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AN INTRODUCTION

OWEN E. HUGHES

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The Role of Government

Introduction

What government should or should not do, and having some familiarity with theories about the role of government is of fundamental concern to public managers. In mixed economies there must be some demarcation between those activities that fall in either the public sector or the private sector. The dividing line varies between different nations and at different times, but, in recent years, it is definitely moving away from the public sector and towards the private sector. This transfer of resources and functions to the private sector obviously affects those who work in the public sector or rely on it in some way. If a public activity is less valued by the community, if activities historically provided by governments are being marketised, the rationales for doing these things are of obvious interest to public managers.

Since the mid-1970s, most OECD nations have undertaken a reassessment of the role of their public sectors. Those who believe in the model of the free market as the basis for a more dynamic economy argue that governments are currently involved in activities which are inappropriate and that the size and role of government must be cut back drastically. The current debate on the role of government mainly concerns its economic aspects: should it provide the goods and services it does, or should some be handed to the private sector? Should it subsidise or regulate to the extent it does? All such questions raise also the very political matter of how the various members of the community perceive and value the things government does.

There is a much broader debate to be found behind particular arguments about the public sector. For example, the 1980s saw an extensive debate about privatising public enterprises, notably in the United Kingdom, associated with an extensive privatisation programme. This might be regarded as a narrow debate about government business activities: but the positions of the participants are fundamentally determined by how they view the public sector in general. The same broad debate may be behind attempts to reform public sector management and to control spending better. The trend towards a market-based public sector may reflect concerns about the role of government, as much as worries about the efficiency and effectiveness of the bureaucratic model (Chapter 2).

If the debate a few years ago was mainly concerned with the *size* of government – and this concern has not completely disappeared – there are now more questions about the *role* of government. The scale of government activity is important, but there are broader questions involved in what government does, as it affects the economy and the society as a whole.

Governments have a variety of roles and their full scope is not easily measured. It is no exaggeration to say the public sector affects the entire economy and society. Without a legal framework to enforce contracts, private business activity would not work. Regulations, taxes, permits, infrastructure, standards, conditions of employment all affect decisions made in private markets. The public sector is a large purchaser of goods and services from the private sector. Government redistributes income from better-off members of the society to those who are not. The public sector has a crucial role to play in determining real living standards which depend for most people on government services – the quality of schools, hospitals, community care, the environment, public transport, law and order, town planning, and welfare services – at least as much as the quality of consumer goods and services. In addition, government 'influences national economic efficiency, the rate of technological and organisational innovation, the direction and speed of structural adjustment, and the cost, to users, of unpriced resources like the environment' (OECD, 1991a, p. 7).

The role of government may be more important now than ever before. Osborne and Gaebler argue (1992, p. 33) that if corporations are to succeed in today's global market, they need 'the highest quality "inputs" they can get – the most knowledgeable workers, the most groundbreaking research, the cheapest capital, the best infrastructure' and that this 'makes government's various roles as educator, trainer, research funder, regulator, rule setter, and infrastructure operator far more important than they were thirty years ago'. The increased concern with competitiveness (Chapter 1) means that governments need to work better, at a time in which what they should do is under greater questioning. It is not that governments should have no role, but rather to decide what that role should be.

As will be seen, there are various theories for deciding those functions that should be provided by government. Some argue that only goods or services that cannot be provided by markets should be provided by governments. On the other hand, it could be argued that as government is the embodiment of the will of the people as expressed through the political process, there should be no limits to its scope.

The public sector

By convention, the economy is divided between the private and public sectors. The public sector is defined by one author as 'engaged in providing services (and in some cases goods) whose scope and variety are determined not by the direct wishes of the consumers, but by the decision of government bodies, that is, in a democracy, by the representatives of the citizens' (Hicks, 1958, p. 1). This definition does not capture the full scope of public sector activity, but it does contain the key point that the public sector is the result of public, political decision-making, rather than involving market processes. Governments are command-based – they can force people to comply – whereas markets are voluntary.

Stiglitz (1989, p. 21) argues there are two distinguishing features of government, the State:

> The State is the one organisation membership of which is *universal*, and the State has powers of *compulsion* not given to other economic organizations. Individuals choose to be members of clubs, they choose to buy stock in a corporation, they choose to work for one firm or another. . . . But by and large, individuals do not view the country in which they live to be a matter of choice, and, having chosen to live in a particular country, they become subject to the State. The fact that membership is compulsory gives the State a power of compulsion which other organisations do not have. . . . More generally, all transactions between parties other than the State (other than theft and 'accidents') are voluntary.

Stiglitz goes on to argue (p. 22) that while governments have this power of coercion, in democratic societies 'government relies for the most part on voluntary compliance'. Despite this, it is universal membership and compulsion that makes government different from the private sector.

Although the private and public sectors are usually seen as quite separate, the division of the economy into two mutually exclusive sectors may be artificial (McCraw, 1986) and there is so much interaction between the two that setting up a strict dichotomy is rather misleading. It could be argued that the modern capitalist economy is a 'thoroughly mixed system in which public and private sector forces interact in an integral fashion' and the economic system is 'neither public nor private, but involves a mix of both sectors' (Musgrave and Musgrave, 1989, p. 4). The private sector relies on government for infrastructure and the system of laws, without which markets could not operate. Government relies on the private sector for the production and supply of goods and services, and for tax revenue. The interaction between sectors is more subtle than simply seeing them as separate and necessarily antagonistic.

Discussion of government and politics is usually about the interplay of parties or political leaders, but there is little attention paid here to the more overt forms of politics. The focus is on that part of government concerned with how the administrative system translates political processes into outcomes for the community. By any definition, government must include the staff employed by the state to carry out the instructions of the elected government, and to administer or manage its institutions. The political process may set the agenda of politics, but the detail is left to the administration. Even if government is everywhere in modern society – it would be virtually impossible for an individual to exist completely removed from government – contact with government by most people is not at the political level, other than on the occasion of voting. The vast bulk of the day-to-day governmental dealings of an ordinary citizen is performed by the bureaucracy. Government outputs are many and varied. They include: the supply of goods and services, ranging from roads to hospitals; the imposition of taxation; the transfer of money from one set of citizens to another; the relationship with other governments; barrier controls over people and goods; and the implementation of laws or regulations which are themselves multifarious. The administration is, for most people, the reality of government.

All government activities require organisation and staff – the public or civil service. But the operations of the bureaucracy, its theories and principles, are not well understood and there is a curious ambivalence in public attitudes towards it by the citizenry. At the same time as there are demands for governments to do more and to do so more effectively and efficiently, the public services are often seen as parasitic on the private sector. Rather than being seen as an instrument of the people, the public service is regarded with suspicion both for its power and for red tape, delay and inefficiency. At the end of the twentieth century, there seems to be great uncertainty as to the role of the public sector.

Instruments of government

An instrument of government is the way it acts, the mechanism used when government action is justified in some way. Most government intervention can occur through four available economic instruments: (i) *provision*, where the government provides goods or services through the government budget; (ii) *subsidy*, which is really a sub-category of provision and is where the government assists someone in the private economy to provide government-desired goods or services; (iii) *production*, where governments produce goods and services for sale in the market, and (iv) *regulation*, which involves using the coercive powers of the state to allow or prohibit certain activities in the private economy. The use of these has varied over time and according to the particular government function.

In the mercantilist era, the main instrument used was government regulation, as budgets were very small and there was little government production. The era of the welfare state relied heavily on government provision of goods and services through higher general taxation and redistribution of resources to the poorer sections of society. Government production was relatively high in some countries, such as the post-war United Kingdom, when it was believed that, through nationalisation, there would be benefits from government ownership of major industries such as steel, coal and utilities.

There are particular instruments which suit the basic functions of government. For example, the maintenance of competition and protection of natural resources functions are most often handled by regulation, and the resolution and adjustment of group conflicts is quite clearly a matter of law. The provision of collective goods and services and providing economic infrastructure is usually a matter of provision, although in some circumstances production has been used. Governments may use other means than these four instruments, but they are relatively unimportant. There may, for example, be government persuasion without any overt action. Laws can be passed which have no direct economic impacts – over moral issues, for example – but these four instruments do capture the major ways in which governments can act and where most current controversy is to be found. Although governments can and do affect the lives of their citizens in many ways, the current debate over its role and size seems fairly narrowly confined to their intervention in the modern mixed economy. Each instrument will be considered separately, although government *production* only briefly as that is the subject of the following chapter.

1. Government provision

Direct provision by government through the budget forms the major part of its operations. The budget sector is also known as the 'general government' sector and includes those areas of government which are funded by taxation rather than user charges: that is, which provide non-market goods and services – roads, defence, education, health and social welfare. These include transfer payments where the government does not finally spend money but redistributes it from one class of taxpayer to another. Most government activities occur through direct provision and are set out in the budget.

Through the budget government tries to determine the level of public activity in the economy, a reasonable distribution of income and wealth, and to provide some control over the overall level of economic activity. These are usually described as policies for allocation, distribution and stabilisation.

Allocation Allocation policy is concerned with the relative size of the public and private sectors. In other words, the budget sets out both the overall level of government activity and specifies which activities are to be carried out publicly rather than privately. Both government expenditure and taxation policies influence the allocation and distribution of resources in the private sector. For example, a decision to raise public expenditure on road construction will have widespread effects on the private sector by directing benefits to contractors, concrete manufacturers and their employees.

Arguments about the size of government are really about the system of allocation. The view that government spending and taxing consume too high a proportion of economic activity, suggests there may be a distribution between sectors which is better than the present one. When a government controls a large proportion of economic activity, shifts in its spending have a substantial effect on the private economy. The amounts involved are large – often more than 40 per cent of the economy – and government spending levels became controversial from the latter 1970s onwards when it was argued that government controlled too much of the economy. However, allocational decisions cannot be made precisely. There is really no *a priori* or explicitly rational level of government spending and taxing which all citizens accept as fair and reasonable. All a government can do is intuitively compare the electoral costs of imposing particular levels of taxation, with the electoral benefits of expenditure. There is certainly a trend towards reduced government spending. Some argued in the 1970s that government spending would continue to increase, and government could go bankrupt (Rose and Peters, 1978), but this prediction has not proved correct. It seems that spending was increased in accordance with public demands and has been reduced – with a lag – in response to complaints about taxes.

Distribution Distribution policy represents the government's attempt to redress to some degree the inequalities in wealth and income between citizens. The major part of distribution policy is the provision of social welfare, including transfer payments to certain classes of citizens, but all other budgetary decisions have some distributional consequences. A tax benefit given to a particular group, such as farmers, is distributional in exactly the same way as are direct payments for social security. As with allocational decisions, the level of transfer payments and the effects on particular groups cannot be determined technically. Musgrave and Musgrave (1989, p. 10) argue: 'the answer to the question of fair distribution involves considerations of social philosophy and value judgment'. Some on the Right even argue that a fairer distribution necessarily leads to a poorer economy by reducing profitability and investment. In practice, as there is no agreement on what a desirable distribution between sectors or income groups should be, arguments about 'fairness' in distribution are inherently controversial.

Stabilisation Stabilisation policy is where the government aims to improve the overall economy through budgetary policy. This is probably the most difficult economic function. All government spending and taxing decisions have marked effects on the private sector as well, so by varying these policies and their aggregate levels, an attempt can be made indirectly to influence the entire economy. With the advent of Keynesian economics, governments explicitly accepted responsibility for promoting full employment, price stability, economic growth and a stable balance of payments.

Fiscal policy is important for providing stability for the economy. Although spending and taxing have economic effects of their own, the net balance between them – the deficit or surplus – is of major importance. Keynesian economic theory argues that if the budget is in deficit – expenditure greater than revenue – the overall effects are multiplied so that the whole economy can be stimulated. If the economy is overheated, then the government can, in theory, budget for a surplus which will slow the economy. The budget balance can also have effects on the net debt position of the government, and can cause reactions in the private sector, especially in financial markets. A large deficit can lead to higher interest rates as the government must borrow, either domestically or overseas, to finance any budget shortfall. This may cause interest rates to rise.

However, there has been a change in the intellectual respectability of the Keynesian model. Relying on the government budget to manage the economy originally represented an economic revolution in that budgets did not have to be balanced every year. By varying its budget balance a government could, in theory, ameliorate the damaging affects of the boom and bust business cycle. The Keynesian model promised much and was successful for some time, but the coincidence of high inflation and high unemployment in the middle 1970s produced a reassessment. There is now a move away from Keynesianism towards 'neo-classicism', with the emphasis placed on reducing government, balancing the Budget and letting market forces find a desirable economic equilibrium. There has been shift away from theoretical unanimity among economic policy-makers. Their opinions now cover a wide spectrum, from those who argue that fiscal policy is virtually ineffective, to those who aver that fiscal policy is the most important and effective of policy weapons.

The current status of the stabilisation function of the Budget is uncertain, but governments still try, in general, to formulate their Budgets to improve the economic condition of the nation. There are several limitations to the success of stabilisation policy. The overwhelming proportion of the Budget comprises fixed commitments (usually more than 90 per cent), so that little variation in spending is possible in the short term. Also, if Budget deficits become too common, as in the 1970s, then politicians may be tempted to run continuous deficits for reasons of political expediency, which in turn produce adverse economic effects in the long run, such as a tendency towards inflation.

2. Subsidy

Subsidies vary widely but could include subsidies to farmers or industry, or to private bus companies or private schools. The private sector provides a particular good or service, but with some assistance from government.

Although part of the funding is public, the detailed administration takes place in the private sector with governments mainly involved in monitoring that their money is being spent in approved ways.

In practice, it is hard to separate the category of government subsidy from that of government provision. The amount of subsidy appears in the budget just like provision. One conceptual difference could be that provision means that government organisations normally provide the service. There are some problems with this when it comes to the contracting out of goods or services. Is it government provision or subsidy when a private firm builds a road or a bridge using government funds? The government is not doing the building but is providing the funds. Perhaps the division between provision and subsidy could be that the latter provides *assistance* to the private sector for things which would be produced anyway. Even this is problematic in that subsidy to farmers often results in far more production than would have occurred without government assistance. So, although subsidy is conceptually different from provision, in practice the two categories may collapse into one.

3. Production

According to the Musgraves (1989, p. 9), a clear distinction must be made between public provision for social goods and public production. Unlike provision, production takes place away from the government budget, and users are charged in the same way as if the items were provided by the private sector. For example, electricity supply or rail services are government-owned in some countries. These services are sold to consumers and use is precluded if consumers are unwilling to pay. Some European countries such as Austria and France have large public enterprise sectors so the amount of government production is quite high; the United States has very little. Public enterprises may receive loans or advances from their respective governments but their receipts and expenditures are not included in that government's own budget.

As might be expected, there is rather more controversy over the role of the public enterprise part of the public sector and, in fact, there is a worldwide trend away from public enterprise by the process of privatisation (see Chapter 5).

4. Regulation

Regulation means using laws made by government to affect the private economy in some way. Another definition sees it as 'a particular kind of incentive mechanism, namely, that set of incentives based on mandated actions and the explicit threat of punishment for non-compliance' and as 'a specific kind of relationship between a government and its citizens' (OECD, 1992a, p. 10). This is not helpful. Regulation does mean using the power of the law for an economic purpose and is distinct from the other instruments for this reason. The issues of incentives and so on are, of course, important and point to regulation being one of a set of alternatives, but there are so many kinds of regulation that their defining characteristic must be *how* they are imposed.

Regulation essentially involves allowing or prohibiting activities in the economy through the legal system, e.g. setting tariffs, granting licences or permits and regulating the labour market. A government has coercive power, and this is the fundamental difference between it and the private sector. The power of law, reinforced in the final analysis by the police and the army, can be used for many purposes, including intervention in the economy. Regulation can vary from the minor and non-intrusive – the collection of statistics, for example – to blanket prohibition with very high penalties such as for smuggling drugs.

Regulations can be either economic or social with the former aimed at encouraging business and other economic actors to undertake certain activities and to avoid other activities. Social regulation is usually seen as attempting to protect the interests of citizens and consumers, especially in regard to quality standards, safety levels and pollution controls. Regulation of the business sector is widespread: there is financial regulation which can include interest rates, exchange rates, foreign investment as well as broader corporate regulation, including rules for company registration. There is often price regulation, quantity regulation, quality regulation and various product or packaging standards. Particular professions are often licensed and businesses must comply with occupational health and safety and environmental standards. Finally, there is usually some kind of trade practices or antitrust legislation to enforce competition within private markets and to restrain any tendency to collusion and monopoly.

There is some controversy over the role of regulation in the economy. With all the government rules applying to the private sector, it is little wonder that part of the reforms to the public sector in recent years has been to improve regulatory arrangements. There is a widespread feeling that there is too much regulation and that regulations have become too intrusive, stifling business and indirectly affecting competitiveness. Many countries have implemented regulatory reform efforts, partly because detailed controls offend to some degree the values of democracy and partly because there is so much regulation that it has become ineffective. The regulatory reform process is 'part of a larger movement in public management towards a *new pragmatism* that emphasises results over actions, outputs over inputs, policy consequences over policy instruments' (OECD, 1992a, p. 9).

Changes to regulation and the regulatory system are part of the managerial agenda. Already, much economic regulation, that is, regulation explicitly intended to affect entry, supply or pricing decisions in the private sector, has been eliminated or revised in a number of countries.

Which function to use?

There is no simple answer as to which instrument of government policy is preferable. Different instruments have been invoked by particular theories and at different times. Countries without a history of government provision, notably the United States, do have a long history of government regulation. Depending on how tight regulation is in practice, a government could be almost as intrusive as if it was providing the good or service itself. Also, the instruments of public policy need not be mutually exclusive. Combinations are possible, with the precise mix varying between various nations.

However, there is reason to suggest a major change is currently taking place in the preferred instrument of government. In recent years, there has been a shift away from government provision with budget cut-backs being quite general. There is an expectation that further cuts will ensue and there is unlikely to be any serious expansion of government provision. There is also a difference in the way that government services are provided, with this occurring less often through the public service and more often through the private or voluntary sector, through contracts. Bureaucratic provision is not necessarily the only way governments can act. This trend by governments is often referred to as 'steering, not rowing' (Savas, 1987), that is separating policy from delivery. Osborne and Gaebler became well-known for advocating this in their 1992 book, *Reinventing Government*, which became a worldwide best-seller. However, as even they argue, provision through contract is still provision by government (1992, p. 45):

> Services can be contracted out or turned over to the private sector. But *governance* cannot. We can privatise discrete steering functions, but not the overall process of governance. If we did, we would have no mechanism by which to make collective decisions, no way to set the rules of the marketplace, no means to enforce rules of behaviour. We would lose all sense of equity and altruism: services that could not generate a profit, whether housing for the homeless or health care for the poor, would barely exist.

The shift away from the public services to contracts should not be seen as a reduction in provision. Rather it is a change from delivery by the public service to delivery by the private sector of a government service.

There is also a major shift away from public production of goods and services through privatisation (Chapter 5). As an instrument of government policy the idea of production certainly lost favour. On the other hand, there has been an increase in public regulation but a shift in its character from the restrictive role of regulation, which was often anti-competitive, towards pro-competitive regulation to force the private sector to be more efficient through competition.