C.D. Howe Institute
Institut C.D. Howe

Communiqué

Embargo: For release 10:00 a.m. *Wednesday*, January 14, 1998

"Tough love" approach needed to prepare the welfare state for the new century, says C.D. Howe Institute study

The welfare state is a magnificent act of generosity and one of the major accomplishments of our age, but generosity is not enough, says a C.D. Howe Institute study released today. Rigorous, "tough love" management plus realistic policy analysis are equally necessary if the welfare state is to meet the challenges of the coming century, the study concludes.

The study, *Retooling the Welfare State: What's Right, What's Wrong, What's to Be Done*, was written by John Richards, a member of Allan Blakeney's NDP government in Saskatchewan in the early 1970s who teaches at Simon Fraser University in Burnaby, BC, and is an Adjunct Scholar of the C.D. Howe Institute.

Richards notes that, in Canada, as in all other industrialized countries, electorates are demanding that binding limits be imposed on the relative size of the welfare state. Moreover, the disappearance of any credible argument for state economic planning and the rising influence of special interest groups make it clear that the welfare state needs retooling to face the challenges that lie ahead. But, Richards says, the parents of the welfare state, the churches and the "traditional left," no longer seem up to the task. Indeed, in many countries the roles of "left" and "right" have been reversed: the traditional left calls for the preservation of the postwar status quo while "neoconservatives" demand radical changes in public policy.

In the first part of the study, Richards argues that the "traditional left," the mass political movements closely allied to organized labor, has abandoned its responsibility to manage the welfare state. The traditional left has been captured by interest groups intent on extrapolating past rates of growth of social programs, and hence cannot credibly address their management within the fixed budgets that citizens are imposing on the welfare state via their refusal to accept further increases in tax rates. The second part of the study surveys what's right with the welfare state, including an extended case study of public health care policy. In the third part, Richards examines what's wrong with the welfare state. In the final part, he discusses what is to be done, and offers five "immodest" proposals to make the welfare state work better:

- *Clarify and balance budgets*: The welfare state rests on the democratic assent of the majority. A necessary condition for that assent is that citizens have a fair idea of both program benefits and their costs in terms of taxes to be paid. Accordingly, Richards says, do not separate the case for social programs from the case for balanced budgets — and use transparent accounting rules.

- *Maintain accountability*: Only one level of government should generally be responsible for any particular domain of social policy, Richards argues, and the responsible government should raise all necessary revenues via own-source taxation.
- *Respect comparative advantage and celebrate competitive federalism*: Ottawa has a comparative advantage in delivering programs that redistribute income according to relatively straightforward rules, but most social programs entail complex administration; in such cases, provincial jurisdiction should unambiguously prevail.
- *Encourage two-parent families*: In general, two-parent families, comprising a mother and a father, raise children more successfully than do other family structures. Accordingly, social policy should discriminate fiscally on behalf of such families.
- *Emphasize workfare*: Be generous in spending on subsidies to training and work, but be conservative in spending on passive income transfers, such as provincial social assistance and federal unemployment insurance.

* * * * *

The C.D. Howe Institute is Canada's leading independent, nonpartisan, nonprofit economic policy research institution. Its individual and corporate members are drawn from business, labor, agriculture, universities, and the professions.

- 30 -

For further information, contact:

John Richards (604) 291-4568
Maxine King (media relations), C.D. Howe Institute
phone: (416) 865-1904; fax: (416) 865-1866;
e-mail: cdhowe@cdhowe.org
Internet: http://www.cdhowe.org

Retooling the Welfare State: What's Right, What's Wrong, What's to Be Done, Policy Study 31, by John Richards (C.D. Howe Institute, Toronto, January 1998). 304 pp.; $18.95 (prepaid, plus postage & handling and GST — please contact the Institute for details). ISBN 0-88806-420-9.

Copies are available from: Renouf Publishing Company Limited, 5369 Canotek Road, Ottawa, Ontario K1J 9J3 (stores: 71½ Sparks Street, Ottawa, Ontario, phone 613-238-8985; 12 Adelaide Street West, Toronto, Ontario, phone 416-363-3171); or directly from the C.D. Howe Institute, 125 Adelaide Street East, Toronto, Ontario M5C 1L7. For trade book orders, please contact: McGraw-Hill Ryerson Limited, 300 Water Street, Whitby, Ontario L1N 9B6. For college book orders, please contact: Prentice-Hall Canada Inc., 1870 Birchmount Road, Scarborough, Ontario M1P 2J7.

C.D. Howe Institute
Institut C.D. Howe

Communiqué

Embargo : à diffuser le *mercredi* 14 janvier 1998 à 10 h 00

Il faut une approche stricte pour préparer l'État providence au prochain siècle, indique une étude de l'Institut C.D. Howe

L'État providence représente un magnifique acte de générosité et l'une des plus importantes réalisations de notre temps, mais la générosité ne suffit pas, indique une étude de l'Institut C.D. Howe publiée aujourd'hui. Une gestion stricte et rigoureuse assortie d'une analyse réaliste des politiques s'impose afin que l'État providence soit en mesure de relever les défis du siècle prochain, conclut l'auteur de l'étude.

Intitulée *Retooling the Welfare State: What's Right, What's Wrong, What's to Be Done (Le réorganisation de l'État providence : ce qu'il y a de bon, ce qu'il y a de mauvais et ce qu'il faut accomplir),* l'étude a été rédigée par John Richards, un membre du gouvernement néo-démocrate d'Allan Blakeney de la Saskatchewan au début des années 70, qui enseigne maintenant à l'Université Simon Fraser de Burnaby en Colombie-Britannique, et qui est attaché de recherche à l'Institut C.D. Howe.

M. Richards indique qu'au Canada, comme dans tous les autres pays industrialisés, l'électorat exige que l'on impose des limites contraignantes à la taille relative de l'État providence. De plus, la disparition de tout argument plausible pour la planification économique d'État et l'influence grandissante des groupes d'intérêt spéciaux indiquent clairement que l'État providence a besoin d'être réorganisé afin d'être en mesure de relever les défis à venir. Cependant, les auteurs de l'État providence, soit l'Église et la « gauche traditionnelle » ne semblent plus être à la hauteur de la tâche, affirme M. Richards. En fait, les rôles de la « gauche » et de la « droite » ont été inversés dans de nombreux pays : la gauche traditionnelle voudrait que l'on préserve le *statu quo* de l'après-guerre, tandis que les « néoconservateurs » exigent que l'on apporte des modifications radicales aux politiques gouvernementales.

Dans la première partie de l'étude, M. Richards soutient que la « gauche traditionnelle », soit les mouvements politiques de masse qui sont étroitement alliés au mouvement syndical, a délaissé sa responsabilité de gérer l'État providence. La gauche traditionnelle est aux mains de groupes d'intérêt résolus à poursuivre les taux de croissance passés des programmes sociaux; elle ne peut donc en aborder la gestion, vus les budgets fixes que les citoyens imposent à l'État providence par le biais de leur refus de nouvelles hausses des taux d'impôt. Dans la seconde partie de l'étude, l'auteur passe en revue ce qui fonctionne dans l'État providence, dont une étude de cas détaillée sur la politique gouvernementale des services de santé, tandis que dans la troisième partie, il discute de ce qui ne marche pas pour l'État providence. Enfin, dans la dernière partie, l'auteur débat de ce qu'il faut faire, et propose « sans modestie » cinq suggestions qui amélioreront l'État providence :

- *Clarifier et équilibrer les budgets :* l'État providence repose sur l'assentiment démocratique de la majorité. Une condition nécessaire à cet assentiment est que les citoyens aient une juste idée des avantages des programmes et de leurs coûts en fonction des impôts à verser. Par conséquent, M. Richards conseille de ne pas dissocier la justesse des programmes sociaux de celle des budgets équilibrés — et d'avoir recours à des règles comptables transparentes.
- *Conserver la responsabilisation :* un seul niveau de gouvernement devrait avoir la responsabilité générale d'un domaine particulier de politique sociale, soutient M. Richards, et c'est le gouvernement responsable qui devrait se procurer les recettes nécessaires par le biais d'une imposition autonome.
- *Tenir compte de l'avantage comparatif et faire l'éloge du fédéralisme compétitif :* Ottawa dispose d'un avantage comparatif en matière de prestation de programmes qui redistribuent les revenus selon des règles relativement simples, mais la plupart des programmes sociaux donnent lieu à une administration complexe; dans de tels cas, c'est la compétence provinciale qui devrait indubitablement l'emporter.
- *Encourager les familles biparentales :* de manière générale, les familles biparentales, soit celles qui comprennent père et mère, élèvent leurs enfants avec plus de succès que les autres structures familiales. Par conséquent, la politique sociale devrait privilégier financièrement ces familles.
- *Mettre l'accent sur le travail obligatoire :* il faut faire preuve de générosité envers les subventions de formation et de travail, mais être conservateur en matière de dépenses de transfert de revenus passifs, comme l'aide sociale provinciale et l'assurance-chômage fédérale.

* * * * *

- 30 -

Renseignements : John Richards (604) 291-4568;
Maxine King (relations avec les médias), Institut C.D. Howe
téléphone : (416) 865-1904; télécopieur : (416) 865-1866
courrier électronique : cdhowe@cdhowe.org; Internet : www.cdhowe.org

Retooling the Welfare State: What's Right, What's Wrong, What's to Be Done, Étude de politique n° 31, par John Richards, Toronto, Institut C.D. Howe, janvier 1998, 304 p., 18,95 $ (les commandes sont payables d'avance, et doivent comprendre les frais d'envoi, ainsi que la TPS — prière de communiquer avec l'Institut à cet effet). ISBN 0-88806-420-9.

On peut se procurer des exemplaires de cet ouvrage auprès des : Éditions Renouf ltée, 5369, chemin Canotek, Ottawa ON K1J 9J3 (librairies : 71½, rue Sparks, Ottawa ON, tél. 613 238-8985 et 12, rue Adelaide Ouest, Toronto ON, tél. 416 363-3171), ou encore en s'adressant directement à l'Institut C. D. Howe, 125, rue Adelaide Est, Toronto ON M5C 1L7. Pour les commandes commerciales, veuillez communiquer avec McGraw-Hill Ryerson Limited, 300, rue Water, Whitby ON L1N 9B6. Pour les commandes d'établissements d'enseignement, veuillez communiquer avec : Prentice-Hall Canada Inc., 1870, chemin Birchmount, Scarborough ON M1P 2J7.

Retooling the Welfare State

What's Right, What's Wrong, What's to Be Done

John Richards

Policy Study 31

C.D. Howe Institute

Contents

Figures

Tables

1 The Welfare State Is a Good Thing

The fall of the Berlin wall in 1989 is as powerful a symbol as the fall of the Bastille in Paris exactly two centuries earlier. For millions of people over those centuries, the French Revolution contained the germ of a utopian future in which *liberté, égalité, et fraternité* would substitute for a state committed to the institutions of capitalism. The fall of the Berlin wall symbolizes the end of that dream. Now, from Europe to the fast-growing countries of east Asia to the United States, the ideology of liberal capitalism prevails. Throughout the world, the Industrial Revolution, which began in Britain and was led by businessmen, has unambiguously prevailed over the political revolution, which began in France and was led by lawyers, philosophers, and soldiers.

Among most members of the professional and business elites across the industrial world, the ideals of Adam Smith and Margaret Thatcher appear relevant; those of Jean-Jacques Rousseau and Mikhail Gorbachev have become historical relics. We cannot know how widespread the sentiment is, but a growing proportion of elite opinion intellectually agrees with Adam Smith's dismissive view of government:

> I have never known much good done by those who affected to trade for the public good. It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. ([1776] 1976, 18.)

All this holds a danger of a kind of hubris different from that of the French revolutionaries. Politics should not be judged solely in terms of its failures; capitalism should not be judged solely in terms of its successes.

In this century — to be more precise, since World War II — governments have massively expanded the welfare state.[1] Given the spirit of the present age, there is much discussion of the welfare state's flaws. Indeed, it has numerous flaws, and later in this volume, I look closely at them. But it is first important to appreciate why the welfare state has been a major accomplishment of this century. What it has accomplished in improving our lives is as significant as the material prosperity generated by successful capitalist economies.

Relatively free competitive markets are institutions essential for realizing the full potential of industrial technology. Capitalism and a minimal state cannot, however, create a decent life for the majority; well-run government social programs are just as essential. With all due respect to the importance of liberal thought in western culture and the positive role of free markets in economic development, Adam Smith pushed a good idea too far.

Start with a simple example: average life expectancy. As of 1931, the average Canadian lived 61 years (which happens to be the current life expectancy at birth in India). Since then, average Canadian life expectancy has risen to 78 years, an increase of roughly a quarter (Brown 1991, 261). In the absence of government health programs, people would have partially compensated with more individual acts to improve their health status. But improvements in public health programs — better prenatal and postnatal programs, mass inoculations, increased access to health care because of universal medical insurance, and generous public funding of hospitals — are central to explaining why the average Canadian now lives 17 years longer than his or her great-grandparents.

1 Throughout, I use *welfare state* to refer to the entire set of *social programs* in place in a country at a point of time. In many instances, I use the two terms as synonyms.

The term *welfare state* has many meanings. Some are associated with a dole for the poor, others with left-wing politics. Nicholas Barr, a British economist and author of a major textbook on the subject, wryly concludes that "[d]efining the welfare state continues to baffle writers and...much high-grade effort has been wasted in the effort." He gives his own informal definition as "shorthand for the state's activities in four broad areas: cash benefits; health care; education; and food, housing and other welfare services" (1993, 742). That strikes me as a perfectly adequate definition at this stage of the discussion. The welfare state, so defined, comprises the major portion of public sector spending in times of peace (although countries differ significantly in the relative importance they give spending on the military and on debt service).

To appreciate the value of good social programs, I invite readers to examine Table 1. It reports basic social indicators for eight countries categorized by the World Bank as low income (India, China, and Sri Lanka), medium income (Thailand and Saudi Arabia), and high income (Sweden, Canada, and the United States).

Unless a country happens to be particularly lucky and contain a lot of exceptionally productive natural resources — as in the case of Saudi Arabia — prosperity means that its society must have undergone the complex transformation required to become industrialized. Economic prosperity, however achieved, is obviously conducive to better life chances. Individuals born into a very poor (bottom quintile) Canadian family or a very rich (top quintile) one in India may have similar life chances. Otherwise, the Canadian is certainly better off.

Yet economic prosperity does not explain everything. Government social policies matter. Look at income distribution. Progressive taxation and other social policies explain the much higher share of income accruing to the bottom quintile (the poorest fifth of the population) in Sweden than in the United States. Weak redistributive policies in Thailand allow more than half of all income to accrue to the top quintile. Aggressive redistribution can, however, reduce economic productivity. The extent of redistributive taxation figures in most explanations of the way Swedish gross domestic product

(GDP) per capita has fallen relative to that of other wealthy industrial countries over the past quarter-century.

Social policy concerns much more than income distribution. Sri Lanka, a member of the low-income sample, has unambiguously better health outcomes than those of the middle-income sample with per capita incomes two to three times higher. The explanation resides in the quality of that country's public health programs. (It is worth noting that Sri Lanka has achieved its impressive results despite a chronic civil war pitting Tamils against Sinhalese.) While Sweden is poorer than the United States, superior Swedish public health programs lead to lower infant mortality rates and are central to any explanation of its higher average life expectancy.

Thailand's tradition of universal primary education is reflected in low adult illiteracy, but its performance at the secondary level is not impressive. The education statistics for Saudi Arabia reveal the damaging effects of discriminatory attitudes toward women that prevail in both government and civil society in many Muslim countries. And, as with the health indicators, Sri Lanka has better education outcomes at the primary and secondary levels than any but the three high-income countries.

Plan of the Book

What this introduction has implied, the next chapter makes explicit: this book is an exercise in policy analysis. It is a modest exploration of the reasons governments do what they do in the design and management of social policy, plus some immodest advice on how they could do better.

The rest of Part I is an avowed polemic in which I argue that, in many countries — Canada included — the “traditional left,” a useful label for a large number of mass political movements closely allied to organized labor, has abandoned its responsibility to manage the welfare state. The traditional left has been captured by interest groups intent on extrapolating past rates of growth of social programs, and hence cannot credibly address their management within the fixed budgets that, as Chapter 2 explains, citizens in typical in-

Table 1: *Basic Social Indicators, Selected Countries*

	Low Income			Middle Income		High Income		
	India	China	Sri Lanka	Thailand	Saudi Arabia	Sweden	Canada	United States
				Income				
Per capita income[a] (US = 100)	5.2	10.8	12.1	28.0	36.6 [c]	68.7	78.3	100.0
				Health				
Life expectancy at birth[b] (years)								
Females	61	71	74	72	72	81	81	79
Males	61	68	70	66	69	76	74	73
Infant mortality[c]								
(deaths per 1,000 live births)	68	34	16	35	21	4	6	8
				Education				
Adult illiteracy[d] (percent)								
Female	62	27	13	8	50	<5	<5	<5
Male	35	10	7	4	29	<5	<5	<5
Percentage of age cohort enrolled in school[e]								
Primary school								
Female	91	116	105	97	73	100	104	106
Male	113	120	106	98	78	100	106	107
Secondary school								
Female	38	51	78	37	43	100	103	97
Male	59	60	71	38	54	99	104	98
Tertiary		4	6	19	14	38	103	81

Income distribution[f]

Quintile of population (percent of income accruing to each quintile)								
Bottom	8.5	5.5	8.9	5.6		8.0	5.7	4.7
Second	12.1	9.8	13.1	8.7		13.2	11.8	11.0
Third	15.8	14.9	16.9	13.0		17.4	17.7	17.4
Fourth	21.1	22.3	21.7	20.0		24.5	24.6	25.0
Top	42.6	47.5	39.3	52.7		36.9	40.2	41.9

Notes:

The World Bank economists who compiled most of the data in this table have attempted to reconcile multiple primary sources, but problems of inadequate national surveys and conceptual differences remain. In particular, income distribution results are problematic.

[a] Purchasing power parity per capita GNP, 1995.

[b] In 1993.

[c] In 1994.

[d] In 1995.

[e] In 1993. For primary and secondary school, enrollment data are estimates of the ratio of children of all ages enrolled to what the country considers to be the standard school age. Most commonly, primary school age is 6 to 11 years of age; secondary is 12 to 17. The sum may exceed 100 because some pupils are younger or older than the country's standard school age. The tertiary enrollment ratio is calculated by dividing the number of pupils enrolled in all postsecondary schools and universities by the population in the 20--to--24 age group. Tertiary data for India are not available.

[f] Data for Saudi Arabia are not available. Data years for the other countries are: Sweden, 1981; United States, 1985; Canada, 1987; Sri Lanka, 1990; India, 1992; China, 1995; and Thailand, 1992. Distributions for India, China, and Sri Lanka are based on the distribution of estimated expenditures, rather than incomes. Distributions for India, China, Sri Lanka, and Thailand are based on per capita data; distributions for Sweden, Canada, and the United States use households as the unit of observation. Compilation and international comparability of income distribution data are subject to many methodological problems, and the results must be treated with caution. Large differences across countries are meaningful; small differences are not. Certainly, the bottom quintile in Sweden is proportionately wealthier than the bottom quintile in the United States. On the other hand, the distinction between income shares of the bottom quintile in, say, Sri Lanka and India may be negligible.

Sources: World Bank 1995b, 162–228; 1996, 188–221; 1997, 214–248; income distribution for Canada and the United States is from Beach and Slotsve 1996.

dustrial countries are imposing on the welfare state via their refusal to accept further increases in tax rates. Chapter 3 suggests that the traditional left and the church are the two parents of the modern welfare state, but they are so enfeebled today that the welfare state risks becoming a political orphan, which is not good for social policy. Chapter 4 explores this idea via a critical survey of the social policy agenda of the New Democratic Party and the federal Liberals over the past decade.

Part II surveys what's right with the welfare state. Chapter 5 informally introduces a number of themes relevant to any analysis of social policy. Somewhat more formally, Chapter 6 discusses three separate goals of social policy: to redistribute income, to redress market failures where redress has a major redistributive effect, and to promote certain important values. Given this complexity, it is not surprising that organizing social programs is such a problematic exercise. Chapter 7 provides an example: an extended case study of public health care policy.

Part III examines what's wrong with the welfare state. Chapter 8 treats the four "hazardous dynamics" that Assar Lindbeck, a prominent Swedish economist, has identified in assessing his country's social programs. Like most Scandinavians, Lindbeck is basically sympathetic to the welfare state; it is, he suggests, a "triumph of western civilization" (1995, 9). Lindbeck chaired a recent Swedish government commission that produced a lucid analysis of what can go wrong with the welfare state and, in the case of post–1990 Sweden, did go wrong. Many of his recommendations amount to sage advice to beware long-term consequences when designing social programs. Over time, individuals adjust to the incentives put in place, and those who are benefiting form powerful interest groups whose goal is to preserve and promote the status quo against the claims of the rest of society. Chapter 9 analyzes the classic theory of interest groups and its relevance to the welfare state. Chapter 10 concerns two new wrongs emerging within civil society: the trend toward increased polarization of market earnings and the decline in commitment to stable two-parent families.

Part IV discusses what's to be done. Chapter 11 immodestly advances five propositions to guide social policy. Chapter 12 is a more detailed look at social policy to help poor families with children; it strongly recommends the use of employment supplements. Chapter 13 offers a few final thoughts.

2 Avoiding Lear's Error: Setting Limits to the Welfare State

Nearly four centuries after Shakespeare wrote it, *King Lear* remains relevant because it portrays so convincingly a fundamental tension of the human condition. The play's central theme is that naive faith in the generosity of men and women leads to chaos. In the opening scene, Lear announces his intent to forsake the "interests of territory, cares of state" by dividing his kingdom among his three daughters. Goneril and Regan accept their father's largesse and shower him with flattery, but Cordelia refuses her share, foreseeing the tragedy to come. When Lear finally understands the intrigue in his entourage and the duplicity of his two elder daughters, he goes mad.

Naiveté induces many of us, leaders and led, to avoid the painful but necessary exercise of understanding, constraining, and reconciling selfish interests. Like Lear, we long to believe that the natural generosity of humanity will lead to a better society, but generosity does not suffice. Admittedly, spontaneous acts of unselfishness arise all around us to sustain faith in human potential. But if as a society we seize on these acts as the essence of human nature and avoid discussing the art of governing, the result is not what we hope.

The twentieth-century welfare state is a magnificent act of generosity relative to the meanness of early industrial life, but the citizens of many countries have repeated Lear's error. As they expanded social programs, they put aside the "cares of state." Now, amid the confusion and complexity of mundane political life, one can detect an important trend: the majority in most industrial countries have come to accept that Cordelia was right, her sisters wrong.

Imagine that, once a year over the past century, a representative sample of citizens in the major industrial democracies had been asked, do you think social programs, and taxes required to pay for them, should absorb a higher share of gross domestic product (GDP)? Some time after 1975, the proportion willing to respond yes undoubtedly fell below 50 percent in most of these countries. In Canada, the proportion of yeses probably stayed above half until some time in the 1990s, when concern over the relative size of government debt finally became a high-profile subject for public debate.

The link between public opinion and government policy is elusive. Interest groups committed to particular components of the welfare state strongly resist the imposition of limits, but, in the long run, democratic governments cannot flout majority wishes on a matter this central. Over the past two decades, most countries of the Organisation for Economic Co-operation and Development (OECD) have faced acute political stress between the majority, which have become adamant that taxes not increase, and particular interest groups, which have favored an extrapolation of social programs as they were during the three decades following World War II. An almost irresistible short-run tactic to reconcile these opposing forces has been for those in power to incur current deficits and promise, on the basis of rosy revenue projections, to balance the books later. In many countries, very much including Canada, that tactic turned out to involve an ominously high ratio of public debt to GDP.

So long as the majority accepted the idea that another 1 percent of GDP devoted to public spending was more valuable than the same amount devoted to private consumption or investment, proponents of the welfare state could simultaneously argue for new programs and ignore criticism of what was in place. They could credibly advocate increased spending on meritorious program A without addressing the weakness of program B. But no longer. To be convincing, champions of the welfare state must now engage in a more complex political discourse: defend explicit tradeoffs within a public sector destined not to grow in relative size.

Willingness to Pay: Some Evidence

An obvious question is, does the evidence support the hypothesis that electorates in many countries are imposing binding limits on the relative size of the public sector? I think it does.

Some readers may feel that the following discussion is belaboring the obvious: of course, government spending in Canada and other OECD countries should have been cut this decade, and a good deal more fat remains to be trimmed. Maybe the political dynamic will generate that outcome. Such readers should appreciate, however, that, in Canada, the post–1992 decline in government spending (measured as a share of GDP) has been substantial. If the present downward trend continues unabated for another half decade, Canada will find itself among the group of countries (including the United States and Japan) with the least generous welfare states. I doubt that is what the majority of Canadians want.

Other readers will note that Canadian government spending was close to the OECD average during most years since the early 1980s and decry the fact that it has fallen below that average since 1995. These readers need to appreciate the severity of the public debt Canada has accumulated and the political impracticability of preserving past spending patterns via further tax increases. They must accept that the majorities in industrial countries — Canada included — have become adamant that governments live within their means.

These conclusions are easy to state. To substantiate them, however, I encourage readers to undertake an evaluation for themselves using the following figures, which summarize trends in general government expenditures, revenues, and deficits for Canada as well as for most OECD countries since 1960.[1] When it comes to paying taxes,

---

1 The figures plot trends among the 19 OECD countries for which continuous data stretch back to 1960: Australia, Austria, Belgium, Canada, Denmark, Finland,...

for example, the evidence clearly suggests that voters have imposed a limit over the past decade (see Figure 1).

In 1960, one-quarter of OECD governments took in revenues amounting to more than 33 percent of their country's GDP; three-quarters made do with less. Two and a half decades later, in the mid-1980s, the most generously financed quarter of OECD governments had revenues above 50 percent of GDP. Since then, this cutoff has remained roughly constant. The cutoff such that one-quarter of the governments have more and three-quarters less is the *top quartile*. In Figure 1, the value of the top quartile is a reasonable proxy for the willingness to pay taxes among citizens living in countries with generous welfare systems.

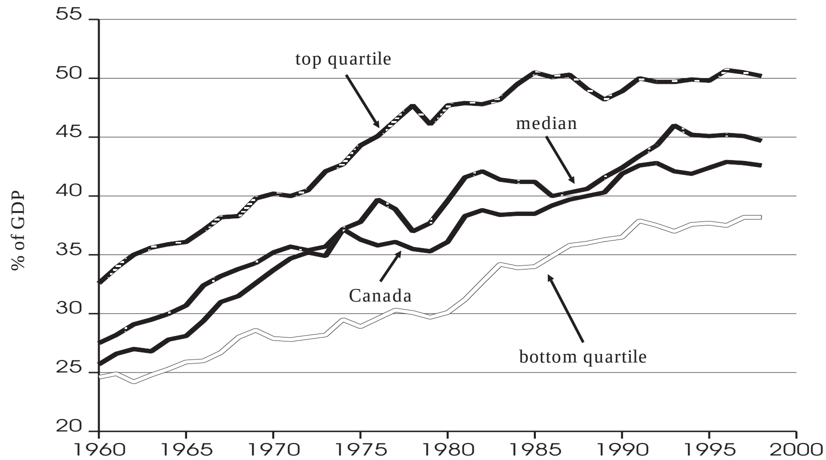
A second way to look at the evidence is to examine low-tax countries. In 1960, one-quarter of OECD governments made do with revenues amounting to less than 25 percent of their country's GDP; three-quarters had more. In the mid-1980s, this cutoff had risen to roughly 35 percent of GDP, and has risen little since. This measure — the percentage such that three-quarters of the governments have more and only one-quarter less — is the *bottom quartile*. Its value is a proxy for the willingness to pay taxes among citizens in countries with modest social programs.

Yet another way to look at the evidence is to consider taxes paid in the typical country. In 1960, one-half of OECD governments had revenues above 28 percent of their country's GDP; one-half had less. By the 1980s, the cutoff was above 40 percent of GDP. This measure — the percentage such that half the governments have more and half less — is the middle quartile, or *median*. From 1960 to the early 1980s,

Note 1- cont'd.

...France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, Portugal, Spain, Sweden, the United Kingdom, and the United States. Obviously, there are ways to measure a government's impact on civil society other than the relative size of its revenues and expenditures. The difficulty in using other concepts (such as extent of regulation) is the difficulty of making comparisons across countries and over time. Revenue and expenditure numbers may be less than ideal, but they have the great virtue of reasonable consistency across all major industrial countries and continuity over a long enough period of time to draw conclusions.

Figure 1: ***Government Revenues, 19 OECD Countries and Canada, 1960–98***



Note: The data reflect a consistent national income accounting methodology used across countries.

Source: Author's construction of quartile time series, using data from *OECD Economic Outlook*, various issues through no. 61 (June 1997).

willingness to pay taxes increased roughly fifteen percentage points in the median OECD country, and then hit a limit in the 40 to 45 percent range. The early 1990s' recession induced higher government spending from the median country, and given financial market pressure arising from historically high debt-to-GDP ratios among many OECD countries, the median government accompanied increased spending with increased taxing effort. Voters in the median country have not accepted the early 1990s' ratio, and tax reduction has become a dominant theme in many OECD countries. The net outcome of fiscal politics in these countries since 1993 has been a slight decline of the median tax-to-GDP ratio.

Since 1960, Canada has remained within the third quartile in terms of taxing effort, much closer in most years to the median than to the bottom quartile. And like the median country, it has substantially increased its taxing effort — by more than fifteen percentage points since 1960. While particular groups have exploited loopholes to escape tax increases, overall the proportionate growth in taxes across income levels has been reasonably uniform. Both rich and poor Canadians can legitimately grumble about a rising tax burden.[2]

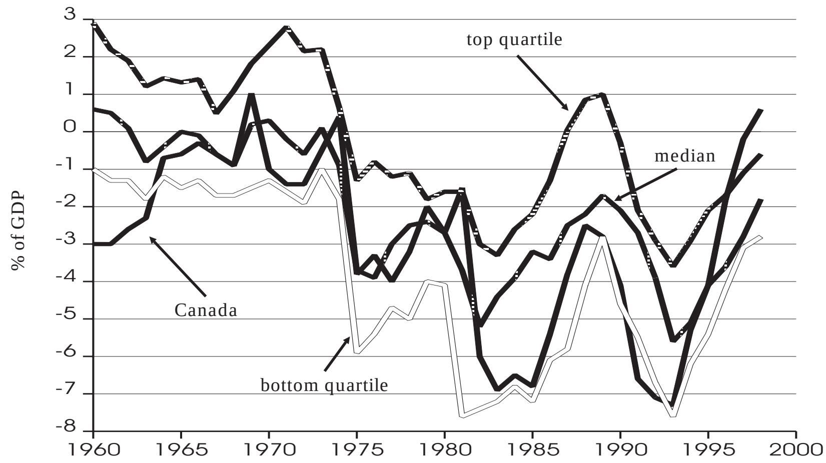
Deficits and Their Result

Either by taxing or borrowing, ministers of finance and their staff raise the money that others in government spend. Inevitably, they are more sensitive than most people in government to shifting public attitudes toward taxation. As the pendulum of public opinion swung, participants in this “finance culture” realized earlier than their colleagues in spending ministries the importance of public resistance to further tax increases and warned that higher tax rates were engendering some significant tax evasion and inefficient tax-avoidance behavior. Elsewhere in government, public sector interest groups and government officials were obviously subject to *current* budget constraints, but the idea of a *permanent* — or even lowered — ceiling on public spending was a hypothetical abstraction. The result of this culture clash can be seen in Figure 2. In most OECD countries, deficits and rising debt-to-GDP ratios became the norm.

Deficits have been worse during recessions than booms, but the trend over the past three decades has been, until recently, in the direction of higher deficits. The year 1973 was the last time the median country realized a surplus. Post–1993 declines in deficits among OECD members are a hopeful dawn after a long night, but it is too soon to decide whether they are more than a cyclical adjustment.

2 There are different ways to measure tax incidence. One simple statistic used in a major recent study of Canadian income distribution (Beach and Slotsve 1996, 102) is an estimate of the proportion of family income devoted to personal income tax across quintiles. Overall, the average family's tax bill went from 15.3 percent of income in 1971 to 19.2 percent in 1992 — a 25 percent jump. The income tax system was slightly more progressive in 1992 than in 1971 inasmuch as the proportionate jump in average family income paid as tax was higher in the two top quintiles of families than in the two bottom quintiles.

Figure 2: ***Government Deficits and Surpluses, 19 OECD Countries and Canada, 1960–98***



Note: The data reflect a consistent national income accounting methodology used across countries.

Source: Author's construction of quartile time series, using data from *OECD Economic Outlook*, various issues through no. 61 (June 1997).

Under federal and provincial governments of many political labels and over all phases of the business cycle, Canada has, since 1960, usually been worse than average in terms of the relative size of its aggregate deficit. From 1982 through 1993, it was *much* worse than average. Recent fiscal restraint by senior governments in Canada has, however, been impressive. Canada also experienced a decline in deficit-to-GDP ratios over the second half of the 1980s, but most other OECD countries were improving their fiscal stance at that time, so Canada remained in the third quartile. During the 1990s, Canada has improved its fiscal position much more aggressively than the typical OECD member. The result: Canada moved from the fourth quartile (in 1991 and 1992) to the first quartile (by 1996), and the OECD is even projecting a slight surplus (for 1998).

If Canadians are honest with themselves, the choice they faced this decade was fiscal virtue or fiscal chaos. Until the late 1970s, Canada's debt-to-GDP ratio was less than 20 percent; by the 1990s, it exceeded 70 percent (Canada 1994h, 12).[3] The most dramatic impact of this increase was the rising share of debt-service costs as a component of public expenditures and the consequent squeeze on the share of tax revenues available to spend on actual services for citizens.

As recently as the 1993 federal election, a majority of Canadians were denying the existence of this painful choice. That year, Canadians repudiated the federal Progressive Conservatives and accepted the Liberals' opportunistic message that Canada could experience sufficient growth and tax revenue to reduce deficits without explicit expenditure cuts. I have more to say later about the economic rationale for fiscal restraint. Here I merely note that, one by one, the leaders of Canada's senior governments experienced an epiphany and came to accept the necessity of expenditure cuts to end fiscal drift.

Being early and vocal in their conversion, Alberta's Conservatives have garnered more publicity than any other Canadian government for their shift from fiscal profligacy to fiscal rectitude. Certainly, Alberta had a lot of fiscal sins to redress: it started from a position of per capita spending far above the national average. The Saskatchewan New Democratic Party (NDP) has undertaken probably the most ambitious fiscal exercise among provincial governments this decade.[4] The province's per capita spending was already below the national average in 1991, and by several measures its indebtedness in 1992 was the worst in the country. Indeed, the indebtedness of Saskatchewan and Newfoundland was so extreme at the time that senior officials in the federal Department of Finance and in private financial institutions were discussing contingencies in the event of these provinces' declaring bankruptcy.

Ontario and Quebec, the two major provinces, were holdouts until 1995. Bob Rae (1996), in his biography, claims to have experi-

3 Debt ratios can be confusing, given alternate definitions of debt. The figures in this chapter rely on the system of national income accounting, the appropriate basis for international comparison. More familiar to Canadians is the public accounts system of the 11 senior governments. The major difference is that the latter measure includes governments' pension liabilities to their employees, whereas the former does not. By a public accounts definition, the ratio of aggregate federal-provincial debt to GDP reached 100 percent by the 1990s.

4 For details, see the appendix to Chapter 4.

enced his personal conversion at the end of 1992, after two years as premier of Ontario. It is an understatement to add that the majority of interest groups allied to the Ontario NDP did not share his new faith in fiscal prudence. Ontario's general conversion took place via a much blunter instrument: the 1995 defeat of the NDP and election of an ideologically conservative government. Quebec's conversion came via a change in premier with no change in the governing party. Jacques Parizeau was a conventional left-wing Keynesian economist who believed in deficit spending to counter high unemployment. Lucien Bouchard, by contrast, has a keener understanding of politics as an exercise in consensus building among a broad range of interest groups. Unlike Parizeau, he mistrusts interest groups, such as public sector unions and elements of his own party, whose agenda denies the legitimacy of limiting the public sector. He is acutely conscious of public resistance to further tax increases and of financial market misgivings over the size of his province's net debt (Tremblay 1997).

Throughout the federal Conservatives' years in power (1984–93), Ottawa talked fiscal prudence but did not adequately practice it. Relative to other OECD countries, Canada was in as serious a deficit position at the end of the Tories' reign in 1993 as at the beginning in 1984. And the debt-to-GDP ratio had obviously worsened. This critique of the federal government must be tempered, however. During the second half of the 1980s, the rapid expansion in provincial government spending (in Ontario in particular) offset a modest exercise by Ottawa in fiscal restraint. The severity of the early 1990s' recession and the excessively restrictive monetary policy pursued by the Bank of Canada in the early years of this decade were also extenuating factors. Restrictive monetary policy contributed to very high real interest rates, whose effect was simultaneously to increase the interest cost of servicing government debt and to worsen unemployment. In turn, high unemployment ballooned the budgets for unemployment insurance and provincial social assistance.

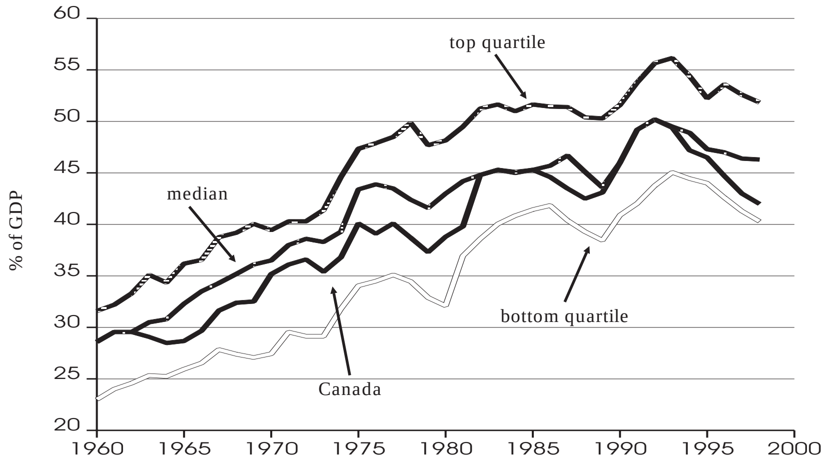
When the Liberals brought down their first postelection budget, they had not yet experienced their conversion to fiscal prudence. That budget juggled some priorities but extrapolated Conservative spending levels unchanged. Holders of Canadian public debt were not impressed and began discussing the possibility of a speculative selloff of that debt (paralleling what would befall Mexico in December 1994). By their reluctance to buy Canadian bonds, they triggered an ominous rise in the country's interest rates. Finally, in spring 1994, members of the federal cabinet experienced their collective epiphany. They came to the painful conclusion that a credible commitment to end deficit spending was required and that such a commitment required expenditure reductions. Unfortunately, given our performance over the past 20 years, we shall need a decade of fiscal prudence by both Ottawa and the provinces to reduce our aggregate debt-to-GDP ratio, and hence debt-service costs, to a comfortable level.

Government Spending

Government spending in countries with generous social programs — those measured by the top quartile of Figure 3 — grew steadily as a share of GDP from 1960 until the late 1970s, when it reached 50 percent. The recession of the early 1990s raised the top quartile again, but it is now falling back. The median peaked in the mid-1970s at roughly 45 percent of GDP; the recession of the early 1990s increased the median, but it too is now falling back, probably to levels prevailing in the 1970s. Government spending among countries with modest welfare states — those measured by the bottom quartile — grew until the mid-1980s. If one ignores the effect of the early 1990s' recession, this group has hovered around 40 percent of GDP since the early 1980s.

In the 1960s and 1970s, Canada increased spending in its public sector but more slowly than the typical OECD country. Accordingly, it declined from the median to the middle of the third quartile. But after the rapid increase in government spending during the early 1980s' recession and until the most recent years, Canada has again been very close to the median in terms of the relative size of its public sector. Many Canadians perceive the fiscal restraint undertaken by Ottawa and provincial governments in this decade as a radical break with tradition. Admittedly, the post–1992 decline in the Canadian

Figure 3: ***Government Expenditures, 19 OECD Countries and Canada, 1960–98***



Note: The data reflect a consistent national income accounting methodology used across countries.

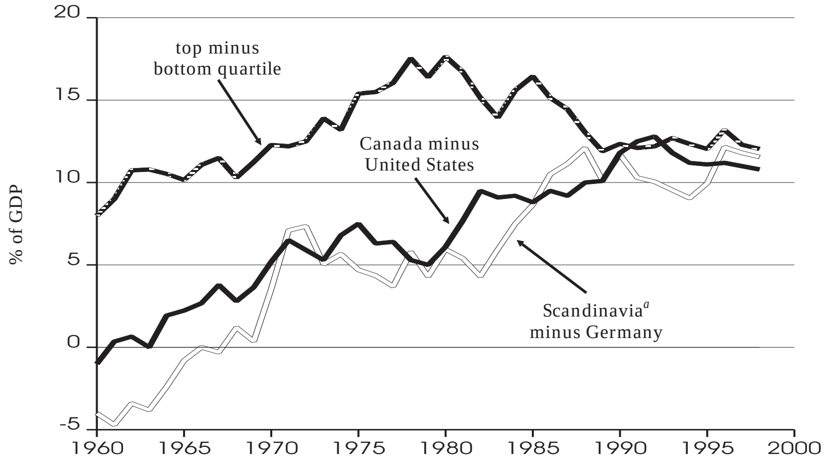
Source: Author's construction of quartile time series, using data from *OECD Economic Outlook*, various issues through no. 61 (June 1997).

public sector has been longer and larger (in terms of percentage points of GDP) than at any other time since 1960, but it has been consistent with what is happening among many other industrial countries. Given Canada's worse than average debt-to-GDP ratio, it is not surprising that its actual and projected public spending reductions have been more aggressive than for the median country.

Tax Gaps

Another way to explore the idea of limits on citizens' willingness to pay taxes is to consider the dispersion in taxing effort across countries. A simple measure of this gap is the difference in tax-to-GDP rato-GDP ratio has, of course, risen dramatically since 1960, but, as shown in Figure 1, has now hit a limit. Despite differences in political culture and institutions across OECD countries, it seems reasonable to conclude that this limit on willingness to pay taxes has operated in virtually all of them.

Figure 4: ***Tax Gaps, 1960–98***



[a] The median of Denmark, Finland, Norway, and Sweden. Although Iceland is a Scandinavian country, I have omitted it here because of an absence of continuous data, as well as its very small size.

Note: The data reflect a consistent national income accounting methodology used across countries.

Source: Author's construction of quartile time series, using data from *OECD Economic Outlook,* various issues through no. 61 (June 1997).

Across particular countries, differences in political institutions and policies have mattered in the willingness to pay — up to a point. To illustrate, Figure 4 also traces the tax gaps among two sets of countries that are in close cultural and geographic proximity and, as a consequence, engage in extensive regional trade: first, the United States and Canada, and, second, Germany and Scandinavia. In both instances, the tax gaps were minor (less than five percentage points of GDP) in the 1960s but increased in the 1970s and 1980s as Canada and Scandinavia created welfare states more generous than those in their large respective neighbors. But having reached the 10 percent

5 Incidentally, the eightieth minus twentieth and eighty-fifth minus fifteenth percentile tax gaps (not shown in Figure 4) trace out the same pattern, increasing in the middle of this period and returning to 1960s' levels by the 1990s.

level, these tax gaps have remained more or less stationary since the mid-1980s.

The conclusion seems to be that social policy arrangements across countries can diverge despite increased formal economic integration — via the European Union and the North American Free Trade Agreement, for example. Countries with generous social programs and high taxes and countries with modest social programs and low taxes can sustain their differences. However, increased economic integration between countries that trade extensively probably imposes a limit on tax gaps.

Summary

In summary, so long as the United States remains a low-tax haven among OECD countries, Canada will never be among the top quartile in terms of size of government. But that is not a cause for dismay among social policy advocates. Applying the "10 percent" margin, Canadians have been willing to pay a share of GDP close to that for the median OECD country. In most years, the gap between the median and Canada's tax-to-GDP ratio has been less than two percentage points. Designers of social programs in Canada have had nearly as much fiscal discretion in terms of the size of government budgets as their counterparts in the typical OECD country.

In the short run, deficit spending allows governments to spend beyond citizens' willingness to pay taxes, up to some ill-defined maximum debt-to-GDP level. Beyond that level, financial markets impose very large interest costs on countries whose politicians obfuscate the simple truth that citizens must pay taxes sufficient to cover the cost of their public services. By the mid-1980s, the constraint imposed by an unwillingness to pay higher taxes and the rising interest costs from higher debt-to-GDP ratios became visible in the international distribution of public sector spending. Since then, the upward shift in the distribution of public spending among OECD countries has stopped (it rose in the early 1990s' recession, but has since fallen back). Were I to choose just one statistic to illustrate that democratic electorates have effectively halted growth in the relative size of the public sector, it would be that the projected median value for government spending among OECD countries in 1998 is within one percentage point of the value of that spending figure 16 years earlier, in 1982.

Explaining the Limit

Why has the era of increasing government come to an end among industrial countries? If, in the long run, the size of the public sector in democratic countries reflects public preferences, the question becomes, why has the typical citizen in the typical industrial country become more skeptical of the state? At the core, I believe the explanation is twofold: the disappearance of any credible argument for state economic planning and the rise of interest groups within the welfare state.

First, the collapse of the Berlin wall in 1989 symbolized the death both of communist central planning and of much of the economic agenda of the traditional noncommunist left. It is no longer credible among the majority in any industrial country to claim that collective political life has some inherent moral superiority over market activity.

The evidence is incontrovertible: a necessary — if far from sufficient — condition for realizing the potential of industrial technology is a set of private property rights and reasonably free markets; state ownership and state planning are not an adequate substitute. As the millennium approaches, the typical citizen of an OECD country accepts this conclusion more firmly than at any time since the beginning of the Industrial Revolution in eighteenth-century Britain. Accordingly, those among the traditional left who view market behavior as inherently suspect have been relegated to the political fringe.

I use *traditional left* as a useful label to identify a large number of mass political movements closely allied to organized labor — from the NDP in Canada, through the British Labour Party, the Scandinavian Social Democrats, and the communist parties of southern Europe. The most significant example of traditional left parties relegated to the fringe is that of the French communists, a party of ideological dogmatists that exercised great influence in France's political life until the early 1980s.[6] An important example of a traditional left-wing party that has come to accept the legitimacy of setting limits to the size of the state is "new" Labour in Britain. (More on it in due course.)

If private markets are necessary to realize the potential of industrial technology, it follows that generous social programs require successful capitalist economies. The case for the welfare state must henceforth be explicitly separated from traditional socialist claims for the benefits of state economic planning over private market be-interested behavior in private market transactions and collective behavior manifest in public provision of social programs are, in general, morally desirable. Since both are desirable and since welfare states have grown dramatically since midcentury, presumably the benefit of incremental public spending has declined, and the cost (in terms of forgone private consumption) of incremental taxation to pay for that spending has risen. Thus, in making their case, contemporary defenders of the welfare state have an obligation to assess — far more carefully than did their predecessors — the effects on market behavior both from taxing individuals to fund public spending and from disbursing public benefits.

The second explanation for the limit is that, as ships of state have grown bigger, they have accumulated barnacles. The barnacles are interest groups, which exert a strong inertial force and over time tend to lower the social benefit derived from any given amount of public spending. The typical citizen is more skeptical than in midcentury as to the ability of the modern welfare state to reach any promised port of destination.

---

6 Although weakened, the party still matters. It commanded 10 percent of the popular vote in the first round of the 1997 French legislative elections and now has several cabinet positions in the socialist-led government.

Conclusion: Machiavelli's Mongrels

Ever since Machiavelli offered advice to his prince in sixteenth- century Florence, people have found in his writings insights about human nature and the art whereby imperfect princes can govern imperfect men. But Machiavelli turned to policy analysis only in an effort to ingratiate himself with the Medicis who had overthrown the Republic of Florence. As secretary of the Republic, Machiavelli had exercised political power; under the new regime, he was out of favor and out of a job. Surely, his critics conclude, public policy is about more than the frustrated ambition and disabused realism of Machiavelli.

Indeed, it is. Politics, at least within democratic states, is also about the ideals that people hope to realize collectively. Machiavelli had little empathy with the democratic ideals of the Renaissance. Were he writing today, he would be equally skeptical of socialism, feminism, liberalism, and the social aims of religious leaders. But if Machiavelli's vision is inadequate, so too is that of those who refuse discussion of the limits and constraints of politics. In short, it is foolish to ignore the art of governing.

It is also foolish — and ultimately self-defeating — to fall into Lear's error. In most industrial countries, including Canada, social programs account for the major part of government program spending in times of peace, a very large slice of GDP. If, however, social programs are simultaneously to be generous, realize the goals set for them, and elicit willingness on the part of the majority to pay the required taxes, policymakers must remember that the realities of human nature can twist the best-meant benevolence.

One ongoing role for those in public life is to assure that those who are not poor are called on to give to those who are. The first element of the traditional left's critique has always been that, without collective exercises in redistribution, capitalist economies lead to a polarized distribution of incomes and wealth: the capitalists get richer; the workers do not. This idea is valid in the sense that countries with pure market economies and governments with weak redistributive policies tend to produce excessively unequal distributions of income. An important role remains for redistribution — but how much before public policy falls victim to Lear's error? And to what extent should redistribution be in the form of cash that recipients can spend as they wish or of merit goods, such as education, training, and health insurance, that the majority decide to make universally available? The conclusion from the first chapter was that good social programs can dramatically enhance the quality of life, in rich countries as much as in poor ones. On the other hand, generosity is not enough. Rigorous, "tough love" management plus realistic — some might say Machiavellian — policy analysis, are equally necessary.