The Case For Small Government

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Picture this: The U.S. government finally sells the Postal Service. As with other functions moved from the government to the private sector, the privatized post office does what the government did for about half the cost. So, with prices correspondingly lower, people spend roughly half as much as before on mail--which frees them to spend the difference on other desirable things. Because the Postal Service costs over $40 billion a year, the saving is $20 billion. By any reasonable measure, the average person in the U.S. is better off. In fact, the per capita increase in well-being is approximately $20 billion divided by 260 million citizens, or about $80 apiece.

But how does this change show up in gross domestic product? It doesn't. The government's contribution to GDP is measured not by how much value it creates but by how much it costs. So the $40 billion spent by the Postal Service counted as a $40 billion contribution to GDP. Cutting that in half through privatization may shift $20 billion from public to private hands but still adds up--under the conventions of national income accounting--to the same $40 billion. So the net effect on GDP of a $20 billion increase in economic well-being is precisely $0.00.

Obviously this is absurd. Indeed, 'gross domestic product is not a good measure of a nation's overall well-being' is what we economics professors tell our students every time we teach a macroeconomics course. (Macroeconomics is the study of employment, inflation, GDP, and economic growth.) But too many macroeconomists promptly forget that basic fact and judge an economy's performance almost solely by the growth of its GDP.

When macroeconomists look at U.S. data on real (inflation-adjusted) GDP, they notice something interesting: The economy's growth rate seems pretty stable. Many then conclude mistakenly that economic policy doesn't matter much. This tendency is bipartisan. Robert Lucas, a libertarian/conservative economist at the University of Chicago and someone who is likely to win the Nobel Prize for economics within the next ten years, once said, 'I think this economy is going to grow at 3% a year, no matter what happens. Forever .' Exhibit A for liberal economists is Paul Krugman of Stanford. In these pages (Fortune, May 1), in a piece mainly devoted to defending the welfare state, Krugman wrote: '[T]he underlying growth rate of the U.S. economy has been a very stable 2.5% right through the past five Administrations.'

Krugman asserted that any politician who claims he can raise the economy's growth rate 'by as much as three-tenths of a percentage point is naive--or worse.' Maybe, but that doesn't mean a politician can't add three-tenths of a percentage point to the growth rate of economic well-being.

Look at the numbers. Simply to have a benchmark that allows us to look at changes, assume that today's $7 trillion GDP, with its current makeup of government and private-sector production, is a measure of economic well-being. To raise the growth rate by one-tenth of a percentage point, you would have to increase economic well-being by $7 billion. Three-tenths of a percentage point, therefore, is $21 billion. Is a politician naive if he promises a $21 billion increase in economic well-being? Not at all. Privatizing the Postal Service alone could achieve that goal for one year. One more fat example along these lines: Say the Department of Defense spends $10 billion a year on a weapons system over a period of ten years. To get members of Congress to vote for that system, the Pentagon usually has to promise to have it produced in various key members' districts, even though that's hardly the most efficient use of taxpayers' money. Unconstrained by congressional pressures, let's say that the Pentagon might have been able to acquire the same quality of weapons system for $60 billion instead of $100 billion. Again, for the nation's GDP, it doesn't matter whether the government spends $100 billion inefficiently or spends just $60 billion and leaves $40 billion in taxpayers' hands. But for our economic well-being, it matters a lot. If the government procured weapons efficiently, Americans would be better off by $40 billion.

Of course, eliminating one program or streamlining procurement policies at one department would not permanently increase the U.S. growth rate. You can't privatize the Postal Service twice. But these examples just scratch the surface. The simple fact is that government has gotten so huge that just by eliminating a few programs a year you could increase the growth rate of economic well-being by three-tenths of a percentage point for at least five years.

Here's how. Assume conservatively that moving a function from the government to the private sector would lower its cost by one-third. Therefore, you would have to move only $63 billion a year in functions out of government to get to $21 billion in savings. That's only about 4% of the U.S. budget. If you did this every year for five years, you would cut the federal government's budget by about 20%.

But wouldn't a 20% cut repeal the whole of the New Deal and take us back to the size of government we had before the Great Depression? I wish. Like Henry David Thoreau, I believe 'That government is best which governs least.' In fact, cutting federal spending by 20% would take it down to the same percent of GDP it claimed in 1965. This hardly seems drastic.

Moreover, privatizing government activities isn't the only way to cut back government and make everyone better off in the process. There's another way to achieve a higher growth rate in economic well-being: deregulate. At the height of the Interstate Commerce Commission's power, its budget was well below half a billion dollars a year. But Thomas G. Moore, a senior fellow at the Hoover Institution and a leading transportation economist, points out that the ICC's budget measures only a tiny fraction of the damage this one agency has done to the U.S. economy. By keeping rates high and restricting the items truckers could carry, the ICC caused a lot of trucks to go out half full and return empty. The ICC's so-called gateway restriction also meant that if a trucker had only two licenses, one to deliver from, say, Charlotte, North Carolina, to Indianapolis, and the second to deliver from Indianapolis to Memphis, the only way he could legally deliver from Charlotte to Memphis would be to drive to Indianapolis first, even if he had nothing to deliver there. This restriction wasted millions of gallons of fuel and thousands of man-years every year. The longer delivery times that the ICC spurred by restricting entry also induced businesses to hold much higher levels of inventory than would have been needed had transportation been cheaper.

Moore estimates that deregulation under Presidents Carter and Reagan increased shippers' economic well-being by about $60 billion, most of which was in the form of lower prices. As recently as two years ago, Moore predicted that ridding the nation of federal and state trucking regulations would save shippers as much as $20 billion a year. That is happening now. Last August, Congress eliminated almost all remaining interstate and intrastate regulation of the trucking industry, and President Clinton, the House of Representatives, and the U.S. Senate have all agreed that the ICC should be abolished.

So trucking deregulation is a success. But the economy is riddled with inefficient regulations. Thomas Hazlett, a telecommunications economist at the University of California at Davis, points out that the technology currently being used for cellular phones was available in the 1960s. But the Federal Communications Commission didn't license it until the early 1980s. A study by three economists at National Economic Research Associates assumes conservatively that this one restriction on technology caused a ten- to 15-year lag in the introduction of the cell phone. The estimated cost to the economy? Some $86 billion.

The U.S. economy is also crowded with barriers to international trade. Free-trader Alan Blinder, the Princeton economist now serving as vice chairman of the Federal Reserve Board, wrote in the Fortune Encyclopedia of Economics that restricting steel imports had cost $750,000 a year for every American steelworker's job saved. Gary Clyde Hufbauer and Kimberly Ann Elliott of the Institute for International Economics estimate the total net cost of restricting textile and apparel imports to be $8.5 billion a year. And remember, those are only a couple of the hundreds of barriers that the U.S. government has put in the way of free trade. Make a bonfire of those U.S. barriers and you would easily save the U.S. economy more than $10 billion annually.

And we haven't even mentioned agriculture. The federal government has improved its agricultural policy in recent years; many price supports, for example, have been virtually weeded out. Nevertheless, the feds still restrict imports of sugar, dairy products, peanuts, and beef, and artificially subsidize wheat exports. Sugar is selling for less than 12 cents a pound in world markets; in the U.S. it costs more than 23 cents. 'You can buy U.S. wheat cheaper in Beijing than in Kansas City,' notes Daniel Sumner, an economist at the University of California at Davis and previously chief economist at the Department of Agriculture. All the agricultural supply restrictions and subsidies added together, Sumner estimates, impose a cost on U.S. consumers and taxpayers that exceeds the benefits to farmers by about $7.5 billion a year.

The view that economic policy is impotent, which is only a slight exaggeration of what Krugman, Lucas, and other macroeconomists appear to believe, isn't just wrong--it's dangerous. It can weaken our resolve to fight off particularly inefficient expansions of government control, such as the Clinton health plan of last year. The fact that the U.S. is still one of the highest-income-per-capita countries in the world is no guarantee that it will continue to be. Remember Argentina. It went from sixth-highest-per-capita income in the world in 1900 to 40th in 1990, slightly behind Iran. Bad economic policies--especially the strict price controls, arbitrary expropriations, and class warfare of the Peronistas, who ran things for decades--were largely to blame.

Bill Clinton is hardly Juan Peron, and the U.S. has a built-in stability because of its political tradition of freedom and the system of checks and balances that slows down change in any direction, good or bad. But that only means that economic policy can change slowly, not that it can't change. Economic policy matters.