ECONOMISING ON GOVERNMENT IN ECONOMIC DEVELOPMENT

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I take as my starting point the words of Jesus as recorded in the New Testament: "Render therefore unto Caesar the things which are Caesar's; and unto God the things that are God's" (Matthew 22:21). A careful exploration of the wellsprings of modern economic development leads to a third admonition: render unto the market that which is the market's.

That which is Caesar's is the use of State power to enforce behaviour that private citizens would not choose of their own accord but which is necessary for economic development in the whole society. It is the use of State power to internalise external costs and benefits of individual decisions. Whatever the private gains from the corrupt use of a public office for private gain, or from theft, or from breach of a contract to deliver to another some goods or services, or from the appropriation of some property that another owns, or from the application of violence in ones private relations with others, these activities impose costs on others that exceed in quantum the private benefit. The removal of these external costs through the exercise of State power leads to an expansion of utility in society as a whole. In addition, whatever the private advantages in enjoying benefits of collectively consumed services provided by others without contributing to their production, an optimal amount of such services will only by supplied if the power of the State is used to collect taxation and directly to provide the public goods. Thus the essential role of the State is the exercise of power to force the internalisation of external costs and benefits of private behaviour. Of course the coercive power of the State may be used foolishly or maliciously, so that it does not achieve its necessary purposes. But if the human material condition is to improve over time, there is an essential, irreducible amount of public goods that must be supplied by the State.

The role of God in economic development is to provide internal constraints on individual behaviour, so that private citizens voluntarily go some way towards avoiding behaviour that imposes unrequited costs on others, and some way towards expanding behaviour that generates unrequited benefits for others. By "God" I do not here refer to any particular conception of a deity, but rather to the origins of the sets of beliefs, social institutions and values that shape an individual's voluntary interaction with others in society. The formation of such beliefs and values, shaping and reinforced by institutions and ritual, is indistinguishable from the formation of human civilisation. At times in human history, such values formation was promoted by the State and interacted intimately with State power: in varying degrees we see this tendency in the God-Emperors of East Asia; the partial deification of Alexander or Iskander after the Greek conquests in Western Asia, and more generally in the religion of ancient Greece and Rome; the Jewish kingdoms of the old Testament; the divine right of kings in Western Europe at the dawn of modernity; the Caliphates; the Inca and Maya civilisations of the Americas. In some places, most importantly in East Asia, notably China, the religious content of the beliefs and the institutions and rituals with which they were associated became marginal to their social roles—contrast Confucianism with the durable sources of values in other pre-modern societies. The eminent Jewish scholar of the religions of the Middle East, Bernard Lewis, notes that the communist states of Europe (and, we might add, Asia), while atheist, had a creed, and a state church complete with scriptures and dogmas, prelates and hierarchs, orthodoxy, heresies and, above all, an inquisition (Lewis 2004 pp 56-57).

Sometimes the processes of religious belief and value formation took on lives of their own, so that the values came to stand apart from and to be applied to judge the State and its officers. This tendency was encouraged as the geographic reach of a successful State, expanding by conquest (or more rarely voluntary association), extended to encompass widely different societies with different belief systems. No case was more important than the expansion of the Roman Empire through the region that the Romans came to call "Asia" and, later, the British the "Near East". This was the original context of Jesus' declaration on the separation of church and state, which underpins what has emerged as the most congenial environment for modern economic development, the secular State. But even in societies governed by the secular State, the values that cause individuals to constrain private maximising behaviour in the interests of others play an important role in the functioning both of the State and of markets. Not all of the assumption of power of the great despotisms of antiquity and modern totalitarianism, combined with all of the technological capacity of advanced modern economies, together with unprecedented dexterity in the skills of Government, would allow the exercise of State power alone to lead to sufficient internalisation of external costs and benefits of private decisions, to support modern economic development. Everywhere it must be supplemented by personal honesty of citizens, and on the part of the individuals through which State power is enforced, forebearance in the use of State power for private ends.

The comprehensive absence of such forebearance by the individuals through which the power of the State is exercised is the distinctive feature of the thoroughly underdeveloped society and economy. In such conditions, a start cannot be made on providing the basic conditions for economic growth.

And then we must leave to the market that which is the market's. By "the market" I mean voluntary exchange between individuals, or between groups of individuals who have chosen to come together for some purpose. Because it is voluntary, market exchange will not occur unless participating parties all judge that they will benefit from it. It is thus in its nature conducive to raising material well-being, so long as it is accompanied by conformity with internal (values) or external (State) rules that lead to the internalisation to participants in exchange of the external costs and benefits of their activities, and by mechanisms to provide the necessary minimum of public goods.

This is more complicated than it seems, as the operation of a market requires the effective application of internal or external rules that ensure respect for or enforcement of property rights and contracts. This, in turn, requires other rules about currencies and measurements and standards. So Adam Smith at the beginnings of modern economics and the global market economy drew attention to the necessary minimum of public goods that must be supplied well if markets were to deliver rising living standards through the operation of an "invisible hand". It is no accident that Smith was Professor of Moral Philosophy, and well known in his own times for his representations on the role of "moral sentiments" as well as for his seminal insights into the contribution of markets to economic development.

The Interaction Between Caesar, God and Markets in History

Human society in its earliest forms contained some capacity to generate and perpetuate values that were conducive to constraining private behaviour in ways that supported internalisation of external costs and benefits. Human society in these times also developed some capacity for public coercion of individuals in the community interest—that is, for Government. But in those paleolithic times, the maximum size of communities was small, allowing personal contact to be maintained amongst most of the people who shared a polity. It was a big step to expand notions of personal obligation to personally distant and therefore abstract elements of humanity. So the development of cohesion within and effective Government across large communities—the development of a sense of obligation to an over-arching State—was slow to develop, and did not develop at all where there was no large and immediate advantage in it.

Some historical circumstances and economic environments were more conducive than others to the development of the qualities that were necessary to support an overarching State. Undoubtedly the differential development of values and State organisation across societies was affected by chance, by opportunity to exploit at great profit an exceptional agricultural resource, by necessity born of disaster, by the uneven dispersion of intellect and genius, by the path-dependant nature of institutional development, and by location in relation to major concentrations of humanity. Once the process had begun in some places, location within the large, populous and ultimately traversible Eurasian continent, and the Middle East crossroads within it, had advantages over all other locations. The rates and nature of development of values and Government capacities that were conducive to rising living standards were influenced powerfully by the ruthless forces of competition for resources, war and conquest, as well as by the human capacities for change and choice. Higher rates of technological innovation and productivity and incomes growth came to be associated with establishment of order and movement of people, goods and services over larger areas and populations. More often than not, expansion was associated with conquest, which was itself not unrelated to capacity for effective Government.

Where the particular forms of Government and values were conducive to it, the establishment of minimum functions of Government and the beginnings of market exchange, led to acceleration of economic development—though to modest rates of change until the extraordinary developments in human values, institutions and knowledge of which the work of Adam Smith was both effect and contributing cause. The system of Government did not need to be ideal for progress to be made, or else humans would still be living the poor, ignorant and short lives that were the common lot of their early forebears. But Government provision of some basic services, including maintenance of order, did need to be effective. And the intrusion of Government into private affairs did need to fall within an optimality band, between oppression on the one hand, and anarchy and disorder on the other.

In the contemporary world, after two and a half centuries of modern economic development, and half a century of extraordinarily rapid growth after the dissolution of the Empires which spread but constrained participation in modern economic life, we see vastly different need and capacity for Government services as a condition for growth across countries and societies. The needs are greatest but the domestic capacities least where value systems conducive to internalising external costs and benefits are weakest. There are also several reasons why more Government is necessary and costs of providing Government higher where populations and economic activity are sparse than where they are dense, which also tends to concentrate greater needs in the underdeveloped societies in which the scarcity of resources of Government are greatest. By their nature, public goods are supplied at lower cost per person in the population that they serve in larger polities. A small and sparsely populated country may be small and sparsely populated because of geographic fragmentation, which means that the overhead costs of many public goods must be repeated across regions. The presence of effective competition reduces the need for Government regulation of economic activity, and competition is possible across a wider range of economic sectors where populations and economic output are larger and more dense.

And a more densely populated economy, with its comparative advantage initially in labour-intensive activities, will generate a more equitable distribution of the gains from international trade and economic growth in the early stages of economic reform in preparation for modern economic development. The latter is important for maintaining political cohesion and stability around a development strategy involving opening to the outside world, which is conducive to economic growth. The achievement of equity through redistribution by Government, rather than through its emergence through market exchange, is demanding of scarce resources of Government.

High quality human resources that can deliver effectively the services that are best provided by Government—public goods—are everywhere scarce and valuable, and limitations on their availability are everywhere a constraint on growth. They are more scarce and valuable, and constrain growth more, in underdeveloped economies and polities with no history of loyalty to or respect for, or effective operation of, an overarching State. They are most scarce and valuable in small, geographically fragmented economies.

The realities that effective provision of public goods is necessary for economic development, but that resources for their supply are scarce, mean that resources need to be applied where their marginal products are most valuable. Economising on Government is a central challenge of development strategy.

The central importance of economising on government in economic development is reinforced by reference to some characteristics of the economies in which the world's poor people, and therefore the global development challenge, are disproportionately concentrated. Less than four decades ago the poorest people of the world were overwhelmingly concentrated in Asia, particularly China and South Asia. Today there are many more poor people in Africa than in China, despite the latter having several times the population. Despite some more hopeful recent signs for development in parts of Africa, that continent will soon hold more poor people than South Asia. On the current trajectory of economic growth, within a generation people living in extreme poverty will be overwhelmingly concentrated in Africa. This is a region in which the absence of history of an effective over-arching State is part of the reason why economising on Government is a matter of high and urgent priority. Within the Asia Pacific region, equally strong conclusions can be drawn about the importance of economising on Government in the small island states in the arc around the northern coast of Australia, from East Timor across Papua New Guinea to Samoa—a matter of great importance to Australia, Indonesia and New Zealand in the immediate neighbourhood if not to others.

Problems With the Aid Paradigm

The common contemporary forms of international development assistance give some recognition to the inadequate supply of good Government, but in practice tend to exacerbate the problem. The main difficulty is that they expand the activities undertaken within the public sector, and therefore increase the demand for the scarce human resources required to deliver good Government services. Inevitably, resources are attracted from centrally important to less valuable activities. They tend to reinforce the attitude that Government needs to provide the wide range of services that are supplied within the public sector in the developed donor countries.

Some quality of the human condition has placed some talented and public spirited people, often with enough formal education to learn more on the job if the institutional environment provides models of good practice, in even the poorest countries with the weakest governance systems. The supply of such resources is nurtured by experience within an effective institution. There are a few examples of effective nurturing of such talent within development assistance programmes, for example through the secondment from the Australian Treasury and Department of Finance of experienced officers to work with domestic talent within the central agencies of countries in Australia's immediate neighbourhood.

The supply of human resources for effective delivery of Government services expands slowly in the best of circumstances. The generation of high quality resources requires experience within good Government institutions, at home or abroad. Expansion is encouraged by political, economic and public sector stability over long periods.

Augmentation of capacity to supply Government services is an integral part of economic development over time and may be strengthened by well designed international development assistance. But it is naïve to imagine that supply within a poor developing country with weak Government systems would extend beyond capacity to meet the most basic requirements for public goods for many years into a successful development process.

Easing the Government Constraint: the Demand for Government

Once economising on government is seen as a central element in development strategy, there are opportunities significantly to reduce the amount of Government required to expand economic output. I will list a few of the more important of them

First, free trade in goods and services reduces demand for Government. This is obvious in relation to the personnel and other resources required to develop policy for and to administer a system of protection, but the sources of reductions in requirements for government extend beyond the obvious. Most importantly, free trade, especially if it is supported by free movement of capital and skilled personnel, expands the range of economic activities in which effective competition removes the need for regulation by Government. In addition, free trade in services may allow distant communities within the country to use utilities in neighbouring countries when similar services could not be supplied at home due to small scale of effective demand. Telecommunications and transport services provide examples.

Second, it is possible to free ride on other Governments' provision of some important services, thus making domestic resources available for other applications. For example, an independent monetary system with its own central bank absorbs a large amount of highly valuable human resources. Operation of a currency board, relying on the central banking services of an appropriately selected advanced economy, is likely to achieve monetary outcomes that are at least as and in all likelihood considerably more suitable for development. Open admission of business institutions that are regulated in their home countries reduces demand for Government in regulatory functions—just as New

Zealand's openness to foreign banks allows it to rely on others' supervision. Some economisation on Government is possible with open access to international transport and telecommunications services. For health and education, open access to international services can readily meet requirements at the high end of incomes and demand for quality, and in specialised areas where the cost of domestic supply would be particularly high.

Third, there can be economisation in use of the highest quality, scarcest and most valuable Government resources—high level policy-making within the central agencies—through the use of rules of thumb rather than fine judgement in many areas of policy. The resource savings from free trade and the use of currency boards are special cases of this general phenomenon. While there may be some special circumstance, based on second best means of internalising externalities, for some small departure from pure free trade, no Government, least of all that of a poor developing economy, is likely to define the case and successfully design and implement policy to take advantage of it. The effort to develop the discretionary policy will absorb large amounts of scarce Government resources. Similarly, while there will be some circumstances in which discretionary policy developed and administered within an independent central bank will be better for development than the absorption of sound monetary policy from an external monetary system through a currency board, these occasional advantages are likely to be greatly outweighed by periods in which misjudged discretion has led to monetary instability. Meanwhile, the management of the national monetary system will have absorbed large amounts of valuable human resources. The advantages of simple rules over sophisticated discretionary policies are present in fiscal policy, where the rules of thumb can embody elements of automatic stabilisation in response to large fluctuations in Government revenue through variations in the terms of trade. They are present as well in regulating prices charged by private monopolies (of which there may be several if the private sector is used widely in delivery of services), and in regimes designed to encourage privately owned utilities to expand the provision of services to larger numbers of citizens.
Fourth, and most importantly of all, Government can choose only to provide those services that are most important to development. The irreducible minima include the

central State functions of collecting revenue and managing its application. They include the provision of an effective legal system, encompassing citizens' personal security and enforcement of the contract and property law upon which large-scale market exchange depends. They include at least the management of systems for funding and delivery of such public goods as the transport and communications that are necessary for widespread participation in modern economic activity, and the education and health that are necessary for participation in society, even if the Government itself is not the institution through which services are delivered. Careful selection of priority areas for Government activity would make it more likely that the most essential and productive functions of Government would be supplied effectively.

A variation within this theme would see the use of private entities—domestic or foreign, and in a poor developing economy the domestic private capacities would be limited-- to deliver services wherever this was feasible. For this to be effective, the central agencies of Government would need to develop legal and regulatory frameworks that aligned the incentive structures facing private entities with the requirements of development. This is much more straightforward when the service to be provided has value to identifiable private users with capacity to pay full costs, and whose access to services can be made conditional on payment. It is more challenging—but meeting the challenge generates high returns--when there are development benefits and costs in extending services to communities whose members' access cannot be made conditional on payment, either because of the characteristics of the service or financial incapacity. Delivery of services to communities which lack capacity or mechanisms to pay for them can be secured through subsidies to private entities if the incentive structures are designed with care. Private entities can function effectively in weak and underdeveloped communities in which the scarcity of resources necessary for good Government is acute, because they rely less on loyalty to a distant State, they are more likely to provide institutional stability over long periods, they more readily embrace remuneration structures that retain, expand and enhance scarce skills, and they can more comfortably lean on external entities to fill gaps in the domestic supply of human capital.

Development Strategy and Aid for Economising on Government

A generation ago, the global development problem had at its centre the requirements of economic growth in the populous countries of Asia. For the most part, these were societies with considerable experience of an over-arching State and substantial supply of the human resources that were necessary for the provision of the public goods that were necessary for development. The challenge was to apply policies that were conducive to development—monetary and fiscal policies to generate stable economic conditions, open policies on trade and investment, establishing conditions for large-scale market exchange, introducing efficient mechanisms for raising Government revenue and monitoring its expenditure. Over time, the lessons of experience at home and abroad and the evolution of the domestic policy discussion under the pressures of political insecurities and international comparisons of performance, led to the adoption of superior policies, most importantly by China from 1978 and India from 1991.

The success of the largest Asian countries leaves the problems of extreme poverty concentrated increasingly in the societies with little historical experience of an overarching

State and limited resources for effective Government. Here more than in other countries, economising on Government has to be at the centre of a successful development strategy. In these circumstances, successful international assistance policy will be designed to support economising on Government, and will avoid measures which have the effect of deflecting scarce Government resources from the uses in which their value is highest.

REFERENCES

Lewis, Bernard, 2004, *From Babel to Dragomans: Interpreting the Middle East*, Oxford University Press, Oxford and New York.