

# Origins and Impact of the Welfare State, 1883-1983 \*

## I. From Nightwatch State to Welfare State 1883-1983

The capitalist epoch began around the time of Marx's birth, and until the 1880s, when he died, the state's role was primarily passive and permissive. Classical political economy advocated policies of *laissez-faire*, and these were generally pursued in both the social and the economic field. It was an era when technology offered large prospects for profit, when international markets were much more open to competition than in the preceding merchant capitalist epoch, when profits were untaxed, and there was an unlimited supply of cheap labour at more or less subsistence wages.

The distribution of the gains from capitalist development was unequal. The bourgeoisie grew in size. They and older landowning and professional élites were enriched. In the working class, average subsistence needs increased as the urban-rural ratio rose, but illiteracy, population pressure, a repressive poor law, legal constraints on union activity and political disfranchisement kept them hungry, insanitary, ragged and exploited.<sup>1</sup>

The state was a nightwatchman whose expenditure was concentrated on soldiery and police protecting property and the national frontiers. It seemed inevitable that such a system should someday crack, as its ultimate legitimacy was so threadbare.

Since then capitalism has not collapsed and the state's role has grown significantly in four main dimensions:

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<sup>1</sup> I am here simply making the point which seems incontestable, that inequality increased. I am not suggesting that working class standards did not increase in absolute terms from 1820 to the 1880s.

a) "welfare state" expenditures (i.e. income transfers and provision of services like education and health) have grown enormously and more or less continuously upward. They now average nearly 30 per cent of GDP in advanced capitalist countries;

b) state involvement in steering the economy through activist macroeconomic management to promote full employment became very substantial from the 1930s to 1970s but is now receding;

c) the state's role as a producer and employer has grown significantly over the long haul. But the process has not been monotonically upward and it has been less important than European socialist parties originally hoped or liberal pessimists (like Hayek, von Mises and Schumpeter) feared;

d) microeconomic intervention in resource allocation through legal prescriptions, regulation, taxes, subsidies and tax expenditures (tax dispensations) is much bigger than it was a century ago, but to a degree which is difficult to measure. Here too the increase in the state role has fluctuated, and has not been inexorably upward.

This paper is concerned with the first of these phenomena where the growth of state responsibility has been the most spectacular. It analyses the reasons for the emergence of the welfare state, and its impact on economic growth.

The classical economists who wrote in the century preceding the 1880s (Smith, Ricardo, Malthus and J.S. Mill) had a good deal to say about state intervention in economic life and its likely repercussions. They were all strongly in favour of minimal state action because they thought that market forces would promote a natural harmony of interests. In particular any sizeable state interference to redistribute income was expected to reduce incentives to work and save. Malthusian population diagnosis predicted an inevitable return to mass poverty because of the stimulus that charity would give to fertility and population growth.

The incentive problem connected with public poverty relief had been extensively discussed in England in the sixteenth century when the Protestant takeover reduced the capacity of the church to provide charity. The classical economists were reiterating views already arti-

TABLE 1

## TOTAL GOVERNMENT EXPENDITURE AS A PERCENT OF GDP AT CURRENT PRICES

	1880	1913	1929	1938	1950	1960	1973	1981
France	11.2	9.9 (a)	12.0	21.8	27.6	33.9	38.8	48.7
Germany	10.0 (b)	17.7	30.6	42.4	30.4	33.4	41.2	47.7
Japan	9.0 (c)	14.2	18.8	30.3	19.8	20.9	22.9	34.1
Netherlands	n.a.	8.2 (d)	11.2	21.7	26.8	36.1	49.1	59.0
U.K.	9.9	13.3	23.8	28.8	34.2	32.9	41.5	46.4
U.S.A.	n.a.	8.0	10.1	18.5 (e)	22.5	27.9	32.0	34.4
Average		11.9	17.8	27.3	26.9	30.9	37.6	45.1

a) 1910-13; b) 1881; c) 1885; d) 1910; e) 1939.

Sources: 1950-81 generally from National Accounts of O.E.C.D. Countries, various issues.

Otherwise as follows:

France: 1880-1938, numerator from L. FONTVIELLE, *Evolution et Croissance de l'Etat Français 1815-1969*, ISMEA, Paris, 1976, pp. 2118, and 2124-9. The current price physical product denominator (p. 1745 for 1880; 1929) was increased by a coefficient of 1.43 to convert it to a GDP basis, and 5 year averages were unscrubbled by interpolation. 1938 GDP from *Statistique of National Product and Expenditure*, No. 2, O.E.C.D., Paris, 1971.

Germany: 1881 and 1913 from S. ANDIC and J. VEVERKA, "The Growth of Government Expenditure in Germany since Reunification", *Finanzarchiv*, January 1964, p. 241-3.

Japan: 1885-1960 from K. OHKAWA and M. SHINOHARA, *Patterns of Japanese Development*, Yale, 1979, pp. 251-4 and 370-2.

Netherlands: 1910-38 very rough estimate derived from *Tidningslaren Statistiek in Tijdskraken*, CBS, The Hague, 1979, pp. 144 and 150. Trend movement derived from "hijnsaigaven" divided by net national product at market prices, adjusted by the 1950 coefficient of this ratio to government expenditure/GDP ratio derived from OECD National Accounts for 1950.

U.K.: 1880 government expenditure from J. VEVERKA, "The Growth of Government Expenditure in the United Kingdom since 1790", *Scottish Journal of Political Economy*, 1963; 1913 from A.T. PEACOCK and J. WISEMAN, *The Growth of Public Expenditure in the United Kingdom*, NBER, Princeton, 1961, p. 164; GDP at market prices from C.H. FEINSTEIN, *National Income, Expenditure and*

*Output of the United Kingdom 1855-1965*, Cambridge, 1972, pp. 1-14-8.

U.S.A.: 1913-59 government expenditure from S. FABRICANT, *The Trend in Government Activity in the United States Since 1900*, NBER, New York, 1952, p. 27; 1913 GNP from J.W. KENDRICK, *Productivity Trends in the United States*, NBER, Princeton, 1961, p. 297; 1929 and 1939 GDP from "The National Income and Product Accounts of the United States: An Introduction to the Revised Estimates for 1929-80", *Survey of Current Business*, December 1980.

culated in preparing Elizabethan legislation, or by Locke and Defoe in the seventeenth and eighteenth centuries.<sup>2</sup> The classical views were expressed most harshly by Malthus, and most generously by J.S. Mill.<sup>3</sup> But, by modern standards, the gap between Malthus and Mill was rather small. Both believed that unless poverty relief was kept to meagre levels (involving material privation and constraints on the liberty of paupers) the economic results would be disastrous.

In 1883, therefore, most observers expected the state's role in economic life to remain minimal. The dominant official view was the *laissez-faire* "liberalism" of classical political economy, which we have just described. Marx viewed the state as an apparatus to reinforce the exploitation of the masses by the ruling class. He never conceived of the capitalist state significantly promoting growth or alleviating social tension. When he did back political action within a capitalist framework it was not to urge the potential for welfare expenditure, but for regulatory intervention to shorten working hours to 10 per day. Most other socialists (e.g. Robert Owen) in the first half of the nineteenth century wanted to solve the social problem via self-starting utopian experiments that did not require state action.

One exception to the received opinion was Adolph Wagner, who in 1883 enunciated his "law" of a steadily rising proportion of public expenditure. Wagner was a *Kathedersozialist* who like many professors before and since, was distilling a tendency which he wanted to see rather than describing a phenomenon based on empirical observation.<sup>4</sup> But Wagner in fact adumbrated the characteristics of a welfare state. He favoured progressive taxation, public education, state control of railways etc. Between 1820 and 1880 there was no observable tendency for increased public expenditure in capitalist countries, but Wagner's prediction was better than his history. "Welfare state" expenditures have grown from below 2 per cent of GDP in 1883<sup>5</sup> to a typical figure of

<sup>2</sup> For the sixteenth century texts see A.E. BLAND, P.A. BROWN, and R.H. TAWNEY, *English Economic History: Select Documents*, Bell, London, 1914, and for eighteenth century views, see D. MARSHALL, *The English Poor in the Eighteenth Century*, Kelley, New York (reprint) 1969.

<sup>3</sup> Mill was more optimistic because he believed that birth control could check the Malthusian spectre. He also favoured freedom for trade unions, encouragement to cooperatives, peasant landownership, wealth equalization through death duties, some limited subsidization of elementary education and regulation of working hours. See J.S. MILL, *Principles of Political Economy*, Sixth (people's) edition, Longmans Green, London, 1880.

<sup>4</sup> See A. WAGNER, "Three Extracts on Public Finance", in R.A. Musgrave and A.T. Peacock, eds., *Classics in the Theory of Public Finance*, Macmillan, London, 1967.

<sup>5</sup> The U.K. figure for 1890 was 1.9 per cent of GDP, see A.T. PEACOCK and J. WISEMAN, *Op. cit.*, p. 184. For other countries, the figure is more difficult to establish, but the German ratio

nearly 30 per cent in 1983, and now dwarf public expenditure on the traditional domain.

One of the remarkable things about the growth of the welfare state is that there has been rather little analysis by economists of the dimensions of its growth, the causes of the growth and its economic impact. As the average per capita output of capitalist countries has increased more than sevenfold since 1883, it is quite clear that the classical economists were wrong about the disincentives to growth arising from state welfare. Their type of critique was also weakened by the discredit into which Malthusian population theory and classical wage theories had fallen by the 1880s when economists such as Marshall and Sidgwick began to take a brighter view of welfare possibilities. From time to time liberal economists have continued to allege the disincentive impact of transfers. Robbins and Rueff suggested that prewar unemployment was caused in large degree by overgenerous unemployment insurance, but until recently, this was regarded as wild exaggeration. The liberal critics therefore concentrated their attack on biases in voting procedure which prevent the electorate from getting what it really wants,<sup>6</sup> or on the "free lunch" illusion by which populist politicians delink social benefits from the taxation required to finance them, or on the bureaucratic dangers that loom when state programmes grow.<sup>7</sup>

There has of course been a very large literature on public choice which has explored the microeconomic efficiency of government expenditure and taxation and its welfare impact, but there is very little on the state in the growth accounting literature or in that on the longer run macroeconomics of capitalist performance. Simon Kuznets, J.W. Kendrick and Dale Jorgenson have more or less ignored the question, and E.F. Denison gives it very little weight. Colin Clark is an exception in that he published an article in 1945 predicting that tax levies beyond a threshold of 25 per cent of GDP would end the capitalist accumulation process. But Clark was proved quite wrong by subsequent experience.

in the 1880s seems to have been well below 2 per cent from the evidence in ANDIC and VEVERKA, *Op. cit.* It is interesting to note that the proportion was similar in England in the seventeenth century. According to Gregory King's calculation for 1688 the poorer half of population (51.4 per cent) were estimated to spend more than they earned by an amount equivalent to 1.4 per cent of national income. This includes dissaving, but most of it was presumably transfers. See G.E. BARNETT, *Two Tracts by Gregory King*, Johns Hopkins, Baltimore, 1936, p. 31.

<sup>6</sup> See J.M. BUCHANAN and G. TULLOCH, *The Calculus of Consent*, University of Michigan, Ann Arbor, 1962.

<sup>7</sup> See W.A. NISKANEN, *Bureaucracy and Representative Government*, Aldine, Chicago, 1971.

In the past decade, however, liberal critics of the welfare state have advanced much stronger allegations about its dysfunctionality and they have also gained greatly in political power particularly in the U.K. and U.S.A. Former welfare state supporters have manifested various kinds of disillusion about its ability to resolve social conflict. In both camps, old fashioned fiscal conservatism has reemerged rather strongly as the momentum of welfare state expansion has been largely responsible for creating sizeable budget deficits in the period of slow economic growth since 1973. Governmental action to dismantle the welfare state has as yet been very limited, and does not begin to match the victories which the "liberal" school has had in moving macroeconomic policy away from what were predominantly Keynesian guidelines. Meanwhile, the evidence on the economic impact of the welfare state remains fuzzy.

This paper is intended as a diagnosis of the growth of the welfare state since 1883. It examines the causal forces behind its expansion, and its impact in mitigating the social conflicts which Marx detected in the first decades of modern capitalist development. It also considers whether the welfare state has reached dysfunctional limits which impede economic performance and which might provide a rationale for its dismantlement.

On such broad issues, it is difficult to assemble convincing evidence. I have therefore augmented the historical record with cross-country analysis of development in the five big capitalist economies plus the Netherlands.

## II The Sociopolitical Forces which Produced the Welfare State

Bismarck was the politician who pushed capitalism in a new direction. Given the Prussian tradition of paternalism and *Staatsräson* he had no *laissez-faire* inhibitions limiting state action in social and economic affairs. As the architect of German unification he had a clearer view of the need to legitimate his new creation than politicians in older countries who took this for granted. Germany also had the best organised socialist movement, and many academics, like Wagner, who felt that the state needed to play a more active role in mitigating the social tensions of capitalism.

Since Bismarck's day, the welfare state has expanded enormously under a variety of political pressures. It has grown incrementally, and not as a grand design or a neatly structured edifice which serves clearly defined goals.

The growth impetus has come from several different sources. On the right side of the political spectrum, we have Bismarck who regarded state provision of welfare as "system-legitimation" — a positive counterpart to the Anti Socialist laws. Marxist critics of welfare capitalism have continued to interpret it in this Bismarckian light. But, on the left, the welfare state has been supported by reformist socialists who have seen its growth as fulfilment of their distributive aspirations, i.e. as "system-modification". This possibility was suggested in 1889 by the English Fabian socialists who saw the possibility of using the state for redistributive purposes because extensions of the franchise would provide opportunities for the labour movement to lobby and govern, and the advancing "material wealth" which was by then discernible made such redistribution possible without wrecking incentives.<sup>8</sup>

Between Bismarck and Bernard Shaw, we find other pundits of the welfare state who occupy a middle ground in the political spectrum. As the franchise was extended and real income rose, populist politicians used the state's taxing power to provide both services and transfer incomes on a huge scale, in a succession of *ad hoc* attempts to mitigate social tension and meet the claims of competing social groups.<sup>9</sup>

In the following discussion, I have defined the welfare state to include government expenditure in kind on services which meet "merit wants" (education, health services, housing etc.), and expenditures on cash transfers (pensions, unemployment compensation, family allowances, cash sickness benefits etc.). I have also assumed that the notion of welfare state requires some consideration of the size and progressivity of tax burdens.

Germany pioneered state insurance with three pieces of legislation. Sickness insurance was legislated in 1883 (extended in 1888) and

<sup>8</sup> See BERNARD SHAW, *et al.*, *Fabian Essays*, Allen and Unwin, London Jubilee edition, 1948. Shaw made these points very clearly on pp. 171-3. Sidney Webb argued with a characteristic piece of gradualist history that the concept of a social organism had been developing since 1848 under the influence of J.S. Mill, and cited regulatory and public health acts which had been passed earlier in the course of the nineteenth century, as evidence of the eclipse of *laissez-faire*.

<sup>9</sup> For a description of the process from one who, by European standards, occupies the populist middle ground, but who sometimes describes himself as a reformist socialist, see J.K. GALBRAITH, *American Capitalism: The Concept of Countervailing Power*, 1952.

provided income maintenance payments for workers during sickness absence who earned below a certain income threshold. In 1884 there was legislation providing compensation for industrial injury in occupations where there were substantial risks of this nature, and in 1889 a system of old age and sickness pensions was introduced. The first two schemes involved compulsory contributions by employers and workers and covered 12 million workers in 1890. The pension scheme was the only one which involved a government subsidy.

In the period from these reforms until the first world war, Western European countries generally moved in the German direction. The U.K. held on to the Malthus-Ricardo-Mill tradition until 1909 when the Welsh populist Lloyd George introduced state coverage for similar risks and also introduced unemployment insurance (which Germany did not have until 1927).

The pressure for such reforms in the U.K. came from the labour movement which grew strongly after the easing of restrictions on trade union activity and the gradual extension of the franchise. The evidence of poverty collected in the first social surveys (Mayhew, Booth and Rowntree) also helped, as did the activism of Fabian reformers like the Webbs who conducted inquiries into the Poor Laws. Beveridge's 1909 enquiry into unemployment had a significant impact and he was later a very influential advocate for a comprehensive welfare state and Keynesian policies to promote full employment.<sup>10</sup>

The last quarter of the nineteenth century saw increased public provision of compulsory primary education, and in the beginning of the twentieth century some secondary education. There was limited state action to improve sanitation and promote public health, but generally no public provision of health services. The motivation for state action in these fields was similar to that in social insurance. There was also some awareness of education's role in improving human capital which in Europe probably went furthest in Germany which promoted higher education and R and D earlier than other European countries.

State education was resisted in ecclesiastical circles and helped to provoke the *Kulturkampf* in Germany and the controversy surrounding the Jules Ferry laicisation reforms in France. In all Western European countries there was a degree of compromise, by which the state left

<sup>10</sup> See W.H. BEVERIDGE, *Unemployment: A Problem of Industry*, Longmans, London, 1909, *Full Employment in a Free Society*, Allen and Unwin, London, 1944, and *Social Insurance and Related Services: Report by Sir William Beveridge*, HMSO, London, 1942.

some role for church education and usually contributed substantially to finance it.

In the U.S.A., the tradition of rugged individualism held strong until 1935 when the social security system was introduced as part of Roosevelt's New Deal. Although the American provision of social insurance still lags well behind that of European countries, the U.S.A. went much further than Europe as an early provider of public education. This was in part because as an immigrant country, education was viewed as a powerful vehicle for national integration. U.S. tradition since Jefferson has always given strong emphasis to social mobility rather than social equality, and there was also a greater awareness than in Europe of the role of education in contributing to the supply potential of the economy.

In Japan, which in spite of location, can appropriately be treated as a major bastion of Western capitalism, the role of the state in social insurance has been a good deal smaller than in Europe, partly because other social arrangements covered some of the risks. But the state has always played a major role in bolstering the supply potential. Ever since the Meiji restoration in 1867, Japanese government has promoted technical progress, industrial investment and spent heavily on a public education system which provides an ample supply of skills and social discipline. Since 1960, Japanese welfare state expenditures have risen very rapidly.

During the first world war, the role of the state increased enormously in absorbing resources directly for military purposes, in raising taxes, and in regulating resource allocation. The degree of mobilization was probably higher than in the Napoleonic wars, and the potential regulatory scope for state action within a capitalist framework was amply demonstrated. The outcome of the war was a shakeup in the social hierarchy, particularly in defeated countries such as Germany and Austria, the emergence of a communist state on the doorstep of Western capitalism, and a strong feeling after such large scale and in retrospect such pointless sacrifices, that the political legitimacy of all Western countries needed to be consolidated by universal suffrage in countries which had been subjected to general mobilization.

Thus the forces that had fostered social insurance in prewar years were strengthened. The wartime growth of the government's role in production and resource allocation was largely reversed, but the coverage of social insurance and public education grew. Most countries developed some kind of unemployment insurance and widened the

TABLE 2

COVERAGE OF PUBLIC PENSION INSURANCE 1900-1970  
(Percent of Labour Force)

	France	Germany	Netherlands	U.K.
1900	8	51	0	0
1915	9	58	50	55
1930	15	64	55	90
1945	52	65	66	109
1960	93	82	169	99
1970	100	81	170	98

Source: P. FLORA and A.J. HEIDENHEIMER, *The Development of Welfare States in Europe and America*, Transaction Books, New Brunswick, 1981, p. 76.

coverage of "public assistance", i.e. non-insured social risks began to be covered with less of the stigma of older attitudes towards the "undeserving poor". In every country included in our table 1, government expenditure increased as a share of GDP between 1913 and 1929. The war also brought a substantial regulatory role for government in housing markets, and in some countries important public housing construction and rental programmes. In almost all countries, the tax structure had been extended in wartime to include income tax, and this feature persisted. In this sense, the expansion of war finance had a certain ratchet effect as suggested by Peacock and Wiseman.<sup>11</sup>

However, this ratchet was only a very partial reason for government expansion as experience subsequent to the 1929 recession demonstrated that government's role could make a major leap forward in peacetime. Between 1929 and 1938 there was a massive increase in the relative importance of public expenditure in all the countries covered in table 1. Germany and Japan both tilted sharply towards totalitarianism with much increased military spending and widespread control of industry. But in France, the Netherlands, U.K. and U.S.A.,

<sup>11</sup> See A.T. PEACOCK and J. WISEMAN, *The Growth of Public Expenditure in the United Kingdom*, Princeton, 1961.

massive unemployment led to increased social spending, to "structural" support programmes for industry, farm relief programmes etc.

The second world war involved many Western governments in even bigger resource mobilization efforts than the first, to higher levels of taxation, and to patterns of taxation which would produce a strong "fiscal dividend" in the subsequent conditions of rapid economic growth and inflation. This was one factor facilitating finance of public spending in the postwar era. Nevertheless, the average proportion of GDP spent by Western governments was lower in 1950 than in 1938. This was due in substantial measure to the dismantlement of the totalitarian state in Japan and Germany and to their demilitarization. In other countries the government role had grown. In the U.K. there was a substantial increase in public spending due to the implementation of Beveridge's comprehensive social insurance proposals by the postwar Labour government, to the introduction of a national health service and education expansion. In France too there was a broadening of social insurance and health coverage, as well as a very generous pro-natal system of family allowances.

Progress in these directions also occurred in the Netherlands, but it was only later that it became the top government spender, when the natural gas bonanza put large extra resources (about 6 per cent of GDP) into the hands of government. In the U.S.A., the increased role of government by 1950 was due to high military spending and the cold war. Social expenditure had not increased.

In the golden years of fast economic growth to 1973, the growth of government expenditure was concentrated in health, education, housing, the new area of "environment", and on social transfers. Expenditure on traditional public goods such as defence actually declined as international tensions eased.

In providing merit goods and social transfers, there was a certain "bandwaggon effect". Once these programmes grew beyond a certain size and involved large tax levies, there was a tendency for their coverage to become universal rather than to remain restricted to beneficiaries who would otherwise be in hardship. Middle class voters could see that there were substantial benefits from participation in schemes which they had in any case to help finance, and the stigma of indigence which may have formerly been involved in participation in such schemes disappeared when their coverage was enlarged and benefits came as cheques in the mail rather than cash in the post office.

The growth of welfare expenditure was encouraged by changes in demographic structure. In the 1880s, people aged 65 and more were on average only 5 per cent of the population of our six countries. Now they are 13 per cent of the population and count rather heavily in voting for both pensions and health services from which they are the main beneficiaries.

The persistent incidence of inflation and general practice of rent control made it difficult to make private provision for retirement or risk contingencies via insurance or small investments. This produced a greater reliance on indexed inflation-proof public schemes.

Another significant influence in raising the welfare share of GDP was the fact that measured productivity in education and health services was declining. There was pressure from professional bodies to increase manning levels, e.g. the teachers' unions pressed for smaller classes, medical personnel in hospitals rose in numbers relative to the patients. In a period of rapid economic expansion, teachers and doctors were also able to preserve rather favourable salary scales.

Finally, an important reason for expansion in transfer payments in the 1960s was the widened concern with poverty whose nature was redefined. In the 1950s, the British tended to think that the postwar expansion of their welfare state had virtually abolished poverty and that progressive taxation had produced much greater equality. In 1951, Rowntree and Lavers found only 2 per cent of the population of York in poverty compared with nearly 18 per cent in 1936.<sup>12</sup> But in the 1960s British poverty was rediscovered and redefined. Titmuss<sup>13</sup> was the leader of the movement in the academic world but it had wide support amongst the growing number of sociologists and social workers who formed the major lobby for the expansion of social coverage on a non-insurance basis, e.g. supplementary benefits. In 1970 Atkinson, after a careful survey of the evidence concluded that 9 per cent of the British population were living in poverty.<sup>14</sup>

<sup>12</sup> See B.S. ROWNTREE and G.R. LAVERS, *Poverty and the Welfare State*, Longmans, London 1951 on poverty levels. DUDLEY SEERS had also argued that there had been a major shift in income distribution because of tax changes, *Bulletin of the Oxford Institute of Statistics*, Vol. 12, no. 10. This induced C.A.R. CROSLAND to downplay the importance of distributional issues in his influential, *The Future of Socialism*, Cape, London, 1956, pp. 42-53. At the same time and using the same evidence J. STRACHEY, *Contemporary Capitalism*, Gollancz, London, 1956 produced a Marxist revisionist analysis of the historical development of welfare states and progressive taxation as social progress obtained by pressure of the labour movement in parliamentary democracies.

<sup>13</sup> See R.H. TITMUSS, *Income Distribution and Social Change*, Allen & Unwin, London, 1962.

<sup>14</sup> See A.B. ATKINSON, *Poverty in Britain and the Reform of Social Security*, Cambridge, 1970. This new awareness of poverty was also present in other European countries, as reflected e.g. by the creation of the Swedish Low Income Commission or L. STOLERU's book, *Vaincre La Pauvreté Dans les Pays Riches*, Flammarion, Paris, 1977.

The rediscovery and redefinition of poverty also occurred in the U.S.A. In 1952 Galbraith wrote "in recent times, for most people the biological minimums of food, clothing and even shelter have been covered as a matter of course. By comparison the further wants are comparatively unimportant".<sup>15</sup> But in 1962 Harrington claimed that a majority of Americans was poor and later Jencks defined poverty as a relative not an absolute level of living.<sup>16</sup> The academic lobby played a smaller role in influencing the Lyndon Johnson welfare expansion (Food Stamps, Medicaid, Medicare and AFDC) than academics did in the U.K. The main reason was the widespread rioting by the black population in the cities, who wanted something more material to supplement civil rights legislation.

In the 1960s and 1970s there was a general move to universalize social benefits, so that the distinction between social insurance and social transfers has become rather blurred in Europe, and in the Netherlands has virtually disappeared. In the U.S.A. where social insurance programmes are run on a trust fund basis, there is still a sharp distinction between insurance and "welfare" payments, and the latter have less political legitimacy than in most of continental Europe. The U.K. is in a somewhat intermediate position with supplementary income payments and various *ad hoc* benefits playing a major role.

Since 1973, there has been another substantial leap forward in government expenditure. This has generally been smaller than in the 1930s, and has occurred because of the built-in stabilizer characteristics of advanced welfare states, even though the macropolicy stance of governments has generally been restrictive. Unemployment compensation has obviously risen, though by less than would seem warranted by the extent of the problem. Other social transfers have risen, to some extent to disguise unemployment. Hence Dutch payments for "handicapped" workers removed from the labour force rose from 2 to 4.3 per cent of GDP from 1973 to 1980. In other countries there have been substantial extra payments for "pensions" to workers persuaded to retire prematurely, and many supplementary (non insurance) programmes have grown to augment the income of the unemployed.

<sup>15</sup> See J.K. GALBRAITH, *American Capitalism*, Penguin, London, 1952, p. 116.

<sup>16</sup> See M. HARRINGTON, *The Other America*, Penguin, London, 1962, and C. JENCKS, *Inequality*, Harper, New York, 1972.

### III. Government Spending Levels in the 1980s

Table 3a classifies the present structure of government expenditure. The traditional domain of "public" wants is not much larger now than it was in the 1880s. The big difference is in "merit" wants,<sup>17</sup> and income maintenance, which together absorb amounts varying from 20 per cent of GDP in Japan and the U.S.A. where the government commitment is weakest to nearly 40 per cent in the Netherlands where it is highest.

Table 3 defines government in a national accounting sense, and therefore excludes public enterprise activity. The importance of this varies between countries a good deal, being now biggest in France amongst the countries listed and smallest in the U.S.A.<sup>18</sup>

Another problem of inter-country comparability arises from "tax expenditures" i.e. derogations deliberately built into the normal system of tax liability as a form of subsidy for certain types of spending. Thus the U.S. gives tax derogations to people with children or for private pensions, health insurance and education spending. These are a substitute for some of the government expenditure on these items which occur in other countries. Table 3 may therefore somewhat understate the U.S. governmental role compared with that of Europe. In Germany tax expenditures amounted to 1.9 per cent of GDP in 1980 and in the U.S.A. federal "tax expenditures" alone were bigger at 5.7 per cent of GDP in 1979.<sup>19</sup> However, it is very difficult to compare "tax expenditures" (a) because they are a tax foregone rather than a tax collected: (b) they require definition of the "normal" tax structure from which a derogation is granted, and (c) a definition of "normal" income as distinct from expenses incurred in producing it.

<sup>17</sup> The terms "public" wants and "merit" wants are taken from R.A. MUSGRAVE, *The Theory of Public Finance*, McGraw Hill, New York, 1959. Public goods must be provided by the State because they benefit everyone, and it is not possible to restrict access to them. They could not be financed by voluntary contributions, because the great majority would choose to be "free riders". Unlike "public goods", "merit goods" flow in some degree to individuals who could be required to pay personally for the services received.

<sup>18</sup> In 1975-9, employment in public enterprise was estimated to be 4.4 per cent of total employment in France, 7.9 per cent in Germany, 8.2 per cent in the U.K. and 1.6 per cent in the U.S.A., see L. PATHIRANE and D.W. BLADES, "Defining and Measuring the Public Sector: Some International Comparisons", *Review of Income and Wealth*, September 1982, p. 273. Since the 1981 nationalizations, French public enterprise employment has risen to around 10 per cent of the labour force.

<sup>19</sup> See DEUTSCHER BUNDESTAG, *Achter Subventionsbericht*, Bonn, 1981 and the annual U.S. reports on this topic.

TABLE 3(a)

## STRUCTURE OF GOVERNMENT EXPENDITURE AS PERCENT OF GDP AROUND 1980

	France 1980	Germany 1980	Japan 1981	Netherlands 1978	U.K. 1979	U.S.A. 1978	Average
Total	46.9	48.5	34.1	57.8	43.4	33.8	44.1
TRADITIONAL COMMITMENTS							
Debt Interest	1.7	1.9	3.6	4.0	4.6	2.7	3.1
"Public Wants" (Defence and General Government)	7.4	8.5	4.2	10.3	8.7	8.5	7.9
MODERN COMMITMENTS							
Economic Services	3.4	5.3	6.0	3.8	3.9	3.4	4.3
"Welfare State" (Merit Wants and Income Maintenance)	34.4	32.8	20.3	39.7	26.2	19.2	28.8

TABLE 3(b)

## DETAIL OF WELFARE STATE EXPENDITURES AS PERCENT OF GDP AROUND 1980

	France 1980	Germany 1980	Japan 1981	Netherlands 1981	U.K. 1979	U.S.A. 1978	Average
"Merit Wants"	15.9	13.8	12.6	(18.7)	13.9	9.0	13.8
a) Education	5.7	5.1	5.0	7.1	5.4	5.7	5.7
b) Health	6.2	6.5	4.7	6.6	4.7	2.5	5.2
c) Housing	3.2	1.4	2.4	} (5.0)	3.3	0.4	} 2.9
d) Other	0.8	0.8	0.5		0.5	0.4	
Income Maintenance							
a) Pensions	11.9	12.5	4.8	13.0	7.4	7.4	9.5
b) Sickness Cash Benefits	1.2	0.7	0.1	1.9	0.3	0.1	0.7
c) Family Allocations	2.2	1.2	1.6	2.0	1.4	0.5	1.5
d) Unemployment Compensation	1.9	1.4	0.4	1.0	1.4	0.5	1.1
e) Other	1.2	1.0	0.7	1.4	0.0	0.5	0.7

Source: OECD Statistics Division, OECD National Accounts, and Dutch national sources.



Other problems in defining the scope of government expenditure arise from government loan guarantees or other devices to disguise off-budget loan activity.<sup>20</sup> However, table 3 is based on national accounting conventions which are more comparable between countries than "budgets", and less likely to conceal governmental off-budget loan activity.

It should be noted that the state is not nearly so important proportionately as an employer or producer as it is in terms of expenditure. Public employment averages about a sixth of total employment in our six countries, and government carries out a somewhat bigger proportion of production.<sup>21</sup>

Table 4 shows the structure of government current revenue in 1950 and 1980 which provides a rough idea of how government finances its expenditure. In 1980 roughly equal amounts were raised from social security levies, direct and indirect taxation (another 4 per cent being raised from miscellaneous current revenue, and in that year all the countries ran a budget deficit). However the situation varies by country. Social security levies are three times as high in the Netherlands as in the U.K. The Netherlands is also in the lead for direct taxes, and "other" sources of revenue; the U.K. is the leader for indirect taxes, levying almost three times the proportion of Japan. Since 1950 all countries have raised the tax burden considerably with the biggest leap in the Netherlands.

#### IV. The Social Impact of Government Action

It is not easy to give an authoritative assessment of the role of government in social progress over the past century, because it is not possible to reconstruct a counterfactual framework, without this very pervasive influence. However, there can be little doubt that government has improved and equalized social welfare by mitigating the hardships associated with unemployment sickness and old age and by improving health and education.

<sup>20</sup> See *The Underground Federal Economy: Off-budget Activities of the Federal Government*, JOINT ECONOMIC COMMITTEE, U.S. CONGRESS, April 1982, which argues that more comprehensive measures of government produce a less alarmist view of budget deficits.

<sup>21</sup> See *Employment in the Public Sector*, OECD, Paris, 1982, p. 12.

TABLE 4  
CATEGORIES OF GOVERNMENT CURRENT REVENUE AS A PROPORTION OF GDP

	Total Current Revenue	Social Security Levies	Direct Taxes	Indirect Taxes	Other
	1950				
France	32.9	9.3	5.6	15.3	2.7
Germany	31.6	7.7	9.0	13.4	1.5
Japan <sup>(a)</sup>	21.9	1.9	8.9	9.7	1.4
Netherlands	33.0	4.3	13.4	12.7	2.6
U.K.	33.5	3.4	13.8	16.0	0.3
U.S.A.	24.0	2.4	13.2	8.3	1.0
Average	29.5	4.8	10.7	12.6	1.6
	1980				
France	45.4	18.3	8.6	14.7	3.8
Germany	42.8	14.1	12.6	12.8	3.3
Japan	28.2	7.4	11.0	7.6	2.2
Netherlands	55.4	18.4	16.1	12.1	8.8
U.K.	40.6	6.2	14.4	16.2	3.8
U.S.A.	32.7	7.9	14.8	8.2	1.8
Average	40.9	12.1	12.9	11.9	4.0

(a) 1952.

Source: *National Accounts of OECD Countries 1950-68 and 1963-1980* editions, OECD, Paris.

The average person in 1983 has a life expectation of around 73 years in the advanced capitalist countries as against 46 a century earlier. Most of this improvement would probably have occurred without much change in government's role, because of progress in medicine and pharmacology. But the rather sharp division of life into three stages of schooling, work and retirement would not have been as marked without the heavy government commitment to both compulsory and postcompulsory education, its provision of pensions and retirement rules. Now the average person gets 10 years of schooling and 8 years of retirement, and government has helped to institutionalize this.

Similarly the average person now works only 1700 hours a year, because of shorter hours, time off for paid vacations and paid sickness absenteeism. Collective bargaining helped to bring this about, but so did government action. The intercountry differences in this field — five week holidays in France and 1 week in Japan clearly reflect different government attitudes.

Kuznets has suggested that capitalist development at first involved increased inequality<sup>22</sup> and then took a U-turn towards increased equality. This conclusion is certainly correct for disposable income after taxes and transfers though it is less true for primary income.

Governments have helped equalize primary income over the past century by provision of more equal educational opportunity and permitting greater freedom for trade union bargaining. The bargaining power of workers was also strengthened by the termination of what Arthur Lewis called the phase of unlimited supply of labour (i.e. the wilting supply of labour from agriculture, and in the U.K. case, from Ireland).<sup>23</sup> This was not due to government action but is probably one of the main reasons why the bargaining power of workers is stronger in advanced capitalist countries than in the third world.

However, in the past two or three decades, the availability of social transfers has tended to increase inequality in primary income because it induces people to stop working and to set up separate household units which are only sustainable because of the existence of social transfers.

When post-tax, post-transfer incomes are considered, the most powerful equalizing instrument is cash transfers provided by social security and welfare schemes. The tax systems of Western countries do much less to promote equality than their apparently progressive structures would suggest, as the big expansion of social transfers since 1950 has been financed mainly by rather regressive social security levies (see table 4).

The relative role of the factors influencing income distribution is shown in table 5. It is clear that transfers reduce the inequality of original income most. The decile ratio for "original" income is 49:1 and

<sup>22</sup> See S. KUZNETS, "Economic Growth and Income Inequality", *American Economic Review*, March 1955. See F. KRAUS' contribution to FLORA and HEIDENHEIMER, *Op. cit.* for an extensive review of the literature on distribution and of causal influences.

<sup>23</sup> See W.A. LEWIS, "Economic Development with Unlimited Supplies of Labour", *Manchester School of Economic and Social Studies*, May 1954. For an interpretation of Japanese experience from this perspective, see R. MINAMI, *The Turning Point in Economic Development: Japan's Experience*, Kinkuniya, Tokyo, 1973. The abandonment of classical (subsistence) wage theory in favour of marginal productivity theory occurred at about the time of the Lewis transition in European countries.

TABLE 5

## RATIO OF TOP TO BOTTOM INCOME DECILE

	Original Income	Pre-Tax Post-transfer Income	Post-Tax Income	Distributive Impact of Transfers	Distributive Impact of Direct Taxes
France	33.7	20.7	21.7	13.0	-1.0
Germany	34.1	12.4	10.8	21.7	1.6
Japan	n.a.	9.9	9.1	n.a.	0.8
Netherlands	n.a.	13.5	10.7	n.a.	2.8
U.K.	66.8	11.8	9.4	55.0	2.4
U.S.A.	61.8	23.7	17.7	38.1	6.0
Average	49.1	15.3	13.2	32.0	2.1

Source: M. SAWYER, "Income Distribution in OECD Countries", *Occasional Studies, Economic Outlook*, OECD, Paris, July 1976.

the post transfer ratio is 15:1. The tax system, by contrast only reduces the post-transfer range from 15:1 to 13:1.<sup>24</sup>

Over the past century, the distribution of wealth has also become more equal mainly because of the spread in house-ownership, but the inequality of wealth is very much greater than that for income. Wealth taxes are small, inheritance tax can often be bypassed, and there have been no revolutionary confiscations of wealth as in Eastern Europe. The U.K. Gini coefficient for wealth distribution in 1971 was .84 compared with .34 for pre-tax income. In the U.S.A. the comparable figure for wealth in 1962 was .76, and .41 for income (in the 1970s).<sup>25</sup> The wealth picture is more equal if future pension rights are considered as capital,

<sup>24</sup> The only country which produces a regular survey of the overall distributional impact of the welfare state including public services in kind such as health and education is the U.K. British education and health expenditures were found to be redistributive but to a milder degree than for transfers. See "The Effects of Taxes and Benefits on Household Income, 1981", *Economic Trends*, December 1982.

<sup>25</sup> See *Social Trends*, No. 4 for U.K. wealth distribution, and D.S. PROJECTOR and G.S. WEISS, *Survey of Financial Characteristics of Consumers*, 1966, p. 30 for U.S. wealth distribution. Income distribution is from M. SAWYER, *Op. cit.* The Gini coefficient ranges from zero (complete equality) to 1 (complete inequality where the top person has all wealth or income).

but few people would consider non-negotiable rights in state pensions (or other social benefits) as part of their wealth.<sup>26</sup>

One of the egalitarian arguments for increased educational expenditures has been the expectation that it would contribute to social mobility. This is an area where change is very difficult to measure, but the evidence suggests that the changes have been rather modest. Thus a major U.S. study concluded that social mobility did not change much in the first half of the twentieth century and sociologists in other countries have reached similar conclusions.<sup>27</sup>

### V. Has the Welfare State Reached Dysfunctional Limits?

Around 1960, there was a spate of literature claiming that the welfare state had created social harmony within Western capitalism,<sup>28</sup> and that class conflict had disappeared because levelling processes had produced a middle class social continuum in which the ruling class had been dismantled and the working class had acquired bourgeois status and aspirations. There was a widespread tendency in such circles to reject the word "capitalist" as an appropriate epithet to describe Western society, and to come up with labels like "post-industrial", "post-capitalist", etc.

In retrospect these views of social harmony seem naïve, although Marx's prediction of continuous sharpening of class antagonism and material welfare between rich and poor has not proved correct.

In the 1960s and 1970s, conflicts within Western society became more obvious, though they were not of the type which Marx predicted. Major race riots in the United States were a reminder that the melting

<sup>26</sup> See ROYAL COMMISSION ON THE DISTRIBUTION OF INCOME AND WEALTH, Report No. 1, *Initial Report on Standing Reference*, HMSO, London, 1975, pp. 86-92 shows the bottom 80 per cent of the population owning 17.6 per cent of conventional wealth, but 40.7 per cent if the capitalized value of occupational and state pensions is included. This calculation does not deduct the capitalized value of future contributions.

<sup>27</sup> P.M. BLAU and O.D. DUNCAN, *The American Occupational Structure*, Wiley, New York, 1967, A. MADDISON, "Education, Inequality and Life Chances: The Major Policy Issues", in *Education Inequality and Life Chances*, OECD, Paris 1975, J.A. BRITAIN, *The Inheritance of Economic Status*, Brookings, Washington D.C., 1977, and J.A. BRITAIN, *Inheritance and the Inequality of Material Wealth*, Brookings, Washington D.C. 1978.

<sup>28</sup> See G. MYRDAL, *Beyond The Welfare State*, Duckworth, London, 1960, D. BELL, *The End of Ideology*, Free Press, New York, 1960.

pot theory was a myth<sup>29</sup> and that major U.S. cities were not harmonious communities but ethnic ghettos, replete with crime. Student disturbances almost toppled the Gaullist regime in France in 1968, and New Left student radicalism shook universities to their foundations in many countries. Urban terrorism became an important menace in Germany and Italy. The Women's Liberation movement gained momentum. Union militancy became greater in many countries.<sup>30</sup>

In the 1970s, there was a sharp acceleration in the rate of inflation and a general failure of attempts to deal with this problem by techniques of social accommodation such as incomes policies and social contracts.

Thus the rosy 1960s views about the degree of social harmony achieved by the welfare state had begun to fade. The difficulty of abolishing poverty (when it is defined as relative deprivation) became clear and a series of studies showed that tax-transfer structures were full of inequities, notches and "poverty traps". In the early 1970s there was a growing realization that a tax-transfer system which had grown piecemeal and involved so many people, was very difficult to reform or rationalize. The Nixon Administration had a first try at simplifying the U.S. tax and social security system by introducing a kind of negative income tax, but failed in this objective, and similar intentions in the U.K. were abandoned at an earlier stage.<sup>31</sup>

These kinds of disillusion were reinforced after 1973 by the substantial budget deficits and growing public debt which were the consequence of slower economic growth in countries with a heavy commitment to income maintenance (see tables 6 and 7). In conditions of stagnating income, there has been greater electoral resistance to high taxation and greater hostility to programmes for the "undeserving poor" than in the earlier postwar decades of rapid growth. This has helped to bring radical conservative governments to power in the U.K. and U.S.A. which are committed to cutbacks in the welfare state. But they are not alone in this, because old-fashioned fiscal worries about budget deficits and increased government debt have induced many other Western countries to envisage similar moves.

<sup>29</sup> See N. GLAZER and D.P. MOYNIHAN, *Beyond the Melting Pot*, MIT Press, Cambridge, Mass., 1963 for a realistic survey of blacks, Puerto Ricans, Jews, Italians and Irish in New York City.

<sup>30</sup> See C. CROUCH and A. PIZZORNO, *The Resurgence of Class Conflict in Western Europe Since 1968*, Macmillan, London, 1978.

<sup>31</sup> For U.S. experience, see D.P. MOYNIHAN, *The Politics of A Guaranteed Income*, Vintage Books, New York 1973, and H.J. AARON, *Politics and the Professors*, Brookings, 1978. For the U.K., see *Proposals for a Tax Credit System*, Cmnd. 5116, HMSO, 1972. For the aspirations of a Giscardist minister, see L. STOLERU, *Vaincre La Pauvreté*, Flammarion, Paris, 1977. The OECD also gave consideration to this kind of arrangement, see *Negative Income Tax*, OECD, Paris, 1974.

TABLE 6

## FISCAL OUTCOME - GENERAL GOVERNMENT NET LENDING AS PROPORTION OF GDP AT CURRENT PRICES

	Average 1960-73	Average 1974-82	1983
France	0.5	-1.1	-3.4
Germany	0.6	-3.3	-3.1
Japan	1.0 <sup>(a)</sup>	-3.5	-3.4
Netherlands	-0.5	-3.1	-8.1
U.K.	-0.8	-3.5	-2.7
U.S.A.	-0.0	-1.2	-3.8
Average	0.1	-2.6	-4.1

(a) 1970-3

Source: 1960-77 derived from *National Accounts of OECD Countries*, 1960-71, 1961-78 and 1962-79 editions, and from OECD *Economic Outlook*, December 1983, p. 33.

TABLE 7

RATIO OF NATIONAL DEBT TO GDP  
end year debt in nominal value divided by GDP for year stated

	1960	1973	1982
France	28.6	7.5	11.2 (a)
Germany	7.4	6.7	19.3
Japan	6.2	6.7	26.4 (b)
Netherlands	43.9	23.1	39.5
U.K.	110.3	52.6	52.7 <sup>(c)</sup>
U.S.A.	46.7	25.9	32.6

(a) 1981; (b) 1979; (c) 1978.

Source: Debt from IMF, *International Financial Statistics*, except U.K. from *Annual Abstract of Statistics*, HMSO, London, adjusted to end-year basis. GDP from OECD National Accounts Statistics.

Within the academic world, economists of "liberal" persuasion have grown hugely in number and have revived the long moribund Ricardo-Malthus spirit in a frontal attack on the welfare state. One of

the most formidable of these is Martin Feldstein, who is Chairman of Mr. Reagan's Council of Economic Advisors. He has claimed that income-transfer programmes have "exacerbated the instability of family life", that social security has reduced U.S. personal saving by half, caused the capital stock to be two fifths smaller than it might otherwise have been, and that unemployment compensation has raised unemployment.<sup>32</sup>

On the macroeconomic level, there is no clear evidence that the growth of the welfare state has had adverse effects on economic performance. The welfare state absorbs the same proportion of resources in Japan and the United States but these two countries have had very different growth records and very different investment rates. The welfare state is bigger in all the European countries than in the U.S.A., and they have also had more rapid growth and much bigger investment rates. The vigour of postwar economic growth was not noticeably impeded up to 1973 by growth of the welfare state, and it would be hard to prove that the welfare state had a major role in the general growth slowdown since 1973.

Nevertheless it is clear that the expansion of the welfare state, which has strengthened the legitimacy of capitalism and modified its social content in the past century, has now produced characteristic problems which affect all six countries to some degree:

*Merit Goods*

(i) In health and education services, the "output" is largely provided by highly organised professional groups who are used to relatively high incomes and to finding employment for virtually all their members. As a result measured productivity in terms of pupil/teacher and patient/doctor ratios has fallen continuously. This has been a major reason for the increasing relative cost of public services (see table 8) and for accusations of overmanning,<sup>33</sup> though this relative price effect has been smaller since 1973;

<sup>32</sup> See M. FELDSTEIN, *The American Economy in Transition*, NBER, Chicago, 1980, p. 3; "Social Security, Induced Retirement, and Aggregate Capital Accumulation", *Journal of Political Economy*, September-October 1974; "The Economics of the New Unemployment", *Public Interest*, Fall 1973.

<sup>33</sup> See R. BACON and W. ELTIS, *Britain's Economic Problem: Too Few Producers*, Macmillan, London, 1978, who stress, wrongly in my view, that overmanning is a peculiarly British problem. In fact the U.K. health service has been able to check costs and ration demand more effectively than other countries have done with different arrangements.

TABLE 8

RATES OF PRICE INCREASE IN THE PUBLIC AND PRIVATE SECTOR  
(per cent)

	Government Consumption		Private Consumption	
	1950-73	1973-80	1950-73	1973-80
France	7.5	12.7	5.3	10.7
Germany	5.6	5.7	2.8	4.7
Japan	9.0 <sup>(a)</sup>	9.5	4.7 <sup>(a)</sup>	9.1
Netherlands	8.2	8.6	4.2	7.3
United Kingdom	6.1	17.9	4.3	15.5
United States	4.5	8.1	2.7	7.9
Average	6.8	10.4	4.0	9.2

(a) 1952-73

Source: OECD, *National Accounts*, 1950-68 and 1963-80 editions.

TABLE 9

MANNING LEVELS IN HEALTH AND EDUCATION

	Population Per Physician		Pupil Teacher Ratios in Primary Education	
	1960	1980	1950	1979
France	1,024	463	28.4 <sup>(b)</sup>	20.0
Germany	699	442	47.7	19.6
Japan	971	785	36.6	25.2
Netherlands	909	545	35.0	24.3
U.K.	1,130 <sup>(a)</sup>	956	29.8	19.4 <sup>(c)</sup>
U.S.A.	718	498	31.0	19.3 <sup>(d)</sup>
Average	909	615	34.8	21.3

(a) 1956; (b) 1955; (c) 1978; (d) 1977.

Source: UNESCO *Statistical Yearbooks*, WHO, *World Health Statistics*, and OECD Dept. of Social Affairs.

(ii) Public health and education services are generally provided free or with user charges very much below cost. This has inflated demand particularly for the most expensive kind of medical services which are both skill and capital intensive. The problem is much more acute in health than in education, because public health expenditure is concentrated on services where the demand is difficult to distinguish from private consumption, and where externalities are not present. In most countries supply is privately organized as well, and governments which finance the services cannot ration their availability. The managerial problems under (i) and (ii) are not confined to government services but have also been felt acutely in private insurance. In fact government is ultimately better placed to handle these problems than are private insurance schemes.

(iii) The third "merit" good provided by government is housing, and in this area there is very wide variation between countries. Dutch government housing expenditure is proportionately ten times as high as in the U.S.A. It is obviously a field where there are environmental externalities, but these can usually be achieved by regulatory intervention, and it is quite clear that the bulk of housing consists of private goods privately provided. Public policy in this area has hindered labour mobility, distorted capital markets, encouraged extravagantly high demand in some areas of accommodation and created scarcities in others. Apart from these efficiency losses, there is no evidence that the impact of public housing and public subsidies is equitable. Indeed the biggest one, which is tax relief on mortgage interest, is regressive in its impact.

*Transfers and Work Incentives*

(iv) It is alleged that social transfers have been pushed to the point of serious "moral hazard", where the levels of benefit are generous enough to induce the characteristics whose adverse effects they were intended to mitigate. As a result they have weakened the incentive to work. The classical argument here concerns unemployment insurance. Robbins and Rueff argued in the 1930s that U.K. unemployment was due in considerable degree to overgenerous unemployment compensation, and this argument has recently been disinterred by

Benjamin and Kochin.<sup>34</sup> It is true that U.K. unemployment benefits were better than in other countries at that period but this school exaggerates the value of benefits as can be seen by a simple comparison of total unemployment compensation payments and the size of unemployment. In fact U.K. unemployment benefits from 1920 to 1939 averaged 0.9 per cent of GDP and unemployment 9.4 per cent of the labour force which hardly suggests a generous enough average benefit situation to encourage much unemployment.<sup>35</sup>

At the beginning of the economic slowdown in 1974, when unemployment started its general rise, there were strong suggestions that a good deal of the extra unemployment was voluntary because the generosity of benefits had been increasing in the course of the 1960s. Analysis of this type did not suggest that increased benefits induced many people to become unemployed, but rather that it lengthened "spells" of unemployment by permitting people the luxury of more careful job search.<sup>36</sup> In spite of the problems inherent in this kind of analysis, particularly in getting an accurate average picture of the degree to which unemployment benefit replaces wages, it seems probable that there is some degree of voluntary unemployment. However, since 1974 unemployment has increased dramatically even though several countries have reduced benefits. It is clear that most of the increase is not voluntary.

Table 10 shows that the work disincentive impact of pensions is likely to be substantially higher than that for unemployment insurance because the income replacement ratios are higher. It is of course the intention of pension schemes to permit or even compel people to stop working, so one can hardly speak of moral hazard in this area. However, some countries now provide pensions to a growing number of people below age 65, and this is one of the reasons why the activity rate for males aged 55-64 has dropped. This problem is most

<sup>34</sup> See L. ROBBINS, *The Great Depression*, Macmillan, 1934, p. 93 refers to "colossal" expenditure as unemployment relief, but does not give this as much causal weight as J. RUEFF, "L'Assurance Chômage, cause du chômage permanent", *Revue d'économie politique*, March-April 1931, pp. 211-41. D.K. BENJAMIN and L.A. KOCHIN, "Searching for an Explanation of Unemployment in Interwar Britain", *Journal of Political Economy*, 1979, pp. 441-78 stick to Rueff's line.

<sup>35</sup> Figures on G.B. unemployment benefits are from *British Labour Statistics: Historical Abstract 1886-1968*, Dept. of Employment, London, 1971, p. 366. GDP (adjusted from U.K. to G.B. basis) from C.H. FEINSTEIN, *National Income, Expenditure and Output of the United Kingdom 1855-1965*, Cambridge, 1972, pp. T 11. Unemployment percentages from A. MADDISON, *Phases of Capitalist Development*, Oxford, 1982, p. 206 and are adjusted to show relation to labour force rather than to insured unemployed.

<sup>36</sup> See H.G. Grubel and M.A. Walker, eds., *Unemployment Insurance: Global Evidence of its Effects on Unemployment*, Fraser Institute, Vancouver, 1978 for a useful survey of the literature.

TABLE 10

## RELATIVE SIZE OF PENSIONS AND THE "PENSIONABLE" POPULATION

	Government Financed Pensions as Percent of GDP 1981	Persons 65 and older as Percent of Population 1981	Income Compensation Ratio
France	11.9	13.7	86.9
Germany	12.5	15.3	81.7
Japan	4.8	9.2	52.2
Netherlands	13.0	11.6	112.1
U.K.	7.4	15.1	49.0
U.S.A.	7.4	11.4	64.9
Average	9.5	12.7	74.5

Source: OECD, *Labour Force Statistics*, and table 3b above.

TABLE 11

## RELATIVE SIZE OF UNEMPLOYMENT COMPENSATION AND THE UNEMPLOYED POPULATION

	Unemployment Compensation as Percent of GDP 1981	Unemployed as Percent of Population 1981	Income Compensation Ratio
France	1.9	3.2	59.4
Germany	1.4	1.8	77.8
Japan	0.4	1.1	36.4
Netherlands	1.0	3.4	29.4
U.K.	1.4	4.9	28.6
U.S.A.	0.5	3.6	13.9
Average	1.1	3.0	40.9

Source: OECD Statistics Division for compensation and population; unemployment from U.S. Bureau of Labor Statistics. The income compensation ratio is column 1 divided by column 2. Averages are arithmetic averages of columns.

marked in the Netherlands where the number of people with permanent handicap pensions had reached 12 per cent of the labour force by 1980, and is perhaps the most outstanding case of moral hazard with regard to labour supply.

There are some other dimensions of labour supply where significant cases of moral hazard seem to be present, but which are difficult to compare between countries. However, there is some evidence that the Netherlands occupies an extreme position within our six countries, with 1.9 per cent of GDP going on sickness benefit, and a 10 per cent rate of sickness absence (roughly three times the U.S. rate of sickness absence).

### *The Tax Burden*

(v) High taxes and social security levies and their unequal or arbitrary incidence are often cited as factors which weaken incentives to work, save or invest, and weaken tax morality, so that there are rapidly growing do-it-yourself, barter and underground economies which reduce overall efficiency and measured output.

It is difficult to accept these arguments in their most simple form because labour force activity rates are generally rising (with rising female participation big enough to offset falling male participation in most countries). The general fall in investment rates since 1973 is dominated by cyclical factors, and investment rates now in advanced welfare state conditions are still higher in most countries than they ever were in pre-war years. The theoretical basis for Feldstein's argument about U.S. savings is hotly disputed and his specific figures were invalidated by an important programming error.<sup>37</sup>

At first sight it is plausible that there is some point or range of taxation which would cause economic collapse because of incentive problems, but it is not clear where it lies. The view of "tolerable" burdens has increased with time as incomes have risen. In the nineteenth century, Giffen suggested 10 per cent of national income, in 1945 Colin Clark said that 25 per cent was the upper peacetime limit. Assar Lindbeck has recently advanced a new version of the argument and has suggested that advanced states like Sweden or the Netherlands, where the tax burden is around 60 per cent have reached a position of arterio-

<sup>37</sup> See H.J. AARON, *Economic Effects of Social Security*, Brookings, Washington, 1982 for a general review of this field.

sclerosis which acts as a major drag on productivity growth.<sup>38</sup> It is true that productivity growth has slowed down considerably since 1973 in all our countries, but difficult to prove that the welfare state has a major responsibility.<sup>39</sup>

The main weakness in the argument about ultimate taxable capacity is that it tends to view government as a black hole into which taxpayers' money disappears, whereas government does provide services and social transfer income in return. The tolerability of big government depends on whether its activity is publicly conceived to be efficient and equitable, rather than on its absolute size. There are clearly differences in tradition between countries which affect this public perception, because discontent with government is bigger in the U.S.A. than in the Netherlands, although the Dutch commitment to welfare is twice as big.

The growth of the underground economy is significant evidence of decline in tax morality, though its size is often exaggerated and its existence is a testimony to the vigour of the capitalist spirit rather than a herald of its collapse.

## VI. Conclusions

It is difficult to reach strong conclusions on the influence of the welfare state on economic development because the evidence does not warrant them. Strong judgements on the question are influenced mainly by ideological positions, or predictions about what might happen in the future. The relative political strength of different ideological positions varies between countries, and is not related to the relative size of the welfare state. Five different ideological positions are currently distinguishable in most Western countries, and the following paragraphs attempt

<sup>38</sup> See PEACOCK and WISEMAN, *Op. cit.*, p. 66 for Sir Robert Giffen's view; C. CLARK, "Public Finance and Changes in the Value of Money", *Economic Journal*, December 1945; A. LINDBECK, "Work Disincentives in the Welfare State", Institute for International Economic Studies, Stockholm, Reprint 176 and A. LINDBECK, "The Recent Slowdown of Productivity Growth", *Economic Journal*, March 1983.

<sup>39</sup> For an alternative interpretation of the slowdown see A. MADDISON "Comparative Analysis of the Productivity Situation in the Advanced Capitalist Countries" in J.W. Kendrick, ed., *International Comparisons of Productivity and Causes of the Slowdown*, Ballinger, Boston, 1984.

TABLE 12

LABOUR FORCE PARTICIPATION RATES  
(per cent of age group in labour force)

	Males Aged 55-64		Males Aged 65 and over	
	1960	1982	1960	1982
France	75.0	59.9	30.5	5.9
Germany	82.0	68.1 <sup>(a)</sup>	22.6	6.0 <sup>(a)</sup>
Japan	86.1	84.9	56.0	38.8
Netherlands	87.7	60.5 <sup>(a)</sup>	19.9	4.6 <sup>(a)</sup>
U.K.	84.7	79.3	25.4	7.8 <sup>(a)</sup>
U.S.A.	85.1	70.2	30.3	17.8
Average	83.4	70.5	30.8	13.5

(a) 1981.

Source: OECD, *Demographic Trends 1950-1990*, Paris, 1979 and OECD, *Labour Force Statistics 1970-1981*, Paris, 1983.

to characterize the current views of these groups — the liberals, the populist middle ground, the egalitarians, the neo-Marxists and the new left.

#### a) *The Liberals*

There is no evidence that high welfare state expenditure has been disastrous for economic incentives and economic growth as early nineteenth century *laissez-faire* liberals (relying heavily on Malthusian population assumptions) would have predicted. The recent emphasis of the liberal school on the dysfunctionality of the welfare state from the point of view of work incentives, savings and economic growth is a reassertion of the more fundamental type of critique which the *laissez-faire* school originally advanced. However, they have not produced acceptable evidence of very significant adverse impact on growth. Their persuasive power derives more from worries about fiscal deficits and current disillusion amongst former welfare supporters of other political persuasions than the power of their own argument. And the new radical governments in the U.K. and the U.S.A are as much concerned to increase inequality of rewards to property and work for their own sake as for their presumptive impact on economic performance.

#### b) *The Populist Middle Ground*

In the postwar period until the 1970s, support for the welfare state was general over a fairly wide spectrum of politicians and bureaucrats in Western countries for pragmatic reasons. Such measures added to the legitimacy of the state by providing programmes broadly in the public interest. Economic growth provided the finance for such schemes without much political effort. It was acknowledged that public transfers involved a fair degree of "churning", but bureaucratic dangers or incentive costs were not thought to be great. Within this group of political managers and administrators, attitudes have swung closer to the liberal school, because tax revenues are less buoyant now that stagnation has replaced growth, welfare state commitments are very large and have a momentum of their own which is difficult to control.

Members of this group are now apt to give more emphasis to the wastes involved in "churning",<sup>40</sup> but are very conscious of the practical difficulties of rationalizing transfers through negative income tax or social security reform and the problems of checking manpower growth in public services.

#### c) *The Egalitarians*

Amongst egalitarians, there has also been some disillusionment with the welfare state, though there can be little doubt that transfers (see table 5) have been highly equalizing.

As far as transfers are concerned, egalitarians complain that there is too much "churning", that the net distributive impact is small relative to the amount of gross tax and transfer activity.<sup>41</sup> Some of them would be content with smaller, more redistributive programmes.

<sup>40</sup> On "churning", see the remarks of H. HOUTHAKKER in *The Economics of Federal Subsidy Programs*, Joint Economic Committee, Part I, 1972 "we are gradually moving towards a situation where everybody is subsidizing everybody else. As we all know from birthdays and Christmas Eves, the exchange of gifts, even rather useless gifts, frequently helps stimulate good fellowship and a sense of community. One could be more sanguine about this trend, however if it did not contain an element of self-deception, in the sense that the beneficiaries of any particular program feel they are getting something for nothing".

<sup>41</sup> See W. BECKERMAN, et al., *Poverty and the Impact of Income Maintenance Programmes in Four Developed Countries*, ILO, Geneva, 1979.



In the merit goods field, there has also been a realization that there are inherent limitations on the degree to which delivery of education and health services can be manipulated to serve egalitarian goals.<sup>42</sup>

d) *The Neo-Marxists*

The neo-Marxists who have written about the welfare state have generally treated it as more than Bismarckian. They suggest that it has been necessary not only to make a capitalist economy legitimate or acceptable, but also that it was functionally necessary, e.g. public education and health services are required to provide the skills and strength needed in productive workers. But they hold that the welfare state now has strong elements of dysfunctionality because its growth has strengthened workers' bargaining power, and higher taxes have squeezed profits. Attempts to remedy these problems by cutting back on welfare will reduce capitalist legitimacy and ultimately lower the quality of the labour force. The argument seems to be that the welfare state has prolonged the duration of the capitalist epoch but that now is a time of crisis and that its heyday is over.<sup>43</sup>

e) *The New Left*

The various New Left views are to large degree a revival of the viewpoint of the utopian socialists with an equally diverse range of interests. They have in common a heavy stress on self-starting schemes involving local initiative, and an attack on government provision as bureaucratic in form and psychologically repressive. Their discontent is concentrated more on public services than on transfers. Ivan Illich is perhaps the most vociferous of this group and has attacked public education because it produces alienation, and public health services because they have created a significant degree of iatrogenic (doctor-made) illness.<sup>44</sup> It is difficult to characterize the policy implications of

<sup>42</sup> See C. JENCKS, *Inequality*, Basic Books, New York, 1972, on education, and J. LE GRAND, *The Strategy of Equality*, Allen and Unwin, London, 1982 on health.

<sup>43</sup> See I. GOUGH, *The Political Economy of the Welfare State*, Macmillan, London 1979, and J. O'CONNOR, *The Fiscal Crisis of the State*, St. Martin's Press, New York, 1973.

<sup>44</sup> See I. ILLICH, *Deschooling Society*, Harper and Row, New York, 1971, and *Medical Nemesis*, Calder and Boyars, London, 1975.

the New Left. Those derivable from Illich do not differ much from liberal programmes for privatization and vouchers such as Milton Friedman has advocated. In several countries, elements of the New Left have been incorporated into welfare state programmes in various ways. These range from leafraking measures to mitigate unemployment in the U.K. or U.S.A. to much wider participation in the Netherlands.

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Although it is clear that the welfare state is no longer regarded as the triumph of social engineering it was widely thought to be in the 1960s, the combination of disillusion and hostility which has developed in the 1980s has thus far been too vaguely focussed to check its growth.

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