Government in Retreat

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Executive Summary

Technological changes are increasing the mobility of labor and capital around the world. Because of this mobility, governments no longer have a fixed supply of productive resources to tax and regulate. Instead, governments are in active competition with each other to make their countries attractive to workers and investors who have increasing freedom of choice about when they produce, save and invest.

Because the most effective way to compete for capital and labor is to reduce the burden of government, government spending is no longer growing relative to the size of the economy in most developed countries.

- In the United States, the ratio of total government spending to gross domestic product (GDP), which grew at a rate of 1.5 percent per year in the 1960s, grew by only 0.7 percent per year thereafter and has not grown at all after 1982.

- In Europe, the size of government relative to the economy grew by 28 percent between 1966 and 1977 but rose by only 8 percent between 1977 and 1988 and has seen little change since 1982.

- In Japan, the size of government relative to the economy grew by 45 percent from 1966 to 1977, but rose by only 13 percent between 1977 and 1988 and has actually decreased since 1982.

Governments around the world are also lowering marginal tax rates, privatizing and deregulating.

- Between 1985 and 1989, 65 percent of non-communist countries lowered their highest marginal tax rates and the (unweighted) average top tax rate among all countries surveyed fell from 55.5 percent to 46.7 percent.

Introduction[1]

As we approach the 21st century, a remarkable change is taking place around the world. Government, once thought to be the number one growth industry, is in retreat. By some measures, the rate at which government has been growing has slowed dramatically. By others, the size of government is actually shrinking.

Except in communist countries, this change is not occurring because there is widespread demand for smaller government. Instead, governments around the world are privatizing, deregulating, lowering tax rates and moderating spending increases in order to make their countries attractive to investors and workers.

"People find it easier to choose the country and political system in which they will work, save and invest."

A technological revolution now underway is making capital and labor more mobile. With this increasing mobility, people find it easier to choose the country and the political system in which they will work and save and invest.

A new international market for governments is emerging. In this market, governments hostile to private enterprise are losing resources in competition with other governments. Government is in retreat because, for the most part, reducing the burdens of government is the most effective way to make jurisdictions attractive in the competition for capital and labor.

The Second Industrial Revolution

Not long ago, science fiction writers believed new technology would make business and government larger and more powerful. Today we know it's doing the opposite. Technology is making things small, mobile and quick. A fundamental change is taking place in the way we produce things and this change is creating new opportunities for workers and investors.

"People in any one country are potential employees of companies located in almost any other."

"Financial capital travels around the world on an electronic highway at the speed of light."

The Mobility of Labor. Changes in transportation and communications technology make it increasingly easy for people to live and produce in a place quite distant from the place where the goods they help produce are ultimately marketed and sold:[2]

- Between 1937 and 1984, the price of an airline ticket for a flight from the West Coast to Japan fell from 300 percent of the average person's disposable annual income to less than 8 percent.
- Average plane speeds in international travel have increased from 149 miles per hour in 1944 to 493 mph in 1986, thus reducing the perceived size of the globe to less than a third of its 1944 dimension.

Not only is it easier and cheaper to travel, it's also easier to communicate from remote places. The number of international telephone calls rose from 3.3 million in 1960 to 478 million in 1986, and new technology is making an international call almost as easy as a local call.[3] To see what this means for the workplace, consider that:

- New York Life Insurance Company air freights insurance claims from Kennedy airport each evening to its processing center in Ireland. The processed claims are returned by computer link to its service center in Clinton, New Jersey within seven days.[4]
- Workers in Ireland also process journal subscription renewals for McGraw Hill (New York) and write computer software for Travelers (Hartford, Connecticut).
- American Airlines (Dallas) employs a thousand data entry personnel in Barbados.

People in any one country are potential employees of companies located in almost any other. As a result, people need only move short distances in order to transfer from jurisdictions hostile to labor to jurisdictions friendly and participate in the increasingly international labor market.

Mobility of Financial Capital. As former Citicorp CEO Walter Wriston has observed, financial capital travels around the world on an electronic highway at the speed of light. Measured in dollars, the volume of capital flowing across international boundaries is from 30 to 50 times the volume of international trade.[5] Today, Americans can invest in other countries and foreigners can invest in the United States with relative ease. Currently:[6]

- U.S. citizens hold about $1.2 trillion in investments abroad, of which about $927 billion (74 percent) is in portfolio assets such as bank accounts and securities.

- At the same time, foreigners have invested about $1.6 trillion in the United States, of which about $1.4 trillion (78 percent) is in the form of portfolio assets.

The ease with which capital can flow between jurisdictions makes it increasingly difficult for governments to tax it, regulate it or confiscate it. Financial capital can travel almost instantaneously from unfriendly to more friendly locations.

"Technology is making things small, mobile and quick."

The Mobility of Real Capital. Until recently, the concept of "real capital" implied concrete and steel, and lots of it. Many factories sprawled over acres (in some cases, even square miles) of ground and employed thousands of workers. Although such factories still exist, the trend is toward smaller factories with shorter payout periods, and towards dispersing segments of the production process among many different factories in different places. Another trend is the tendency to use outside suppliers for any production task they can perform more efficiently.

One consequence of these changes is that small business is expanding and large business contracting, at least in terms of employment. MIT economist David Birch has estimated that, between 1981 and 1985, small business (1 to 19 employees) created 82 percent of net new jobs in the United States, while large business (5,000+ employees) reduced employment by almost 14 percent.[7]

"Large manufacturers can disperse parts of the production process to the corners of the earth."

Another consequence is that large manufacturers are able to disperse various parts of the production process (either directly or under contract with other firms) to the corners of the earth. Wedded to the past, we continue to talk about trade and the balance of trade between countries. But what is an "American" company or a "Japanese" company?

- In 1985, American firms producing in Japan sold more than $53 billion of goods and services to the Japanese — an amount that exceeded the U.S. trade deficit with Japan that year.[8]

- By the end of 1986, Japanese corporations had at least a 50 percent stake in 489 U.S. assembly or production companies.[9]

- Four of America's largest chemical companies, half the nation's cement industry and a sizable segment of the country's financial industry are owned by foreigners.[10]

The Mobility of Human Capital. The most important form of capital is human capital — in the form of brainpower. The importance of knowledge as capital is indicated in the recent dramatic divergence between the wages of college graduates and of high school graduates:[11]

- In 1979, college graduates earned 32 percent more than high school graduates.
- By 1986, the education earnings gap had more than doubled to 69 percent.

One of the most striking examples of brains and computers substituting for "sweat labor" is in manufacturing:

"Even as U.S. manufacturing employment dropped, U.S. share of manufacturing output worldwide rose."

- Between 1950 and 1980, employment in manufacturing fell from 31 to 22 percent of total U.S. employment, then dropped to 18 percent in 1989.[12]
- This change is not the result of the U.S.'s losing manufacturing market share in international markets since similar changes are underway in every country.
- Even as manufacturing employment dropped in the United States, the U.S. share of manufacturing output worldwide rose from 36 percent in 1973 to 38.7 percent in 1987, and the U.S. share of total industrial jobs rose from 25.6 to 29 percent over the same period.[13]

Case Study: Kuwait. The enhanced mobility of capital and labor was fully evident in Saddam Hussein's takeover of Kuwait. Fifty years ago, Hussein's troops could have captured the entire economy of Kuwait by a military invasion. However, in August 1990, Hussein was able to capture far less than half of the Kuwaiti economy.

"An entire bank was faxed out of Kuwait prior to the Iraqi invasion."

On the day of the invasion and shortly thereafter, labor and capital poured out of the Kuwaiti economy. As many as 300,000 of the country's workers migrated, and many of these workers were the brains behind the country's landlocked resources. Much of the rest of the Kuwaiti economy went inactive or sought refuge in the underground. An entire bank — that is, its critical assets, documents — was faxed out of the country at the cost of a day-long telephone call (made longer than necessary because of the fighting outside the bank windows). Nevertheless, the bank continued operations the very next day from the island nation of Bahrain. Hussein got only the building, one of the least important of the bank's assets.[14]

The Market for Government

The technological changes transforming our work and our opportunities to save and invest have stunning political implications. In democratic countries, we used to choose the government we live under through the ballot box. Today, people are increasingly voting with their feet, choosing the governments they live under simply by moving.

"The greater the mobility of capital and labor, the more competitive the market for government becomes."

To the degree that labor and capital can quickly and easily move across political boundaries, governments must compete with one another to make their jurisdictions attractive. The greater the mobility, the more competitive the market for government becomes.

A good example of the market for government at work is the competition among the state governments in the United States to attract people and jobs. One study found that between 1975 and 1988 the states with the highest tax effort (state taxes as a percent of the tax base) have been losing population (including jobs and brainpower) to the states with the lowest tax effort.[15] For example:

- New York, with a tax effort more than 62 percent above the national average, will have lost more electoral votes between 1972 and 1992 than any other state.
- By contrast, Florida, with one of the four lowest tax efforts, has already picked up several of New York's lost electoral votes.
- Overall, the ten states with the greatest population growth between 1970 and 1990 had an average tax effort 12 percent below the national average.

"The ten states with the largest population growth had taxes 12 percent below the national average."

The movement of population is also reflected in the movement of jobs:

- Between 1970 and 1990, the ten states with the lowest tax effort had an average employment growth of 18 percent.
- The ten states with the worst job growth records all had tax efforts above the national average.

Government in Retreat: Taxes and Spending

In most countries around the world, government budgets continue to grow, consuming more resources. In the 1980s, however, a dramatic change took place in industrialized, market economies. The rate at which government was growing fell substantially in almost all developed countries and in a few cases the size of government actually began to shrink.

Government Spending. In the United States, the ratio of total government spending (federal, state and local) to gross domestic product (GDP) grew at about 1.5 percent per year during the 1960s. During the 1970s, however, the rate of growth fell to 0.7 percent per year, and since 1982 when government spending stood at 36 percent of GDP, there has been virtually no increase in the size of government relative to the economy. Even more dramatic changes occurred in Europe and Japan.[16] [See Table I and Figure I.]

- In Europe, government spending as a percent of GDP rose from 34.6 percent in 1966 to 44.2 percent in 1976 — reflecting a 28 percent increase in the size of government relative to the economy.

- Over the next 12 years (1977 to 1988), the rate of growth of government in Europe fell by almost two-thirds, and there has been virtually no increase in the relative size of government since 1982.

- In Japan, government spending as a percent of GDP rose from 19.1 percent in 1966 to 27.7 percent in 1976, reflecting a 45 percent increase in the size of government relative to the economy.

- Over the next 12 years, however, the size of the Japanese government relative to the economy grew by only 13 percent and it was actually smaller in 1988 than in 1981.

"The size of the U.S. government relative to the economy grew at 1.5 percent per year in the 1960s, 0.7 percent in the 1970s, and showed virtually no growth since 1982."

Measured in terms of spending, the size of government remains quite large in developed market economies. In Japan, about one-third of national income flows through the state. In the United States, it's slightly more than one-third and in Europe, close to one-half. Yet unlike prior periods, the 1980s saw the growth of government come to a virtual halt.

"Since 1982, there has been virtually no increase in the size of government relative to the economy among developed countries."

TABLE I

Government Spending as a Percent of Gross Domestic Product

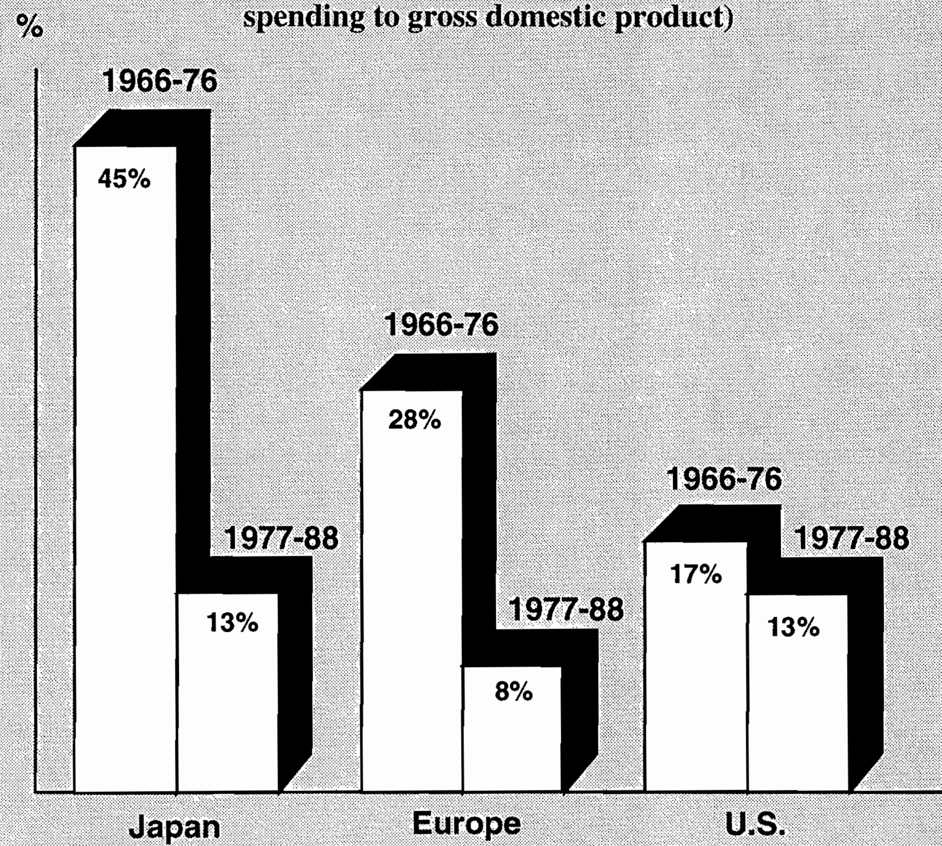
	United States	Europe	Japan
1966	28.5%	34.6%	19.1%
1967	30.5%	35.9%	18.2%
1968	30.7%	36.9%	19.2%
1969	30.4%	36.9%	18.9%
1970	31.6%	36.6%	19.4%
1971	31.6%	37.4%	20.9%
1972	31.3%	38.1%	22.1%
1973	30.6%	38.5%	22.4%
1974	32.2%	40.4%	24.5%
1975	34.6%	44.1%	27.3%
1976	33.4%	44.2%	27.7%
1977	32.2%	44.4%	29.0%
1978	31.6%	45.2%	30.5%
1979	31.7%	45.2%	31.6%
1980	33.7%	45.7%	32.6%
1981	34.1%	48.0%	33.5%
1982	36.5%	48.8%	33.7%
1983	36.9%	49.1%	34.1%
1984	35.8%	49.1%	33.2%
1985	36.7%	49.2%	32.7%
1986	37.0%	48.9%	33.1%
1987	36.9%	47.9%	32.4%
1988	36.3%	47.9%	32.9%

Source: Organization for Economic Cooperation and Development, *OECD Economic Outlook* (December 1990), p. 189.

FIGURE I

Slowdown in the Rate of Growth Of Government Spending

(Increase in the ratio of government spending to gross domestic product)



Source: Organization for Economic Cooperation and Development, *OECD Economic Outlook*, December 1989, p. 179

"The rate of growth of government fell by two-thirds in Japan and Europe."

Taxes. Government spending is a better measure of the size of government than taxes, because spending reflects the actual amount of resources diverted from the private sector, whereas taxes are simply one way in which the diversion is financed. Nonetheless, international evidence on taxes tells much the same story:[17]

"The growth of taxes relative to the U.S. economy slowed from 11 percent to 7 percent over the past two decades."

- The ratio of taxes to GDP in the United States rose 11 percent from 1966 to 1976 but only 7 percent over the next 12 years.
- In Europe, the ratio of taxes to GDP rose 20 percent from 1966 to 1976, but the rate of growth fell to almost a third of that level over the next 12 years.
- Japan is an apparent exception to the general trend, but Japan's greater tax increases in the later period were used to decrease deficits rather than to fund spending increases.

Government in Retreat: Marginal Tax Rates

Another measure of government interference in the economy is marginal tax rates. High taxes *rates* do not necessarily produce high government *revenues.* In fact, in most countries there is a negative relationship between the highest tax rate and the amount of revenue government collects from taxpayers who pay that rate. The higher the rate, the lower the total revenue. High marginal tax rates wreak havoc on the private sector economy, however, and if tax collections are low government benefits little in return for the harm it causes.[18]

Tax Rates and Tax Revenues. In general, the worst possible tax system is one which imposes very high marginal tax rates and collects very little revenue. Yet this is precisely what occurs in most Latin American countries. For example:[19]

- In the mid-1980s, all taxes on labor income combined (income tax plus payroll tax plus sales taxes) produced a marginal tax rate on labor of 95 percent in Argentina, 90 percent in Peru and 60 percent or higher in Brazil, Mexico and Ecuador.

"Most Latin American Countries have very high marginal tax rates and collect very little revenue."

- As a percent of gross domestic product, however, taxes actually collected were quite modest — only 12.7 percent in Argentina, 8.8 percent in Peru and 9.3 percent in Mexico.

If one ignores sales taxes and focuses on the direct taxes on labor income, the differences are even more striking:[20]

- Before the 1989 tax reform, Argentina's personal income tax rate reached 45 percent and its social security tax rate is still 46 percent; yet the amount of revenue Argentina collected from both these taxes was only 3.5 percent of GDP.

- Peru's personal income tax rate reaches 45 percent and its payroll tax rate is 36 percent; yet the amount of revenue Peru collects from both these taxes is only 1.1 percent of GDP.

In Latin America, high marginal tax rates are not reserved for the rich. They fall on workers whose earnings are very modest. For example, in many

Latin American countries marginal tax rates are 50 percent or higher on annual incomes as low as $5,000. Moreover, the practice of imposing high marginal tax rates on modest incomes is a fairly recent phenomenon. Prior to 1961, for example, Mexico did not even have a progressive income tax.[21]

Increasing Revenues by Lowering Rates. When governments lower their tax rates, they lift an enormous burden from shoulders of the private sector. Instead of channeling resources and effort into tax avoidance and tax evasion, people are likely to produce more and earn more. In making decisions about work and investments, people will focus more on real economic advantages rather than tax advantages.

Moreover, at lower rates government is likely to collect more revenue. For example, in the United States there has almost always been an inverse relationship between the highest income tax rate and income tax payments made by the wealthiest taxpayers:

"Between 1985 and 1989, 65 percent of the countries lowered their highest marginal tax rates."

- In 1963, when the top tax rate was 91 percent, the top 5 percent of taxpayers paid 35.6 percent of all income taxes. In 1965, when the top rate had been lowered to 70 percent, the top 5 percent of taxpayers paid 38.5 percent of all income taxes.[22]

- This pattern was repeated during the 1980s. Although the highest income tax rate was reduced from 70 percent to 28 percent, the share of taxes paid by the top 1 percent of income earners grew from 18 percent in 1981 to more than 27 percent in 1988.[23]

Moreover, this pattern is not confined to the richest taxpayers. The share of tax payments increased for every high-income group over the past decade, even though tax rates were reduced.[24]

The Worldwide Reduction in Marginal Tax Rates. Following the example of tax cuts and tax reform initiated in the United States by the Reagan Administration, almost every country in the world has lowered its highest marginal tax rate or expressed a strong interest in doing so. One survey found that:[25]

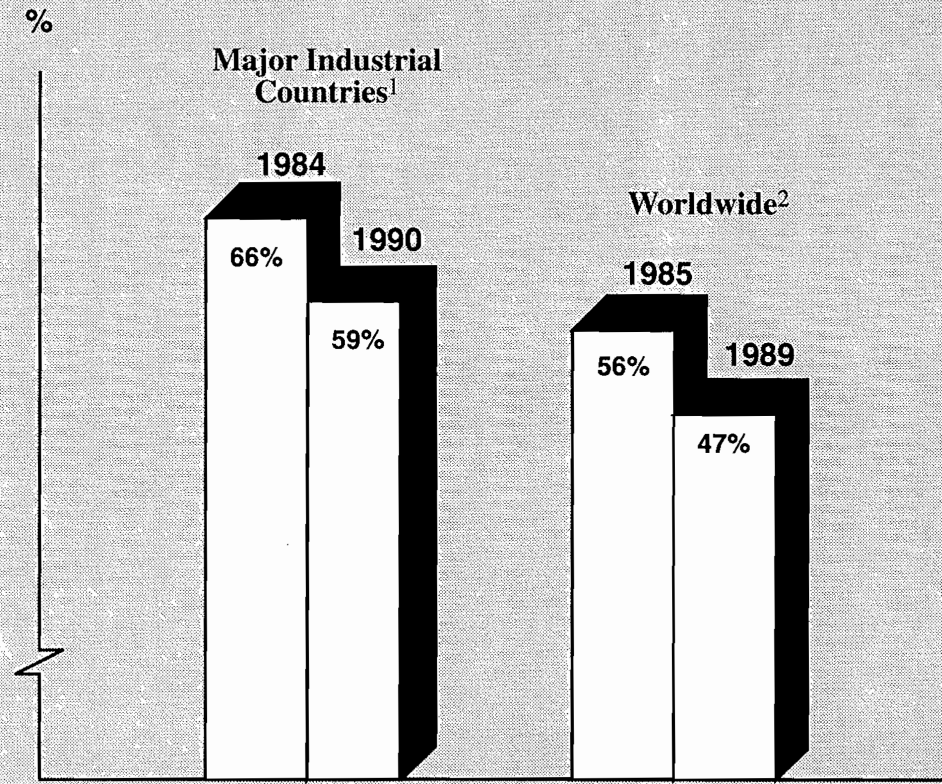
- Between 1985 and 1989, 55 of 86 countries lowered their highest tax rates while only two countries raised their highest tax rate.

- On the average, the highest tax rate fell from 55.5 percent to 46.7 percent for the 86 countries over the five-year period.

Another study found that among the 11 leading industrialized countries during the 1980s, the (unweighted) average top rate fell from 66 percent in 1986 to 59 percent in 1990.[26] [See Figure II.]

FIGURE II

Reduction in the Highest Personal Income Tax Rates



[1]Unweighted average of top income tax rates in Sweden, Denmark, France, Netherlands, United Kingdom, West Germany, Italy, Canada, Australia, United States and Japan.

[2]Unweighted average of the tax rates shown in Table II.

Sources: Joseph A. Pechman, "Introduction," in Joseph A. Pechman, ed., *World Tax Reform: A Progress Report* (Washington, DC: Brookings Institution, 1988), p. 4; and Table II.

"The world-wide average marginal tax rate fell 9 percentage points."

The U.S. Corporate Income Tax. One of the government's most aggressive means of taxing capital is the corporate income tax. However, the government's capacity to draw revenues from capital taxation has obviously been impaired, as evident in the decline of the percentage of federal revenue obtained from the corporate income tax:

"As a percent of all federal taxes, the federal income tax dropped from 47 percent in 1928 to 10 percent in 1989."

- In 1928, corporate income taxes accounted from 46.6 percent of federal tax collections.
- By 1950, the corporate income tax generated 27.9 percent of federal tax collections.
- The percentage was down to 24.2 percent in 1960, then to 17.9 percent in 1970, 12.5 percent in 1980 and 10 percent in 1989.

"Almost every country has lowered its highest marginal tax rate or expressed interest in doing so."

TABLE II

How Top Tax Rates Changed From 1985 to 1989

	1985	1989		1985	1989
Argentina	45%	35%	Libya	35%	35%
Australia	60	49	Luxembourg	57	58.8
Austria	62	50	Malawi	50	50
Bangladesh	60	50	Malaysia	45	45
Barbados	60	50	Malta	65	65
Belgium	71.5	55	Mexico	55	40
Belize	50	50	Morocco	60	60
Bolivia	30	10	Netherlands	72	72
Bophuthatswana	40	40	New Zealand	66	33
Botswana	60	50	Nigeria	70	55
Brazil	60	25	Norway	40	27.5
Canada	34	29	Pakistan	60	45
Channel Islands	20	20	Panama	56	56
Chile	56	50	Papua New Guinea	50	45
China	45	45	Paraguay	30	30
Colombia	49	30	Peru	50	45
Costa Rica	50	25	Philippines	60	35
Cyprus	60	60	Portugal	76.6	40
Denmark	73	72	Puerto Rico	67.5	38
Dominica	55	45	Senegal	65	60
Dominican Republic	73.1	73.1	Singapore	40	33
Ecuador	46	46	South Africa	50	45
Egypt	65	65	South Korea	70.1	63.7
El Salvador	60	60	Spain	66	56
Fiji	50	50	Sri Lanka	55	40
Finland	51	44	Sudan	70	40
France	65	56.8	Swaziland	50	45
Ghana	60	55	Sweden	80	72
Greece	63	50	Switzerland	11.5	11.5
Guatemala	48	34	Taiwan	60	50
Honduras	40	40	Tanzania	95	55
Hong Kong	25	25	Thailand	65	55
Iceland	44	28.5	Trinidad & Tobago	70	45
India	61.9	50	Turkey	55	50
Indonesia	35	35	Uganda	70	60
Ireland	65	58	U.K.	60	60
Isle of Man	20	20	U.S.	50	28
Italy	65	50	Venezuela	45	45
Ivory Coast	37.5	37.5	West Germany	56	56
Jamaica	57.5	33.3	Zaire	60	60
Japan	70	50	Zambia	80	75
Kenya	65	50	Zimbabwe	61.1	60
Lebanon	44	50			
Liberia	73	73	Unweighted Average	55.5	46.7

Source: Bruce Bartlett, compiled from Price Waterhouse and Coopers & Lybrand tax guides.

Government in Retreat: Growth of the Informal (Underground) Economy

High tax rates also affect the tax base for the not-so-rich. In the presence of high tax rates, people increasingly conduct their economic activities in the "underground," "black market" or "informal" sector of the economy — where they escape official scrutiny and costly government regulations as well as high taxes.

"The U.S. underground economy is from 15 to 25 percent of the GNP."

The Underground Economy in the United States. According to one estimate, income from strictly illegal (what is considered to be truly criminal) sources accounts for less than half of the total economic activity in the "underground economy."[27] The underground now includes people down the block who sell a variety of goods and services — from firewood to scarves to housecleaning to haircuts to fence posts — all on the condition that payment must be made in cash and is, therefore, difficult for taxing authorities to trace. It also includes the many self-employed people who hide — or fail to report — business income or who engage in barter.

- Estimates of the relative size of the underground economy in the United States vary greatly and range upward to 15 and even 25 percent of GNP.[28]

- Few doubt that the underground, untaxed and unregulated segment of the economy has been growing in recent decades faster than its aboveground counterpart — possibly giving rise to an understatement in the annual growth rate of the U.S. economy since World War II of at least a quarter of one percent.[29]

The Informal Economy in Latin America. The most extensive research on the informal economy in less developed countries has been done in Peru. Under the direction of Hernando De Soto, researchers at the Instituto Libertad y Democracia (Institute of Liberty and Democracy) estimate that:[30]

"About 38 percent of Peru's output is produced in the informal economy."

- About 48 percent of the working age population is involved in the informal economy.

- The informal economy accounts for 61 percent of all man-hours worked and 38 percent of Peru's gross domestic product.

The informal economy is a thriving, bustling marketplace. It has developed despite numerous legal obstacles, with virtually no access to credit and no foreign aid. Overall, it assembles cars, manufactures precision tools, builds furniture and repairs buses. For example, in Lima, the informals carry on 90 percent of the clothing construction business, 75 percent of furniture construction, 60 percent of housing construction and 95 percent of public transportation.[31]

"The typical Argentine is holding one U.S. dollar for every dollar's worth of australes."

Peru is not alone. The informal economy is a general phenomenon throughout the less-developed world, although rigorous estimates of its size have been made in only a few countries. Using different methodology from that used in Peru, the Instituto de Estudios Contemporaneous (Institute for Contemporary Studies) in Argentina estimates that 38.5 percent of Argentina's gross domestic product is produced by the informal economy, where more than half of Argentina's working population has its principal job.[32]

Just as there are black markets in goods and services, so there are black markets in currency. In Argentina, the government actively manipulates exchange rates to influence foreign trade and domestic production and as a source of revenue. The controls are so extreme that an enormous black market in dollars has developed. Even though few Argentine citizens have investments in the United States, the Institute for Contemporary Studies estimates that:[33]

- The total value of dollars in Argentina is approximately equal to the total value of Argentine currency.
- Put another way, the typical Argentine is holding one dollar for every dollar's worth of australes.

Retreat of Government: Privatization

The worldwide privatization revolution has spread to six continents and at least 65 countries, including the Soviet Union, Eastern Europe and China.[34] Although there were some privatization efforts prior to the 1980s, Margaret Thatcher's innovative techniques of privatization[35] paved the way:[36]

"The worldwide privatization revolution has spread to six continents and at least 65 countries."

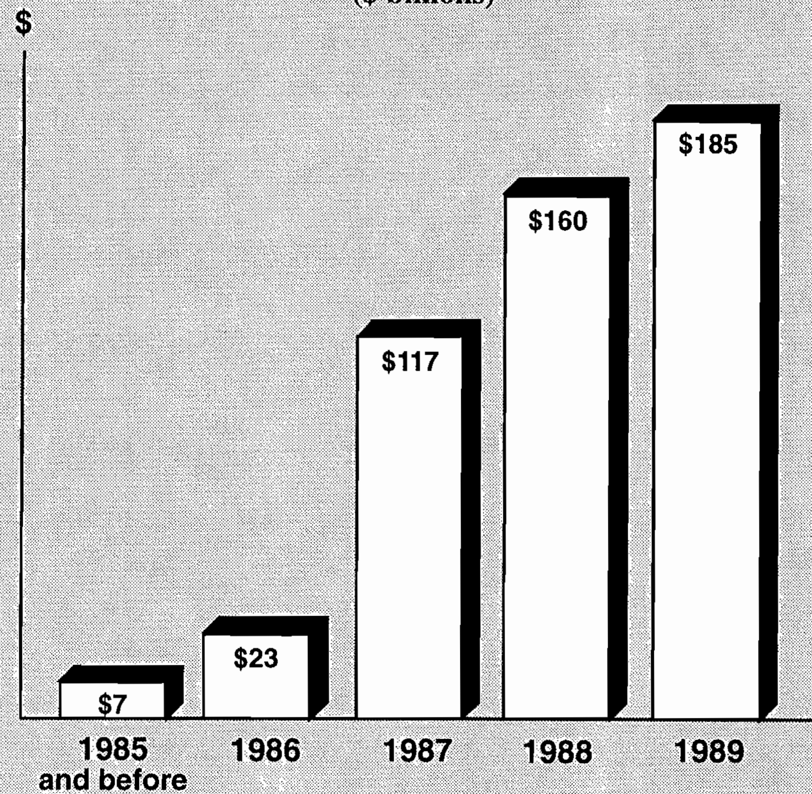
- In modern times, sales of state-owned enterprises to the private sector totaled only $23 billion worldwide, prior to 1987.
- In 1987, that figure jumped to $117 billion and kept climbing to $185 billion by 1989.
- Worldwide, more than 2,000 state-owned operations are currently under consideration for privatization worldwide by the year 2000.

"Sales of state-owned enterprises in 1987 were five times the total of all previous years."

FIGURE III

Worldwide Sales of State-Owned Enterprises

($ billions)



Source: *Privatization 1990*, (Santa Monica, California: Reason Foundation, 1990)

In addition to the more visible privatization efforts in the developed countries, significant privatization is occurring elsewhere. According to a World Bank study:[37]

- In 1980, there were at least 4,137 state enterprises in Africa, Latin America and Asia.
- By 1987 at least 136 had been closed or liquidated, 433 had been sold, 120 were targeted for sale and 55 were being operated under management contracts with private firms.

"At the local level, privatization in the U.S. is proceeding at full speed."

In the United States only two significant privatization accomplishments occurred at the federal level: the sale of Conrail and a number of public housing projects. At the local level, however, the privatization revolution is proceeding at full speed.[38]

"*Encorse, Michigan, has become almost fully privatized.*"

- Vehicle towing is provided by the private sector in 85 percent of all the cities reporting.
- The private sector provides street lighting in 53 percent of the cities.
- Residential garbage collection is privatized in 49 percent of the cities and legal services in 48 percent.

One study of privatization in 34 cities found aggregate first-year savings of $17 million. In only three instances were there no first-year savings.[39] Among other developments:[40]

- In 1989 Louisiana became the first state to contract out a medium security prison (to Corrections Corporation of America).
- In another milestone, Monroe County, Florida, in 1989 contracted out its entire county correctional system to Wackenhut Security, a private corrections firm.
- Encorse, Michigan, has become the most fully privatized city in the United States by selling almost all city assets and privatizing almost everything — including a partially privatized fire department.

Government in Retreat: Deregulation

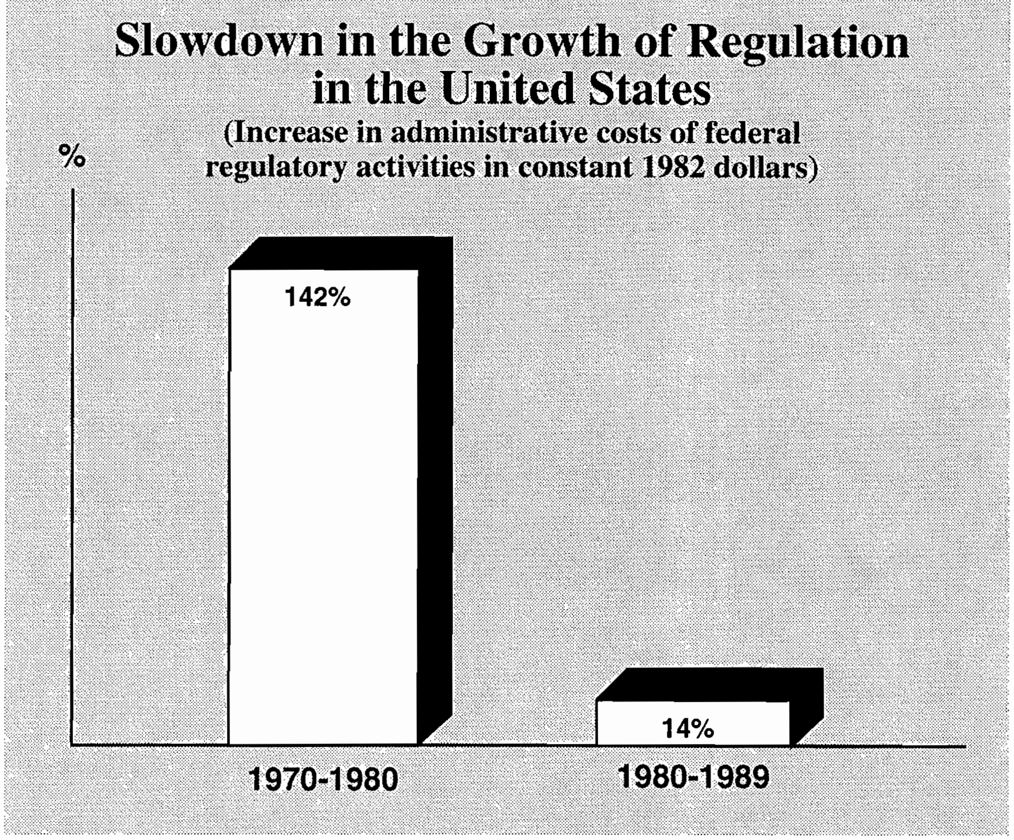
Beginning in the late 1970s, the United States began to deregulate numerous industries: banking and finance, air travel, trucking, broadcasting, oil and gas. Moreover, evidence indicates that the remaining regulatory agencies are becoming less important.

"*Pages of federal regulations fell by more than one-third in the 1980s.*"

- The *Federal Register* (which lists federal regulations) peaked at 87,000 pages in 1980 and was down to under 54,000 in 1990.[41]
- Employment in federal regulatory agencies declined in the 1980s, from 119,000 in the employees in 1980 to 106,000 by 1987.[42]
- Spending by federal regulatory agencies increased by only 14 percent in the 1980s after increasing by 142 percent in the 1970s [See Figure IV], and administrative regulatory costs as a fraction of GNP fell 13 percent in the 1980s.[43]
- The combined employment by all levels of government (yet another indicator of regulatory burden) continues to grow, but has declined as a percentage of the civilian labor force. [See Figure V.][44]

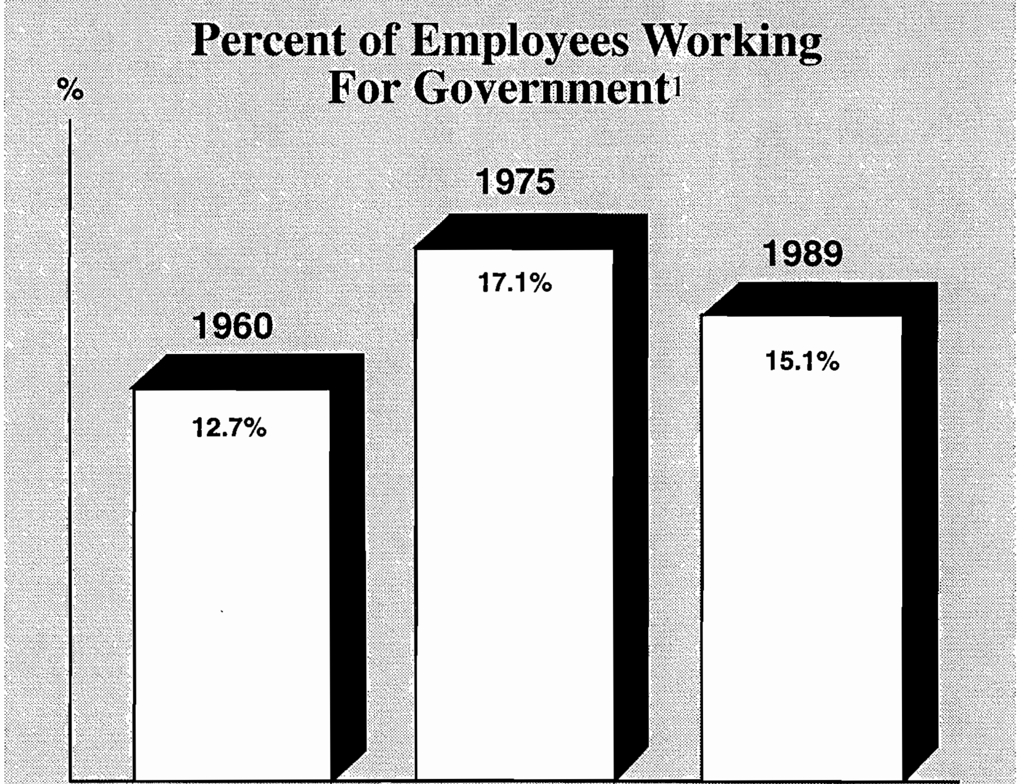
"The rate of growth of regulatory spending has been cut by 90 percent."

FIGURE IV



"Federal employment is declining as a percent of the U.S. labor force."

FIGURE V



[1]Total government employment as a percent of the civilian labor force.

"Practically the only nondefense departments that grew during the 1980s were Justice and Treasury."

Formal congressional efforts to deregulate additional industries in the United States were slowed, if not stopped, in the late 1980s. Moreover, through the expansion of governments efforts to regulate plant closings, the environment and the hiring of the disabled, Congress has demonstrated in the last couple of years a penchant for reversing the deregulatory gains of the 1970s and 1980s. However, more than anything else, Washington-based politicians are governing by pretense, or the appearance of extended control. While the federal government has continued to spend more real dollars and to employ more people in its regulatory efforts, its expenditures and employment figures have not kept pace with the growth in the national economy. Hence, the federal government has been forced to stretch more thinly its regulatory resources over the economy it is supposed to regulate more carefully, but which it cannot.

The extent to which Congress appears to be governing by pretense can be most dramatically seen in the absolute decline of the workforce of important regulatory departments and agencies:

- From 1982 to 1988, the number of inspectors at the Food and Drug Administration contracted by 40 percent, from 33,000 to under 20,000.

- In spite of a population that is aging and more concerned than ever about food quality, the workforce at the Social Security Administration fell by 21 percent, from 80,000 to 63,000, while the number of meat inspectors at the Agriculture Department dropped by 15 percent, from 8,400 to 7,100.

- Between 1980 and 1988, employment at the Housing and Urban Development Department dropped 24 percent; employment in Education went down by 38 percent; Labor, down by 22 percent; Agriculture, down by 7 percent; Commerce (excluding the Census Bureau), down by 29 percent; Energy, down by 21 percent; Health and Human Services (excluding Social Security), down 24 percent; and Transportation, down by 12 percent.

- Practically the only nondefense departments whose employment grew significantly during the 1980s were Justice (associated with the growth in crime) and Treasury (all of which is associated with the expanded tax collection efforts of the Internal Revenue Service).

And the count of the government workforce does not reflect the likely "brain drain" in government, spurred by the fact that government work is no longer looked upon as having the same romantic aura achieved in the 1960s. All told, most federal workers faced the daunting task of coping with a flow of new laws and demands endemic to a larger economy — with, relatively speaking, fewer resources.

The United States is not alone. Like privatization, deregulation is an international phenomenon:[45]

Banking and Finance. Almost every developed country has deregulated its financial markets to one degree or another, with the United States taking second place to New Zealand, which will allow almost anyone to open a new bank there.

"Countries are deregulating everything from finance and transportation to energy and agriculture."

Airlines. New Zealand has not only deregulated domestic routes, it also allows Australian airlines to fly those routes and freely compete. Australia has also deregulated its domestic air travel, has relaxed its controls on domestic air freight and has refused to enforce the tariffs and rules of the international airline cartel. Canada and West Germany plan to encourage entry and exit into their domestic airline industries in order to foster greater competition.

Transportation. In addition to air transport, other forms of transportation also are being deregulated. Britain is deregulating buses and railroads and France is deregulating trucking.

Telecommunications. Britain and Germany have ended their state monopolies on television broadcasts, permitting private broadcasters to enter the market, and France is beginning to deregulate telecommunications.

Energy. Britain has ended state control of the British oil industry and is permitting private use of the pipelines of the state-owned British Gas Corporation. Canada is relaxing its restrictions in the oil market and West Germany is in the process of phasing out cartel agreements in the electricity, gas and water industries.

Industrial Policy. France and Spain are backing away from industrial policies under which taxes, subsidies, and tariffs were used to encourage some industries relative to others. New Zealand has made the greatest progress by virtually eliminating agricultural subsidies and at the same time making major strides in eliminating all tariffs.

Conclusion

The reality of the new international marketplace is that countries are in vigorous competition with each other for capital and labor resources. Those countries that tax capital and labor will inevitably experience a diminishing tax base unless they provide services that are worth more to taxpayers than the taxes government takes. Those countries that try to impose regulations will find fewer activities left to regulate unless the benefits of regulation (to those who are regulated) are greater than the burdens the regulations impose.

In the light of this new reality, governments are unlikely to embark on major new social programs which merely transfer income from one group to another and they will seek ways to pare down the entitlement programs they have already erected. Only those spending programs which result in investments in infrastructure and add to overall productivity are likely to survive the competitive dismantling of the state.

"Countries that heed the new lessons of survival will grow and prosper."

Governments around the world can be expected to continue the trend toward abolishing purely "economic" regulatory activities. In the competitive dismantling of the regulatory bureaucracy, those regulations which survive are likely to be regulation of activities which have important "third-party" effects (such as environmentally destructive activities).

Not every country will heed the lessons of survival in the new economic world order. Those that do not heed these lessons will stagnate. Those that do will grow and prosper.

Footnotes

[1] This study is based largely on Richard B. McKenzie and Dwight R. Lee, *Quicksilver Capital: How the Rapid Movement of Wealth Has Changed the World* (New York: Free Press, 1991).

[2] Bureau of the Census, *Historical Statistics of the United States* (Washington, DC: U.S. Government Printing Office, 1975), p. 770; and Bureau of the Census, *Statistical Abstract of the United States* (Washington, DC: U.S. Government Printing Office, 1989), p. 593.

[3] *Statistical Abstract of the United States* (1989), p. 545.

[4] Steve Lohr, "The Growth of The 'Global Office'," *New York Times,* October 18, 1988.

[5] Water B. Wriston, "On Track with the Deficit," *Wall Street Journal,* January 6, 1989, p. A10.

[6] McKenzie and Lee, *Quicksilver Capital*, p. 69.

[7]David L. Birch, *Job Creation in America: How Our Smallest Companies Put the Most People to Work* (New York: Free Press, 1987), p. 14. The Small Business Administration estimates of growth in "small" business employment are not nearly as large as Birch's. Still, the SBA found that in the 1980-86 period more than half of the nation's new jobs occurred in firms with fewer than one hundred employees (U.S. Small Business Administration, *The State of Small Business: A Report to the President* [Washington: U.S. Government Printing Office, 1988], p. 38). The growth of small firms has also accelerated in other countries, most notably Great Britain. In Britain, the number of self-employed people expanded by 59 percent between 1979 and 1987, reaching 2.0 million in 1987. The number of businesses registered for tax purposes in Britain grew by an average of nine hundred a week in 1987, a rate triple the 1980 growth rate. This gave rise to claims that Britain was going through an "entrepreneurial renaissance," as much a change in attitude as a change in statistics (Steve Lohr, "A Small-Business Boom in Britain," *New York Times,* November 29, 1988, p. 31).

[8] Robert Reich, "Corporations and National," *Atlantic Monthly,* May 1988, p. 79.

[9] Linda M. Spencer, *American Assets: An Examination of Foreign Investment in the United States* (Arlington, VA: Congressional Economic Leadership Institute, July 1988), p.12.

[10] Martin Tolchin and Susan Tolchin, *Buying into America: How Foreign Money Is Changing the Face of Our Nation* (New York: Times Books, 1988), pp. 6-8.

[11] As reported in "The Soaring Payoff from Higher Education," *The Margin* (January/February 1990), p. 22. The same article notes that estimates of the high school-college earnings gap differ but generally show an increase in the 1980s. For example, University of Maryland economist Frank Levy estimates that in 1979 male college graduates aged 25 to 34 earned 18 percent more than their high school counterparts did. However, by 1986, the estimated earning gap had more than doubled to 43 percent. See also Marvin H. Kosters, "Schooling, Work Experience, and Wage Trends," *American Economic Review* (May 1990), pp. 308-312.

[12] McKenzie and Lee, *Quicksilver Capital*, p. 53.

[13] See William Baumol, Sue Anne Batey Blackman and Edward Wolff, *Productivity and American Leadership: The Long View* (Boston: MIT Presss, 1989).

[14] Murray Weidenbaum, *The Business Response to the Global Marketplace* (St. Louis: Center for the Study of American Business, Washington University, March 14, 1991), p. 3.

[15] David L. Littmann, "States Tax Constituents Away," *Wall Street Journal,* March 8, 1991, p. A10; and David L. Littmann, "High-Tax States Are Low-Growth States," *Wall Street Journal,* August 6, 1990, p. A12.

[16] All figures relating to government outlays as a percent of GDP were obtained from Organization for Economic Cooperation and Development, *OECD Economic Outlook* (December 1990), p. 179.

[17] OECD, *OECD Economic Outlook,* P. 180.

[18] See Lawrence Lindsey, *The Growth Experiment* (New York: Basic Books, 1990).

[19] Alan Reynolds, "The Case for Radical Tax Reform in Latin America," in John C. Goodman and Ramona Marotz-Baden, *Fighting the War of Ideas in Latin America* (Dallas: National Center for Policy Analysis, 1990), pp. 234-239.

[20] Ibid.

[21] Ibid.

[22] Calculations by James Gwartney and Richard Stroup. Reproduced in Yale Brozen, "The Cost of Bad Government," National Center for Policy Analysis, NCPA Policy Report No. 122, August 1986.

[23] Internal Revenue Service, *Statistics of Income Bulletin,* Spring 1990, Washington, DC, 1990, pp. 15-25.

[24]Tax Foundation. See also, Gary Robbins and Aldona Robbins, *Tax Fairness,* National Center for Policy Analysis, NCPA Policy Report No. 90, March 1991.

[25] Statistics compiled by Bruce Bartlett based on information provided by Price Waterhouse and Coopers & Lybrand tax guides. *Wall Street Journal,* August 29, 1989.

[26] Joseph A. Pechman, "Introduction," in Pechman, ed., *World Tax Reform: A Progress Report* (Washington, DC: Brookings Institution, 1988), p. 4.

[27] Michael Cusack, "Economics in Our Lives," *Senior Scholastic,* October 1, 1982, pp. 6,7 and 13.

[28] See Edgar Feige, "How Big Is the Irregular Economy?", *Challenge* (November/December 1979), pp. 5-13; Frank de Leeuw, "An Indirect Technique for Measuring the Underground Economy," *Survey of Current Business* (April 1985), pp. 64-72; Kevin F. McCrohan and James D. Smith, "A Consumer Expenditure Approach to Estimating the Size of the Underground Economy," *Journal of Marketing* (April 1986), pp. 48-59; and Vito Tanzi, "The Underground Economy in the United States: Annual Estimates, 1930-1980," *International Monetary Fund Staff Papers* (June 1983), pp. 283-305.

[29] De Leeuw, "An Indirect Technique for Measuring the Underground Economy."

[30] Hernando De Soto, "The Role of the Informal Economy in Peru," in Goodman and Morotz-Baden, *Fighting the War of Ideas in Latin America,* pp. 23-25.

[31] Ibid.

[32] Goodman and Marotz-Baden, "Editors' Introduction," *Fighting the War of Ideas,* p. 117.

[33] Ibid.

[34] Phillip E. Fixler, Jr., and Robert W. Poole, Jr. *Privatization 1988: Second Annual Report on Privatization* (Santa Monica, CA: Reason Foundation, 1988), p. 20.

[35] See Madsen Pirie, *Dismantling the State* (Dallas: National Center for Policy Analysis, 1985).

[36] Phillip E. Fixler, Jr. and Robert W. Poole, Jr. *Privatization: 1990* (Santa Monica, CA: Reason Foundation, 1990).

[37] The numbers are approximate because of missing data on the number of state enterprises in several underdeveloped countries. According to the World Bank study, Guinea had 65 state enterprises in 1980. During the decade of the 1980s, it liquidated or closed 16 and targeted for sale 43. Brazil had 527 state enterprises in 1980, closed or liquidated 12, targeted 155 for sale, and sold 27 by 1987. Chile had 421 state enterprises and sold 133. For information on more countries, see Elliot Berg and Mary M. Shirley, *Divestiture in Developing Countries* (Washington, DC.: World Bank, 1987), tables 1, 2 and 3.

[38] Fixler and Poole, *Privatization 1990;* and Robert Poole, "The Local Privatization Revolution," Heritage Foundation, Heritage Lectures, No. 258, March 13, 1990.

[39] Ibid.

[40] Ibid.

[41] The page counts reported in the text are not the actual number of pages, but the number of pages that would have been included if all pages in the 1936-1987 volumes were the same in terms of words per page as the 1988 volume. The actual page count for 1936 was 2,411. The number of words per page was reduced by approximately 24 percent in 1978.

[42] See Melinda Warren and Kenneth Chilton, *Regulation Rebound: Bush Budget Gives Regulation a Boost* (St. Louis: Center for the Study of American Business, Washington University, 1990), p. 5.

[43] Ibid., p. 4.

[44] McKenzie and Lee, *Quicksilver Capital,* p. 177.

[45] Ibid., pp. 145-147.

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The NCPA is the source of numerous discoveries that have been reported in the national news. According to NCPA reports:

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