Taming Leviathan

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The current public debt crises in Western democratic countries provide an important illustration of what Adam Smith had described as the "juggling trick"—namely deficit increases, accumulation of debt, and debasement of currency—that all governments resort to when confronted with public bankruptcy. In this paper, we utilize the discussion on the public sector growth to illuminate the puzzle in political economy regarding effective government constraints, or questions of how to "tame leviathan." We argue that altering the institutional structures to be more polycentric would contain important self-generating mechanisms to tame leviathan. Specifically, we point to the role of hard budget constraints and the role of competition in polycentric institutions for generating incentives compatible for reducing the size of government. Furthermore, we argue that public debt can be reduced by decentralizing money because it would eliminate the federal government's option of monetizing its debt.

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> "Building on Progressive initiatives, the New Deal greatly expanded fiscal intergovernmentalism and entrenched it in the institutional architecture of American Federalism. . . . The power to tax indeed proved all that the New Deal needed, or at least most of what it needed. . . . The distinctive, innovative feature of Progressive and New Deal fiscal programs was the conscious design and deployment of intergovernmental schemes as a means of reducing fiscal competition among the states."
>
> —Michael Greve[1]

I. INTRODUCTION

The public debt crisis in Greece seems to have reached an endgame. Prior to joining the European Union, Greece's government would have simply engaged in what Adam Smith had described as the "juggling trick"—namely deficit increases, accumulation of debt, and debasement of currency—that all governments, ancient and modern, resort to when similarly confronted with public bankruptcy.[2] But Greece (along with other countries in a similar situation) cannot engage in the debasement of currency to pay off debt because they operate under the common currency of the European Union. To pay off debt, these countries face the following options: (1) exhibit fiscal discipline; (2) rely on European Union bailouts; or (3) exit the European Union in order to engage in the debasement tactic. This is the drama unfolding in European democracies of the twenty-first century.

This situation in Europe simply highlights and brings to the forefront the public management of fiscal affairs and the embedded question for public management of the appropriate scale and scope of governmental activities. This problem also extends to the fiscal state of affairs in various states such as California, Illinois, Michigan, New York, or Wisconsin, and to the United States federal debt and fiscal gap, as identified by Laurence Kotlikoff and Scott Burns.[3] All of these examples serve to illustrate this new era of the "economics of illusion,"[4] whereby nations have embraced fully Smith's "juggling tricks" as the necessary approach and skill for public sector management. Richard Wagner explains that the essence of the peculiar

[1] Michael Greve, *The Upside-Down Constitution* 243, 248–49 (Harvard 2012).

[2] Adam Smith, *Wealth of Nations* 466–68 ([1776] Chicago 1976).

[3] Laurence Kotlikoff and Scott Burns, *The Coming Generational Storm* (MIT 2004); Laurence Kotlikoff, *The Clash of Generations* (MIT 2012).

[4] Albert Hahn, *The Economics of Illusion: A Critical Analysis of Contemporary Economic Theory and Policy* (Squier 1949).

business of politics is for citizens, interest groups, politicians and bureaucrats to exchange votes for power, prestige, and privileges.[5] Therefore, unless the public sector is constrained through constitutions and perhaps even more effectively by competition, the public sector will grow both in terms of scale and scope.[6]

The aim of this paper is to utilize the discussion of the public sector growth to illuminate the puzzle in political economy regarding effective government constraints and to provide an analysis of the institutional structures that can "tame leviathan." We argue that altering the institutional structures to be more polycentric would contain important self-generating mechanisms to tame leviathan. Specifically, we point to the role of hard budget constraints and the role of competition in polycentric institutions for generating incentives compatible for reducing the size of government. Furthermore, we argue that one of the reasons governments have grown expansively in the last century is because they are in a position to increase public debt and have the opportunity to monetize these debts. We discuss why a central bank's status as an "independent bank" is unable to effectively constrain government from monetizing its debt. As such, we contend that the decentralization of money would eliminate the federal government's option of monetizing its debt and thus be able to constrain the federal government in its natural quests to spend and grow.

In proceeding with our analysis, we taken as given that such growth of government is both undesirable and unsustainable. Thus, our title—Taming Leviathan—reflects both our starting point, (1) that public sector growth over the past seventy years has turned Western democracies into leviathans that threaten both continued economic progress and political freedom, and (2) that analytical efforts at taming such a beast deserve our full scholarly attention. In this sense our paper is not normative in nature, though it begins with what Schumpeter terms a "pre-analytic cognitive act" of vision about the appropriate functions of government in a society of free and responsible individuals.[7] In other words, we taken as given that the appropriate functions of government should be limited to small, defined

[5] Richard Wagner, *Politics as Peculiar Business* (manuscript 2014).

[6] See also Greve, *The Upside-Down Constitution* at 257 (cited in note 1). Greve explains that founding architects of the US Constitution were not oblivious to the prospects of fiscal end-runs, but they thought that the prohibitions against paper money and unapportioned direct taxes would serve as a constraint. Furthermore, they operated under the assumption that the central government functioned under a hard-budget constraint.

[7] Joseph Schumpeter, *History of Economic Analysis* (Allen & Unwin 1954).

boundaries, and we proceed with a series of positive questions and analysis regarding the best means to achieve this end. Government in this vision should be prohibited from expanding its ranges of activities outside of its clearly delineated boundaries.[8] Our project follows in the footsteps of James Buchanan on what is referred to as "constitutional political economy." As Buchanan put it when he founded the Thomas Jefferson Center for Studies in Political Economy at University of Virginia in the late 1950s:

> The Thomas Jefferson Center strives to carry on the honorable tradition of "political economy"—the study of what makes for a "good society." Political economists stress the technical economic principles that one must understand in order to assess alternative arrangements for promoting peaceful cooperation and productive specialization among free men. Yet political economists go further and frankly try to bring out into the open the philosophical issues that necessarily underlie all discussions of the appropriate functions of government and all proposed policy measures. They examine philosophical values for consistency among themselves and with the ideal of human freedom.[9]

This paper proceeds as follows. In Section II we will address the growth of government. In Section III, we introduce the concept of polycentricism and discuss the role of hard budget constraints and interjurisdictional competition in taming leviathan. In Section IV, we discuss how the decentralization of money can constrain the growth of government, and in Section V, we conclude.

II. GROWTH OF GOVERNMENT

Much of the discussion on the growth of government should begin with understanding the transformation of public administration in the early twentieth century. This period is referred to as the Progressive Era, which started with Woodrow Wilson seeking to relax the constraints that the constitution imposed on government. Wilson argued that constitutional restrictions designed during an earlier age must be relaxed in our modern age.[10] He explains:

[8] We will not go into specific details of what these activities are, but we believe that the ongoing public debt crises occurring in Western democracies is one important indication of governments that have massively expanded beyond their delineated boundaries.

[9] James M. Buchanan, *The Thomas Jefferson Center,* 35 U Va News Letter 5 (Oct 15, 1958).

[10] See Woodrow Wilson, *Congressional Government* ([1885] Meridian 1956); Woodrow Wilson, *The Study of Administration,* 2 Pol Sci Q 197 (1887).

> The "literary theory" of checks and balances is simply a consistent account of what our constitution makers tried to do; and those checks and balances have proved mischievous just to the extent to which they have succeeded in establishing themselves as realities. It is quite safe to say that were it possible to call together again the members of that wonderful Convention to view the work of their hands in the light of the century that has tested it, they would be the first to admit that the only fruit of dividing power had been to make it irresponsible.[11]

According to the ideas of the Progressive Era, constitutions must not be allowed to "pinch." The checks and balances of that earlier age are in modernity merely nuisances for good government. Richard Epstein summarizes the intellectual transformation when he states that in the Progressive mindset

> the benevolent force of state power, exercised by dedicated and impartial administrative experts, can eliminate the chronic economic imbalances wrought by the unprecedented scale of industrialization that untamed market forces had driven . . . the traditional safeguards against excessive state power that animated early constitutional theory on both structural issues and property rights were perceived as pointless roadblocks that the modern technological state should overcome through a greater concentration and use of governmental power at all levels.[12]

Because progressive thought resulted in a transformation of public administration, it also resulted into a transformation of economics—since economics is an input into public administration. Economics as a discipline moved from a philosophical tool for social understanding and social criticism to a quasi-engineering tool for social control.[13] Paul Samuelson, arguably the most influential economist of the twentieth century and also a product of the Progressive Era, writes in the first edition of *Economics* that such older ideas of the classical liberal political economists and their individualist social philosophy must be rethought in the light of modernity.[14] The vast interdependence of modern commercial society has made it impossible to continue to believe "that government governs best which governs least." Unbridled capitalism, Samuelson argued, no doubt produced rapid economic growth in the eighteenth and nineteenth centuries, but it also resulted in business cycles, the wasteful

[11] Wilson, *Congressional Government* at 187 (cited in note 10).

[12] Richard Epstein, *The Classical Liberal Constitution* 7 (Harvard 2014).

[13] See Peter Boettke, Christopher Coyne, and Peter Leeson, *High Priests and Lowly Philosophers: The Battle for the Soul of Economics* 56 Case W Res L Rev 551 (2006).

[14] Paul Samuelson, *Economics* (McGraw-Hill 1948).

exhaustion of resources, income inequality, monopoly power, and political corruption by moneyed interests. The complex economic conditions of modern life necessitate, for Samuelson, that "sensible men of good will be expected to invoke the authority and creativity of government."[15]

The growth of government beginning in the early twentieth century reflects a natural consequence of the changes in the intellectual ideas regarding the role of the state. These transformations happened not only in the United States, but also in Europe. In Table 1 and Figure 1, we present some measures of government expenditures as a percentage of GDP to illustrate the growth of government in Western democracies.

As the table and figure show, government expenditures as a percentage of GDP during the period 1870–2013 has increased by 347 percent. This reflects a radical transformation of the scale and scope of government in the democratic west. Another common measure of the expansion of the scope of government is to look at regulation of economic activities. Figure 2 shows the growth of the number of pages published in the Federal Register, which is a document containing all United States government federal rules and regulations.

As shown, there has been a significant growth in the federal regulations since 1936. And this increase in the quantity of regulations does not even capture the extent of which certain regulations have significantly increased the scope of government power.[16] The growth of government since the early 1900s and now into the twenty-first century has been thoroughly documented and scholars have attributed this increase in the growth of government to the Progressive Era and then the aftermath of World War I and World War II.[17]

In the United States, for example, government expenditures as a percentage of GDP increased from 7.3 percent in 1870 to 7.5 percent on the eve of World War I in 1913, and 12.1 percent after World War I to 19.7 percent during the Great Depression and the brink of World War II in 1937.[18] But in 1980, just as the United States is about to embark on the Reagan revolution, that figure is 31.4 percent and in 2009, as the United States is coping with the global financial crisis

[15] Id at 153.

[16] See, for example, Terry L. Anderson and Peter J. Hill, *The Birth of a Transfer Society* (Hoover 1980).

[17] Epstein, *The Classical Liberal Constitution* (cited in note 10); Vincent Ostrom, *The Intellectual Crisis in American Public Administration* (Alabama 1973); Randall Holcombe, *Growth of the Federal Government in the 1920s,* 16 CATO 175 (1996); Robert Higgs, *Crisis and Leviathan: Critical Episodes in the Growth of American Government* (Oxford 1987); Philip Hamburger, *Is Administrative Law Unlawful?* (Chicago Press 2014).

[18] We are referring to the numbers in Table 1.

Table 1. Government Spending as a Percentage of GDP

	1870	1913	1920	1937	1960	1980	1990	2000	2005	2009	2010	2011	2012	2013
Austria	10.5	17	14.7	20.6	35.7	48.1	38.6	52.1	50.2	52.3	52.8	50.8	51.7	51.2
Belgium	n/a	13.8	22.1	21.8	30.3	58.6	54.8	49.1	52	54	52.6	53.5	55.1	54.5
Britain	9.4	12.7	26.2	30	32.2	43	39.9	36.6	40.6	47.2	49.7	47.9	45	43.8
Canada	n/a	n/a	16.7	25	28.6	38.8	46	40.6	39.2	43.8	47.3	45.8	44.8	44.5
France	12.6	17	27.6	29	34.6	46.1	49.8	51.6	53.4	56	56.6	55.9	56.7	57.2
Germany	10	14.8	25	34.1	32.4	47.9	45.1	45.1	46.8	47.6	47.7	45	44.7	44.5
Italy	13.7	17.1	30.1	31.1	30.1	42.1	53.4	46.2	48.2	51.9	50.4	49.9	54.4	54.5
Japan	8.8	8.3	14.8	25.4	17.5	32	31.3	37.3	34.2	39.7	40.6	42.3	40	39.9
Netherlands	9.1	9	13.5	19	33.7	55.8	54.1	44.2	44.8	50	51.3	50.1	47	46.7
Spain	n/a	11	8.3	13.2	18.8	32.2	42	39.1	38.4	45.8	46.4	45.9	47.8	44.9
Sweden	5.7	10.4	10.9	16.5	31	60.1	59.1	52.7	51.8	52.7	52.3	51.5	52	53
Switzerland	16.5	14	17	24.1	17.2	32.8	33.5	33.7	37.3	36.7	33.9	33.9	32.8	32.9
United States	7.3	7.5	12.1	19.7	27	31.4	33.3	32.8	36.1	42.2	40.1	39	37.8	36.6
Average	10.4	12.7	18.4	23.8	28.4	43.8	44.7	43.2	44.1	47.7	47.8	47	46.9	46.5

Sources: The Economist; IMF; OECD.

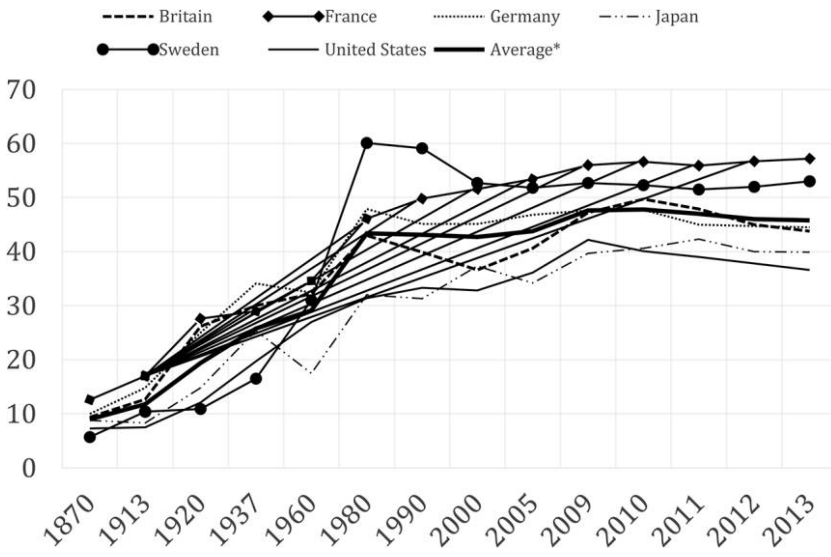

Figure 1. Government spending as a percentage of GDP.
Sources: **The Economist; IMF; OECD.**

that figure, is 42.2 percent. Recent years have seen a decline, but not anywhere near the pre-9/11 number of 32.8 percent. This is of course a far different picture than the pre–World War I and pre–Progressive Era where government expenditures as a percentage of GDP were consistently low. These numbers by themselves do not indicate causality between beliefs and massive expansion of government, but they do provide a description of the significant changes in government expenditures between the pre– and post– World War era, which should be understood in the light of the changes also occurring in the culture of public administration and the appropriate role of government.[19] The erosion of the constitutional checks and balances and the transformation of the nature of government and its relationship to the economy is fully institutionalized by the end of World War II.[20] How was this larger government financed? Taxes

[19] See Epstein, *The Classical Liberal Constitution* (cite in note 10), and Richard Epstein, *How the Progressives Rewrote the Constitution* (Cato 2006). Epstein provides evidence and an examination of how the Progressives ideology led to an expansion of government powers.

[20] Take for example the emergence of Keynesian economics after the Progressive Era. The Keynesian hegemony, and in fact, the neoclassical synthesis of macroeconomic demand management to eradicate economic fluctuations and mass unemployment with microeconomic regulation to address the inefficiencies of market failures, including, but not limited to, monopoly power, was established in the economics

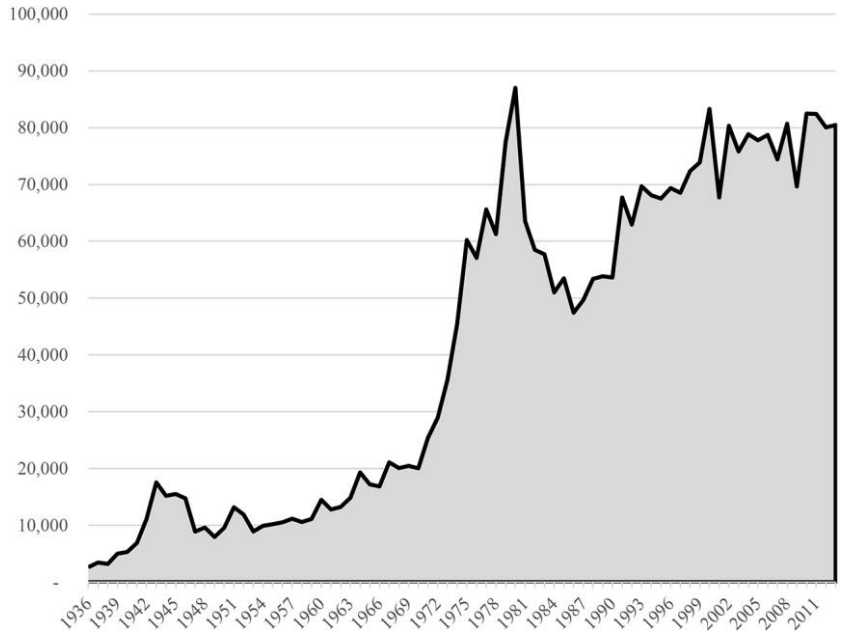

Figure 2. Federal Register: Total number of pages published, 1936–2013.

were not enough and running deficits and debts became the norm. Kevin Hoover and Mark Siegler analyze U.S. fiscal policy beginning in 1791 and find that taxes "caused" spending before World War I.[21] Meaning, increases in spending came from revenue generated through taxes. Hoover and Steve Sheffrin also find a distinct change before and after the 1960s. They find that before the 1960s, taxes also appear to be causing spending whereas after the 1960s, there's a decoupling between taxes and spending.[22] These studies provide some evidence for this transformation in public administration and the nature of government. Government spending was dependent on the revenues it received. But this relationship changed throughout

profession to fit the new institutional reality of government. There has been a long "clash of economic ideas," as Lawrence White, *The Clash of Economics Ideas* (2012), details, where this post–World War II consensus in economics gets challenged on a theoretical and empirical level at every turn. Although ideas are important and can help serve as constraints, it is important also to analyze the institutional structures and the ways they can constrain government growth.

[21] Kevin Hoover and Mark Siegler, *Taxing and Spending in the Long View: The Causal Structure of U.S. fiscal Policy, 1791–1913*, 52 Oxford Econ Papers 745 (2000).

[22] Kevin Hoover and Steve Sheffrin, *Causation, Spending, and Taxes: Sand in the Sandbox or Tax Collector for the Welfare State?*, 82 Am Econ Rev 225 (1992).

the twentieth century, and especially after World War II, where government spending would now be financed by something besides taxes—mainly, borrowing money. Our existing fiscal gap (obligations for future payments versus ability to make those payments given current assumptions about administrative costs, real income growth, demographics, tax rates, and so on) in the United States is a product of seventy years and not something that just occurred in the past decade or two.[23]

James Buchanan posed the following puzzle. It is said that if a fly that grew nine times its current size could no longer fly, what does that say about fiscal dimensionality and the modern democratic state. Buchanan's question is attempting to direct scholars toward the question of scalability and institutional architecture. From a certain perspective, governmental activities are scalable, yet from another perspective governmental capacity has constraints independent of the philosophical case made for government activism. Administratively, the task simply overwhelms the apparatus of government as it grows in size and complexity. Milton Friedman also addressed this concern and warned readers in his review of Abba Lerner's *The Economics of Control* that we cannot engage in public policy analysis as if the administration takes place in a vacuum.[24]

[23] See Kotlikoff and Burns, *The Coming Generational Storm* (cited in note 3). Also, in *Deficits, Debt and Democracy*, Richard Wagner (2013) argues: "Once it is recognized that budgets arise through a political process, we can use the pattern of budgetary outcomes over some sequence of years to draw inferences about the central operating properties of the budgetary regime out of which that pattern has emerged. During the first 150 years or so of the American republic, that pattern conformed largely to the budgetary principles of sound finance. Deficits were acquired during wars and depressions, while surpluses were accumulated during normal times to reduce the debt. In contrast, the past fifty or so years of budgetary experience shows a starkly different budgetary pattern, one that conforms pretty much to the principle of functional finance, where little significance is attached to the condition of the budget per se. With functional finance, the condition of the budget, whether in deficit or surplus, should be whatever is necessary to promote full employment, however this might be defined. To be sure, it could be argued that a proper application of functional finance over the past half-century would have seen more than five years of surplus. Nevertheless, a regime of functional finance is the alternative to a regime of sound finance in that the budget balance is no longer a standard against which fiscal responsibility can be judged." As Wagner goes on to explain in this book, institutional constraints that were in place under a regime of sound finance, were relaxed under functional finance, and the ability to wrestle with the fiscal commons is jeopardized and the peculiar business of politics exacerbates the deterioration of fiscal discipline and fiscal responsibility.

[24] Milton Friedman, *Lerner on the Economics of Control* 55 J Pol Econ 405 (1947): "Lerner writes as if it were possible to base conclusions about appropriate institutional arrangements almost exclusively on analysis of the formal conditions for an optimum. Unfortunately, this cannot be done. It has been long known that there are

There will always be incentive alignment issues, and information acquisition and utilization issues, even among men of good will who have received expert training. As the tasks of government grow exponentially, the administrative burden grows as well. It's true that the growth of government may represent an investment in improvements in our society, but we should also recognize that the problems of a lack of fiscal discipline that is evident throughout the democratic West is also causing problems for the long term economic growth and vitality in these societies. Thus, it is important to consider Buchanan's question about fiscal dimensionality and the architectural design of the modern state.[25]

The great puzzle in political economy and the puzzle in our theme of taming leviathan revolves around the issue of defining and constraining governmental activity. Buchanan distinguishes between what he refers to as the protective state (providing secure property rights and enforcing contracts), the productive state (providing essential public goods), and the redistributive state (providing special privileges to groups).[26] The puzzle is how to simultaneously empower the protective and productive state without unleashing a redistributive state that threatens governmental capacity. Implicit in Buchanan's puzzle is the understanding that governments have a natural tendency to grow and expand. If the incentives were not aligned to encourage government growth, perhaps the puzzle would not be that difficult to address.

One solution is for government to precommit to a set of policies and a set of promises to abide by these policies. However, the problem with this solution is that during times of crises, government breaks these promises and expands under the justification of an "emergency." This was the case in the growth of government post–World War II. Robert Higgs documents how the growth of government during World War II was thought of as a necessary response to the emergency nature of the war. However, even after the war ended, he discusses how there was a ratchet effect—meaning governments did not roll back the huge bureaucratic organizations for their initially "temporary" needs.[27] Thus, when the emergency ended, the

alternative institutional arrangements that would enable the formal conditions for an optimum to be attained."

[25] Aspects of government growth, such as through scale and scope, are conceptually different. However, for the purposes of our Article, scope is tied to scale and thus they are treated as interrelated.

[26] James Buchanan, *The Limits of Liberty* (Liberty Fund 1975), and James Buchanan, *Freedom in Constitutional Contract: Perspectives of a Political Economist* (Texas A&M 1977).

[27] Higgs, *Crisis and Leviathan* (cited in note 17).

emergency government programs did not. These times of crises are an opportunity to call for short run relief from the vagaries of the disruptions of economic change and are normally justified because the trade-off with long term economic growth are either muted by off-setting factors or hidden through some combination of monetary and fiscal illusion. Calls on the fiscal side for a balanced budget proposal or a tax limitation proposal are not sufficient to bind the political authority because they can break them when needed. In the context of our discussion, taming leviathan requires institutional solutions that have self-generating incentives to constrain government even crises. In the following sections, we address how altering the institutional structures to be more polycentric and how decentralizing money can effectively constrain governments during these moments of temptations to expand.

III. TAMING LEVIATHAN WITH POLYCENTRICITY

A polycentric organization of government describes a system with many centers of decision-making units that are formally independent of each other and involves multiple, overlapping systems of autonomous governments.[28] This idea is similar to Bruno Frey's analysis of functional, overlapping, competing jurisdictions.[29]

The organization of a society can be understood as being "more" or "less" polycentric. The more autonomy and competition there is among localities, the more polycentric a given country or society is. If many activities are organized at the level of the central government, then we can classify the U.S. system, for example, as "less" polycentric. If states and localities in the United States have significant autonomy and are more independent from the central (federal) government, then the organizational structure is "more" polycentric.[30] The significance of a polycentric system of governance is that it has important features that create self-generating mechanisms to incentivize governments to be more accountable to their citizens and that force citizens and political actors to internalize the

[28] Vincent Ostrom, Charles Tiebout, and Robert Warren, *The Organization of Government in Metropolitan Areas: A Theoretical Inquiry,* 55 Am Pol Sci Rev 831 (1961).

[29] See Bruno Frey, *A Utopia? Government without Territorial Monopoly,* 157 J Intl & Theoretical Econ 162 (2001) and Bruno Frey, *Functional Overlapping, Competing Jurisdictions: Redrawing the Geographic Borders of Administration,* 5 Eur J L Reform 543 (2005).

[30] For the purposes of this Article, we will use states and local governments interchangeably as a way to refer to subgovernments or subunits of government.

costs of a more expansive government. It is our contention that leviathan can be tamed through polycentric institutions. Specifically, we point to the role of hard budget constraints and the role of competition in polycentric institutions for generating incentives compatible for reducing the size of government.

A. Role of Hard Budget Constraints

An important feature of what makes an institutional structure "more" or "less" polycentric is the degree of autonomy of the states, localities, or subunits in the society. This also refers to the fiscal independence of localities, which means that each locality faces a hard budget constraint when financing their activities. When the subunits of government are more autonomous, then each unit of government finances their spending either through increasing taxation in their jurisdiction or borrowing money. The budget of this local government can "soften" when it receives external money. This is called intergovernmental fiscal transfer—or "federal aid," as it is referred to in the United States. Michael Greve documents how there was a radical shift in the institutional structures of a federalist system in the United States after the advent of intergovernmental fiscal transfers and federal aid programs.[31] The number of grants-in-aid programs in the United States rose from fifteen in 1930 to 530 by 1970 and to 1,122 in 2010.[32] Federal aid going to states and localities totaled to 607 billion dollars in 2011, and it is now the third largest item in the federal budget after Social Security and national defense.[33]

Intergovernmental fiscal transfers lead to a growth of government in scope and scale through two mechanisms. First, because they soften the budget constraint of state governments, states become less sensitive to the desires of taxpayers and these additional funds allow state governments to increase their activities in all areas. Second, intergovernmental fiscal transfers transform state and local governments into special interest groups who engage in lobbying the central government to give them money. That is, state and local political actors want to bring back the "bacon" to their home states. Intergovernmental fiscal transfers in this way transform the subunits of

[31] Greve, *The Upside-Down Constitution* (cited in note 1).

[32] Chris Edwards, *Fiscal Federalism,* Cato (June 2013), online at http://www.downsizinggovernment.org/sites/downsizinggovernment.org/files/pdf/fiscal-federalism_0.pdf (visited Oct 11, 2015).

[33] Congressional Budget Office, *Federal Grants to State and Local Governments,* Report (Mar 5, 2013), online at https://www.cbo.gov/publication/43967 (visited Oct 11, 2015).

governments into special interest groups that lobby for more funds and consequently increase overall *federal* government spending.

In the first mechanism, when the federal government gives states and localities such things as block grants, this means that states now have an additional source of income for financing their activities. Prior to the grants, states could finance their activities through either increasing the taxes of their citizens or by borrowing money. The additional source of income from the federal government allows states to expand their activities more than they would have been able to do otherwise. However, it is possible that when states receive these grants, they actually maintain their original level of activity and thus are able to return tax-money back to their citizens. This is called the substitution effect with federal aid. But, this is unlikely to occur because financing more activities through aid is beneficial to the political actors since it allows political actors at each level of government to receive the "praise" for spending, while pushing off the blame in terms of high tax burdens to other levels of government. Also, many of these grant programs have promoted growth in state bureaucracies to administer the program, and these bureaucracies have an incentive to continue asking for more and more money year after year. This is the logic of bureaucracies and the reason why we almost never see a downsizing of a bureaucracy.[34]

Furthermore, the few empirical studies available on this question also suggest that federal grants and aid *do not* result in reduced tax burden for the citizens in that jurisdiction (substitution effect), but instead, federal aid results in greater expenditures in the particular area where aid was directed to and also into other areas of government activities. For example, Jack Osman found that each dollar of federal aid was associated with an increase in total expenditures for the state and that there is a "highly significant positive impact of federal aid to all [other] functions.[35] The Advisory Commission on Intergovernmental Relations also found no substitution pattern with federal aid and in fact, finds that federal grants tend to *stimulate* expenditures by the state in other areas.[36] They conclude, "Total

[34] Gordon Tullock, *Bureaucracy* (Liberty Fund 2005).

[35] Jack Osman, *The Dual Impact of Federal Aid on State and Local Government Expenditures,* 19 Natl Tax J 362, 367 (1966). Osman here is describing how, when aid was directed to education, expenditures on government activities other than education increased. He also finds similar results when analyzing aid to other areas, such as health.

[36] Advisory Commission on Intergovernmental Relations, *Federal Grants: Their Effects on State-Local Expenditures, Employment Levels, Wage Rates,* Report (Feb 1977), online at http://www.library.unt.edu/gpo/acir/Reports/policy/A-61.pdf (visited 11, 2015).

state and local expenditures for all jurisdictions increased more than proportionally per dollar of Federal aid."[37] In both studies, there is a "stimulating" effect of intergovernmental fiscal transfers—that is, fiscal transfers result in greater expenditures in the state and localities. Thus, instead of political actors returning tax money to citizens when they receive fiscal transfers from the federal government, they instead use that money to finance more activities and increase the extent of their powers and domain.

In terms of a slightly different but pressing example, consider how federal government transfers through military equipment and police funds have allowed local police to move beyond the scope of their original domains and into such things as drug raids, war on terror raids, SWAT raids, and a number of other activities.[38] The "we have a police state" sentiment reflects the notion that state and local police have vastly expanded into areas where citizens do not desire them to be. But these activities were enabled through fiscal transfers from the federal government.

One of the other reasons state and local government activity expands through intergovernmental fiscal transfers is because some federal grant programs require matching—for every x amount a state spends on a program, the federal government will contribute y amount. This incentive has stimulated state spending and has led to continuous program expansion and creation of bureaucracies to supervise spending and to continue applying for these various grants.[39]

Eliminating the current institutional structure of intergovernmental fiscal transfers and thereby giving the government subunits more autonomy and independence from the central government would better constrain the growth of these state and local governments. This is because it forces the state and local government budget constraint to be more binding because they now can only finance government programs through either (1) increasing taxes or (2) borrowing money. The third option of fiscal transfers has been eliminated.[40] In other words, government becomes more constrained in its ability to spend and grow. When we alter the institutional structures of our society to be more polycentric by eliminating these intergovernmental fiscal transfers, we can significantly constrain overall growth of government by constraining the expansions of state and local governments.

[37] Id at 2.

[38] See Radley Balko, *Rise of the Warrior Cop* (Public Affairs 2014); Radley Balko, *Overkill: The Rise of Paramilitary Police Raids in America* (CATO 2006); Abigail Hall and Christopher Coyne, *The Militarization of U.S. Domestic Policing,* 17 Independent Rev 485 (2013).

[39] Chris Edwards, *Fiscal Federalism* (cited in note 32).

[40] Unlike the federal government, states do not have the ability to print money.

In the second mechanism, intergovernmental fiscal transfers increase *federal* government spending. This occurs because when state and local governments are tied to the central government fiscally, a new avenue is created for state and local governments to demand *more* grants from federal governments in a political bargain exchange. Just as special interest groups lobby to the government to enact certain polices, to receive subsidies, or to obtain other special privileges, state governments now essentially turn into special interest groups lobbying to the federal government to increase the amount of bacon that they can bring to their home states or lobbying for certain policies that would benefit their states or the companies in their states. As states and localities lobby for more and more grants from the federal government, this increases federal government spending and adds to the growing problem of public debt that has motivated this paper. It is no surprise that when we open up this avenue for states to lobby for more and more Medicaid funding, for example, this leads to skyrocketing, national spending on Medicaid.

Furthermore, opening up this avenue of intergovernmental fiscal transfers creates a moral hazard problem for the states, which leads to even more federal government spending. Because the states now face a soft budget constraint, they can run deficits in anticipation of the federal government subsidizing them and bailing them out. States can now act more "carelessly" with their finances. This is analogous to the moral hazard problems created when firms are given an implicit or explicit guarantee for bailouts or financial assistance from the government. Janos Kornai describes how this idea can be applied to government: "If a local government gets additional funds from a higher-level government budget, then a soft budget constraint situation may evolve," and just like a soften budget constraint incentivizes firms to act carelessly, it also incentivizes local governments to act carelessly.[41] Take for example California's asking for 6.9 billion dollars in federal aid in 2010 when it was on the brink of a budget crisis.[42] California and states such as New Jersey, New York, Illinois, Massachusetts, and Kentucky were ranked as among the worst in their fiscal conditions in 2013.[43] Thus, by creating an avenue for states to become special interests lobbying to the government, intergovernmental fiscal transfers has allowed for and led to a massive growth of *federal* government spending.

[41] Janos Kornai, *The Soft Budget Constraint,* 38 Kyklos 3, 22 (1986).

[42] Stu Woo and Jim Carlton, *California Requests Billions from the U.S.,* Wall St J (Jan 9, 2010).

[43] Eileen Norcross, *Ranking the States by Fiscal Condition,* Mercatus Center Report (July 7, 2015).

Altering the institutional structures of the U.S. government to be more polycentric by creating more autonomous state and local subunits would eliminate the problems caused by intergovernmental fiscal transfers. This is because when we eliminate the intergovernmental fiscal transfers, we also eliminate the two channels we identified that allow for massive public debt problems and growth of state, local, and federal governments.

B. Role of Competition

The central feature of polycentricism is that it allows for competition among localities for citizens. In this type of setting, there is a high degree of Tiebout competition that can effectively act as a check on governments because citizens "vote with their feet" and this generates incentives for localities to compete for citizens.[44] In other words, because citizens have the ability to leave jurisdictions, this gives them the power to incentivize government officials to provide governance services that are better suited for their needs, or else they will relocate their "payments" (taxes) to other suppliers of governance.[45] The possibility of exit power in a polycentric organization mimics (to a lesser degree) market competition where consumers "vote" with their dollars for the products or services that meet their desires and needs. The competition for the consumer dollar incentivizes firms to provide better products and services.

This type of competition thus creates self-generating mechanisms to align the incentives of government closer with the desires of their people and thereby creates a more responsive government. Localities that heavily burden their citizens with taxes and provide bad services in exchange will see their citizens migrate to other jurisdictions. If a particular locality chooses to cater more to special interest groups and less to their citizens, these citizens (taxpayers) can punish government actors by moving elsewhere. The competition among localities for citizens on a whole creates subgovernments that cater less to special interest group and as result; we would see fewer things like large farm bills benefiting only big farmer owners.

[44] See Charles Tiebout, *A Pure Theory of Local Expenditures,* 64 J Pol Econ 416 (1956).

[45] One structure of a polycentric order is federalism. We use polycentricism in this paper because it is a broader concept and encompasses the structure of federalism. Thus, our analysis here can be extended to include federal structures and fiscal federalism. Federalism refers to a hierarchic structure of government that allows for considerable autonomy and competition between lower-levels of government. Polycentric systems of government organization do not necessarily have this direct hierarchic structure.

It is true that some citizens would prefer to live in areas where there are "larger" governments and where governments provide more services such as transfer programs. In this case, citizens would move to localities that have more government programs. However, these citizens would be forced to internalize the costs of having a large government because the cost of government programs is now spread among a smaller populous. This is one important self-generating mechanism in polycentric institutions that would help minimize growth of government. In polycentric institutions, citizens who prefer to have "large" governments could live in that world, but they would have to pay for their own large government. In other words, you can have your welfare state, but it's going to cost you. Because polycentric institutions force citizens to internalize the cost of large government programs, this leads to pressure for "demanding" a smaller government. Furthermore, political actors also internalize the costs of spending because citizens have the ability to exit and vote with their feet. If one state or locality provides a large welfare state and because the costs of the welfare state are spread among a smaller populous making it more costly per person, then citizens who choose to leave because it's too expensive to live in that area are putting pressure on government leaders to internalize their natural proclivities to expand.

This idea that competition between localities can constrain is also discussed in Scott Gordon's *Controlling the State*.[46] Gordon argues that "efficient government and constrained government are not incompatible" and that the critical institutional discovery over time and place (from ancient Athens to modern Britain) is that, in the experiences where this was achieved, there was a pluralistic distribution of political power and the principle of countervailance was embedded in the constitutional construction. When these principles are absent in the institutional configuration, or they are allowed to be eroded, then efficient government and constrained government are in conflict. Leviathan gets tamed by competition, rather than unleashed through the suppression of the competitive forces that nudge decision makers to pursue prudent fiscal policy. Good governance—that is, the quest for efficient and constrained government—results as a byproduct of the competitive forces at work in the political economy.

The importance of a polycentric system of government in constraining government power here is that it has self-generating incentives to keep government small even in the face of a crisis. If we want political leaders to abide by certain principles, it should be in

[46] Scott Gordon, *Controlling the State* (Harvard 1999).

their best interest to do so. Polycentric institutions align the incentives of government with their citizens, so that the "not overstepping their boundaries" is in the best interest of the government. These self-generating incentives are present because localities face hard budget constraints (no intergovernmental fiscal transfers) and this is coupled with interjurisdictional competition.

IV. DECENTRALIZATION OF MONEY

The narrative in taming leviathan must also begin with the recognition that the federal government can raise revenue in only three ways: taxing, borrowing, or printing money. In *The Wealth of Nations*, Adam Smith expounded on the idea of the "juggling trick" whereby governments hide the extent of their public debt through "pretend payments."[47] Smith's idea was that government spending in the name of the public interest often leads to significant increases in the public debt. This public debt is sustainable for a period of time and can be serviced through pretend payments such as subsequent borrowing or the printing of money. Smith explains:

> When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. . . . public bankruptcy has been disguised under the appearance of a pretend payment. . . . When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonorable to the debtor, and least hurtful to the creditor. The honour of a state is surely very poorly provided for, when in order to cover the disgrace of real bankruptcy, it has recourse to a juggling trick of this kind . . . Almost all states, however, ancient as well as modern, when reduced to this necessity, have upon some occasions, played this very juggling trick.[48]

The reason Smith argued that governments resort to borrowing and printing money is that there are real problems and limits to financing spending by taxing. First, it creates political backlash and

[47] We should note here that from Smith's time through World War II, these "juggling tricks" were not the norm and were not seen as acceptable. The basic fiscal policy wisdom permitted the running of deficits and accumulating public debt in times of crises or to engage in public investment to improve the productive or protective state, but prudent public management required the servicing of that debt to pay it down as soon as possible once normal times returned.

[48] Smith, *Wealth of Nations* 466–68 (cited in note 2).

is political suicide for politicians who advocate burdening citizens with increases in taxes. Second, increasing tax rates may actually result in less revenue (the Laffer curve) because citizens are incentivized to work less. Third, it creates an underground economy and tax-evading responses. Lastly, it incentivizes citizens to move their work to areas with more favorable tax climates.

Borrowing money and inflating are the remaining choices, and this is what politicians tend to do. Buchanan and Wagner argue that because present taxpayers are not burdened by debt-financing expenditures and because present taxpayers are the ones voting for politicians, politicians have an incentive to keep tax rates low (so as to not burden the present generation) and pay for public expenditures with debt.[49] Governments can finance spending by borrowing money and then they have the ability to inflate and pay it back in a cheaper currency. Thus, when the federal government is not constrained in its borrowing and inflating abilities; it will continue to use those methods. In this light, the public debt crisis should not come as a surprise.

One way that has been proposed to prevent this natural growth in public debt is to create a rule that stipulates independence between the federal government and the Federal Reserve (the Fed). And further, scholars have also argued for the Fed to follow a set of rules in their guides to practice monetary policy so that they are not acting as an arm of the federal government. There are a variety of ways this argument has been presented from Friedman's long and variable lag, to Kydland and Prescott's time inconsistency, to Epstein's simple rules for a complex world.[50] But our concern with this traces back to what Hayek saw as the critical contribution of Smith and his contemporaries: to establish an institutional regime of governance that minimized the downside risk of bad men in power doing harm. In *Capitalism and Freedom,* Friedman captured this point when he argued:

> It may be that these mistakes were excusable on the basis of the knowledge available to men at the time—though I happen to think not. But that is really beside the point. Any system which gives so much power and so much discretion to a few men that mistakes—excusable or not—can have such far-

[49] James Buchanan and Richard Wagner, *Democracy in Deficit* 79–80 ([1977[Liberty Fund 1999).

[50] Milton Friedman, *A Monetary and Fiscal Framework for Economic Stability* in *Essays in Positive Economics* (Chicago 1953); Finn Kydland and Edward Prescott, *Rules rather than Discretion: The Inconsistency of Optimal Plans* 85 J Pol Econ 473 (1977); Richard Epstein, *Simple Rules for a Complex World* (Harvard 1995).

> reaching effects is a bad system. It is a bad system to believers in freedom just because it gives a few men such power without any effective check by the body politic—this is the key political argument against an "independent" central bank. But it is a bad system even to those who set security higher than freedom. Mistakes, excusable or not, cannot be avoided in a system which disperses responsibility yet gives a few men great power, and which thereby makes important policy actions highly dependent on accidents of personality. This is the key technical argument against an "independent" bank. To paraphrase Clemenceau, *money is much too serious a matter to be left to the Central Bankers.*[51]

The manipulation of money and credit, as well as deficit financing, is simply too seductive of a tool-set for earning short run political "profit" to be easily bound by rules. This is evident from the history of the Fed's relationship with political leaders. Even though the Fed is technically supposed to be independent, the reality is that the Fed regularly accommodates debt and succumbs to political pressures.[52] Peter Boettke and Daniel Smith document the relationship between each Federal Reserve chairman (beginning in the 1950s) with the president and Treasury Department. Consider some of these instances. In November of 1955, the Treasury was having a difficult time issuing securities on the market. As a response, the Federal Open Market Committee supported this debt issue.[53] Describing the events of this time, Jerome Clifford notes:

> Such quick and strong cooperative action showed that there was indeed a "revolving door" in the "fence" between the independent agencies, the Treasury and the Federal Reserve. Perhaps it could be said that really the fence was invisible and that the neighbors cultivated a common garden, but each with his own tools.[54]

Boettke and Smith also document how Dwight Eisenhower constantly put pressure on then chairman William Martin to provide

[51] Milton Friedman, *Capitalism and Freedom* 50 (Chicago Press 1962) (emphasis added).

[52] See Peter Boettke and Daniel Smith, *An Episodic History of the Federal Reserve Independence,* 20 Independent Rev (*forthcoming*), draft online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2135233 (visited Oct 11, 2015).

[53] Id at 5.

[54] Jerome Clifford, *The Independence of the Federal Reserve System* 321 (Pennsylvania 1965).

accommodating monetary policy throughout the 1950s.[55] This passage from Eisenhower's diary also illustrates this point:

> talked to the secretary of the Treasury in order to develop real pressure on the Federal Reserve Board for loosening credit still further. . . . Secretary Humphrey promised to put the utmost pressure on Chairman Martin of the Federal Reserve Board in order to get a greater money supply throughout the country.[56]

When Lyndon Johnson took office in 1963, he also utilized the Fed as he vastly expanded spending to begin his Great Society programs and to finance the Vietnam War.[57] Another well-documented event is the ongoing pressure that was put on then chairman Paul Volcker in the 1980s. Boettke and Smith write that, "thus, under the pressure to accommodate deficit spending, and under the pressure from the executive and legislative branch, Volcker delivered easy monetary policy."[58]

What these examples illustrate is that the Fed is often used as a tool for politicians, and this reality stands in direct opposition to Bernanke's statement that we need an independent Fed to "make monetary policy independently of short-term political influence."[59] In fact, it seems as though the Fed's monetary policy is used precisely for the purposes of short-term political needs.

In monetary policy, the three leading classical liberal political economists of the second half of the twentieth century—Hayek, Friedman, and Buchanan—all sought ways to bind the monetary authority by rules, only to be frustrated in their efforts and to think through additional ways to establish effective constraints. In frustration they all decided in one way or another to take monetary policy out of the hands of state decision makers.[60] Hayek, who originally advocated for central banks, became disillusioned with this idea. He most famously called for the denationalization of money and for the abolition of a state monopoly supplier of the currency. He stated:

> I do not want to question that a very intelligent and wholly independent national or international monetary authority might

[55] Boettke and Smith, *An Episodic History* at 4–6 (cited in note 52).

[56] As quoted in id at 5.

[57] Id at 6.

[58] Id at 18.

[59] Ben Bernanke, *Central Bank Independence, Transparency, and Accountability*, speech at the Institute for Monetary and Economic Studies International Conference (Nov 2010), online at http://www.federalreserve.gov/newsevents/speech/bernanke20100525a.htm (visited Oct 11, 2015).

[60] Peter Boettke and Daniel Smith, *Monetary Policy and the Quest for Robust Political Economy,* working paper (2014).

> do better than an international gold standard, or any other sort of automatic system. But I see not the slightest hope that any government, or any institution subject to political pressure, will ever be able to act in such a manner.[61]

He continued: "Money is certainly too dangerous an instrument to leave to the fortuitous expediency of politicians—or, it seems, economists."[62]

One of the great benefits of taking monetary policy out of the hands of the government is to immunize money from the influence of democratic politics. There are other institutional immunizations—for example currency boards—in fact, the European Central Bank was one such attempt to eliminate the ability of the member nations to monetize their fiscal irresponsibility and thus impose on them a need for fiscal discipline that otherwise they never could have pursued. Sound money may only be possible under a competitive note issue system, as advanced and argued by Lawrence White.[63] Political pressures aside, sound money requires a matching of the supply and demand for money in order to both provide the "needs of trade" and approximate, as best as is humanly possible, a "neutral" money.[64] George Selgin has argued that a free banking system best accomplishes this task because of the incentives and information provided through the competitive process of note issue, whereas a monopoly supplier of the currency would have to attempt to match the supply and demand for money without such guiding signals.[65]

Thus, in order to tame leviathan, we need to complement polycentricism with the decentralization of money. Since the Fed acts as an arm of the Treasury and is not constrained by its "independence" rule, the federal government does not face a hard budget constraint. Recall that a hard budget constraint is necessary to induce a government to act carefully with its finances. This ability to monetize debt

[61] F.A. Hayek, *Choice in Currency: A Way to Stop Inflation* (Institute for Econ Affairs 1976), online at http://www.iea.org.uk/files/upld-book409pdf?.pdf (visited at Oct 15, 2015).

[62] F.A. Hayek, *Denationalisation of Money* (Institute for Economics Affairs 1976).

[63] See Lawrence White, *Free Banking in Britain* (Cambridge 1984); Lawrence White, *Competition and Currency* (NYU 1992); Lawrence White, *The Theory of Monetary Institutions* (Wiley-Blackwell 1999).

[64] See George Selgin and Lawrence White, *How Would the Invisible Hand Handle Money,* 32 J Econ Lit 1718 (1994). Also, George Selgin, William Lastrapes, and Lawrence White, *Has the Fed Been a Failure?,* 34 J Macroecon 569 (2012). In this paper, they explain macroeconomic performance under the Federal Reserve System in the United States and argue that it has not outperformed earlier systems.

[65] George Selgin, *A Theory of Free Banking* (Rowman & Littlefield 1988).

basically tells the federal government that it can "go crazy" with spending. Taking money out of the hands of the federal government would harden the budget constraint of the government such that if it wanted to increase spending, it would only have two options: (1) increase taxes and (2) borrow. But this time, borrowing would have an enormous cost because the government would have to behave as other borrowers do in the market for loanable funds. Taking money out of the hands of government would constraint government in its growth and spending habits.

V. CONCLUSION

One of the reasons governments have grown expansively in the last century is because they are in a position to increase public debt and have the opportunity to monetize debts. The second half of the twentieth century was a long march away from the governing principles of classical liberal political economy. And, the twenty-first century has continued that trend rather than reversed it despite the evidence of the failure of the socialist alternative in Eastern and Central Europe and the former Soviet Union, and the problems identified with the social democratic welfare states of the western democracies. The public debt crisis that is identified with the PIIGS (Portugal, Ireland, Italy, Greece, Spain) countries could easily be applied to the situation in the United States with various states such as California, Illinois, Michigan, New York, and Wisconsin.

Adam Smith long ago identified the natural proclivities of governments to engage in the tactics of deficits, debts, and debasement. Left unconstrained, this method will lead to a breakdown of economies and economic well-being. Rather than serving as a warning as it had for roughly the first 150 years of U.S. history, the last seventy years have seen an intellectual justification for this tactic, and it has, in fact, become institutionalized. The unleashing of leviathan that results from the ability to run deficits, debts, and debasement resulted in an extraordinary expansion of the scale and scope of government. The problem is that this method is unstable, and in terms of long run economic vitality, it is disastrous.

The taming of this leviathan cannot rely on asking politicians to cut down on spending. We propose that the only way effectively to constrain government is by altering the institutional structures to be more polycentric and by eliminating the government monopoly on currency. While we acknowledge that these institutional fixes are not perfect, we believe they are the best available options since

they have important self-generating mechanisms to constrain government even in the face of temptations to expand. The complementary features of a polycentric institution with the decentralization of money would move us closer to a reality of a constrained government.