/special interests at the expense of efficiency and service quality. 2) The state can legislate a right or benefit without any cost incurred. The people do not see, or they ignore, the economic costs inherent in legislation which reduces the work week. 3) Legislation which removes individual risk has no cost. The public does not perceive the burden of regulation and compliance. 4) The state can provide benefits to an increasing number of groups who define themselves as
disadvantaged, underprivileged, or excluded from something, without transferring the cost to another group. The final assumption is considered the most dangerous. Blackwell believed that the enlargement of the state has stifled the dynamics of capitalism and offered a quote from John Stuart Mill: “A state that dwarfs its citizens will find that, with small men, no great things can be achieved.” Socialism by stealth has become the *bête noire* of market economies.

**Government and Economic Growth**

Growth theory is an important component in the evolution of modern macroeconomics. The analysis of economic growth had long been based on the Solow (1956) “growth accounting” approach, which was also called *neo-classical growth theory*. The Solow model assumed that countries would use their resources efficiently, and there are diminishing returns to increases in capital and labor. From these two premises, the neo-classical model makes three predictions. First, increasing capital relative to labor creates economic growth, since people can be more productive given more capital. Second, poor countries with less capital per person will grow faster, because each investment in capital will produce a higher return than rich countries with ample capital. Third, because of diminishing returns to capital, economies will eventually reach a point at which no new increase in capital will create economic growth. This point is called a "steady state."

In the long run, the Solow model made two predictions concerning economic growth. Economic growth would occur as a result of exogenous, technological change, and per-capita income of countries would converge. It was
assumed that all determinants of economic growth were exogenous, and government policy did not affect growth rates, except temporarily, during the transition of economies to their "steady state." Consequently, the Solow model disregarded the role of government as a factor in economic growth.

Three decades later, a new growth model began to emerge with the work of Romer (1986), Lucas (1988), Barro (1990), Rebelo (1991) and Quah (1993). This new theory contained an endogenous growth model that changed the perception of the role of government, which was viewed as internal and operating within the mechanics of economic growth. As a result, long-term growth rates and income per capita would not converge and could differ among nations. Dar and Amirhalkhali (1992) found that a major implication of the endogenous growth model was that government policy could impact economic growth and be a source of varying economic performance. The three main fiscal instruments of government, taxation, expenditures, and the aggregate budget balance would affect long-run economic growth through their effect on the efficiency of resource use, the rate of capital accumulation, and the pace of technological progress. Empirical analyses of the determinants of economic growth seemed to present strong evidence that a larger government sector had a negative effect on economic growth (Pecvin 2003).

Quah (1993) criticized the regression analysis that produced acceptance of the theory concerning convergence of incomes. He concluded that the theory was flawed by Galton's fallacy, which induced a mathematically skewed conclusion. Quah applied a more direct test of the data and provided evidence
against the convergence hypothesis. His results showed a world of economies moving toward income polarization. In the long-run, economic growth and increased income were dispersed toward the very rich or the very poor, with the middle classes vanishing. Quah’s analysis found that the disparity between rich and poor was widening.

Barro (1990) predicted that the negative effect of excessive government should be expected in countries where the size of government exceeds a definable threshold. He pointed out that different sizes of government would have two effects on the growth rate. An increase in taxes would reduce the growth rate through a disincentive effect, but an increase in government spending would raise the marginal productivity of capital and labor, which would increase the growth rate. Barro argued that the second force dominates when the government is small, and the first force dominates when the government is large. Consequently, the effect of increasing government spending should be non-linear, and some optimal size of government should exist. Empirical examination by Barro indicated an inverted U-shaped curve showing the relationship between economic growth and government expenditures.

Armey (1995) expanded the concept of an optimal size of government. He argued that the non-existence of government causes a state of anarchy and low level of output per capita, because there is no discipline of law and no protection of property rights. As a consequence, there is little incentive to save and invest, because the threat of expropriation exists. Similarly, when all input and output decisions are made by government, output per capita is also low. However,
where there is a combination of private and public sector decisions on the allocation of resources and levels of output, economic growth and production should be larger. The output-enhancing features of government should dominate when government is very small, and expansion in the size of government should be associated with increased output. As the public sector builds up, wealth creation will gradually grow larger. A state of law and order is installed, and a collective infrastructure such as roads, bridges, and means of communication are built, all contributing to increased productivity. The installation of education structures and social programs increase the productivity of workers and stabilize the society. However, at some point, the growth enhancing properties of government will diminish, and further expansion of government will not contribute to increased production. As spending rises, additional projects financed by government become increasingly less productive. The taxes and borrowing levied to finance increased government spending impose an increasing burden on economic growth. Additional public projects increasingly lose their productivity advantage over private investment, while the heavier tax burden needed for financing government increasingly discourages the private sector from investing in productive endeavors. Social programs also lose their growth effect when they tend to provide incentives to leave the labor force or remain unemployed.

At some point, the marginal benefits from increased government spending reach zero, as indicated by point $E^* g^*$ in Exhibit 12. Beyond this optimal point, additional government spending leads to lower wealth creation, as more scarce resources are withdrawn from the private sector where they could have been
used more productively (Pecvin 2003). According to Chao and Grubel (1998), the inverted U shape of the Armey curve indicates the existence of the *law of diminishing returns* with regard to additional government spending.

**Exhibit 12: Government Spending and the Economy (the Armey Curve)**

There have been several attempts to determine the level at which government spending provides the most positive stimulus to the economy and optimizes the rate of growth. An examination of the relationship between the size of government relative to the economy and the levels of productivity was conducted by Peden (1989). He concluded that there is a negative relationship between government size and productivity. Peden estimated that the optimal size of government is 20 percent of GDP.
Vedder and Galloway (1998) extended the work of Armey and produced an estimation of 17.45 percent of GDP as the appropriate size of government. These authors suggested a federal budget strategy of constrained spending growth below the level of output growth. This would not require a reduction in the size of government, but would require that the public sector grow at a slower rate than the economy. This policy would reduce the size of government as a proportion of GDP. Particular attention should be addressed to the restraint of growth of transfer payments and subsidies.

Grossman (1988) asserted there are two sides to government policy—government spending and government revenue. The author felt that we tend to analyze spending as if it were a function of tax revenues, when it would be more practical to accept that government spending drives taxation. Grossman investigated the reasons for declining marginal contribution as government spending increases and offered an explanation as to why governments grow beyond the point of maximum efficiency. According to Grossman, government contribution to total output will be positive when concentrated in the provision of public goods that enhance the efficiency of the private sector. Since total output is the summation of private sector production and government contribution, an additional dollar of government output would increase total output by one dollar. However, Grossman recognized that government activity increases output indirectly through interaction with the private sector. A dollar spent on the provision of roads might increase economic activity by more than a dollar. Private sector output is also enhanced by expanding government activity designed to
correct the inadequacies and excesses of an unrestrained marketplace. Government provides a level playing field for all participants.

Grossman had serious concerns as to how public decisions are made and the efficiency of their outcomes. With participants in the political process motivated by rational self-interest, combined with the rational ignorance of voters, decisions made by government tend to favor the interests of a small, cohesive, and vocal minority at the expense of the public interest. The author suggests that politicians lack the incentives of profit-maximizing in the private sector, so they seek a budget which maximizes their personal utility. There is seldom an efficient outcome from this process. Grossman suggested that there is a direct relationship between the influence of special interest groups and the size of government. As government grows, citizens become increasingly ignorant of the activities of their government. The return to special interests increases with the size of the public sector, and an increasingly large share of government activity is designed to benefit a small group at the expense of the general public.

Inefficiency increases as the positive influence of government decreases. The final phase of degeneration in government effectiveness is called rent-seeking, which is defined as the pursuit, through government, of a transfer of wealth at someone else's or society's expense (McConnell and Brue 1990). There is no interest in private sector efficiency. The intent is to alter the distribution of income in the rent-seeker's favor. Choi and Magee (2002) found that the extent of rent-seeking in a country is proportional to the number of lawyers in a country. Those countries with below average lawyer densities, such as Germany and the United
Kingdom, had more favorable current account and government budget balances, while countries with higher densities, such as the United States and Spain, had larger current accounts and government budget deficits. These authors suggested that 25 percent of the federal deficit in the United States is accounted for by rent-seeking.

Gwartney (1998) found that excessively large governments retard economic growth. He expressed the conviction that governments must reject the momentum for increased size and begin to implement plans for future reduction in their spending as a percentage of Gross Domestic Product. The role of government should be concentrated in the protection of property rights, the provision of public goods and education, and activities conducive to the maximum rate of economic growth, while providing a legal framework suitable for the operation of a competitive market economy. Gwartney’s empirical analysis of data from twenty-three member countries of the Organization for Economic Cooperation and Development (OECD) indicated that as governments moved beyond these core functions, they have a negative effect on economic growth. Reasons offered for this negative effect are: the disincentive effect of higher taxes and income redistribution, inefficiencies and diminished returns as governments undertake activities for which they are ill-suited, and an interference in the wealth creation process, because governments are not as efficient as markets in adjusting to changing conditions and innovating to maximize profits. Gwartney’s analysis showed a correlation between increased government spending and decreased private investment, productivity, and economic growth.
In 1960, government expenditures among OECD countries averaged 27 percent of their GDP; by 1996, they had grown to 48 percent. In illustration of the effects of this growth in government, Gwartney stated that if government activity in the United States had remained at its 1960 level, GDP in 1996 would have been $9.16 trillion instead of $7.64 trillion, which would have increased per-capita income in the United States by $5,860. There is no reference as to whether this increased purchasing power would have produced demand-pull inflation or if the income would have been distributed homogenously across income categories. After considerable empirical analysis, Gwartney concluded that the optimal amount of government spending is 15 percent of GDP.

As socialism became unworkable and was abandoned for the better promise of market economies, Gwartney theorized that the rejection of socialism should have resulted in an environment more consistent with economic freedom and the efficient function of a market economy. Economic growth should have accelerated. Trade barriers had been reduced, monetary systems had become more stable, and resources had been freed to move at the direction of markets. However, in one critical dimension, the size of government, most nations had moved in the opposite direction. Since the end of World War II, government expenditures as a percentage of GDP had risen, resulting in more resource allocation through government. Also, more regulatory intervention in markets and the workplace environment occurred. In contrast to his previous work, Gwartney increased the number of countries in the analysis from twenty-six to sixty. His hypothesis stated that increasing the size of government past its core
competencies would result in a reduction in the rate of economic growth. An alternative explanation allowed for slower growth due to the effects of higher energy prices, lower savings rates, constraints imposed by technology, and the mobility of capital due to the emergence of globalization. According to Gwartney, the alternative explanation was not viable. Statistical analysis provided in his study indicated that increases in the size of government slow economic growth. The inverse relationship dictates that a more rapid rate of growth may be achieved by a reduction in the relative size of government. The regression results presented suggest that a 10 percent reduction in government expenditures as a share of GDP would result in an increase in the GDP growth rate of about 1 percent. The economic benefits of this increase are easily understated. An economy that increased its growth rate from 2 percent to 3 percent would increase its growth in production by 50 percent. The compounding nature of growth would have a massive impact on future output and prosperity. An economy growing at 2 percent would double its size in 35 years. An economy growing at 3 percent would achieve this in 23.3 years. The conclusion is that bigger governments extract a heavy toll on present growth and future prosperity. Gwartney amended the previous estimate of the optimal size of government, which was 15 percent, to the range of 20 to 25 percent. However, he insisted that the necessary functions of government could still be provided at 15 percent.

Scully (1994a) investigated the aggregate tax burden that maximizes the rate of economic growth in the United States. After analyzing data for the years 1949 to 1989, he concluded that the growth maximizing tax rate for the United
States is between 21.5 percent and 22.9 percent. Scully invoked Adam Smith and his 18th century observation that tariff rates beyond a certain level become self-defeating, because they reduce imports and tariff revenue. The modern application of this observation is the Laffer curve (McConnell and Brue 1990). High taxes give workers incentives to not report, or underreport income, or to change their behavior and simply earn less taxable income. This conduct is also referred to as "tax fatigue." Laffer noticed that beyond a certain point, government realizes less revenue when taxes are increased. This became the basis for supply-side economics (one might label this a re-statement of Say's law, which stipulates that supply creates its own demand) and the Reagan administration's reduction of marginal tax rates. The result was a large increase in tax revenue and tax compliance. According to Scully, a lower tax rate encourages people to realize more taxable income, base their investments on economic rather than tax considerations, and spend less on wasteful tax avoidance. Scully rejected the assumption that the actions of government are benign. He contended that public policy is often irrational and enigmatic, because the behavior of politicians often has more to do with re-election and rent-seeking than with economic efficiency. He concluded that the optimal size of government is the size that maximizes economic growth.

In a more recent work, the long run effect of higher taxes on the performance of the American economy between 1950 and 2004 is examined. During that period, real GDP increased at a compounded rate of 3.5 percent. Scully's econometric model indicated that a combined federal, state, and local
tax of about 23 percent would maximize economic growth (Scully 2006). Tax revenues as a share of GDP have not been at this level since 1950 and have risen to as high as 34 percent of GDP. Between 1950 and 2004, the United States has maintained a compounded growth rate of 3.5 percent in GDP. If tax rates had remained at the optimal level of 23 percent during that 54-year period, the growth would have been 5.8 percent per year. Scully’s model indicated that the higher rate of growth would have resulted in a GDP of $37 trillion in 2004, or about three times greater than the current output with the higher tax rate. Implicit in this finding is that an American family would have received a higher level of real income and standard of living. This increase in income would not have been at the expense of reduced government services and provision of public goods. A lower level of taxation and the resultant increased rate of economic growth would have produced an increase in government revenues. Scully’s model indicated that governments would have collected $61.9 trillion more in taxes in that 54-year period. This revenue enhancement is sufficient to fund all government spending programs enacted during that period without incidence of public debt.

Landau (2003) attempted to explain the non-linear nature of economic growth, while acknowledging the complication of the task. Growth is not solely an economic process, because political/institutional factors have a decisive influence over whether economies grow or not. In the opinion of the author, growth is economically natural but politically exceptional. Free markets seek profits that drive the engine of economic growth. It is easy to explain why political forces have often thwarted the natural tendency of markets to produce growth. It
can be extremely profitable for those in government to impose heavy taxes and
give themselves high salaries, to collect bribes for economically
counterproductive activity, or to have control over large sections of the economy.
The degree of avarice is mitigated by the security and tenure of the government.
A low security of government tenure produces a "roving bandit" mentality that
takes what it can while it can. The roving bandit ignores any effects of taking
wealth from a victim, because it probably will not have the opportunity to repeat
the activity in the future. High security tends to produce a "stationary bandit" in
government. This government is concerned about economic growth and
increased income, because it will be fleecing its citizens on a continual basis.
Increasing income would provide a broader base from which it could appropriate
taxes. The assertion has merit. Butler and Mitchell (2006) cited projections of the
Congressional Budget Office that the tax burden in the United States will
increase by almost 6 percent by 2050. Approximately one-third of the increase in
tax revenue will come from increased income generated by economic growth.
Almost one-half of the increase in tax revenue would come from an expanded
application of the Alternative Minimum Tax, and most of the rest would be
generated by tax increases that would occur with the expiration of temporary tax
cuts.

The question of which type of government gives its citizens the best
services, the best standard of living, and the most socially just outcomes is at the
core of the divergent paths pursued by the United States and Europe in the
provision of social models. Marsden (2006) examined the performance of ten
OECD countries over the last two decades in twenty different economic performance fields. Canada, Ireland, New Zealand, Spain, and the United States are classified as "leaner" governments. France, Germany, Italy, Portugal, and the United Kingdom are labeled "larger" governments. The distinction between "leaner" and "larger" is the relative percentage of government spending as a proportion of GDP.

Keynesian advocates of larger governments claim that the prosperity of a nation and the welfare of its people cannot be left to the mercy of unrestrained market forces. This mandate gives government a duty to implement plans and programs to achieve social justice and harmony, defined by interpretation of the duly elected. They declare an egalitarian social philosophy and claim the resources necessary to achieve this end. A common moniker for this mantra is "The European Social Model," which is generally synonymous with large and interventionist governments. The question of whether such governments deliver on this broad social promise is answered through a comparison of descriptive statistics. Marsden (2006) suggested that big governments lack business acumen. They demonstrate little familiarity or sympathy with consumer needs. In addition, they fail to allocate resources in the efficient manner of markets, and a lack of profit awareness and the discipline of competitive forces make them poor stewards of the taxpayer's money. Big governments discourage free enterprise and initiative by confiscating too much of the rewards accrued by such entrepreneurship and risk taking, and they promote indolence by providing social protection to the point of discouraging work.
It is concluded that tax cuts stimulate entrepreneurial activity, which results in higher levels of private investment. Job creation and productivity growth are enhanced. Additional resources are provided for government to apply to key public services. More income would be retained by households and businesses to dispose of in ways that they know best, which would generate more growth and a higher level of revenue for government. Smaller governments do not have to be "mean" in the sense that a smaller government would provide less services or poorer quality services. The result is compelling.

Exhibit 13: Growth of GDP, Household Consumption and Public Services

<table>
<thead>
<tr>
<th>LEANER GOVERNMENTS</th>
<th>GDP Average annual growth rate (%)</th>
<th>HOUSEHOLD CONSUMPTION Average annual growth rate (%)</th>
<th>PUBLIC SERVICES Average annual growth rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>2.2 3.5</td>
<td>3.1 2.8</td>
<td>2.4 3.3</td>
</tr>
<tr>
<td>Ireland</td>
<td>5.2 7.0</td>
<td>2.2 5.6</td>
<td>0.1 6.4</td>
</tr>
<tr>
<td>New Zealand</td>
<td>2.8 3.0</td>
<td>2.1 3.2</td>
<td>1.7 3.4</td>
</tr>
<tr>
<td>Spain</td>
<td>2.9 3.7</td>
<td>2.6 2.6</td>
<td>5.0 6.0</td>
</tr>
<tr>
<td>US</td>
<td>2.9 3.3</td>
<td>3.9 3.7</td>
<td>2.8 2.5</td>
</tr>
<tr>
<td>Average</td>
<td>3.2 4.1</td>
<td>2.8 3.6</td>
<td>2.4 4.3</td>
</tr>
<tr>
<td>LARGER GOVERNMENTS</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>1.9 2.2</td>
<td>2.2 1.6</td>
<td>2.7 2.8</td>
</tr>
<tr>
<td>Germany</td>
<td>2.6 1.3</td>
<td>2.3 1.5</td>
<td>1.4 0.7</td>
</tr>
<tr>
<td>Italy</td>
<td>1.9 1.4</td>
<td>2.9 1.6</td>
<td>2.9 1.8</td>
</tr>
<tr>
<td>Portugal</td>
<td>4.0 1.9</td>
<td>2.5 2.8</td>
<td>5.0 2.4</td>
</tr>
<tr>
<td>UK</td>
<td>2.4 2.8</td>
<td>4.0 3.1</td>
<td>0.9 3.2</td>
</tr>
<tr>
<td>Average</td>
<td>2.6 1.9</td>
<td>2.8 2.1</td>
<td>2.6 2.2</td>
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Exhibit 13 is from Marsden's analysis. The leaner governments reduced their taxes by 6.5 percent of their GDP between 1985 and 2005. The larger governments increased their taxes by 4.8 percent over the same period. Spending for leaner governments averaged 37 percent of GDP, while larger governments averaged 49 percent. Per capita income was 12 percent higher in the countries with leaner governments. Some of the contrast in income can be explained by the relative rates of growth. Between 1997 and 2003, the leaner government economies averaged 4.1 percent growth, while the larger government countries managed only 1.9 percent. Leaner governments expanded their spending on public services at a faster rate than larger governments, and in terms of the United Nations Human Development Index (which is an indication of relative life expectancy, availability and quality of education, and the standard of living), lean governments performed better than larger governments.

Between 1964 and 1994, government spending among industrialized European countries rose from 33.4 percent to 51 percent of GDP. Government spending in the United States increased from 28.4 percent to 33.5 percent. This increase manifested in a European growth rate that was only half of the United States, and European industrial production declined by one-half of one percent, while America's grew by 11.4 percent. The cause of this disparity is the welfare state (Bartlett 1997). It required a much larger level of taxation to provide more social protection, but the generous benefits reduced the penalty for not working. The European Nations, on average, provided benefits that replaced more than 40
percent of the salary of a worker who became unemployed. In the United States, the replacement ratio was 14.3 percent. In 1996, European Union unemployment reached 10.3 percent, while in France it reached 12.7 percent. In the United States, unemployment was 5.3 percent during the same time.

Mitchell (2005) reached the conclusion that large and growing governments are not conducive to better economic performance. Reducing the size of government would lead to higher income and improved competitiveness. According to Mitchell, advocates of larger governments, in adherence to Keynesian theory, insist that government programs provide essential public goods such as education and infrastructure. It is claimed that increases in government spending bolster economic growth by providing multipliers of economic activity based on increased larger government.

Mitchell refuted this as spurious and based on less than sound assumptions. He contended that a government which is too large and increases taxes will undermine economic growth by transferring resources, both physical and financial, from the more productive private sector to an inefficient public sector. Private businesses seek profit, which mandates a minimal cost approach to production. Government has no directive toward efficiency, because it is not profit driven.

The progression is logical. With no enforcement authority for contracts, protection of property, and provision of infrastructure, there would be little or no economic growth. Anarchy is not conducive to market economies. Economic activity increases rapidly as government begins to provide the essentials of a
market economy. As government activity and spending increase beyond core competencies, economic growth and government efficiency decline. Exhibit 14 on the next page illustrates the necessity of government and the consequences of unrestrained public sector enlargement.

Exhibit 14: The Rahn Curve

The Rahn Curve: Economy Shrinks When Government Grows Too Large

Source: Peter Brinckerhoff, "Why the Deficit is the Wrong Number," Fortune, March 15, 1993.

Critique

While there is no absolute consensus, the literature on the relationship between government and economic growth indicates that many economists are concerned with the size of governments. Empirical evidence supports the claim of the above mentioned economists. The literature exploring an optimal size of government and the literature illustrating the contrast between the American
Social Model and the European Social Model will be linked through the examination of growth of government spending. The literature that analyzes the varieties within the European model does not integrate the effects of government on economic performance with its findings. They mostly conclude that variances in social models are based on culture and different perceptions relative to the priorities of work and leisure. The research of this dissertation will establish that government growth inversely impacts economic growth and that the sustainability of social models is ultimately determined by economic growth. The existing literature is extended, and the potential for sustainability among social models is determined.

This literature review is a vast body of inferential and empirical evidence indicating that almost all modern governments have grown in size, as measured by their spending as a percentage of Gross Domestic Product. The methodology will investigate the size of government and its potential effect on economic growth. Sustainability of social models is determined by many factors, but the foundation of sustainability is the capacity of an economy to maintain sufficient economic growth to perpetuate that system. It is the intent of this author to provide analyses and conclusions that are free of bias to whatever extent can be provided by the imperfections inherent in the human condition. It is acknowledged that rationality and contemplation are not, of necessity, mutually exclusive. However, they may be difficult to homogenize, as in the manner of oil and water. The effect may be achieved, but will require diligence in pursuit of objectivity and unbiased methodology.
CHAPTER III

METHODOLOGY and ANALYSIS

The methodology for analysis of the relationship of the size of government and economic growth is divided into three stages. Stage 1 will display successive exhibits that graphically illustrate the relationship between the growth of government and economic growth. Each exhibit will be discussed at length. Stage 2 is composed of three models and regression analyses to test their hypotheses. Stage 3 is contingent upon the rejection of the null hypotheses in Stage 2. If rejected, there will be an evaluation of the sustainability of the varying social models of Organization for Economic and Cooperative Development (OECD) countries.

The economy of the United States has demonstrated consistent economic growth in recent decades and has been one of the more stable economies of the OECD countries (Kane 2004). However, the empirical data on economic growth shows a steady decline in the rate of growth as a percentage of GDP. Growth rates for the United States economy during the first decade of the twenty-first century are less than one-half of those experiences during the 1960s (see Exhibit 15). Many other OECD countries have experienced the same trend. They are growing, but at a slower rate than in previous decades (Gwartney, Holcombe, and Lawson 1998). According to Gwartney, this defies economic convention because economic growth compounds and increases at an increasing rate. The economic "rule of 70" is a quantitative illustration of the compounding nature of growth. This rule, which is a staple of growth economics, dictates that small
variations in current growth produce large changes in future economic performance and the quality of life.

The demise of socialism and central planning opened the door for worldwide expansion of international trade and market liberalization. Tariff rates were reduced and homogenized. Financial institutions adapted to globalization. Capital, both financial and physical, moved more freely in international markets. Gwartney observes that growth should have accelerated, while in fact, it decelerated.

Socialism is characterized by large governments, which promise security “from cradle to grave” and a homogenous society with no poor and no wealthy. These governments were inefficient, and the economies which they controlled produced low rates of economic growth and a poor quality of life for their citizens. They failed because central authority cannot accrue the information necessary to control an entire economy (Muravchik 2002). There is also the contention that the monopoly control by government of the means of production destroyed the incentive of individuals because they could not own the fruits of their labor and profit from them (Hayek 1988) (Friedman 1962).

In recent decades there has been a consistent tendency for governments in OECD countries to grow faster than the growth rates of their domestic economies. In a New York Times opposition-editorial piece, Milton Friedman alludes to this phenomenon when he says, “Everybody agrees that socialism has been a failure. Everybody agrees that capitalism has been a success... yet everybody is extending socialism.” This dissertation will examine the relationship
between the growth in the size of government and economic growth. The anticipated result is an indication of an inverse relationship. Governments that continue to grow beyond an optimal size will impede economic growth, while governments that return to a focus of core competencies will enhance growth. Implicit in this anticipated outcome is exposure of a process that might be characterized as “socialism by stealth” (Bryant 2005).

Stage 1

Exhibit 15 illustrates the growth of government in twenty-three nations that are members of the OECD. Data from the years 1960 to 2002 are used. These statistics indicate that government activity, as a percentage of Gross Domestic Product (GDP), has increased considerably in all OECD countries. In 1960 government expenditures for the twenty-three OECD countries averaged 27 percent of GDP. By 2002, governments had grown to more than 44 percent of GDP. In absolute terms, this is an increase of 17 percent. However, the increase from 27 percent to 44 percent is a 63 percent increase in the relative size of government.

According to Gwartney (1998), these figures are conservative in their indication of the growth of government because they are not measured in constant purchasing power units or on a per capita basis. If they had been measured in constant purchasing power units, the increases in the size of government would have been substantially higher. Governments have an inherent tendency to grow because at some point they loose the direction of market forces and transition to the expediency of political forces. Higher taxes or
increased borrowing exert a negative effect on the economy. As larger
governments require more of the earnings of workers to fund increasing
government activity, the incentives to finance their activity, to work, invest, and
take risks inherent in the promise of high return, are diminished (Gwartney,

Because the public sector has no real mandate for efficiency, other than
the threat of reprisal by voters, these increased financial resources are often
expended in a fashion that compares poorly with the mandated efficiency of the
private sector. Private endeavors are punished for waste or poor decision making
by reduced profits and value or extinction if efficiency is not found through
adaptation or correction. With no mandate for efficiency or measure of
performance, such as profits, governments react to changing market forces and
conditions more slowly than the private sector. The consequence is that
governments often become an impediment to the dynamics of economic growth
rather than a contributor to the process.

An examination of Exhibit 15 indicates that all governments in the sample
population grew substantially in the period from 1960 to 1990. Between 1990 and
2002, that consistency is replaced by a pattern of continued growth in some
governments, while others began to reduce their expenditures as a percentage of
GDP. The largest percentages of increase were shown by Japan (6.7%), Iceland
(4.9%), France (4.7%), Portugal (4.2%), and Germany (2.9%). In contrast, New
Zealand (13.5%), Netherlands (10.2%), Canada (7.2%), Italy (6.7%), and Ireland
(6.3%) decreased government activity as indicated.
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<td>36.0</td>
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<td>30.9</td>
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<td>42.3</td>
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<td><strong>Average</strong></td>
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<td>42.8</td>
<td>46.3</td>
<td>44.7</td>
<td>17.7</td>
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</table>

Source: OECD Economic Outlook Volume 2003/1 No.73, June
OECD Historical Statistics from various issues

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Exhibit 16 on the following page illustrates the theory that government growth, past a point of optimal economic contribution, will result in reduced economic growth. The historic perspective on government is revealing. At the beginning of the twentieth century, the governments of Europe and the United States spent approximately 10 percent of national income. This was also a time of limited government intrusion in markets and the workplace. Public services were limited, and there was no equivalent of modern social services and safety net. The five decades after World War II became the era of big governments.

There will be no attempt to quantify the optimal size of government. An extensive body of literature on this subject has been produced and will be displayed as Exhibit 16 (Conte and Darrat 1988; Balcerowicz 2004; Barro 1990; Gwartney, Holcombe, and Lawson 1998; Quah 1988). There is no exact consensus of a single value in the findings among the various scholars. Scully (1994a,) believes that government spending, accounting for 20 percent of GDP, is most conducive to economic growth and makes the following comment:

As the size of government has expanded in the United States, growth of real gross domestic product has steadily fallen. Even though the United States economy is now moving into the eighth year of an expansion, the growth of real GDP during the 1990s is only about half what it was during the 1960s and well below even that of the turbulent 1970s. Likewise, as the size of government in other nations has increased, economic growth has declined. On average, government expenditures in the Organisation of Economic Cooperation and Development's 23 long-standing members rose to 48 percent of GDP in 1996 from 27 percent in 1960. The average economic growth rate fell from 5.5 percent in the 1960s to 1.9 percent in the 1990s. (p-17)
The data from Exhibit 16 indicates that all OECD governments exceed the highest postulated percentage of government expenditures necessary for optimal economic growth.

Exhibit 16: Size of Government Growth Curve

Exhibit 17 graphically displays the growth in government expenditures in the United States. It divides those expenditures into four categories: 1) Transfers and subsidies, 2) Net interest on national debt, 3) Nondefense spending, and 4) Defense spending.
Exhibit 17: Increase in Transfer Payments and Net Interest Payments as a Percentage of GDP in the U.S.

This exhibit indicates that the long-run increase in government expenditures is primarily in the category of transfer payments and subsidies, which has increased by 127 percent in forty-two years. Interest payment on the national debt has increased by 117 percent, and in 2002, accounted for 14 percent of government expenditures. This interest payment is also a transfer payment.

The expansion of transfer payments and subsidies will have an undesirable consequence in reduced economic performance. The expansion of government is facilitated by increased taxes, which have a negative impact on entrepreneurial incentives. When government expands beyond its core...
competencies, it contributes little in terms of economic performance and stimulation of growth.

Implicit in an increase in government transfers of income is the potential for special-interest groups to seek benefit by directing government payments to their own benefit and interest. This process of enhancing wealth by redirecting government transfers, rather than engaging in productive economic activity, has become known as rent-seeking (Gwartney, Holcombe, and Lawson 1998). The recipient benefits, but the economy is damaged by the nonproductive nature of the transaction. Gwartney feels that the term "rent-seeking" is inappropriate because it does not refer to the payment made to the owner of property, which is the customary meaning.

Exhibit 18 indicates the absolute increase in the size of government in the United States between 1960 and 2002. In the 1960s, government expenditures averaged 29.9 percent of GDP. The level of government spending increased to 32.8 percent in the 1970s, 35 percent in the 1980s, and 36.7 percent for the period 1990 to 2002. Subtracting the first period average of 29.9 from the last period average of 36.7 percent indicates an increase of 6.8 percent in government’s portion of GDP expenditures. Dividing that 6.8 percent by the base year of 29.9 percent, reveals that total government spending increased by 23.1 percent. Exhibit 17 shows that most of this increase in government spending is in transfer payment and subsidies and interest payment on accrued government debt.
Exhibit 18: Increasing Government Expenditures in the US

Exhibits 17 and 18 indicated that government in the United States has grown in scale and potential impact on economic growth. Exhibit 19 is a comparison of the growth of government in the United States and the growth of government in the European Union 15. The European Union 15 is identified as member countries in the European Union prior to the accession of ten candidate countries on 1 May 2004. Those member countries are as follows: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom. This exhibit shows that government spending is 33 percent higher in the European Union 15 than in the United States. Tax revenues are 41.9 percent higher, and government debt as a percentage of GDP is 69.3 percent higher than...
in the United States. This contrast and its implications will be examined extensively in Stage three of the methodology.


Exhibit 20 indicates gross investment as a share of GDP from 1960 to 2002. This data reveals the possibility that increases in government expenditures that are financed by deficit spending, or borrowing, might result in a "crowding-out effect." Crowding-out occurs when government either expands its borrowing to finance increased expenditure or cuts taxes, thus crowding out private sector investment by way of higher interest rates. Increased borrowing leads to higher interest rates by creating a greater demand for money and loanable funds.
resulting in a higher price for investment funds. The private sector, which is sensitive to interest rates, will likely reduce investment due to a lower rate of return. The weakening of fixed investment and other interest-sensitive expenditure counteracts to varying extents the expansionary effect of government deficits. More importantly, a fall in fixed investment by business potentially reduces long-term economic growth (Spencer and Yohe 1970).

Exhibit 20: Increasing Government Expenditures and Borrowing "Crowd Out" Investment

The following quote is from Thomas Hoenig, President of the Federal Reserve Bank of Kansas City (1996).
A major reason our economy has slipped in terms of generating savings and investment is the large federal government budget deficits of recent years. These deficits have absorbed financial resources from the private sector, increased the cost of capital, and thereby inhibited productive investment and enhancements to the country's growth potential. It is vitally important, therefore, that we continue to reduce and ultimately eliminate these deficits. (P-5)

Gwartney explains the occurrence of crowding-out through a reasoning process, which focuses on the increase in government transfer payments. The increase in availability of transfers and subsidies will increase the incentive for individuals and businesses to seek financial gains through this process rather than through investment and increased productivity. Government transfers are generally from higher income brackets to lower income brackets, and consequently, are from those who tend to save more to those who tend to save less. This process results in a reduction of savings, a higher real rate of interest, and a decline in private sector investment.

Because a key determinant of labor productivity is the amount of capital available per worker, a decline in investment as a percentage of GDP will impact the productivity of the individual laborer and the workforce in total. Since capital formation and technological advance are closely related, the rate of adaptation for new technology and improved production processes will decline and contribute to the decline in labor productivity growth.

An increase in the quantity of labor has accounted for 33 percent of the growth of GDP in the United States since 1929. The other 67 percent is attributed to increases in labor productivity during that period. Technological advance and investment in new capital were the driving force in increased labor productivity
(Dennison 1985). This directly implies that improvement in labor productivity has been the most important source of economic growth. Exhibit 21 shows the decline of labor productivity growth in the United States from the period 1960-2002.

Exhibit 21: Change in Real GDP per Capita Growth 1960-2002

The identity of causal reasons for changes in labor productivity is difficult to isolate due to the complexity of the process and the number of contributing variables. This analysis suggests that increases in the public sector and
government deficits have contributed to a decline in labor productivity in the United States.

Exhibit 22 shows the long-run economic growth trend of the United States for the period 1960 to 2002.

Exhibit 22: Growth of Real GDP

Growth of Real GDP

\[ y = -0.005x + 0.046 \]
\[ R^2 = 0.786 \]

Source: OECD Economic Outlook No.78; Gwartney

Growth lessens the burden of scarcity. It provides the path to greater material abundance and a higher standard of living. Increasing output is
analogous to increased income, which allows increased acquisition of goods and services and a better quality of life. Economic growth may be the only realistic mechanism to reduce poverty since redistribution of income reduces incentives and is often perceived as unjust and counterproductive by a major portion of the voting population. This conviction reduces political support for increases in such activity by the public sector. In 1994 the number of Americans receiving welfare payments reached a maximum of 5.5 percent of the population. By 1999 this percentage had dropped to 2.4 percent due to the passage of the Welfare Reform Act of 1996, which set time limits for welfare and established work requirements (Saving and Cox 2000). Altruism and political expediency are seldom homogenous. This divergence emphasizes the primacy of economic growth in human development and the pursuit of happiness. The pursuit of happiness requires opportunity. A growing economy is synonymous with increasing opportunity for all participants. Any reduction in the rate of growth, whether the result of government error or outright misfortune, will reduce the potential for prosperity and a better life for future generations.

Exhibit 23 displays the long-run data and trends in the size of government and economic growth in a stacked comparison. This divergence will provide the basis for later statistical analysis that will attempt to show a causal relationship beyond what is inferred by the descriptive statistics in Stage 1. Is there an inverse relation between the growth of government and the rate of economic growth in a country, or is the relationship merely an economic coincidence?
Exhibit 23: Size of Government and Economic Growth

Increasing Government Expenditures in the United States

\[ y = 0.022x + 0.279 \]
\[ R^2 = 0.986 \]

Source: OECD Economic Outlook No.78; Gwartney

Decreasing Growth of Real GDP in the United States

\[ y = -0.005x + 0.046 \]
\[ R^2 = 0.786 \]

Source: OECD Economic Outlook No.78; Gwartney
Exhibit 24 illustrates the rates of growth for twenty-three OECD countries from 1960 to 2002. Exhibit 24 indicates that all twenty-three countries in the sample experienced increasing government size as a percentage of GDP.

Exhibit 24: The Change in the Size of OECD Governments 1960-2002

These twenty-three OECD countries share a number of positive characteristics. They are all democracies and politically stable, at least in comparison with other regions of the world. Per capita income and production are among the highest in the world. Property protection, enforcement of contracts, and the rule of law are all priorities of their legal systems. Their monetary systems are generally stable and guard against the destructive effects of extreme
inflation. They have embraced globalization to varying degrees and have fostered more liberal trade policies through expanded trade alliances and mutually beneficial trade agreements. According to Scully (1989), this set of consistent characteristics adds significance to analysis of the size of governments among OECD countries because they vary substantially across time and individual countries in regard to government spending as a percentage of GDP.

Exhibit 24 is revealing. In the 1960s, there were seven of the twenty-three sample countries that accounted for less than 25 percent of economic activity. Another seven were between 25 and 29 percent, and nine were between 30 and 39.9 percent. None equaled or exceeded 40 percent.

During the 1970s, the less-than-25-percent bracket had shrunk to five countries and the distribution between 25 percent and 40 percent had grown to fourteen countries. The bracket of larger than 40 percent, which previously had none, was occupied by four countries.

By the 1980s, there were no OECD governments smaller than 25 percent and only two were smaller than 30 percent. The bracket between 30 and 50 percent contained 15 countries. Five governments exceeded 50 percent of GDP and one exceeded 60 percent. In the 1990s, no governments were smaller than 30 percent, and only five were smaller than 40 percent. Eleven were between 40 percent and 49 percent and the larger-than-50-percent category had grown to six countries. There was still one government larger than 60 percent.
The change in distribution from 1990 to 2002 is perhaps an indication that there was a growing concern about the possible relationship between the size of government and economic performance. None were larger than 60 percent, and the 50 percent category was reduced from six to five countries. The 40 percent category remained at eleven countries. However, the 30 percent category expanded from five to seven countries. There is still no government in the smaller-than-30-percent category in 2002.

Exhibit 25 displays a comparison of the size of government and economic performance defined as the rate of economic growth.

Exhibit 25: Growth Rate of OECD Countries 1960-2002
This exhibit gives a strong suggestion of an inverse relationship between the growth of government and slower economic growth.

Exhibit 26 is a scatter-plot that displays the size of government for a four decade period on the x-axis. The rate of economic growth is displayed for a four year period on the y-axis. There are four plots representing four decades for each of the twenty-three OECD countries. This procedure produces a total of ninety-two plots. This plot illustrates that there is an inverse relationship between the growth of government and long-run economic performance. The trendline is a logarithmic regression line with an R-squared of 0.32, indicating that government spending as a percentage of GDP, accounts for 32 percent of the variance in economic growth among the twenty-three countries. The trendline illustrates that the relationship of government to economic growth is not linear in nature. Moving left on the trendline, toward the range of smaller governments, the rate of economic growth indicated on the vertical axis increases at an increasing rate. Below 20 percent there are four countries that equal or exceed an economic growth rate of 7 percent. Those plots are from the data indicated by the 1960's data. Moving toward the right on the trendline indicates that government expenditure of 20 percent would produce a growth rate of near 5 percent, while government expenditures of 45 percent would reduce that rate of growth by one-half. The data from 2002 indicates that the smallest government as a percentage of GDP was Switzerland at 33 percent. This evidence is in agreement with the findings of Gwartney and indicates that big governments impose a heavy penalty in the form of reduced rates of economic growth.
Exhibit 26: Relationship of Government to Economic Growth During a Four-Decade Period

Scatter Plot Showing the Relationship of Government to Economic Growth During a Four-Decade Period

\[ y = -0.02\ln(x) + 0.137 \]

\[ R^2 = 0.328 \]

Total Government Spending as a Percentage of GDP: 4 Plots for each Country -1 per Decade

2003 No.73

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Stage 2

There are three regression models in Stage 2. A summary exhibit of the regression results and discussion of findings will conclude each model.

Model 1

In the first regression model, the dependent variable is the growth of GDP in a nation during a decade. The independent variables are government expenditures as a percentage of GDP at the beginning of a decade and the change in government spending during that decade.

Statement of Model 1 Null and Alternative Hypotheses:

$H_0$: There is no relationship between government size and economic growth.

$H_1$: There is an inverse relationship between government size and economic growth.

Hierarchical multiple regression analyses is conducted to evaluate the impact of the size of government on the rate of economic growth. Evaluations of linearity, normality, homoscedasticity, and multicollinearity justify the rejection of the null hypothesis, which states that there would be no relationship between the size of government and the rate of economic growth. The alternative hypothesis, which states that the size of government and economic growth are inversely related, is accepted.

In the first regression, the size of government as a percentage of GDP is the first independent variable. The change in government as a percentage of GDP, is the second independent variable, and the average percentage change in
gross investment is the third independent variable. The rate of growth increase in real GDP is the dependent variable. The sample population is twenty-three OECD countries. Data is entered for the four decades from 1960 to 2002, generating an N of ninety-two for the variables. Exhibit 27 indicates the Beta results of the first regression.

Exhibit 27: Regression 1

<table>
<thead>
<tr>
<th></th>
<th>B</th>
<th>SE B</th>
<th>( \beta )</th>
<th>t</th>
<th>Sig.</th>
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<td>.047</td>
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<td>10.406</td>
<td>.000</td>
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<td>Govt. as a Percent of GDP</td>
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<td>.000</td>
<td>-.385</td>
<td>-6.025</td>
<td>.000</td>
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<td>Change in Govt. as a Percent GDP</td>
<td>.000</td>
<td>.000</td>
<td>-.136</td>
<td>-2.215</td>
<td>.029</td>
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<tr>
<td>Average Percent Change in Gross Investment</td>
<td>.003</td>
<td>.000</td>
<td>.644</td>
<td>10.547</td>
<td>.000</td>
</tr>
</tbody>
</table>

The results of the regressions, \( R^2 = .723; R^2_{adj} = .713; F (1, 88) = 76.518; p = < .05 \) indicate that independent variables are accounting for 72.3 percent of the variation in economic growth. The unstandardized regression coefficients are -.00 for Government as a Percentage of GDP, .000 for the Change in the Size of Government as a percentage of GDP, and .003 for Average Percentage Change in Gross Investment. The standardized coefficients are -.539, \( t (90) = -6.067, \) and \( p = .032 \). The bivariate and partial correlations are -.385, -.136, and .644 respectively. The Durbin-Watson coefficient is 2.191, which indicates a low probability of autocorrelation between the residual terms.
These results indicate that the size of government as a percentage of GDP, the rate of change in the size of government, and the rate of gross investment in capital goods have a significant influence on the rate of economic growth. The results of these two tests suggest that government can grow beyond a point of optimal contribution and reduce the potential for economic performance.

Model 2

Further insight may be gained by examining the internal composite factors of economic growth. They are indicated by the following equation:

\[ \Delta \text{Real Gross Domestic Product} = \Delta \text{Labor inputs} \times \Delta \text{Labor productivity} \]

Source: (McConnell and Brue 1990)

Labor input is determined by the size of the labor force and total number of hours that each laborer works. Though important in consideration, and certainly influenced by government action (as in legislation mandating hours worked), this factor is considered exogenous to the research question. Labor productivity is determined by the available technology, the quantity of capital goods available to workers, the quality of the labor itself (human capital), and the efficiency with which the labor is combined and managed. Technological advance and investment in capital are largely two sides of the same coin.

The second regression model will include investment as a percentage of GDP as an independent variable, while retaining economic growth as the dependent variable.

Statement of Model 2 Null and Alternative Hypotheses:

\( H_0: \) There is no relationship between investment and economic growth.
H₁: Nations with higher growth rates have higher investment as a percentage of GDP.

A hierarchical multiple regression analysis is conducted to evaluate the impact of the size of government on the level of gross private investment. Evaluations of linearity, normality, homoscedasticity, and multicollinearity, justify the rejection of the null hypothesis, which states that there would be no relationship between investment and the rate of economic growth. The alternative hypothesis, which states that nations with higher growth rates have higher investment as a percentage of GDP, is accepted.

Exhibit-7 indicates the Beta results of the second regression.

Exhibit 28: Regression 2

<table>
<thead>
<tr>
<th>B</th>
<th>SE B</th>
<th>β</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant: Economic Growth</td>
<td>.022</td>
<td>.001</td>
<td>15.208</td>
<td>.000</td>
</tr>
<tr>
<td>Average Change in Gross Investment</td>
<td>.004</td>
<td>.000</td>
<td>.780</td>
<td>11.828</td>
</tr>
</tbody>
</table>

The generated results indicate that investment and economic growth are closely related, with $R^2 = .609$; $R^2_{adj} = .604$; $F(1, 90) = 139.905$; $p < .05$, showing that increasing gross investment explains 60.4 percent of the rate of economic growth. The unstandardized regression coefficient is .004, the standardized coefficient is .780, $t(90) = 11.828$, and $p < .05$. The bivariate and partial correlation is .780. The Durbin-Watson coefficient is 1.734, which indicates a low probability of autocorrelation between the residual terms. The results suggest
that gross investment is an essential contributing factor to the dynamics of economic growth, because labor productivity and production are enhanced.

Model 3

The third regression model will evaluate the possibility that the growth of government might crowd-out private investment. Increased public sector expenditures must be financed by increased taxes or increased borrowing. Financial crowding-out is the loss of private capital formation due to an increase in the interest rates. The interest rate rises because government absorbs financial resources through bond financing or fiscal deficits, and consequently reduces the supply of financial resources (Charkraborty 2002).

The percentage change in investment as a share of GDP will be the dependent variable. The size of government as a percentage of GDP and the change in the size of government as a percentage during a decade will be the independent variables.

Statement of Model 3 Null and Alternative Hypotheses:

H₀: There is no relationship between government size and investment.

H₁: Nations with higher investment have smaller governments.

The sample population is twenty-three OECD countries. Data is entered for the four decades from 1960 to 2002, generating an N of ninety-two for the two variables. Exhibit 29 indicates the Beta results of the first regression.
Exhibit 29: Regression 3

<table>
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<th></th>
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<th>SE B</th>
<th>β</th>
<th>t</th>
<th>Sig.</th>
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<td>Constant: Percentage Change in Gross Investment</td>
<td>97.426</td>
<td>28.834</td>
<td>3.379</td>
<td>.000</td>
<td></td>
</tr>
<tr>
<td>Govt. As a percentage GDP</td>
<td>-1.688</td>
<td>.559</td>
<td>-.381</td>
<td>-3.019</td>
<td>.003</td>
</tr>
<tr>
<td>Change in Government as a percentage GDP</td>
<td>-.260</td>
<td>.227</td>
<td>.145</td>
<td>1.146</td>
<td>.255</td>
</tr>
</tbody>
</table>

The results of the regression, $R^2 = .239$; $R^2_{adj} = .221$; $F(2, 87) = 36.545$; $p = .05$ indicate that government is accounting for 22.1 percent of the variation in gross investment. The unstandardized regression coefficients are -1.688, and .260. The standardized coefficients are -.381, $t(85) = -3.019$, $p = .05$ and .145, $t(85) = 1.146$ and $p = .255$. The bivariate and partial correlations are -.311 and .123. The Durbin-Watson coefficient is 1.995, which indicates a low probability of autocorrelation between the residual terms. These results indicate that the size of government as a percentage of GDP has a significant influence on the rate of economic growth. The findings indicate that there is reason to reject the null hypothesis, which states that there is no relationship between government size and investment, and accept the alternative hypothesis which affirms that nations with higher investment have smaller governments. The $R^2$ factor indicates that investment is complex and an amalgam of many varied factors. There is an inverse relationship between the size of government and
gross investment, but the effect of government is one of many in a host of causal agents.

Discussion:

The results generated by section two of the methodology suggest that the presence of government is not exogenous to the dynamics of economic growth. Indeed, the rejection of the null hypotheses indicates that a growing public sector will take a toll on economic growth. Investment is central to the dynamics of growth, and larger governments tend to have reduced rates of capital accumulation. Excessive government deficits tend to crowd-out private investment. The correlation between the variables might be explained by the complexity of investment theory and the evolution of global economics. Foreign Direct Invest would inject investment decisions from sources external to, and insulated from, the effect of the indigenous government. Dreher (2003) concludes that globalization promotes growth, in part, because it restricts government intrusion in the marketplace and enhances the accumulation of capital. Countries that are more globalized experience higher rates of economic growth.

Stage 3

The findings and conclusions in Stage 1 and Stage 2 of the methodology will provide the platform for Stage 3. The weight of the evidence agrees with the conclusions of the scholarly findings in the literature review and demonstrates an inverse relationship between government size and economic growth. The null hypotheses from stage 1 and stage 2 are rejected, which will allow an evaluation
of the various social models for their potential sustainability. Those models, including relevant countries, will be defined and characterized as follows:

1) The Anglo/American Model—This model is characteristic of the United Kingdom, Ireland, and the United States. It has a low degree of job protection, which allows for easy hiring and firing. The result is a dynamic economy that is good at creating jobs. Unemployment is consistently lower than the European Union average. There is a smaller social safety net than other European Union members and these economies are not as successful in reducing poverty and enhancing income equity.

2) The Nordic Model—This model is used in Norway, Sweden, Denmark, Iceland, and Finland. The Nordic model has a highly developed and government-funded welfare state that provides generous unemployment benefits. Workplace regulation is extensive, which makes it difficult for firms to fire workers. The tax structure is highly progressive. This egalitarian approach produces the least income disparity among workers of the different models. Extreme wealth is socially disapproved, and high taxation is publicly accepted. "Flexicurity," which features more liberal labor markets, is a recent innovation. This policy allows discretionary hiring and firing by employers with government provision of generous benefits to protect the unemployed.

3) The Mediterranean Model—This system is similar to the Continental model but focuses welfare in generous state pensions for retirement. Labor markets are inflexible, but are less successful at reducing poverty in lower income brackets. This model is used by Italy, Greece, and Spain. The essential
distinction between the Nordic model and the Mediterranean model is that the former focuses on unemployment benefits while the latter focuses on retirement benefits.

4) The Continental Model—This model is used by France, Germany, Belgium, and Luxembourg. Their governments are active in job protection and regulation of industry. Their labor markets are inflexible and threatened by globalization. Generous unemployment benefits, health care, and state provided pensions result in a low poverty rate. This also produces high unemployment and low motivation to seek employment.

The size of government as a portion of GDP, increased in all OECD countries between 1960 and 2002. However, there is wide variation in the percentage of increase and comparative economic growth among those countries. Insight concerning the relationship between an expanding public sector and economic growth may be gained from an assessment of OECD members with contrasting rates of government growth and their relative rates of economic performance.

Exhibit 30 displays a comparison of five countries with the smallest increase in the size of government as a percentage of GDP for the time period 1960 to 2002, with the five countries experiencing the largest increase in the size of government during the same time period. If the expansion of government negatively impacts economic growth, the performance of the group of countries with the largest increase in size should be poor in comparison.
A Comparison of the Growth of Real GDP and the Growth in the Size of Government from 1960 to 2002

<table>
<thead>
<tr>
<th>Countries with the Smallest Increase in the Size of Government</th>
<th>Government as a Percent of GDP</th>
<th>Growth of Real GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1960</td>
<td>2002</td>
</tr>
<tr>
<td>Canada</td>
<td>28.6</td>
<td>40.6</td>
</tr>
<tr>
<td>New Zealand</td>
<td>27.4</td>
<td>36.5</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>32.2</td>
<td>40.9</td>
</tr>
<tr>
<td>United States</td>
<td>28.4</td>
<td>35.6</td>
</tr>
<tr>
<td>Ireland</td>
<td>28</td>
<td>34.6</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>28.92</strong></td>
<td><strong>37.64</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Countries with the Largest Increase in the Size of Government</th>
<th>Government as a Percent of GDP</th>
<th>Growth of Real GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1960</td>
<td>2002</td>
</tr>
<tr>
<td>Spain</td>
<td>13.7</td>
<td>39.8</td>
</tr>
<tr>
<td>Sweden</td>
<td>31</td>
<td>58.3</td>
</tr>
<tr>
<td>Greece</td>
<td>17.4</td>
<td>46.3</td>
</tr>
<tr>
<td>Portugal</td>
<td>17</td>
<td>46.1</td>
</tr>
<tr>
<td>Denmark</td>
<td>24.8</td>
<td>55.3</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>20.78</strong></td>
<td><strong>49.16</strong></td>
</tr>
</tbody>
</table>

Source: OECD Historic Statistics, OECD Economic Outlook

Canada, New Zealand, United Kingdom, United States, and Ireland experienced an average growth in the size of government of 8.72 percent from
1960 to 2002. Their average rates of growth declined by .7 percent. The governments of Spain, Sweden, Greece, Portugal, and Denmark, grew by an average of 28.38 percent for the same time period, and their average rates of growth declined by 3.68 percent. The contrast in the relative rates of change between the two groups is revealing. The countries with the largest increases saw a 325.4 percent higher expansion in the size of their governments when compared to the countries with the smaller increases in the size of their governments. The decline in economic growth for the countries with the largest increases in government was over five times greater than the countries with smallest increases in government. This contrast suggests that expanding governments are not economically neutral or benign. Big government imposes a heavy economic burden in the form of lower rates of economic growth.

Other relevant contrasts are revealed in the data. The size of governments and the rate of economic performance is reversed in the 1960 data. The five countries with the smallest increases in the period 1960 to 2002 had larger governments and lower rates of growth in 1960, when compared to the governments with larger increases in government size. Ireland, which experienced the smallest increase in the size of government (6.6 percent) from 1960 to 2002, is the only country with an increase in its rate of economic growth. The other twenty two countries experienced a decline in economic growth. The United States, which saw the smallest increase in the size of government after Ireland saw a decline in economic growth of 30 percent. The government of the United States had grown by 10 percent more than the government of Ireland.
Exhibit 31 is a comparison of the four market models for the size of government and the rate of economic growth. In each of the four models, the country with the smallest government as a share of GDP is experiencing the highest rate of growth or is sharing that distinction with another country. The country with the largest government as a share of GDP is experiencing the slowest rate of economic growth or sharing that characteristic with another country. The Anglo / American model has the smallest average size of government by far (37.4 percent) and highest average rate of growth (4.0 percent). However, without the presence of Ireland's 7.2 percent rate of growth, the performance of that model would be only slightly better than the other three models.

The Mediterranean Model has the second smallest average size of government (44.4 percent), but is third in average economic growth (2.3 percent), exceeding the Nordic Model by only .1 percent. This is perhaps due to the inflexibility of labor markets and the economically repressive nature of accumulated retirement benefits and social entitlements. The Continental Model has an average size of government of 49.9 percent, which is substantially larger than the Mediterranean Model. However, the Continental Model experiences the second largest average economic growth rate of 2.6 percent. Without the growth rate of Luxembourg (4.6 percent), the Continental Model would experience the most anemic growth rate of the four models. The Nordic Model has the largest average size of government and the lowest average growth rate, which indicates a correlation between the size of government and economic growth.
Exhibit 31: A Comparison of the Size of Government and the Rate of Economic Growth in the Four OECD Economic Models

A Comparison of the Size of Government and the Rate of Economic Growth in the Four OECD Economic Models

<table>
<thead>
<tr>
<th>The Anglo / American Model</th>
<th>Country</th>
<th>Size of Government 2002</th>
<th>Percent Growth Rate 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>United Kingdom</td>
<td>40.9</td>
<td>2.1</td>
</tr>
<tr>
<td></td>
<td>Ireland</td>
<td>34.6</td>
<td>7.2</td>
</tr>
<tr>
<td></td>
<td>United States</td>
<td>36.7</td>
<td>2.8</td>
</tr>
<tr>
<td></td>
<td>Average</td>
<td>37.4</td>
<td>4.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>The Nordic Model</th>
<th>Country</th>
<th>Size of Government 2002</th>
<th>Percent Growth Rate 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Norway</td>
<td>46.7</td>
<td>3.2</td>
</tr>
<tr>
<td></td>
<td>Sweden</td>
<td>58.3</td>
<td>1.8</td>
</tr>
<tr>
<td></td>
<td>Denmark</td>
<td>55.3</td>
<td>2.1</td>
</tr>
<tr>
<td></td>
<td>Finland</td>
<td>49.2</td>
<td>1.8</td>
</tr>
<tr>
<td></td>
<td>Average</td>
<td>52.4</td>
<td>2.2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>The Mediterranean Model</th>
<th>Country</th>
<th>Size of Government 2002</th>
<th>Percent Growth Rate 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Italy</td>
<td>47.1</td>
<td>1.5</td>
</tr>
<tr>
<td></td>
<td>Greece</td>
<td>46.3</td>
<td>2.7</td>
</tr>
<tr>
<td></td>
<td>Spain</td>
<td>39.8</td>
<td>2.7</td>
</tr>
<tr>
<td></td>
<td>Average</td>
<td>44.4</td>
<td>2.3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>The Continental Model</th>
<th>Country</th>
<th>Size of Government 2002</th>
<th>Percent Growth Rate 2002</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>France</td>
<td>54.6</td>
<td>1.9</td>
</tr>
<tr>
<td></td>
<td>Germany</td>
<td>48.6</td>
<td>2.0</td>
</tr>
<tr>
<td></td>
<td>Belgium</td>
<td>50.2</td>
<td>2.0</td>
</tr>
<tr>
<td></td>
<td>Luxembourg</td>
<td>46.1</td>
<td>4.6</td>
</tr>
<tr>
<td></td>
<td>Average</td>
<td>49.9</td>
<td>2.6</td>
</tr>
</tbody>
</table>

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Exhibit 31 displays the fourteen countries of the market model analysis in descending order, sorted by the percentage of government activity devoted to transfer payments in the form of social benefits. The relative rate of growth, divided among the four social models, is listed next to the model. The Anglo/American Model, which exhibits the smallest average size of government and highest average rate of economic growth, holds three of the four bottom places, indicating the smallest devotion to transfer payments as a percentage of GDP. The Continental Model, which has the second highest average size of government and second highest average rate of economic growth, occupies the top four positions, indicating the highest level of devotion to transfer payments. The Mediterranean and Nordic Models occupy the middle of the field. The inference is that a smaller percentage of government transfer payments is conducive to economic growth. However, in the short run, governments and their population may adapt and compensate for the disincentive nature of social activism.

The increased concentration of government activity in transfer payments is an expansion of the scope of government past the core competencies that are considered most desirable in government. Government makes a positive contribution to economic growth when it focuses on the provision of infrastructure and public goods, a stable monetary system, an unbiased legal system, property rights, and national defense. As government expands toward political, rather than market forces, it damages the incentives that drive the dynamics of market economies. The increased taxation necessary to finance increased transfers
begins to stifle economic entrepreneurship. Exhibit 32 illustrates the divergence of transfer payments by market model.

Exhibit 32: The Divergence of Transfer Payments by Market Model

<table>
<thead>
<tr>
<th>Country</th>
<th>2002 GDP</th>
<th>Social Benefits and Transfers 2002</th>
<th>Social Benefits as a Percent of GDP</th>
<th>Market Model</th>
<th>Growth Rate Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>2145020</td>
<td>610810</td>
<td>28.5</td>
<td>Continental</td>
<td>2</td>
</tr>
<tr>
<td>France</td>
<td>1548555</td>
<td>410307</td>
<td>26.5</td>
<td>Continental</td>
<td>2</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>22805</td>
<td>5882</td>
<td>25.8</td>
<td>Continental</td>
<td>2</td>
</tr>
<tr>
<td>Belgium</td>
<td>261124</td>
<td>65326</td>
<td>25.0</td>
<td>Continental</td>
<td>2</td>
</tr>
<tr>
<td>Sweden</td>
<td>2352938</td>
<td>575154</td>
<td>24.4</td>
<td>Nordic</td>
<td>4</td>
</tr>
<tr>
<td>Italy</td>
<td>1260598</td>
<td>279121</td>
<td>22.1</td>
<td>Mediterranean</td>
<td>3</td>
</tr>
<tr>
<td>Finland</td>
<td>140853</td>
<td>31054</td>
<td>22.0</td>
<td>Nordic</td>
<td>4</td>
</tr>
<tr>
<td>Denmark</td>
<td>1362511</td>
<td>297682</td>
<td>21.8</td>
<td>Nordic</td>
<td>4</td>
</tr>
<tr>
<td>Greece</td>
<td>142369</td>
<td>29386</td>
<td>20.6</td>
<td>Mediterranean</td>
<td>3</td>
</tr>
<tr>
<td>Norway</td>
<td>1519131</td>
<td>312858</td>
<td>20.6</td>
<td>Nordic</td>
<td>4</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1048456</td>
<td>179790</td>
<td>17.1</td>
<td>Anglo / American</td>
<td>1</td>
</tr>
<tr>
<td>Spain</td>
<td>729004</td>
<td>121562</td>
<td>16.7</td>
<td>Mediterranean</td>
<td>3</td>
</tr>
<tr>
<td>Ireland</td>
<td>127992</td>
<td>17678</td>
<td>13.8</td>
<td>Anglo / American</td>
<td>1</td>
</tr>
<tr>
<td>United States</td>
<td>10417600</td>
<td>1337000</td>
<td>12.8</td>
<td>Anglo / American</td>
<td>1</td>
</tr>
</tbody>
</table>

Japan was almost totally destroyed during World War II. Through the industrious nature of its people and the generosity of the Marshal Plan, Japan began to rebuild itself in a fashion that would become known as a “growth miracle.” In 1960, government expenditures were 17.5 percent of total...
expenditures and averaged 22 percent during that decade. Average economic growth was over 10 percent. During the next four decades, the government of Japan grew steadily, and by 2002 accounted for 38.6 percent of total spending. The growth rate had fallen to an anemic 1.6 percent. Exhibit 33 illustrates the divergence of government and growth in Japan.

Exhibit 33: The Growth of Government and the Rate of Economic Growth in Japan

![Graph showing the growth of government and the rate of economic growth in Japan.](source: National Accounts of OECD Countries: General Government Accounts Vol. IV 1993-2004)
While the government of Japan increased by more than 220 percent, economic growth declined by more than 600 percent. As in the United States, the data suggests that the growth of government in Japan has been associated with a slowdown in economic performance (Gwartney, Holcombe, and Lawson 1998).

Conclusions:

The data analysis in this chapter supports the hypothesis that there is an inverse relationship between an expanding public sector and economic performance. In the four decades studied, governments in the sample population countries have grown and economic growth in all of those countries has slowed. The evidence reinforces the assertion made by Gwartney, Lawson, and Holcombe, in 1998. Governments provide essential public services that directly impact an economy, and without which free market operations would be tenuous. However, there is a point of optimal contribution in the size and scope of government beyond which the sum of government activity would have a harmful impact on economic growth. The evidence strongly suggest that the governments of the twenty-three member nations of the Organization for Economic and Cooperative Development have all grown beyond that point of optimal contribution.

The long-run increase in government expenditures is primarily in the category of transfer payments and subsidies. This function has grown past a point of optimal social contribution and has produced undesirable economic consequences in the form of reduced economic growth. Current economic theory suggests that this is the result of a reduction in incentives due to rising levels of
taxation necessary to finance increased transfer payments (Easterly 2002). The increase in government subsidies has resulted in an increase in rent-seeking activity. The economy is damaged because wealth is accrued by redirecting income through government largess, rather than in productive economic activity and entrepreneurship.

Much of the growth in government expenditures of the OECD nations has been financed through government borrowing. This has contributed to a reduction of investment in the accumulation of capital, which is one of the driving forces of economic growth. Gross investment as a share of GDP has declined by almost 15 percent in the past four decades. This is surely a contributing factor in the decline of economic performance. As the per capita availability of capital has declined, the productivity of the individual worker has been eroded, and economic growth has slowed. This pattern has been consistent among the countries surveyed. The social model data gives a strong indication that larger governments, which are devoted to collective homogenization of income and living standards, impose a heavy burden in higher taxation and lower rates of economic expansion. There is a consistent pattern among the models that supports the original hypothesis of this dissertation. The regression analysis in this chapter gives a positive indication that the size of government effects economic growth.
CHAPTER IV

CONCLUSION

This dissertation is intended to argue the concept that the growth in government that almost all modern nations have experienced is a contributing factor in the reduced rates of economic growth that have occurred concurrently. The extant literature agrees that economic growth is a universal goal, but the process is complex and not totally understood. As humanity evolves and becomes more sophisticated socially and technologically, the dynamics and intricacies of growth expand exponentially. Government cannot be the sole agent of cause and effect in the process of growth, or receive total blame for a lack of growth. There is a host of collateral variables influencing the process at all times. However, the research conducted has indicated that beyond a point of optimal contribution, a growing government may well be the antithesis of economic performance and expansion of the standard of living.

The historic record indicates that the growth of government was founded in well intended sentiments and may have achieved its goal of softening the plight of human existence. Altruism and benign sentiment helped to mitigate the grinding oppression of poverty and raise the standard of living for the masses of the new economic order brought by the transition from feudalism to capitalism. This was accomplished through government activism and the judgment of history is positive. It could not be otherwise when the standard of living, life expectancy, infant mortality, and the general level of health all improved.
Because capitalism produced extremes in wealth and poverty, it gave birth to an alter-ego in socialism. The capitalists were characterized by the socialists as the epitome of depravity, and the great conflict between have and have-not was joined. Both sides evolved and adapted in Darwinian fashion. The capitalists, fearing the confiscation of the source of their wealth, grudgingly allotted more of the fruits of labor to those who labored. The socialists habitually promised everything and Utopia to those who had almost nothing. Through ebb and flow, neither side prevailed.

The failure of communism has not resolved the issue. It would seem to have given the ascendency to the proponents of free markets, but the seductive nature of the promises gathered in socialism, make it difficult to forsake. Today, collective sentiments are no longer an economic creed that rallies the unfortunate. Government has become the ultimate source of egalitarianism and homogenous income distribution. The warnings of Hayek and Friedman go unheeded, as we grant increasing power, influence, and income to government in quest of social perfection. The inherent flaw in an increasing devotion to government as the path to a just society is the failure to acknowledge that the government is populated by imperfect people. They are subject to the whim and temptation of greed, lust for power, and political expediency. In this, they may act in their own self-interest or the interest of a “special interest” and forsake the best interest of the society.
Implications and Findings

The expansion of governments since World War II varies in cause from the expansion brought about in the infancy of capitalism. Karl Marx predicted that democracy and capitalism would work, until the workers and voters discovered that they could vote for benefits for themselves. He seems prescient. We have been promised benefits and see them not as a privilege, but as an "entitlement." Politics recognizes an opportunity when it sees one, and has exploited the prospect appropriately. Almost all aspirants to public office offer something for nothing. One deserves and is entitled to enhanced retirement benefits, free medical care, low cost prescription drugs, inexpensive housing, more food, and free money to maintain the welfare and standard of living we deserve. Few who preach personal reliance and fiscal responsibility are elected. These promises have become the union card of modern politics, and they are not made in a spirit of compassion or kindness. They are made for the purpose of buying votes, and this process has brought into existence a class of citizens who are totally dependent on government entitlements.

The government cannot give something to someone without first taking from another person. More than 50 percent of current government activity is in transfer payments, or taking money from one person and redistributing it to another person. Social Security, Medicare, and Medicaid exceed one trillion dollars in the United States’ budget. Much of this generosity has been financed by borrowing, which also must be repaid. Interest payment on national debt is
increasing in almost all OECD nations. In the United States, it exceeds one billion dollars per day.

The sum effect of increased taxes to fund entitlements, increased borrowing to continue funding expanding entitlements, and reduced investment due to increased costs of borrowing is a reduction of the incentives that have been the foundation of market economics. Exhibit 34 illustrates the disincentive effect of the increasing size of government.

Exhibit 34: Increasing Government Size and Declining Economic Growth

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Limitations and Analysis for Subsequent Research

As with any study and analysis, this dissertation has limitations and weaknesses. We have concentrated on a period of time and reached conclusions for the present without acknowledgement of, and compensation for, future events that might influence the relationship of the variables considered. While the data is consistent with the hypothesis, there are exceptions and variations that do not fit well and require equivocation. The analysis does not address standardized measures of association, while high significance tends to imply strong relationship between the variables considered.

The future influence of unpredictable and uncertain energy sources is a variable that would be well considered in future research. China and India will bring several billion new consumers of energy to energy markets in the near future. This will certainly shift the balance of world power among nations and modify the relationship between people and government. Will petroleum become a new entitlement? Energy politics will intensify old political questions and create volatile new ones. It is not facile to predict that there will be calls for expanded government power to deal with new problems.

The forces of globalization have not been considered in this dissertation because they might be sufficient in scope and complexity to require another dissertation. There will be new economic realities in outsourcing, downsizing, and employment legislation. Education will require more funding to compete effectively with market enthusiasts spawned by emerging markets which produce new opportunity and risk. The debate concerning the size and role of government
will only intensify as we face the reality of elusive and expensive solutions to our growing problems.

The combination of capitalism and democracy has been the foundation for an era of unequaled prosperity in human history. These two forces are beginning to diverge, and they might contain the seeds of self-destruction. Global forces have eroded democratic processes and allowed corporations to neglect the common good for the bottom line, while government forsakes its role of protecting the greater interest and allows business to write the rules of the game. Democracy and capitalism may well evolve toward an analogous two wolves (government and business) and a sheep (the people) voting on what is for dinner.

The former topics are fertile ground for additional research. The most compelling would be the question of what outcome or events would bring about the end of the march toward socialism. Collectivism has been discredited and declared dead, but the growth of government has sustained and revived the corpse, much in the fashion of Lazarus. Will this inertial mass in government continue to grow and accrue power as Ayn Rand predicted in *Atlas Shrugged*? It seems likely, because centralized control and power are the light of attraction for the moth of socialism. However, history shows that socialism has been a story of high hopes and bitter disappointments.
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