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## **The Economic Impact of an Oversized Government**

**Author: Fidelis Antonio Fantin Junior  
Advisor: Professor Kathryn Newcomer**

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## 1. Introduction

The scope of action of the public sector in Brazil has broadened steadily in the last decades. The concern about the constant increasing tax-burden in Brazil has been growing year by year, as the economy feels the weight of taxes raising prices and reducing investments. But, paradoxically, when the media touch this matter, usually the articles approach the increasing public revenues as a good accomplishment by the government.

High revenues are seen as a good thing mostly because there is a great deficit to be covered, a large debt to be paid and uncountable “social demands” that many people believe should be solved directly by the government. Particularly in the case of the public debt, to find revenues to stop it to increase is though necessary, but there are bad consequences of raising taxation for the productive sector, hence needs to be limits for that.

Besides, many people see the increased revenue of the government always as a good thing, especially because they think their demands are more likely to be granted. They don't realize or don't care that the money that is given to the government has been taken from the pockets of the consumers, the producers and the investors.

According to IBPT<sup>1</sup>, a Brazilian institute that make research on taxation issues, the tax-burden in Brazil has raised from 25,09% of the GDP in 1993 to amazing 36,11% in 2003, and in the first quarter of 2004 the burden reached 40,01% of the GDP.

The investor, the workers and the consumers are always paying that money, in one way or another. The consequences are most of the time hidden from the public in general. This paper intends to unveil these consequences, and clarify to the reader how large intervention has led Brazil to a situation of slowness in economic growth and economic development. I hope, at the end of this paper, help people to understand that all revenues that the government gains correspond in the same amount that investors and consumers lose, with bad consequences for the economic activity and development.

Moreover, the efficiency of solving some sorts of socioeconomic problems through the hands of the government is something to be doubted. Despite that inefficiency, the public sector has been trying to provide private goods because some people believe the government can create and distribute wealth, forgetting that for the government to provide goods and services it needs to take resources from the taxpayers that run the economy. Besides, there is some danger in concentrating power in the hands of the public administration, because politicians, bureaucrats, citizens and organizations, although acting allegedly with only good intentions, may be affected by the human nature that can lead many of them to act in self-interest, with lack of motivation or competence, increasingly using public resources wastefully, in disregard with the consequences for the economic development or even against the interests of the people.

To worsen the situation, the actual public services, such as regulation, justice, public security and defense, that should be provided with proper efficiency are being left behind, due to the action of groups of interest, politicians, bureaucrats and individuals from the society in general when trying to gain personal benefits. Then, leading the public administration to divert its scope of action from its main responsibilities on the collective needs to look at personal interest and necessities.

The public sector has been widening its scope of action and streighten the focus on private goods and benefits for groups of pressure. Hence, as consequence provoked both 1) failure in providing dependable public services to back economic activity and 2) heavy tax-burden that prevents the private sector from investing and producing more. As a final consequence we have the economy growing too slow, which reflects on the social development and welfare.

The primary intention of this working paper is to provide an overview on the causes and consequences of this array of policies that defocused the state from the core of its natural and desirable role. At the end of this paper I hope I can help people to understand what Brazilian government, among many other, has been doing wrong that hamper the economy from growing and developing and understand how to change the mistakes to favor economic growth and hence achieve a higher level of development.

## **2. A too Broad and Costly List of Governmental Activities Overcharges the Treasury and the Productive Sector**

Governmental spending at large has grown steadily along with the revenues that have been pushed up as well and our government has reached such a huge size that is too difficult for our economy to bear. This “phenomenon” can be observed better in the federal level, where the flexibility to raise taxation is much bigger than in state and local levels, yet that the federal government has the power to either create or raise taxes quite easily according to the Constitution and, specially, by putting pressure on politicians to approve governmental proposals that raise taxes that in great extent will be used for grants to states, regions or sectors of interest. That easiness to increase revenue has led the government to fight the public deficit mostly increasing the taxation rather than rationalizing the spendings.

It should cut spendings, but what has happened is rather the contrary. As the revenues increase, the public managers are stimulated to spend more – especially due to the countless demands that come from many groups and individuals. As the state magnify itself, the political power gather with economic power, dislocating the economic power from the productive sector and individuals to the political sector; where some elected people have given huge amounts of resources to manage in the way they find convenient, supposedly for the good of the entire society. However, the human nature are always present where there is human been, and the human nature leads man to seek his own benefit before asking what is better for the others and for the community.

The worse part is that even when those in charge of managing the government have good intentions and are seriously trying to do the best to accomplish the goals of the society, they not always have the better means to allocate the resources in the more efficient combination to have the most useful application of the resources taken from the society. Both theoretically and empirically<sup>2</sup> we can observe that the probability of using more efficiently any resource, for whatever end, is much greater in the private sector than in the public sector. But, sometimes, as the public resources are badly applied, many people have the perception that the problem is the lack of more resources.

As we will see ahead in this working paper, the high taxation harms the economic growth and the employment, which in the case of Brazil is quite easy to notice. This situation of unemployment, associated with the actions of interest groups, stimulates the actions from the state in areas that isn't its field, because do not belong in the field of public goods, hence not efficiently provided by governmental hands. Actually, behind the excuse of low income and unemployment many demands are put in front of the government. That demands are enforced by the voting power of those who demand benefits, such as healthcare, medication, food, land, housing, etc. Even though voting is part of the democratic process, when people are voting to be granted personal benefits from the state, the role of the state are disfocused, yet that the role of the government is to provide public services, not personal benefits. If the state is pushed to provide personal benefits in exchange of votes for politicians, the actual collective interest is in jeopardy.

It is easy to find people that says that would vote for anybody who give them any personal benefit such as cloth, money or a piece of land. Then, we face a problem similar to the "tragedy of commons" (garret/1968), where seemingly infinite, but in fact finite, public resources haven't got taken care because they are public, and each person try to maximize his personal benefit regardless the overall results for the whole community.

The use of public resources to guarantee directly or indirectly many kinds of benefits for individuals who could support those in power to remain in power is also a concern in our society, specially because the possibility to waste resources for that purpose. Many uses of the public structure for the end of remaining in power have been already identified, such as the “assistencialism”, which is those actions of giving assistance for people by the hands of the government, to maintain people under the control of the government or of the group in power, rather than stimulating employment and freedom.

The so called “clientelism” is another kind of action to use public resources to remain in power. In this kind of behavior those in power use public resources more directly and selectively to benefit those who give them direct political support. In both assistencialism and clientelism the use of public resources to benefit groups of people are fairly difficult to hide. Here we have a situation where public power and resources are used to benefit few groups of people hardly with efficiency or fairness. Nevertheless, we’ve seen more accountability in that regard in the last few years, but it still exists in large scale.

Along with such problems of misuse of public resources arises the use of patronage by the politicians that, when victorious, reward their workers and followers with public jobs, as pointed by Morrow (1994, 101). Besides the inherent inefficiency and corruption associated with this behavior, in some democracies, as the leading party often lack from majority to govern, the necessary agreements among parties prevent many of the old partisans of the leaving party to be replaced; then, to accommodate the new people more public jobs need to be created. That inevitably leads to increasing spendings in the civil service.

Other great obstacle to keep the application of public resources from been efficient and rational is the cost of incompetence and corruption. That always-around factors have been shown to be heavily costly and quite inevitable to be fully extinguished. Under the veil of “political decision”, in opposition of



“technical decision”, policymakers sometimes prefer to take decisions that sound better for the ears of the audience, but such policies may be good for a target-group while been ineffective or even dangerous for the society and for the economy.

Furthermore, there is a inherent incompetence associated with the fact that the resources are get with a sort of mandatory and unilateral decision from the state and without direct compromise in giving back any specific service or good, nor quality of the public services are associated or required. Although there are some inherent public goods the state is supposed to provide, the government is rather free to decide what to do and in what quantity, while the taxpayers have no choice and few opportunities or conditions to make dependable evaluation or take decisions upon the outlays.

Cultural understanding that every collective or individual problem can be blamed on the government pushes people to complain against authorities on any problem that turns out such as lack of medical assistance or jobs. By the way, as long as job is concern, is usual people complain and as government to give them jobs. In fact, to create jobs is not direct responsibility of the state; yet that public job is not an end in itself, but a natural input to produce the necessary, and only the necessary, output. State wasn't conceived to create jobs, but to provide public services that are necessary to maintain the conditions for people to invest, work and live in good condition, and then create and exchange goods and services which contribute to creation of wealth.

The broad is the spectrum of goods or services the government is allowed to allocate resources the freer are the policymakers to decide what to do with the money get from the society. When the public administration has excessive flexibility to apply the resources, specially to apply them to benefit specific groups or individuals, unscrupulous politicians have more freedom to use public resources for their own benefit, including to guarantee permanence in power. It happens because imperfections in the politic process may lead to

enactment of rules that allow authorities to manage public resources and public authority in discordance to the public interest.

In other cases, there are plenty of “obstacles” to reach a good decision on behalf of the society, because of the competition among interests. Now, considering that the policymakers have no intentions of misusing the public resources, we still have the problem of the fragmented analysis, where a lack of comprehensive understanding about causes and consequences of the major problems leads policymakers to look at the problems trying to solve them immediately and isolatedly, without comprehensive and effective solutions for the long-run.

Besides, when government interferes directly in an issue, the perception for the population is that government is being more effective in that regard, because people with few knowledge in economics do not perceive the indirect consequences of each governmental action, especially regarding costs.

The 1988 Federal Constitution aggravated the vast spectrum of duties for the government, invading the private spectrum of responsibilities. It created an important list of rights without considering if the economy was able to finance without harming the socioeconomic development. With the 1988 Constitution, people were put in the position of demanding personal benefits from government and not stimulated to contribute. The policy included in the Constitution has been considered to be much more focused in the rights of those benefited than in the condition of the whole economy to bear costs. In fact, it looks like there was no concern with the high costs of the policies attributed to the government, specially in the social security and health areas.

If we analyze the President’s Budget for the FY2005 which was sent to Congress late August 2004, considering only the part of the budget<sup>3</sup> effectively defined in terms of area, we see that while some 35% are directed for areas associated with actual public services, such as Defense, Law Enforcement,

Judiciary System and Foreign Affairs, the other 65% of the resources to be effectively applied by the Federal Government are related mostly with Ministries of the so called “social area”, such as Agrarian Reform, Retirement System, Food Distribution, Education and Health Assistance. Although sometimes necessary, social assistance needs to be better evaluated in term of dimension and effectiveness; otherwise, it’s going to be only a huge misbalance with low effective results.

Politicians tend to be more concerned with the short-term, because of the perception by the population and the repercussions in the elections; and public policy focused in the short-term strives to deal with the consequences of the bad policies, rather than creating good conditions for the long-term and sustainable development. The government has been running to save the lives of those who suffered accidents, instead of providing good roads to avoid accident; running to save the lives of those who were shot instead of providing security; running to give the unemployed social security, instead of letting the economy to flow better and create jobs. Those mistakes represent cost. Those mistakes represent people worse off, and have to change as soon as possible.

Besides to be spending badly, the government has been spending too much, and the more resources government has to spend, the more is the resources wasted. These problems are related with the (bad) understanding about the Keynesian Theory that (in any situation) increase in government spendings would increase GDP. That is an understanding mostly used by people that heard roughly about the Keynesian Theory developed in the 1930’s, which has based in a situation of depression, consequently with a high level of unemployment.

In the present time, as shown by Abel & Bernanke<sup>4</sup> (2005, 411-413) in normal conditions, an increase in government spendings would raise the level of income only in the short-run. The consequences in the long-run would rather be higher interest rates and inflation, and the level of GDP would remain the very same as before. Fortunately, now the non-Keynesians already have shown that

the Keynesian Theory needs to be taken carefully, and a responsible fiscal administration is the better way for most of the present economies to grow and develop.

Given the assumption just mentioned that is wildly accepted now both by Keynesians and Classics, we can understand what occur when the government raises its expenditures: increased governmental spending would only provide increased consumption and diminish investments. “The effect of increased government purchases on output in the Keynesian model lasts only as long as needed for the price level to adjust... Thus an increase in government purchases doesn’t raise output in the long run” (Abel & Bernanke 2005, 412).

Byt the policy of raising government purchase pledging to raise output has being developed in Brazil in the last several years, when the government has increasingly taken resources from the private sector – which we would expect would invest at least some 15% of that resources – to finance governmental consumption. In the federal budget, investments in capital in the last several years have represented barely two percent of the actual budget<sup>5</sup>.

Government has sucking out each year greater part of the national savings - which should go to investments - to finance a large sort of new spendings, with special attention on programs that use mostly current spendings. Thus, the Brazilian economy hasn’t seen the necessary investments to grow.

The major consequence of that kind of policy is disequilibrium between the supply of labor and the demand for labor, because to create jobs economy needs investments. Just few jobs have been created in the last several years, when the economy didn’t lose jobs. Such unemployment, obviously, ends up creating more “social needs”, more demands on the government to solve the problems of the unemployed ones. Then, again, more pressure to raise even more the government spendings. Instead of giving them jobs and have production and

investments, we rather have given “social assistance” and getting more demands and less production and investments.

The size of the capitals of states in Brazil is one of the symptoms of the exaggerated importance the government has economically and politically in our society. This oversized state hasn't being synonym of either economic nor social prosperity. On the contrary, the major economic problems the whole country has experiencing in the last decades have being clearly due to the impact of bad policies made by the government especially on the federal level that hinder the economic growth.

Policies have forgotten the human nature which consists basically that man tends to take advantage of the situations to gain benefits. If to have something a person needs to invest or work to give something in exchange, he will do so. But, if instead, nothing is needed in exchange, nothing will be offered. If the government guarantee the basic needs of everybody, unfortunately many people will give up work and prefer leisure instead. Less people will feel stimulated to work to have some more things. Instead, if granted, especially in exchange for easy votes, people are affected by the *moral hazard* because there will be no fear about being unemployed or unproductive, and just a few would be willing to make effort to be productive. Why should I get up early, study a lot, work hard if I can be at leisure and receive what I need by granted? Many may say.

But not only politicians or goodhearted-with-non-economic-background bureaucrats are those who try to “help” people with other's resources without asking for anything in compensation or at least a little bit more responsibility by the population in general. Important part of the society believes that granting personal benefits for poor people is necessary and fair. They think that poor people only will be able to work if granted by many kinds of services and things such as food, healthcare, leisure, education, land, housing, etc. In part that's true. Services related with health and especially education can help people

to be more productive, and may be worthy for the society in general guarantee for all some level of education and some health policies. But the problem is that all these services do represent cost and can only be provides up to certain level. Up to a point that do not diminish the capacity of the economy to grow; otherwise everybody will be worse off, because the economy remains standstill and no jobs are created, no wealth is added, and more necessities are unattended. In that situation a vicious circle is created, and to get rid of it becomes each time more difficult, as the role of the government inflates and inflates the dead load for the economy to bear.

Besides, when we talk about health, for example, we need to keep in mind that some activities need to be developed by the government, while other activities should be done by private initiative. Than not the whole area can be considered to be public duty. Some policies need to be managed by the public sector, actions like fiscalization of sanity, epidemy control, drug regulation, etc., which means services that represent collective action, need to be provided collectively through government. Now, medical assistance and most of the medications, that is supplied individually do not need to be provided collectively, and might work better if let to the market system, provided only that government implements policies to regulate to avoid distortions and push that market toward balance between consumers and suppliers.

Consequently, it's a mistake to consider all activities in the field of health, for instance, as public responsibility. Than, it needs to rest clear that within areas such as health and education the role of government is limited, specially considering the imperfections of the public choice, which lead to waste of resources if compared with the efficiency of the private choice.

Another great interference is when the government tries to manipulate the distribution and redistribution of income. Then, people divert them attention towards the state trying to get as much as possible from public institutions. People start to defend more taxation for others and more benefits for themselves,

in a “beggar-thy-neighbor” behavior, as everybody became fighting among themselves to be granted with bigger part of the wealth. Meanwhile, the economy stagnates, because those who invest and work are the only ones that are supposed to give something and to carry on the burden. Beggar-thy-neighbor tends to bring about a sum-less-than-zero game, yet that the actors use their energies to strive to gain benefits rather than to offer something in exchange of the benefits they need. For one to gain, others need to lose, and the process itself takes money, so the overall result of this process is a loss of wealth.

Instead, in an economy with less public intervention, people more stimulated to produce useful things, so they can exchange those goods and be rewarded according to the benefit they provide to the consumer. This situation is the very contrary to that with governmental intervention pledging “redistribution”. Without charging production and granting non-production, people would be more stimulated to produce and the result is more wealth and prosperity, more welfare at the end.

It doesn't mean that government shouldn't do anything or to do “the minimum necessary”. Government needs to do what needs to be done by collective action. There are some public services that need to be provided by the state; besides some distortions and imperfections in the market system need to be taken care by the government, especially through regulation, but only as long as the government helps the market to work properly.

### **3. What Should Government Do?**

For what purpose does the state exist? This question is not new, and the answer already has been known for long time. The state was created to provide the so-called “public goods”, such as national defense, legislation and law-enforcement. Why? Because such products wouldn't be provided properly if financed in the same way that private goods are financed. Everybody would try to avoid paying for it, because one cannot identify the value of the benefit for everyone; then, there would be no way to charge each individual for the benefit they obtain.

Public goods have two characteristics: they are nonrival in consumption and are nonexclusive. Which means that by definition, once provided, public good cannot be exclusive of a group nor can this consumption exclude anybody from benefiting equally. Well-known examples of public goods are legislation and national defense. No one can be excluded from benefiting from the defense provided by the army; they also cannot be excluded from the benefits of having law. With that kind of goods, exclusion is practically impossible, than collective action takes place through the state and be financed compulsorily by .the people in general.

In opposition to the public goods, we have private goods that are those of which consumption is considered individual and people can be excluded of their consumption. Consequently the consume by one person negates the consumption for others. Examples are food and clothing. The free market is far



the better way to provide this type of goods, as people can decide for themselves what are their choices according their individual preferences.

A third kind of good is a group of goods that, though belonging to the private sphere of goods, have such important externalities for the society in general that is worthy to be provided by the state with public resources when the market system might not provide in enough quantity to satisfy the necessity of the society. Examples of the so-called semi-public goods are related with education and health care. Within the health area we can find public services such as regulation and control and we can find private services or goods such as consultation and medicine. Either one is largely understood to be worthy of being provided for by the government, but it is questionable.

The major question mark about public sector providing private goods rest in the efficiency of the production of those goods through public administrators and the fairness of making some to pay for others.

When a person uses his own money, most likely the use will be much more useful than if anybody else would make the choices for him. So, only to provide public goods is really necessary the government to obligate people to contribute, otherwise is better to let the individuals to decide for themselves, especially due to the imperfection of the public choice to decide for individuals.

For other purposes, there are some reasons to charge people for something they do or consume that cause harm to other people. On the contrary, we have reasons to benefit people who may somehow promote good for other people due to their consumption. This is the case of the externalities that can have positive or negative effects.

To discourage the use and to require compensation for the damage caused, government can charge through taxes the producers or users of the good which causes negative externality. On the other hand, to encourage the

affordability of goods that causes external benefits, the government has instruments to directly or indirectly subsidize their production or consumption. With these tools, the government has the insurance of to intervene when necessary to raise or decrease the production or consumption of such private goods, so doesn't need to play direct role in the production when the intention is to afford given goods.

Much of the overcharge imposed to the taxpayers is due to the practice of adding to the governmental roles and responsibilities that are not familiar to the natural role of the state. Acting with certain emotional impact and, sometimes, trying to solve rapidly a problem that come in the agenda, many policymakers tend to involve the state in individual problems, ending in producing goods that are not well or efficiently produced by the state.

When the policy is managed by people that do not have good economic background, the analysis tends to look only at the immediate effects for the interested group. But, as asserted by Hazlitt<sup>6</sup> (1946) "The art of economics consists in looking not merely at the immediate but at the long effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but of all groups." Regardless the good intentions, public policies that attend to the demands of individuals or groups may be outside the role of the state and may bring bad economic and political consequences.

Besides usually being more costly, when the government makes private goods, an economic power is assigned to the policymaker, politicians and bureaucrats, there is a danger of concentrating power. By giving them such power, they are induced to take advantage of that power and be subject of self-benefit, corruption, etc. Lost of economic power by the individuals means lost of freedom for them. Concentration of economic power in the hands of those who have political power means more concentration of power and more loss of freedom by the individuals, as they would be more dependent of the favors of the

“authorities”, and the “authorities” might use this power to oppress and exchange favors.

The private market is much more efficient to find the quality and quantity of the private goods people want. The very person that will consume and pay for a given good is, in the vast majority of the cases, the person that would make the better choice. He is the more interested in the better product for his case and the more interested in paying the lowest cost. Differently, the policymakers and bureaucrats may don't know what the best options for each person are or how to acquire or afford the good at the lowest cost.

Furthermore, when the government provides all sorts of necessary goods, rises than the probability of the so called *moral hazard* in the sense that people are much more comfortable in not working or striving in find a work because all their needs are being provided by the state, and their behavior may be much more irresponsible, since the government is alike to assume the responsibility for the acts of the irresponsible ones; in the sense that people can be less concerned about the consequences of their acts. As examples we can consider the concern about being effective in their jobs, because if someone loss his job, the government will take care of the consequences of his unemployment by giving grants to compensate the loss. In the same way, the concern about studying more to guarantee his job will be less, for the same reason. Also many people are less concerned about having the number of children according their conditions of taking care, because, if they don't have conditions to raise them, someone (the rest of the society represented by the state) will assume the responsibility.

In create extent the invasion of the private area by the state has being due to the short view that leads to look to the short run of the social-economic problems. As we have elections each 2 years, the policymakers are constantly concerned about gaining votes, and to gain votes many candidates are lead to solve or at least to promise to solve the immediate problems of the electors, as

well as to avoid saying or doing anything that may disappoint their voters, so they may not be reelected. But many times the better and necessary decision may be lost by some policymakers – that are politicians – to lose votes, thus important decisions may not be put in place.

So groups of pressure, small or large, as well as the public opinion in general when based in poor knowledge may mislead the policy process. This kind of mistake may occur basically in two ways: doing something that harm the public resources or not doing something to avoid or remediate the harm.

In the first case, the government usually acts under pressure to raise spendings to provide what is asked by groups in fields that are not role of the state. As long as that the resources don't belong to the policymakers, they are pushed to agree if it's possible. Sometimes they are motivated by sentiments of pity and grant resources to solve problems of people they are concerned regardless the effectivity of cost; and in other situation they might be motivated by greed and try to gain some benefits for the decision taken.

It's very hard to avoid the use of public resources without good criteria, but information for the population in general to be aware about what's going on is one way to avoid dumping resources to particular beneficiaries while public needs are left behind. But it's not enough, yet that to compose a majority the government sometimes needs to award minorities. In these cases, good information to the majority may not be enough to get rid of bad politicians, because they may be elected by minorities they give benefits with public resources. In this regard, Brazil has trying to build a strong regulation to forbid distribution of favors among voters, which may be a good tool to avoid misuse of public resources as well as to avoid election of bad politicians.

The system of political decisions has always imperfections that makes difficult to achieve the best policy to really benefit fairly in the best way the population in general. Personal interests and misperception about the reality

associated with factor like asymmetry of power among people and the cyclical majorities (Black 1958/1963), tend to lead the political decisions to interests of groups or individuals, and the efficiency either economical and political is compromised.

Pressure by groups or individuals to receive benefits from the government is somehow inevitable, as rational people understand that benefit is individual while all the taxpayers shear the costs. As portrayed in the “The Tragedy of the Commons” (Hardin/1968), as people have public resources available to be taken, anyone would prefer to transform public wealth in his own wealth. If possible, people would than try to get those resources rather than let them to be used for public purpose, they also will be kept from using their capacity to get wealthier by being productive. Thus has to be rules to strongly regulate the transfer of public resources to individuals, excepting only those cases where the transfer is strictly necessary.

On the other hand, the government needs to take action to push the governmental structure to its natural and necessary limits. To cut benefits is far harder to do than to avoid their creation, but its needed. When regulation, as shown in the first case, wasn’t enough to avoid that, government needs to take a reactive action to solve the problem. Then good comprehensive information and resistance to the counter-pressure against the changes are important to allow the decisions to be taken.

Government should concentrate in services that need to be provided by collective action, so those services can be better provided by the state, yet that people individually cannot afford to do properly actions such as public security, law-enforcement and justice; and the economy feels the lack of those services when they do not work well or in enough quantity. If for instance, a country doesn’t have law or the law is not enforced, nobody will feel confident enough to invest, as they may be stolen, murdered, etc. Without strong and reliable public institutions, people will be rather being encouraged to cheat and wave the law,

harming the others. Productive honesty doesn't payback if the state cannot guarantee the necessary security, for the individuals. That is the importance of the government to provide actual public services that are essential for prosperity and welfare.

The actual public services, which need to be provided by the state, cannot be underdone; they need enough resources and attention. Therefore, we shouldn't divert the focus of the public policies for activities that are not natural role of the state.

#### **4. Governmental Weight Keeping the Economy from Growing**

As discussed in the last topic, the government seems to be lost the border between the role of government and the role of private sector. When government try to interfere directly in all sorts of questions, including private issues, trying to decide who is going to have what, who is going to loose and who is going to gain; all this made by the hands of politicians and bureaucrats; the economic system is distorted and efficiency and justice are at risk, specially due to the power of coercion the state has and the discretionary way of allocate and distribute money. Economic justice we are not supposed to discuss here, but economic efficiency has being harmed by the governmental weight, and it needs to be better discussed, because this damage in the economy causes serious also for the social development.

The society, and economy within, needs the basis provided by public services to reach a reasonable environment to develop. Services such as regulation, justice and security are indispensable to hold the conditions for people to run the economy. For that, the state is authorized by the people to force themselves to finance the government, as public goods are inevitable and benefits everybody. The power given for the state to force people to finance the public goods shouldn't be used to collect money to benefit particular groups. It is too dangerous, because people in power may use political and economic power for self-benefit. Besides, the pressure to increase the revenues to raise the benefits might push the taxation even high.

But instead of focusing in actual public services, if an already heavy and slow government intend to provide other kinds of goods such as housing, alimentation and leisure, it will be focusing in the consequences of the bad environment for business and the economy – and, thus, for job creation and people in general. It will be hampering the economy to create jobs, because it is inefficient in provide political, social and economic stability for people to invest and work; and on the other hand, will be taking care of people that do not find job especially because no investment is stimulated.

People are afraid to invest and to finance economic activities because there is no confidence that the law will really be effective and that they will be able to enjoy the fruits of their labor and investments. Violence, disrespect with intellectual property, jurisdictional uncertainty are examples of serious problems that every potential investor may fear when thinking about making an investment in Brazil as well as in many other countries. Within those countries, many people may think that letting people to appropriate from investors' properties is a good think because it is a kind of “redistribution of wealth”. However, besides that is a very narrow-minded idea, it's not effective to improve the wealth of the poor. On the long run this kind of policy of making “redistribution” for any reason and for any cost tends to be ineffective to increase and distribute wealth and prosperity.

The policy that works as a non-zero-sum game is a policy that is based in mutual cooperation and rule of law; and is this kind of policy that government should stimulate, yet that people get aware that only contributing with production they will increase their wealth. But instead, if wealth is taken by the state and distributed as people fight for a larger part of it, that is a less-than-zero-sum game, where people lose wealth while fighting and people who would be stimulate to produce more will instead be stimulated to produce less or do not produce at all, while demanding favors from the state, yet that leisure will be the option instead of work.



While government does not change its policies that stimulate rent seeking groups and individuals at the expenses of those who strive produce, people that are thinking about investing and work will require higher gains to do so, because as the risks are higher, the required profits and salaries need to be higher too. If a bank – on behalf of its investors – finances a house, for example, and the probability of the full repayment is low, the interest rates will be inevitably higher. Honest people will be penalized by the higher interest to be paid and the dishonest ones that do not repay the loans will have advantage. When jurisdictional uncertainty causes such instability, businesses are unlike to be profitable and we hardly will find people to run the economy, jobs are unlike to be created and the economy tends to stagnation.

As consequence of bad public services, businesses aren't stimulated and hardly would push forward the economy, jobs aren't be found and the government is pushed to solve more “social problems” that rise because of the lack of jobs. Thus, more and more governmental resources are diverted from the core of state role to solve “social problems”. To assist the “social area” government needs even more to raise revenue and than prevent productive sector from growing.

As the vast majority of the taxes do not represent direct benefit for the taxpayers, it actually represents a heavy cost. That cost pushes up prices and squeezes both profits and wages. Consequently, people tend to invest and to work less.

One may say: - but, as the government transfers back to the economy much of those resources, the aggregate demand should remain the same. On that regard, we need to consider that those transfers many times occur without production. If the money remains in the pocket of those who produce the goods, they will be sure to spend their money only in exchange of production, which means in goods and services effectively produced and with good quality; but the government, on the contrary, may send money for people who do not produce

anything, sometimes much less things are produced than if the resources were spent by the actual producers of that wealth. In many cases the public spending finance corruption and waste of money. In those cases resources are wasted and people that should be benefited are left at large. Nothing is produced in exchange of those governmental spendings, and that means less wealth, lower real GDP.

When the money is simply transferred to people who will consume, one step of the economic chain gets lost. Production that should have happened did not, which represents less GDP, less wealth. But, who has lost? Those from whom the money was taken: producers, workers and consumers. The consequences, though, go further, people that would get employed if the economy had grown remain unemployed, and this kind of consequences is seamless for the majority of the population that does not have enough economic knowledge.

In order to make exemplification, let's consider that just a few people, for whatever reason, produce in a given economy, and the largest part of the population do not work (for whatever reason), and those who work have to pay for the consumption of those who do not work. The situation will be that: 1) those who work will require to be better rewarded or will join the others; 2) those who do not work hardly will be stimulated to switch sides. People in general will be stimulated to switch work for leisure, yet that great part of the needs will be provided by the government using others' money, and to improve the gains a person would have to give up to much leisure and make a lot of effort to reach a level of gain that makes worthy to work.

The reward for those that do not work in that case became something considerable, while the reward for those who work became something to be questionable. Brazil seems to be going toward that kind of situation, where the cost of working honestly is something unbelievable high and tends to discourage people from being productive and prevent economy from growing. This situation

only guarantees that everybody is going to be in a similar level of wealth by smashing the wealth and making people in general poorer.

One good example of an intervention that dampens effort and investment is to favor students from public schools with prejudice against those who studied in private school, the so-called “quotas”. To study in private school, first of all, demands effort and many times sacrifice, as people make trade-off between leisure and work, working more to afford to pay for private school as well as trade-off between the payment for the school and other goods and services that they might be taking advantage, such as cars, cloths, travel, etc.

If those to make effort to afford to study in a private school, because it will provide better education, are penalized, because that they will have less opportunities that are limited by the “quotas”. It once again will be one more factor against effort to development. If to work more and better to provide better education for the children, thing that tends to be good and creates good externalities, can be penalized, than people will change it for the worse. If those who study in public schools gain more benefits (quotas/opportunities), than why pay for a private school and be penalized? In fact government should never penalize those who: study (wherever), work and invest, especially those who have succeed, because success should never be penalized. To force people to contribute proportionally is something natural, but when the “contribution” turns to be “punishment”, than economic efficiency and justice are at risk.

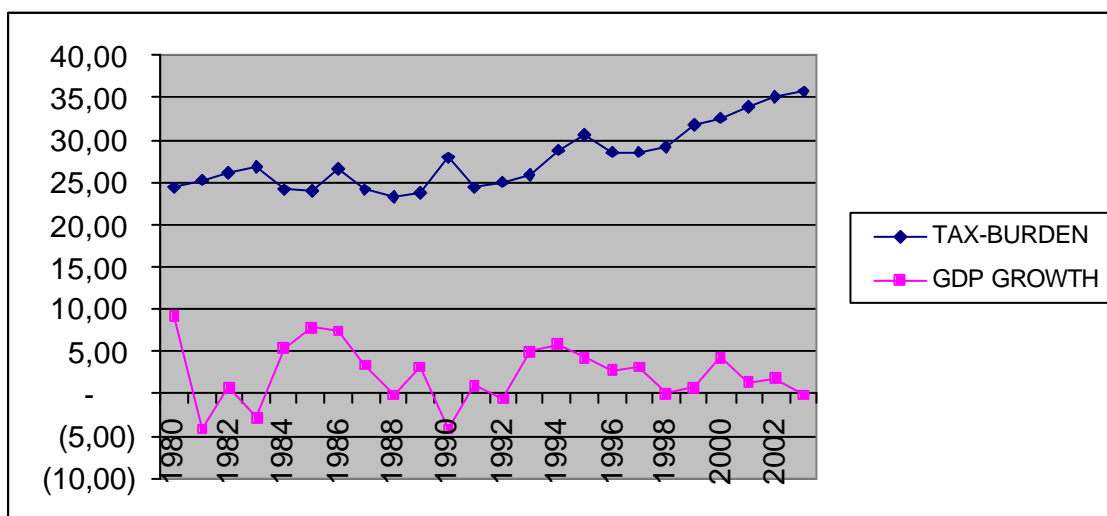
Other huge cost of the population in general and for the entrepreneurs is the cost of the lacking public goods and services such as security, infrastructure, regulation and justice. All these public goods are needed in order to provide a good environment to produce. That’s what a state is supposed to do mainly, at first. With those services well provided, investments and work find the necessary environment to produce and spread wealth, provided that natural resources are available.

As taxation rises, fewer resources are available to reward the factor of production, which is basically capital and labor. Profits are weak, especially in the small and medium enterprises, that have more competitive market and narrower margin of profit, and salaries have been constantly decreasing in real terms. The net gain for the producers has been squeezed, as a larger part of the price of the products is got away through taxes.

The data have shown clearly that as the public revenue goes up (regardless the GDP grows or not) the wages go down. As shown in *Veja*<sup>7</sup> magazine (Oct 9, 2004), the worker's income has decreased steadily from 1996, with 852 reais *per capita*, to 2003, with 692 reais *per capita*, while the public revenue has grown 157 percent. In terms of the GDP the slice taken by the government went up from 27,29%, in 1996, to 36,11%, in 2003!!! The last data for 2004 shows that tax-burden has reached 40% of the GDP.

As long as the GDP growth is concerned, it is interesting to observe Chart 1, where we can see that an increase in taxation does not seem to be related with any economic boost at all, but on the contrary. As the taxation rises, the level of GDP growth tends to fall.

Chart 1 – Taxation and GDP Growth (Brazil 1980-2003/percentage)



Source: Fundacao Instituto Brasileiro de Geografia e Estatistica (IBGE) <http://www.ibge.gov.br/> (GDP Growth) and Instituto Brasileiro de Planejamento Tributario (IBPT) [http://www.ibpt.com.br/estudos/estudos.viw.php?estudo\\_id=c9f0f895fb98ab9159f51fd0297e236d](http://www.ibpt.com.br/estudos/estudos.viw.php?estudo_id=c9f0f895fb98ab9159f51fd0297e236d) (Tax-Burden)

The graphic shows us a negative correlation (-0,15) between fiscal interference and economic growth. In the same direction in the opinion of the professor Stephen Smith<sup>8</sup>, who we have the opportunity to ask about that matter, supported by studies that had shown that economic growth is rather inversely correlated with the size of governmental spending; which means that in those countries where the governmental spendings are higher, the “performance variables”, especially growth rate and income, tend to the lower.

This statement is backed by studies such as the World Economic Outlook from the IMF (May 2001, Box 3.3), where is stated that “The evidence for other countries is more mixed, with several authors finding evidence that some fiscal contractions can be associated with somewhat higher growth even in the short term, particularly if the contraction is associated with falls in government spending.”

In the same text mentioned in the last paragraph we can see also a good synthesis about economic consequences of a possible decrease in public spending, where stated that: “Reductions in public expenditure and the associated public wage compression (which can impact private sector wages) can reduce production costs, which raises profitability and competitiveness, thus stimulating investment and exports.”

The “2002 INDEX of ECONOMIC FREEDOM” published by The Heritage Foundation and The Wall Street Journal shows a chart<sup>9</sup> called Economic Freedom and Income, in which we can see a strong correlation between economic freedom (which also considers the level of intervention) and the income per capita. The greater is the economic freedom, the greater is the income per capita.

But, while the government is increasing spending to rather provide actual private goods and individual benefits, we haven't got enough public goods such as security, infrastructure, regulation and justice. This lag costs for the entrepreneurs, worker and consumers huge amount of money, as well as for the population in general. All of them have to spend great part of their gains to pay for security, for damages and losses due to robbery, accidents, judicial trials, etc. Furthermore, the loss of lives due to the lack of those public goods is something remarkable.

The raising in spendings have been concentrated in the so called "social area", where the emotional appeal is stronger, and the return in terms of votes is larger than that related with actual public services and fiscal responsibility, for which the sensitivity expressed in terms of votes is smaller, yet that the results of programs which provide public goods are felt more in the long-term than in the short-term, and the benefits are more diffused. So politicians in general are led to prefer policies for the short-term and to spend more through the government, so people have stronger perception of their actions.

Due to this kind of policy, the private sector seldom sees the results of the taxes paid. Those taxes that are supposed to finance the benefits of all are sent to solve specific problems of some chosen groups or people. For the part of the economy that pays and expects to see at least the minimum conditions to continue working just a little has been provided, much less than it needs to grow as needed. The sum of taxes paid represents only a cost without return. Such resources prevent investors and worker to be better rewarded hence stimulated, no incentives for them. Can the economy grow and develop without incentives and reward for entrepreneurs and workers? One would hardly believe. On the other side, consumers also have their share of the burden, bearing part of the taxes, directly or indirectly.

Indirect taxes represent costs for production and transaction, while direct taxes represent reduction in disposal income. The taxation has to be as

neutral as possible in terms of harming the level of employment, but when it reaches the level of taxation we have in Brazil, the desired neutrality of taxation is left far behind and the economic growth is inevitably low. Hardly we could expect augment in investments and employment.

Within the activities of the Minerva Program – Fall 2004, we had the opportunity to talk with personalities from institutions in New York such as JP Morgan Chase, Goldman & Sachs and Moody's. Such institutions are well known by their capability to evaluate the economic conditions of the countries they analyze, and in the conversations the high level of the taxation was pointed as something outstanding on the bad way.

As long as economic growth is a concern, the high taxation is pointed as a barrier to investments and production. Sure. Yet that tax is cost and raises the prices of the goods, the quantities demanded in the economy will be inevitably less than if the tax were low or inexistent. Besides, part of the resources that would be used to pay salaries and profits are crowded out by the government. The factors of productions are than underpaid. Consequently the resources to invest and to consume are less and the stimulus to invest and work is less as well.

One may say that the resources taken by the government through taxes may return into the economy and the productive sector by its spendings. But most of the resources taken by the government return via transfer or consumption and do not consist in something productive. Furthermore, those spendings are only made in the amount the government took from the productive sector, but the damage has already been made in the extent that the production has decreased because the high prices due to taxes and the costs of transactions for the same reason. The damage on the GDP is made proportionally to the level of taxation.

Another interesting observation made in the meetings has about the capacity of Brazil to honor its debts. Even though Brazil has shown quite good

capacity of recovery from crises, the high level of tax-burden was pointed as a very negative issue, yet that shall the government raise taxes to overcome in case of crises, the capacity of doing that is already very limited or inexistent at all, unless harming even more the economy.

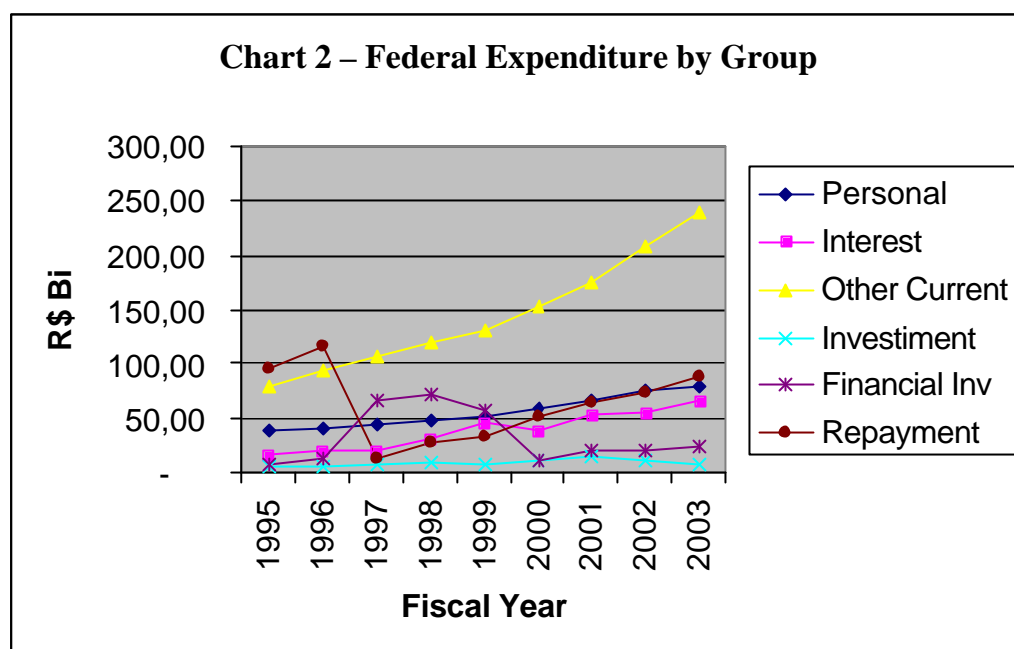
Although we need to recognize that the surpluses that the public sector in Brazil has run in the last decade, in the three levels of government, is an important step towards a relief for the economy and for the desired savings, yet that the surplus means increasing in savings, which allow both the economy to increase investments and the government, in the future, to reduce taxation, as the debt tend to decrease in real terms.

Obviously, this good sign, though, isn't enough to mean a turning point in the direction of letting the productive sector with a lower burden to carry and more breath to economic grow. After run surpluses and reducing the public debt, the government needs to decrease the tax-burden, provided that public spendings are kept controlled.

Unfortunately, the surpluses were achieved more due to increasing taxation than due to cuts in ineffective spending. But some cuts in spending have been done in the last several years and need to be continued with some corrections.

Interesting to observe is that the primary surpluses of the federal budget was achieved by reforms that especially aimed on the salaries of the public servants and on cuts in investments. But in the same time that salaries and investments are proportionally reduced, interest and other current spendings rose strongly, as we can see in the following chart.





Source: Budget Advisory/Chamber of Deputies/Brazil

The whole amount of investments in capital in the federal budget barely reached two percent of the net<sup>10</sup> budget. If we consider the whole federal budget, which includes refinancing, investment would represent less than one percent. Of course, the two percent of investment in capital represent gross investments. If we discount depreciation – My God! –, we’d see that Brazil has losing its infrastructure, its capital. It is unacceptable, especially because – as mentioned – one of the most important roles of state is to provide infrastructure.

Rests clear that government intervention has sucking out investments from the economy, because householders would to invest greater part of such income if it remain in their accounts. Private savings and investments should represent some twenty percent, varying depending on the economic conditions provided especially by the government.

We see that government has been more concerned with redistribution of wealth, in a game of “beggar-thy-neighbor”, than with creation of wealth and opportunities for all, which would allow the economy to distribute wealth with

increased output, in a situation where everybody would be better off. For an actual good distribution, wealth needs to be created, not wasted.

Usually, the more resources the government has to carry on its duties, the better. But the contribution for those who pay shouldn't be too high that they cannot afford to pay without harming the economic activity and shouldn't be too high that the level of the yield they need to give up is something unfair to be paid.

## **5. Economic Freedom as Part of a Free Society**

We cannot disregard the threat for freedom that concentration of political and economical power means. Some of the greatest catastrophes for democracy occurred and continue occurring now in some of the communist and socialist countries in the name of equity on the field of economics. With the excuse of redistributing wealth and equalizing people's conditions, government were lead to dominate economically and politically its people by the hands of dictators, instead of letting the spread of wealth occur in a natural way; which means let the market work and people to be really free.

If nothing of the considerations shown here (and elsewhere) could convince policymakers that they need to change the way they are conducting our economy, let's simply observe what happens in the countries that tried to bring goodness and fairness by making "distribution" of wealth by the hands of the state and compare with the efficiency and fairness of the people whose government let the economy and marketing work. Anybody that really wants to understand will se that the better way to distribute fairly more wealth is through a free market.

Distribution of wealth through the hands of policymakers tends to waste a significant part of the wealth; besides, will centralize power in an ineffective and dangerous way, because people will be much more dependent on the will and decisions those in charge of the state. Those decisions will,

inevitably, be affected by those interferences already cited in this paper; interferences that constantly lead to waste of resources, corruption, etc.

But still now, after see many economies be vanished and people be oppressed because of the centralized and dictatorial way to allocate resources, we are facing the threat for freedom due to concentration of power by the state. This dangerous and unnecessary concentration of power is happening constantly and seems that people are thinking that it's the natural course of the things and don't see that government is becoming larger and larger. In the early 1940's Hayek already had a good perception of the consequences of the socialism, when he wrote "Although we had been warned by some of the greatest political thinkers of the nineteenth century, by De Tocqueville and Lord Acton, that socialism means slavery, we have steadily moved in the direction of socialism. And now that we have seen a new form of slavery arise before our eyes, we have so completely forgotten the warning that it scarcely occurs to us that the two things may be connected" Hayek (1944, 13). At that time Hayek didn't know what was to happen in East Europe after many countries be on domination by socialism. He had an amazing fore view of what would be the economic and political consequences of socialism in those countries. History confirmed what he was trying to warn.

Now many countries, and with special velocity Brazil, are taking the same road of those whose economies failed and whose political power<sup>11</sup> made such unbelievable atrocities. Our government is allowing – on behalf of the people which it represents, sometimes passively, sometimes actively – groups, organizations and authorities to take the way towards socialism; tolerating even the ferocity of individuals who defend the use of force against people who do not accept the socialist way of taking and distributing things. We have seen situations were people that seems to hate investment and work and love to take things by force, distribute other's properties among themselves and destroy the rest, acting freely against democracy and liberty, while authorities watch passively.

The acceptance by force of socialism, or other similar system were state strongly controls the lives of everybody, was made sometimes in the past because the people who promoted such “revolution” believed that that was the better thing to do. Those people were simple people that had no knowledge to understand precisely what they were imposing to the others. They didn’t know what was to follow: economic, political and humanitarian disasters in many countries due to socialism and while in socialism.

State forcing people to give to the government some forty or fifty per cent of their gains is something that can scares anybody. That seems to be something like socialism, or something dangerously leading our country towards socialism. That very same socialism that takes freedom either economic or political from the people it pledges to help. This kind of “help” that already showed to be inefficient, unfair and harmful economically and politically.

On the other hand, after the end of the Cold War, the changes in the socialist countries, such as Russia, Poland, etc. towards democracy and economic liberalization provided the conditions to improve economic development and civil rights, which contribute a lot to improve the welfare of its people. Other good examples are the economic situation in China after the economic modernization towards free initiative and the difference between South (capitalist) and North Korea (communist). It may be obvious that capitalism is better, both economically and politically, for the people; but what need to be kept in mind is that as the state grows more and more, we get close to socialist way of the state to control the lives of everyone.

Brazil is considered a capitalist democracy, but neither capitalism nor democracy is complete if there is so much dependency by the people in general on the government, bureaucracy, politicians, etc. Large part of the population depends too much on the favors provided by the policymakers through the state. The state concentrates both political and economic power, and the trend of those in power to use both, through the governmental structure, to maintain themselves

in power is difficult to avoid. Why would they decline to use the power of the state in self-benefit? Because it's wrong? Hopefully. But we shouldn't rely on their conscience. Not because they may be bad people, but because sometimes people may fail in keep themselves in the right way, yet that for many people is difficult to avoid to surrender to the temptation of having more power and money. Then, needs to have strict limits on the power of those in charge of public business and very good controls to avoid distortion and misuse of that power.

Public policies in Brazil have been too much linked in the interest for elections that led to short-run-focused policies and to specific-interest-group-focused policies. Sometimes, as elections close, authorities tend to use public resources to guarantee votes and control people, rather than taking the best options for the public interest, either in economic and democratic terms.

It was already said that those who have power have the tendency to abuse of that. If some power is inevitable, let's keep the power granted in the necessary limits, nothing more and nothing less. Otherwise, inefficiency and risk for democracy are imminent.

People need and deserve freedom. But freedom is intrinsically and naturally associated with responsibility. So, when freedom is as high as responsibility is, the equilibrium abounds, and the high is their level the healthy is our political and economic system.

If we have to give someone power to take care of some of our interests, that power should be the smallest necessary and very well controlled. Unless, that power can, and probably will, be use in some somehow against us and lead to servitude.

## **6. What Needs to Change**

What really helps people to solve their economic problems is a good free market to stimulate production and exchange goods and services. A market in which people are free and stimulated to invest and work and exchange the goods and services produced. It creates wealth, and where wealth is created wealth is distributed and creates prosperity.

But it doesn't mean, as many would say, that "free market" means no-government at all. On the contrary, government has some very important roles to play, such as an arena for people and its representatives to create a good law framework to guarantee freedom and fairness in the market. Law-enforcement is also an important public service that guarantee freedom and fairness defined by the laws are respected.

As mentioned before, some other goods and services can be provided by the state, especially those that demand collective action. What mostly has been overcharging the government in Brazil are a variety of private goods and services that are granted to people due to rather political motivation instead of by technical justification, need. Government has given private goods such as house, food, land and even money. This kind of goods is something that everyone, in normal conditions, is supposed to provide for himself, is responsibility of the person and that responsibility shouldn't be transferred to others (taxpayers), unless in very special condition such as for people who have physical impediments or are caught in very extremes situation, such as natural

catastrophes or uncontrolled accidents/disasters, and need to be taken care of, which is the case of the orphans, the mentally sick and the elderly. In other special cases, services related with health and education, whose outcomes can create good externalities, can also be provided through collective action.

But not in the whole areas of health and education is necessary the collective action, because not all services in those areas create externalities that are desirable by the collectivity, and don't need to be paid by other people that not those benefited. For example, see the case of someone that does a master's degree paid with public resources. No one is more economically benefited than he is. Thus maybe the collectivity prefers do not pay for his course, considering his benefits he may be sufficiently stimulated to pay for his course. The others may and probably will think that is much fairer if the money that everyone strove to gain remain in their pockets to pay for they needs and for the needs of their families instead of paying courses for other people that may be chosen and favored by politicians or bureaucrats.

If we have doubt, who is going to apply better the resources: individuals or the state, is better to allow the people who have invested and worked to keep the fruits of their investments and labor to be spent according their needs instead of taking from them to give for anyone else.

On the other side, taxes to pay for the goods provided by the state are taken from investor and workers. When taxes are upon investments and related profits, they damp down investments. When taxes are upon wages, they damp down work and the offer of job. When taxes are upon sales, they damp down exchange of goods and services. Thus taxes inevitably have the tendency of diminishing the economic activity and consequently worsen the wealth and the prosperity of people. Economic weakness increases unemployment and the dependence of the unemployed on the state.



After reaching a certain limit of tax-burden, public policies became to do more harm than good for the people, yet that jobs are lost and more people became to depend on the assistance of government, while government cannot afford to face such amount of demands. This creates a vicious circle while the dependency on an unable government to promote economic growth and development may create chaos.

Government needs to do the inverse. The stimulus on the economy when a tax-relief takes place has been clearly seen in developed economies as well as what we've seen in developing countries when facing less tax-burden. Obviously, these tax-cuts need to be made in a balanced way, concomitantly with reduction in spendings to keep the public finances in equilibrium.

A tax cut followed by selective cuts in spendings – especially current spendings – would be an important step to stimulate investments as private sector has much higher propensity to save in the Brazilian economy than public sector has.

In 2001, the United States enacted the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), which provided a substantial reduction on the taxation for individuals and families. Some criticism rose based in the Ricardian equivalence theory, which suggests that tax-cuts should increase private saving by the same amount that decreases in public savings. In the case of the United States in 2001, it turned out to be true; the increase in the private savings was almost the same of the reduction in the public savings.

Particularly in the present situation of Brazilian economy, the government wouldn't have other option but cut current spending, yet that it doesn't have saving much in the last decades. In fact, Brazilian government in the last years has been disaving, rather than saving. So, any resource left to the private sector would have higher propensity to be invested than if remained in the government's pocket.

Considering specially that our government practically does not invest in productive capital, if it reduces its spendings along with a reduction in taxes, more savings would be provided and more investments. More productive investments made by the private sector would lead to more employment and production, which means more development and wealth for more people. The dependency on external investments would fall as well, and our economy would be less vulnerable to crises.

But the cut cannot be in essential public services. Even though many private goods provided by government are good for the beneficiary population, large part of the private goods provided by the state under the tag of “public goods” allegedly because it is socially important, the efficacy of this deployment of goods for socioeconomic improvement has been shown to be much lower than policies that provide good environment for living and make business. As people are more confident and stimulated to live, invest and work in a given place, economic prosperity rises; and as investments come about and income are spread, people that once didn’t have employment start to see opportunities to work and develop.

Government needs to govern and provide dependable public goods. After that, government can even provide other amenities and personal benefits for people, things that are desirable for that people but less effective economically, because it cost for the other side of the economy. If government inverts the natural order of things, which means first provide private goods and benefits that have doubtful economic results when provided by the state, and than, think in provide dependable public goods, the public system won’t work properly, and the society will suffer the direct and indirect, but also strong, consequences.

Brazilian government at large seems to have inverted the natural order along with some other countries, and has been feeling the consequences: the economic growth for the last twenty year has been weak and social development

has stagnated even with large percentages of the GDP spent in the “social area”. The so-called social spending has shown to be ineffective if we don’t have good economic environment, with good regulation, security, justice to favor economic development.

What needs to be done is to reduce the public spending, provided that the actual public services have the necessary resources that allow them to be dependable and effective. Some cuts ought to be done in spending in assistencialism as well as in those grants made by the governments for some fractions of the population that demand easy benefits in exchange for easy votes. Some people may feel the loss of the benefits that were provided easily by the government; but, as economic environment are provided and more resources are left to be invested in a situation where investment and work are stimulated, more employment is offered, and salaries also tend to rise. Much less people would be depending on public resources. A vicious circle is broken, and a virtuous circle is created.

Government needs, than, to cut resources to paternalism, hence avoid rent-seeking people, that would be lead to seek productiveness, because it will be the only and necessary way to improve their lives. In this way, government get rid also the moral-hazard that is brought about by the paternalism, because people get much more relaxed and lazy if the government guarantee the comfort of having a last resort for the major problems.

On the other hand, with a better economic environment, people that are able to work, find jobs, and people that cannot work, because they might don’t have conditions at all, can be taken care properly, as more resources are left for the really needed, such as orphans, disable, elderly, etc. when they are caught in a situation where no other option have but to rely on the good willing of the community.

It takes some time until the results of a better fitting in the desirable governmental limits appear for everybody. Not long, probably. What is certain is that the results are much more substantial, broad and permanent.

## 7. Conclusion

The greater challenge for our economy is to avoid the illusion of solving all their problems and acquire wealth through the government as if it would be able to create wealth and resources; or to think that someone would be willing to make the effort enough to promote great growth for themselves and pay lots of money to the government to solve all problems of those who expect the solutions from the government. Because the consequences of those policies disfocused from the natural role of government is that many individuals have being discouraged to make effort. Obviously that some times government needs to intervene either providing public goods, solving imperfections or helping people that are really unable to take care of themselves.

But, our government has being allowing beggar-thy-neighbor behavior among groups and failing to create good conditions and stimulus for entrepreneurs and workers to contribute for the growth. If government alleviates the burden on the productive sector, then everybody will be better off, with more opportunity and incentives to grow, the country will be wealthier and those who really need to be taken care of – that shouldn't be too many – will have plenty of resources. Investor will be more stimulated to invest, will gain more profits; workers will find more jobs and higher salaries, and the production will be higher as well, probably with less cost, due to less taxes on prices and increasing returns to scale<sup>12</sup>.

With the adoption of the policy supported in this paper, the greater difference, then, will be related with people that although with skills to work do not find jobs, either because there is not enough capital to match<sup>13</sup> the labor force available or because they are not stimulated to strive for job due to the state assistance that provides rent without work or production.

Decrease taxation and current spendings would be probably the most important factor to make possible but also stimulate saving and investment. In doing that, the fundamental problem of unemployment inevitably tends to decrease, and the demand for public intervention to decrease as well. Government and private sector would be given more breath, and the acceleration of the economic growth to be a matter of time.

At the end, we may conclude that not everything that is good or desirable should be done by the government; because, even with good intentions, private goods are not well produced and managed by public administrators, and the cost may be more than the benefits. The analysis of the costs needs to be brought about and people need to be advised by the effective economic cost of the public actions.

We may summarize saying that high public economic intervention, as explained before, probably will: 1) raise production costs; 2) decrease resources for investments; 3) increase inefficiency of the economy in general; 4) stimulate *rent-seeking* behavior from groups and individuals; 5) elevate *moral hazard*; 6) reduce economic growth (as consequence of the previous items); 7) dangerously concentrate power on the hands of authorities and raise people's dependency on politicians.

By pushing government back to its limits we can avoid the problems mentioned in the last paragraph and allow government to do better what it needs to do and what people need to receive from the state, which are those actual public goods mentioned such as law-enforcement, regulation and public safety.

Because of the importance of those services for the good functioning of the society and its economy. Getting rid, though, of the duties that are not properly assigned to government we can redirect the resources and even diminish the burden on taxpayers. Less taxation means better reward and stimulus for investments, work and production. Hence, we could see a more prosperous economy and more wealthy, free and happy people.

For to reach such good results in economic and political term, may be necessary some cultural changes in the society in general, and, specially, among politicians, voters. We need to be aware to see where rests the collective interests and to avoid to seek individual interests that should be reached mainly by individual action. It is important that everybody to have in mind in what services and how should the government invest, and clarify what are the responsibilities of each actor of our society. We need to keep in mind that freedom comes with responsibility, that everyone needs to carry on his responsibilities along with his freedom. People with more freedom and more responsibility will act better in their interests and in the interests of the others, provided that the government acts in collective interest to guarantee both the freedom and the responsibility of each person.

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<sup>1</sup> IBPT: Instituto Brasileiro de Planejamento Tributário (www.ibpt.com.br)

<sup>2</sup> See the graphic from the 2002 Index of Economic Freedom, page 23, where we can find a strong correlation between economic freedom (less intervention) and economic growth and the World Economic Outlook from the IMF (May 2001, Box 3.3), where is stated that "The evidence for other countries is more mixed, with several authors finding evidence that some fiscal contractions can be associated with somewhat higher growth even in the short term, particularly if the contraction is associated with falls in government spending."

<sup>3</sup> For the purpose of defining the federal budget in terms of area, we consider the whole budget minus mandatory transfers for states and cities, payment of debt and reserve for contingencies.

<sup>4</sup> Abel, Andrew B. & Bernanke, Ben S. 2005. Macroeconomics. 5<sup>th</sup> Edition. Pearson Addison Wesley.

<sup>5</sup> The actual budget is the gross budget minus the appropriations to pay the debt with refinancing.

<sup>6</sup> Hazlitt, Henry. 1996. Economics in one Lesson. New Edition. San Francisco. Laissez Faire Books. 5

<sup>7</sup> Nucci, Carina. 2004. Menos dinheiro no bolso - Pesquisa do IBGE mostra uma dura realidade: plano vai, plano vem e a renda não cresce. *Veja*. Abril. October 9, 2004.

<sup>8</sup> Smith, Stephen. Professor of Economics and International Affairs. George Washington University and co-author Economic Development 5<sup>th</sup> Edition. Pearson Addison Wesley. 2003.

<sup>9</sup> 2002 Index of Economic Freedom, page 23.

<sup>10</sup> Net budget considers the whole budget minus refinancing.

<sup>11</sup> There is plenty of examples where concentration of power led to lost of freedom and, consequently, to use of the power taken on behalf of people in benefit of those in power, using all sorts of improprieties, such as arrests, prosecution and prison for dissidents, etc.

<sup>12</sup> Increasing returns to scale are defined as "a situation in which output increases in greater proportion than input use" (Browning & Zupan/2003, 178). As production is higher the likely situation in to be seen gains due less fix costs per unit.

<sup>13</sup> For more information about the combination between capital and labor, see the Solow model (Abel & Bernanke/2005, 220-240)



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